IN THE INCOME TAX APPELLATE TRIBUNAL,
AGRA BENCH, AGRA

[Coram : Bhavnesh Saini JM and Pramod Kumar AM]

I.T.A. No.: 257/Agr/2013
Assessment year: 2008-09

Deputy Commissioner of Income Tax
Circle 1, Agra ***……Appellant***

Vs.

Gupta Overseas ***……Respondent***
[PAN : AAFD6004D]

Appearances by:
Waseem Arshad, *for the appellant*
S P Satsangi, *for the respondent*

Date of hearing : January 21, 2014
Date of pronouncing the order : February 4th, 2014

ORDER

Per Pramod Kumar:

1. By way of this appeal, the assessee appellant has challenged the correctness of learned Commissioner (Appeals)'s order dated 21st March 2013, in the matter of assessment under section 143(3) of the Income Tax Act, 1961 (hereinafter referred to as 'the Act') for the assessment year 2008-09.

Issue in appeal

2. Grievance raised by the Assessing Officer, in substance, is that, on the facts and in the circumstances of the case, learned Commissioner (Appeals) erred in deleting the disallowance of Rs 1,05,27,465 made under section 40(a)(ia) in respect of foreign remittances, accounted for under the head 'design and development expenses', without deducting tax at source.

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Preliminary issue regarding invoking rule 27

3. During the course of hearing of this appeal, learned counsel for the assessee- respondent submitted that he wishes to raise a preliminary issue, by invoking Rule 27 of the Appellate Tribunal Rules, 1963, and that in the event of assessee being successful on this issue, all other issues in this appeal will be rendered academic and infructuous. The issue so being sought to be raised is covered by additional ground of appeal no. 2 before the CIT(A), which is reproduced below:

> *"2. (i) Because the provisions of section 40(a)(i) of the Income Tax Act, 1961 can be invoked only to disallow the expenditure of the nature referred therein which is shown as 'payable' as on the date of Balance Sheet and is to be read pari-pasu with section 40(a)(ia).*
>
> *(ii) Because on appreciation of the decision of Hon'ble ITAT Special Bench, Vishakapatnam in case of Merilyn Shipping & Transport Vs. ACIT (2012) 136 ITD 23, the assessee has nil amount as payable on the Balance Sheet dated i.e. 31.03.2008 and hence disallowance made is liable to be deleted. The sum of Rs.1,07,27,465/- disallowed was paid during the year and was not outstanding at the end of the year.*
>
> *(iii) Because in any view of the case due to non-discrimination clause in the Double Taxation Avoidance Agreement (DTAA) between Indian and foreign countries in consideration, no disallowance under section 40(a)(i) could be made on the amounts paid during the year."*

4. This grievance, however, has been rejected by the learned CIT(A) by observing as follows:

> *"10.3 In the **Second Additional Ground,** it has been contended that the provisions of section 40(a)(i) can be invoked only to disallow the expenditure of the nature referred therein which is shown as 'payable' as on the date of Balance Sheet and is to be read pari-pasu with section 40(a)(ia) in view of the decision of the Hon'ble ITAT Special Bench, Vishakhapatnam in the case of Merilyn Shipping & Transport Vs. ACIT (2012) 136 ITD 23 because the assessee has "nil" amount as payable on the Balance Sheet dated i.e. 31.03.2008 and hence, disallowance of Rs.1,05,27,465/- made is*

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liable to be deleted as the sum disallowed was paid during the year and was not outstanding at the end of the year. This additional ground was taken by the appellant solely on the basis of the decision of Hon'ble ITAT Special Bench, Vishakhapatnam in the above mentioned case but now, the decision has been suspended by the Hon'ble High Court of Andhra Pradesh and moreover, the said decision is with respect to section 40(a)(ia) applicable in respect of payment made to resident, while in case of the assessee (appellant), the provision applied is of section 40(a)(i) relating to payment made to non-resident and TDS provisions of resident and non-resident payee are based on different principles because under section 195 applicable to nonresident payee, tax at source is to be deducted on the sum chargeable under the provision of this Act, while in various TDS provisions relating to resident payees, tax at source is to be deducted on making of any specific type of payment as mentioned therein and hence, it cannot be said that the decision rendered in respect of the provision of section 40(a)(i) shall also apply in case of section 40(a)(i). Despite such difference in both sections, now since decision of the Hon'ble ITAT Special Bench, Vishakhapatnam has been suspended as interim measure by the Hon'ble Andhra Pradesh High court till final decision, it may not be proper to follow such decision till the final decision of the Hon'ble Andhra Pradesh High Court is delivered. ***Therefore, the second additional ground taken by the appellant has not been found to tenable and hence dismissed, though the impugned addition has already been deleted by me while deciding the Ground no.2 & 3 and the first additional ground."***

5. Learned counsel submits that even though the learned Commissioner (Appeals) has decided the above issue against the assessee, and even though the assessee is not in appeal or cross objection before the assessee, the assessee-respondent has a right, vested under rule 27, to support "the order appealed against, on any of the grounds decided against him (i.e. the assessee respondent)". We are thus urged to adjudicate on the impact of non discrimination clauses in the treaties, as read with the Special Bench decision in the case of **Merilyn Shipping & Transport Vs ACIT (136 ITD SB 23)**, which, according to the learned counsel, stands approved by Hon'ble jurisdictional High Court in **CIT Vs Vector Shipping Services Pvt Ltd (Judgment dated 9.7.2013 in ITA N0. 122 of 2013)**. Learned Departmental Representative does, however, submit that in case the assessee was really aggrieved of the impugned

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order, he should have filed a cross appeal or cross objection. Once he does not do so, there is no way that the appellant knows of respondent's intention to raise an issue during the course of hearing and prepare on the same. This is, according to the learned Departmental Representative, contrary to the scheme of the appellate proceedings before this Tribunal and in violation of the principles of natural justice. Learned Departmental Representative, however, was gracious enough not to seriously oppose the prayer of the assessee for adjudication on this issue by us, and left the decision on this procedural aspect entirely to the bench, though he reserved his right to make submissions on merits, or rather lack of merits, in the plea so raised.

6. We have given our careful consideration to the rival contentions on this preliminary issue, as also the statutory provisions with regard to the appellate proceedings before this Tribunal

7. We find that Rule 27 of the Appellate Tribunal Rules, 1963, provides that, "**(t)he respondent, though he may not have appealed, may support the order appealed against on any of the grounds decided against him**". This provision is independent of, and quite distinct from, the statutory right to file cross objection under section 253(4) of the Income Tax Act, 1961, which allows the respondent, on being put to notice about the fact of an appeal having been filed against an order, to raise his grievances against the said order by filing the cross objections within stipulated time. Section 253(4) provides that, "**(t)he Assessing Officer or the assessee, as the case may be, on receipt of notice that an appeal against the order …… by the other party, may, notwithstanding that he may not have appealed against such order or any part thereof; within thirty days of the receipt of the notice, file a memorandum of cross-objections, verified in the prescribed manner, against any part of the order ……, and such memorandum shall be disposed of by the Appellate Tribunal as if it were an appeal presented within the time specified in sub-section (3) or sub-section (3A)**".

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8. The important distinction between the scope of a cross objection under section 253(4) and an objection under rule 27 is that while former calls into question correctness of a part of the operative order, the latter merely challenges a part of the reasoning adopted in the process of arriving at operating order, i.e. conclusion, even as it does not challenge the conclusion itself. As we take note of this fine distinction, it is also important to bear in mind that the order, in strict legal terms, is confined to what is eventually decided, while, the process of reasoning which leads to this conclusion, is termed as reasons for arriving for arriving at the order. Under Section 253(4), one can challenge the conclusions. Under rule 27, one cannot challenge the conclusions, even though it can challenge the reasons for arriving at those conclusions, to the limited extent of the please which have been decided against the respondent, as it provides that the respondent "**may support the order on any of the grounds decided against him**". In effect thus, under rule 27, those grounds which have been decided against the respondent, even when the assessee does not challenge the same, can be agitated again, and to that extent, reasoning of even a favourable order can be called into question. However, cross objection under section 253(4) can call into question the conclusions arrived at in the impugned order, and, therefore, cross objections constitute a remedy against unfavourable portion of the order. It is thus clear that the scope and purpose of cross objections are distinct and mutually exclusive. No doubt that it is a common practice that the cross objections are routinely filed to support the orders appealed against by the other party, but a wrong practice, no matter how prevalent, can affect the correct legal position.

9. In our considered view, therefore, it is not right to suggest, as has been suggested by the learned Departmental Representative, that when an assessee is not in cross appeal or cross objection, it is not permissible for the assessee to challenge correctness of the rejection of any of the grounds, which were rejected in the said order, even if, such grounds having been allowed, would have led to the same conclusion which were ultimately arrived at in the impugned order. All grounds raised by the assessee, if wrongly rejected by the

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Commissioner (Appeals) in the impugned order even if he has ultimately held the issue in favour of the assessee, can be pursued by the assessee in his capacity as respondent before the Tribunal.

10. We have also noted that no formal procedure for mechanism of invoking rule 27 has been prescribed under the Appellate Tribunal Rules or otherwise. However, whether or not such a procedure has been prescribed, it is only elementary that the manner in which rule 27 is invoked should be fair and reasonable. As learned Departmental Representative rightly states, if these issues are allowed to be raised without any prior intimation to the other party, the other party may not even have an opportunity to prepare on the issue sought to be raised. In any case, proviso to rule 11 which provides that "**(p)rovided that the Tribunal shall not rest its decision on any other ground unless the party who is affected thereby has had a sufficient opportunity of being heard on that ground**". It is, therefore, necessary that the affected party is properly put to notice in respect of the issues which are sought to be raised under rule 27. In our considered view, therefore, while the respondent may indeed raise any of the issues, with regard to the grounds decided against the assessee even though the assessee may not be in appeal or cross objection, the respondent can do so only by way of a written intimation to that effect duly served on the other party reasonable in advance, and, in a situation in which the other party seeks time for preparing or seeking instructions on that issue, the hearing is to be rescheduled so as to allow the affected party "sufficient opportunity of being heard on that ground".

11. In view of the above discussions, and having taken note of the petition under rule 27 filed by the assessee respondent in response to our requisition to do so and particularly having taken note of very fair and gracious approach of the learned Departmental Representative, we admit the petition under rule 27 and proceed to decide the issue so raised on merits.

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The impact of non-discrimination clause under the tax treaties on the scope of Section 40(a)(i)

12. Let us now move on to adjudicate on merits the issue so raised by the assessee respondent under rule 27. As evident from a plain reading of the grounds of appeal set out earlier in this order, the short issue for our adjudication is whether or not the learned CIT(A) was justified in not holding that the scope of Section 40(a)(i), in view of the impact of non-discrimination clauses in respective tax treaties, cannot be any broader than the scope of Section 40(a)(ia) which, as is the legal position held by a Special Bench decision in the case of **Merilyn Shipping & Transport Vs ACIT (136 ITD SB 23),** restricts disallowance in respect of payments, made to resident enterprises - without complying with tax withholding requirements, remaining payable at the year end. As a corollary to this proposition, and as no amount remained payable at the year end in this case, learned counsel urges us to hold that the provisions of Section 40(a)(i) could not have been invoked on the facts of this case. Learned counsel has heavily relied upon the decision of **Herbalife International India Pvt Ltd Vs ACIT (103 TTJ 78)** in support of the proposition that the tax withholding requirements from remittances to residents of treaty partner countries cannot be any more stringent vis-à-vis tax withholding requirements from remittances to domestic residents.

13. So far as this purely legal plea is concerned, it is sufficient to take note of only a few material facts. The assessee before us has made certain payments, aggregating to Rs 1,05,27,465, to certain non-residents based in Spain, Italy, Ireland, UK, Denmark, Austria and Belgium. Undisputedly, no taxes were withheld from these payments. One of the pleas raised by the assessee is that since entire amount was paid during the relevant period, and nothing remained payable at the end of the period, no part of these amounts could have been disallowed by the Assessing Officer if the payments were made to non-residents, in the light of the scope of section 40(a)(ia) read with judicial precedents in the cases of **Merilyn Shipping & Transport Vs ACIT (136 ITD SB 23)** and **CIT Vs**

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Vector Shipping Services Pvt Ltd (Judgment dated 9.7.2013 in ITA N0. 122 of 2013) by Hon'be jurisdictional High Court. It is then contended that in the light of judicial precedents in the cases of Herbalife (supra) read with non discrimination clauses in the respective tax treaties with the countries in which recipients are based, the consequences of non tax withholding from payments to residents in treaty partner countries cannot be any harsher than consequences of non tax withholding from payments to domestic residents. This plea was rejected by the Commissioner (Appeals) on the short ground that the operation of Special Bench decision has been stayed by Hon'ble Andhra Pradesh High Court, and, therefore, "it may not be appropriate to follow such decision till final decision of Hon'ble Andhra Pradesh High Court is delivered". The assessee is not satisfied with the rejection of this plea by the CIT(A) and has raised the same issue before us as well.

14. We have heard the rival contentions, perused the material on record, and we have carefully considered factual matrix of the case as also the applicable legal position.

15. Even as learned counsel has referred to deduction neutrality clauses in the non-discrimination provisions in the relevant tax treaties, his primary contention is that it is discriminatory for the nationals of a country that the payments made to them by an Indian enterprise, under similar circumstances i.e. without deduction of tax at source, are allowed as not allowed as a deduction, whereas the payments made to by an Indian enterprise, without deducting tax at source, to another Indian domestic enterprise, is allowed as a deduction. Learned counsel has, in this regard, also referred to and relied upon a landmark decision of this Tribunal in the case of **Herbalife** (*supra*).

16. As we deal with this contention, it is necessary to first take a look at the scope of non-discrimination clauses in the respective treaties, so far as the issue of deductibility of payments, with respect to the payments made to the residents

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of the treaty partner country, in the hands of the person making the payment is concerned. As we have noted earlier, the recipients of the payments in questions were residents of Spain, Italy, Ireland, UK, Denmark, Austria and Belgium. The provisions of the non-discrimination clauses in the respective tax treaties, for ready reference, are set out below:

Indo Spanish DTAA

ARTICLE 26- Non-discrimination

1. The nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances and under the same conditions are or may be subjected.

2. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities in the same circumstances or under the same conditions.

3. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of that first-mentioned State are or may be subjected.

4. Except where the provisions of Article 10, paragraph 7 of Article 12, or paragraph 7 of Article 13, apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first mentioned State. Similarly, any debts of an enterprise of a Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.

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India Italy DTAA

ARTICLE 25- Non-Discrimination

1. The nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances and under the same conditions are or may be subjected.

2. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprise of that other State carrying on the same activities in the same circumstances or under the same conditions.

3. Nothing contained in this Article shall be construed as obliging a Contracting State to grant to persons not resident in that State any personal allowances, reliefs and reductions for taxation purposes which are by law available only to persons who are so resident.

4. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of that first-mentioned State are or may be subjected in the same circumstances and under the same conditions.

5. In this Article, the term "taxation" means taxes which are the subject of this Convention.

India Ireland DTAA

ARTICLE 24- Non-discrimination

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States.

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2. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.

3. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents, of the other Contracting State, shall not be subjected in the first-mentioned State to any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

4. Except where the provisions of paragraph 1 Article 9, paragraph 7 of Article 11 or paragraph 6 of Article 12 apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State.

<u>India United Kingdom DTAA</u>

ARTICLE 26- Non-discrimination

1. The nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected.

2. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities in the same circumstances or under the same conditions. This provision shall not be construed as preventing a Contracting State from charging the profits of a permanent establishment which an enterprise of the other Contracting State has in the first mentioned State at a rate of tax which is higher than that imposed on the profits of a similar enterprise of the first mentioned Contracting State, nor as being in conflict with the provisions of paragraph 4 of Article 7 of this Convention.

3. Nothing contained in this Article shall be construed as obliging a Contracting State to grant to individuals not resident in that State any personal allowances, reliefs and reductions for taxation

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purposes which are by law available only to individuals who are so resident.

4. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first mentioned Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of that first mentioned State are or may be subjected.

5. In this Article, the term "taxation" means taxes which are the subject of this Convention.

<u>India Denmark DTAA</u>

ARTICLE 24- Non-discrimination

1. The nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances and under the same conditions are or may be subjected.

2. The taxation of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities in the same circumstances and under the same conditions.

3. Nothing contained in this Article shall be construed as obliging a Contracting State to grant to persons not resident in that State any personal allowances, reliefs, reductions and deductions for taxation purposes which are by law available only to persons who are so resident.

4. Except where the provisions of paragraph 1 of Article 10, paragraph 7 of Article 12, or paragraph 7 of Article 13, apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable

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capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.

5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of that first-mentioned State are or may be subjected in the same circumstances and under the same conditions.

6. In this Article, the term "taxation" means taxes which are the subject of this Convention.

<u>India Austria DTAA</u>

ARTICLE 24- Non-Discrimination

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States.

2. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

3. Except where the provisions of paragraph 1 of Article 9, paragraph 7 of Article 11 or paragraph 7 of Article 12 apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State.

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4. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents, of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more, burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

5. The provisions of this Article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind and description.

<u>India Belgium DTAA</u>

Article 24 - Non-Discrimination

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances and under the same conditions are or may be taxed. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States.

2. Subject to the provisions of paragraph 3 of Article 7, the taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities in the same circumstances or under the same conditions.

3. The provisions of paragraph 2 shall not be construed as preventing:

(a) a Contracting State from charging the profits of a permanent establishment which an enterprise of the other Contracting State has in the first-mentioned State at a rate of tax which is higher than that imposed on the profits of a similar enterprise of the first-mentioned Contracting State;

(b) Belgium from imposing the movable property prepayment on dividends paid to a permanent establishment in Belgium of a company which is a resident of India.

4. Nothing contained in this Article shall be construed as obliging a Contracting State to grant to persons not resident in that State any

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personal allowances, reliefs or reductions for tax purposes which are by law available only to persons who are so resident.

5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirement to which other similar enterprises of that first-mentioned State are or may be subjected in the same circumstances and under the same conditions.

6. In this Article, the term "taxation" means taxes of every kind as specified in this Agreement.

17. A quick look at the above provisions shows that while there are specific clauses seeking discrimination against deductions available for payments made to residents in the treaty partner countries, in Indo Spanish, Indo Irish, Indo Danish and Indo Austrian treaties, there are no such clauses in Indo Belgian, Indo UK an Indo Italian tax treaties. However, so far as Indo Spanish tax treaty is concerned, there is a specific rider by the 1993 protocol to the said treaty, but we will deal with that impact of this protocol a little later. Coming back to these deduction neutrality provisions, it is to be noted that these provisions seek neutrality in availability for tax deductions for payments made to the residents of treaty partner countries vis-à-vis payments made by an enterprise to local residents under the same conditions, and that these provisions are broadly the same as first limb of Article 24(4) of UN Model or OECD Model convention. Elaborating upon the scope of this provision, the OECD Model Convention Commentary, which is reproduced with approval and concurrence in the UN Model Convention Commentary as well, observes as follows:

73. <u>This paragraph is designed to end a particular form of discrimination resulting from the fact that in certain countries the deduction of interest, royalties and other disbursements allowed without restriction when the recipient is resident, is restricted or even prohibited when he is a non-resident.</u> The same situation may also be found in the sphere of capital taxation, as regards debts contracted to a non-resident. It is however open to Contracting

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States to modify this provision in bilateral conventions to avoid its use for tax avoidance purposes.

74. Paragraph 4 does not prohibit the country of the borrower from applying its domestic rules on thin capitalisation insofar as these are compatible with paragraph 1 of Article 9 or paragraph 6 of Article 11. However, if such treatment results from rules which are not compatible with the said Articles and which only apply to non-resident creditors (to the exclusion of resident creditors), then such treatment is prohibited by paragraph 4.

75. <u>Also, paragraph 4 does not prohibit additional information requirements with respect to payments made to non-residents since these requirements are intended to ensure similar levels of compliance and verification in the case of payments to residents and non-residents</u>

(Emphasis by underlining supplied by us)

18. It is thus clear that while there can be addition information compliance requirement- which is not of our concern at present anyway, so far as payments made to non-residents is concerned, in the cases in which deduction neutrality clauses exist [such as Article 26(4) of India Spanish treaty, India Irish treaty, India Denmark treaty and India Austria treaty], there cannot be any discrimination so far as deductibility of the payments in the hands of the person making the payment is concerned. If appropriate tax withholding by the person making the payment is a *sine qua non* for business deduction so far as payments to non-residents are concerned, unless there is a similar pre-condition for deductibility of related expenses to the payments to residents as well, that disabling provision cannot be enforced in respect to payments made to non-residents either.

19. Learned Departmental Representative's contention is that just because a different treatment is given to the non- residents, this treatment cannot be construed as discrimination.

20. In all fairness to the learned Departmental Representative, there indeed was a school of thought that mere differentiation in treatment cannot be treated

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as discrimination in effect, unless differentiation is discriminatory in character. This school of thought proceeded on the implicit assumption that the heading of the clause, i.e. non-discrimination, plays a significant role in deciding the scope of the subject provision itself. As we take note of this school of thought, it is useful to bear in mind the well known Latin legal maxim i.e. ***"A rubro ad nigrum"*** which means, literally, from red to the black. In olden times, the title of a statute as well as headings of a provision, were written in red while its body text was written in black. Viewed in this background, this Latin maxim implies that in the process of interpreting a statute, one must start from the title and interpret the text of the provision with reference to its title. Somewhat identical were the views of the Hon'ble Supreme Court in the case of **Shree Sajjan Mills Ltd. vs. CIT & Anr. 156 ITR 585**, wherein Their Lordships took note of the title of the section and interpreted the scope of the section in the light of title thereof. Their Lordships observed that : **"Sec. 40A is with the marginal note under the heading 'Expenses or payments not deductible in certain circumstances'. If the marginal note or heading is any indication, and it certainly is a relevant factor to be taken into consideration in construing the ambit of the section, then these payments mentioned therein are not deductible, according to the statute, in certain circumstances. Therefore, the heading of this section is a clear indication that certain payments and expenses which would be otherwise deductible would not be deductible except in certain circumstances indicated in the section…."**. It was thus considered appropriate to cover only such differentiation in the scope of these non-discrimination provisions as were discriminatory in character and in harmony with the heading of these treaty provisions. While articulating the school of thought drawing a line of distinction between differentiation and discrimination, and while dealing with the scope of non-discrimination clauses in Indo American tax treaty, a coordinate bench of this Tribunal, speaking through one of us (i.e. the Accountant Member) in the case of **Automated Securities Inc. Vs ITO (118 TTJ 619)**, had observed as follows:

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30. A plain reading of this preamble would show that the US Model Convention is drawn from a variety of sources, including US Treasury Department's draft Model IT Convention, OECD Model Convention, prior US income-tax treaties, US negotiating experience, US tax laws, etc. OECD Model Convention is only one of the several inputs which have produced this US Model Convention. It is, therefore, futile to proceed on the basis that US Model Convention, or its underlying approach, is always in harmony with the approach of the OECD. It is also specifically mentioned that "references are made in the Technical Explanation to the OECD Commentaries, where appropriate, to note similarities and differences" which shows that Technical Explanation is to be considered on standalone basis—unless, of course, when a reference is made to the OECD Model to highlight similarities or differences. These factors, in our humble understanding, do not require us to view the US Model Convention's Technical Explanation necessarily in conjunction with OECD Commentary. On the contrary, we consider it appropriate to view this Technical Explanation to be a standalone document except where specific reference is made in Technical Explanation itself to the OECD Commentary. We have also noted that, as the preamble categorically states, "another purpose of the Model and the Technical Explanation is to provide a basic explanation of US treaty policy for all interested parties, regardless of whether or not they are prospective treaty partners". This would show that this Technical Explanation is an authoritative statement on the treaty policy of the US. Therefore, this authoritative statement, which is binding on one of the treaty partners, has a very strong persuasive value on the ground of reciprocity as well.

31. In the case of tax treaties in which US is a partner, Technical Explanation to the US Model Convention is indeed the best guide for contemporaneous thinking on the expressions finding place in the tax treaty. This is so for the reason that, as mentioned in the preamble to US Model Convention itself, "a principal function of the Model is to facilitate negotiations by helping the negotiators identify differences between income-tax policies in the two countries" which presupposes that the other negotiating treaty partner is aware of the US Model Convention and its accompanying Technical Explanation. As a corollary to this, when an expression appearing in the US Model Convention is being used in a tax treaty, and unless there is anything to the contrary is placed on record, this expression shall have the same meaning, intent and context as assigned to the expression in the Technical Explanation. Of course, when meaning, intent and context assigned in the OECD Model Convention Commentary is the same as assigned in the Technical Explanation to the US Model Convention, this debate about which is better guide to understand contemporaneous thinking on the issue is a non-starter. When there is no conflict between the approaches in these documents, a reference to the OECD Model Convention Commentary does not make a difference anyway, but when there is a conflict, howsoever basic or seemingly trivial, the OECD

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Model Convention Commentary has to give way to the Technical Explanation to the US Model Convention.

32. In view of the above discussions, in our considered view, the OECD Model Convention Commentary has a role to play in construing the scope of provisions of the Indo-US tax treaty, only to the extent (i) the relevant provision, though based on OECD Model Convention, is not explained in the Technical Explanation to the US Model Convention, and (ii) specific reference is made to the OECD Model Convention Commentary, and the interpretation so given by the OECD Model Convention Commentary is not in conflict with the Technical Explanation to the US Model Convention. The case before us does not fit into any of these categories because while the relevant clause of the non-discrimination article is the same as art. 24(2) of the OECD Model Convention, the scope of non-discrimination is, as we will see a little later, well defined in the Technical Explanation and also because the scheme of non-discrimination in the OECD Model Convention and US Model Convention is materially different. It is only elementary that a sound interpretation of a sub-article of non-discrimination article cannot be based on reading of that clause in isolation, but it would require that the non-discrimination clause as a whole, or even a treaty as a whole, is to be carefully analysed.

Scope of non-discrimination clauses in the tax treaties

34. The expressions 'discrimination' and 'non-discrimination' are not defined in the tax treaties, but, as noted by Brian J. Arnold and Michael J. McIntyre, in their oft referred book 'International Tax Primer' (Second Edition @ p. 128), "in general, discrimination means distinguishing between persons adversely on the grounds that are unreasonable, irrelevant, or arbitrary". 'Conversely', according to distinguished authors, 'non-discrimination means equal (functionally equivalent) or neutral treatment'. Prof. Kees Van Raad, in his book 'Non-discrimination in International Tax Laws', notes that while the original meaning of the expression 'discrimination', which refers to 'distinction' and 'differentiation', is neutral, in modern parlance the neutral meaning of the word 'discrimination' has virtually disappeared. He then proceeds to make following important observations :

> *"....In the course of time, two elements have been added. At present, the term is restricted to instances where discriminated person is treated with less, rather than more, favour. In addition, the term nowadays implies that, in view of the nature of treatment concerned, the grounds of differential treatment are unreasonable, arbitrary or irrelevant. Whether a distinction is unreasonable, arbitrary or irrelevant is a matter of judgment……"*

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35. It is thus clear that in order to establish discrimination, not only that a taxpayer has to demonstrate that he has been subjected to different treatment vis-a-vis other taxpayers, but also that the ground for this differentiation in treatment is unreasonable, arbitrary or irrelevant.
36. This principle on reasonableness of the differential treatment is also evident from the Technical Explanation issued by the treaty partner State, i.e. US, to art. 26(2) its Model Convention which, barring the opening words "except where the provisions of para 3 of art. 7 (business profits) apply" is exactly the same as art. 26(2) of Indo-US tax treaty. This Explanation, inter alia, observes as follows :

"…….There are cases, however, where the two enterprises would not be similarly situated and differences in treatment may be warranted. For instance, it would not be a violation of the non-discrimination protection of para 2 to require the foreign enterprise to provide information in a reasonable manner that may be different from the information requirements imposed on a resident enterprise, because information may not be as readily available to the Internal Revenue Service from a foreign as from a domestic enterprise. Similarly, it would not be a violation of para 2 to impose penalties on persons who fail to comply with such a requirement [see, e.g., ss. 874(a) and 882(c)(2)]. ……

> *Sec. 1446 of the Code imposes on any partnership with income that is effectively connected with a US trade or business the obligation to withhold tax on amounts allocable to a foreign partner. In the context of the Model Convention, this obligation applies with respect to a share of the partnership income of a partner resident in the other Contracting State, and attributable to a US PE. There is no similar obligation with respect to the distributive shares of US resident partners. It is understood, however, that this distinction is not a form of discrimination within the meaning of para 2 of the article. No distinction is made between US and non-US partnerships, since the law requires that partnerships of both US and non-US domicile withhold tax in respect of the partnership shares of non-US partners. Furthermore, in distinguishing between US and non-US partners, the requirement to withhold on the non-US but not the US partner's share is not discriminatory taxation, but, like other withholding on non-resident aliens, is merely a reasonable method for the collection of tax from persons who are not continually present in the US, and as to whom it otherwise may be difficult for the US to enforce its tax jurisdiction. ……"*

37. The Technical Explanation issued by the USA, which is treaty partner State in the present case, is of very significant persuasive value. When the treaty partner State takes the stand that a differential treatment, which meets the test of reasonableness, cannot be construed as discrimination

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under art. 26(2), and with a view to ensure reciprocity in treatment, the same stand should ideally be followed by the other treaty partner State.

38. It is also interesting to note that art. 26(5) of the Indo-US tax treaty, inter alia, states that nothing in the non-discrimination article, "shall be construed as preventing either Contracting State from imposing the taxes described in art. 14 (permanent establishment tax)". A permanent establishment tax, which is levied in the US, obviously puts an additional tax burden on the PEs of Indian enterprise vis-a-vis US enterprise, and yet it is not construed as an act of discrimination against the PEs of Indian enterprise. This strengthens our interpretation that to make out a case for discrimination, demonstrating differential treatment, by itself, cannot suffice. In our considered view, to establish a case discrimination, it is to be established that the basis of differentiation lacks any coherent relationship with the object ought to be achieved by the legal provision which is alleged to be discriminatory.

39. The Technical Explanation on the US Model Convention having recognized that "there are cases, however, where the two enterprises would not be similarly situated and differences in treatment may be warranted", what becomes very important and crucial is to take note of the dissimilarities in the position of a PE of the US company vis-a-vis an Indian enterprise, and to test reasonableness on the limitations on incentive deduction under s. 80HHE in the light of these dissimilarities.

40. This approach is quite in harmony with the concept of non-discrimination well founded in the Indian legal system. Guarantee against non-discrimination is one of the fundamental rights granted by the Constitution of India. There are certain non-discrimination articles, e.g., Arts. 15 and 16, which are exclusively for the citizens, but Art. 14 of the Constitution of India specifically prohibits discrimination against any person, whether citizen or not, by guaranteeing that "the State shall not deny to any person equality before the law or the equal protection of the laws within the territory of India". While construing the scope of this right to equality, Hon'ble Supreme Court of India has time and again held that notwithstanding wide scope of this constitutional guarantee, art. 14 does not rule out classification for the purpose of legislation. In Kedar Nath Bajoria vs. State of West Bengal AIR 1953 SC 404, 406, Hon'ble Supreme Court has observed that "the equal protection of laws guaranteed by Art. 14 of the Constitution of India does not mean that all laws will have to be general in character and universal in application and that the State is no longer to have the power of distinguishing and classifying persons or things for the purposes of classification". A valid classification must be reasonable, and it must always rest upon some real and substantial distinction bearing reasonable and just relation to the needs in respect of which classification is made. As held by the Hon'ble Supreme Court, in the case of State of West Bengal vs. Anwar Ali Sarkar AIR 1952 SC 75 and reiterated thereafter in

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several judgments, in order to pass the test of permissible classification, two conditions must be fulfilled, namely (i) the classification must be founded on an intelligible differentia which distinguishes persons or things that are grouped together from others left out of the group, and (ii) the differentia must have a rational relation to the object ought to be achieved by the legislation in question. Unless, therefore, a case is made out that the basis for differentiation has no rational relation to the object sought to be achieved by the legislative provision, it cannot be said that there is indeed discrimination.

41. Rakesh Kadakia and Nilesh Mody, in their book "The Law and Practice of Tax Treaties—an Indian Perspective", observe that the non-discrimination provisions in a tax treaty constitute a set of special rules providing protection against discrimination against nationals or residents of another Contracting State. Learned authors, however, hasten to add as follows :

> *"……However, not all differences in tax treatment, either between nationals of the two States or between residents of the two States, are violations of the prohibition against non-discrimination. Rather, the non-discrimination provisions …..would apply only if the nationals or residents of two States are similarly situated. Thus…..(it) does not cover indirect indiscrimination and does not introduce an all encompassing non-discrimination rule……."*

42. In the light of the above discussions, we are of the considered view that a differential treatment to the PE of the US tax resident, by itself, cannot be treated as covered by the scope of rule prohibiting non-discrimination. The true test for deciding whether or not there is a non-discrimination is whether or not the resident enterprise and the PE of the other Contracting State, who are similarly situated, get the same tax treatment or not. There could indeed be different tax treatments to the PE of the other Contracting State and the enterprise of the source State, but, as long as such tax differentiation could be justified on the grounds of dissimilarities in their situation, the prohibition against discrimination cannot be invoked.

21. However, the views so articulated by the coordinate bench were with specific reference to the India US tax treaty, which, as we have noted above, is altogether a different pedestal in view of peculiarities of its provisions and the stand taken in the Technical Explanation accompanying the US Model Convention, which is a starting point for any US treaty negotiation. In any case, each tax treaty is a standalone instrument and the connotations of expressions employed in the tax treaties cannot have a universal meaning *de hors* the overall

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scheme of the tax treaty, which must remain valid in all situations. Not only in different tax treaties, even within a tax treaty, the same expression may have a different meaning depending on the context in which that expression is used. Explaining the manner in which tax treaties are required to be interpreted and pointing out such instances dealt in judicial precedents, a coordinate bench of this Tribunal, in the case of **Hindalco Industries Ltd Vs ACIT (94 TTJ 945)**, observed as follows:

> *11. Elaborating upon the principles governing interpretation of tax treaties, Lord Denning in Bulmer Limited vs. S.A. Bollinger (1972) 2 All ER 1226, said :*
>
> *"…… ..The treaty ……..is quite unlike any of the enactments we have been accustomed…… It lays down general principles. It expresses aims and purposes… ..what are English Courts to do when they are faced with a problem of interpretation ? They must follow the European pattern. No longer must they examine the words in meticulous detail. No longer must they argue about the precise grammatical sense. They must look to the purpose or intent……"*
>
> *12. Echoing these views and justifying his departure from the plain meaning of the words used in the treaty, Goulding J., in IRC vs. Exxon Corporation (1982) STC 356 at p. 359, observed :*
>
> > *"In coming to the conclusion, I bear in mind that the words of the convention are not those of a regular Parliamentary draughtsman but a text agreed on by negotiations between the two Contracting Governments. Although I am thus constrained to do violence to the language of the Convention, I see no reasons to inflict a deeper wound than necessary. In other words, I prefer to depart from the plain meaning of language only in the second sentence of art. XV and I* ***accept the consequence*** *(strange though it is)* ***that similar words mean different things in the two sentences****."*
>
> *13. In a later judgment, Harman, J. in Union Texas Petroleum Corporation vs. Critchley (1988) STC 69, affirmed the above observations of Goulding, J. and added :*
>
> > *"I consider that I should bear in mind that this double tax agreement is an agreement. It is not a taxing statute, although it is an agreement about how taxes should be imposed. On that basis, in my judgment,* ***this agreement should be construed as ut res magis valeat quam pereat, as should all agreements. The fact that the parties are 'high contracting parties', to use an old description,***

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> ***does not change the way in which the Courts should also approach the construction of any agreement**."*

We are in considered agreement with this school of thought which lays down the proposition that, strictly speaking the principles of literal interpretation do not apply to the interpretation of tax treaties. To find the meaning of words employed in the tax treaties, we have to primarily look at the ordinary meanings given to those words in that context and in the light of its objects and purpose. Literal meanings of these terms are not really conclusive factors in the context of interpretating a tax treaty which ought to be interpretated in good faith and ut res magis valeat quam pereat, i.e., to make it workable rather than redundant.

14. Hon'ble Supreme Court in the case of Union of India & Anr. vs. Azadi Bachao Andolan & Anr. (2003) 184 CTR (SC) 450 : (2003) 263 ITR 706 (SC), had an occasion to deal with the principles governing the interpretation of tax treaties. In this regard, Hon'ble Supreme Court held that the principles adopted in the interpretation of treaties are not the same as those adopted in the interpretation of statutory legislation. Their Lordships quoted, with approval, following passage from the judgment of the Federal Court of Canada in the case of N. Gladden vs. Her Majesty the Queen 85 DTC 5188, at p. 5190, wherein the emphasis is on the 'true intentions' rather than 'literal meaning of the words employed' :

> *"Contrary to an ordinary taxing statute, a tax treaty or convention must be given a liberal interpretation with a view to implementing the true intentions of the parties.* ***A literal or legalistic interpretation must be avoided when the basic object of the treaty might be defeated or frustrated insofar as the particular items under consideration are concerned**."*

In the said judgment, as noted by Their Lordships at p. 743, the Federal Court of Canada recognized that "we cannot expect to find the same nicety or strict definition as in modern documents, such as deeds, or Acts of Parliament, it has never been habit of those engaged in diplomacy to use legal accuracy but rather to adopt more liberal terms".

15. In Azadi Bacahao Andolan's case (supra), Their Lordships also quoted with approval, Fancis Bennion's certain observations in his work Statutory Interpretation (Butterworths, 1992 Edn. at p. 461). Extracts from the said observations are as follows :

> *"With indirect enactment, instead of the substantive legislation taking a well known form of an Act of Parliament, it has the form of a treaty. In other words, form and language found suitable for embodying an international agreement, at the stroke of a pen, also the form and language of a municipal legislative instrument. It is*

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rather like saying that, by Act of Parliament, a woman shall be a man. Inconveniences may ensue. One inconvenience is that the interpreter is likely to be required to cope with disorganised composition instead of precision drafting.....

.....The interpretation of a treaty imported into municipal law by indirect enactment was described by Lord Wilberforce as being 'unconstrained by technical rules of English law, or by English legal precedent, but conducted on the broad principles of general acceptation'. This echoes optimistic dictum of Lord Widgery, C.J. that the words 'are to be given their general meaning, general to lawyer and laymen alike..... the meaning of diplomat rather than the lawyer'."

16. Hon'ble Supreme Court, in the case of K.P. Varghese vs. ITO & Anr. (1981) 24 CTR (SC) 358 : (1981) 131 ITR 597 (SC) and even in this context of interpretation of taxing statutes, have held that the task of interpretation is not a mechanical task and, quoted with approval Justice Hand's observation that ***"it is one of the surest indexes of a mature and developed jurisprudence not to make a fortress out of the dictionary but to remember that statutes always have some purpose or object to accomplish, whose sympathetic and imaginative discovery is the surest guide to their meaning"****. Their Lordships observed as follows :*

".....The task of interpretation of a statutory enactment is not a mechanical task. It is more than a mere reading of mathematical formulae because few words possess the precision of mathematical symbols. It is an attempt to discover the intent of the legislature from the language used by it and it must always be remembered that language is at best an imperfect instrument for the expression of human thought and, as pointed out by Lord Denning, it would be idle to expect every statutory provision to be 'drafted with divine prescience and perfect clarity'. We can do no better than repeat the famous words of Judge learned Hand when he said :

'... it is true that the words used, even in their literal sense, are the primary and ordinarily the most reliable source of interpreting the meaning of any writing : be it a statute, a contract or anything else. But it is one of the surest indexes of a mature and developed jurisprudence not to make a fortress out of the dictionary; but to remember that statutes always have some purpose or object to accomplish, whose sympathetic and imaginative discovery is the surest guide to their meaning.'

We must not adopt a strictly literal interpretation of ..... but we must construe its language having regard to the object and purpose which the legislature had in view in enacting that provision and in

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> *the context of the setting in which it occurs. We cannot ignore the context and the collocation of the provisions in which ..... appears, because, as pointed out by Judge Learned Hand in the most felicitous language : 'interpret .... the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create.....'."*

When such are the views of the Hon'ble Supreme Court on the interpretation of taxing statutes, essentially the tax treaties, which are to be subject to less rigid rules of interpretation, cannot be subjected to literal interpretation in isolation with the context in which the words have been employed.

17. It is also important to bear in mind that the ***provisions of tax treaties are required to be read as a whole and not in isolation with each other. The Court's duty is to give effect to the provisions of the treaty in its natural meaning, and not to interpret them in isolation. It is done in their context and in the light of the object and purpose of the treaty****. The context in which the words are used is, therefore, of the paramount importance. General words and phrases, therefore, however wide and comprehensive in their literal sense, must be construed as being limited to the actual objects of the enactment. Therefore, what is really needed in the context of interpretation of treaties is that a holistic view of the matter is taken. This exercise essentially requires that the provisions of the treaty are required to be treated in a harmonious manner.....*

(Emphasis by underlining supplied by us)

22. What has been decided thus in the context of Indo US tax treaty does not necessarily apply in the context of the other treaties as well. Within a few months of the aforesaid decision, that very bench of the Tribunal, consisting of the same quorum, observed so, in the case of Daimler Chrysler India Pvt Ltd Vs DCIT (120 TTJ 803), by stating that, "**..... the decision in the case of Automated Securities Clearance Inc. *(supra)* was given in the context of Indo-USA tax treaty in which differentiation on the ground of reasonableness is institutionalized in the treaty and the Technical Explanation to the US Model tax treaty. Whether or not the same principles will apply in the case of India's tax treaties with other countries is yet to be examined**". Therefore, revenue does not derive any advantage from the decision in the case

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of Automated Securities Clearance Inc *(supra)*. In any event, a special bench of this Tribunal, in the case of **Rajeev Sureshbhai Gajwani Vs ACIT (137 TTJ 1)** not only virtually held that differentiation *simplicitor* is enough to invoke the non-discrimination clause, but proceeded to criticize the division bench decision in the Automated Securities Clearance Inc *(supra)* decision by observing as follows:

> *8.3 Having considered the rival submissions, we may now deal with them. In so far as the status of Commentary on OECD Model Convention is concerned, for interpretation of DTAA, it is clear from the decisions referred to by the learned counsel that the commentary does not lay down any binding precedent. The commentary contains the views of the author about the Model Convention. This view can be taken as an argument by the assessee but finally, it will be for the Courts or the quasi judicial authorities in India to decide as to whether the views expressed by the author are in conformity with the intent and purpose of the DTAA or not. In the case of P.V.A.L. Kulandagan Chettiar (supra), the Hon'ble Supreme Court has held that taxation policy is within the power of the Government and s. 90 of the IT Act enables the Government to formulate its policy through treaties entered into by it and even such treaties contain provision for deciding fiscal domicile in one State or the other and thus prevail over other provisions of the IT Act. It would be unnecessary to refer to the terms addressed in the OECD or in any of the decisions of the foreign jurisdictions. This can also be illustrated by examining the contents of para No. (2) of art. 26 of the treaty with United Kingdom of Great Britain and Northern Ireland, which permits the levy of higher rate of tax on the profits of the PE of that country in India. This para is reproduced below :*
>
> > *"2. The taxation on a PE which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities in the same circumstances or under the same conditions. This provision shall not be construed as preventing a Contracting State from charging the profits of a PE which an enterprise of the other Contracting State has in the first-mentioned State at a rate of tax which is higher than that imposed on the profits of a similar enterprise of the first-mentioned Contracting State, nor as being in conflict with the provisions of para 4 of art. 7 of this Convention."*
>
> *Therefore, in our considered view it will be unnecessary for us to refer to the Commentary on OECD Model Convention, decision of any foreign jurisdiction or other jurisdiction if the provisions contained in the DTAA are capable of clear and unambiguous interpretation. Accordingly, we consider*

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it unnecessary to examine the commentary or the technical explanation for coming to a conclusion in the matter.

8.4 The learned Departmental Representative referred to the Board Circular No. 621, dt. 19th Dec., 1991, issued after introduction of s. 80HHE in the IT Act. Reference is made to para No. 34 of the circular which states that with a view to provide fiscal incentives for export of computer software, a new s. 80HHE has been inserted in the Act for providing tax concession similar to the earlier s. 80HHC of the IT Act. We do not find anything in the circular which could be of aid in interpreting art. 26(2). Further, reference has been made to Circular No. 333, dt. 2nd April, 1982, issued in respect of "treaty override". The heading of the circular is "specific provision made in DTAA—whether it would prevail over general provisions contained in the IT Act". In para 3, it is mentioned that where DTAA provides for a particular mode of computation of income, the same should be followed irrespective of the provisions in the IT Act, which is the basic law, i.e., the IT Act will govern taxation of income. The case of the learned Departmental Representative on the basis of this circular is that since there is no provision in the DTAA analogous to s. 80HHE of the IT Act, the assessee is not entitled to the deduction. We are of the view that the interpretation placed on the circular by the learned Departmental Representative is misplaced. The reason is that the wording of art. 26(2) is to the effect that if a US enterprise is carrying on a business in India, it shall not be treated less favourably than an Indian enterprise carrying on the same business for the purpose of taxation. It follows automatically that exemptions and deductions available to Indian enterprises would also be granted to the US enterprises if they are carrying on the same activities. Thus, following the decision in the case of P.V.A.L. Kulandagan Chettiar (supra), there is no further need to discuss the case of Gracemac Corporation (supra). Otherwise also, the ruling rendered by the Authority for Advance Rulings is with reference to the facts of that case and is not applicable to any other case as a precedent. Similarly, it is also not necessary to go into the ruling in the case of Dassault Systems K.K., In re (2010) 229 CTR (AAR) 105 : (2010) 34 DTR (AAR) 218.

8.5 At this stage, we may also examine the decision of Mumbai Tribunal in the case of Metchem Canada Inc. (supra). The crux of the decision is that restriction placed on deduction of head office expenses under s. 44C will not be applicable in the case of a Canadian company in view of art. 24 contained in the treaty between India and Canada. The decision has been arrived at for the reason that art. 24 of the treaty will have precedence over art. 7, which contains deductions of general nature, and if provisions in the Act come in conflict with the treaty, the provisions of the Act are applicable only to the extent they are more beneficial to the assessee; if not, the provisions of the treaty shall prevail. The case of the learned Departmental Representative is that this decision has been rendered under s. 44C and, therefore, it is distinguishable. To our mind, the decision harmonises

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provisions of the treaty and the provisions contained in s. 44C of the Act. Similar exercise is involved in this case as the provisions of the Act and the treaty are required to be interpreted in a harmonious manner. Therefore, the ratio of this decision is applicable to the facts of the case before us.

8.6 There is also a dispute regarding the words "same activities" used in art. 26. The case of the learned counsel is that the assessee is engaged in the business of export of software in the same manner in which a number of Indian enterprises are exporting software. The fact that the assessee has been allowed to export software shows that the business does not fall in the prohibited category. Accordingly, the assessee's case has to be compared with the case of an Indian enterprise engaged in the business of exporting software. If that is done, the assessee would be entitled to deduction under s. 80HHE on the same footing and in the same manner as the deduction is admissible to a resident assessee. On the other hand, the case of the learned Departmental Representative is that various deductions under ss. 80HHE, 10A or 10B are area specific or industry specific. However, he was not able to carry this argument any further. The case of the learned counsel is that the provision contained in s. 80HHE is industry specific and the assessee is not precluded in any manner from conducting this business in India. We agree with this view as no debate seems to be feasible in this regard. Therefore, we are of the view that the assessee is carrying on the activities of export of software. An Indian company or any other resident person carrying on the business of export out of India of computer software or its transmission from India to a place outside India by any means is entitled to deduction under s. 80HHE. Therefore, the deduction admissible to an Indian company or a person resident in India will be allowable to the assessee also.

9. Before parting, it may be mentioned that the decision in the case of Automated Securities Clearance Inc. (supra) is not in conformity with the provisions contained in art. 26(2). ***It appears that the Bench unnecessarily considered the commentary and the technical explanation. The plain meaning of the provisions was not considered. The Bench laid greater stress on the heading "Non-discrimination" rather than on the contents of para (2) of art. 26, which are clear and unambiguous.*** *It is for this reason that the Bench considered Art. 14 of the Constitution of India to examine whether refusal to grant deduction would amount to non-discrimination. Correct position is that there is no discrimination when we test the contents of s. 80HHE on the basis of Art. 14 of the Constitution. But that is not the question before us and that was also not the question before the Division Bench.* ***The question here is whether provisions contained in para (2) of art. 26 will override the distinction made between the resident persons on one hand and the nationals of the USA and a non-resident on the other. On the facts of this case, such a distinction could not have been made****. Therefore, we are of the considered view that the Division Bench erred in coming to the conclusion that the assessee was not entitled to deduction under s. 80HHE.*

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(Emphasis by underlining supplied by us now.)

23. Learned Departmental Representative's argument is, therefore, rejected for several reasons. The issue is covered against the revenue by the Special Bench decision in Rajeev Sureshbahi Gajwani's case (supra) and this decision binds this division bench. The theory of differentiation vs discrimination was relevant, relevant if it was, only for the India US tax treaty, primarily on the ground of reciprocity in treatment and on the ground of India US tax treaty institutionalizing the validity of differentiation in treatment by the US on the ground of reasonableness, and it may not apply to the other tax treaties. As held by a special bench in the case of Rajeev Sureshbhai Gajwani *(supra),* a different treatment to the foreign enterprise *per se* is enough to invoke the non-discrimination clause in the tax treaties. Finally, as opined in the UN and OECD Model Convention Commentaries, with which we are in considered agreement, deduction neutrality clause in non-discrimination provisions is designed to primarily seek parity in eligibility for deduction between payments made to the residents and non-residents. Clearly, therefore, it will be contrary to the scheme of the tax treaties in question that if appropriate tax withholding by the person making the payment is a *sine qua non* for business deduction so far as payments to non-residents are concerned, unless there is a similar pre-condition for deductibility of related expenses to the payments to residents as well, that disabling provision cannot be enforced in respect to payments made to non-residents either.

24. However, so far as India Spain tax treaty is concerned, a protocol clause to the treaty states that, "Notwithstanding the provisions of paragraph 4 of Article 26 (Non-discrimination) it is understood that in the case of India, payments by way of interest, royalties and fees for technical services made by an enterprise of India to a resident of Spain, shall not be allowed as a deduction for the purpose of determining the taxable profits of such enterprise unless tax has been paid or deducted at source from such payments under Indian law and

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in accordance with the provisions of this Convention". Therefore, even if there is legal requirement for inadmissibility of deduction unless proper taxes are deducted from payment of interest, royalties or FTS is made by the Indian enterprise to a resident of Spain, such a requirement cannot be hit by the deduction neutrality clause under Article 26(4). As is the settled legal position, DCIT Vs ITC Limited (82 ITD 239), in the case of a protocol is an integral part of the tax treaty and it is to be given effect in the same manner as any other substantive part of the tax treaty.

25. In view of the above discussion, it is clear that so far payments made to the residents of Ireland, Denmark and Austria are concerned, these are indeed protected by the deduction neutrality clauses, and any pre conditions for deductibility, which are harsher than payments made to the residents, are ineffective in law by the virtue of non-discrimination clauses in the respective tax treaties. Coming to the remaining payments, i.e. payments to the residents of Belgian, UK, Italy and Spain, learned counsel's contention is that even these payments will be eligible for deduction neutrality because of the scope of sub article (1) in non-discrimination clauses in the respective tax treaties. It is submitted that this provision is a general omnibus provision which covers all types of non-discrimination against nationals of a treaty partner country. We, however, are not inclined to accept this plea. A plain reading of this clauses shows that, in broad terms, the discrimination, which is prohibited under this clause, is nationals of the other Contracting State vis-a-vis nationals of the host State in the same circumstances and same conditions, and, therefore, for the discrimination, which is sought to be prohibited by art. 24, all that is relevant is that national of one of the Contracting State should not be discriminated against, for the reason of the nationality, in the other Contracting State. That is what was observed by a coordinate bench of this Tribunal in the case of Daimler Chrysler India Pvt Ltd Vs DCIT (120 TTJ 803). English House of Lords, in the cases of Boake Alleen Ltd. & Ors. vs. HM Revenue & Customs (2007) UKHL 25 (HL), has also followed the same approach and observed, with approval, that

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"**In relation to art. 24(1) of the OECD Model Convention, which prohibits discrimination between residents on grounds of nationality, the commentary says that the 'underlying question' is whether two residents are being treated differently 'solely by reason of having a different nationality'** ". It is not enough to invoke this clause that national of a tax treaty partner country may ends up getting discriminated, but what is equally, if not more, important is that person should be discriminated because of such nationality. It is not even necessary that a person seeking treaty protection under this clause should be resident of any of the Contracting States, and, therefore, residential status, which is all relevant in the present context, is irrelevant for this kind of a discrimination. It is also important to bear in mind the fact that this provision refers to the comparison between nationals 'in the same circumstances and similar conditions'. The expression "in the same circumstances" would be sufficient by itself to establish that a taxpayer who is a resident of a Contracting State and one who is not a resident of that State are not in the same circumstances. The situation that we are dealing with right now is the differentiation, if at all, between the treatment given to the payments made to the residents and the non-residents. That is not a situation, in view of the fact that the differentiation is due to residential status and not the nationality, which can be dealt with by non-discrimination measures in Article 24(1). In our considered view, a differentiation in treatment due to residential status cannot be covered by the scope of Article 24(1) as such a differentiation is not due to nationality factor. As regards learned counsel's reliance on Herbalife decision by a coordinate bench, that is a case dealing with Indo US tax treaty which has a specific deduction non-discrimination provision under Article 26(3) of the said tax treaty. There is no corresponding provision in the treaties that we are now dealing. The assessee, therefore, derives no advantage from Herbalife decision in this context. We, therefore, reject this plea of the learned counsel. As a result, the assessee succeeds in claiming deduction neutrality so far as the payments to residents of Ireland, Denmark and Austria are concerned. To that extent, we uphold the plea of the assessee in principle.

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26. The next question that we must address ourselves to is whether deduction neutrality is indeed infringed upon in the cases of payments to non-residents vis-à-vis residents.

27. Learned counsel, as we have noted earlier as well, mainly relies upon Special Bench decision of this Tribunal in the case of Merilyn Shipping (supra) in this regard. It is, therefore, necessary to take a quick look at this judicial precedent, as also the subsequent developments, as well.

28. The issue which was referred to the Special Bench in this case was "whether Section 40(a)(ia) of the Income Tax Act, 1961 can be invoked only to disallow expenditure of the nature referred to therein which is shown as payable as on date of Balance Sheet or it can be invoked also to disallow such expenditure which become payable at any time during the relevant previous year and was actually paid within the previous year ?" In plain words, thus, the issue before this Special Bench was whether or not the disallowance in terms of section 40(a)(ia) for expenditure incurred by the assessee is relatable to payments made without compliance with tax withholding requirements is confined to the amounts remaining outstanding as at the end of the year or whether such disallowance can also be invoked in respect of expenditure relatable to payments made during the year. In the lead order, one of our distinguished colleagues, expressed the view that the scope of such disallowance must include all amounts, whether actually paid during the year or have remained unpaid at the year end. Speaking for the bench, thus, he proposed the opinion as follows, "(t)he provisions of section 40(a)(ia) of the Income Tax Act, 1961 are applicable not only to the amount which is shown as payable on the date of Balance Sheet but it is applicable to such expenditure which become payable at any time during the relevant previous year and was actually paid within that period." However, two other distinguished colleagues forming part of this special bench quorum, declined to, though with all respect and humility, concur. Speaking for the majority, however, another distinguished colleague of ours, expressed the view that, "the provisions of section 40(a)(ia)

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of the Act were applicable only to the amount of expenditure which are payable as on the date of 31st March of every year and it cannot be invoked to disallow the expenditure which had already been paid during the previous year without deduction of tax." What does thus emerge as a majority opinion in the Merilyn Shipping & Transport's case is that so far as disallowance under section 40(a)(ia) in respect of expenditure which has been incurred without complying with tax withholding requirements is concerned the disallowance is restricted only to such amount which remained outstanding at the year end.

29. The said decision of the Special Bench was carried in the appeal before the Hon'ble Andhra Pradesh High Court, and Their Lordships, vide an interim judgement, stayed the operation of the order. That is where the matter stands as on now, so far as the developments in the case of Merilyn Shipping & Transport are concerned. Even though the operation of that decision is stayed, there was a school of thought, well articulated by several coordinate benches of this Tribunal, that the judicial precedent in the case of Merilyn Shipping continues to be a binding judicial precedent in the absence of any other binding precedent to the contrary.

30. In the meantime, however, this issued also travelled in appeal before the Hon'ble Gujarat High Court in the case of **CIT vs. Sikandarkhan & Tanwar, 87 DTR 137**. The issue for adjudication before their Lordships were framed as follows:-

> ***1. Whether disallowance under section 40(a)(ia) of the Income Tax Act, 1961 could be made only in respect of such amount taken which are payable as on 31st March of the year under consideration?***
>
> ***2. Whether the decision of Special Bench of the Tribunal in the case of Merilyn Shipping & Transport vs. ACIT lays down the correct law?***

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31. Hon'ble Gujarat High Court rejected the majority view in Merilyn Shipping & Transport's case and observed as follows:-

> ***21. In the present case, we have no hesitation in accepting the contention that the provision must be construed strictly. This being a provision which creates an artificial charge on an amount which is otherwise not an income of the assessee, cannot be liberally construed. Undoubtedly if the language of the section is plain, it must be given its true meaning irrespective of the consequences. We have noticed that the provision makes disallowance of an expenditure which has otherwise been incurred and is eligible for deduction, on the ground that though tax was required to be deducted at source it was not deducted or if deducted, had not been deposited before the due date. By any intendment or liberal construction of such provision, the liability cannot be fastened if the plain meaning of the section does not so permit.***
>
> ***22. For the purpose of the said section, we are also of the opinion that the terms "payable" and "paid" are not synonymous. Word "paid" has been defined in Section 43(2) of the Act to mean actually paid or incurred according to the method of accounting, upon the basis of which profits and gains are computed under the head "Profits and Gains of Business or Profession". Such definition is applicable for the purpose of Sections 28 to 41 unless the context otherwise requires. In contrast, term "payable" has not been defined. The word "payable" has been described in Webster's Third New International Unabridged Dictionary as requiring to be paid: capable of being paid: specifying payment to a particular payee at a specified time or occasion or any specified manner.***
>
> ***In the context of section 40(a)(ia), the word "payable" would not include "paid". In other words, therefore, an amount which is already paid over ceases to be payable and conversely what is payable cannot be one that is already paid. When as rightly pointed out by Counsel Mr. Hemani, the Act uses terms "paid" and "payable" at different places in different context differently, for the purpose of Section 40(a)(ia) of the Act, term "payable" cannot be seen to be including the expression "paid". The term "paid" and "payable" in the context of Section 40(a)(ia) are not used interchangably. In the case of Birla Cement Works and another vs. State of Rajasthan and another reported in AIR 1994(SC) 2393, the Apex Court observed that "the word payable is a descriptive word, which ordinarily means that which must be paid or is due or may be paid but its correct meaning can only be determined if the context in which it is used is kept in view. The word has been frequently understood to mean that which may, can or should be paid and is held equivalent to "due".***

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23. Despite this narrow interpretation of section 40(a)(ia), the question still survives if the Tribunal in case of M/s. Merilyn Shipping & Transports vs. ACIT (supra) was accurate in its opinion. In this context, we would like to examine two aspects. Firstly, what would be the correct interpretation of the said provision. Secondly, whether our such understanding of the language used by the legislature should waver on the premise that as propounded by the Tribunal, this was a case of conscious omission on part of the Parliament. Both these aspects we would address one after another. If one looks closely to the provision, in question, adverse consequences of not being able to claim deduction on certain payments irrespective of the provisions contained in Sections 30 to 38 of the Act would flow if the following requirements are satisfied:-

(a) There is interest, commission or brokerage, rent, royalty, fees for professional services or fees for technical services payable to resident or amounts payable to a contractor or sub-contractor being resident for carrying out any work.

(b) These amounts are such on which tax is deductible at source under Chapter XVII-B.

(c) Such tax has not been deducted or after deduction has not been paid on or before due date specified in sub-Section (1) of Section 39.

For the purpose of current discussion reference to the proviso is not necessary.

24. What this Sub-Section, therefore, requires is that there should be an amount payable in the nature described above, which is such on which tax is deductible at source underChapter XVII-B but such tax has not been deducted or if deducted not paid before the due date. This provision no-where requires that the amount which is payable must remain so payable throughout during the year. To reiterate the provision has certain strict and stringent requirements before the unpleasant consequences envisaged therein can be applied. We are prepared to and we are duty bound to interpret such requirements strictly. Such requirements, however, cannot be enlarged by any addition or subtraction of words not used by the legislature. The term used is interest, commission, brokerage etc. is payable to a resident or amounts payable to a contractor or sub-contractor for carrying out any work. The language used is not that such amount must continue to remain payable till the end of the accounting year. Any such interpretation would require reading words which the legislature has not used. No such interpretation would even otherwise be justified because in our opinion, the legislature could not have intended to bring about any such distinction nor the language used in the section

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brings about any such meaning. If the interpretation as advanced by the assessees is accepted, it would lead to a situation where the assessee who though was required to deduct the tax at source but no such deduction was made or more flagrantly deduction though made is not paid to the Government, would escape the consequence only because the amount was already paid over before the end of the year in contrast to another assessee who would otherwise be in similar situation but in whose case the amount remained payable till the end of the year. We simply do not see any logic why the legislature would have desired to bring about such irreconcilable and diverse consequences. We hasten to add that this is not the prime basis on which we have adopted the interpretation which we have given. If the language used by the Parliament conveyed such a meaning, we would not have hesitated in adopting such an interpretation. We only highlight that we would not readily accept that the legislature desired to bring about an incongruous and seemingly irreconcilable consequences. The decision of the Supreme Court in the case of Commissioner of Income-Tax, Gujarat vs. Ashokbhai Chimanbhai (supra), would not alter this situation. The said decision, of course, recognizes the concept of ascertaining the profit and loss from the business or profession with reference to a certain period i.e. the accounting year. In this context, last date of such accounting period would assume considerable significance. However, this decision nowhere indicates that the events which take place during the accounting period should be ignored and the ascertainment of fulfilling a certain condition provided under the statute must be judged with reference to last date of the accounting period. Particularly, in the context of requirements of Section 40(a)(ia) of the Act, we see no warrant in the said decision of the Supreme Court to apply the test of payability only as on 31st March of the year under consideration. Merely because, accounts are closed on that date and the computation of profit and loss is to be judged with reference to such date, does not mean that whether an amount is payable or not must be ascertained on the strength of the position emerging on 31st March.

25. This brings us to the second aspect of this discussion, namely, whether this is a case of conscious omission and therefore, the legislature must be seen to have deliberately brought about a certain situation which does not require any further interpretation. This is the fundamental argument of the Tribunal in the case of M/s. Merilyn Shipping & Transports vs. ACIT (supra) to adopt a particular view.
……….

37. In our opinion, the Tribunal committed an error in applying the principle of conscious omission in the present case. Firstly, as already observed, we have serious doubt whether such principle can be applied

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by comparing the draft presented in Parliament and ultimate legislation which may be passed. Secondly, the statutory provision is amply clear.

38. In the result, we are of the opinion that Section 40(a) (ia) would cover not only to the amounts which are payable as on 31th March of a particular year but also which are payable at any time during the year. Of course, as long as the other requirements of the said provision exist. In that context, in our opinion the decision of the Special Bench of the Tribunal in the case of M/s. Merilyn Shipping &Transports vs. ACIT (supra), does not lay down correct law.

32. There was also a judgment to the same effect by Hon'ble Calcutta High Court, but, for our present purposes, it is not really necessary to deal with that decision in much detail.

33. We may now refer to the decision of Hon'ble jurisdictional High Court in the case of **CIT vs. Vector Shipping Services (P) Limited**. This is also a case in which a co-ordinate bench of this Tribunal, relying upon the Special Bench decision in the case of Merilyn Shipping & Transport (supra), disallowance under section 40(a)(ia). The decision was challenged before Hon'ble jurisdictional High Court, though, as it does appear to us by reading the judgment, grievance against the ratio of Merilyn Shipping (supra) was not raised by the income tax department. The only substantial question of law which was admitted against the said decision by the Hon'ble jurisdictional high court at the instance of the income tax Department was as follows:

"Whether on the facts and in the circumstances of the case, the Hon'ble ITAT has rightly confirmed the order of the CIT(A) and thereby deleting the disallowance of Rs.1,17,68,621/- made by the Assessing Officer under section 40(a)(ia) of the I.T. Act, 1961 by ignoring the fact that the company M/s Mercator Lines Ltd. had performed ship management work on behalf of the assessee M/s Vector Shipping Services (P) Ltd. and there was a Memorandum of Understanding signed between both the companies and as per the definition of memorandum of understanding, it included contract also."

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34. Upon hearing parties and upon perusing material on record, Hon'ble jurisdictional High Court was of the considered view that "**we do not find that the Tribunal has committed any error in recording the finding on the facts, which were not controverted by the department and thus the question of law as framed does not arise for consideration in the appeal**." In plain words what their Lordships did was simply rejection of question of law proposed by the Income Tax Department by observing that this question of law does not arise for consideration in the appeal.

35. Having noted the above, we must also take note of the fact that there is indeed an observation of Their Lordships to the effect that "**this is to be noted, for disallowing expenses from business or profession on the ground that TDS has not been deducted, the amount should be payable and not which has been paid by the end of the year**" but such an observation may probably stem from the fact that apparently income tax department did not question the law laid down by the Special Bench in the case of Merilyn Shipping & Transport and that is precisely what the Special Bench had held. In these circumstances, the question that we should normally ask ourselves is whether we should proceed on the basis that the Special Bench decision in the case of Merilyn Shipping & Transport indeed stand approved by the Hon'ble jurisdictional High Court in the case of above mentioned decision in Vector Shipping *(supra).*

36. Of course, there is a school of thought the views expressed by Hon'ble Courts above, whether as a part of the decision or as on *obiter dicta* or in any other manner, should be given fullest possible respect, and, without going into much analysis, followed in letter and spirit. After all, everything we do is, and shall always remain, subject to the judicial scrutiny by Their Lordships, and, if there are any error and omission in our *bonafide* following the esteemed views of Their Lordships, these errors and omissions can be rectified at that stage of judicial scrutiny. One may possibly understand discomfort in treating the words of Hon'ble Courts above as a blind man's walking stick rather than as

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luminosity of judicial lamp enabling imparting of justice, and thus erring on the side of excessive caution, but, apart from all other virtues of such an approach, it is certainly a safe approach. Going by this school of thought, now that Their Lordships of Hon'ble jurisdictional High Court have observed, in whatever setting and context, that "**this is to be noted, for disallowing expenses from business or profession on the ground that TDS has not been deducted, the amount should be payable and not which has been paid by the end of the year**", we could proceed on the basis that this proposition has the approval of Their Lordships.

37. There could also be a school of thought that since the correctness or otherwise of the case of Merilyn Shipping & Transport did not even fall for consideration by the Hon'ble jurisdictional High Court, it can not be said that Hon'ble jurisdictional High Court has approved the view taken by the Special Bench in Merilyn Shipping & Transport *(supra).* The conceptual support for this proposition could be this. As a reading of the substantial question of law before their Lordship's case would clearly show that the question which fell for adjudication by their lordships was altogether different i.e. whether carrying out of work by Mercator Lines Ltd. under the Memorandum of Understanding, which included contract, the provisions of section 40(a)(ia) of the Act were attracted. As Their Lordships observed in unambiguous words, this question did not arise from the Tribunal's order and that was the reason why their Lordships decline to consider the same. As observed by Hon'ble Supreme Court in the case of **CIT vs. Sun Engineering Works P. Ltd. (198 ITR 297)** a " **judgement must be read as a whole and the observations from the judgement have to be considered in the light of the question which were before this court**" and that "**a decision of this court takes its colour from the questions involved in the case in which it is rendered and, while applying the decision to a later case, the courts must carefully try to ascertain the true principle laid down by the decision of this court and not to pick out words or sentences from the judgement, divorced from the context of the questions under consideration by this court, to support their**

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reasoning." What was thus expressed for analyzing decision of Hon'ble Supreme Court must equally apply in analyzing of Hon'ble High Court's judgement. It could thus be, by this school of thought, wholly inappropriate to proceed on the basis of the ratio of Merilyn Shipping & Transport stands approved by the Hon'ble jurisdictional High Court particularly when that aspect of the matter was not even in challenge before Their Lordships. However, one of the demerits, if we can term it as a demerit, of this school of thought is that there is an inherent risk of being less than right in such a subjective decision, as in any cerebral pursuit.

38. We are, however, saved of taking this call as, at this stage, it is useful to take note of the CBDT Circular # 10/DV/2013 [F No. 279/Misc/M 61/2012 – Section 40 (a)(i) of the Income Tax Act, 1961] dated 16th December 2013, which, inter alia, observes as follows:

> ***3.3. The Hon'ble Allahabad High Court in CIT Vs Vector Shipping Services Pvt Ltd [2013] 38 taxmann.com 77 (Allahabad) has affirmed the decision of the Special Bench in Merilyn Shipping that for disallowance under section 40(a)(ia) of the Act, the amount should be payable and not which has been paid during the year……***

39. The said circular then expressed the departmental view to the effect that the disallowance under section 40(a)(ia) will not only include the amount payable at the year-end but also the amount paid during the year. Having said so, the circular also observed as follows:

> ***5. Where any High Court decides an issue contrary to the 'departmental view', the 'departmental view' thereon shall not be operative in the area falling in the jurisdiction of the relevant High Court……***

40. An analysis of the stand so taken by the CBDT, which is binding on all the field officers under section 119 of the Act, leads us to the conclusion that so far

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as Allahabad High Court decision is concerned, it is to be treated as approval of Merilyn Shipping decision *(supra),* and, accordingly, there is no requirement for tax withholding with respect to payments actually made to the residents during the relevant previous year itself. No doubt, this circular does not bind this Tribunal, but, as is the binding legal position in the light of a series of decisions by Hon'ble Supreme Court, such a circular, being in the nature of a benevolent circular, binds the income tax authorities. This circular is, therefore, required to be given effect by us, to that extent, as well. Once it is accepted, as has been accepted by the CBDT itself, that Hon'ble Allahabad High Court has decided this issue in favour of the assessee, the rigour of disallowance under section 40(a)(ia) must stand relaxed in the area falling within the jurisdiction of Hon'ble Allahabad High Court. It cannot, therefore, be said that there for the purposes of disallowance under section 40(a)(ia), so far as the assessee before us is concerned, it is necessary that the assessee should have deducted tax at sources so far as payments made during the relevant previous year are concerned. However, so far as payments made to the non-residents are concerned, it is an admitted position that the disallowance under section 40(a)(i) is also attracted as regards the payments made during the year itself without deduction of tax at source. To this extent, the current legal position, with respect to disallowance on account on not complying with tax withholding requirements, infringe deductibility neutrality. Even as we say, we make it clear that whatever we say here is, and shall always remain, subject to the esteemed views of Hon'ble Courts above on the scope of Section 40(a)(ia) as indeed on other related issues. We may also mention that, as fairly accepted by the learned counsel for the assessee, the issue on the scope of section 40(a)(i) vis-à-vis the controversy on whether amounts actually paid during the relevant previous year itself will be outside the ambit of such a disallowance, the same is covered against the assessee, on merits, by this very bench of the Tribunal in the case of **Metro & Metro Vs ACIT (2013 TII 195 ITAT AGRA)**. With these observations, in our considered view, so far as payments made to the residents in Ireland, Denmark and Austria are concerned, learned CIT(A) was justified in upholding the disallowance under section 40(a)(i).

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41. In the result, the petition under rule 27, filed by the assessee, is partly allowed in the terms indicated above.

The appeal filed by the Assessing Officer

42. We now turn to the appeal before us and proceed to adjudicate on the grievance raised by the Assessing Officer, on merits, against deletion of disallowance of Rs 1,05,27,465 section 40(a)(i) in respect of payments made to non-residents, without deducting tax at source.

Background

43. In order to adjudicate on this controversy, it is necessary to take a look at the relevant material facts, as culled out from the material on record, and the developments leading to this litigation before us. The assessee before us is an exporter of leather footwear and footwear uppers. During the course of scrutiny assessment proceedings, the Assessing Officer noticed that the assessee has, inter alia, made payments aggregating to Rs 1,05,27,465 under the head 'design and development expenses', without any deduction of tax at source. The Assessing Officer was of the view that the assessee was under an obligation to deduct tax at source from these payments, as required under section 195 r.w.s. 9(1)(vii) of the Act, and that the assessee having failed to comply with these tax withholding requirements, these payments were rendered ineligible for business deduction in view of the provisions of Section 40(a)(i) of the Act. It was in this backdrop that the assessee was required to show cause as to why the amount of Rs 1,05,27,465 not be disallowed under section 40(a)(i) of the Act. Elaborate submissions were made by the assessee to the effect that the payments so made are not in the nature of fees for technical services within meanings of that expression under section 9(1)(vii) of the Act or under the applicable double taxation avoidance agreement. It was also submitted that since none of these persons had any permanent establishment in India, the amounts in question could not be brought to tax in India as business profit

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either. The assessee submitted that since none of these amounts were taxable in India, and as held by Hon'ble Supreme Court in the case of **GE India Technology Centre Pvt Ltd Vs CIT (327 ITR 456)**, the assessee did not have any obligation to deduct tax at source in India. It was thus argued that since there was no failure on the part of the assessee in deducting tax at source, disallowance under section 40(a)(i) could not be invoked. None of these submissions, however, impressed the Assessing Officer. He rejected the explanation of the assessee and proceeded to make the disallowance under section 40(a)(i) by observing, *inter alia*, as follows:

> **Designing and development of shoes for international market is a very technical job and it requires a lot of data collection, development of trends in different areas depending upon the atmospheric and other conditions. It also requires knowledge of quality of leather and use of leather depending upon different parameters set by different countries. It requires managerial, technical and consultancy services in the nature of consultancy also. Such services fall under the definition of FTS as defined in Explanation below Section 9(1) of the Act.**
>
> **Explanation below section 9 clearly states that for accrual of FTS, there is no requirement of residence, place of business or business connection in India. If any payment is made by a person resident in India, to a non-resident person by way of FTS, income is deemed to accrue or arise in India.**
>
> **FTS is covered under Article 13 of DTAA between the Government of India and most other countries. Contents of Article 13 have also been examined. DTAA is of no help to the assessee as it simply states that FTS 'may' be taxed in the other contracting state, which means it is taxable in India also.**
>
> **On the facts and in the circumstances of the case, as discussed above, it is crystal clear that design and development charges is on account of technical cum consultancy services only. It is deemed to accrue or arise in India, and is taxable in India. Therefore, design and development charges paid to foreign nationals/ companies of Rs 1,05,27,465 without deduction of tax, as required under section 195, is disallowed under section 40(a)(i) of the Act and added to the income of the assessee.**

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44. Aggrieved, assessee carried the matter in appeal before the learned CIT(A) who deleted the impugned disallowance by holding, on merits and by giving detailed reasoning – which we will set out, and deal with, a little later, that none of the amounts so paid by the assessee was actually taxable in India. The Assessing Officer is aggrieved and is in appeal before us.

45. We have heard the rival contentions, perused the material on record and duly considered factual matrix of the case as also the applicable legal position.

46. It is only elementary that section 40(a)(i) can only be invoked when the assessee had a liability withhold the taxes and the assessee failed to discharge such a liability, because, as held by Hon'ble Supreme Court in the case of G E Technology *(supra)*, tax withholding obligations under section 195 come into play only when income embedded in the payments is liable to be taxed in India. In other words, unless the income embedded in payments in question is held to be taxable in India, the provisions of Section 40(a)(i) cannot be invoked. We should, therefore, begin by examining taxability of income in the hands of the non-residents. Since these recipients are residents of different tax jurisdictions, and since tax treaties that India has entered into with those jurisdictions will have to be considered while examining the taxability in the hands of the recipients, we will bunch these cases for each tax jurisdiction separately.

Payments made to Spanish residents

47. We will first take up the payments made by the assessee to the residents of the Kingdom of Spain.

48. During the relevant previous year, the assessee has made following payments, without any tax withholdings, to Spanish residents:

Sl.No.	Name and Address of the Non Resident	Country of residence	Payment currency	Amount in I Rs.

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1.	JAVIER VERA PALAO PADRE MANJON NO 28 ATICO AB 03600 ELDA ALICANTE	SPAIN	EURO 43,000.00	24,42,860
2.	HORMAS AGUILERA SL AVDA H. BERNARDO HERRERO 41 APDO 22 03630 SAX ALICANTE	SPAIN	EURO 4,865.48	2,76,621
3.	IMPRONTA DESIGN SLU VALENCIA 3, PALOMAR ALICANTE	SPAIN	EURO 7,500.00	4,24,800
4.	BISANI SL PITAGORAS 7-1- PARQUE INDUSTRIAL 03203 ALICANTE	SPAIN	EURO 209.10	12,475

49. As far as payment of € 43,000 to Javier Vera Palao (JVP, in short) is concerned, this payment is made for samples, photographs and sketches supplied by JVP. Copies of the invoices raised on the assessee were placed before us at pages 103 to 105 of the paper-book, and a copy of JVP's passport was placed before us at paper-book page 106. The details of services rendered by JVP, as evident from the invoices raised, are as follows:

- Samples, sketches and photographs Season 08/09 € 10,000
- Samples, sketches and photographs € 10,000
- Sale of 20 designing lines € 20,000
- Moxy Collection Materials € 3,000

50. Learned CIT(A) has deleted disallowance under section 40(a)(i), in respect of the above payments, after extensively reproducing from the written submissions filed by the assessee, and observing as follows:

> **I agree with the learned AR that such payments made by the assessee (appellant) for this category of design and development charges is nothing but payments made on purchases of commercial information, by way of sample, drawing, photograph, design of shoes etc, from foreign parties outside India, and hence these payments are not taxable in India as not being in the nature of FTS, and, therefore, there is no obligation on the assessee to deduct tax at source on such**

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payments. As the assessee (appellant) has not been found liable for making TDS on such payment, after analyzing the nature of payment in this para, the question of adding back such sum under section 40(a)(i)…….does not arise…….

51. In order to adjudicate upon Assessing Officer's grievance against this disallowance, it is necessary to examine the scope of taxability of payments in question under Indo Spanish tax treaty. The relevant provisions of the Indo Spanish tax treaty are as follows:

Article 13- Royalties and fees for technical services

1. Royalties and fees for technical services arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such royalties and fees for technical services may also be taxed in the Contracting State in which they arise and according to the law of that State, but if the recipient is the beneficial owner of the royalties or fees for technical services, the tax so charged shall not exceed :

(i) in the case of royalties relating to the payments for the use of, or the right to use, industrial, commercial or scientific equipment, 10% of the gross amount of the royalties;

(ii) in the case of fees for technical services and other royalties, 20% of the gross amount of fees for technical services or royalties.

3. The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematographic films or films or tapes used for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience.

4. The term "fees for technical services" as used in this Article means payments of any kind to any person other than payments to an employee of the person making the payments and to any individual for independent personal services mentioned in Article 15 (Independent Personal Services), in consideration for the services of

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a technical or consultancy nature, including the provision of services of technical or other personnel.

5. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties or fees for technical services, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties or fees for technical services arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right, property or contract in respect of which the royalties or fees for technical services are paid is effectively connected with such permanent establishment or fixed base. In such case, the provisions of Article 7 or Article 15, as the case may be, shall apply.

6. Royalties and fees for technical services shall be deemed to arise in a Contracting State when the payer is that State itself, a political sub-division, a local authority or a resident of that State. Where, however, the person paying the royalties or fees for technical services whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or fixed base in connection with which the liability to pay the royalties or fees for technical services was incurred, and such royalties or fees for technical services are borne by such permanent establishment or fixed base, then such royalties or fees for technical services shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

7. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties or fees for technical services paid, exceeds the amount which would have been paid in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention

Article 15- Independent personal services

1. Income derived by a resident of a Contracting State from the performance of professional services or other independent activities of a similar character shall be taxable only in that State except in the following circumstances when such income may also be taxed in the other Contracting State :

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(a) if he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities; in that case, only so much of the income as is attributable to that fixed base may be taxed in that other State; or

(b) if his stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 183 days in the relevant "taxable year"; in that case, only so much of the income as is derived from his activities performed in that other State may be taxed in that other State.

2. The term "professional services" includes independent scientific, literary, artistic, educational or teaching activities, as well as the independent activities of physicians, surgeons, lawyers, engineers, architects, dentists and accountants.

Protocol dated 8th February 1993

At the moment of signing the Convention between the Government of the Republic of India and the Government of the Kingdom of Spain for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes on Income and on Capital, the undersigned have agreed upon the following provisions which shall be an integral part of the Convention.

……..

……..

7. The competent authorities shall initiate the appropriate procedures to review the provisions of Article 13 (Royalties and fees for technical services) after a period of five years from the date of its entry into force. However, if under any Convention or Agreement between India and a third State which is a Member of the OECD, which enters, into force after 1st January, 1990, India limits its taxation at source on royalties or fees for technical services to a rate lower or a scope more restricted than the rate or scope provided for in this Convention on the said items of incomes, the same rate or scope as provided for in that Convention or Agreement on the said items of income shall also apply under this convention with effect from the date on which the present Convention comes into force or the relevant Indian Convention or Agreement, whichever enters into force later.

……..

52. While the scope of 'fees for technical services' under the Indo Spanish tax treaty is on the traditional model inasmuch as, under article 13(4), it includes all kind of technical and consultancy services, there are two important riders in

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this regard. The first rider is that it does not include the cases in which payments made to individuals for 'independent personal services', which are separately covered by article 15. The second rider is the application of most favoured nation clause (MFN clause) set out in protocol to the Indo Spanish tax treaty. Under the MFN clause, in case any tax treaty that India enters into with any OECD country, and which enters into force after 1st January 1990, taxability of fees for technical services has a more restricted scope of taxation or lesser rate of taxation, the provisions of the said treaty will automatically apply to the India Spanish tax treaty as well. It is well settled in law that a protocol is an integral part of the tax treaty, that it is to be given effect in the same manner as any other substantive part of the tax treaty and that the application of more restricted treaty provisions, in a situation where it is so specified by the protocol provision, is automatic. The authority of this proposition, if needed, is contained in **DCIT Vs ITC Limited (82 ITD 239).**

53. During the course of the hearing, learned counsel has invited our attention to the provisions of Article 12 of India US tax treaty, which has been notified on 20th December 1990, and has, as such, come into force well after 1st January 1990. The scope of definition of 'fees for technical services', which is referred to as 'fees for included services', is much narrower in scope as it is on 'make available' model. These provisions are reproduced below for ready reference:

> **Article 12 - Royalties and fees for included services**
>
> **1. Royalties and fees for included services arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.**
>
> **2. However, such royalties and fees for included services may also be taxed in the Contracting State in which they arise and according to the laws of that State; but if the beneficial owner of the royalties or fees for included services is a resident of the other Contracting State, the tax so charged shall not exceed :**

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(a) in the case of royalties referred to in sub-paragraph (a) of paragraph 3 and fees for included services as defined in this Article (other than services described in sub-paragraph (b) of this paragraph):

(i) during the first five taxable years for which this Convention has effect,

(A) 15 per cent of the gross amount of the royalties or fees for included services as defined in this Article, where the payer of the royalties or fees is the Government of that Contracting State, a political sub-division or a public sector company; and
(B) 20 per cent of the gross amount of the royalties or fees for included services in all other cases; and

(ii) during the subsequent years, 15 per cent of the gross amount of royalties or fees for included services; and

(b) in the case of royalties referred to in sub-paragraph (b) of paragraph 3 and fees for included services as defined in this Article that are ancillary and subsidiary to the enjoyment of the property for which payment is received under paragraph 3(b) of this Article, 10 per cent of the gross amount of the royalties or fees for included services.

3. The term 'royalties' as used in this Article means :

(a) payments of any kind received as a consideration for the use of, or the right to use, any copyright of a literary, artistic, or scientific work, including cinematograph films or work on film, tape or other means of reproduction for use in connection with radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience, including gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof; and

(b) payment of any kind received as consideration for the use of, or the right to use, the industrial, commercial, or scientific equipment, other than payments derived by an enterprise described in paragraph 1 of Article 8 (Shipping and Air Transport) from activities described in paragraph 2(c) or 3 or Article 8.

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4. For purposes of this Article, 'fees for included services' means payments of any kind to any person in consideration for the rendering of any technical or consultancy services (including through the provision of services of technical or other personnel) if such services :

(a) are ancillary and subsidiary to the application or enjoyment of the right, property or information for which a payment described in paragraph 3 is received; or

(b) <u>make available technical knowledge, experience, skill, know- how, or processes, or consist of the development and transfer of a technical plan or technical design</u>.

5. Notwithstanding paragraph 4, 'fees for included services' does not include amounts paid :

(a) for services that are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of property other than a sale described in paragraph 3(a);
(b) for services that are ancillary and subsidiary to the rental of ships, aircraft, containers or other equipment used in international traffic;

(c) for teaching in or by educational institutions;

(d) for services for the personal use of the individual or individuals making the payment; or

(e) to an employee of the person making the payments or to any individual or firm of individuals (other than a company) for professional services as defined in Article 15 (Independent personal services).

……

[Emphasis underling supplied by us]

54. Learned Departmental Representative, apart from relying upon the stand of the Assessing Officer and assailing the impugned CIT(A)'s order as consisting of sweeping generalizations, has invited our attention to Hon'ble Calcutta High Court's judgment in the case of CIT Vs Davy Ashmore India Limited (190 ITR 626) it is only when there is an outright sale of drawings and designs that the consideration for such drawings and designs cannot be treated as royalties or fees for technical services. He submits that here is a case in which though

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assessee has paid for drawings, designs and photographs, there is nothing to suggest that there is a sale of such drawings, designs and photographs inasmuch as nothing restrains the seller from selling the same items to others. He also submits that it is a clearly a case of fees for technical services, whether under the provisions of the Act or under the provisions of the applicable tax treaty. Learned counsel's submissions are two fold. His first line of defence is that since, by the virtue of protocol clause in Indo Spanish DTAA, the provisions of Article 12 of India US tax treaty are to be taken into account under which the fees for technical services can only be said to have been made available when there is a transfer of technology in the sense that recipient of services is enabled to use these services in future without recourse to the service provider. He further submits that in any case the payment was made to an individual for his professional services which is not only specifically covered under article 15 of the treaty but specifically excluded from the scope of fees for technical services in the Indo Spanish tax treaty as also in the Indo US tax treaty. Learned counsel then submits that the payment in question cannot be taxed under the article 15 as fees for professional services, or as independent personal services – as is the terminology employed in the tax treaties, because the service provider did not have any fixed base in India, nor did the service provider stay in India for more than 183 days – as is the precondition for taxability of such an income in India.

55. We find that even though the assessee has all along stated that the payment is made to an individual i.e. Javier Vera Palao, but copies of the relevant invoices, which are placed at pages 103 to 105, seem to have been raised by an entity by the name of Fusde Trading SL. The assessee has filed a copy of JVP's passport but this document, by no stretch of logic, evidences the payment having been made to an individual. The bank advices, which may establish the actual facts, are also not on record. There is no specific finding on this aspect of the matter in the orders of any of the authorities below. Under these circumstances, it would not be appropriate for us to proceed on the basis that the payment is made to an individual and that it is taxable, taxable if it is, under article 15 of the treaty. This aspect of the matter is very important

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because in the event of the amount being of such a nature as to invite taxability under article, for this reason alone, it gets out of the ambit of scope of fees for technical services under the applicable tax treaty.

56. As regards the restricted scope of 'make available' clause in the Indo US tax treaty, which is applicable in the present case by the virtue of MFN clause discussed earlier in this decision, we see no support to assessee's case by this clause either. It is to be noted that under article 12(4)(b), the connotations of fees for included services, as it is termed under the Indo US tax treaty, includes consideration of services if such services, *inter alia,* "**consist of the development and transfer of a technical plan or technical design".** In the present case, the Spanish vendor has invoiced for samples, sketches and photographs, as also designing lines and collection material. Just because the vendor has developed and transferred technical designs or plans in respect of shoes or such other material, it does not mean that it is not a technical design. We may, in this regard, also refer to decision of a co-ordinate bench, in the case of **Sintex Industries Ltd Vs ADIT (141 ITD 98),** which has held that payment made to UK based consultant for providing fabric along with its details in writing, which can be used by assessee to process and produce garments and it can also sell and transfer such fabric design to outsider for consideration, amounts to FTS under the Indo UK tax treaty. In any event, all these important aspects of the matter have not even been looked at by the authorities below.

57. As regards the scope of article 13(4) of the Indo Spanish tax treaty, which include, its scope, consideration for services of a technical or consultancy nature, we find that the amounts paid seem to be covered by the scope of article 13(4) inasmuch as the payment is made for services which are consultancy and technical services. The payments are made for designs, sketches and photographs but these designs, sketches and photographs are in the context of assessee's line of business and, as stated by the assessee himself, for the purposes of product development by the assessee. These are not purchases *simplictor*. However, in the event of assessee's claim regarding payment having

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been made to an individual for professional services being correct, the exclusion clause under 13(5) will come into play.

58. In view of the above discussions, and bearing in mind entirety of the case, we deem it fit and proper to remit the issue to the file of the CIT(A) for adjudication de novo in the light of our above observations, in accordance with the law and by way of a speaking order dealing with all such contentions as the assessee may take. We order so. We, however, make it clear that if the payment is indeed made to an individual, as a consideration for professional services rendered by him, the said payment will not be taxable in India in view of the undisputed position that this individual did not have a fixed base regularly available to him in India and that this individual did not spend more than 183 days, in the relevant previous year, in India.

59. We now take up item no. 3 in the list of payments to the residents of Spain.

60. We find that the assessee has not even furnished a copy of invoice or any other details in respect of the above remittance. At page 107, the assessee has merely furnished passport copy of one Alejandro Gil Fernandez but that is hardly sufficient to establish anything in support of the assessee's contention to the effect that the payment was made to a Spanish resident for rendering the independent professional services. There is also an undated and unsigned letter but it has no value at all. There is no specific findings in respect of this payment in the impugned order passed by the CIT(A).

61. In view of the above situation, we deem it fit and proper to remit this issue also to the file of the CIT(A) for specific findings on nature and taxability of this payment as well.

62. We now take up item no. 2 and item no. 4 in the list of payments to Spanish residents.

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63. These two payments, i.e. payments to Hormas Aguilera SL and Bisani SL, are made against invoices raised by the respective concerns. Copies of relevant invoices are placed at pages 93 to 97 of the paper book. As these payments are made for the purchases of goods, and as the recipients do not have any PE in India, it is clear that these transactions do not lead to any taxability in India with respect to its business profits. Business profits of Spanish enterprises can only be brought to tax in India under article 7, when those enterprise have a PE in India in terms of article 5, and then also the taxability is restricted to the extent the profits are attributable to the PE. It is not even in dispute that the recipients do not have any PE in India. It is only elementary that tax withholding liability is a vicarious liability, and where it can be shown that principal liability does not exist, the vicarious liability will also not survive. Since the assessee did not have any tax withholding liability in respect of these payments, learned CIT(A) was quite justified in deleting the impugned disallowance under section 40(a)(i) to that extent.

Payments made to Italian residents

64. We now take up the payments covered by Indo Italian tax treaty. These payments are as follows:

Sl.No.	Name and Address of the Non Resident	Country of Resident	Payment in Foreign Currency	Amount Rs.
1.	RENZI MASSIMO VIA CAVOUR 2 63018 PORTO SANTE' ELPIDIO (AP)	ITALY	EURO 36,000	20,38,840
2.	MARTELLO LUCIO 30010 COMONOGARA VE	ITALY	EURO 19,000	10,82,120
3.	EUROLAST SRL VIA S. FILIPPO 5 H 63018 PS ELPIDIO (AP)	ITALY	EURO 3,900	2,21,286
4	SULOFICIO STELLA SRL VIA MARG EGEO	ITALY	EURO 159.50	9,594

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	95B 63018 PORTO SANTELPIDIOOP			
5.	SPERECAS ZENGARINI SRL VIA PAOLO VI 20-62015 MONTE S. GUISTO	ITALY	EURO 2,640	1,55,074

65. As far as payment of € 36,000 to Renzi Massimo is concerned, copies of relevant invoices are placed at pages 108 to 111. These invoices show that the amounts are paid for, what is termed as, 'cost contribution – summer collection' for various fairs. A copy of Renzi Massimo's passport is also placed at page 112 of the paper-book. The assessee's contention is that the payment is made for payment of samples for the trade fair, but the assessee regretted his inability to furnish any agreement, or further details, in this regard.

66. In this case also, the CIT(A) has given relief without recording specific findings with respect to this payment and has made rather general observations which have been reproduced earlier in the context of payments made to Spanish residents.

67. Having regard to the rival contentions and having perused the material on record, it is beyond doubt that the payment has been made to an individual and is made for cost contribution for developing collection of samples etc for various trade fairs. It is in this factual backdrop that we may take a look at the relevant provisions of Indo Italian tax treaty, which are reproduced below for ready reference:

> **Article 13- Royalties and Fees for Technical Services**
>
> **1. Royalties and fees for technical services arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.**
>
> **2. However, such royalties and fees for technical services may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the recipient is the beneficial owner of the royalties, or fees for technical services, the tax so charged shall**

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not exceed 20 per cent of the gross amount of the royalties or fees for technical services.

3. The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematography films or films or tapes used for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience.

4. The term "fees for technical services" as used in this Article means payments of any amount to any person other than payments to an employee of the person making payments, in consideration for the services of a managerial, technical or consultancy nature, including the provisions of services of technical or other personnel.

5. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties or fees for technical services, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties or fees for technical services arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right, property or contract in respect of which the royalties or fees for technical services are paid is effectively connected with such permanent establishment or fixed base. In such a case the royalties or fees for technical services shall be taxable in that other Contracting State according to its own law.

……..
……..

Article 15- Independent Personal Services

1. Income derived by a resident of a Contracting State in respect of professional services or other independent activities of a similar character may be taxed in that State. Such income may also be taxed in the other Contracting State if such services are performed in that other State and if :

> **(a) he is present in that other State for a period or periods aggregating 183 days in the relevant fiscal year, or**

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(b) he has a fixed base regularly available to him in that other State for the purpose of performing his activities but only so much of the income as is attributable to that fixed base.

2. The term "professional services" includes independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, surgeons, lawyers, engineers, architects, dentists and accountants.

68. We have noted that there is some confusion about the exact nature of services for which the impugned payments are made. While in the written submissions filed, this payment is stated to be for offshore services, neither there is any material on record to show the nature of services nor supporting invoices indicate that fact. The invoice show that the arrangement is for cost contribution but what is the nature of this cost contribution is far from clear. There is, however, a letter from Renzi Massimo on record, which , inter alia, states that he has been supplying samples and sketches etc to the assessee to "enable them to seek information in respect of the fashion trends in Europe". These services, in the nature of legal position succinctly set out by a coordinate bench of this Tribunal in the case of **Graphite India Ltd Vs DCIT (86 ITD 384),** are clearly in the nature of professional services rendered by an individual, and, for this reason alone, the specific provisions of article 15 will come into play. We have also noted that its undisputed position that Renzi Massimo did not have a fixed base available to him regularly in India, nor did he stay in India for more than 183 days in the relevant previous year. The amounts paid to him are, therefore, not taxable as income under the head 'independent personal services' under article 15 of the Indo Italian tax treaty either. Even if we proceed on the basis that the payment is in the nature of cost contribution, there will be no tax implications in India because in such a situation it will have to be treated as reimbursement of expenses which does not necessarily include income element. In view of these discussions, as also bearing in mind entirety of the case, we uphold the action of the CIT(A) so far as deleting the disallowance under section 40(a)(i) in respect of this payment.

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69. So far as taxability of € 36,000 to Renzi Massimo is concerned, the conclusions arrived at by the CIT(A) are upheld.

70. The next payment to the Italian residents, as mentioned in the chart above, is for € 19,000 to Martello Lucio.

71. We find that copies of relevant invoices are placed at pages 113-114 which, in the description column, merely state that "*Saldo prestazione eseguita presso Nostra sede*" and that English translation of these invoices is not on record. As we could make out, with the help of unauthentic translation through google translation tool, it means "Balance services performed at our HQ". That does not enlighten us about the nature of payment. There is a confirmation, in a standard format, by Martello Lucio on record but it is not only contrary to the contents of the invoice but it is also vague. In the case of such a glaring contrast, the right course for the authorities below should have been to call for more details and examine the issue on merits. In any case, there should have been a categorical finding about the nature of payment, reasonably supported by cogent material or reasoning, by the learned Commissioner (Appeals) before granting impugned relief. Unless there is a reasoned finding about the nature of payment, there cannot be any occasion to adjudicate on taxability of the payment. In view of these discussions, and bearing in mind entirety of the case, we deem it fit and proper to remit the matter regarding taxability of receipt of € 19,000, in the hands of Martello Lucio, also to the file of the learned CIT(A) for fresh adjudication in accordance with the law, by way of a speaking order and after giving a due and reasonable opportunity of hearing to the assessee to present his case in the light of our observations. The observations we have made earlier, while remitting back some other adjudications on taxability, will also apply *mutatis mutandis* here as well.

72. We will take up the balance three payments to residents in Italy together as these three payments seem to be of similar nature and can be adjudicated together.

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73. In all these three cases, i.e. payments of € 3,900 to Eurolast SRL, of € 159.50 to Suolifico Stella SRL and of € 2,640 to Sperecas Zengarini SRL, the payments are made against invoices which are placed on record at pages 99 to 102 of+ the paper-book. As a plain look at the invoices would show, these transactions are in the nature of sale of various types of products and samples. As these payments are made for the purchases of goods, and as the vendors donot have any PE in India, it is clear that these transactions donot lead to any taxability in India with respect to its business profits. Business profits of such enterprises can only be brought to tax in India under article 7, when those enterprise have a PE in India in terms of article 5, and then also the taxability is restricted to the extent the profits are attributable to the PE. It is not even in dispute that the recipients donot have any PE in India. When there is no income embedded in these payments, there cannot be any occasion for the assessee to deduct tax at source from these payments. As the assessee did not have any tax withholding liability in respect of these payments, learned CIT(A) was quite justified, to that extent, in deleting the impugned disallowance under section 40(a)(i) . We uphold the order to that extent.

Payment made to UK resident

74. During the relevant previous year, the assessee had also made a payment to UK resident, as detailed below, in respect of the Assessing Officer had made a disallowance under section 40(a)(i):

Sl.No.	Name and Address of the Non Resident	Country of Residence	Payment in Euros	Amount in I Rs.
1	ARDEN FOOTWEAR LTD UNIT 14 NARBOROUGH WOOD BUSINESS PARK LEICHESTER	UNITED KINGDOM	GBP 6000	4,83,900

75. As far as this payment of £ 6,000 is concerned, as a copy of the relevant invoice, a copy of which was placed before us at page 118 of the paper-book, shows, the payment was made for the following reimbursement:

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Development Costs: April 2007 to March 2008

All costs incurred in samples, lasts, research and material for the development of the range produced by Gupta Overseas, Agra, for Arden Footwear Limited

76. It is important to bear in mind the fact that the reimbursement invoice is raised by the customer (i.e. Arden Footwear Limited) itself and for the costs that the customer had to incur in development of product range. Clearly, there is no income embedded in the same inasmuch as these are the reimbursements made to the customer, for costs of product development produced by the assessee.

77. It is a settled legal position, in the light of Special Bench decision in the case of **Mahindra & Mahindra Ltd Vs DCIT (122 TTJ 577)** that where a particular amount of expenditure is incurred and the sum is reimbursed as such, it cannot be considered as having any part of it in the nature of income. In any event, there is nothing to suggest that there is any income embedded in these payments. Consequently, the assessee did not have any obligations to deduct the tax at source from this payment. Since the assessee did not have any tax withholding obligation from this payment, the very foundation of disallowance under section 40(a)(i) ceases to hold good in law. Learned CIT(A) rightly deleted the same.

Payment to Belgian resident

78. During the relevant previous year, the assessee had also made a payment to a Belgian resident by the name of NV. Muderi for € 20,000, as detailed below, in respect of the Assessing Officer had made a disallowance under section 40(a)(i):

Sl.No.	Name and Address of the Non Resident	Country of Residence	Payment in Euros	Amount in I Rs.
14	N V MUDERI	BELGIUM	EURO 20000	12,62,000

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	GERAARDSBERGSESTEENWEG 5329400 NINOVE VOORDE			

79. So far as this payment of € 20,000 is concerned, we find that it has been made for 'design and development expenses' to a concern by the name of N V Muderi said to be owned by Kathleen, a Belgian national resident of Belgium. It has been confirmed by the Kathleen, though in a standard format, that he has been paid for providing the assessee samples and sketches etc to enable them to seek information in respect of fashion trends in Europe.

80. As we deal with this matter, it is appropriate to take a look at the relevant provisions in Indo Belgian tax treaty which is reproduced below for ready reference:

Article 12- Royalties and Fees for Technical Services

1. Royalties and fees for technical services arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such royalties and fees for technical services may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the royalties or fees for technical services is a resident of the other Contracting State, the tax so charged shall not exceed 20 per cent of the gross amount of the royalties or fees for technical services.

3. (a) The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience.

(b) the term "fees for technical services" as used in this Article means payments of any kind to any person, other than payments to an employee of the person making the payments and to any individual for independent personal services mentioned in Article 14, in consideration for services of a managerial, technical or

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consultancy nature, including the provision of services of technical or other personnel.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties or fees for technical services, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties or fees for technical services arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which, or the contract under which, the royalties or fees for technical services are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply.
……..
……..

81. It is clear that payment of any kind made to any person, "**other than …….any individual for independent personal services mentioned in Article 14, in consideration for services of a managerial, technical or consultancy nature**" is covered by the scope of fees for technical services within meanings assigned under article 12(3)(b) of Indo Belgian tax treaty. In the present case, admittedly the payment is not made to an individual. The fact that the entity to which payment has been made is owned by an individual, even if that be so, does not, in our humble understanding, take that outside the ambit of article 12(3)(b). The services, for which the payment in question has been made, are also clearly in the nature of consultancy, even if not technical, services. On these facts, a view does seem to emerge that the amount paid was very well covered by the scope of article 12(3)(b) of India Belgian tax treaty, and the assessee ought to have deducted tax from the same. This view is also supported by a coordinate bench decision in the case of **Sintex Industries Ltd** *(supra) in* which it is held that payment made to a non-resident for providing fabric along with its details in writing, which can be used by assessee to process and produce garments and it can also sell and transfer such fabric design to outsider for consideration, amounts to fees for technical services, even under narrower scope of that expression.

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82. However, as learned counsel has, on the strength of a coordinate bench decision in the case of **MSEB Ltd Vs DCIT (90 ITD 793),** contended that even the benefit of taxability under the head 'independent personal service' under article 14 is not restricted to individuals, let us also deal with that aspect of the matter. To complete learned counsel's contention, in a case an amount could be of such a nature as it could be taxed under article 14 as income from 'independent personal services', those provisions being narrower in scope, the provisions of article 12 will not come into play. In all fairness to learned counsel, his plea is, in principle, supported by an AAR ruling in the case of **Dieter Eberhand Gustav Van Der Mark Vs CIT (235 ITR 698).**

83. The provision regarding taxability of independent personal services, as set out in the Indo Belgian tax treaty, are as follows:

> **Article 14- Independent Personal Services**
>
> **1. Income derived by an individual who is a resident of a Contracting State from the performance of professional services or other independent activities of a similar character shall be taxable only in that State except in the following circumstances when such income may also be taxed in the other Contracting State:**
>
> **(a) if he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities; in that case, only so much of the income as is attributable to that fixed base may be taxed in that other State; or**
>
> **(b) if his stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 183 days in the relevant "previous year" or "taxable period", as the case may be; in that case, only so much of the income as is derived from his activities performed in that other State may be taxed in that other State.**
>
> **2. The term "professional services" includes independent scientific, literary, artistic, educational or teaching activities, as well as the independent activities of physicians, surgeons, lawyers, engineers, architects, dentists and accountants.**

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84. As is unambiguous in the wordings of article 14, the provisions of article extend only to the individuals and not all residents of the treaty partner country. Learned counsel's reliance on MSEB decision (supra) is misplaced because that was in the context of India UK tax treaty wherein expression used was only 'resident' and there was no mention of the expression 'individual' in the article related to independent personal services. What is decided in the context of one treaty does not necessarily apply in other treaties as well, particularly when the treaties are differently worded.

85. In the present case, we are dealing with a situation in which the payment has been made to N V Muderi, a business entity other than an individual, and, therefore, the provisions of article 14 donot come to the rescue of the assessee. In any case, the normal rule, as is articulated by the UN model convention commentary as well, that article 14 comes into play only when services are rendered by the individuals, whereas article 7 comes into play when services are rendered by entities other than individuals.

86. In view of the above discussions, as also bearing in mind entirety of the case, we are of the considered view that the assessee ought to have deducted tax at source from payment of € 20,000 to NV Muderi, His failure to do so is to be visited with disallowance of the said sum under section 40(a)(i). The relief granted by the CIT(A) is vacated to that extent, and the disallowance by the AO is restored.

Payments to residents of Ireland, Denmark and Austria

87. That leaves us with one payment each made to the residents of Ireland, Denmark and Austria.

88. As we have already upheld the relief granted by the CIT(A), so far as these payments are concerned, though on the ground of application of deduction neutrality non-discrimination provisions in the respective tax treaties, we see

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no need to deal with taxability of these payments in India, at this stage. That aspect of the matter will be academic as on now.

89. In view of the above discussions, we uphold the relief granted by the CIT(A) so far as disallowance under section 40(a)(i) in respect of the above payments as well.

Summing up

90. To sum up, while we partly uphold the petition rule 27 in the terms indicated above, we partly uphold the relief granted by the CIT(A) as discussed above and we partly remit the matter back for adjudication *de novo* in the light of our observations.

91. In the result, the appeal is partly allowed. Pronounced in the open court today on 4th day of February, 2014.

Sd/-
Bhavnesh Saini
(Judicial Member)

Sd/-
Pramod Kumar
(Accountant Member)

Agra, the 4th day of February, 2014

Copies to :
(1) The appellant
(2) The respondent
(3) CIT
(4) CIT(A)
(5) The Departmental Representative
(6) Guard File

By order etc

Senior Private Secretary
Income Tax Appellate Tribunal
Agra bench, Agra

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