IN THE INCOME TAX APPELLATE TRIBUNAL
PANAJI BENCH, PANAJI

BEFORE SHRI P.K. BANSAL, HON'BLE ACCOUNTANT MEMBER
AND SHRI D.T. GARASIA, HON'BLE JUDICIAL MEMBER

ITA NOS. 194, 195 & 287/ PNJ/2014	:	**(ASST. YEARS : 2008-09, 2009-10 & 2010-11)**
Asst. Commissioner of Income Tax, Circle-2, Margao, Goa. (Appellant)	Vs.	M/s.Indian Furniture Products Limited. Jai Kissan Bhawan, Zuarinagar, Goa. **PAN : AAACZ1715A.** (Respondent)

Appellant by : **Shri Vinay Singh Rawat, Ld. D.R.**
Respondent by : **Shri Elson Sequeira, C.A.**

Date of Hearing : **06/01/2015**
Date of Pronouncement : **07/01/2015**

O R D E R

PER P.K. BANSAL

All these three appeals are filed by the Revenue against the orders of CIT(A) dt. 03.03.2014, 04.03.2014 and 15.05.2014 for assessment years 2008-09, 2009-10 and 2010-11 by taking the following effective grounds of appeal:-

"1. The order of the learned Commissioner of Income-Tax (Appeals) is opposed to law and facts of the case.

2. The Ld. CIT(A) has erred in allowing relief to the assesse in respect of disallowances made by the Assessing Officer u/s 40(a)(ia) of the IT Act on account of non deduction of tax at source u/s 195(1) of the IT Act on usance charges paid of Rs.18,99,772/- to a non resident through an intermediatory bank.

3. The Ld. CIT(A) failed to appreciate that as per section 10(15)(iv)(c) interest payable outside India on the purchase of raw material / capital goods on delayed period from 01.06.2001 is taxable in the hands of purchaser and liable to tax.

4. The Ld. CIT(A) failed to appreciate that the case law of CIT vs. Vijay Ship Breaking Corporation & Others (2003) 181 CTR 134 (Gujarat High Court) is very much applicable in the present case."

2. The only issue involved in all these appeals filed by the revenue relate to whether the Assessee was bound to deduct TDS u/s 195(1) in respect of usance charges paid by the Assessee on import of raw material from countries outside India like Japan, Belgium, Germany, USA etc. Both the parties agreed since the issue involved in all the three years is common. All these appeals be decided on the facts for the assessment year 2008-09. The brief facts for the assessment year 2008-09 are that the AO noted that the Assessee is engaged in manufacture of wooden doors, frames, furniture etc. The Assessee has paid usance charges of Rs.18,99,772/- on import purchase. The AO was of the view that the usance charges incurred by the assessee is the income arising to the non-resident reckoning within the meaning of provisions of Sec. 5(2)(b) r.w.s. 9(1)(v)(b) and therefore the Assessee was liable to deduct TDS in accordance with the provisions of Sec. 195. Since the Assessee has not deducted the TDS, therefore, AO disallowed the sum u/s 40(a)(i). The Assessee went in appeal before the CIT(A). CIT(A) deleted the addition relying on the explanation to Sec. 10(15)(iv)(c) of the Income Tax Act by observing as under:

"7. I have gone through the assessment order and the submission of the appellant. The A.O disallowed the usance charges paid to banks for non-deduction of TDS. The reason, why the A.O thought that the provisions of TDS are applicable is as under :

In the present case, the assesse has imported raw material for its consumption based on a letter of credit and has paid usance charges. The issuing bank of the assesse merely acts as an agent of the assesse. Usance charges in the present case is an income of a non-resident as envisaged in provisions u/s 9(1)(v)(b) r.w.s. 5(2) of the Act. Therefore, the assessee while paying usance charges should have deducted TDS as provided in Sec.195(1) of the Act.

On the other hand, the appellant contended that the A.O has not appreciated the facts in right perspective. The appellant argued that the usance charges have been taken by the banks which are all nationalized banks and which operate in India. The appellants have not paid any amount to the non-resident suppliers either directly or through the bankers.

The learned A.R. of the appellant also contended that since no payments have not been made to non-resident suppliers in the form of usance charges or interest / commission, the ration of judgement, relied upon by the A.O in the case of CIT vs Vijay Ship Breaking Corporation and others (2003) 181 CTR B4, does not apply in the case of appellant as the facts are entirely different. Also, in this case, the payment has been made to suppliers, no parts of whose income are assessable in India. In view of the above facts, in my opinion, the A.O was not justified in making the disallowance u/s 40a (i) amounting to Rs.18,99,772/- on account of usance charges / commission. The A.O is directed to delete the addition accordingly."

3. We heard the rival submissions and carefully considered the same. We noted that the Hon'ble Supreme Court has reversed the decision of Hon'ble Gujarat High Court in CIT vs. Vijay Ship Breaking Corporation as reported in 314 ITR 309 (SC) by observing as under :

"As regards the second question, we may state that in this case, the controversy which arose for determination was whether the assessee was bound to deduct TDS under section 195(1) of the 1961 Act in respect of usance interest paid for purchase of the vessel for ship breaking ?

According to the Department, TDS was deductible under section 195(1) whereas, according to the assessee, such interest partook of the character of the purchase price and, therefore, TDS was not deductible. Therefore, the key question which arose for determination was whether the assessee was in default for not deducting TDS under section 195(1) of the 1961 Act.

It may be mentioned that we are not required to examine this question in the light of the impugned judgment because after the impugned judgment which was delivered on March 20, 2003, the Income-tax Act was amended on September 18, 2003, with effect from April 1, 1983. By reason of the said amendment, Explanation 2 was added to section 10(15)(iv)(c), which reads as under :

" Explanation 2.- For the removal of doubts, it is hereby declared that the usance interest payable outside India by an undertaking engaged in the business of ship-breaking in respect of purchase of a ship from outside India shall be deemed to be the interest payable on a debt incurred in a foreign country in respect of the purchase outside India."

On reading that Explanation 2, it is clear that usance interest is exempt from payment of income-tax if paid in respect of ship breaking activity. This amendment came into force only after the impugned judgment. It was not there when the impugned judgment was delivered.

For the aforestated reasons, question No. 2 as to whether the assessee was bound to deduct TDS under section 195(1) is answered in favour of the assessee and against the Department. The assessee was not bound to deduct tax at source once Explanation 2 to section 10(15)(iv)(c) stood inserted as TDS arises only if the tax is assessable in India. Since tax was not assessable in India, there was no question of TDS being deducted by the assessee. Therefore, question No. 2 is answered in favour of the assessee and against the Department.

Accordingly, the civil appeals filed by the assessee(s) are allowed and the civil appeal filed by the Department is dismissed, with no order as to costs."

4. From this judgement it is apparent that the Hon'ble Supreme Court has not reversed the decision in the case of CIT vs. Vijay Ship Breaking Corporation, 261 ITR 113 on merit but this decision has been reversed as the Assessee was engaged in ship breaking business and the Assessee had imported the ship for breaking in respect of which the Assessee had to incur the usance charges. The Hon'ble Gujarat High Court has taken the view that the usance charges are interest within the provisions of Sec. 2(28A) of the Income Tax Act and has accrued in India, therefore Sec. 195 was clearly applicable and Assessee has committed default by not deducting TDS. When the matter went before the Hon'ble Supreme Court, explanation (2) was inserted u/s 10(15)(iv)(c) by the Taxation Laws (Amendment) Act, 2003 with retrospective effect from 1.4.1962. This explanation reads as under :-

"For the removal of doubts, it is hereby declared that the usance interest payable outside India by an undertaking engaged in the business of ship-breaking in respect of purchase of a ship from outside India shall be deemed to be the interest payable on a debt incurred in a foreign country in respect of the purchase outside India."

5. From the reading of this explanation it is apparent that this explanation is applicable only in a case where an undertaking is engaged in business of ship breaking and usance charges are payable outside India by that undertaking in respect of purchase of a ship from outside India. The nature of the business of

the Assessee is not that of ship breaking. This explanation is applicable only to ship breaking activity, not to other activities. Therefore, in our opinion, explanation (2) to Sec. 10(15)(iv)(c) on which the ld. AR has heavily relied on, will not assist the Assessee. The nature of the usance charges has been discussed in detail by the Hon'ble Gujarat High Court in CIT vs. Vijay Ship Breaking Corporation, 261 ITR 113 (*supra*). Except to the extent that the Assessee was engaged in ship breaking business and due to insertion of explanation (2) to Sec. 10(15)(iv)(c), the Hon'ble Supreme Court allowed the relief to the Assessee but the Hon'ble Supreme Court did not reverse the finding of the Hon'ble Gujarat High Court in the case of CIT vs. Vijay Ship Breaking Corporation, 261 ITR 113 (*supra*) in which the Hon'ble High Court has clearly held that usance interest paid by the Assessee was not any part of the purchase price and was interest within the meaning of the definition of the term 'interest' u/s 2(28A). The usance interest was interest within the meaning of article concerning the taxation of the interest in the relevant Double Taxation Avoidance Agreement (DTAA). The Assessee being responsible for paying to the non-resident usance interest which was chargeable under the provisions of Income Tax Act was liable to deduct income-tax thereon u/s 195(1). If the Assessee did not deduct the tax at source u/s 195(1) of the Income Tax Act on the usance interest payable outside India and on which tax has not been paid, he was not entitled to deduct the amount of such usance interest in computing its income chargeable under the head 'profit and gains of business or profession'. The Tribunal was, therefore, wrong in deleting the disallowance u/s 40(a)(i).

6. The relevant findings of the Hon'ble Gujarat High Court are reproduced as under:-

> *"The definition of "interest" in section 2(28A) of the Income-tax Act, 1961, was inserted with effect from June 1, 1976, by the Finance Act, 1976. "Interest" means interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes any service fee or other charge in respect of the moneys borrowed or debt incurred or in*

respect of any credit facility which has not been utilised. The meaning of the word "interest" is thus very wide and would include interest on unpaid purchase price payable in any manner which would include by means of irrevocable letter of credit. The word "debt" is defined in section 2(c) of the Interest Act, 1978, inter alia, to mean any liability for an ascertained sum of money. According to the accounting standards, revenue from sale of goods is recognised when the seller transfers the goods to the buyer for consideration. Interest revenue is recognized on a time proportionate basis using the effective interest rate. The provisions of section 9(1)(v)(b) read with section 5(2) and section 4(1) and (2) of the Income-tax Act leave no room for doubt that the income payable by way of interest by a resident to a non-resident (which is not payable for the purpose of carrying on the business of such resident outside India or for earning income from any source outside India) would be deemed to have accrued or arisen to such non-resident in India, and will be part of his total income that would be chargeable to income-tax which shall be deducted at source or paid in advance when it is so deductible at source or payable in advance under the provisions of the Act. Even if the sum which was payable to the non-resident by the resident assessee is paid by the mode of releasing a letter of credit and received by the non-resident outside India from the negotiating/intermediary bank, such sum would be none the less income deemed to be accruing or arising to the non-resident in India. The letter of credit is a document issued by a bank as per instructions by a buyer of the goods, authorising the seller to draw a specified sum of money under specified terms, usually receipt by the bank of certain documents, within a given time. Acceptance by the seller of a commercial credit constituting absolute payment which would debar him from his ordinary right to pursue the buyer if the seller did not receive payment under the credit has to be expressed in clear terms in the absence of which the seller's rights against the buyer are not exhausted by the issue of credit. An irrevocable credit constitutes an independent contract between the issuing banker and the seller, and it is not qualified by or subject to the terms of the contract of sale or the contract between the issuing banker and the buyer. It is only a banking arrangement to effect payment and has nothing to do with the statutory obligations of the buyer which continue to bind the buyer in respect of the income by way of interest and other sums that are deemed to accrue or arise in India in favour of the non-resident seller. The buyer does not get absolved from his contractual liabilities under the contract of sale or from his statutory liabilities, such as, of making deduction of tax at source under section 195(1) of the Act while making payment by the mode of a letter of credit. The seller, in the absence of any contrary stipulations, accepts payment by the mode of a letter of credit on an understanding that the drafts drawn by him on the letter of credit will be honoured. Issuance of a confirmed irrevocable letter of credit is an assurance to him that he will get the payment for the goods sold by drawing on the letter of credit, but it would be only a conditional payment, the condition of its acceptance being that the amount will be realised on the basis of the credit released in his favour.

The Double Taxation Avoidance Agreements follow the pattern of the Organisation of Economic Co-operation and Development (OECD) Model Convention. The Model Convention has been used by the covenanting States as a basic document of reference while entering into such bilateral treaties. Such double taxation avoidance treaties are international agreements. Section 90 of the Act enables the Central Government to enter into such an agreement with the Government of another country, inter alia, for relief where income-tax is paid in both countries or for avoidance of double taxation. A formula reserving the exclusive taxation of interest to one State, whether the State of the beneficiary's residence or the State of source was not sure of general approval. Therefore, article 11 of the Model Convention concerning the taxation of interest adopted a compromise solution providing that interest may be taxed in the State of residence but leaves to the State of source of income the right to impose a tax, if its laws so provide, it being implicit in this right that the State of source is free to give up all taxation on interest paid to non-residents. Its exercise of this right will however be limited by a ceiling which its tax cannot exceed. The addition of the words "including interest on deferred payment of sales", in parentheses after the words "debt claim of every kind" in the Double Taxation Avoidance Agreements with Indonesia (reproduced in [1988] 171 ITR (St.) 27, at page 35) or words to the same effect in the Double Taxation Avoidance Agreement with Philippines is explanatory and makes explicit what is implicit in the phrase "debt claims of every kind", to prevent unnecessary arguments. Article 11 of the Double Taxation Avoidance Agreements with Singapore and article 12 of the Double Taxation Avoidance Agreements with the U. K. deal with "interest" and provide in clauses (1) and (2) that interest arising in a contracting State and paid to a resident of the other contracting State may be taxed in that other State. However, such interest may also be taxed in the contracting State in which it arises, and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other contracting State, the tax so charged shall not exceed the percentage of the gross amount of the interest specified therein. The term "interest" as used in these articles of the said two agreements means "income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits".

By the nature of its very setting, one has to construe the expression "manufacture or produce articles" in sub-section (2)(i) of section 80HH and the expression "manufactures or produces any article or thing not being any article or thing specified in the list in the Eleventh Schedule", appearing in section 80-I(2)(iii) in the context of the fact that the deduction under section 80HH is meant to encourage establishment of new industrial undertakings in backward areas when such industrial undertaking "has begun or begins to manufacture or produce articles" and in the context of the fact that section 80-I is designed to encourage industrial undertakings to manufacture or produce "any article or thing". The provisions of sections 80HH and 80-I are meant for the benefit of industrial

undertakings that carry out the activity of manufacture or production of articles or things and not for scrap merchants who trade in buying old articles or things and take out their parts to sell them separately. Merely because ship breaking is considered as an industry, it would not be an industry engaged in manufacture or production of any article or thing. The benefit of the provisions of sections 80HH and 80-I is clearly not intended for such ship breaking activities which do not result in bringing into existence any new article or thing. The word "manufacture" in the context of sections 80HH and 80-I of the Act would mean making articles or things. While dismantling the ship, steel plates are not made but only removed which is not the same thing as making steel plates. The word "production" in the context of these provisions would mean the action of making or manufacturing from components or raw materials an article or thing and not just removing an existing article or cutting it.

The assessee-firm was engaged in the business of ship breaking at Alang during the previous year relevant to the assessment year 1995-96. Two old and condemned ships were acquired by the assessee for demolishing purpose. One was purchased by the assessee from a London party under the memorandum of agreement dated March 15, 1993, for a total purchase price of the ship which was agreed at US $ 901252.98 calculated at the rate of US $ 184.5 per long ton of LDT. The ship had been manufactured in 1965 in Finland. In the memorandum of agreement, credit for 180 days usance period from the date of physical delivery of the vessel at safe anchorage Alang was agreed and the rate of interest was stipulated in para. 2 thereof flat at 6 per cent. per annum. The other vessel was purchased by the assessee from a Singapore party under the memorandum of agreement dated July 14, 1994, for a total purchase price which was agreed at US $ 3069416.5 calculated at the rate of US $ 166.06 per long ton. The ship had been manufactured in the U K. in 1969. Interest was stipulated to be paid at 7.25 per cent. from the date of notice of release for 180 days of usance period worked out on the purchase price of the ship. The total amount with interest was payable by confirmed irrevocable 180 days usance letter of credit with confirmation charges at seller's cost and acceptable to sellers through any nationalised Indian bank, to be established in favour of the sellers for the net amount by September 19, 1994. The Assessing Officer found that as per the terms of the memorandum of agreement, the assessee was making interest payment to the non-resident parties on account of credit facility availed of by it for the purchase of the ships. The Assessing Officer negatived the contention of the assessee that both the principal amount of the purchase price of the ship and the interest amount paid on the usance credit constituted the purchase price of the ship. The Assessing Officer disallowed the expenditure of usance interest payment under the provisions of section 40(a)(i) of the Act in respect of both the ships. In the same order, he considered the assessee's claim to deduction under sections 80HH and 80-I of Rs. 21,23,798 made on the ground that the assessee was an industrial undertaking engaged in the activity of manufacture. The Assessing Officer held that ship breaking would not constitute any

manufacturing activity. The Tribunal held that the purchase of a ship was a single transaction for which the agreement was entered into and although the purchase price of the ship and usance interest for 180 days from the date of the delivery/notice of readiness were separately mentioned in the memorandum of agreement, none the less it remained a single transaction of purchase and sale of the ship. The Tribunal concluded that the interest amount though separately mentioned in the memorandum of agreement and described as "interest" therein, partook of the character of the purchase price for the buyer and should be treated as purchase price. It held that the assessee was not liable to deduct tax at source from the payment of interest to the non-resident and hence, the disallowance of interest made under section 40(a)(i) was not warranted. It also held that ship breaking resulted in production of articles and amounted to manufacture, and that deduction should be allowed to the assessee under sections 80HH and 80-I. On further appeal to the High Court :

Held, (i) that the intention of the parties to the contract was clear and the price of the ship was considered to be separate as certified in the invoice, which reflected its price agreed in the memorandum of agreement, and the buyer in lieu of the credit facility of 180 days from the date of the notice of readiness was required to pay interest at the rate stipulated in the memorandum of agreement and worked out thereunder for which a separate invoice was prepared. There was no nexus between the interest amount and fixation of the price of the ship which was on tonnage basis. The nexus of interest was only with the period from which the purchase price of the ship became due on notice of readiness or delivery. The stipulation in the memorandum of agreement showed that the purchase price became payable on the delivery being effected as per the notice of readiness when the risk passed to the buyer. These were not cases where the total amount payable under the memorandum of agreement included a mere estimate of interest loss made as an integral part of the purchase price on incremental basis. These were cases in which there existed conscious and deliberate stipulations of purchase price of the ship and the interest amount specifically calculated at the agreed rate for the period fixed. Thus, there was no scope for contending that the outstanding price of the ship was not a "debt incurred" within the meaning of section 2(28A) of the Act or not a "debt claim" under the article concerning taxation of interest in the Double Taxation Avoidance Agreements, on the date of delivery or that the interest payable thereon under the contract was part of the purchase price or incremental price of the ship. The usance interest paid by the assessees was not any part of the purchase price of the ships and was interest within the meaning of the definition of the term "interest" under section 2(28A).

(ii) That the usance interest was "interest" within the meaning of the article concerning taxation of interest in the relevant double taxation avoidance agreements.

(iii) The assessee being responsible for paying to the non-residents usance interest which was chargeable under the provisions of the Income-tax Act was liable to deduct income-tax thereon under section 195(1).

(iv) That the assessee, which did not deduct tax at source under section 195(1) of the Income-tax Act on the usance interest payable outside India and on which tax had not been paid, was not entitled to deduct the amounts of such usance interest in computing its income chargeable under the head "Profits and gains of business or profession". The Tribunal was, therefore, wrong in deleting the disallowance under section 40(a)(i)."

7. From reading the decisions of the Hon'ble Supreme Court and the Hon'ble Gujarat High Court it is apparent that the Hon'ble Supreme Court has not reversed the decision in the case of CIT vs. Vijay Ship Breaking Corporation, 261 ITR 113 (*supra*) on the finding that the usance charges are not interest u/s 2(28A) except where an undertaking is engaged in the business of ship breaking in view of explanation (2) to Sec. 10(15)(iv)(c) inserted by the Taxation Laws (Amendment) Act, 2003 with retrospective effect. In our view, the decision of the Hon'ble Gujarat High Court has impliedly been approved by the Hon'ble Supreme Court in respect of Assessees who are engaged in the business of ship breaking. We, therefore, set aside the order of CIT(A) and allow the appeal of the Revenue.

8. In the result, all the appeals filed by the revenue stands allowed.

9. Order pronounced in the open court on 07.01.2015.

Sd/-	Sd/-
(D.T.Garasia)	(P.K. Bansal)
Judicial Member	Accountant Member

Place : PANAJI - GOA
Dated : 07/01/2015

A

Copy to :

(1) Appellant
(2) Respondent
(3) CIT concerned

(4) CIT(A) concerned
(5) D.R
(6) Guard file

True copy,

By order

Assistant Registrar
ITAT, Panaji Bench, Panaji