IN THE INCOME TAX APPELLATE TRIBUNAL
DELHI I BENCH, NEW DELHI
[Coram: Pramod Kumar AM and C. M. Garg JM]

I.T.A. No.: 5042/Del/11
Assessment year 2007-08

Mitsubishi Corporation India Pvt. Ltd ***…….Appellant***
5th floor, Birla Tower, Barahkhamba Road,
New Delhi 110001 [PAN:AAFCS1248E]

Vs.

Deputy Commissioner of Income Tax
Circle 6(1), New Delhi ***……Respondent***

Appearances by:
M S Syali and **Tarandeep Singh**,
alongwith Harkunal Singh, *for the appellant*
Sanjeev Sharma, **Peeyush Jain and Y K Verma**
alongwith Vivek Kumar, *for the respondent*

Date of concluding the hearing : September 4, 2014
Date of pronouncing the order : October 21, 2014

O R D E R

Per Pramod Kumar, AM:

1. This appeal is directed against the order dated 14th October 2011 passed by the Deputy Commissioner of Income Tax, Circle 6(1), New Delhi *(hereinafter referred to as 'the Assessing Officer')* under section 143 (3), read with section 144(C), of the Income Tax Act, 1961 *(hereinafter referred to as 'the Act'),* for the assessment year 2007-08.

Core issues in this appeal which require our adjudication

2. Although the assessee has raised as many as fourteen grounds of appeal, there are only two issues which really require to be adjudicated upon by us, i.e.,: (a) whether or not the arm's length price adjustment of Rs 68,15,17,853 under section 92C, is justified on the facts and in the circumstances of the case – *referred to in grounds of appeal nos. 1 to 4, and subsidiary grounds of appeal set out in these main grounds of appeal;* and (b) whether or not the disallowance of Rs 102,17,16,483 under section 40(a)(i) is justified on the facts and in the

circumstances of the case– *referred to in grounds of appeal nos. 5 to 11, and subsidiary grounds of appeal set out in these main grounds of appeal*. We will take up these issues in the same sequence.

Issue 1: Correctness of ALP adjustment of Rs 68,15,17,853

Background

3. So far as ALP adjustment of Rs 68,15,17,853 is concerned, the relevant material facts are like this. Mitsubishi Corporation India Pvt. Ltd. (**MCI**, in short) is a wholly owned subsidiary of Mitsubishi Corporation Japan (**MCJ**, in short) – one of the leading ***sogo shosha*** establishments in Japan. While 'sogo shosha', a Japanese expression, can be transliterated as a 'general trading' and sogo shosha companies are, therefore, generally described as 'general trading companies', the true connotations of sogo shosha companies are quite different from a typical general trading company as can be discerned from the TPO's observation, set out in the TPO order itself, to the effect that, **"……These** *(sogo shosha)* **companies <u>are unique in the world of commerce</u>, and play an important role in linking buyers and sellers for products ranging from bulk commodities, such as grain and oil, to more specialized products, like industrial equipment"** *(Emphasis by underlining supplied by us)***.** We will come back to the uniqueness of sogo shosha business model a little later, and deal with this aspect of the matter in more detail, but let us first complete setting out the relevant material facts as also the developments leading to this adjudication by us. Coming back to the TPO's order, Transfer Pricing Officer has, describing profile of the assessee, noted that, "**MCI is a wholly owned subsidiary of MCJ**….*(which)*… **is a general trading company and the group plays an important role in linking buyers and sellers for products in a variety of industry segments**" and that "**MCI is considered to be a low risk activity and the primary source of activity is in the nature of commission earned on the traded goods**". The Assessing Officer further noted that the assessee had entered into following transactions with its AEs in the relevant financial period:

Sl No.	Nature of transaction	Value of transaction (figures in Rs.)
1.	Provision for services	20,82,45,453
2.	Purchase of goods	99,61,04,689
3.	Purchase of capital goods	3,50,94,295
4.	Rent received	57,19,843
5.	Business Promotion	1,14,750
6.	Communication Expenses	1,00,17,241
7.	Membership and subscription	6,99,453
8.	Reimbursement of expenses	2,67,78,928

The proceedings at the assessment stage:

4. The Transfer Pricing Officer further noted that the assessee has used TNMM (Transactional Net Margin Method) as the most appropriate method, and that the PLI (profit level indicator) selected is 'Berry Ratio' which, as stated in the transfer pricing study, benchmarks gross profit and/ or net revenues (after subtraction of any potential cost of sales) against operating expenses. The assessee's claim was that since MCI's three year's average berry ratio is 1.19, whereas in the case of 22 comparables set out in the report, using three year data, the average berry ratio is 1.14 and adjusted average berry ratio is 1.13, the international transactions entered into by the assessee are at arm's length price.

5. The approach so adopted by the assessee was rejected by the TPO. The TPO was of the considered view that under rule 10B(4), the data to be used in comparability of an uncontrolled transaction with an international transaction shall only be of the related financial year, though an exception could be made out for data of two immediately preceding financial years only if such data reveals facts which could have an influence on the determination of transfer prices in respect of international transaction being compared. It was in this background, and supported by a detailed analysis of the legal position as also judicial precedents on this issue, the TPO rejected the use of multiple year data.

6. The TPO was also of the view that since the assessee has used berry ratio as PLI, entire international transactions relating to sales and service of commodities have remained out of PLI, and that, most importantly, the cost of sales is not included in the denominator of PLI used. The TPO was further of the view that the legal provisions, as set out in the Income Tax Act, 1961 or the

Income Tax Rules, 1962, do not permit the use of operating expenses in the base as these expenses do not include cost of sales. It was noted that under rule 10B(1)(e)(i), net profit margin realized by an assessee from an international transaction, entered into with AEs, is computed in relation to costs incurred, sales effected or assets employed by the assessee. The TPO contended that, as against non inclusion of cost of sales by the assessee, entire costs are included in computing margins in the cases of all the comparables, selected by the assessee, in the transfer pricing study. The TPO was further of the view that so far as service/ commission income segment is concerned, the right course of action will be to treat the same as equivalent to trading segment, because what the assessee has disclosed as service/ commission income is infact trading income. Accordingly, the cost of goods sold by the AEs, which was Rs 2927,92,05,406, was also to be included in cost base of / service/commission segment. The TPO also tinkered with the selection of comparables, but, for the reasons we will set out in a short while, it is not really necessary to deal with that aspect of the matter in much detail. The stand of the assessee to the effect that the assessee was "essentially in the business of providing sales support and coordination activities in relation to the international transactions" and that if FAR (functions, assets and risks) analysis of the assessee was to be analyzed , it will be akin to that of a service provider rather than that of a trader, did not find favour with the TPO.

7. As the Transfer Pricing Officer rightly noted, the main issue in this case is adjudication on the question "**whether ...***(the assessee)..* **is being adequately compensated**" for the functions performed by the assessee. The TPO then proceeded to analyze functions of the assets, risks assumed by the assessee and assets employed by the assessee. He noted that, as set out in paragraph 3.4 of the transfer pricing study, the assessee has provided the services for **(a) facilitating communication between buyer and seller; (b) arranging freight, insurance and custom clearance through third parties; (c) collecting market information; (d) identifying potential customers (in import transactions only) or suppliers (in export transactions only); and (e) advising an associated enterprise or third party in regulatory or**

financial matters. It was also noted that, as stated in the transfer pricing study, "**the presence of assessee in India provides AEs a medium of communication through which they can compete with their competitors eyeing similar business in India**". The TPO was of the view that "the assessee has performed all the critical functions, assumed significant risks and used both tangible and unique intangibles developed by it over a period of time". He then summarized the FAR analysis as follows:

Functions performed by the assessee:

- **Purchasing activities: Mitsubishi India places orders with related party vendors after receiving orders or projections from its customers**

- **Distribution activities: In some of the principal transactions, Mitsubishi India warehouses Inventory at public bonded warehouses and maintains sufficient Inventory as per agreement with customers. It performs Inventory control and ships goods to customers. Mitsubishi India's customers sometimes arrange for their own shipping and handling.**

- **Sales marketing and after sales activities: In principal transactions, the Group Companies coordinates in negotiating prices with Mitsubishi India's customers. Mitsubishi India's sales personnel requirements are Identified by Mitsubishi India and also remuneration of sales personnel is determined by Mitsubishi India. Mitsubishi India is responsible for billing and collection. Mitsubishi India provides market research relating to local market and develops marketing strategy.**
- **Identifying potential customers and suppliers.**
- **Information gathering.**
- **Facilitating communication**
- **Arrangement of logistics.**
- **Accounting and administration.**
- **Developing long term strategic policies.**
- **Dealing with finance, accounting, IT and legal issues.**
- **Human Resource Management:**

(b) risks assumed by the assessee:
- **bears volume risk**
- **bears foreign exchange risk**
- **bears manpower risk**

(c) assets used by the assessee:
- **Fixed asset**

8. The TPO did take note of the assessee's contention that AEs have assisted the assessee in so doing the business and in that sense even this trading is in the nature of a service to the AEs, but rejected the same on the ground that there is no evidence to indicate availability of technical capacity or manpower to the AEs, and that, in the absence of any credible evidences, such vague contentions cannot be accepted.

9. The Transfer Pricing Officer was of the considered view that "**in this case, the assessee has developed several unique intangibles which have given advantage to the AE in form of lower cost of the product, quality of the product and enhanced profitability of the AE**" but adequate compensation for these unique intangibles is not reflected in the compensation to the assessee. In other words, according to the TPO, these intangibles have increased profit potential of the AEs and the same should be reflected in increased margins to the assessee. These unique intangibles were stated to be (a) supply chain intangibles, and (b) human assets intangibles. As for the supply chain intangibles, it was noted that the MCJ is "one of Japan's leading sogo shoshas or general trading companies" which "deals in products ranging from bulk commodities such as grain and oil, to specialized equipment. It was noted that functions of the assessee included, apparently in the case of sourcing the goods, (1) identification of contacted manufacturer, (2) qualifying the contract manufacturer, (3) identifying appropriate source of goods, (4) warehousing the goods, (5) control over contracted manufacturer and quality control over manufacturing process, (6) scheduling of the product and order tracing, (7) packaging and labelling, (8) quality control, (9) consignment of goods,(9) consignment of the goods, (10) transportation of goods to the port of departure, and (11) random quality check prior to shipping. The TPO observed that "since risks largely follow functions, in this case the assessee has borne all the major risks association with the above referred functions" as also the following major business risks – single customer risk (because, as per contract, the assessee could not work for any unrelated customer), sourcing risk, risk associated with development and use of intangibles, risk associated with quality of service, and capacity utilization risk. The TPO was of the view that that "the assessee has

used its assets, including human assets (technical manpower) to discharge the functions referred to above". The TPO was of the view that "**the assessee has developed a supply chain management intangible over a period of time which is all about having the right product in the right place, at the right price, at the right time and in the right condition**". The supply chain management developed by the assessee, as per the TPO, is management of the link between organization and its suppliers as also customers to achieve strategic and pricing advantage, and this supply chain management, as developed by the assessee in India, was part of the global supply chain management of Mitsubishi group of companies. According to the TPO, it consisted of (a) knowledge of sub contractor, (b) knowledge of product and design, (c) knowledge of acquisition, (d) knowledge of distribution and supply, (e) knowledge of quality control, (f) knowledge of storage, and (g) knowledge of logistic involved in export of goods. The TPO was of the view that "**all these activities provided significant value added trade benefit and strategic advantage to the AE**" but "**the assessee was not allowed to share the benefit in cost plus arrangement**". The TPO also observed that, "admittedly, the assessee is in a business of sourcing which requires skilled manpower" and concluded, relying upon US Court of Appeal decision in the case of **Ithaca Industries Vs Commissioner of Inland Revenue [97 TC 253(1994)]**, that a workforce in place was also an intangible asset with ascertainable value. In the light of these discussions, as also an erudite discussion on the importance of human resources, the TPO concluded as follows:

> **5.3 I have carefully examined the compensation model in this case, and have noted that the assessee was allowed a very nominal markup (which does not include cost of development and use of intangibles) without allocating any profit component for development and use of unique intangibles by the assessee which has resulted in huge commercial and strategic advantage to the AE in the form of low cost of goods, high profit margin and assured timely supply of quality goods i.e. these intangibles have enhanced the profit potential of the AE, without any corresponding markup to the assessee. In the light of these facts, I am of view that cost plus model used by the AE is not the most appropriate method because it does not capture the compensation for the development and use of intangibles by the assessee. These facts lead to the irresistible conclusion that the remuneration model used in this case does not provide**

compensation to the assessee at the arm's length price as the model does not include compensation form development and use of intangibles.

10. It was also noted that as a result of transfer of manufacturing and procurement activities from high cost economies to a low cost economy like India, considerable locations savings have accrued to the AEs but the compensation model, which provides for a mark up on costs, does not take into account the benefits from the locational savings. As for the use of berry ratio, the TPO finally rejected the same for two main reasons – first, that the scheme of section 10B(1)(e)(i) does not permit the same, and – second, that berry ratio is unsuitable for the situations involving unique intangibles (like supply chain intangibles and human assets intangibles) and since it is highly sensitive to the costs and the treatment of costs may vary from accounting policies in different comparables and it is difficult to make appropriate adjustments in respect of such variations in accounting treatment. The TPO was of the view that berry ratio is *de facto* cost plus method, as accepted in one of the observations made by Charley H Berry, author of this ratio, himself – which was reproduced by the TPO, the assessee cannot resort to the use of this ratio when the assessee has consciously chosen the TNMM as most appropriate method.

11. It was in this background, and having arrived at an arithmetic mean of 2.49% in respect of the OP/OE in respect of finally selected comparables (i.e. Frost International Limited, Cottage Industries Exposition Ltd, General Commodities Pvt Ltd, Kotak Ginning and Pressing Industries Limited, PKS Limited, Sakuma Exports Limited, and Euro Vista India Limited), that the TPO finally concluded as follows:

8. Calculation of arm's length price

Based on above, it is concluded that the assessee has not been able to substantiate its arguments with valid documentary evidences. Following the discussion in the preceding paras, the FOB value of goods sourced from India, being Rs.2,910,000,000 shall be taken as part of the cost base to calculate the remuneration of the assessee. Computation of arm's length profit for the combined AE segment

(computation of profit of AE segment is attached as Annexure 1) is given below :

Cost base of AE segment (AE-service segment + AE-trading segment) (A)	**29,506,838,234**
Mean of OP/TC of comparables (Arm's length OP/TC): (B)	**2.49%**
Operating profit reported: (C)	**53,202,419**
Arm's length profit (D)=(A)X(B)	**73,47,20,272**
Difference to be adjusted= D-C	**68,15,17,853**

The difference of Rs.68,15,17,853 is to be adjusted to the value of international transitions for the FY 2006-07. The assessing officer shall enhance the income of the assessee by Rs.68,15,17,853. The Assessing Officer may examine issue of initiation of penalty u/s 271(1)(c) of the Act in accordance with Explanation 7 of the same.

No adverse inference is drawn in respect of other transactions undertaken by the assessee during FY 2006-07. The assessee was given adequate opportunity including oral hearing as per details at Col.7 at Page 1 of this order

12. Aggrieved with the ALP adjustment of Rs 68,15,17,853 consequently proposed by the Assessing Officer, on the basis of the TPO's order, assessee carried the grievance before the Dispute Resolution Panel but without any success. Accordingly, the Assessing Officer framed the assessment by making addition in respect of, inter alia, this ALP adjustment. The assessee is not satisfied and is in appeal before us.

13. We have heard the rival contentions on this transfer pricing dispute, perused the material on record in respect of the same and duly considered factual matrix of the case as also the applicable legal position. Shri M. S. Syali, Senior Advocate, alongwith Shri Tarandeep Singh, appeared for the assessee and Shri Peeysh Jain and Shri Y K Verma, Commissioner – Departmental Representatives, appeared for the revenue.

The position in the immediately preceding assessment year- views of the coordinate bench:

14. We must begin by taking note of the fact that an identical adjustment, so far as buy-sell segment is concerned, made by the Assessing Officer in the assessee's own case for the immediately preceding assessment year, had come up for consideration before a coordinate bench of this Tribunal, and the coordinate bench, vide order dated 23rd August 2013 *(now reported as **63 SOT 162**),* has remitted the matter back to the assessment stage by observing as follows:

> **10. The second ground of the assessee is on the issue of transfer pricing adjustment. The nature of assessee's business as described in the DRP order is to undertake (sogo shosha) activities i.e. role of a trade intermediary. The purchases are made by the assessee are recorded as such in its books of accounts and there after when sold, the sales recorded as such. The title in the goods is held by the assessee for some time. The assessee deals on a principle to principle basis. Though it is claimed that it is intermediary activities, in our view, the activity cannot be bracketed with the activity of a commission agent or a broker. In our view the activity in question is akin to trading activities. Thus we uphold these findings of the revenue authorities.**
>
> **10.1. Having held so, as pointed out by both the parties, the comparables in its case have not been selected keeping in view the functional profile of a trading organization. Both the assessee as well as the Assessing Officer have bench marked the transactions by using comparables which have a functional profile of a service provider. Such an exercise cannot be sustained.**
>
> **10.2. Thus, as submitted by both the parties, the issue is set aside to the file of the Assessing Officer for fresh adjudication in accordance with law. As fresh comparables have to be found, the assessee would be at liberty to conduct a fresh T.P. study and file additional evidences/comparables before the A.O./T.P.O. for his consideration. The T.P.O. would also be at liberty to conduct fresh search and come out with his list of comparables, if any, and dispose of the issue de-novo, in accordance with law. With these observations this ground is allowed for statistical purposes.**

The position in the immediately preceding assessment year- esteemed views of Hon'ble High Court:

5. The views so expressed by the coordinate bench were challenged by the assessee before Hon'ble Delhi High Court, and upholding the stand so taken by

the coordinate bench- though with a clarification, Hon'ble Delhi High Court, vide judgment dated 4th July 2014 [now reported as **48 taxmann.com 45 (Del)**], has observed as follows:

> **7. The international transactions reported by the appellant are of four kinds; services, commission, cost to cost reimbursement as well as from sale of products imported from the Associated Enterprise. While, there is no dispute as to the international transactions resulting in receipts as commission and cost to cost reimbursement for rendering service, the assessee seriously contests the addition made on account of transactions of sale and purchase of goods. The assessee is aggrieved by the margin of 19.6% being applied with respect to transactions of sale and purchase.**
>
> **8. It was submitted by the learned counsel that its functional profile was not that of a trader but that of a service provider. It was explained that the assessee places orders for purchase with its parent company on the basis of confirmed orders from its customers. It was submitted that in substance the assessee only front ends the transactions of its parent company. The assessee is, thus, not exposed to the risk of carrying any inventory and/or deploying any significant working capital. Accordingly, it was claimed by assessee that the cost of goods sold should not be taken into consideration while computing the profit margins which should be calculated on the operating costs and the appropriate ratio to be considered for comparing with other entities would be the ratio of net revenue to operating costs.**
>
> **9. The said contentions had also been advanced by the assessee before the ITAT. In the alternative, the assessee had submitted, before the ITAT, that if the transactions of buying and selling were considered to be trading then the ALP should be determined in comparison with companies which were similarly situated.**
>
> **10. The Tribunal had considered the submissions of the assessee and held as under:—**
>
>> **"10. The second ground of the assessee is on the issue of transfer pricing adjustment. The nature of assessee's business as described in the DRP order is to undertake (sogo shosha) activities i.e. role of a trade intermediary. The purchases are made by the assessee are recorded as such in its books of accounts and thereafter when sold, the sales recorded as such. The title in the goods is held by the assessee for some time. The assessee deals on a principle to principle basis. Though it is claimed that it is intermediary activities, in our view, the activity cannot be bracketed with the activity of a commission agent or a broker. In our view the activity in question is akin to trading**

activities. Thus we uphold these findings of the revenue authorities."

11. It is apparent from the order of the ITAT that the ITAT had concluded that the transaction entered into by the assessee work on principal to principal basis and that the activities were in the nature of trading. Accordingly, the ITAT has held that the activities undertaken by the assessee could not be classified as activities of a commission agent or a broker. It is not disputed that the transactions of purchase and sale between the assessee and Mitsubishi Corporation are done on a principal to principal basis. We find no infirmity with the reasoning of the ITAT that such transactions are akin to trading and cannot be considered activities of a commission agent or a broker. However, the learned counsel for the assessee has expressed his apprehension that in view of the findings of the ITAT, the assessee is likely to be treated as an ordinary trader and compared with other traders who may not be similarly situated. We do not find any ground for such apprehension as the ITAT has made it clear that appropriate comparables would have to be considered for determination of the ALP. <u>This would obviously mean that entities which are similarly placed as the assessee including in respect of their functional and risk profile as well as working capital exposure would be chosen as comparables</u>.

12. We accordingly find no reason to interfere with the order of the Tribunal. <u>The appeal is accordingly dismissed with the above clarification.</u>

(Emphasis by underlining supplied by us)

<u>Rival contentions:</u>

16. Learned counsel points out that so far as assessment year 2006-07, in respect of which the above decisions were rendered, the dispute was confined to the trading transactions. In the assessment year before us, however, the assessee has undertaken two types of transactions, i.e. – (a) service/ commission transactions, in which MCI has acted as a mere facilitator for transactions; and (b) trading/ buy sell transactions, i.e. where assessee takes flash title of the goods momentarily while buying the goods against confirmed orders and then selling the same to third parties. As regards service/ commission transactions, the assessee collects information such as market data and financial conditions of such entities, and these activities are carried on by the assessee based on broad strategies and guidelines provided by the AEs. These are the activities, according to the learned counsel, in which functions

and risks are minimal. As regards the trading transactions, the assessee enters into transactions on principal to principal basis with AEs as also non AEs but as the assessee takes flash title of the goods only momentarily and buys goods based on confirm back to back orders, the value addition, even in buy sell segment, is akin to that of service or commission segment. Learned counsel's basic argument is that even though the above issue is now covered to the limited extent that trading activities carried out by the assessee are to be treated as normal trading, as against akin to agent's function claimed by the assessee, and that the matter requires to be reconsidered at the assessment stage for finding suitable comparables, there is a clear observation by the Hon'ble High Court to the effect that the comparables should be such entities which are similarly placed as the assessee in all material respects, including functional and risk profile as also working capital exposure. It is also pointed out that sogo shosha activities are not trading activities *simplictor*, even if these are to be treated as trading activities, and these activities constitute a unique business model. It is pointed out that though the assessee did seek working capital adjustment and adjustment on account of risk profile and other significant variations in the assessee vis-à-vis the selected comparables, the DRP has declined the same. Learned counsel then submits that in the immediately preceding assessment year, there is no adjudication on the relevance of berry ratio as a profit level indicator (PLI), as has been adopted by the assessee. Our attention is invited to the fact that the authorities below have duly accepted the uniqueness of business model of the assessee group and made elaborate observations to the effect that it is a low risk and high volume business model. When this is the admitted position, and it is also not in dispute that it is a case of back to back trading with no inventory risks involved, according to the learned counsel, there cannot be any justification for including the cost of inventories in PLI computation. It is submitted that the PLI adopted by the assessee, i.e. berry ratio, takes care of this critical aspect. It is pointed out that, for all these reasons, berry ratio is the most appropriate PLI in the present case particularly as, beyond any doubt or controversy, assessee does not carry any inventory risk and its actual financial risk is confined to the operating costs minus inventory costs, i.e. operating expenses. Learned counsel

relies upon the literature filed by the assessee, in support of the relevance and utility of berry ratio on the facts of this case, and contends that its usage is most appropriate to the facts and circumstances of this case. In the kind of peculiar activity that the assessee is involved in, it would be, according to the learned counsel, wholly irrelevant to take into account, in computing the PLI, the cost of goods sold or value of goods sold. Learned counsel then points out that the reasons assigned for rejecting the berry ratio are not legally sustainable. He submits that it is incorrect that use of berry ratio is not permitted under rule 10B(1)(e)(i) as there is no specific prohibition on use of berry ratio, and that since the so called unique intangibles on account of supply chain and human assets are pure figments of imagination of the TPO and these vague allegations cannot restrict the use of berry ratio. Learned counsel submits that there is nothing unique about these intangibles of supply chain and human assets, as anyone engaged in trading will have a vendor development and the human resources taking care of this aspect of the matter. He points out that the intangibles, in order to be taken into account for profitability of the assessee on trading with its AEs, should be unique intangibles, not present in the business of the comparables, owned by the assessee and not the AEs. He also points out that as regards the berry ratio being unworkable due to variations in accounting policies, no specific issues are raised by the TPO and that his remarks are nothing but vague and sweeping generalizations. He thus urges us to hold that the use of berry ratio as a PLI is appropriate to the peculiar cases for sogo shosha companies which, even though treated as trader, donot carry any inventory risk.

17. It is then pointed out that, in any event, the TPO's action in including FOB value of goods sold/ purchased by the AEs, on which commission has been earned by the assessee, in the cost base of the assessee is directly contrary to the law as now clarified by Hon'ble Delhi High Court in the case of **Li & Fung India Pvt Ltd Vs CIT (361 ITR 85)** and to the stand taken by the coordinate benches of this Tribunal in the cases of **DCIT Vs Cheil Communications India Pvt Ltd (137 TTJ 539)** and **Sojitz India Pvt Ltd Vs DCIT [24 ITR (Trib) 274]**. In these cases, according to the learned counsel, it is held that costs of the AEs

cannot be taken into account while computing OP/TC of the tested party under indent/ commission/ service transactions. We are thus urged, so far as this segment is concerned, to give specific directions to the effect that the costs borne by the AEs with respect to the sales are to be excluded from the cost base of the assessee. It is the submitted that the TPO has made some factually inaccurate comments, based on pure surmises and conjectures, with respect to alleged ownership of supply chain management intangibles and human assets intangibles. It is submitted that these intangibles are figments of his imagination of the TPO and the onus is on the revenue authorities to show, based on material on record, that these intangibles exist. It is submitted that the assessee was not even put to notice, in the proceedings before the TPO, in respect of these inferences. It is further submitted that there is no basis for TPO's coming to the conclusion that profit on account of location savings ought to have been taxed in India and that the compensation model of the appellant did not include profit attributable to the assessee due to locational savings. It is further contended that despite the assessee having raised grievances against these findings before the Dispute Redressal Panel, the DRP has not at all adjudicated on these grievances. This issue is also now, according to the learned counsel, covered in favour of the assessee inasmuch as in the case of **Li & Fung India Pvt Ltd** *(supra),* Hon'ble High Court has rejected similar contentions, which were also raised without any cogent material to support the same, raised in that case. In any event, as per provisions of Section 92 C(3) r.w.s. 92CA(1), the TPO can determine the ALP of a transaction only when there is any material nor information so as to satisfy fulfilment of conditions set out in 92 C(3) (a) to (d). In support of this proposition, reliance is placed on a decision of the coordinate bench in the case of **Mentor Graphics Vs DCIT (18 SOT 76)**. It is thus urged that while the matter can indeed be remitted to the file of the Assessing Officer, clear directions need to be given in the light of the settled legal position as set out above and treating the commission and service fee segment as per the settled legal position.

18. Learned Departmental Representative, on the other hand, relied upon the orders of the authorities below and took us through the same. He contended

that since the matter in the immediately preceding assessment year has been remitted to the file of the Assessing Officer for fresh consideration and there is no reason to give a different treatment in this year, he has no objection to the matter being set aside to the file of the Assessing Officer. It was further submitted that now that a coordinate bench has given a categorical finding, which has been affirmed by Hon'ble jurisdictional High Court as well, to the effect that the assessee is required to be treated as a trader for the purpose of transfer pricing benchmarking, there cannot be any legally sustainable reason to treat the assessee as a service provider or agent for the same activity. It is also submitted that whether the assessee shows the goods sold in its inventory or not, the actual business carried on by the assessee is of the trading, and, accordingly, the costs of the goods, even if borne by the AE, is required to be included in the cost base. It was also submitted that this aspect of the matter is a purely factual matter and, as such, judicial precedents have limited role to play in deciding whether or not, on the facts of a particular case, the costs borne by the AEs can be included in the OP/TC computation. Whether it is a situation in which flash title of the goods has changed for a short while or not, the nature of business activity remains the same. As regards the use of intangibles, learned Departmental Representative relied upon the observations made by the TPO and justified the same. It was thus submitted that delivery supply chain management and human assets are important intangibles and the assessee's compensation model, which clearly does not take account adequate compensation for developing these intangibles, cannot be accepted as an arm's length price for the services rendered by the assessee. Learned Departmental Representative contends that all these issues, as being raised by the assessee now, are indeed open issues which can be agitated before the TPO and that there is no need for any further directions beyond the directions given by the coordinate bench in the immediately preceding assessment year. We are thus urged to follow the orders of the coordinate bench, in letter and in spirit, and to remit the matter to the file of the TPO for adjudication *de novo* in the light of the observations made in the said order.

19. Learned counsel for the assessee, in his rejoinder, submitted that the subject matter of adjudication before us travels much beyond what was adjudicated in the preceding assessment year, that there is benefit of guidance available on legal issues from the Hon'ble Courts above as also by the coordinate benches, and that, therefore, simply remitting the matter to the assessment stage will result in inordinate delays in resolving the core dispute. It is also submitted that now that we are *in seisin* of the matter, and it is clearly discernible that perceptions of the parties on some peripheral key issues do not have any meeting ground, the right course will be to give specific directions in the matter so as the assessment reaches finality sooner rather than later.

Our analysis:

Disparities in facts of the immediately preceding assessment year and the assessment year before us:

20. We find that, as learned counsel rightly points out, so far as the decision for the assessment year 2006-07 is concerned, it is confined only to the trading activities of the assessee and it does not deal with service fee/ commission segment. As the coordinate bench itself has observed in so many words, the activity in question pertains to the situation in which "**purchases are made by the assessee are recorded as such in its books of accounts and thereafter when sold, the sales recorded as such**" and in which **"title in the goods is held by the assessee for some time".** These are the transactions in which assessee dealt with the parties **"on a principal to principal basis"**. Hon'ble High Court has also take noted of the fact that **"it is not disputed that the transactions of purchase and sale between the assessee and Mitsubishi Corporation are done on a principal to principal basis"**, and, therefore, **"we find no infirmity with the reasoning of the ITAT that such transactions are akin to trading and cannot be considered activities of a commission agent or a broker".** Clearly, therefore, this could not have been a reference to the situation in which the assessee has merely acted as a facilitator, the sale transaction is not on principal to principal basis, and the assessee has received only a commission or service fee for that activity. As a matter of fact, the

Transfer Pricing Officer himself has, as noted in paragraph 11 earlier in this order, referred to these two segments distinctly as 'AE- trading segment' and as 'AE-Service segment'. To that extent, facts of the assessment year before us are a little different vis-à-vis the facts of the immediately preceding assessment year which were before the coordinate bench.

The nature of assessee's trading activity:

21. We have also noticed that even with respect to the trading transactions, which were claimed by the assessee to be in the nature of a service rather than a trading activity, Hon'ble Court has taken note of assessee's apprehension that the assessee may be "**treated as an ordinary trader and compared with other traders who may not be similarly situated"** and clarified that the assessee will only be compared with such entities **"which are similarly placed as the assessee including in respect of their functional and risk profile as well as working capital exposure would be chosen as comparables".**

22. The Transfer Pricing Officer himself has, at page 2 of the order, set out the profile of the MCJ, the holding company, and MCI, the assessee before us, as follows:

> **2.2 Profile of the Group**
>
> **Mitsubishi Corporation ("MC") is one of the Japan's leading sogo shoshas or general trading companies. These companies are unique in the world of commerce and play an important role in linking buyers and sellers for products ranging from bulk commodities, such as grain and oil, to more specialized products like industrial equipment.**
>
> **'Sogo' means general and 'shosha' is a trading company, hence the sogo shosha handle a wide range of products. They are characterized firstly by colossal sales, secondly by diversity of goods traded (from noodles to missiles), engage in both import and export with every major market in the world, and thirdly by global reach of their network**
>
> **2.3 Profile of Mitsubishi India**
>
> **MCI is wholly owned subsidiary of MCJ. MCJ is a general trading company and the group plays an important role in linking buyers and sellers for products in a variety of industry segments. MCI is considered to be a low**

> **risk activity and the primary source of activity is in the nature of commission earned on the traded goods.**
>
> *(Emphasis by underling supplied by us)*

23. A plain look at the above analysis of profiles shows that even the TPO does not dispute that (a) MCI is a low risk activity in the field of trading, (b) MCJ group is primarily involved in high volume sales, or 'colossal sales' – as TPO's profile analysis puts it, of a wide range of merchandise; (c) MCJ, following the sogo shosha business model, has global network and MCI is a part of this network. The low risk high volume business model of the assessee is thus not even in dispute. It is also not the case of the revenue that the assessee is only playing an assigned role in linking the buyers and sellers and is not engaged in the sogo shosha activity as a whole. As a corollary to this accepted position, the unique intangible of sogo shosha business model, even if that can be treated as a unique intangible asset, belongs to the MCJ group and not the MCI individually. That aspect of the matter will be particularly relevant as we deal with adequacy of compensation, for the use of unique intangibles of supply chain management, a little later in this order.

Our understanding of 'Sogo Shosha' activities

24. The assessee thus plays an assigned role, which is essentially a support function, in the core sogo shosha activity of the parent company MCJ. While sogo shosha is a Japanese expression which means, when translated literally, a general trading company, in business parlance a sogo shosha is something much more than a general trader. As the TPO himself has rightly noted, sogo shosha is a unique business model in the world of commerce. As a corollary to this observation, it is an admitted position that a sogo shosha cannot be equated with a general trading company in all material respects. Sogo shosha has been described as follows at www.referenceforbusiness.com :

> **A sogo shosha is a form of industrial organization and a kind of vertically integrated trading company that originated in Japan and for the most part has remained unique to Japan. At the center of these organizations is a trading company that arranges financing, coordinates activities, and handles marketing functions for the companies in its group of companies. These subordinate companies may be considered operating companies, because they specialize in**

certain types of business. Since World War II, Japan has emerged as one of the dominant world traders in part because of the sogo shosha.

While the term *sogo shosha* is Japanese for "general trading company," the term generally refers to the entire group of operating companies that comprise the conglomerate or sogo shosha. Unlike typical Western trading companies and Japan's some 9,000 other trading companies, the sogo shosha are distinguished by their international networks, their trade of numerous commodities, and their large market shares. For example, a sogo shosha may control about 10 percent of Japan's trade, handle a range of 10,000 to 20,000 products including food, clothing, automobiles, and appliances, and have a network of over 200 offices throughout the world. Although developing and industrial countries have experimented with the sogo shosha system, few, if any, have succeeded in completely replicating the Japanese organization. The major sogo shosha include Mitsubishi, Mitsui, C. Itoh, Sumitomo, Marubeni, Nichimen, Kanematsu-Gosho, and Nissho Iwai Corp. In the late 1990s the sogo shosha controlled about 10 percent of the world's exports and over 50 percent of Japan's overall trade, according to *Marketing Intelligence and Planning.*

The sogo shosha are also characterized by their ability to issue large volumes of credit and to help small manufacturers buy and sell goods in the global market. These trading companies serve as intermediaries for distribution at home and abroad for Japanese companies. Nevertheless, the sogo shosha's responsibilities extend beyond trading because they take active measures to ensure stable levels of supply and demand over long periods. In addition to their ability to make the greatest use of the marketing intelligence network, the sogo shosha work on extremely thin margins, commonly little more than 1.5 percent. It is therefore necessary for these companies to maintain very high sales volumes and remain focused on long-term business development.

25. In a book titled '**Japan's Sogo Shosha and the Organization of Trade**' (authored by Prof M Y Yoshino, a Harvard Business School Professor, and Thomas B Lifson, an Associate in US Japan Relations Program in Harvard University; published by MIT Press – ISBN 978-0262240253), Sogo Shosha is explained as follows:

A sogo shosha is like no other type of company. It is not defined by the product or even by the particular services it performs, for it offers a broad and changing array of goods and functions. Its business goals are equally elusive, for maximisation of profits from each transaction is clearly not the major goal, either at operational or philosophical level. There are really no other comparable firms, though the Governments in United States and elsewhere have become convinced that there should be.

.....

These huge Japanese companies *(names are set out, including that of the assessee's parent company)* **.....share pattern of business strategy, operations and organization that are very different from those of other types of business firms. Defining their business is an elusive goal, for their activities donot fit into any of the conventional categories. They could be called commodity traders, wholesalers,**

bankers and manufacturers, miners, venture capitalists and many other labels but none of these conveys a true picture of the substance of their activities.

26. There could indeed be somewhat varying perceptions on the precise connotations of 'sogo sosha' as a business model, and, as Prof Yoshino, in his above mentioned book, states at page 3, "**Even in Japan, the sogo shosha is indeed regarded as a mysterious entity, difficult to know about or understand but universally acknowledged as a powerful force in the economy**", but one common thread in all descriptions of 'sogo shosha', whatever be the source, is sheer complexity of its business model, range of its activities and integrated link it provides between the buyer and seller. When such is the description of the core business activity of the MCJ, and the role of the assessee is restricted to a support function by way of a trading, as it is held to be, this kind of a trading, as assessee is held to have carried out, cannot be equated with activities of a normal trader. If there is no parallel to sogo shosha as a business model, there cannot obviously be a parallel to trading activity under this business model.

27. No doubt that the assessee before us, i.e. MCI, is playing only a small role of linking the buyers with sellers, either as a service activity or even as a trader, but the importance of the activity of sogo shosha being pursued by the group lies in the admittedly lower trading margin that sogo shosha trading operates on and in relatively lesser importance of the trading activity in overall scheme of a complex interdependent set of sogo shosha business activities. When the operating margin in the sogo shosha are typically characterized by "extremely thin margins", it is a natural corollary thereto that even the support trading function carried on by the assesse, i.e. MCI, will have lower margins than the usual margins in typical business of trading *per se*.

<u>Vital dissimilarities between a normal trader and sogo shosha</u>

28. In case we are to apply normal PLI of operating profit to operating costs (including inventory costs) or operating profit to sales, every comparable which is picked up for comparing trading activity of the assessee, which is admittedly

an integral part of sogo shosha activities of the MCJ group, will, therefore, have its inherent limitations because functional profile of the assessee's trading activity is, and cannot be, the same as that of the comparables. It is, therefore, important to find out a way, by selecting the appropriate profit level indicator, to eliminate this critical difference between sogo shosha activity of the assessee and any other trading activity that the comparables may have. As a matter of fact, it is the level of inventory which is crucial factor in determining the kind of trading activity an assessee has carried out. In this context, we may usefully refer to a recent notification, in which CBDT has defined wholesale trader with reference to, *inter alia*, its monthly inventory level being less than 10% and prescribes a lower tolerance range at one third the level of normal tolerance range. Of course, this notification is in the context of tolerance range, prescribing lesser tolerance range for the whole traders implying that the margin of profits for wholesalers must move in a lower range which can only happen when margins are also lower vis-à-vis margins in wholesale trading, but this also indicates that lower inventory levels lead to lower inventory risks and generally resultant lower profit levels also. There is thus a direct relationship between the normal inventory levels and the normal profitability.

29. It is beyond dispute and controversy that the comparables carrying on the trading activity similar to assessee group's trading activity are difficult to find. Here is a case in which true comparables are difficult, or almost impossible, to find and, therefore, a way is to be found to find such comparison meaningful by adopting a profit level indicator which ignores the impact of vital dissimilarities in inventory levels between the assessee and the comparables. We will deal with this aspect of the matter a little later.

Impact of Hon'ble High Court's directions on comparability adjustments between a normal trader and sogo shosha

30. We are alive to the fact that, in the immediately preceding assessment year, decision of the Tribunal was against the assessee on this issue inasmuch reconsideration of functional profile of the assessee was specifically rejected in

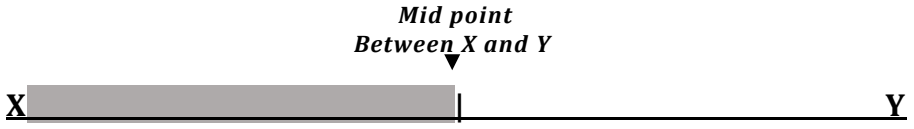
the order dated 4th April 2014 passed by the Tribunal, on rectification petition filed by the assessee. However, we have also noted that Hon'ble High Court, in order dated 4th July 2014, have construed Tribunal's observations to the effect that "**appropriate comparables would have to be considered for determination of the ALP**" as implying that "**entities which are similarly placed as the assessee including in respect of their functional and risk profile as well as working capital exposure would be chosen as comparables**" which essentially involves reconsideration of profile of the assessee vis-à-vis the profile of comparables, and making such adjustments in the comparables as may be warranted due to variations in these profiles.

31. As there has been no adjudication on the suitable profit level indicator, including on account of taking care of vital dissimilarities between the tested party and the comparables, in the immediately preceding assessment year, that aspect of the matter is still open for examination by this forum. Additionally, when profit level indicator is such that the impact of FAR analysis dissimilarities in question can be meaningfully controlled, even these dissimilarities will not have significant impact on the outcome of comparison.

Trading activities Vs Activities akin to trading activities

32. As a matter of fact, the finding of the coordinate bench, in respect of immediately preceding year, is that activity of the assessee **"cannot be bracketed with the activity of a commission agent or a broker"** and that it **"is akin to trading activities".** Obviously, a trading activity can only be a trading activity and not "***akin to"*** trading activity. The appropriate adjustments, therefore, will have to be necessarily made in the comparables, vis-à-vis functional profile of the assessee, even when comparables are in respect of trading activity. It is important to bear in mind the fact that the finding that the activities of the assessee are "akin to trading" was given in the context of question before the bench as to whether the activities were in the nature of trading or in the nature of commission agent. If trading activity and commission agent activity are two ends of a broad spectrum of activities dealing in goods and commodities, and these ends are plotted by mark X and mark Y, sogo shosha

activity, is somewhere between these two extremes and between the point X and point Y. The location of this point, as implicit in coordinate's bench observation that sogo shosha is akin to trading and it cannot be bracketed with commission agent or broker, is closer to point X. There can be no dispute with this proposition at this stage; that is an uncontroverted finding of fact. This can be shown in the following way:



(If X is trading and Y is commission agency, as held by the Tribunal in immediately preceding assessment year, Sogo shosha is in the shaded area above- somewhere between X and Y but before the midpoint, i.e. closer to X rather than with Y)

33. Yet, clearly, there is still a difference between normal trading and sogo shosha trading, and one vital aspect of this difference is that in the present sogo shosha trading there are no inventories at all. Any comparison exercise, which takes into account the impact of inventories or cost of inventories, will, therefore, end up making the comparison useless.

Does zero inventory level affect exclusion of cost of inventories in PLI determination

34. Once it is not in dispute, as is the position in that case, that the trading activity involved carried on by the assessee is a back to back operation, without any value addition to inventories or without any functions performed on the inventories, and is, that sense, without any risks associated with inventories, the cost of inventory being included in the cost base of the assessee cannot be justified on the economic principles, even as this cost of sales may have to be entered into books of accounts in compliance to the accounting principles and accounting standards.

35. In the cases in which no economic risk for inventories is assumed, in which these inventories do not even find their way to the current assets, and in which no functions are performed in respect of these inventories, except to facilitate trading in respect of the same, the very raison d'être for the cost of inventories being included in the cost base ceases to exist. The FAR analysis set

out in the TPO's order, which is summarized in paragraph 7 earlier in this order, does not support the inclusion of inventory costs in the cost base either.

Conflict of accounting and legal principles with economic principles

36. However, there does seem to be an incongruity in the sense that, on one hand, cost of sales is accounted for in the books of accounts, and yet this cost is being sought to be excluded from the profit level indicator analysis. This exercise of excluding cost of inventories from profit level indicator analysis does indeed seem to be running contrary to the accounting treatment. The question then arises that while under the accounting principles, cost of goods sold is to be accounted for in the books of accounts, can its exclusion in the PLI computation model be justified on the economic principles.

37. The determination of ALP is an exercise based on economic principles and even if there is a conflict in economic principles and accounting principles, so far as determination of arm's length price is concerned, the accounting principles have to make way for economic principles.

38. The reason is not difficult to seek. While accounting principles primarily contribute the financial information inputs and mechanism for financial analysis, economic principles lay down the foundational principles on the basis of which such inputs and mechanism are to be used in transfer pricing analysis. The very fundamental economic concept, which is foundation for the arm's length price determination, is that all business entities, irrespective of their inter se relationship, should make profit from a transaction and such a profit should be commensurate with "functions performed, risks assumed and assets utilized". This exercise, by definition, cannot exalt the accounting entries to a status that these accounting entries, *dehors* the FAR analysis, determine the arm's length price. Whatever be the call of accounting and legal principles, once we come to the conclusion that cost of inventories is not a material factor so far as FAR analysis is concerned, it is wholly justified to exclude the cost of inventories in formulae adopted for the ALP determination.

39. That exclusion, however, proceeds on the assumption that there is a vital nexus between inventory levels and profitability.

Economic nexus between inventory levels and profitability

40. The fact that there is a clear relationship between the inventory levels and margin levels is also evident from the stand taken by the CBDT that where inventory levels are 10% of turnover or less, the permissible tolerance range is much less at 1/3 of permissible range where the inventory levels are more than 10% of the turnover. On economic principles, profit is reward for the functions performed, assets employed and risks assumed, and, going by that principle, for the same functions of trading performed, when assets employed are lesser and risks assumed lower, the profit reward should also be correspondingly lower. In the case of the assessee before us there are no functions performed with regard to inventory and no risks assumed with respect to inventory. To that extent, going by the pure economic theory, profit, which as we have noted above is nothing but a reward for the risks assumed, functions performed and assets employed, the assessee's normal profits should be corresponding than normal comparable trading entities.

41. It is thus clear that a zero inventory level, or even a low inventory level, is a significant factor in TP analysis and the methodology adopted for appropriate comparison must also factor for this peculiarity in a business situation.

Eliminating impact of inventory risk on profitability

42. What follows is that use of transfer pricing mechanism, on the facts of this case, should be in such a manner in such a manner so as to minimise the impact of higher risks assumed by, and higher assets employed by, a normal trader vis-à-vis a sogo shosha entity. It is, therefore, worth an examination whether use of berry ratio, which assessee has all along contended to be appropriate to eliminate differences between an ordinary trader and the assessee, could indeed help in elimination of this vital difference of profile of

the assessee vis-à-vis normal trading entities which may be available as comparables.

The mechanism, as suggested by assessee's TP study, to eliminate impact of uniqueness of the business model adopted by the assessee group

43. There is an interesting discussion on this aspect of the matter in assessee's TP study, a copy of which was placed before us in the paperbook. It does recognize that looking to the FAR analysis of the assessee's activities, the of the CPM may be appropriate, the method employed in determining ALP has to be used with certain modification which take it within definition of Transaction Net Margin Method but has berry ratio as the PLI. In plain words, thus, the mechanism suggested to eliminate the impact of uniqueness of assessee's business model is use of berry ratio as a PLI in TNMM analysis.

Berry ratio: connotations and its background

44. Simply put, berry ratio is ratio of gross profit to the operating expenses.

45. Unlike in Indian TP regulation, wherein no specific ratios are prescribed, US Regulation 482-5(b)(ii)(4)(B) accepts this PLI as one of the "financial ratios that may be appropriate" to measure the arm's length price, even though it puts a rider that, "reliability under this profit level indicator also depends on the extent to which the composition of tested party's operating expenses is similar to that of the uncontrolled comparables". So far as Indian TP provisions are concerned, the PLIs set out in rule 10B(1)(e)(i) are only illustrative inasmuch as it ends with the expression "or having regard to any other relevant base" but there is no prohibition as such on the use of this ratio. However, having regard to the use of this ratio worldwide, and for the reasons we will set out in detail in a short while, the use of this ratio cannot be eliminated from the India transfer pricing practices altogether.

46. In the July 2010 version of **OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations**, berry ratio is specifically recognized as follows:

2.100 "Berry ratios" are defined as ratios of gross profit to operating expenses. Interest and extraneous income are generally excluded from the gross profit determination; depreciation and amortisation may or may not be included in the operating expenses, depending in particular on the possible uncertainties they can create in relation to valuation and comparability.

2.101 The selection of the appropriate financial indicator depends on the facts and circumstances of the case, see paragraph 2.76. Concerns have been expressed that Berry ratios are sometimes used in cases where they are not appropriate without the caution that is necessary in the selection and determination of any transfer pricing method and financial indicator. See paragraph 2.92 in relation to the use of cost-based indicators in general. One common difficulty in the determination of Berry ratios is that they are very sensitive to classification of costs as operating expenses or not, and therefore can pose comparability issues. In addition, the issues raised at paragraphs 2.93-2.94 above in relation to pass-through costs equally arise in the application of Berry ratios. In order for a Berry ratio to be appropriate to test the remuneration of a controlled transaction (e.g. consisting in the distribution of products), it is necessary that:

- The **value of the functions performed in the controlled transaction (taking account of assets used and risks assumed) is proportional to the operating expenses**,

- The **value of the functions performed in the controlled transaction (taking account of assets used and risks assumed) is not materially affected by the value of the products distributed, i.e. it is not proportional to sales**, and

- The taxpayer **does not perform, in the controlled transactions, any other significant function (e.g. manufacturing function)** that should be remunerated using another method or financial indicator.

2.102 **A situation where Berry ratios can prove useful is for intermediary activities where a taxpayer purchases goods from an associated enterprise and on-sells them to other associated enterprises. In such cases, the resale price method may not be applicable given the absence of uncontrolled sales, and a cost plus method that would provide for a mark-up on the cost of goods sold might not be applicable either where the cost of goods sold consists in controlled purchases. By contrast, operating expenses in the case of an intermediary may be reasonably independent from transfer pricing formulation, unless they are materially affected by controlled transaction costs such as head office charges, rental fees or royalties paid to an associated enterprise, so that, depending on the facts and circumstances of the case, a Berry ratio may be an appropriate indicator, subject to the comments above**.

(Emphasis by underlining supplied by us)

47. As evident from the underlined portion of the OECD approach, highlighted above, berry ratio can be particularly useful in the situations in which the entity is engaged in the business as a trade intermediary, the value of services performed by the entity is adequately reflected by operating expenses, the value of functions performed and assets employed in the controlled transactions is not proportionate to sales and when the entity does not perform any significant operations such as manufacturing or processing. Typically, a low risk high volume trading business involving back to back trading without any value addition to the goods traded, which is what MCJ is engaged in and the MCI is contributing to, satisfies all these tests. We are in agreement with the approach adopted by the OECD document in this regard. Going by this approach, and, applying the tests laid down above, it does indeed seem that berry ratio could be appropriate in the present case.

48. Berry ratio is increasingly finding specific acceptance in many jurisdictions. While it is use in US for long, in Japan, even as berry ratio was used in APAs earlier as well, the 2013 amendment to the transfer pricing regulations, with effect from 1st April 2013, now specifically list berry ratio as acceptable in appropriate cases. In India, there have been several recent judicial precedents, which we will deal with a little later, upholding the use of berry ratio as a PLI.

49. Lets take a pause here and take a look at the circumstances in which berry ratio came into existence and its common usage in the TP analysis.

50. In the landmark case of **E.I. DuPont de Nemours & Co. v. United States, 608 F.2d 445**, Charles Berry, an economist, served as an expert witness on behalf of the U.S. government and the development of berry ratio is attributed to his testimony. What came up for consideration in the said case was the "proper," arm's length compensation that a Swiss subsidiary of DuPont-USA, engaged as a distributor of the DuPont-USA, should earn on the distribution services it performed in Switzerland on behalf of the AE. In his analysis, Charles Berry determined that the best method for determining an arm's length result

was to compare the Swiss distributor's markup on operating expenses to the same markup earned by uncontrolled (i.e., third-party) distributors performing substantially similar functions. Berry's key insight in the case was that distributors should earn a return commensurate to the distribution services performed and that the value of the products being distributed, in other words, was irrelevant. The implicit emphasis was thus on the service element even in trading activity, and in the costs incurred on rendering this service rather than in the value of goods traded. That was a case in which the assessee was simply involved in distributorship function without much risks, though certainly much more risks than in a back to back trading, associated with inventories or with uncertainties of normal trading. The key contribution to the economic activity was recognized as performing the distributorship function rather than the value of goods sold. Accordingly, distributors must achieve a particular gross profit in order to compensate them for their services, the costs of which are accounted for, almost entirely, in their operating expenses. To reflect the reality of distributors' economic significance and to provide an arm's length return to DuPont's Swiss subsidiary, Berry utilized a ratio that has since been named in his honor and is computed as gross profit to operating expenses. There are some variants to this ration but that aspect of the matter is not really relevant for the present purposes.

51. The underlying assumption for applicability of berry ratio is that the return to the tested party should be commensurate with his operating expenses and the value of goods dealt in was irrelevant for this purpose. While this proposition so laid down was in the case of a limited risk distributor without any value addition to the goods or significant risks associated with inventories, we are of the considered view that it is equally useful in a case in which the business entity is engaged in trading, with zero or low inventory levels, and particularly as it does not involve any unique intangibles or value addition to the goods traded.

52. The answer to the fundamental question of whether a taxpayer should be entitled to a return on the value of goods handled by it, would actually depend

on the functions performed and the related risks borne by it, with respect to the goods; and not on whether the taxpayer has taken title to the goods, shorn of the assessee's FAR profile.

53. Clearly and undisputedly, on the facts of this case, neither the assessee has performed any functions on or with respect to the goods traded by it, beyond holding flash title for the goods in some of the cases, nor has the assessee borne any significant risks associated with the goods so traded. All the functions, assets and risk of the assessee are quite reasonably reflected by the operating costs incurred and the value of goods traded does not have much of an impact on its analysis of FAR. The cost of goods sold would be relevant if and only if the assessee would have assumed any significant risks associated with such goods sold and when monetary impact of such risks is not reflected in operating expenses of the assessee. The berry ratio should, therefore, be equally useful in the present case as well. In the case of the traders like assessee, who neither assume any major inventory risk nor commit any significant assets for the same and particularly as there is no value addition or involvement of unique intangibles, the berry ratio should also be equally relevant as in the case of a limited risk distributor.

54. In the case of **GAP International Sourcing India Pvt Ltd Vs ACIT [20 ITR (Trib) 779],** a coordinate bench has upheld the use of this ratio. While taking note of the contentions of the assessee in this case, the coordinate bench has, i*nter alia*, observed as follows:

> *6.4 Ld. counsel then referred to the well recognized Berry ratio in determination of ALP. Berry ratio also propounds that routine distributors should earn a return commensurate to the distribution services performed, measured as a percentage of the value-adding (operating) expenses incurred by them. The value of the products being distributed, in other words, is irrelevant. Distributors must achieve a particular gross profit in order to compensate them for their value-adding services, the costs of which are accounted for in their value-adding (operating) expenses. An excerpt from the article by Dr. Berry on this aspect reads as under:-*
>
> > *"Similarly, the cost of goods sold is excluded from the cost base because the measure indicates the value of the merchandise distributed, not the service rendered by the firm that distributes the merchandise. It was for exactly the same reason that*

I excluded in the case of advertising agencies, the cost of advertisement placement. The placement cost is a measure of the activities of the media carrying the advertising agency in planning and designing that advertising. If we use a cost plus method, and the Berry ratio is a cost plus method, we want a measure of the costs of the firm involved, i.e. the distributor or advertising agency in these examples, not something that measures only the value of the product distributed, or the value of the exposure provided by radio, television or print media".

6.5 *It is contended that the Berry ratio is merely a variant of the cost plus method. If one were to think of the gross margins earned by a distributor as analogous to a firm's total revenues available to a distributor, and the operating expenses incurred to distribute products as analogous to the firm's total costs, then the ratio of gross margin to operating expenses would capture the mark-up on operating expenses that is afforded to the distributor.*

6.6 *The Berry ratio can also be applied to service providers, as it can be conceptualized as the mark-up earned on the costs of provision of services, by subtracting one from the Berry ratio expressed in unit terms as follows:-*

Berry ratio - 1 = GP/VAE - 1

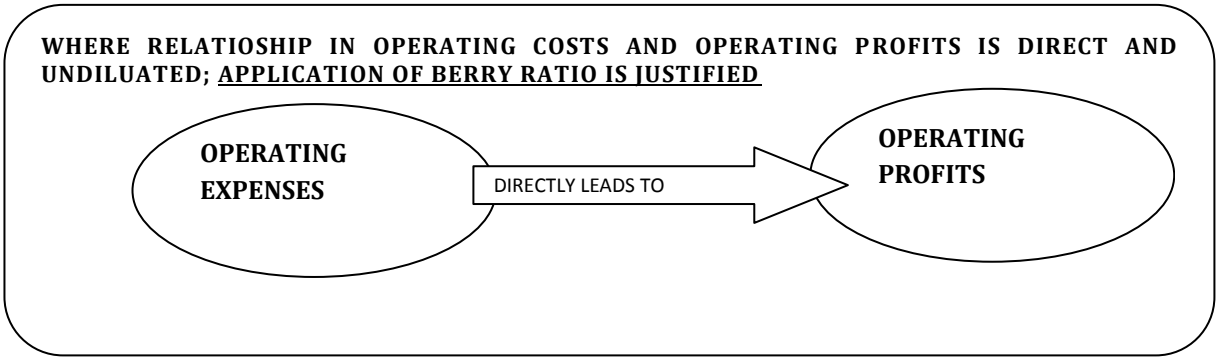
= (GP-VAE)/VAE = OP/VAE

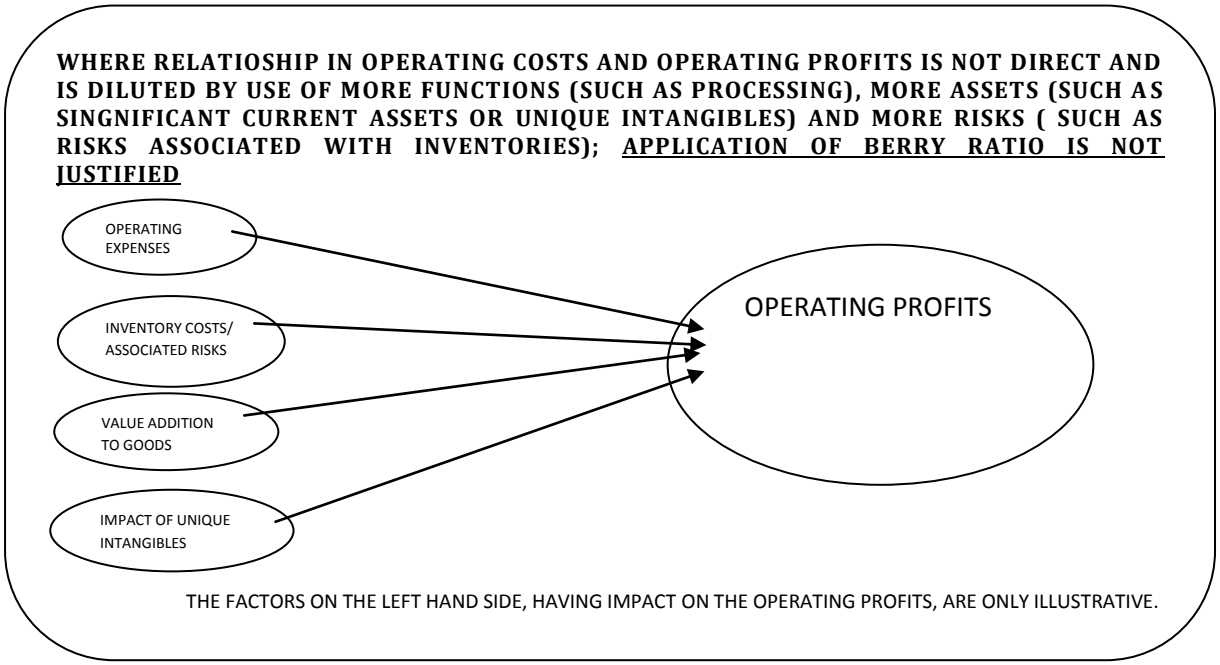
wherein GP = gross profit; OP = operating profit; and VAE = value adding (operating) expenses.

55. In the case before the coordinate bench, it was noticed that the berry ratio is used for distributorship functions, though, as a variant of the berry ratio, its application could also be related to the service providers. This decision, however, is important for the short reason that it recognizes and upholds application of berry ratio in the situations in which value of goods traded is not important enough a consideration. We would draw analogy from this case to the limited extent that when the assessee does not assume any significant risks associated with the goods traded nor performs any functions on the same, and all the risks assumed by the assessee are adequately reflected by the operating costs, the berry ratio could be equally relevant.

56. What berry ratio thus seeks to examine is the relationship of the operating costs with the operating profits. It thus proceeds on the basis that there is a cause and effect relationship between operating costs and the operating profits. The factors, however, which can also have substantial impact on the operating profits, and thus dilute this direct relationship, could be factors like (a) in terms of functions – processing and value addition to the goods; (b) in

terms of assets – fixed assets such as machinery, inventory, debtors and otherwise high assets, including intangible assets; and (c) in terms of risks – risk associated with holding inventories. In a diagram form, this relationship could be as follows:





57. In our considered view, to sum up, in a situation in which a business entity does not assume any significant inventory risk or perform any functions on the goods traded or add any value to the same, by use of unique intangibles or otherwise, the right profit level indicator should be operating profit to operating expenses i.e. berry ratio. In such a situation, no other costs are relevant since (a) the cost of goods sold, in effect, is loses its practical significance, (ii) there is no value addition, and, accordingly, there are processing costs involved, and (iii) there is no unique intangible for which the business entity is to be compensated.

58. In typical cases of pure international trading, there is neither any processing of goods involved nor is there use of any significant trade or marketing intangibles. The inventory levels are also extremely low, at least with respect to the goods traded, since the nature of activity does not require maintenance of inventories and there is sufficient lead time between order being received and the actual procurement activity. There are no other factors, in addition to the operating costs, which affect direct relationship between operating costs and operating profits. Therefore, except in a situation in which significant trade or marketing intangibles are involved or in a situation in which there is further processing of the goods procured before selling the same or in a situation which necessitates employment of assets in infrastructure for processing or maintenance of inventories, the use of berry ratio does seem to be quite appropriate.

59. As we make the above observations, we also make it clear that in case the assessee is not able to find other comparables with significantly low or zero inventory levels, it does not prejudice the interests of the revenue authorities in any manner. The reason is this. When a comparable has an additional risk associated with inventories, which is not present in the case of the assessee, the profits achieved by the comparables can only be higher than the profits achieved by the assessee. As is elementary, higher the functions performed, risks assumed and assets employed, higher the profits. A comparables, with economic justification for higher profits, cannot be rejected on the ground of being eligible for higher profits.

<u>The stand of the coordinate bench on the use of the berry ratio</u>

60. As we have noted earlier in this order, the application of berry ratio as a PLI has been rejected by the TPO as also by the DRP. We have also noted that while the coordinate bench, in the immediately preceding assessment year, had remitted the matter to the file of the Assessing Officer, the bench had no occasion to adjudicate on the question as to whether or not berry ratio, as claimed by the assessee, should have been used in computing the ALP. There is no discussion whatsoever on this aspect of the matter.

Our analysis on the objections to the berry ratio

61. However, as the matter is being remitted to the assessment stage for selection of suitable comparables, and making necessary comparability adjustments to the same, we consider it appropriate to deal with this issue, particularly from the point of view whether use of this ratio will address, in whatever limited measure, the financial impact of variations between a normal trader and assessee's trading activity as sogo shosha subsidiary in which, as claimed by the assessee, no funds are blocked in the inventories or cost of sales, and, whether, in such a situation, computation of return on the value of goods will not lead to an exorbitant return on the operating expenses or value added expenses which is all that the assessee has *de facto* borne.

Use of berry ratio when assessee is following TNMM

62. One of the reasons of the TPO's rejection of the berry ratio is that the berry ratio is *de facto* cost plus method and that the assessee cannot resort to the use of this ratio when the assessee has consciously chosen the TNMM as most appropriate method. While on this objection, it is interesting to take note of the fact that in the transfer pricing study itself it has been noted that "**even though principles of the CPM may be appropriate, it cannot be used in this analysis for the reasons stated herein and has to be used with modification thus falling within definition of Transaction Net Margin Method**" (at internal page 30; paper-book page 242) and thus presence of some traits of CPM, by itself, does not render this ratio inapplicable as long as it fits with the scheme of rule 10B(1)(e), which, as we will see now, it does fit in. The Assessing Officer's observations about assessee's conscious choice of TNMM, and, for that reason, inapplicability of berry ratio, which is a based on CPM principles, are thus irrelevant and ill conceived. As a matter of fact, if this TP report at all indicates anything in this regard, it indicates that even when assessee selected TNMM, the assessee was very well aware that TNMM with berry ratio will be most suitable in the present case, and there is no legally sustainable objection to the stand so taken by the assessee in the TP study.

TPO's other objections to application of Berry Ratio

63. We have noted that the TPO has raised three other objections with respect to the berry ratio, i.e. (a) use of berry ratio is not permitted under rule 10B(1)(e)(i) as it does not deal with costs incurred, sales effected or assets employed or to be employed; (b) use of berry ratio is not appropriate to the facts of this case as there are unique intangibles like supply chain intangibles and human assets intangibles; and (c) use of berry ratio is unworkable due to adjustments for variations in accounting policies for recording costs.

64. None of these objections, for the reasons we will set out now, merits acceptance.

Rule 10B(1)(e)(i) and use of berry ratio

65. As for the objection that use of berry ratio is not permitted under rule 10B(1)(e)(i) as it does not deal with costs incurred, sales effected or assets employed or to be employed, it proceeds on the fallacy that the basis of computation, as set out in rule 10B(1)(e)(i), is exhaustive whereas it is only illustrative and it ends with the expression "or having regard to any other relevant base". Just because a cost base is not of costs incurred, sales effected or assets employed, such a base does not cease to permissible under rule 10B(1)(e)(i) unless such a base can be held to be irrelevant. In view of the elaborate discussions earlier, justifying exclusion of inventory costs, the cost of base of the operating expenses is relevant. When cost of inventory is excluded from the cost base, for all practical purposes, cost bases consists only of the operational costs. In our considered in a situation in which trading is on back to back basis without anything actually going to the current assets and flash title of goods is held only momentarily, it could indeed actually be a relevant base as to what are the operating costs or value added expenses – particularly when, as we have noted above, no resources are used in the inventories.

Use of berry ratio when tested party has high level of current assets

66. As for the objection regarding use of this ratio only in the situations in which current assets are not significant, there cannot indeed be much dispute

with this proposition on principle but there is nothing on the record to evidence that there are high current assets in the present case either. Such vague generalities, as resorted to the TPO, cannot be sustained in law. There is no mention about any specific element of assets which can be related to high current assets. The TPO has mentioned about use of intangibles but on the question of intangibles as well, for the reasons we will set out in a short while, the stand of the TPO was devoid of any legally sustainable foundation. It is not the case of the TPO that the assessee owns any significant unique intangibles, which are acquired by the assessee at a specific cost, which have significant replacement cost or which are developed otherwise than as a bye product of carrying out routine business activities of the assessee. As we have noted elsewhere in this order, not only that there should be intangibles in use in the business and owned by the assessee but such intangibles should be unique-unique to the assessee which are not found in the comparables. A trained workforce, unless it has significant development cost or replacement cost, is a routine business intangible which almost all comparables will have.

Cost classification issues in application of berry ratio

67. As regards the alleged unsuitability of use of berry ratio due to operational difficulties due to variations in accounting policies, it is sufficient to take note of the fact that coordinate benches of the Tribunal have upheld the use of berry ratio in appropriate cases, including the case of **GAP International Sourcing India Pvt Ltd** *(supra),* and that no specific issues are raised by the TPO with regard to operational difficulties in the cases of selected comparables. The problem, thus, is hypothetical problem at this stage which may arise in case there are significant issues in the accounting policies of the comparables vis-à-vis the assessee. That stage has not yet come as the comparables are yet to be finalized, and no such specific issues are raised with respect to the comparables used in the analysis so far.

68. In any case, when we are dealing with business entities engaged in the trading activities and all their operating expenses pertain to the trading

activities only, the issue regarding classification of operating costs are somewhat academic.

69. There is, therefore, neither there is anything inappropriate in the use as such of berry ratio *per se*, nor there are any real issues with respect to accounting policies of the assessee vis-à-vis accounting policies of the comparables finally selected. Obviously, as final comparables are not yet selected, there cannot be any question of the accounting policies adopted by the comparables vis-à-vis accounting policies of the assessee being so significantly different that the very comparability is not possible. The apprehensions are premature. We, therefore, see nothing wrong in principle in use of berry ratio in the case of an assessee like the one before us though, in the absence of any specific comparables before us, it is not possible to visualize and deal with the difficulties with regard to variations in, and impact of, accounting policies in such cases. Having said that, we must may also reiterate that when we are only dealing with trading activities of the tested party and the comparables, without any processing or other costs, the occasion for any impact of significant variations in the accounting policies does not arise. There can be little scope of differences in approach so far as trading costs are involved,

<u>TPO's stand on locational savings not being accounted for</u>

70. We have also noted that the TPO has also taken up a point regarding locational savings which, according to him, have accrued to the AEs but the compensation model, which provides for a mark up on costs, does not take into account the benefits from the locational savings. It is elementary that locational savings can only relate to net savings in costs that may be derived by an MNE group that relocates some of its activities to a place where labour or real estate expenditures, to cite only a couple of examples, are lower than in the location where the activities were initially performed. It follows that the savings have to be with respect to the activities and operations performed, which MNE was earlier performing at another location, and not with respect to the costs of purchases. Therefore, if an assessee is able to buy a product or service at a lower price vis-à-vis price in another jurisdiction, including the domicile

jurisdiction, such purchases of goods or services *per se* donot give rise to a locational saving for the purpose of ALP determination. In the present case, the price advantage to the assessee, on account of sourcing his purchases from India, thus may not amount to any locational savings at all, but then, as we could make out from a perusal of material on record, that precisely is the case of the TPO. No doubt "**United Nations Practical Manual on Transfer Pricing for Developing Countries**" does include 'locational savings' in its comparability analysis and defines it as "**net cost savings that an MNE realizes as a result of relocation of operations from a high cost jurisdiction to a low cost jurisdiction**" but then it is not even TPO's case that any business operations have been relocated from another location to this location. There is no specific identification of locational savings or even efforts to compute the same. In any event, locational savings in procurement of goods, even if any, will arise to the AEs actually buying the goods and not the assessee assisting such buying by way of acting as an intermediary. In a recent OECD report, released as part of a series of deliverables pursuant to the Action Plan on Base Erosion and Profit Shifting (BEPS) project, titled "**Guidance on Transfer Pricing Aspects of Intangibles**", while it is accepted that the principles of locational savings will not only apply to business restructuring but also generally to all situations where location savings are present, it is also stated that in determining how location savings are to be shared between two or more associated enterprises, it is necessary to consider (i) whether location savings exist; (ii) the amount of any location savings; (iii) the extent to which location savings are either retained by a member or members of the MNE group or are passed on to independent customers or suppliers; and (iv) where location savings are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate any retained net location savings. We are in considered agreement with this approach but then no such exercise, as suggested in the above four step process, has been carried out in the present case, nor is there any concrete finding even about something as fundamental as existence of locational savings. The TPO has raised some murmurs of locational savings being present in this case but such vague generalities are devoid of legally sustainable foundation. The allocation of

location savings comes into play only when these savings are not directly passed on to the independent customers and thus add to the profits of the group as a whole. However, in a situation in which the group is only a facilitator, as *sogo shosha* business model apparently envisages, there may not be any locational savings to the group. These locational savings may at best be derived by the independent customer. The question of allocating the locational savings between the AEs would have arisen only when there were any such locational savings but given the facts of the present case that aspect of the matter is wholly academic in effect.

Human asset intangibles and supply chain intangibles– correctness of TPO's stand

71. Coming to TPO's observations that the compensation model adopted in this case does not provide for meeting the costs of developing supply chain intangibles and human assets intangibles, but the intangible so developed by the assessee are routine intangibles developed only during the course of work carried out by the assessee and any other intangibles, other than the ones developed in the course of this business, are owned by the AEs and not the assessee company. It is only when intangibles are owned by the person, using these intangibles or transferring these intangibles *per se*, that the question for compensating for use or transfer of intangibles arise. There is nothing to corroborate and support the vague generalization that cost plus method does not "capture the compensation for development and use of intangibles". It is not even the case of the TPO that these intangibles were acquired or developed by the assessee by incurring certain specific costs and such costs are not taken into account in the compensation model. In the process of carrying on a business activity, an assessee may develop certain intangibles but that is quite different from the intangibles that the assessee uses in the business activities as an input or at the starting point, and, even if there were any such intangibles at the starting point, these intangibles could only have belonged to the AEs of the assessee. The value of intangibles created in the process of carrying out the business activity cannot be built in the compensation for carrying out the activity which leads to creation of these intangibles. In any event, the onus is on the revenue authorities to demonstrate and quantify, on the basis of cogent

material and reasonable basis, the value of intangibles which has not been take into account in the arm's length price of the services so rendered. It is also important to note that not only that there should be intangibles in use but these intangibles should be unique intangibles which may not be possessed by the comparable entities. There is no unique intangible pointed out in this case. Any comparable involved in the similar activity will essentially have the same intangibles, and no adjustments can be justified or warranted in the cases of routine intangibles. In view of these discussions, as also bearing in mind entirety of this case, the action of the TPO is devoid of any legally sustainable merits on this count as well.

72. The particular business model which gives rise to this edge, assuming that there is indeed an edge, to the assessee is a result of group synergy and intangibles as a result of such group synergy cannot, therefore, be assigned to the assessee alone. In any event, when the impact of group synergy is taken into account, it is only when it consists of deliberate concerted action benefits, and not when it merely consists of the passive association benefits. There is no such suggestion of deliberate concerted action benefits in the present case.

73. In any event, as observed by Hon'ble Delhi High Court, in Li & Fung's case (supra), the assesse may have "**developed experience and expertise which the Tribunal has held to be human capital and supply chain intangibles but such description does not in any way reveal how the appellant bears any risk - either enterprise or economic**". Summing up the decision, Their Lordships have further observed that, "**Tax authorities should base their conclusions on specific facts, and not on vague generalities, such as "significant risk", "functional risk", "enterprise risk" etc. without any material on record to establish such findings. If such findings are warranted, they should be supported by demonstrable reason, based on objective facts and the relative evaluation of their weight and significance**". These observations equally apply to the fact situation before us as well. As learned counsel for the assessee very aptly puts it, all these intangibles, as perceived by the TPO, are more of his figment of his imagination rather than

based on any cogent material. The use of intangibles cannot be inferred or assumed. It is to be demonstrated, on the basis of cogent material, by the revenue authorities.

Itacha Industries decision by the US Court of Appeal and its relevance to the ALP determination:

74. As for the US Court of Appeal decision in the case of Ithaca Industries *(supra),* referred to and relied by the TPO in support of the proposition that a trained workforce is also an intangible asset and it should be factored in the TP analysis, this decision was concerned with the question, as this judgment states in so many words, "whether an assembled workforce is an intangible asset having an ascertainable, limited useful life over which the value of the asset may be amortized". It is important to bear in mind that in the said case, the assessee had taken over the business and one of the asset taken over was "assembled workforce of 5,153 hourly production workers and 212 staff employees" and the appraiser had assigned this "workforce in place" a value of $7.7 million" with a useful life of seven years for production employees, and eight years for staff employees".

75. The court held that workforce is an intangible asset, though it declined depreciation on the ground that its useful life has ascertainable limits, but nothing really turns on that as it cannot even be in dispute that an assembled workforce is an intangible. The question that really is required in the context of determination of an arms' length price, and impact of intangibles involved therein, is whether the intangible is a significant unique intangible or not. When all business entities involved in that line of activity have the same or materially similar intangible asset, such an intangible asset cannot have any impact on the determination of the arm's length price of activity involving such intangibles.

76. In the case before us, it is not the case of the TPO that the assessee had acquired the asset of trained workforce at a cost which is not factored in the arm's length price or even that the assessee has incurred any significant costs for developing the workforce which is not factored in the arm's length price. All that the assessee has incurred as costs are the routine staff costs and all such

costs are already factored in the arm's length price. No matter which PLI is adopted, these operating costs will anyway be taken into account. The question of its being a unique intangible, justifying a separate specific adjustment in the ALP, arises only when it is acquired or developed at a cost which find no mention in the TP analysis. A trained workforce is an intangible asset and it is on the basis of this asset that the assessee carries out his business activity but that intangible is common to all business entities inasmuch as anyone pursuing a business activity, as it goes along, develops a workforce trained in that activity. In order to have its impact on determination of the ALP, as we have noted earlier as well, not only an intangible should exist but it should also be a unique intangible giving an edge to the business in which such an intangible is used.

77. A trained workforce, in the absence of any specific and significant features attached to it, significant training or development costs related thereto or significant replacement cost, cannot treated as a unique intangible having impact on determination of arm's length price. An assembled workforce, even without any identifiable direct costs in raising the same, can at best be taken into account only when it has significant replacement costs, such as in the case of construction activities, for determination of the arm's length price. The situation that we are dealing with is qualitatively different.

78. Learned TPO's reliance on Itacha Industries decision *(supra)* is thus wholly irrelevant for the purpose of the determination of ALP which is the issue in appeal before us. While assembled workforce could always be an intangible asset, as held in the said case, such an intangible asset gets into ALP computation only when such an intangible asset has a significant value such as by way of replacement cost, cost of acquiring the same or cost of developing this intangible.

<u>Conclusion on trading segment of assessee's activities</u>

79. In view of these discussions, in our considered view, the use of berry ratio as PLI is appropriate to the facts and circumstances of this case, the

objections taken by the authorities below to the use of berry ratio are unsustainable in law, and the adjustments for use of intangibles and locational savings are unwarranted. With these observations, the computation of ALP so far as buy sell segment of assessee's activities are concerned stands restored to the assessment stage. The matter will be examined afresh in the light of our above observations. Learned counsel for the assessee has filed certain computations before him which, according to him, show that on these propositions being accepted, there will be no necessity of any ALP adjustments being made. However, we are not inclined to address ourselves to these submissions. We have laid down the broad principles which, in our humble understanding, will be appropriate to this fact situation. However, it is for the field authorities to examine and quantify the impact of these principles on the actual ALP determination. That aspect of the matter will have to be examined afresh at the assessment stage.

Service fee/ commission segment of assessee's activities

80. Coming to the service fee/ commission segment, we have noted that as regards the service fee/ commission segment, the TPO has re-characterized the same as trading activities as he was of the view that the right course of action will be to treat the same as equivalent to trading segment, because what the assessee has disclosed as service/ commission income is infact trading income. Accordingly, the cost of goods sold by the AEs, which was Rs 2927,92,05,406, was also to be included in cost base of the service/commission segment and then ALP was recomputed. So far as this aspect of the matter is concerned, the issue is now covered in favour of the assessee by Hon'ble jurisdictional High Court's decision in the case of Li & Fung wherein Their Lordships have, *inter alia*, observed as follows:

> **…….This Court is of opinion that to apply the TNMM, the assessee's net profit margin realized from international transactions had to be calculated only with reference to cost incurred by it, and not by any other entity, either third party vendors or the AE. Textually, and within the bounds of the text must the AO/TPO operate, Rule 10B(1)(e) does not enable consideration or imputation of cost incurred by third parties or unrelated enterprises to compute the**

> **assessee's net profit margin for application of the TNMM. Rule 10B(1)(e) recognizes that "the net profit margin realized by the enterprise from an international transaction entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed <u>by the enterprise</u> ..." (emphasis supplied). It thus contemplates a determination of ALP with reference to the relevant factors (cost, assets, sales etc.) of the enterprise in question, i.e. the assessee, as opposed to the AE or any third party. The textual mandate, thus, is unambiguously clear.**
>
> **40. The TPO's reasoning to enhance the assessee's cost base by considering the cost of manufacture and export of finished goods, i.e., ready-made garments by the third party venders (which cost is certainly not the cost incurred by the assessee), is nowhere supported by the TNMM under Rule 10B(1)(e) of the Rules. Having determined that (TNMM) to be the most appropriate method, the only rules and norms prescribed in that regard could have been applied to determine whether the exercise indicated by the assessee yielded an ALP.**

81. Clearly, therefore, it is impermissible to make notional additions in the cost base and thus take into account the costs which are not borne by the assessee. It is so opined by Hon'ble jurisdictional High Court on a careful analysis of rule 10B(1)(e)(i). It is, therefore, no longer open to the revenue authorities to reconstruct the financial statements of the assessee by including the cost of products incurred by the AEs, in respect of which services are rendered, in its reconstructed financial statements, and then putting the hypothetical trading profits, so arrived at in these reconstructed financial statements, to the tests for determining arms' length price. Respectfully following the esteemed views of Their Lordships, we hold that the adjustments carried out in the cost base of ALP computation, in respect of service fee/ commission segment, are indeed devoid of legally sustainable merits. We direct the Assessing Officer to delete these adjustments. Once this notional adjustment is deleted, the ALP determination is to be done on the basis of the commission/ service fees. As we have stated earlier in this order as well, in the course of proceedings before us, the assessee has filed fresh computation of the ALP which attempts to demonstrate that, if notional adjustments made by the TPO

are deleted, no ALP adjustment will be warranted. However, we are not inclined to go into verifications which must take place at the assessment stage.

Conclusion on commission /service fees segment of assessee's activities

82. Accordingly, we deem it appropriate to uphold the grievances of the assessee in principle, as the terms above, delete the notional adjustments by TPO's adopting cost base of the AEs in assessee's ALP determination, and remit the matter to the file of the TPO for the necessary factual verifications on impact of this corrections. Accordingly, the matter stands restored to the file of the TPO in this respect also.

Conclusions with respect to correctness of ALP determination

83. In the result, so far as grievances against ALP adjustment of Rs 68,15,17,853 are concerned, the matter stands restored to the file of the TPO but in the terms indicated above.

Correctness of disallowance, under section 40(a)(i), of Rs 102,17,16,483

84. So far as this issue is concerned, the relevant material facts are like as follows. During the relevant previous year, the assessee made payments to following associated enterprises for purchase of goods:

Sl No.	Particulars	Amount (Rs)
1.	**Mitsubishi Corporation, Japan**	9,180,507
2.	**MC Metal Service Asia (Thailand)**	489,550,760
3.	**Metal One Corporation, Japan**	497,373,422
4.	**Mitsubishi Corporation, Singapore**	93,345
5.	**Metal One Asia Pte Ltd, Singapore**	17,472,633
6.	**MC Tubular Inc, USA**	3,376,808
7.	**Thai MC Company Ltd. Thailand**	2,373,391
8.	**Petro Diamond Japan Corporation, Japan**	2,295,618
	Total	1,021,716,483

85. The Assessing Officer begun by taking note of the tax history of the case of Mitsubishi Corporation- Japan, parent company of the assessee company, in

India. It was noted that MCJ had a liaison office in India but when a survey was conducted in the business premises of this liaison office, it was found that the liaison office was carrying on core business activity, and, accordingly, MCJ conceded taxability of its business profits in India. The AO noted the MCJ typically operates worldwide through its small business segment units called divisions and the liaison office in India was structured in such a way that it corresponds to the structure of MCJ. These divisions in the liaison office were maintained in such a way that these divisions were virtual projections of corresponding divisions of MCJ. The AO was of the view that even after the incorporation of MCI, i.e. the assessee before us, MCJ continues to operate through liaison office and look after the interests of MCJ divisions, It was also noted that various divisions of the MCJ i.e. Business Initiative Group, Energy Business Group, Metals Group, Machinery Group, Chemicals Group and Living Essentials Group continue to work under the liaison office of MCJ, though sometimes overlapping with MCI, and there is no difference in their functioning so far as business model is concerned. All these complex factual aspects, which are relevant to us only from the point view of revenue's contention that the payments made to the MCJ and its affiliates were taxable in India, were discussed in detail in the assessment order. A reference was then made to Metal One Corporation and its affiliates and it was noted that this group was following the same business model, that, though it was a separate entity, it was assigned to deal with metal business earlier being carried on by metal division of MCJ and that the Metal One Corporation must also, therefore, be held to have a PE, and consequent tax liability, in India. The Assessing Officer noted that these entities, even though non-resident, are taxable in India "in the light of their business model and their presence in India" under the provisions of the Income Tax Act, 1961, as also under the provisions of relevant DTAA as these entities have a permanent establishment in India. The purchases in the instant case are "not purchases *simplictor* as the non-resident entities are trading houses whose work is liaison with the seller and purchaser and to make that deal happen". It was also observed that "the assessee is not an end user of the product but a mediator between seller and the end user". Accordingly, in the opinion of the Assessing Officer, the assessee was required to deduct tax at source from these payments

to non-residents, in terms of the mandate of section 195, which casts responsibility of deducting tax source from any payments, chargeable under the provisions of the Act, to the non-residents. The Assessing Officer was of the view that since assessee has failed to deduct tax at source from these payments, the same are required to be allowed in computation of income from business. Reliance was also placed on the decision of Hon'ble Supreme Court in the case of **Transmission Corporation of India Ltd Vs CIT (239 ITR 587)**. As regarding assessee's contention that section 40(a)(i) was discriminatory in character as no such disallowance was required to be made if the payments for purchases are made to a resident, and as such liable to be read down by the virtue of non-discrimination provisions set out in the respective tax treaties, the Assessing Officer contended that neither such a disallowance constituted a discrimination, nor, in any event, it was open to a resident assessee to invoke provisions of a tax treaty. As regards assessee's reliance on a decision of the coordinate bench, in the case of **Herbalife India Pvt Ltd Vs ACIT (101 ITD 450)**, the same was rejected by placing reliance on decision of another coordinate bench in the case of **Automated Securities Clearance Inc vs ITO (49 SOT 333)** wherein in the context of this decision, it was, *inter alia*, observed that, "**neither the Bench had an occasion to consider the impact of Technical Explanation to the US Model Convention issued by the treaty partner State, nor the question whether or not differential treatment, *de hors* the justification for such differential treatment, came up for consideration for the Bench**". Relying upon this decision, the Assessing Officer rejected assessee's reliance on Herbalife decision. The AO further observed that the assessee is resident in India and thus not eligible for the treaty benefits under the India Japan Double Taxation Avoidance Agreement. The AO was thus of the view that since these vendors had a permanent establishment in India and that the assessee had an obligation to deduct tax at source from the payments made to these non-resident vendors, and, since the assessee has failed to discharge these tax withholding obligations, these payments cannot be allowed as a deduction in computation of business income. The assessee did raise a grievance before the DRP but without any success. The AO thus proceeded to make the impugned

disallowance of Rs 102,17,16,483. The assessee is aggrieved and is in appeal before us.

86. We have heard the rival contentions, perused the material on record and duly considered facts of the case in the light of the applicable legal position. Shri M. S. Syali, Senior Advocate, alongwith Shri Tarandeep Singh, argued for the assessee on these issues as well while, so far as these aspects in the present appeals are concerned, now Shri Sanjeev Sharma, Commissioner – Departmental Representatives (International Taxation), made his submissions for the revenue.

87. We find that there are three broad categories of non-resident entities to which payments for purchases have been made without deducting tax at source, namely - (a) foreign entities which did not have any permanent establishment in India and there is material on record to show that revenue's claim of their having PE in India is negated by the judicial authorities; -(b) foreign entities which may not have any permanent establishment in India but there is no material to demonstrate that fact and there is also no material on record to show that revenue's claim of their having PE in India is negated by the judicial authorities; and –(c) foreign entities which have PE in India and there is no dispute about its taxability in India as such.

Disallowance under section 40(a)(i) in respect of payments made, without deduction of tax at source, to the foreign entities which did not have any permanent establishment in India and there is material on record to show that revenue's claim of their having PE in India is negated by the judicial authorities

88. Let us first take up the first segment i.e. disallowance in respect of payments made to the foreign entities which did not have any permanent establishment in India and there is material on record to show that revenue's claim of their having PE in India is negated by the judicial authorities . We find that so far as payments made to the non-resident entities, set out at point no. 2,3 and 5 of the chart reproduced earlier, i.e. payment of Rs 48,95,50,760 to MC Metal Services Asia (Thailand), payment of Rs 49,73,73,422 to Metal One Corporation (Japan) and payment of Rs 1,74,72,633 to Metal One (Asia) Pte Ltd

(Singapore) are concerned, there is a categorical finding that these entities had not have any permanent establishment in India. Dealing with this aspect of the matter, a coordinate bench of this Tribunal, for the immediately preceding assessment year, opined as follows:

> **9.5 Now we take up the issue of P.E. in the case of MC Metal Services Asia, which is a Resident of Thailand and Metal One Asia P.Ltd. which is a Resident of Singapore. The Assessing Officer in his assessment order passed u/s 143(3) r.w.s. 144C of the Act dt. 25.10.2010 at para 4.13 page 17 and 18 held as follows:**
>
> > **"4.13. The above information is reproduced only to reinforce, the statement that Metal One Corp is functioning on identical lines of MC and following the same business model and philosophy. Metal One Corp is also functioning in India by way of a so called liaison office and the said L.O. is undertaking core activity of creating a market chain for vendors and customers in metal market. Therefore on the lines of taxability of MC, Metal One Corporation's income is also chargeable to tax in India. From the business model discussed above, it is apparent that it does not make any difference if the trading is down through the business model discussed above, it is apparent that it does not make any difference if the trading is down through/with an entity based in Singapore or Thailand. The said offices also function in similar manner in respect of entire group of locating and negotiating with potential buyer and seller in metal market. The tax residency certificate etc. are of no consequence in such a business model. "**
>
> **9.6 The Delhi "E" Bench of the Tribunal in the case of *Metal One Corpn.* (*supra*) for the Assessment Year 2008-09 considered the issue whether the assessee M/s Metal One Corporation has a P.E. in India. At para 6.6 to 6.8 it was held as follows :**
>
> > **"6.6. We may now consider the decision in the case of Sofema SA. The finding of the Tribunal is that in absence of any evidence on record with regard to commercial activity having been done by the assessee in India, the LO cannot be considered to be a PE. The Hon'ble High Court of Delhi dismissed the appeal of the Revenue by mentioning that no substantial question of law arises. However, the Hon'ble Supreme Court dealt with the case in greater detail and mentioned that there is concurrent finding that Sofema SA does not have a PE in India. This finding has been given on the basis that there is no evidence or justification forth coming from the Revenue to show that the assessee has a PE in India. On this account alone, the Hon'ble Court did not interfere in the matter. What follows from this decision is that there has to be evidence on record that the assessee has carried on some essential activities of business**

from the LO. The Court found that no such evidence was coming from the side of the Revenue which means that such evidence has to be brought on record by the Assessing Officer. In this case the Assessing Officer has ruled that only selective and sketchy information has been furnished by the assessee in the course of assessment. This is in fact correct, and it may be a cleaver way of presenting facts. However, the Assessing Officer has not taken any step to bring on record information that the activity was beyond the limit prescribed by the RBI. No doubt that the ld. CIT, DR referred to three pages in the paper book which, according to him, furnish a definite clue that India office was engaged in price negotiation. However, that is not correct as quotations were made on the basis of instructions from the Head Office. Some more information was added about internal dispute in the case of TOPY. But that does not form an essential part of the business of the sale of iron/iron material and iron product by the assessee in India.
6.7 On the basis of aforesaid discussion it can be concluded that the presumption which can validly be raised in this case that India office does not constitute a PE as no violation was noticed by the RBI. This presumption has not been rebutted by the Assessing Officer by bringing any positive material to show that any substantive business activity was carried on by the assessee in India.

6.8 Coming to similarity of activities of the assessee and MCJ. The draft order in the elad case is not available on record. There is no evidence that this order was shown to the assessee and it was given a chance to rebut the inference of similarity of functioning. It is also not mentioned as to what finally happened to that order. Therefore, we are of the view that these observations do not constitute any foundation for coming to any conclusion for or against the assessee. Therefore, we are of the view that the India office does not constitute PE of the assessee in India. The result is that the assessee succeeds on ground No.1."

9.7 In the above decision the Tribunal has concluded that Metal One Corporation does not have a P.E. in India. The Assessing Officer on the analogy that the functions of Metal One Asia Pte.Ltd. Thailand are similar to that of Metal One Corporation, drew an inference that Metal One Asia Pte. Ltd. have a P.E. in India. Similar inference has been drawn in the case of MC. Tubular Inc. USA, Petro Diamond Corp. Japan and Miteni Japan. As the ITAT had, in the case of *Metal One Corpn.* (*supra*) held that the entity does not have a P.E. in India, on the facts and circumstances of the case, the ratio applies to all other entities other than Mitsubishi Corporation, Japan. We are informed that, for none of the entities, other than Metal One Corporation, Japan the Revenue authorities have passed any order holding that those entities have a P.E. in India. We find that the A.O. drew an inference that these entities have a P.E. in India while examining the provisions of S.195 and

S.40(a)(ia) in the case of the assessee but, the department has not passed any order holding that these entities have a P.E. in India. Thus the income of these entities are not taxed in India. Under these circumstances we have to necessarily hold that the payments made for purchases from these entities are not taxable in India as these entities have not held as having a P.E. in India and hence the provisions of S.195 are not attracted and consequently the disallowances made u/s 40(a)(ia) of the Act are bad in law.

89. When it was pointed out to the learned Departmental Representative, he fairly accepted that there is no change in the factual position with respect to these companies and the findings of the Tribunal, on this aspect of the matter, will hold good for this assessment year as well. He, however, made it clear that he is not conceding the point as it may be further in appeal and he nevertheless places his reliance on the orders of the Assessing Officer and the DRP in this regard.

90. We find that once it is an undisputed position that the recipient entities did not have any permanent establishment in India and the transactions in question, as in these cases, are of purchases *simplictor*, the payments made to entities cannot give rise to any income taxable in India. It is so for the reason that it is only when the recipient has a PE in India under article 5 of India Japan tax treaty, it's income from trading can be brought to tax in India only when such an income is "directly or indirectly" attributable to such a PE. This condition cannot be satisfied in these two cases. It is also well settled in law, as very well set out by Hon'ble Supreme Court in the case of **GE Technology Center Pvt Ltd Vs CIT (327 ITR 456)** that unless the non-resident has a tax liability in respect of income embedded in the payment, tax deduction obligation under section 195 cannot come into play. Once we come to the conclusion that the assessee did not have any obligation to deduct tax at source from these payments, the very foundation of impugned disallowances ceases to hold good in law. By no stretch of logic, therefore, payments made to these entities can be disallowed under section 40(a)(i) on the ground that taxes have not been deducted at source from these payments. The disallowances of payments of Rs 48,95,50,760 to MC Metal Services Asia (Thailand), of Rs 49,73,73,422 to Metal

One Corporation (Japan) and of Rs 1,74,72,633 to Metal One (Asia) Pte Ltd Singapore, accordingly stand deleted.

Disallowance of payments under section 40(a)(i) made to the foreign entities, without deduction of tax at source, which may not have any permanent establishment in India but there is no material to establish that fact and there is also no material on record to show that revenue's claim of their having PE in India is negated by the judicial authorities.

91. In the second segment, we take up disallowance of payments made to the foreign entities which may not have any permanent establishment in India but there is no material to establish that fact and there is also no material on record to show that revenue's claim of their having PE in India is negated by the judicial authorities. So far as this segment is concerned, the related payments are (i) payment of Rs 93,345 to Mitsubishi Corporation Singapore, (ii) payment of Rs 33,76,808 to MC Tubular Inc USA, (iii) payment of 23,73,391 to Thai MC Co Ltd, Thailand, and (iv) payment of Rs 22,95,618 to Peto Diamond Corporation, Japan.

92. Coming to the taxability of these payments in the hands of the recipients in India, it is only elementary that the onus of establishing that the recipient of an income has a PE in India, so as to invite its taxability in India, is on the revenue authorities. The existence of PE cannot be inferred on assumed on the basis of some vague and sweeping generalizations as have been made in this case. In the landmark Special Bench decision in the case of **Motorola Inc. vs. DCIT (95 ITD SB 259)**, a Special Bench of this Tribunal had observed that "**DTAA is only an alternate tax regime and not an exemption regime**" and, therefore, "**the burden is first on the Revenue to show that the assessee has a taxable income under the DTAA, and then the burden is on the assessee to show that that its income is exempt under DTAA**". It is thus wholly inappropriate to proceed on the basis of assumption that since the recipient entities were following certain business model, these entities must be having a PE in India. Such an approach, as adopted by the revenue authorities on this aspect of the matter, cannot meet any judicial approval.

93. In any case, as has been observed by Hon'ble Supreme Court, in the case of **KP Varghese Vs ITO (131 ITR 597)**, nobody can be expected to prove a negative as it would be to cast an impossible burden upon him to establish a negative. Expecting the assessee to prove that the recipient did not have a PE in India is also expecting the assessee to establish a negative, which, as noted above, is an impossible burden to discharge.

94. We have noted that in the DRP order, there is also a mention about the limited force of attraction rule in view of the words profits 'directly or indirectly' attributable to the PE, appearing in Article 7(1) of India Japan tax treaty, and it is noted that, in the light of Tribunal decision in the case of **Linklaters LLP Vs ITO [9 ITR (Trib) 217]**, the mere existence of a PE in India will result in taxability of all profits on account of such goods as are same or similar to the ones sold in India through the PE of a Japanese enterprise. It is not only a case of completing assessment based on a hypothetical assessment of an imaginary fact situation, it is building a foundation of assessment by resorting to fiction upon fiction inasmuch as it is assumed that the vendor in question must be having a PE in India, for which there is no factual support on record, but it is also assumed that such a non-existent PE must also be dealing in the same or similar products as sold by that vendor. Such a fertile imagination may indeed help as inputs for investigation but it does no good to assessment of income which must be based on cogent material on record. We are unable to see any legally sustainable merits in this approach. On the basis of these assumptions, as made by the Assessing Officer and which we find to be unsustainable in law and on facts, tax liability of recipients cannot be inferred. In any event, normal purchases from non-resident companies based in Thailand, Singapore and USA, as these vendors are, cannot give rise to taxability of income from such purchases, in the hands of the non-resident vendor, unless such non-resident companies have a permanent establishment in India. The onus to show that a foreign company has a PE in India is on the revenue and when that onus is not discharged, there cannot be any occasion to hold taxability of business profits of those entities in India. It is also well settled legal position that when

the income embedded in the payments in question is not held to be taxable in India, there is no requirement to deduct tax at source under section 195.

95. Accordingly, on the facts of this case and in respect of these payments, there is no failure on the part of the assessee in deducting tax at source under section 195 and there is no cause of action for disallowance under section 40(a)(ia). In view of these discussions, we deem it fit and proper to direct the Assessing Officer to delete the impugned disallowance under section 40(a)(ia) in respect of payment of Rs 93,345 to Mitsubishi Corporation Singapore, payment of Rs 33,76,808 to MC Tubular Inc USA, payment of 23,73,391 to Thai MC Co Ltd, Thailand, and payment of Rs 22,95,618 to Peto Diamond Corporation, Japan.

Disallowance under section 40(a)(i) in respect of payment made, without deduction of tax at source, to a foreign entity which has a PE in India and which is taxable in India in respect of such payments

96. That leaves us with only disallowance under section 40(a)(ia) in respect of one payment of Rs 91,80,507 to MCJ.

97. So far disallowance of payments made, without deduction of tax at source, to an entity which have a PE in India and which has accepted the tax liability in respect of the transactions in question, is concerned, i.e. MCJ, assessee's defence is in seeking deduction neutrality, so far as payments made to these Japanese tax residents are concerned, vis-à-vis payments made to the resident entities. It is in this respect that the assessee's case hinges on non-discrimination clause.

The position in the immediately preceding assessment year

98. We find that so far as the issue on non-discrimination, seeking deduction parity, is concerned, it is covered in favour of the assessee, by decision of a coordinate bench, in assessee's own case for the immediately preceding assessment year. While deleting similar disallowance, the coordinate bench has, *inter alia*, held as follows:

9. On the first issue of disallowance u/s.40(a)(ia), except in the case of MC Metal Services Asia which is a tax resident of Thailand and Metal One Asia Pte Ltd. a tax resident of Singapore, the common argument of the assessee is that the Non discrimination Clause of the DTAA entered into between India and USA in the case of Mc. Tubular Inc. USA and DTAA between India and Japan in all other cases apply. We now examine this contention.

9.1 The Delhi Bench of the Tribunal in the case of *Herbalife International (P.) Ltd.* (*supra*), held as follows:

> **"22. Article 26 of India-US DTAA deals with 'non-discrimination'. Article 26(1) says that nationals of one contracting State shall not be subjected in the other contracting State to any taxation or any requirement connected therewith which is much more onerous, than it is on the nationals of that other contracting State. Article 26(2) provides against discrimination in the context of a permanent establishment in the other contracting State. Article 26(3) is a general clause providing for indirect discrimination against a non-resident.**
>
> **The provisions of section 40(a)(i), as it stood prior to it's amendment by the Finance Act, 2003 with effect from 1.4.2004, applied to payments by an assessee outside India to a non-resident only. After 1-4-2004, the provisions apply equally to both resident and non resident. In the instant appeal, the provisions of section 40(a)(i) as it existed prior to 1-4-2004 alone were applicable. Admittedly in the instant case, the exceptions set out in article 26(3) were not attracted. Therefore, the payment made by the assessee to 'H' was of the nature contemplated by article 26(3). [Para 22]**
>
> **The payment in question by assessee to 'H' attracted the provisions of the Indo-US DTAA. The payment in question, if at all, would be taxable in the hands of 'H' in India only if it was a payment for included services within the meaning of article 12(4) of the said DTAA and not taxable in India otherwise. The sum in question could not be taxed as business income, since 'H' admittedly did not have a permanent establishment in India. If the income was considered as having accrued or arisen to 'H' in India, yet it could be taxed in India only if it was fees for included services. Even if the payment was considered as 'fees for technical services' within the meaning of the Act, yet it could not be taxed because 'fees for technical services' and 'fees for included services' under India-US DTAA had different meaning and they were not one and the same. If the revenue wanted to tax the payment by assessee to 'H' in the hands of 'H' in India, it had to bring its case within the ambit of article 12(4) of the DTAA, i.e., fees for included services. The payment in question would,**

therefore, have to be judged in the context of the DTAA as to whether it was taxable in India or not. [Para 24].

The provisions of section 40(a)(i), as it existed prior to it's amendment by Finance Act, 2003 with effect from 1-4-2004, provided for disallowance of payment made to a non resident only where tax is not deducted at source on such payment at source. A similar payment to a resident does not result in disallowance in the event of non-deduction of tax at source. Thus, a resident left with a choice of dealing with a resident or a non-resident in business, would opt to deal with a resident rather than a non-resident owing to the provisions of section 40(a)(i). To that extent, the non-resident is discriminated. Article 26(3) of Indo-US DTAA seeks to provide against such discrimination and says that deduction should be allowed on the same condition as if the payment is made to a resident. Thus, this clause in DTAA neutralizes the rigour of the provisions of section 40(a) (i). By virtue of the provisions of section 90(2), the law, which is beneficial to the assessee to whom the DTAA applies, should be followed. Therefore, in view of article 26(3) of Indo-US DTAA, the Assessing Officer could not seek to invoke the provisions of section 40(a)(i) to disallow the claim of the assessee for deduction even on the assumption that the sum in question was chargeable to tax in India. [Para 26]"

9.2 The propositions laid down in this decision are squarely applicable to the transactions with MC. Tubular Inc. USA, as this is covered by the Indo-US DTAA.

9.3 The Non Discrimination Clause under Indo-Japan DTAA reads as follows:

"Except where the provisions of paragraph 1 of article 9 (Associated Enterprises), paragraph 7 of article 11 (interest) and paragraph 8 of article 12 (Royalties and Fees for Included Services) apply, interest, royalties and other disbursements paid by a resident of a contracting state to a resident of the other contracting state shall, for the purposes of determining the taxable profits of the first mentioned resident, be deductible under the same conditions as if they had been paid to a resident of the first mentioned contracting state".

As the wording of this Clause is *pari materia* with the wording used in the Non Discrimination Clause in the Indo-US DTAA. This is not disputed by the Revenue. Hence, we hold that the propositions laid down in the case of *Herbalife International (P.) Ltd.* (*supra*) apply to all the entities which are governed by the Indo-Japan DTAA.

9.4 The Ld. D.R. relied on the decision of the Tribunal in the case of *Automated Securities Clerance Inc.* (*supra*). In this context we find that the Special Bench of the Tribunal in the case of *Rajeev Sureshbhai Gajwamni* (*supra*) also considered the issue and held as follows:

> **"Section 90(2) provides that where the Central Government has entered into an agreement with the Government of any country outside India or specified territory outside India for grant of relief of tax or avoidance of double taxation, then in relation to the person to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to the person. In a nutshell, this provision makes it obligatory in respect of a person to whom the DTAA applies that the assessment shall be made in accordance with the DTAA, but if any provision of the Act is more beneficial to the person, then he shall be granted benefit under the Act. In common parlance this principle is known as 'Treaty Override". What it means is that the assessment of such a person shall be made in accordance with the provision contained in the DTAA. However, if any provisions of the Act are found to be more beneficial, then the assessment shall be made in accordance with the provisions contained in the Act. Since according to the assessee, the provisions of the Act were not more beneficial to him, he was to be assessed under the DTAA. In this connection, article 26(2) provides that except where the provisions of paragraph (3) of article 7 (business profits) apply, the taxation of a PE of an enterprise of a Contracting State in the other Contracting State shall not be less favourably levied in that other Contracting State than the tax levied on enterprises of that other Contracting State carrying on the same activities. While interpreting this paragraph, it is also necessary to examine the contents of paragraph (3) of article 7. This paragraph deals with deduction of expenses incurred for the purpose of the business of the PE, including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest and other expenses inc urred for the purpose of the enterprise as a whole. On consideration, it is seen that these provisions were not material insofar the facts of the instant case were concerned because there was no dispute about the computation of income which included deduction of expenses from the income earned by the PE. Therefore, it was necessary to examine and interpret the intent and purpose of the paragraph (2) of article 26. In simple language and taking into account the facts of case, the language employed in the provisions means that taxation of a PE of the USA shall not be less favourable than the taxation of a resident enterprise carrying on the same activities. [Para 8.1].**

Insofar as the status of commentary on the OECD Model Convention is concerned, for interpretation of the DTAA, it is clear 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. [Para 8.3]

The revenue referred to the Board Circular No. 621, dated 19-12-1991, issued after introduction of section 80HHE. Reference was 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 section 80HHE has been inserted in the Act for providing tax concession similar to the earlier section 80RRe. Nothing was found in the circular which could be of aid in interpreting article 26(2). Further, reference was made to Circular No. 333, dated 2.4.1992, issued in respect of the "Treaty Override". The heading of the Circular is 'Specific provision made in double taxation avoidance agreement - whether it would prevail over general provisions contained in the Income-tax Act'. In Para 3, it is mentioned that where double taxation avoidance agreement provides for a particular mode of computation of income, the same should be followed, irrespective of the provisions in the Income-tax Act, which is the basic law, i.e., the Income-tax Act will govern taxation of income. The case of the revenue on the basis of this Circular was that since there was no provision in the DTAA analogous to section 80HHE, the assessee was not entitled to the deduction. The interpretation placed on the circular by the revenue was misplaced.

The reason is that the wording of article 26(2) of the DTAA 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 an Indian enterprises would also be granted to the US enterprises if they are carrying on the same activities. [Para 8.4]"

In this decision the Tribunal at para 9 page 162 held that the decision in the case of *Automated Securities Clearance Inc.* (*supra*) is not in conformity with the provisions contained in Article 26(2) of the Indo-US DTAA. Hence this decision in the case of *Automated Securities Clearance Inc.* (*supra*) does not help the Revenue. Thus on the ground of Non Discrimination the disallowances of purchases in the case of (i) MCJ, (ii) MOCJ, (iii) Mc.Tubular Inc, USA, (iv) Petro Diamond Corp. Japan and (v) Miteni, Japan are to be deleted.

Rival contentions

99. Learned counsel for the assessee takes us through the orders of the authorities below and the order of the Tribunal, in assessee's own case, for the immediately preceding assessment year. Learned counsel also takes us through a coordinate bench's decision in the case of **DaimlerChrysler India Pvt Ltd Vs DCIT (29 SOT 202)** in support of the proposition that it is not a condition precedent for the assessee to be a resident of the treaty partner country in order to seek treaty protection. It is submitted that discrimination is against the entities which are tax residents of treaty partner jurisdictions inasmuch as the payments made to these entities is discriminated vis-à-vis payments made to similarly situated domestic business entities. It is this discrimination against the tax residents of treaty partner jurisdictions that is being sought to be nullified. He also takes us through some observations made by Prof Klaus Vogel in his oft quoted book 'Klaus Vogel on Double Taxation Conventions' in support of the contention that this type of a discrimination with regard to the deductibility of payments made to resident taxpayers and non-resident taxpayers is impermissible. When it is put to him that with the insertion of Section 40(a)(ia) in the Income Tax Act with effect from 1st April 2005, there does not seem to be any discrimination under the Income Tax Act so far as payments made to residents and non-residents are concerned, he submits that there is still a discrimination inasmuch as while there is no tax deduction at source requirements from purchases from residents, there is a tax deduction at source requirement from the non-residents. Learned counsel submits that if assessee makes purchases from a resident assessee and does not deduct tax at source, the purchases will qualify to be tax deductible as there is no tax deduction at source requirement from such payments. However, if assessee makes purchases from a non resident and does not deduct tax at source, the purchases will cease be tax deductible in case the income embedded therein is held to be taxable in India. It is this discrimination, according to the learned counsel, that the assessee is aggrieved of.

100. Learned Departmental Representative, however, does not give up even as he recognizes that there is a direct decision on this assessee, in assessee's own case, in favour of the assessee. While he admits that the issue is indeed covered in favour of the assessee by coordinate bench's decision for the immediately preceding assessment year, he submits that this aspect of the matter deserves reconsideration. In addition to the elaborate submissions made by the learned Departmental Representative during the course of the hearing, he has also filed exhaustive written submissions. The thrust of his argument that there are no independent findings on the non-discrimination issue by the coordinate bench and the coordinate bench has simply relied upon the Herbalife decision *(supra)* of the Tribunal but, in doing so, what it has overlooked is that post insertion of sub section 40(a)(ia), Herbalife is no longer good in law. It is pointed out that in the case of the Herbalife, the Tribunal was dealing with the assessment year 2001-02 and that was the point of time when section 40(a)(ia) was not on the statute. It was in this backdrop that section 40(a)(i) was held to be discriminatory vis-à-vis non-residents. However, subsequently, though much before even this decision was rendered, law was amended and such an inequity, even if that be so, was removed. As the law stands now, whether payments are made to non-residents without compliance with tax withholding requirements or payments are made to residents without compliance with tax withholding requirements, the fate is the same i.e. both the categories of payments are disallowed in computation of business income of the person making such payments. As for learned counsel's point that there is no tax deduction at source requirements from payments made to Indian residents on account of purchases, and that any such requirement in the case of non-residents will thus be discriminatory, there is no discussion whatsoever on this aspect of the matter in the order under reference nor has it been even specifically taken up by the assessee before the authorities below. The coordinate bench was simply swayed by the Herbalife decision, and there is not even a whisper of a discussion on this aspect of the matter. Learned Departmental Representative submits that that the decision of the Tribunal in the case of **Automated Securities Clearance Inc Vs ITO (118 TTJ 619)** is indeed irrelevant in the present context but the reliance of the assessee on **Suresh Rajeevbhai**

Gajnani's case *(supra)* is also equally irrelevant as both this decisions deals with PE tax neutrality, which is a distinct and separate clause in India Japan tax treaty i.e. Article 24(2), whereas deduction neutrality, which is sought to be enforced in a different clause i.e. Article 24(3). These two types of discriminations have different connotations and scope, and what is decided in the context of one type of discrimination does not necessarily apply in the context of the other type of discrimination.In a written note filed at the time of hearing, the submissions of the Departmental Representative, on this point, are summed up as follows:

> *2. It has been claimed that disallowance under section 40a (i) is bad in law in view of the non-discrimination clause i.e. Article 24(3) of the DTAA between India and Japan. Reliance is placed on the order of the Hon'ble ITAT in its own case for AY 2006-07.*
>
> *3. The Revenue submits that the order of the Hon'ble ITAT cannot be relied for this year for the reasons given below.*
>
> *4. The reasoning of the Hon'ble ITAT is given in paragraphs 9.1 to 9.4 of the order for assessment year 2006-07. The sole basis of the Hon'ble ITAT for deciding the issue is the order of the Hon'ble ITAT Delhi Bench in the case of Herbalife International India Private Limited (101 ITD 450 (Del) = (2006-TII-ITAT-INTL). Paragraph 22 of that order is reproduced in paragraph 9.1 and 9.2 hold that the propositions laid down I this decision are squarely applicable to the transactions with MC. Tubular Inc. USA, as this covered by the Indo-US DTAA. Paragraph 9.3 holds that the wording of non-discrimination Clause in Indo-Japan DTAA is para materia with the wording used in Non-discrimination clause in the Indo-US DTAA and this is not disputed by the Revenue. Hence, we hold that the propositions laid down in the case of Herbalife apply to all the entities which are governed by the Indo-Japan DTAA.*
>
> *5. Therefore, there is no independent finding except following the order of the Hon'ble ITAT in the case of Herbalife. It is respectfully submitted that the reasoning given in the order of Herbalife is not applicable for the year under consideration and it was even not applicable for AY 2006-07. Paragraph 22 of the order in case of Herbalife clearly stated that "the provisions of section 40(a)(i), as it stood prior to its amendment by the Finance Act, 2003 with effect from 1.4.2004, applied to payments by an assessee outside India to a non-resident only. After 1.4.2004, the provisions apply equally to both resident and non-resident. In the instant appeal, the provisions of section 40a (i) as it existed prior to 1-4-2004 alone were applicable".* ***The decision in case of Herbalife clearly stated that after 1.4.2004, the provisions apply equally to both resident and non-resident.*** *Therefore, as the year under appeal is AY 2007-08, the Revenue*

relies on the decision of Herbalife to contend that the ratio is in favour of the Revenue for AY 2007-08 and there is no discrimination.

6. It is humbly submitted that the Hon'ble ITAT for AY 2006-07 fell in error and committed an error in applying the decision in case of Herbalife wrongly and in fact the decision was in favour of the Revenue. It is humbly submitted that such a decision which was wrongly arrived at need not be followed. The Revenue places reliance on the judgment of the Hon'ble Supreme Court in the case of Distributor (Baroda) Pvt. Ltd v. UOI 155 ITR 120 to submit that paragraph 2 of the judgment reads as: " To perpetuate an error is no heroism. To rectify it is the compulsion of judicial conscience. A judge ought to be wise enough to know that he is fallible and therefore ever ready to learn: great and honest enough to discard all mere pride of opinion and follow truth wherever it may lead: and courageous enough to acknowledge his errors". Further paragraph 19 of the judgment by Hon'ble Justice Bhagwati wrote that "The doctrine of stare decisis should not deter the court from overruling an earlier decision, if it is satisfied that such a decision is manifestly wrong or proceeds upon a mistaken assumption in regard to the existence or continuance of a statutory provision or is contrary to another decision of the Court. Kindly refer to pages 148 to 158 of the Revenue's PB). Paragraphs 2 (page 150) and paragraph 19 (page 156) of the order are relied.

7. In the present case, the Revenue is arguing not to overrule the decision for AY 2006-07 but humbly praying for not to follow as that decision was given based on mistaken assumption and not considering the applicability of amended law for AY 2006-07.

8. In the above matter, the Revenue also relies on the judgment of the Hon'ble Apex Court in the case of Sun Engineering Works (P) Ltd [1992] 198 ITR 297 (SC). Paragraph 37 on page 12 of the order is relied upon.

9. It is further submitted that paragraph 9.4 of the order of the ITAT in case of the assessee for AY 2006-07 refers to the decisions in cases of Automated Securities and Rajeev Sureshbhai Gajwani dealt with non-discrimination issues in relation to taxation of permanent establishment (pargarph2 of the Article) whereas the present case deals with paragraph 3 of the Article therefore those decisions are not all relevant to the case and not applicable.

101. Learned Departmental Representative then addressed his arguments on merits and contended that the decision of the coordinate bench in the case of Herbalife was inappropriate and contrary to the first principles of international taxation. It was also pointed out that assuming that the assessee is aggrieved of discrimination in respect of purchases from resident assessees vis-à-vis Japnese non-resident assessees, even this argument is legally untenable. There is no

such discrimination on the facts of this case and this arguments proceeds on the fallacious assumption that there is no tax deduction requirement from purchases from resident assesses, when made under a contract as was the case of purchases from Japanese non-resident assessees. He also prayed that this written arguments may please be taken on the record so that, even if we follow the decision of the coordinate bench in the immediately preceding assessment year, Hon'ble Courts above may have the benefit of examining revenue's perspectives on this aspect of the matter. However, for the reasons we will set out in a short while, it not necessary to go into all these fine points, so strenuously argued by the learned Departmental Representative, though we must reproduce extracts, from the written submission filed by the learned Departmental Representative, as follows:

> **Paragraph 1 of non-discrimination Article does not apply**
>
> 11. This paragraph applies to situations when the Nationals of a Contracting State are subjected in the other Contracting State to any taxation and any requirement connected therewith. It is not the case of the assessee that non-resident (foreign company) is being subjected to any discrimination. Therefore, this paragraph is not applicable.
>
> **Paragraph 3 does not apply to deductions on account for purchases**
> 12. The provisions apply to interest, royalties and other disbursements. The payments were made for purchases and not are of the nature of interest, royalties and other disbursements.
>
> 13. Copy of Article 24 of the United Nations Model Double Taxation Convention between Developed and Developing Countries (UN Model Tax Convention) and its Commentary on paragraph 4 of Article 24 (pages 106 to 108 of the Revenue's PB). This document is available on the ITAT website www.itatonline.org.
>
> 14. It is humbly submitted that paragraph 4 of Article 24 of the United Model Tax Convention is similar to paragraph 3 of Article dealing with non-discrimination in the US and Japan treaty (kindly refer to page 106 of the Revenue's PB). Page 108 of the Revenue's PB contains a copy of the UN Commentary on paragraph 4 of Article 24 of the UN Model Convention. The purpose of introducing the provision is explicitly stated therein. It applies in a situation while the deduction of interest, royalties and other disbursements are restricted or prohibited. This refers to regulatory restrictions like imposed by the Central Bank of a country or under any other law or regulations. For example say payments were earlier restricted under RBI Regulations in regard to royalties (kindly see

pages 114 to 125 of the revenue's PB). In view of the provisions of paragraph 4, the deduction for claims could have been made even if the payments of royalties or interest or fee for technical services could not be allowed under FEMA Regulations.

15. Paragraph 74 of the Commentary (page 108 of Revenue's PB) clearly mentions that application of thin capitalization rules provided in domestic rules are not covered by paragraph 4 of the Article. This indicates that domestic rules do not automatically results into discrimination if the purpose is well established.

16. Similarly, paragraph 75 of the Commentary refers to additional information requirements for ensuring similar levels of compliance. In the present case it is submitted that disallowance under section 40a (i) are to ensure compliance of the provisions of deduction of tax at source and payments thereof. This is separately discussed below in this submission.

17. Paragraph 2 of the Commentary on paragraph 4 (kindly refer to page 108 of the revenue's PB) further explains the reasons of restrictions. Deductibility of disbursements made abroad by foreign owned corporations (meaning subsidiaries of foreign companies) conditional on the recipient being taxed in such countries. Meaning deduction will not be allowed if the payments are not subjected to tax in the country of recipient.

US Treasury Department Technical Explanation of the Convention and Protocol between the USA and the Republic of India for the avoidance of Double Taxation and Prevention of Fiscal Evasion.

18. This explanation pertaining to Article 26 is attached (pages 109 to 113 of the Revenue's PB).

19. It is submitted that the DTAA is an international agreement. The interpretation adopted by the USA also equally applies in India as the obligations and its effect is reciprocal. If the USA interprets some portion of its law and Regulations (which do not have corresponding provisions in Indian law) are not affected or not covered in the scope of non-discrimination provisions then on reciprocal basis some provisions of domestic law of India, which has a genuine and legal requirements, would also not be covered in the scope.

20. Explanation says that the requirement to withhold tax on distributions to Indian partner and not to US partner's share is not discriminatory taxation, but, like other withholding tax on non-resident aliens, is merely a reasonable method for the collection of tax from persons who are not continually present in the United States to enforce its tax jurisdiction. For this reason, the contention of the assessee that non-resident gets discriminated because no Indian company will make

purchases from non-resident because its purchase are subjected to disallowances under section 40a (i) and not purchases from residents. If this analogy is applied in the USA then the partnership discriminates Indian partners and no firm will then keep Indian partners. Such an argument is farfetched and has no logic.

21. Explanation further states that the term other disallowances is understood to include a reasonable allocation of executive and general administrative expenses, research and development expenses and other expenses incurred for the benefit of a group of related persons which includes the person incurring the expenses. This indicates that the paragraph covers expenses which may be subjected to restrictions/prohibitions but does not cover any temporary disallowances that are made to ensure compliance of the provisions of tax laws.

Disallowances under section 40a (i) are to ensure compliance

22. Provisions of section 40a (i) of the Act are to ensure compliance of TDS provisions. It covers cases where the tax is either not deducted or after deduction is not paid as required under the provisions of Chapter XVVII-B of the Act. In this regard reference is made to Circular No. 528 dated 16th December, 1988 explaining the scope and effect of section 40(a)(i) of the Act (page 159 to 161 of the Paper Book). This circular explicitly states that " in order to ensure effective compliance of the provisions of section 195 of the Act relating to deduction of tax at source in respect of payments made outside India. The law as well as circular provides that if in any subsequent year, tax is deducted at source or paid; such sum will be allowed as deduction in computing the income chargeable to tax for that year. Therefore, the purpose of these provisions is not to provide a different taxation system or any connected requirements but to ensure the effective compliance of the TDS provisions.

Now even the Act has been amended

23. Act has been amended effective 1.4.2004 (duly taken note in the case of Herbalife by the Hon'ble ITAT) to provide for similar disallowances for ensuring compliance of TDS provisions in regard to payments to residents (section 40 (a)(ia)). Tax is deductible under various sections of Chapter XVII-B of the Act out of various payments to residents. The deduction for these payments is not allowed under section 40a (ia) of the Act if the tax is either not deducted or after deduction the same is not paid to the government account.

24. These provisions are compliance provisions only as the payer is under obligation to deduct tax and authorised to do so far and on behalf of the Government. It is a great obligation and such deductors act as an arm of the government. A great responsibility is cast on them to deduct the tax and not to use the same for their business use but to pay to the government. This provision is similar to section 43B of the Act and if this

provision is not in Statute then the deductors will not deposit the tax deducted until detected by the Government.

25. The contention that there is no disallowance in cases of payments to residents if tax is not deducted out of payments for purchases. It is submitted that there is no deduction of tax out of payments on account of purchases made therefore no question arises for disallowances. Further, if the purchases are a part of contract then the provisions of section 194C apply and in case of non-deduction of tax or non-payments, the provisions of section 40(a)(ia) will apply.

TDS provisions are collection and recovery provisions

26. Provisions of Chapter XVII-B are collection and recovery provisions (Deduction of Tax at Source) and do not determine the taxability of amount paid or the income that arise due to these payments. If any amount is deducted in excess then the payee can claim refund for the same. Provisions of section 190 of the Act are explicit on the issue.

27. Provisions of TDS are not discriminatory because the same apply to residents as well as non-residents. They need to deduct tax if payments are made to residents or non-residents.

28. Similarly, no resident can claim discrimination under paragraph 3 of non-discrimination article because the disallowance under section 40(a)(ia) will be made in case of residents as well as non-residents. It cannot be the case that disallowances are made in case of residents only. Such disallowances are also required to be made in case of non-residents if they fail to deduct or deposit the TDS as required by provisions of section 195 of the Act.

29. The contention that a resident will not make a purchase from non-resident vis-à-vis resident because in case of non-resident tax is required to be deducted and if not paid disallowance will be made. This contention is farfetched and has no basis because in that case business decisions are considered to have been dictated for the reason of tendency of a taxpayer for not obeying the law. There is no justification for no-deduction and after deduction non-payment of tax when these functions are performed in a fiduciary capacity and acting as a part of government tax collection machinery.

Deductible under the same conditions

30. The deduction of tax out of payments from non-residents and residents are not under the same conditions. Residents and non-residents are subjected to different requirements and enforcement provisions. Question of territorial jurisdiction is also important. The Act does not empower the tax authorities to enforce compliance in case of non-residents as in case of residents. Indian Act has no direct application in a

foreign territory. Provisions of section 195 and section 40(a)(ia) have proper justifications as to ensure collection of tax out of payments to non-residents. They can claim refund if excess tax is deducted.

31. In case of residents the AO can take actions under section 131, 132, 133A and 133(6) of the Act. Such an actions are not possible in case of non-residents. In some cases (Section 115), the non-residents are not requiring to file tax returns. Residents and non-residents are not under the same conditions.

32. The non-discrimination clause is not intended to offer the protection to resident or non-resident so as to encourage them to disobey the law of the land or reward them for non-compliance of law. The purpose of non-discrimination clause is to protect from discrimination but not to enable them to disobey the law of the land or allow them to unnecessary enrich themselves. For example, if the contention of the Ld Sr. Counsel is accepted then in that case, the resident can deduct the tax and it need not pay the money and use the government money for its business and get enriched at the cost of the government and at the same time non-discrimination clause will protect it. Such type of unintended interpretation will lead to disastrous consequences which are not thought of at present.

33. Further, the residents are subjected to full tax liability (taxation of word wide income) and they will tax even if tax is not deducted out of payments and those can be subjected to enforcement actions and tax can be collected from them, however, no such enforcement actions is possible in case of non-residents.

A selected reference to Kluwer Book by Kees Van Raad on "Non-discrimination in International Tax law" part of Series on International taxation.

33. Page 174 of the Book states that, "The provision protects resident enterprises against the practice of-particularly Latin American- States to disallow as a deduction from taxable profit certain payments made to non-residents. This practice apparently stems from the fear of these States that the national tax basis will be eroded by shifting income abroad through payments by a resident taxpayer to related non-resident company". (Page 174 of the Book).

Effect of insertion of second proviso to Section 40(a)(ia) and impact of non discrimination clause, in India Japan DTAA, on extending this benefit to the Japanese tax resident entities receiving payments from India

102. During the course of this hearing, learned Departmental Representative was asked whether, given the facts of this case and given the developments in law, this issue has not become academic. It was pointed out to the learned

Departmental Representative that there is only one case of non-resident recipient in which the existence of PE is established and of the recipient having filed its return of income in India, and even in that case recipient is admitted to have taken into account the impugned receipt of Rs 91,80,507 in its computation of business income. It was also put to the learned Departmental Representative that when the recipient non-resident has already included the receipt in question in computation of its business income in India and paid taxes thereon, and in the light of second proviso to Section 40(a)(ia) having been held to be retrospective with effect from 1st April 2005, there seems to be no valid ground to discriminate against a non-resident assessee. Learned Departmental Representative was asked to address on this aspect of the matter, on the justification for difference in treatment of non-resident recipients vis-à-vis resident recipients in disallowances under section 40(a)(i) vis-à-vis 40(a)(ia), and on the impact of non-discrimination clause in Indo Japan tax treaty on this, what seems to us to be, a somewhat discriminatory practice. Learned Departmental Representative was also asked to take into account, in his submissions, two decisions of the Tribunal – one, in the case of **Rajeev Kumar Agarwal Vs ACIT (149 ITD 363)**, wherein it is held that insertion of second proviso to Section 40(a)(ia) is to be treated as effective from 1st April 2005; and – second, in the case **of DCIT Vs Gupta Overseas [30 ITR (Trib) 738]**, wherein, following special bench decision in the case of **Rajeev Sureshbhai Gajwani Vs ACIT [8 ITR (Trib) 616)]** it was held that even a differentiation *simplictor* for treatment in deductibility of payments made to residents vis-à-vis non-residents will amount to impermissible non-discrimination.

103. Learned Departmental Representative submitted his argument is primarily on principle and to highlight the correct legal position because whatever is held by the Tribunal in one case essentially becomes a precedent for other similarly placed cases as well. It was submitted that his basic contention is that Herbalife is no longer good law, and, as evident from the unambiguous caveat put in by the bench to the effect that "in this appeal we are concerned with asst. yr. 2001-02 in which the provisions of s. 40(a)(i) as it existed prior to 1st April, 2004 alone are applicable", even the coordinate bench was essentially

aware that the principle laid down in this case will cease to be relevant post insertion of section 40(a)(ia). It was submitted that his grievance against this principle implicit in the arguments of the learned counsel that disallowance is a discriminatory in the light of Herbalife decision. As for the second proviso to Section 40(a)(ia) being discriminatory to non-residents in the absence of similar provision in Section 40(a)(i), learned Departmental Representative very fairly submitted that it is inherently impossible, no matter how much one strives for it, to visualize all possible real life situations when legislation is drafted. He accepts that similarly placed assesses making payments to non-residents, i.e. where recipients have taken into account the related receipts in computation of their income and duly filed their income tax return under section 139(1) in respect of the same, will be placed at a disadvantage but hastens to add that it cannot be for this Tribunal to supply *casus omissus*, even if there be any. As regards the principles laid down by the coordinate bench in the case of Gupta Overseas *(supra)*, so far as impermissible non-discrimination with regard to deductibility conditions in respect of payments to non-residents, learned Departmental Representative once again relied upon the stand of the Assessing Officer and his detailed note reproduced earlier in this order. Learned Departmental Representative reiterated that post insertion of Section 40(a)(ia), there is no discrimination in disallowing payments made to non-residents without deduction of tax at source. In rejoinder, learned counsel for the assessee reiterated that it is indeed true that the decision of Tribunal, in the case of **Automated Securities Clearance** *(supra),* is not relevant for deciding the issue in appeal before us but then this decision was relied upon by the revenue authorities in support of their rejection of treaty protection but now that the view so taken by a division bench is reversed by a Special bench of the Tribunal in the case of **Rajeev Sureshbhai Gajwani** *(supra)*, this decision is being termed as irrelevant. The reference to Rajeev Sureshbhai Gajwani's case was made by the assessee because the decision relied upon by the Assessing Officer was disapproved in this case. If nothing turns on this case, the Assessing Officer had no reasons to reject the treaty protection demanded by the assessee because the only defence available to the Assessing Officer was this decision of the Tribunal. Learned counsel further submitted that whether or not treaty

protection is available in respect of the deduction neutrality, this issue is no longer *res integra*, inasmuch as Herbalife decision *(supra)* lays down that principle and a large number of decisions of the coordinate benches, including in the case of Gupta Overseas *(supra)* have consistently followed that path. Learned counsel submits that when the claim for deduction neutrality for payments made to Japanese tax residents was put, the Assessing Officer had only two objections- first, that the assessee, being a tax resident of India, was not eligible for treaty protection; and, second – that Herbalife decision is not good law in view of certain observations made in a later decision of the Tribunal in the case of Automated Securities Clearance. Both of these objections are devoid of any legally sustainable foundation. As for the eligibility of the assessee for treaty protection, there are direct decisions by the coordinate benches, including specifically in the case of DaimlerChrysler India Pvt Ltd *(supra),* wherein it is held that even in the Indian tax residents are eligible for treaty protection in appropriate situations. As for the reliance on observations made in Automated Securities Clearance decision, these observations, even if can be construed against the assessee, are no longer good in law in view of the subsequent special bench decision. Learned counsel points out that even the author of the said decision has, in a later decision authored by him in the case of Gupta Overseas *(supra),* acknowledged this position and followed the special bench decision declining to be guided by Automated Securities decision which he himself had authored a few years ago. As for the argument that the issue of deductibility of purchases from non residents being discriminatory not having been dealt with in the order of the coordinate bench, learned counsel submits that a judicial authority can only decide an issue on which there is a difference in the stand of the parties and when assessee's claim of this discrimination was not disputed by the Assessing Officer on this count, there could not have been any occasion to adjudicate on this aspect of the matter. What has been accepted by the AO himself in the preceding assessment year cannot be disputed now. In any case, even on merits, the discrimination is glaring inasmuch as when payments are made from a resident assessee, which essentially has an income embedded in it, there is no tax deduction at source requirement, whereas when payment is made to a non-resident Japanese assessee, whether or not there is

any income embedded in it, tax is required to be deducted at source. If this kind of a discrimination is permitted, non-discrimination clauses in the tax treaties will be rendered meaningless. Learned counsel then moves on to legislative amendments in section 40(a)(ia) by the virtue of Finance Act 2012 and by inserting second proviso to section 40(a)(ia). It is pointed out that in view of this amendment, when an assessee makes a payment, even without deducting tax at source, to the resident assessee but resident assessee takes into account such receipt in its computation of income and files the income tax return under section 139(1) in respect of income so computed, no disallowance under section 40(a)(ia) can be made. However, in corresponding provision for payments made to non-resident assessees, i.e. under section 40(a)(i), when an assessee makes payments to non-resident assessees without deducting tax at source and even if the recipient takes into account such receipts in his computation of business income and files income tax under section 139(1) in respect of the same, the disallowance will be made nevertheless. Learned counsel submits that since the provision of section 40(a)(ia) is held to be retrospective with effect from 1st April 2005 by a coordinate bench's decision in the case of Rajeev Kumar Agarwal (supra), there is a clear discrimination so far as deductibility of the related amounts paid to a MCJ, a Japanese tax resident, is concerned. In this view of the matter, according to the learned counsel, even the question of disallowance under section 40(a)(i) being discriminatory in the light of Herbalife decision is now purely academic. Learned counsel further submits that it is an undisputed position, as evident from the material on record, that the recipient has duly taken into account the impugned receipts in its computation of business income liable to tax in India, duly filed the return of income and paid taxes thereon. In such a situation, and in view of the fact that when similar payments in similar situation to a resident taxpayer disallowance under section 40(a)(ia) will not be attracted in view of second proviso to the said provision read with decision of this Tribunal in the case of Rajeev Kumar Agarwal (supra), the disallowance being made in respect of these payments to Japanese tax residents will be a clear violation of Article 24(3) of India Japan tax treaty. Learned counsel for the assessee places his reliance on the decision of Gupta Overseas (supra) by a coordinate bench of this Tribunal. Learned counsel

makes elaborate submissions in support of his stand that second proviso to section 40(a)(ia) is discriminatory inasmuch as it only applies to the resident taxpayers . It is pointed out even if a non resident taxpayer files his return of income in India and takes into account the payments, from which taxes were not deducted at source, in his computation of income, the payments made to such non resident taxpayer will continue to be hit by the disallowance under section 40(a)(i) while similarly placed domestic enterprises will not be hit by disallowance under section 40(a)(ia) in view of application of second proviso to Section 40(a)(ia) which has been held to be retrospective in effect by a coordinate bench decision in the case of Rajeev Kumar Agarwal Vs *(supra).* He submits that for this reason also the impugned disallowance is discriminatory in nature and it should be read down in the light of the Article 24(2) of the Indo Japan tax treaty. In his short rejoinder on this proposition put to the parties, learned Departmental Representative reiterated his earlier submissions and contended that a differentiation in treatment for deductibility particularly when it is warranted by reasonable basis, as is the case, cannot be treated as differentiation and that it is not open to us to supply any omissions in the legislation, even if there be an element of differentiation therein, which is wholly permissible under the law and in tax treaties, on the ground that such an omission leads to discrimination to the residents of a treaty partner jurisdiction. It is submitted that we cannot supply an omission no matter how desirable the provision be. He submits that now that taxability of income embedded in a payment in India is beyond doubt or controversy, and there is no dispute that the assessee has not deducted tax at source from the said payment, there is no escape from the conclusion that the assessee ought to have deducted tax at source from such a payment and that the assessee's failure to do so has to be necessarily visited with disallowance under section 40(a)(i). We are thus once again urged to confirm the action of the Assessing Officer on this point and decline to interfere in the matter.

Is deduction parity to Japanese non residents covered by non discrimination clause of Indo Japan DTAA even in the assessments of Indian tax residents?

104. A preliminary objection which has been very strongly taken up by the AO, duly approved by the DRP, is that the assessee being a resident taxpayer is not at all entitled to the protection of India Japan DTAA. On this issue, the DRP has *inter alia* observed as follows:

> **" ....the argument of the applicant quoting non-discrimination clause is entirely misplaced and out of context inasmuch as a resident applicant cannot take recourse to non-discrimination clause contained in the treaty between two countries. AO's argument have merit. Undisputedly, the applicant is a resident company for the purposes of the Act and is incorporated under the Indian laws. Therefore without going further into this contention, the objection of the applicant is rejected *ab initio*"**

105. When we asked learned Departmental Representative as to how does he defend DRP upholding AO's action of denying treaty protection to assessee on the ground that the assessee was an Indian tax resident, he submitted, after a long pause, that he has nothing to add to whatever has been stated by the authorities below. His gracious silence was perhaps far more eloquent than spirited defence by the DRP.

<u>Our analysis of this preliminary objection</u>

106. We find that a similar objection raised by the revenue authorities came up for adjudication before a coordinate bench of this Tribunal, in the case of DaimlerChrysler India Pvt Ltd (supra), and the coordinate bench, rejecting this objection, observed as follows:

> **.....A plain reading of the above treaty clauses shows that, in broad terms, the discrimination, which is prohibited under the treaty, is (a) nationals of the other Contracting State vis-a-vis nationals of the host State in the same circumstances and same conditions; (b) PE of the other Contracting State vis-a-vis enterprises of the host State carrying out the same activity; (c) payments made to the residents of the other Contracting State vis-a-vis payments made to the residents of the host State—so far as deductibility in computation of business profits is concerned; and (d) enterprises of the host State in which capital is, partly or fully directly or indirectly, held by one of more residents of the other Contracting State vis-a-vis other similar enterprises of the host State. These four types of discriminations are quite distinct in character and in scope. In the first category of 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. As evident from the plain wordings of the art. 24(1), it is not even necessary that a person seeking treaty protection under this clause should be resident of any of the Contracting States. In the second category, the discrimination is prohibited against the PEs of the other Contracting States. That of course implies that an enterprise of a Contracting State has a PE in the other Contracting State, which, in turn, requires that in order to claim non-discrimination in the host State, the PE must belong to an enterprise of the other Contracting State. In the third category of non-discrimination provisions, payments made to the residents of the other Contracting State vis-a-vis payments made to the residents of the host State—so far as deductibility in computation of business profits is concerned, must be dealt at par. Therefore, it is not necessary that the assessee must belong to the other Contracting State; just a payment to the resident of the other Contracting State would suffice to claim the treaty protection under this clause. Finally, and that is the situation that we are dealing with, non-discrimination provisions can be invoked when enterprises of the host State in which capital is, partly or fully directly or indirectly, held by one or more residents of the other Contracting State, is discriminated against vis-a-vis other similar enterprises of the host State. This analysis shows that barring the case of invoking PE non-discrimination clause, i.e. under art. 24(2), it is not even necessary that the assessee seeking treaty protection in one Contracting State must belong to the other Contracting State. In the case of nationality non-discrimination clause, i.e. under art. 24(1), the assessee must be national of the other Contracting State, though resident or not. <u>In the remaining two situations, i.e. non-discrimination against payments made to the residents of the other Contracting State, i.e., under art. 24(3), non-discrimination against capital held by the residents of the other Contracting State, i.e. under art. 24(4), it is not at all necessary that the assessees, in whose cases this non-discrimination is invoked, should be resident of, or even national of, the other Contracting State. In this view of the matter, we are unable to accept the plea of Mr. Kapila that since assessee before us is not resident of the other Contracting State, the assessee cannot seek treaty protection against discrimination, even if there be any</u>.

(Emphasis, by underlining, supplied by us)

107. We are in considered agreement with the views so expressed by the coordinate bench. In any case, the stand of the AO proceeds on the fallacy that non-discrimination protection is being invoked for the assessee before us, though, as a matter of fact, non-discrimination protection is being invoked in respect of the payments made to a tax resident of treaty partner country, i.e. Japan in this case. What is being sought by the assessee in the present case is deduction neutrality so far as payments made to the resident taxpayers in India

vis-à-vis payments made to non-residents fiscally domiciled in Japan are concerned. The treaty protection is thus being sought in respect of the Japanese tax residents- even though it does affect deductibility of payments made to them in India, and, to that limited extent, it has impact on determination of taxable income in the hands of the Indian tax residents. The benefit of deduction neutrality, in Indian tax laws, in respect of payments made to Japanese tax residents does affect the assessment to an Indian resident because the deduction parity is ensured in India, when there is a discrimination, by reading down the disabling provisions, but the subject matter of treaty protection is Japanese tax resident. There is thus no legal infirmity in the treaty protection canvassed by the assessee. We may also add that there is a series of decisions on this issue, starting with path-breaking decision in the case of **Herbalife** *(supra)* and including other oft quoted decisions in the cases of **Asianet Communications Ltd Vs DCIT (38 SOT 158), B4U International Holdings Limited Vs DCIT (52 SOT 545), Central Bank of India Vs DCIT (42 SOT 450), DCIT Vs Lazard India Ltd (41 SOT 72), DCIT Vs Incent Tours Pvt Ltd (53 SOT 308), Millennium Infocom Technologies Vs ACIT (21 SOT 152)**, and **Sandoz Pvt Ltd Vs ACIT (149 ITD 507)**, holding, by implication, that the treaty protection against non-discrimination, to ensure deduction parity, can be extended in the assessments of the domestic enterprise claiming the deduction. We are in respectful agreement with the stand so taken by the coordinate benches on this aspect of the matter. In view of these discussions, in our considered view, the preliminary objection raised by the authorities below was ill conceived, and we reject the same.

<u>Our analysis of non discrimination clause in India Japan DTAA</u>

108. We consider it appropriate to reproduce Article 24 of India Japan Double Taxation Avoidance Agreement, for ready reference, below:

> **ARTICLE 24**
>
> **1. Nationals of a Contracting State shall 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 Contracting 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.

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 Contracting State than the taxation levied on enterprises of that other Contracting 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 article 9, paragraph 8 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 Contracting State.

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 the first-mentioned Contracting State are or may be subjected.

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

109. Article 24(3) of India Japan DTAA, which is materially similar to the 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 dis- crimination 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 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)

110. We are in considered agreement with the above analysis of the scope of the deduction neutrality clause in non-discrimination provision in the Indo Japan DTAA.

111. It is thus clear that so far as payments made to Japanese non-residents is concerned, 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. It is not a question of applying the *casus omissus*, which could have been relevant in the case of supplying something in the process of interpretation of statute, but it is giving life and practical effect to a treaty provision, which has overriding effect on the provisions of domestic tax legislation, specifically providing for ensuring non-discrimination against the tax residents of the treaty partner jurisdiction. The mechanism is provided in the tax treaty and Income Tax Act itself and is not a result of any creative exercise in the process of interpretation of statutes. *Casus omissus* is not ordinary permissible in the process of interpretation but that principle does not restrict implementing the tax treaty provision when such

implementation requires a legal provision to be held inapplicable for an assessee, where it is otherwise applicable on that assessee, or where such implementation of tax treaty provision requires a legal provision to be extended to an assessee, who is otherwise not eligible for the same. There are any number of judicial precedents on this issue where a legal provision, such as section 14A, section 40(a)(i), section 44 C etc, has been held to be inapplicable for an assessee, even though these provisions were applicable on that assessee as evident from a plain reading of the related legislative provision, because of the treaty provisions, and where a legal provision, such as section 80HHE, has been held to be applicable even when the assessee was, on a simple reading of the legislative provision, was not eligible for the same. We are unable to uphold this plea of the learned Departmental Representative.

Differentiation Vs discrimination– legal position

112. In all fairness to the learned Departmental Representative, there indeed was a school of thought that mere differentiation in treatment cannot be treated as discrimination in effect, unless differentiation is discriminatory in character, but than this school of thought, which was articulated in the case of **Automated Securities Clearance Inc** *(supra),* is in particular respect of the Indo US tax treaty. This school of thought proceeded mainly on the basis of equality in treatment in treaty partner jurisdiction, even though it has been specifically clarified in the case of **DaimlerChrysler India Pvt Ltd** (supra), by the same bench consisting of the same coram 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"** and that **"Whether or not the same principles will apply in the case of India's tax treaties with other countries is yet to be examined."** The same principle does not therefore necessarily apply to other tax treaties. Be that as it may, in the case of the Automated Securities Clearance *(supra)*, the Tribunal had, *inter alia,* observed as follows:

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....."*

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 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 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.

113. Not only that the above decision was treaty specific in the context of Indo US tax treaty and did not automatically to the other tax treaties entered into by

India, a special bench of this Tribunal, in the case of **Rajeev Sureshbhai Gajwani** *(supra)* ruled that differentiation *simplicitor* is enough to invoke the non-di
scrimination clause even in Indo US tax treaty 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 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 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.*
>
> (Emphasis by underlining supplied by us now.)

114. The views so expressed by the special bench bind us in the division bench. The strength of the hierarchical judicial system that we have in India is in each lower tier of judicial forum giving way to the higher wisdom of the superior judicial forum. It is duty of the division bench to loyally follow the views of the special bench. When this is the view taken by the special bench with regard to the non-discrimination provisions in the Indo US tax treaty, in which the emphasis on valid differentiation due to reasonableness is perpetuated in the treaty itself- as also in the US Technical Explanation, it is stretching the things too far to suggest that such reasonableness criterion should also be read into non-discrimination provisions of all the tax treaties. Learned Departmental Representative's plea, therefore, does not merit acceptance. Accordingly, in our considered view, a different treatment to the foreign enterprise *per se* is enough to invoke the non-discrimination clause in the Indo Japan DTAA. 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. We may also add that, 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.

Payment of related Indian income tax by recipient foreign entity and its impact on the impugned disallowance

115. In the present case, we are dealing with a situation in which payment has been made to a non-resident taxpayer but the said non-resident taxpayer has taken into account the receipts in question in his business income and has already filed his income tax return under section 139(1), a copy of which is also produced by the learned Departmental Representative in support of his contention that the recipient non-resident indeed had a tax liability in respect of these amounts. As to what would have been the status of deductibility of such payments, if the recipient was a resident and all other facts were materially similar, we find guidance from decision of a coordinate bench in the case of Rajeev Kumar Agarwal *(supra),* wherein a coordinate bench of this Tribunal, while dealing with provision regarding disallowance of payments made to a resident assessee without deduction of tax at source, has, *inter alia,* observed as follows:

> *4. Let us first take a look at the legislative amendment of section 40(a)(ia), vide Finance Act 2012, and try to appreciate the scheme of things as evident in the amended section. Second proviso to Section 40(a)(ia), introduced with effect from 1st April 2013, provides, that "where an assessee fails to deduct the whole or any part of the tax in accordance with the provisions of Chapter XVII-B on any such sum but is not deemed to be an assessee in default under the first proviso to sub-section (1) of section 201, then, for the purpose of this sub clause, it shall be deemed that the assessee has deducted and paid the tax on such sum on the date of furnishing of return of income by the resident payee referred to in the sa id proviso". In other words, as long as the assessee cannot be treated as an assessee in default, the disallowance under section 40(a)(ia) cannot come into play either. To understand the effect of this proviso, it is useful to refer to first proviso to section 201(1), which is also introduced by the Finance Act 2012and effective1st July 2012, and which provides that "any person, including the principal officer of a company, who fails to deduct the whole or any part of the tax in accordance with the provisions of this Chapter on the sum paid to a resident or on the sum credited to the account of a resident shall not be deemed to be an assessee in default in respect of such tax if such resident-(i)has furnished his return of income under section 139; (ii) has taken into account such sum for computing income in such return of income; and(iii) has*

paid the tax due on the income declared by him in such return of income, and the person furnishes a certificate to this effect from an accountant in such form as may be prescribed." The unambiguous underlying principle seems to be that in the situations in which the assessee's tax withholding lapse have not resulted in any loss to the exchequer, and this fact can be reasonably demonstrated, the assessee cannot be treated as an assessee in default. The net effect of these amendments is that the disallowance under section 40(a)(ia) shall not be attracted in the situations in which even if the assessee has not deducted tax at source from the related payments for expenditure but the recipient of the monies has taken into account these receipts in computation of his income, paid due taxes, if any, on the income so computed and has filed his income tax return under section 139(1). There is also a procedural requirement of issuance of a certificate, in the prescribed format, evidencing compliance of these conditions by the recipients of income, but that is essentially a procedural aspect of the matter. The legislative amendment so brought about by the Finance Act, 2012, so far as the scheme of disallowance under section 40(a)(ia) is concerned, substantially mitigates the rigour of, what otherwise seemed to be, a rather harsh disallowance provision.

5. As for the question as to whether this amendment can be treated as retrospective in nature, even in the case of Bharti Shipyard (supra)- a special bench decision vehemently relied upon in support of revenue's case, the special bench, on principles, summed up the settled legal position to the effect that "any amendment of the substantive provision which is aimed at ……(inter alia)removing unintended consequences to make the provisions workable has to be treated as retrospective notwithstanding the fact that the amendment has been given effect prospectively ". It was held that if the consequences sought to be remedied by the subsequent amendments were to be treated as "intended consequences", the amendment could not be treated as retrospective in effect. The special bench then proceeded to draw a line of demarcation between intended consequences and unintended consequences, and finally the retrospectivity of first proviso was decided against the assessee on the ground that this special bench was of the considered view that " the objective sought to be achieved by bringing out section 40(a)(ia) is the augmentation of TDS provisions" and went on to add that " If, in attaining this main objective of augmentation of such provisions, the assessee suffers disallowance of any amount in the year of default, which is otherwise deductible, the legislature allowed it to continue ". It was further observed that "this is the cost which parliament has awarded to those assessees who fail to comply with the relevant provisions by considering overall objective of boosting TDS compliance"(Emphasis by underlining supplied by us). In other words, the amendment was held to be prospective because, in the wisdom of the special bench, the 2010 amendment to Section 40(a)(ia) by inserting first proviso thereto, which is what the special bench was dealing with, was an " intended consequence" of the provision of Section 40(a)(ia).

6. However, the stand so taken by the special bench was disapproved by Hon'ble Delhi High Court in the case of CIT Vs Rajinder Kumar (362 ITR 241). While doing so, Their Lordships observed that, "The object of introduction of Section 40(a)(ia) is to ensure that TDS provisions are scrupulously implemented without default in order to augment recoveries…….Failure to deduct TDS or deposit TDS results in loss

of revenue and may deprive the Government of the tax due and payable" (Emphasis by underlining supplied by us)". Having noted the underlying objectives, Their Lordships also put in a word of caution by observing that, "the provision should be interpreted in a fair, just and equitable manner". Their Lordships thus recognized the bigger picture of realization of legitimate tax dues, as object of Section 40(a)(ia), and the need of its fair, just and equitable interpretation. This approach is qualitatively different from perceiving the object of Section 40(a)(ia) as awarding of costs on the "assessees who fail to comply with the relevant provisions by considering overall objective of boosting TDS compliance". Not only the conclusions arrived at by the special bench were disapproved but the very fundamental assumption underlying its approach, i.e. on the issue of the object of Section 40(a)(ia), was rejected too. In any event, even going by Bharti Shipyard decision (supra), what we have to really examine is whether 2012 amendment, inserting second proviso to Section 40(a)(ia), deals with an "intended consequence" or with an "unintended consequence".7. When we look at the overall scheme of the section as it exists now and the bigger picture as it emerges after insertion of second proviso to section 40(a)(ia), it is beyond doubt that the underlying objective of section 40(a)(ia) was to disallow deduction in respect of expenditure in a situation in which the income embedded in related payments remains untaxed due to non-deduction of tax at source by the assessee. In other words, deductibility of expenditure is made contingent upon the income, if any, embedded in such expenditure being brought to tax, if applicable. In effect, thus, a deduction for expenditure is not allowed to the assessees, in cases where assessees had tax withholding obligations from the related payments, without corresponding income inclusion by the recipient. That is the clearly discernible bigger picture, and, unmistakably, a very pragmatic and fair policy approach to the issue - howsoever belated the realization of unintended and undue hardships to the taxpayers may have been. It seems to proceed on the basis, and rightly so, that seeking tax deduction at source compliance is not an end in itself, so far as the scheme of this legal provision is concerned, but is only a mean of recovering due taxes on income embedded in the payments made by the assessee. That's how, as we have seen a short while ago, Hon'ble Delhi High Court has visualized the scheme of things - as evident from Their Lordships' reference to augmentation of recoveries in the context of "loss of revenue" and "depriving the Government of the tax due and payable".

8. With the benefit of this guidance from Hon'ble Delhi High Court, in view of legislative amendments made from time to time, which throw light on what was actually sought to be achieved by this legal provision, and in the light of the above analysis of the scheme of the law, we are of the considered view that section 40(a)(ia) cannot be seen as intended to be a penal provision to punish the lapses of non-deduction of tax at source from payments for expenditure- particularly when the recipients have taken into account income embedded in these payments, paid due taxes thereon and filed income tax returns in accordance with the law. As a corollary to this proposition, in our considered view, declining deduction in respect of expenditure relating to the payments of this nature cannot be treated as an "intended consequence" of Section 40(a)(ia). If it is not an intended consequence i.e. if it is an unintended consequence, even going by Bharti Shipyard decision (supra), "removing unintended consequences to make the provisions workable has to be

treated as retrospective notwithstanding the fact that the amendment has been given effect prospectively". Revenue, thus, does not derive any advantage from special bench decision in the case Bharti Shipyard (supra).

9. On a conceptual note, primary justification for such a disallowance is that such a denial of deduction is to compensate for the loss of revenue by corresponding income not being taken into account in computation of taxable income in the hands of the recipients of the payments. Such a policy motivated deduction restrictions should, therefore, not come into play when an assessee is able to establish that there is no actual loss of revenue. This disallowance does deincentivize not deducting tax at source, when such tax deductions are due, but, so far as the legal framework is concerned, this provision is not for the purpose of penalizing for the tax deduction at source lapses. There are separate penal provisions to that effect. Deincentivizing a lapse and punishing a lapse are two different things and have distinctly different, and sometimes mutually exclusive, connotations. When we appreciate the object of scheme of section 40(a)(ia), as on the statute, and to examine whether or not, on a "fair, just and equitable" interpretation of law- as is the guidance from Hon'ble Delhi High Court on interpretation of this legal provision, in our humble understanding, it could not be an "intended consequence" to disallow the expenditure, due to non-deduction of tax at source, even in a situation in which corresponding income is brought to tax in the hands of the recipient. The scheme of Section 40(a)(ia), as we see it, is aimed at ensuring that an expenditure should not be allowed as deduction in the hands of an assessee in a situation in which income embedded in such expenditure has remained untaxed due to tax withholding lapses by the assessee. It is not, in our considered view, a penalty for tax withholding lapse but it is a sort of compensatory deduction restriction for an income going untaxed due to tax withholding lapse. The penalty for tax withholding lapse per se is separately provided for in Section 271 C, and, section 40(a)(ia) does not add to the same. The provisions of Section 40(a)(ia), as they existed prior to insertion of second proviso thereto, went much beyond the obvious intentions of the lawmakers and created undue hardships even in cases in which the assessee's tax withholding lapses did not result in any loss to the exchequer. Now that the legislature has been compassionate enough to cure these shortcomings of provision, and thus obviate the unintended hardships, such an amendment in law, in view of the well settled legal position to the effect that a curative amendment to avoid unintended consequences is to be treated as retrospective in nature even though it may not state so specifically, the insertion of second proviso must be given retrospective effect from the point of time when the related legal provision was introduced. In view of these discussions, as also for the detailed reasons set out earlier, we cannot subscribe to the view that it could have been an "intended consequence" to punish the assessees for non-deduction of tax at source by declining the deduction in respect of related payments, even when the corresponding income is duly brought to tax. That will be going much beyond the obvious intention of the section. Accordingly, we hold that the insertion of second proviso to Section 40(a)(ia) is declaratory and curative in nature and it has retrospective effect from 1st April, 2005, being the date from which sub clause (ia) of section 40(a) was inserted by the Finance (No. 2) Act, 2004.

> *10. In view of the above discussions, we deem it fit and proper to remit the matter to the file of the Assessing Officer for fresh adjudication in the light of our above observations and after carrying out necessary verifications regarding related payments having been taken into account by the recipients in computation of their income, regarding payment of taxes in respect of such income and regarding filing of the related income tax returns by the recipients.*

116. It is thus clear that no disallowance can be made in respect of payments made to a resident assessee, even without applicable deduction of tax at source, as long as related payments are taken into account by the recipients in computation of their income, and taxes in respect of such income are duly paid and related income tax returns are duly filed by the resident recipients under section 139(1). However, as section 40(a)(i) does not have an exclusion clause similar to second proviso to Section 40(a)(ia), so far as payments made to non-residents, without deduction of applicable tax deduction at source, are concerned, such payments will be disallowable even in a situation, as is the admitted factual position in this case, even when the non-resident recipient has taken into account such payments in computation of his income, has paid taxes on the same and duly filed, under section 139(1), related income tax return. It is also elementary that so far examining discrimination to the non resident Japanese taxpayers is concerned, the right comparator will be a resident Indian taxpayer. As we are examining the issue of deduction parity, we have to examine the position of deductibility in respect of a similar payment, i.e. without deduction of tax at source, made to a resident Indian taxpayer. To this extent, in the light of the legal position prevailing as on now and as there is no binding judicial precedent contrary to coordinate bench decision in the case of Rajeev Kumar Agarwal *(supra)*, there is indeed an element of discrimination, in terms of Article 24(3) of the India Japan DTAA, in the deductibility of payments made to resident entities vis-à-vis non-resident Japanese entities. Clearly, therefore, it will be contrary to the scheme of the tax treaties in question that if rigour of disallowance of a payment, on account non-deduction of tax at source from the related payment, is to be relaxed in the situations in which the resident recipient has taken the said amount into account in computation of income, paid taxes on the income so computed and filed, under section 139(1), related income tax return, and yet the rigour of disallowance in respect of payments

made, without appropriate deduction of tax at source, to the non-residents are concerned, is not relaxed in the cases in which the non-resident recipient has taken such receipts into account in computation of income, paid taxes on the income so computed and filed, under section 139(1), related income tax return. Article 24(3) of the India Japan DTAA requires similar relaxation in respect of the rigour of disallowance for payments made to the Japanese entities. Accordingly, the relaxation under second proviso to Section 40(a)(ia) is to be read into Section 40(a)(i) as well and it is required to be treated as retrospective in effect in the same manner as second proviso to Section 40(a)(i) has been treated. Such an interpretation will lead to the deduction parity as envisaged in Article 24(3) of Indo Japan DTAA which, subject to the exceptions set out therein which are admittedly not applicable on the facts of this case, provides that, "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 Contracting State". When we interpret these words in the present context, it follows that the payments made by an Indian enterprise to a resident of Japan shall be deductible, in the assessment of India enterprise, under the same conditions as if the payments were made to the Indian residents. Any deviations from this non-discrimination principle are to be read down in view of clear mandate of section 90(2).

117. In view of the above discussions, in our considered view, second proviso to Section 40(a)(ia) is also required to be read into Section 40(a)(i), in the cases where related payments are made to the tax residents of Japan, inasmuch as long as the Japanese tax residents have taken into account the payments made to them by Indian residents, without deduction of tax at source, in their computation of income, paid interest thereon and have filed the related income tax returns, under section 139(1), in India, the payments so made by the Indian enterprise cannot be disallowed in their hands. As this proviso in held to retrospective in effect, i.e. with effect from 1st April 2005, in the case of Rajeev Kumar Agarwal *(supra)* and as no contrary decision has been brought to our

notice, this provision will be equally applicable in the assessment year before us as well. What holds good for section 40(a)(ia) on a conceptual note, so far as deincentivizing non deduction of tax at source is concerned, must hold equally good for section 40(a)(i) as well. As was noted by a coordinate bench in the case of Rajeev Kumar Agarwal (supra), on a conceptual note, primary justification for disallowance under section 40(a)(ia) is that such a denial of deduction is to compensate for the loss of revenue by corresponding income not being taken into account in computation of taxable income in the hands of the recipients of the payments. Such a policy motivated deduction restrictions should, therefore, not come into play when an assessee is able to establish that there is no actual loss of revenue. This disallowance does indeed deincentivize not deducting tax at source when due for deduction, but, so far as the legal framework is concerned, this provision is not for the purpose of penalizing for the tax deduction at source lapses. There are separate penal provisions to that effect. Deincentivizing a lapse and punishing a lapse are two different things and have distinctly different, and sometimes mutually exclusive, connotations. The scheme of Section 40(a)(ia), as the coordinate bench concluded, is aimed at ensuring that an expenditure should not be allowed as deduction in the hands of an assessee in a situation in which income embedded in such expenditure has remained untaxed due to tax withholding lapses by the assessee. It was not seen as a penalty for tax withholding lapse but it is a sort of compensatory deduction restriction for an income going untaxed due to tax withholding lapse as penalty for tax withholding lapse per se is separately provided for in Section 271 C, and, section 40(a)(ia) does not add to the same. When it is held to be the scheme of the law when it comes to deductibility of payments made to residents without deduction of tax at source, deduction neutrality under Article 24(3) of Indo Japan DTAA requires the same to be read into the scheme of deduction conditions under section 40(a)(i) so far lapses in deducting tax at source in respect of payments made to the non-residents, covered by Indo Japan DTAA, are concerned. In view of the evidences brought on record by learned Departmental Representative himself, it not in dispute that the MCJ has taken into account the impugned payments into account in computing the income liable to tax in India, paid taxes on the same and duly filed, under section

139(1), related income tax return. In view of this factual position, and in the light of legal position discussed above, the impugned disallowance of Rs 91,80,507 is also deleted.

118. As we have deleted this disallowance under section 40(a)(ia) on the short ground that the MCJ, the recipient, has taken into account the related payments in computing its business income in India, paid taxes on the same and duly filed, under section 139(1), its income tax return in India, we see no need to deal with the issue whether Section 40(a)(i) itself will not apply to the facts of this case in view of Article 24(3) of India Japan DTAA- as was held in the immediately preceding assessment year and which has been so vehemently challenged by the learned Departmental Representative. That aspect of the matter is, in the present situation, wholly academic in this assessment year. Whether Herbalife decision, for the assessment years in which section 40(a)(ia) is on the statute, is good in law or not is wholly irrelevant because, for the detailed reasons set out above, even when section 40(a)(i) is applicable, the disallowance under section 40(a)(i) can be invoked on the peculiar facts of this case. It would not be appropriate for us to get into this issue which has been, given our findings above, rendered academic.

Our conclusion on disallowance under section 40(a)(i)

119. We thus hold that, so far as second grievance raised by the assessee before us is concerned, the Assessing Officer was indeed in error in law and on facts in making a disallowance of Rs 102,17,16,383. Accordingly, we direct him to delete the impugned disallowance.

Our parting observations

100. Before we part with the matter, we would like to place on record our appreciation for very able assistance by both the parties before us. We may add

that even though learned Departmental Representative did very vehemently contended that we should simply remit the matter to the assessment stage, on the same lines as in the immediately preceding assessment year and without giving any findings on the specific points on which perceptions of the parties clearly do not have any meeting ground, we do not think that would have been the appropriate course of action. At a time when there is a clarion call by the Government of India, at the highest level, to simplify the process of implementing the laws, and ensure certainty friendly measures to the foreign enterprise doing business in India, we would perhaps fail in our duty if we do not, though within whatever be our inherent limitations, rise to the occasion and discharge our judicial functions in a comprehensive, rather than superficial, manner, and contribute to the dispute reaching finality sooner rather than later. There is no point in our simply remitting the matter to the assessment stage when it is clear that there is no meeting ground on the perceptions even on the issue as to how the remanded matter is to be decided afresh. Of course, whatever we decide is, and shall always remain, subject to the judicial scrutiny by Hon'ble Courts above but our endeavour should be to facilitate and expedite that process of such a judicial scrutiny, if and when required, by analyzing the issues in a comprehensive manner in the light of arguments before us and the material on record. It was possible in this particular case because of, as we have noted earlier as well, very able assistance by the parties before us.

Conclusion

101. In the result, the appeal is partly allowed and partly allowed for statistical purposes, in the terms indicated above. Pronounced in the open court today on 21st day of October, 2014.

Sd/ xx	***Sd/ xx***
C M Garg	**Pramod Kumar**
(Judicial Member)	(Accountant Member)

New Delhi, the 21st day of October, 2014

Copies to:	*(1)*	*The appellant*	*(2)*	*The respondent*
	(3)	*Commissioner*	*(4)*	*DRP*
	(5)	*Departmental Representative*		
	(6)	*Guard File*		

By order etc

Assistant Registrar
Income Tax Appellate Tribunal
Delhi benches, New Delhi