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Has our banking system become unsound?

by
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This article argues, in the light of recently released data by the State Bank, that our banking system has become unsound. Banks have been swamped with demands of riskfree lending from the government, bulging levels of non-performing loans, drying up of genuine business projects and a general risk aversion amongst the bankers. Read complete article at http://tribune.com.pk/story/411751/point-of-concern-has-our-banking-system-become-unsound/ to join the on-going discussion or continue reading here.

Pakistan's financial sector liberalization in general and privatization of banks in particular, has largely been hailed by experts on account of professionalization, financial inclusion and penetration of banks. Notwithstanding the usual criticism of a low interest spread and high bank charges, strong evidences have now emerged which suggest that Pakistan's banking sector has become visibly unsound.

Since 2009, State Bank of Pakistan has maintained 'financial soundness indicators' of the banking system of the country. These parameters include Capital Adequacy, Assets Quality, Earnings and Liquidity. The most recently released "Statistics of the Banking System" actually erodes the goodwill that has been associated with a liberalized banking industry.

The most startling fact is that the exposure of all banks to non-performing loans has more than doubled since 2006. The stock of NPL in public sector commercial banks has increased from 9% to 21%; in foreign banks from 1% to 10.5%; and in commercial banks from 5.7% to 15.5%. In the case of public sector commercial banks, the ratio of net NPL to their capital is 44%, which was 6.4% in 2006; whereas this is 23.8% in the commercial banks, up from 6.2% in 2006.

In nutshell, the assets of our banks have become significantly more toxic. The bad quality toxic assets of the banking sector were the single most important symptom, though not the cause, of the great financial depression, the world witnessed recently.

The increasing exposure of NPL has dampened the profitability of banks as well. Overall, the earnings before tax, when measured by returns on assets, have been decreased by 24% over last six years. Certainly, this reduction is much more pronounced in public sector commercial banks, which has come down from 4% in 2006 to 1.9% in 2012. Return on equity before tax has been reduced from 35.2% to 26.3% in the same time period.

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Another disturbing indicator is the increasing cost of operations as measured by cost/income ratio. For public sector commercial banks, this was 31.8% in 2006 which now stands at staggering 57.9% in 2012. For foreign banks, this has jumped from 49.8% to 69.3%.

Despite these developments, the liquidity in banks has increased from 31.9% to 44%. But at the same time, the advances/deposit ratio has decreased from 74.6% to 54.3%. It means that the banks are preferring to keep the cash to their tills.

The moral of the story: our banking system is becoming more unsound, less profitable, more expensive, more liquid and more toxic. Has the mantra of deregulation, denationalization and privatization failed?

My hypothesis is that the banks of all categories have been increasingly swamped with demands of risk-free lending from the government, drying up of genuine business projects, and a general risk aversion amongst the bankers. Banks of all creeds share a similar fortune to varying degree now.

According to the State Bank, the top five banks, which hold 51% of total banking assets and 50.9% of total investments, have parked 82.2% of their investments in government securities. The foreign banks have parked 99.9% of their investments in government securities. This trend is common across the entire banking system. Now imagine that our federal government is slightly less credible than some “In God we trust” zealots in the Western hemisphere. Who will repay all this investment with such quality of governance?

That the return to a NPL dominated regime, which was characteristic of nationalized banks, will only feed into risk aversion of bankers should not be a surprise. However, unlike the political pressures which were usually held culprit for these loans in the nationalization era, the deregulated banks should bear the brunt themselves now. It means that the owners, directors and majority shareholders should be held responsible to this extent. If a bank fails on this ground, the state must stay away, and unlike what the Western governments did, must not socialize the costs of default. Although insurance of small deposits can be a viable consideration.

It is true that the bankers alone cannot be held responsible for uninterrupted demand of risk-free loans and a shocking absence of business projects of scale. Probably the non-availability of business projects can be explained by poor, expensive and unreliable energy infrastructure. For the risk free loans, the political ambitions of the government, always devoid of any economic wisdom will be held responsible. It is evidently clear that increased government borrowing not only sucks up available capital, but it also induces risk aversion in bankers, and at the same time, makes it prohibitively expensive for the private sector to borrow. In an economy, where state is considered a source of expropriation by all, this scenario will unfortunately reduce confidence in the private sector and may even pave the way to renationalization. The present federal government has single handedly achieved all this in a matter of four year. The records of State Bank of Pakistan bear testimony of this financial suicide. The tax payers and genuine entrepreneurs must stand and refuse to finance the plunder any further that has been orchestrated by rent seekers from all quarters.

Invoices issued by non-active, blocked persons: no input adjustment under Punjab Sales Tax on Services Act: PRA

Punjab Revenue Authority (PRA) has categorically conveyed to the service providers that no input tax adjustment would be admissible under the Punjab Sales Tax on Services Act against invoices issued by persons who have been declared non-active or blocked or suspended by the Federal Board of Revenue (FBR).

According to the frequently asked questions (FAQs) issued by the PRA here on Thursday, no input tax adjustment shall be admissible under the Punjab Sales Tax on Services law against invoices issued by persons who have been declared non-active or otherwise blocked in the computer system or suspended by the FBR. However in cases where a suspension of any registration has been restored and it is proved that suspension was unjustified, input tax adjustment shall subject to the prescribed conditions and restrictions become admissible on post facto basis immediately after restoration of the suspended (or even cancelled registration). The rules relating to registration and deregistration, and adjustment of tax take care of such situations.

The PRA said that the input tax paid on the purchase of goods or acquisition of services used exclusively in rendering of taxable services shall be admissible in terms of the Punjab Sales Tax on Services (Adjustment of Tax) Rules, 2012 read with section 16 of the Punjab Sales Tax on Services Act, 2012. The said rules, however, provide for certain conditions and restrictions on the admissibility of adjustment of input tax paid on certain goods or services.

The input tax adjustment shall be limited to the extent of taxable services. Where a person is providing both taxable and exempt or non-taxable services, adjustment shall be confined to the extent proportionate to the quantum of taxable services. For this purpose, apportionment formula has been incorporated in the Punjab Sales Tax on Services (Adjustment of Tax) Rules, 2012. The deduction of admissible adjustment of input tax shall be made at the time of filing of tax return wherein the output tax liability shall be reduced to the extent of input tax admissible for adjustment under the aforesaid rules.

The PRA said that said that certain kind of services like marine insurance for export, life insurance, health insurance and crop insurance have been exempted from sales tax under the Punjab Sales Tax on Services Act, 2012.

The PRA said that under section 2 (38), definition of "service or services" is available, which says that service means anything which is not goods or providing of which is not a supply of goods and shall include but not limited to the services listed in the First Schedule of the Punjab Sales Tax on Services Act, 2012. For clarification purpose, an explanation has been added to the said definition, which says that a service shall remain and continue to be treated as service regardless whether or not rendering thereof involves any use, supply or consumption of any goods either as an essential or as an incidental aspect of such rendering. The services which are liable to sales tax are listed in the Second Schedule. The services which are covered under the First Schedule but are not included in the Second Schedule are non-taxable services. However, in the Second Schedule there are certain exemptions within the taxable categories of services. For instance in case of advertisements on television and radio, the advertisements sponsored by the Federal and Provincial governments for health and education purposes are exempted. Similarly in case of insurance, marine insurance for export, life insurance, health insurance and crop insurance are exempted.

Responding to a question about treatment of previous carried forward amount/refund available with the FBR, PRA said that no input tax adjustment shall be admissible to the input tax carried forward from the period prior to the commencement of the Punjab Sales Tax on Service Act, 2012. The PRA has also informed the service providers that no exemption threshold is applicable in case of services taxable under the Punjab Sales Tax on Services Act, 2012 except hotels for which exemption threshold would be issued through a notification.

It said that the government of Punjab will however, consider to prescribe suitable exemption threshold in case of services provided by hotels in terms of sub-section (3) of section 10 of the said Act. Notification in this regard shall be issued shortly.

To another question, the PRA said that section 4 of the Punjab Sales Tax on Services Act, 2012 is based upon a universally recognised and fundamental principle of VAT, ie in case of taxable services provided from one territory and consumed in another territory, the right to tax vests with the Authority of the territory where service is consumed. VAT is not concerned with the source or locale of payment of the price of the service. In broader terms, this principle is also applicable in international trade. Under VAT, exports to other countries are zero-rated by the exporting country and imports are charged to tax by the importing country. In countries where VATs are administered at sub-national levels, reciprocal zero-rating of trade of goods or services between sub-national units is allowed only if the tax authorities of the concerned sub-national units agree. In Pakistan, no such agreement exists between the two provinces (Sindh and Punjab) which are collecting and administering sales tax on services at their own respective ends.

Hence no input tax adjustment has been allowed against output tax payable under section 4. That being so, the aforesaid section 4 envisages two scenarios of the situation where a service provider is located outside Punjab but service consumer is located in Punjab, namely: Where service provider is registered but service recipient is not registered and where both service provider and service recipient are registered.

Where a person is registered for sales tax purposes under the law other than the Punjab Sales Tax on Services Act, 2012, such person shall send electronic or other intimation to both PRA and PRAL giving the basic particulars of his existing registration. PRAL will retrieve his all registration data from the computer system of FBR or SRB as the case may be, add prefix "P" to his registration number and allow him access to PRA's portal where upon he will be in position to file his returns and make tax payments to the Punjab Government. In this way, answer to the aforesaid two scenarios is as under:

In cases where both the service provider and the service recipient are registered, the responsibility to deduct and deposit tax and file return will be with the service recipient. In cases where service recipient is not registered, the responsibility to charge/pay tax and file return will be with the service provider. Non-compliance will attract legal action by PRA, PRA added. – *Courtesy Business Recorder*

Relaxation in input tax adjustment offered: PRA empowered to conduct taxpayers' audits

The Punjab Revenue Authority (PRA) on Thursday obtained powers to conduct audits of registered persons, where the Federal Board of Revenue (FBR) has not commenced audit proceedings even for the period prior to the commencement of the Punjab Sales Tax on Services Act of 2012.

In a related move, PRA informed the services' sector that the credit of input tax could be taken relating to the invoice issued under the Punjab Sales Tax on Services Act, 2012 not older than six months. Earlier, PRA clarified that under Section 32 of the Punjab Sales Tax on Services Act, the standard or normal period for retention of sales tax records was five years and the competent PRA officer could call for record maintained either under the said Act or any other law for official purposes. Provisions for departmental audit are given in Section 33 of the aforesaid Act.

Under Article 264 of the 1973 Constitution read with Section 4 of the Punjab General Clauses Act of 1956 and Section 87 of the Punjab Sales Tax on Services Act of 2012, the recovery of sales tax arrears on relevant taxable services shall continue to be effected by the FBR unless the government of Punjab specifically undertakes to realise such arrears at its own level.

It is however, clarified that the Punjab government has so far not taken any decision in this regard. Deposit of such arrears shall nevertheless, be made with the Punjab government on prescribed return on PRA portal. Under Section 87(2) of the Punjab Sales Tax on Services Act, 2012, pending adjudications, including appeals etc, shall be decided by officers/authorities previously competent to decide such adjudications. These officers/authorities shall accomplish the outstanding adjudication work as if the Punjab Sales Tax on Services Act, 2012 had not come into force, PRA maintained.

Meanwhile, PRA informed the services' sector that the credit of input tax can be taken relating to the invoice (issued under the Punjab Sales Tax on Services Act, 2012) not older than six months. The PRA clarified to the service providers through FAQs here on Thursday that under Sub-Section (4) of Section 10 of the Punjab Sales Tax on Services Act, 2012, credit of input tax can be taken relating to the invoice (issued under the said Act) not older than six months. This is a general relaxation.

However, on the expiry of six months period in case of any particular input tax invoice, the unclaimed adjustment or deduction can still be made in the returns of the succeeding four tax periods under intimation to the concerned Commissioner of PRA. Thus, in case of any particular invoice accumulated extended period in claiming input tax credit is ten months, ie six months prior to the return in which the credit could be last taken but was somehow not taken and four months after filing of such return.

In this way, an input tax invoice remains admissible for adjustment or credit for ten consecutive months but intimation to the Commissioner is must if adjustment or credit is taken after expiry of six months from the tax period (inclusive) to which tax invoice relates. This is, of course, an extraordinary facility to the taxpayers and will also take care of late-received invoices.

The PRA added that under the Punjab Sales Tax on Services Act, 2012, no direct zero-rating is available in respect of any taxable services. Export of taxable service as such is not liable to tax. However, in view of the provisions of Sections 12 and 16, the export of taxable services outside Pakistan has been allowed the facility of refund under Chapter IV of the Punjab Sales Tax on Services (Adjustment of Tax) Rules, 2012.

Taxable service shall be treated as having been exported if its delivery has been consummated for consumption outside Pakistan against receipt of its price in convertible foreign exchange through declared banking channels and use/supply or consumption of any goods in the export-related rendering of such service has been treated as zero-rated under the Sales Tax Act, 1990. PRA will refund only such amount of tax as has been paid on any service under the Punjab Sales Tax on Services Act, 2012 used in the providing of the exported service. A complete procedure of refund has been prescribed in the aforesaid rules. – *Courtesy Business Recorder*

FBR solicits stakeholders' comments: SRO issued on rules for calculating CGT

Stock market brokers, investors in stock exchanges and other stakeholders have been asked to submit their comments on 'special procedures for computation of capital gain and collection of tax' to the Securities and Exchange Commission of Pakistan (SECP) and Federal Board of Revenue (FBR).

In this connection, the FBR issued an SRO902(I)/2012 here on Thursday to amend the Income Tax Rules of 2002 pertaining to 'Special provisions relating to Capital Gain arising from the disposal of securities of listed companies and tax thereon'. The provision was introduced through the insertion of Section 100B and a new Eighth Schedule through Presidential Ordinance dated April 24, 2012. It also stipulates that the rules for computing capital gain tax have been laid down in the Eighth Schedule. Draft amendments in the rules have been vetted by the Law Division and would be sent to the Printing Corporation of Pakistan after incorporating views of all stakeholders, FBR added.

According to SRO902(I) /2012, the draft of certain amendments in the Income Tax Rules, 2002 has been published for information of all persons. The draft will be taken into consideration after 15 days of its publication in the official Gazette. Any objection or suggestion, in respect of the said draft which may be received from any person, before the expiry of the aforesaid period, shall be considered by the FBR.

Sources said that the CGT rules have been drafted in active consultation with the SECP and any comments relating to the capital market could also be shared with the SECP. After the vetting by the law ministry, the Federal Board of Revenue (FBR) has placed the amended draft of Capital Gains Tax on its website, soliciting public comments.

The draft law authorised the National Clearing Company of Pakistan Limited (NCCPL) to collect taxes made on profits during the purchase and sale of shares in capital markets, and the NPCCL will be responsible to deposit the tax collected to the FBR.

Sources said that the new amendment laid a major emphasis on automation and minimising human interaction in collection of CGT. The collection procedure has been further simplified under the draft rules. The CGT will not be liable on shares that have been retained by investors for more than 12 months (one year), while the base of computation will be April 24, 2011. The time of holding will be calculated from April 24, 2011 for the shares sold after April 24, 2012.

The draft law said: "NCCPL shall, in accordance with this rule, collect tax on capital gains," and added, "These rules shall apply to capital gains derived from listed securities on or after the 24th April, 2012." According to the draft rules, the capital gain or loss arising on the disposal of listed securities shall be computed on the basis of First-In, First Out (FIFO) inventory accounting method: Provided that while applying FIFO method, market based transactions shall be taken into account first: Provided further that the FIFO method shall not apply in respect of sale of shares purchased on the same trading day or in same futures or derivative contract and capital gain or loss shall be computed by applying average method.

The capital loss arising on disposal of listed securities as determined by NCCPL in any financial year shall be set off against capital gain arising from the disposal of securities during that financial year to determine the taxable capital gain arising from the disposal of listed securities. The capital loss arising on disposal of listed securities in any financial year shall not be carried to a subsequent financial year.

NCCPL shall deduct or add 0.5 per cent for client's trade and 0.25 per cent for broker's proprietary trade of the consideration received on disposal or cost of acquisition of securities, respectively, in lieu of brokerage, commission, transaction fee, levy, Laga or any other similar incidental expenses incurred by the person while disposing or acquiring a security, subject to the condition that such deduction shall only be allowed in respect of market based transactions, draft rules added.

NCCPL shall issue certificate as provided in clause (4) of rule 1 of the said Eighth Schedule, as set out in Part I of Rule 13O, showing computation of capital gains and tax thereon, if any, to each person subject to tax under the said Eighth Schedule within thirty days from the end of the financial year. NCCPL shall furnish electronically to the Board, a quarterly statement of amount collected, within thirty days from the end of each quarter as set out in Part II of Rule 13O, FBR said. – *Courtesy Business Recorder*

FBR chairman to brief PAC about taxation measures

Federal Board of Revenue (FBR) Chairman Ali Arshad Hakeem in his first interaction with the Public Accounts Committee (PAC) on August 6, 2012 would share achievements in revenue collection, progress in different areas and landmark reforms in the tax machinery during 2011-2012 with the parliamentarians. In this connection, the FBR has issued an office order to all FBR members here on Thursday.

Sources told here on Thursday that the newly elected Chairman would brief the PAC about the revenue collection position, operational strategies, administrative reforms, enforcement measures, audit, recovery of input tax adjustment and results of the reforms in the tax administration. Tax authorities have directed the FBR members to submit report on the achievements of the FBR during 2011-2012. The FBR will brief the PAC about the key taxation issues like recovery of arrears, input tax adjustments, implementation of reforms, simplification in tax procedure and position of court cases.

It is expected that the FBR team of tax managers headed by top tax manager Ali Arshad Hakeem would inform the PAC members about his vision and policy measures to be adopted for bringing transparency in the affairs of the FBR. The tax managers would also share data with the PAC to give a realistic picture about the payment of sales tax and income tax refunds to the taxpayers. The refund payment is the most crucial issue and the FBR Chairman is expected to share figures about the payment of refund to the registered units.

Tax managers would also inform the PAC about the focus of the department on taxpayer's facilitation and enforcement. Sources said that the FBR Chairman would be fully prepared to respond to the queries of the PAC members by taking input from all concerned members. Tax authorities believed that the tax machinery should behave in a manner to attract the people having black money to come within the documented regime as this is the only way to broaden the tax base for generating more revenue. The sizable black economy exists in the country and FBR as a most important organisation should work in a manner so that the people should shift from black economy to white economy. In Pakistan, entrepreneurship is very difficult for carrying out businesses. The tax officials should facilitate people in such a way that the people prefer to voluntarily shift from black economy to white economy. Through facilitation and easy to understand tax laws, the FBR can attract people to switch over from black economy to white economy. – *Courtesy Business Recorder*

Sales of cosmetic products of non-tariff areas in tariff areas: major flaw detected in Sales Tax Act 1990

A major flaw of check and balance has been detected in the Sales Tax Act 1990 regarding sales of cosmetic products produced in non-tariff areas of Swat and Mingora in tariff areas of Pakistan, causing huge revenue loss to the national exchequer. Sources told here on Thursday that the FBR had abolished the federal excise duty (FED) on cosmetic products in budget 2012-13.

This move has also abolished the FED on the cosmetic manufactured in non-tariff areas of Swat and Mingora. Likewise, Sales Tax Act is also not applicable on these non-tariff areas. There is no exemption of sales tax on cosmetics brought to tariff areas (ie rest of Pakistan), therefore sales tax should be chargeable on cosmetic products when enter into the territorial jurisdiction of tariff areas. However, since there is no proper check and balance in place and no proper modalities were provided/clarified anywhere, the point of charging sales tax on movement of goods from non-tariff areas to tariff areas of Pakistan did not arise.

The due amount of sales tax thus seems to remain unaccounted which cause loss of revenue to the exchequer. On the other hand since the cosmetic manufacturers in tariff areas have to pay the due amount of sales tax, the situation put them in a disadvantageous position as they cannot compete with the cosmetic manufacturers paying no sales tax or FED in Swat and Mingora and operating from there in whole of Pakistan.

Sources said that the cosmetics' manufacturers of non-tariff areas of Swat and Mingora had paid a fixed amount of Federal excise duty (FED) for the last many years. The cosmetics' manufacturers of non-tariff areas and the board had inked an agreement for payment of fixed amount of FED in 2006-2007. Swat and Mingora are part of Provincially Administered Tribal Areas (Pata) where Federal Excise Act, 2005 and Sales Tax Act, 1990 are not applicable. Every year, these manufacturers renew the agreement to pay a fixed amount of duty, which was made part of the overall revenue collection under the head of the FED.

In the past, the tax authorities and cosmetics manufacturers, representing 16 units of non-tariff areas, had agreed to collectively pay fixed amount of the FED. The total amount of FED was divided into 12 instalments to be paid on monthly basis.

In the past, some unscrupulous elements had earned income by charging consumers full amount of duties and taxes on various items including soap and cosmetics at the prescribed rate but actually paying taxes to the government on fixed-amount basis, which is much less than the amount realised from the consumers and termed such 'agreements' between the tax officials and persons involved in this trade as a wheel to evade taxes. – *Courtesy Business Recorder*

MQM MNA elected chairman National Assembly body on Finance, Revenue

National Assembly Standing Committee on Finance here on Thursday on the basis of track record unanimously elected top taxpayer Khawaja Sohail Mansoor, MNA of Muttahida Quami

Movement (MQM) as new Chairman of the National Assembly Standing Committee on Finance and Revenue.

Sohail Mansoor informed the members of the committee here on Thursday that he will try his level best in improving the business environment through elimination of smuggling, under invoicing, damages caused by transit trade and broadening of tax base with removal of hardships faced by the taxpayers to put the economy on growth track.

It was decided by the chairman that in the first regular session of the committee likely to be held on August 3, 2012, FBR would be asked to give detailed briefing on under invoicing, smuggling and transit trade. The Chairman directed the committee secretary that Chairman FBR, Member Customs and other senior members be directed to come and brief the committee on the above mentioned issues and also give recommendations for remedial measures. Khawaja Sohail Mansoor, is leading industrialist and businessmen as well as top taxpayer of the country and was elected from Karachi from the platform of Muttahida Qaumi Movement. The slot became vacant due to the death of Fauzia Wahab, MNA of Pakistan People's Party.

National Assembly Standing Committee on Finance and Revenues met in the Parliament House where glowing tribute were paid to the late Fauzia Wahab, MNA the former chairperson of the NA committee on Finance and Revenue in the presence of Federal Minister Syed Khursheed Shah. Her services for role in managing the affairs of the committee in good manner during her tenure helped the economic managers with many useful suggestions to improve the economy.

Munir Khan Orakzai MNA from Fata proposed the name of Khawaja Sohail Mansoor for the slot of chairman NA Committee on Finance and Revenue and Abdul Rashid Godil MNA from MQM as well as Aftab Shaban Mirani from PPP, Dr Nafisa Shah PPP, Ms Shehnaz Wazir Ali PPP, Maulana Muhammad Qasim, Khawaja Muhammad Asif PML (N), Shahid Khakan Abbasi PML (N), Mian Abdul Sattar, Kashmala Tariq supported Khawaja Sohail Mansoor.

After the election of Chairman of the committee fateha was offered for the departed soul of Fauzia Wahab MNA and all the members of the committee hailed the services of Fauzia Wahab for the country, parliament, committee and her party. Sohail Mansoor termed current economic situation as going worst and said that many things can be improved without much effort and committee would provide its strong input and support to the economic managers to overcome the challenges to put the country on path to growth. – *Courtesy Business Recorder*

Cigarette manufacturers: FBR accused of introducing complicated FED system

The Federal Board of Revenue (FBR) has introduced a very complex 'slabs system' of the Federal Excise Duty (FED) for the cigarette manufacturers which has only benefited the multinational companies with stagnation in the incidence of taxes ie sales tax/FED on most popular brands of the product. Tax experts told here on Thursday that the multinational companies and the FBR had deliberately implemented a very complicated excise duty system to charge less amount of FED on popular brands of cigarettes.

The existing taxation system of the FED is so complicated which only give maximum benefit to the cigarette manufactures. Prior to budget (2012-2013), World Health Organisation (WHO) has recommended that the FBR should abolish the existing FED charged on the basis of threshold and slabs of the FED for different brands of cigarettes. All brands be treated at par instead of tier system, there should be one system which ensure revenue for the government, help FBR in ensuing compliance and easy to comprehend by all stakeholders. Due to unknown reasons, the FBR fully endorsed the complicated excise regime which facilitates the leading multinational companies. Tax officials and the cigarette manufacturers have made the excise duty structure in such a manner that ordinary consumer would be totally confused while understating the techniques used for imposition of the excise duty on cigarettes. One of the reasons for implementing a confusing tax system for cigarettes is that some of retired bureaucrats have been hired by multinational companies having connection in government circles and policy makers.

Recently, it has been reported that the foreign companies have transferred an amount of over $1 billion aboard on account of profit and dividend during the last fiscal (2011-12). The repatriation of profit and dividend by foreign companies is again on rise and they are repeatedly transferring their profits and dividends. The foreign investors have repatriated nearly $1.061

billion on account of profit and dividend in fiscal 2012 against $758.3 million in fiscal 2011, depicting an increase of $303 million.

On the other hand, multinational companies in the tobacco sector are using different techniques to ensure minimum increase in incidence of taxes on cigarettes. When contacted, a tax official, who have done research on cigarette industry, explained that firstly the existing tax structure should be simple. The present tax structure is complicated and favors to the multinational companies. The incidence of taxes on lower brands should be higher as compared to existing structure.

The incidence of sales tax and federal excise duty on cigarette has not been increased at par with the globally applicable tax rates on popular brands. Globally, there is a standard that the incidence of tax on cigarettes should be at least 70 percent as the cost of production of this commodity is very low.

The incidence of sales tax and FED on the strong brands of cigarette could be termed as stagnant in Pakistan as compared to other countries where incidence of taxes goes up to 70 percent. In Pakistan, if the incidence of sales tax/FED was 42 percent on a specified brand, it has been increased to 45 percent and then 52 percent on annual basis. However, even the incidence of sales tax/FED has been taken up to 60 percent it is still very low as compared to the 70 percent. The technique used by the multinational companies is to re-adjust the middle slabs with upward adjustment in price. In this way, the incidence of the sales tax and the FED has not been increased, but the price has been increased for popular brands to ensure that the incidence of taxes should remain on the lower side. "Resultantly, the FED has been increased in terms of rupees, but in term of percentage, the incidence of the FED did not increase. Apparently, the excise duty has been increase due to increase in price of cigarettes, whereas the incidence in actual terms of percentage has not proportionately increased, he added.

If the incidence of taxes is 70 percent on a specific brand, the technique is to ensure incidence of tax of 50 percent or 60 percent on most popular brands. If the market is captured by two popular brands, their actual incidence of taxes would not be increased at par with the global prevailing rates of taxes. This has been done by increasing prices linking with the FED, but the direct incidence of taxes has not increased.

Official said that the multinational companies have also adopted another technique to discourage introduction of new brands by local units of Mardan etc. This has been done by fixing a minimum price for launching of a new brand. A new brand cannot be launched unless of until a specific price has been fixed which discourages local units to introduce new brands.

When asked about complexity of the tax structure on cigarettes, sources said that the Board has done different experiments in the past since 1988. Sometimes, it was tried to fix tax on the ad valorum basis and sometimes it has been fixed on the basis of specific amount. As there is advancement in different counties, the incidence of taxes has to be increased at par with the global practice. However, the existing structure is very complicated which needs to be simplified. It is in the favour of the tobacco sector to continue with the existing tax slabs structure. For this purpose, in budget (2012-13), the FBR has enhanced tax incidence on cigarettes by revising upward price tiers, official added.

Experts said that the FBR had received proposals from different quarters including WHO to introduce the concept of tax stamping on each pack of cigarette to know about the exact number of sticks and packets manufactured by the units. It is a very easy way of documentation of each and every packet of cigarette produced in Pakistan. In this way, the FBR or Ministry of Finance would be able to implement the track and tracing system of the manufactured items cleared from the factories. The two multinational companies are strongly resisting the proposal of implementing tax stamping or band rolling on cigarette packs. Besides, tax stamping, the multinational companies are also against the restoration of the supervised clearance system at factories. Both restoration of supervised clearance system and tax stamping are the most crucial steps to counter tax evasion in the cigarette industry, experts added.

In the past, World Health Organisation (WHO) had expressed serious concern over nominal increase in the federal excise duty (FED) on cigarettes and withdrawal of excise duty on cigarette rods in budget 2012-13.The government has abolished the FED on filter rods used in manufacturing of cigarettes in budget (2012-13). It is unclear that how such a big facilitative measure has been given to the cigarette manufacturer with no major increase in the incidence of taxes on cigarettes. Instead of simplifying the tax collection system from the industry, the cigarette manufacturer particularly multinational companies were given relief. – *Courtesy Business Recorder*

2012 PTR 1291 (Trib. Ind.)

INCOME TAX APPELLATE TRIBUNAL
MUMBAI "L" BENCH, MUMBAI

P.M. Jagtap, Accountant Member and Amit Shukla, Judicial Member

FACTS/HELD

1. **Rendering of services is not "supply of knowledge or information" to be "royalty"**
2. The assessee was engaged as a consultant by Essar Oil Ltd to provide consultancy services in connection with sale of its energy business. As the consultancy required high level technical and industry knowledge, the assessee engaged KPMG LLP, USA & KPMG Consulting LP, Canada for rendering professional services and paid Rs. 20 lakhs & Rs. 13 lakhs respectively. The AO held that the said fees constituted "royalty" u/s 9(1)(vi) & Article 12 and as there was no TDS, the amount was to be disallowed u/s 40(a)(i). This was reversed by the CIT(A). On appeal by the department, HELD dismissing the appeal:

   > The professional services rendered does not fall in the definition of "royalty" in Article 12 of the DTAA. It was purely a **professional service for consultancy** which were rendered outside India and **not for supply of scientific, technical, industrial or commercial knowledge or information**. Thus, there was no liability to deduct TDS and consequently no disallowance u/s 40(ia) can be made.

Appeals partly allowed.

ITA No. 8824/Mum/2004 (Assessment Year: 2001-2002), ITA No .8787/Mum/2004 (Assessment Year: 2001-2002), ITA No. 2251/Mum/2006 (Assessment Year: 2002-2003), ITA No. 2379/Mum/2006 (Assessment Year: 2002-2003) ITA No. 1979/Mum/2007 (Assessment Year: 2003-2004) and ITA No. 2057/Mum/2007 (Assessment Year: 2003-2004).

Heard on: 14th May, 2012.

Decided on: 8th June, 2012.

Present at hearing: A.V. Sonde, for Appellant. Mahesh Kumar, for Respondent in ITA No. 8824/Mum/2004, Mahesh Kumar, for Appellant. A.V. Sonde, for Respondent in ITA No .8787/Mum/2004, A.V. Sonde, for Appellant. Mahesh Kumar, for Respondent in ITA No. 2251/Mum/2006, Mahesh Kumar, for Appellant. A.V. Sonde, for Respondent in ITA No. 2379/Mum/2006, A.V. Sonde, for Appellant. Mahesh Kumar, for Respondent in ITA No. 1979/Mum/2007 and Mahesh Kumar, for Appellant. A.V. Sonde, for Respondent in ITA No. 2057/Mum/2007.

JUDGMENT

Per Amit Shukla:– (Judicial Member)

These are bunch of cross appeals filed by the assessee and the department for the assessment years 2001-2002, 2002-2003 & 2003-2004. Since the issues involved in all these appeals are common, therefore, the same are being disposed of by this consolidated order.

2. ITA No.8824/mum/2004(AY 2001-02)(By Assessee):

In ground No.1, the assessee has challenged the disallowance of Rs.12,18,732/- in respect of professional fees and expenses not recoverable from clients and claimed as bad debts.

3. The relevant facts necessary for adjudication of this ground are that the assessee has written off in the books of account Rs.12,18,732/- as bad debts in respect of eight parties the details of which are given in para 5.1 of the CIT(A)'s order. Before the Assessing Officer, it was contended that the reasons for non recovery of the amounts from the clients were that:–

i) *fee claim raised for additional work not covered in the original fee agreement;*

ii) *re-negotiation over agreed fees by clients;*

iii) *non-acceptance/part acceptance of deliverables by the client; and*

iv) *differences over quantum and quality of deliverables.*

Further, these amounts have been written off only after making the required efforts for recovery. The management ultimately was of the view that legal recourse could not be in the interest of the company. With respect to the allowability of claims of bad debt, it was submitted that **firstly**, it has complied with requisite condition that the fee amount disclosed as bad debts have been considered as income of the previous years in which the respective invoices were raised and **secondly**, the company has disclosed the debts as irrecoverable and written off as bad debts in the books of accounts of the previous year ended 31st March, 2001. Reliance was placed to the amendment made to section 36(1(vii) and 36(2) w.e.f. 1-4-1989 that once the bad debts has been written off, the same should be allowed. The Assessing Officer did not agreed with the contention of the assessee had held that the assessee cannot write-off any amount arbitrarily or irrationally. The write-off has to be bonafide and reasonable. He held that even after the amendment the basic condition relating to establishing the debt as bad is still effective. He, thus, disallowed the claim of bad debts amounting to Rs.12,18,732/-.

4. Before the CIT(A), the assessee contended that bad debt has to be allowed if the debt has been actually written off in books of accounts and has been taken into account in computing its income of the previous year in which the debt is written off. There is no onus to establish the debt as bad. Learned CIT(A) too rejected the explanation of the assessee and after relying upon the decision of the Hon'ble Gujarat High Court in the case of *CIT vs. Ahmedabad Electricity Co. Ltd.*, reported in (2003) 262 ITR (Guj.), and held that the assessee has not brought on record the necessary evidence to show that its claim of writing off the debt as bad debt was an objective of a bona fide belief. He, thus, upheld the disallowance.

5. Learned Senior AR on behalf of the assessee submitted that this issue has been set at rest by the decision of the Hon'ble Supreme Court in the case of T.*R.F. Limited vs. CIT*, reported in (2010) 323 ITR 397 (SC). This was fairly agreed by the Ld. CIT DR also.

6. We have carefully considered the rival submissions and also the findings of the CIT(A) as well as the Assessing Officer. It is not disputed that fees amount disclosed as bad debts has been taken as income of the previous year in respect of the invoices relating to the said eight parties and subsequently the assessee had disclosed the debts as irrecoverable and written it off in the books of account for the previous year ending 31st March, 2001 i.e. in the relevant assessment year. Thus, after the amendment w.e.f. 1st April, 1989, it is sufficient that the assessee has written off the bad debts in the account and the same has to be allowed. This issue has now been set at rest by the decision of the Hon'ble Supreme Court in the case of *T.R.F. Limited vs. CIT* (supra), wherein the Hon'ble Supreme has held that after 1st April, 1989, it is not necessary for the assessee to establish that the debt, in fact, has become irrecoverable. It is enough if the bad debt is written off as irrecoverable in the accounts of the assessee. Thus, following the law settled by the Hon'ble Supreme Court in the aforesaid case, we hold that the claim of bad debts for a sums aggregating Rs.12,18,732/- is allowable as bad debts and the findings of the CIT (A) on this score is set aside. **In the result, ground No.1 is allowed**.

7. In ground No.2, the assessee has challenged the ad hoc disallowance of 10% for sums aggregating Rs.42,20,000/- made under Section 37(1) read with section 40A(2)(b) out of professional fees paid for

services paid to KPMG Consulting Private Limited (KCPL) and KPMG firm. The facts are that the assessee company had made a payment of Rs.4,12,00,000/- to KCPL as professional fee and an amount of Rs.1,87,50,000/- and Rs.10,50,000/- to KPMG in the form of support service charges and professional fees. It was submitted by the assessee that the professional fee was paid to KCPL for doing certain specialized work to various concerns like Airport Authority of India, BFL Software Limited, CMC Ltd, FCL Technology India Ltd and SSI Technology. As the assessee did not had sufficient specialized manpower to carry out the job, hence, the service of KCPL was engaged. Besides this, the KPMG had provided support to the company by way of computers, laptops, office space, communication facilities, office supplies for which support service charges of Rs.1,87,50,000/- was paid and further professional fee of Rs.10,50,000/-was paid for accounting, secretarial, human resources and technology related services by it. Further, it was submitted that the payments were made as per the standard rates and no excessive or any unreasonable payment has been made. The Assessing Officer rejected the contention of the assessee on the ground that the assessee has failed to furnish any particular which would through light on the exact nature of work done by either KPCL or KPMG and in absence of any verifiable specific details for the ascertainment of reasonableness of expenditure, he made the disallowance of Rs.60,95,000/- u/s. 40A(2)(b) by holding that the amount equivalent to 10% of such charges is excessive and unreasonable.

8. Before the CIT(A), the assessee placed documents like:–

i) copies of invoices raised by KCPL;

ii) etails of time spent by personnel of KCPL on each assignment of the assessee and the value thereof;

iii) qualifications of the personnel of KCPL;

iv) amounts billed by the assessee on each engagement where personnel of KCPL were engaged;

v) copy of agreement with KCPL;

vi) copies of invoices raised by KPMG; and

vii) details of time spent by personnel of KPMG and their charge out rates.

Learned CIT (A) did not accept the contention of the assessee and agreed with the Assessing Officer that the excessiveness of the payment of service/professional charges cannot be ruled out. However, he directed the Assessing Officer to exclude the amount of reimbursement of costs of Rs.1,87,50,000/- and to calculate the disallowance on the balance amount at 10%.

9. Learned Senior AR on behalf of the assessee submitted that details of charges and time spent, invoices and confirmations were filed

before the authorities below and it was in consonance with the payments made to non related parties i.e. the same rate has been paid to other parties also. Therefore, the provision of Section 40A2(b) cannot be applied in regard to such payments. He referred to various documents submitted in the paper book in this regard. Further in support of his contentions reliance was placed on the following decisions:–

i) *Upvan International* [1986] 15 ITD 215 (Del);

ii) *Shankar Trading Co.(P) Ltd.*[2006] 152 TAXMAN 49 (Del);

iii) *Girnar Construction Co.* [2003] 261 ITR 463 (Raj.); and

iv) *Voltamp Transformers* [1981] 129 ITR 105 (Guj).

10. On the other hand, learned Senior DR relied upon the findings given by the CIT(A) as well as the Assessing Officer and submitted that whether the payment to the non-related parties have been made on the same proportion or on same rate, could not be established from the records as it was not placed before the Assessing Officer as well as the CIT(A). Hence, the disallowance made should be confirmed.

11. We have carefully considered the submission of the rival parties and the findings given by the CIT(A) as well the Assessing Officer. Section 40A (2)(b) provides that:–

> *"(2)(a) Where the assessee incurs any expenditure in respect of which payment has been or is to be made to any person referred to in clause (b) of this sub-section, and the [Assessing] Officer is of opinion that such expenditure is excessive or unreasonable having regard to the fair market value of the goods, services or facilities for which the payment is made or the legitimate needs of the business or profession of the assessee or the benefit derived by or accruing to him therefrom, so much of the expenditure as is so considered by him to be excessive or unreasonable shall not be allowed as a deduction."*

From the plain reading of above, it is amply clear that the payments which are made to persons specified in sub-clause b of sub section 2 of Section 40A, if in the opinion of Assessing Officer, is excessive and unreasonable;

firstly, having regard to the fair market value of the goods, services or facilities for which the payment is made;

secondly, looking to the legitimate needs of the business or profession of the assessee; or

thirdly, the benefit derived by or accruing to him therefrom;

then such an expenditure as is considered by the Assessing Officer to be excessive or unreasonable, shall be disallowed. In a given case, the question whether the expenditure is excessive or unreasonable has to be examined keeping in mind the goods, services or facilities provided by the relative persons for which payment is made. In such a process, the legitimate needs of the business or profession of the assessee or the benefit derived by or accruing to the assessee from such services has also to be kept in mind. After applying this test, if it is found that the expenditure is excessive or unreasonable, then excess or unreasonable portion of the expenditure is to be disallowed. The initial onus to prove that the payment made to specified persons is excessive or unreasonable rests upon the assessee, who has to show that such payments are in consonance with the market rate or the payment made to any relative parties are for legitimate needs of the business or profession. It is then the Assessing Officer has to prove from the material placed on record that such a payment on which expenditure is incurred is excessive or unreasonable and is not for the legitimate needs of the business or profession, or any kind of benefit is derived to the assessee. Here in this case, the Assessing Officer has neither enquired nor brought anything on record to show that the payment is excessive as compared to unrelated parties or it was not for the legitimate needs of the business or profession of the assessee. The same does not seem to have been doubted. It is also not borne out from the finding of the Assessing Officer as well as the CIT(A), as to what was the basis for disallowance of 10%, whether there was any some kind of material or some comparable payments to other parties. In absence of such material on record, we are unable to sustain the view taken by the Assessing Officer as well as the CIT(A) that disallowance of 10% should be made on ad hoc basis. Under these facts and circumstances of the case, we find that it would be proper that matter is restored back to the Assessing Officer, who will examine whether the similar payments to other unrelated parties have been made in the same proportion or on similar rates or whether there was any legitimate need for its business. Thus, this matter is restored back to the file of the Assessing Officer for verification from the end of the Assessing Officer to examine similar nature of payments made to unrelated parties are in consonance or are on similar rate and then decide this matter. If it is found that payments made to related parties are in consonance with the payments made to unrelated parties or it is for legitimate needs of the business or profession, no addition or disallowance should be made. **In the result, this ground is allowed for statistical purpose**.

12. In grounds No.3 & 4, the assessee has challenged disallowance of Rs.1,12,404/- made under Section 43B in respect of the assessee's contribution to the Employees Provident Fund. The assessee has raised additional ground before the CIT(A) for allowing the payments of provident fund contribution by the employer on the ground that the same should be allowed in view of the second proviso to section 43B. The learned CIT(A) dismissed the additional ground as not admitted on the following reasons:–

(1) *The appellant had suo motto made the disallowance as per the then provision of the second proviso to Section 43B and total income cannot be reduced below the returned income at this stage.*

(2) *The amendment omitting the second proviso to Section 43B was made by the Finance Act, 2003 w.e.f. 01-04-2004 i.e. after the appellant had filed its return of income.*

(3) *The aforesaid decisions having been delivered recently do not apply to the concluded assessment because this does not give rise to the cause of action for raising the additional ground. The return of income filed after making payment of self assessment tax becomes a concluded assessment if the returned income is accepted u/s. 143(1) or u/s 143(3)."*

13. Both the parties fairly agreed that this issue is covered by the decision of the Hon'ble Supreme Court in the case of *CIT vs. Alom Extrusions Ltd.*, reported in (2009) 319 ITR 306, wherein the Hon'ble Supreme Court concluded that the omission of second proviso to Section 43B and the amendment of first proviso by the Finance Act, 2003, bringing about uniformity in payment of tax duty, cess and fee on one hand and contribution to employees welfare funds on the other are curative in nature and thus, is effective retrospectively from 1st April, 1988 i.e. the date of insertion of proviso. It is also not disputed that payments have been made before the due date of filing of a return. Thus, the disallowance of Rs.1,12,404/- is deleted and the same is to be allowed as deduction under Section 43B. Thus, grounds No.3 & 4 are allowed. **In the result, appeal filed by the assessee stands allowed subject to directions given in respect to the ground No.2**.

14. <u>ITA No.8787/mum/2004(AY 2001-02)(By Department)</u>

In this appeal, the department has raised the following grounds of appeal:–

1. *"On the facts and in circumstances of he case and in law, the CIT(A) erred in directing the Assessing Officer to allow the payments made to foreign parties without TDS, disallowed by the Assessing Officer u/s.40(a)(i) on the grounds that the same were in the nature of professional fees not liable to TES as per the provisions of DTAA without appreciating the fact that payments of all kinds including reimbursement of expenses is hit by the provisions of section 40(a)(i) r.w.s. 195 as held by the Mumbai ITAT in the case of DCIT, SPl. Rg. 20 Vs. M/s Arthur Andersen & Co. (ITA No.9125/Mum/1995).*

2. *On the facts and in the circumstances of the case and in law, the CIT(A) erred in directing the Assessing Officer to exclude the reimbursement costs from the total payments made to sister*

concerns for working the disallowance at 10% of the total payment made without appreciating the fact that the assessee had not produced any proof to determine the reasonableness of payments made u/s.40A(2)(b) and acceptance of the same by the CIT(A) was in contravention of Rule 46A."

3. *On the facts and in the circumstances of the case and in law, the CIT(A) erred in directing the Assessing Officer to allow the late payment of PF contribution u/s.43B without appreciating the fact that the grace period is solely for the purpose of section 14B of the P.F. Act and the due date under both the Acts remains the same."*

15. The facts apropos ground No.1 is that, the assessee company had made the following payments to non-residents towards professional charges for services rendered and for reimbursement of expenses.

a)	KPMG LLP, USA	
	-Professional fees	Rs.20,89,906 (USD46,248.00)
b)	KPMG Consulting LP, Canada	
	-Professional fees and	Rs.13,37,229 (USD 30,678,08)
	Reimbursement of expenses	

The payments were made without deduction of tax at source. The Assessing Officer held that these payments were in the nature of royalties under Section 9(1)(vi) and the relevant article dealing with royalties under the respective Double Taxation Avoidance Agreements (for short 'DTAAs'). While coming to his conclusion, he has relied upon the following decision:–

1) *ITAT Delhi Bench-ITO vs. Munak Galva Sheet Ltd.* [1990] 35 ITD 304;
2) *ITAT Bangalore Branch-AEG vs. Commissioner* [1994] 48 ITD 359 (Bang.);
3) *EPW Da Costa and Another vs. Union of India* [1980] 121 ITR 751 (Delhi);
4) *Continental Construction Ltd. vs. CIT* [1990] 185 ITR 178 (Delhi);
5) *Continental Construction Ltd. vs. CIT* [1992] 195 ITR 81 (SC); and
6) *ITAT, Mumbai-Capt. K.C.Saigal vs. ITO* [1995] 54 ITD 488 (Del.).

Accordingly, he held as under:–

"i) The Professional Fees paid to KPMG are in the nature of royalties within the meaning of explanation to section 9(1)(vi) of the I.T.Act, 1961.

ii) Article 15 of DTA Agreement does not apply in as much as KPMG Dallas is the resident of USA and being a beneficial owner of royalties is not carrying on business in India through a permanent establishment situated in India s per the provisions of Article -12(6).

iii) Article-14 of DTA Agreement does not apply as the said article applies only to individuals and not Partnership firms and KPMG Dallas is a Partnership Firm.

iv) That, royalties payable to KPMG Dallas are taxable in India under Article 12 of DTA Agreement and Section-9(1)(vi) of the I.T. Act, 1961.

In view of the above, it is stated that the company should have deducted tax in respect of amount payable to KPMG Dallas under the provisions of section 195 r.w.s. 195A on the ground that the amount payable to KPMG Dallas was chargeable to tax in India under Article-12(2) and section -9(1)(vi) r.w.s. 115A.

Therefore, the amount of Rs.20,89,906/- is not allowed as a deductible expenditure under the provisions of section -40(a)(i) r.w.s.195 r.w.s. 195A and is accordingly included in the total income of the assessee company.

For the same reason as discussed in forgoing paragraphs in relation to remittance of professional fees to KPMG Dallas it is held that the company should have deducted tax in respect of amounts payable to KPMG Consultancy LP, Canada of a sum of Rs.13,37,229/- under the provisions of section 195 r.w.s. 195A on the ground that the amount payable to KPMG Consulting LP, Canada was chargeable to tax in India under Artilce-12(2) and section 9(1)(vi) r.w.s. 115A to the exclusion of Article-7 which for the above reasons are held as not being applicable and relevant to the case of the remittances ot KPMG Consulting LP, Canada who has rendered professional services in connection with developing the transaction strategy/value proposition, etc. to Essar Oil Ltd. Accordingly, the amount of Rs.13,37,229/- is not allowed as deductible expenditure under the provisions of section 40(a)(I) r.w.s. 195 and is included in the total income of the assessee company."

16. Before the CIT(A), it was submitted that the none of the case laws as have been relied upon by the Assessing Officer are applicable and

further in order to be covered under the definition of the term royalty used in the DTAA, it has to fulfil certain criteria which in this case is not applicable at all. The Assessee also relied upon the decision of the M.P. High Court in the case of *CIT vs. HEG Ltd.*, reported in [2003] 130 Taxman 72 (MP). The CIT(A) agreed with the contention of the assessee and held that the payments were not in the nature of royalties either under Section 9(1)(vi) or under respective DTAAs, hence, there is no obligation to deduct the tax under Section 195. The relevant finding of the CIT(A) are reproduced herein below:–

"4.2 Finding

<u>Payment made to KPMG LLP, USA</u>

The appellant has placed on record invoice, letter of engagement dated 19 April, 2000, note on services rendered, RBI approval and declaration dated 18 August 2000 received from KPMG LLP, USA.

The appellant has stated that it was engaged as a consultant by Essar Oil Limited to provide consultancy services in connection with the sale of its energy business. In this connection KPMG LLP, USA was engaged to render professional services.

The scope of engagement was for rendering professional services. The services were rendered outside India. KPMG LLP, USA is a firm of individuals. Pursuant to the provisions of Article 15 of the Indo-US DTAA, the income from the services is not taxable in India. Accordingly, there was no requirement of tax deduction at source from the remittance.

<u>Payment made to KPMG Consulting LP, Canada</u>

The appellant has placed on record invoice, letter dated 09 April, 2001, note on services and declaration dated 29 May 2001 received from KPMG Consulting LP, Canada.

The appellant has stated that it was engaged along with SBI Capital Markets Ltd. by Essar Oil Limited for assisting it in the search of a strategic partner as Essar Oil was planning to enter the retail oil marketing sector post de-regulation. In this connection KPMG Consulting LP, Canada was engaged to render professional services. The payment was towards fees of USD 28,000 and reimbursement of expenses in the nature of air travel, transportation, lodging, meals and other expenses amounting to USD 2,678.08.

The scope of engagement was for rendering professional services. The services were rendered in Canada and in India. KPMG Consulting LP is a partnership of body corporates. It did *not have a fixed base/permanent establishment in India. Pursuant to the provisions of Article 7 of the Indo-Canada DTAA, the income from the services is not taxable in India. Accordingly, there was no requirement of tax deduction at source from the remittance.*

To sum up, the above mentioned payments are not in the nature of 'royalties' either under section 9(1)(vi) of the Act or under the respective DTAAs. There was no obligation to deduct tax u/s 195 of the Act. Therefore, the subject amounts are not disallowable u/s. 40(a)(i) of the Act. In the result, Ground Nos. 1 to 5 are allowed."

17. Learned Senior AR on behalf of the assessee submitted that it is not a case of royalty under Article 12 of the Indo-US DTAA as the payment was made purely for rendering of professional services to KPMG, US and KPMG Canada. In support of his contentions, he relied upon the following judgments:–

i) *HEG* 130 Taxman 73 (MP);

ii) *Hindalco* 96 TTJ 1009 (Mum);

iii) *JDIT vs. Harward Medical International USA* [2011] 16 taxman.com 69 (mum); and

iv) *Standard Chattered Bank vs. DDIT* (Intl.tax) [2011] 11 taxman.com 105 (mum).

He, thus, finally relied upon the findings of the CIT(A). On the other hand learned CIT DR relied upon the findings given by the Assessing Officer.

18. We have carefully considered the rival submissions and also gone through the findings given by the Assessing Officer as well as the CIT(A). The relevant facts are that the assessee company was engaged as a consultant by Essar Oil Limited to provide consultancy services in connection with sale of its energy business. Such a sale was expected to require application of high level office skills besides technical and industry knowledge. For rendering such consultancy a significant number of such overseas companies are based in USA. The assessee engaged the services of KPMG Dallas, which is a firm of individual and resident of USA, which had the skill and technical knowledge relating to energy division based industry and technical parameters in giving such consultations and conduct negotiations with the potential parties. It was in lieu of this, that a professional fee of USD 46,248 which in terms of INR come to Rs.20,89,906/-, was paid. The second payment was made to KPMG consulting LP Canada for rendering professional services for the Essar Oil Limited for retail oil marketing and other related services. The payment towards fee was made at USD 30,678/- which in terms of INR is

Rs.13,37,229/-, which also included reimbursement of expenses in the nature of transportation, lodging, meals and other expenses. The Assessing Officer has given categorically finding that so far as the Article 15 of DTAA is concerned, the same does not apply to KPMG USA as it does not have any PE or business based in India and the services were not rendered for a period exceeding 90 days within the period of 12 months. His only case is that the professional fees paid to KPMG USA are in the nature of royalties within the meanings of 'explanation' to section 9(1)(vi) and is taxable under Article 12 of Indo-US DTAA. The royalties and fees for included services is taxable as per Article 12 in clause 3, reads as under:–

> **"3. The term "royalties" as used in this Article means:**
>
> (a) payments of any kind received as a consideration for the use of or the right to use any copyright or a literary, artistic or scientific work, including cinematograph films or work on film, tape or other means of reproduction for use in connection with radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience, including gains derived from the alienation of any such right or property which are contingent on the productivity use or disposition thereof: and"

18.1 Looking to the nature of professional services rendered to the KPMG USA, it is evident that it does not fall in any of the terms of definition given for Royalty under Article 12 of Indo US DTAA. It was purely a professional service for consultancy which were rendered outside India and nor for supply of scientific, technical, industrial or commercial knowledge or information. Thus, nature of payment do not fall within the meaning of Article 12 and, therefore, there was no liability to deduct TDS and consequently disallowance made under section 49(ia) is uncalled for. Similarly, in the case of payment made to KPMG, Canada were also purely for professional services and reimbursement of expenses, which in any manner does not fall under Article 12. Thus, on such payment also there was no liability to deduct TDS and consequently Section 40(ia) will not be applicable. The finding of the CIT(A) is, thus, upheld. **Accordingly, ground No.1 as raised by the department is dismissed**.

19. At the outset, as admitted by both the parties that ground No.2 is similar to ground No.2 of the assessee's appeal in ITA No.8824/M/2004. Therefore, in view of the finding given in the aforesaid appeal, the matter has to be examined by the Assessing Officer in the light of the directions given above in para 11. Thus, this ground is treated as allowed for statistical purposes.

20. In ground No.3, the department has challenged the disallowance of Rs.4,81,778/- made under Section 43B by the Assessing Officer. It is seen that there is a categorical finding by the CIT(A) that the assessee had made contribution to the provident fund within the grace period of five days. Based on this fact, learned CIT(A) has deleted the addition. It is undisputed fact that contribution to provident fund has been made within the grace period of 5 days and in any case, it has been paid within the due date of filing of return. Under these facts and circumstances, no disallowance under Section 43B can be made on this score and, **therefore, the finding of the CIT(A) is upheld and the ground No.3 raised by the department is dismissed.**

21. <u>ITA No.2251/Mum/2006 (AY 2002-03)(By Assessee):</u>

In this appeal, the assessee has raised the following grounds of appeal:–

"1. On the facts and circumstances of the case and in law the Commissioner of Income Tax (Appeals) erred in upholding the disallowance made by the Assessing Officer of the amounts not recoverable from clients and claimed as bad debts amounting to Rs.33,14,803/-.

2. On the facts and circumstances of the case and in law the Commissioner of Income Tax (Appeals) erred in upholding disallowance to the extent of Rs.2,10,000 made by the Assessing Officer u/s.40A(2)(b) of the Income Tax Act, 1961 out of professional fees paid to KPMG, a firm registered in India."

The ground No.1 deals with disallowance of amount of claim of bad debts. This issue has already been decided in the assessee's favour in appeal for the assessment year 2001-2002 in ITA No.8824/m/2004. Thus, in view of the reasoning given in the aforesaid appeal, the disallowance made for bad debts is deleted and **accordingly ground No.1 is allowed**.

22. The ground No.2 relates to ad hoc disallowance of Rs.2,10,000/- made by the Assessing Officer under Section 40A(2)(b). This issue has also been decided in the aforesaid appeal and in view of the reasoning given above, this issue is set aside to the file of the Assessing Officer as per the directions given therein. In the result, the ground No.2 is allowed for statistical purpose.

23. <u>ITA No.2379/Mum/2006 (AY 2002-03)(By Department):</u>

In this appeal, the revenue has raised the following ground of appeal:–

"1. On the facts and circumstances of the case and in law the CIT(A) erred in restricting the disallowance of Rs.15,85,00/- us/.40A(2)(b) of the Act to Rs.2,10,000/- without appreciating the

fact that the assessee had not produced any proof to determine the reasonableness of payments made u/s.40A(2)(b) and acceptance of the same by the CIT(A) was in contravention of Rule 46A."

This ground has already been decided while deciding the assessee's appeal for the assessment year 2001-2002 and also the department's appeals for the same year. Since, this matter has been restored back to file of the Assessing Officer it is treated as allowed for statistical purposes. **This ground is thus allowed for statistical purposes**.

24. <u>ITA No.1979/Mum/2007 (AY 2003-04)(By Assessee):</u>

In this appeal, the assessee has raised the following ground of appeal:–

"1. On the facts and circumstances of the case and in law the Commissioner of Income tax (Appeals) erred in upholding the disallowance made by the Assessing Officer us/.40A(2)(b) of the Income tax Act, 1961 of Rs.2,10,000/- being 10% of professional fees amounting to Rs.21,00,000/- paid to KPMG, a firm registered in India."

In this case, only one issue has been raised with regard to adhoc disallowance of Rs.2,10,000/- under section 40A(2)(b). In view of the finding given in I.T.A.No.8824/M/2004 (AY 2001-02), this issue is restored back to the file of the Assessing Officer as per the directions given in the aforesaid appeal. **In the result, this ground is allowed for statistical purpose**.

25. <u>ITA No.2057/Mum/2007 (AY 2003-04)(By Department):</u>

In this appeal, the revenue has raised the following ground of appeal:–

"1. On the facts and circumstances of the case and in law the CIT(A) erred in restricting the disallowance of Rs.15,85,00/- us/.40A(2)(b) of the Act to Rs.2,10,000/- without appreciating the fact that the assessee had not produced any proof to determine the reasonableness of payments made u/s.40A(2)(b) and acceptance of the same by the CIT(A) was in contravention of Rule 46A."

The issue raised by the department in the present appeal has also been covered by the decision given in ITA No.8824/M/2004. In view of the finding given in the aforesaid appeal, this ground is also allowed for statistical purpose.

26. In the result, the appeals of the assessee are partly allowed for statistical purposes and departmental appeals are also partly allowed for statistical purposes.

Order pronounced on this 8th day of June, 2012.
