IN THE INCOME TAX APPELLATE TRIBUNAL
"A" BENCH : BANGALORE

BEFORE SHRI N.V. VASUDEVAN, JUDICIAL MEMBER
AND SHRI ABRAHAM P. GEORGE, ACCOUNTANT MEMBER

ITA No. 1091/Bang/2013
Assessment year : 2009-10

Zanav Home Collection, No.38/3, Block-2, "Lakshmi", Madiwala Post, Bangalore – 560 068. **PAN: AAAFZ 1447J**	Vs.	The Joint Commissioner of Income Tax, Range 10, Bangalore.
APPELLANT		RESPONDENT

Appellant by	:	Shri Cherian K. Babay, C.A.
Revenue by	:	Shri P. Dhivahar, Jt. CIT(DR)

Date of hearing	:	28.01.2015
Date of Pronouncement	:	13.02.2015

O R D E R

Per N.V. Vasudevan, Judicial Member

This appeal by the assessee is against the order dated 1.5.2013 of the CIT(Appeals)-V, Bengaluru relating to assessment year 2009-10.

2. The first issue that arises for consideration is as to whether the revenue authorities were justified in denying the claim of assessee for

deduction on account of bad debts written off amounting to Rs.1,33,28,670 u/s. 36(1)(vii) of the Act.

3. The facts and circumstances under which the aforesaid issue arises for consideration are as follows. The assessee is a partnership firm, engaged in the business of export of furnishing fabrics. In the course of assessment proceedings, the Assessing Officer noticed that a sum of Rs.1,33,28,679 was claimed as deduction under the head "provision for doubtful debts which was disallowed in the previous year relevant to A.Y. 2007-08, now allowed on bank's approval for write off". The undisputed facts are that this balance pertained to a customer M/s. Starky & Associates located in U.S.A., from whom recovery had to be made in foreign exchange. Out of the sum of Rs. 1,33,28,679/-, Rs. 1,29,96,647/- represented the amounts due from the customer and balance Rs. 3,32,032/- is the corresponding credit allowable under the Duty Entitlement Pass Book Scheme (**DEPB** Scheme) which was taken credit on accrual basis at the time of effecting the exports, but could not be realised as export collections were not realised.

4. In that year (AY 2007-08), consequent to the above finding, this sum was fully provided for by debiting the profit and loss account (through the expense ledger) and crediting provision for doubtful debts. However, the debt in the party's a/c. was not written off as this pertained to export debts and certain approvals were required before the same could be written off.

This provision for doubtful debts (credit balance) was reflected as a negative figure (deducted from the balance of debtors) on the assets side of the balance sheet as at 3lst March, 2007 (see Schedule VI to the Balance Sheet). The corresponding debit is reflected on the expenditure side of the Profit and Loss account under the head Administrative and Other Expenditure (see Schedule XIII to the Profit and Loss Account). '

5. The Reserve Bank of India's Master Circular No.09/2008-09 dated 1st July, 2008 [hereinafter referred to as "the RB! Circular"], the relevant extracts of which are furnished in Annexure D in the Paper Book) requires that the AD Category-I bank approve any write off of foreign exchange debtors. ('B21 - Write off by AD Category-I banks' in Section B – Operational Guidelines for AD Category-I banks in Part 3 of the Circular).

6. Therefore, pending this approval, the assessee was legally precluded from writing off the balance of Rs. 1,33,28,679/- in AY 2007-08. Hence 100% provisioning was done in that year. This provision was created with the intention of complying with the said RBI Circular while simultaneously seeking to ensure that the financial statements present a true and fair view as at that date (31st March 2007).

7. Accordingly an application was made to Syndicate Bank (the relevant AD Category-I bank, [hereinafter referred to as "the Bank"], (with whom the export documents were lodged for collection) on 23-02-2008 who accorded its approval to the write off as on 31.3.2009 vide their letter on

21st April, 2009, prior to the finalisation of accounts for the year ended 31st March, 2009. The debt was thus written off as bad for the year ended 31st March, 2009.

8. The assessee follows the mercantile system of accounting. Accounting principles generally accepted in India (issued by the Institute of Chartered Accountants of India's Accounting Standard 4 — Contingencies and Events Occurring After the Balance Sheet Date) define the circumstances under which and the conditions upon the satisfaction of which adjustments can be made in the accounts of a period based on events occurring after the end of the period. These circumstances and conditions, broadly and to the extent pertinent to the present case, are as follows:-

> "7.1. An event occurs after the balance sheet date.
>
> 7.2. Such subsequent event provides additional information that could materially affect the determination of amounts in the accounts/financial statements for the period ending on the said balance sheet date."

So, if these two conditions are satisfied, adjustments are to be made to the accounts for the period ending on the said balance sheet date for such events despite the fact that they occur after the balance sheet date.

9. Considering that both the balances of the debtor and of the provision (of equal amounts) were in the accounts as at 31st March, 2009 prior to the adjustment under dispute, according to the Assessee it was clear that such

approval materially affected the determination of the amounts in the accounts as at that date. Moreover the approval specifically mentioned the date of write off as 31st March 2009. The approval, thus, attains the character of an event occurring after the balance sheet date warranting an adjustment in the accounts as on the balance sheet date. In fact, had this adjustment not been made, the truth and fairness of these figures in the financial statements could have come into question apart from non-compliance with the statutory approval.

10. The amount was thus written off by debiting the provision and crediting the debtor as at 31st March, 2009 without a debit to the profit and loss account in AY 2009-10, since a debit had already been given during the year ended 31st March, 2007 while creating the provision.

11. Since such provisions are not allowable under the Income Tax Act, 1961, no claim was made for the provision made in the financial year ended 31st March, 2007 in AY 2007-08. However, bad debts written off are allowable in terms of section 36(1)(vii) of the Act. A claim was thus made for the amount actually written off as bad debt as at 31st March, 2009 in AY 2009-10. It is this claim that is in question under consideration.

12. The AO did not allow the claim of assessee for the reason that there was no write off of the debt in question in the previous year relevant to A.Y. 2009-10, but that was written off as bad debts in the previous year 2006-07 relevant to A.Y. 2007-08. The second objection of the AO was that

Syndicate Bank permitted the assessee for write off of the debt as bad debt by its letter dated 21.4.2009, which date falls within the previous year relevant to A.Y. 2010-11 and therefore the assessee, if at all, can make a claim for deduction only in A.Y. 2010-11.

13. On appeal by the assessee, the CIT(Appeals) concurred with the view of the AO.

14. Aggrieved by the order of CIT(Appeals), the assessee has preferred the present appeal before the Tribunal.

15. We have heard the submissions of the ld. counsel for the assessee, who after bringing out the undisputed facts as explained in the earlier part of this order, placed reliance on the decision of the Hon'ble Supreme Court in the case of *TRF Ltd. v. CIT, 323 ITR 398 (SC)* and *Southern Technologies Ltd. v. JCIT, 320 ITR 577.* It was his submission that the assessee should be allowed the deduction as the debt in question has been written off by squaring off the debtors account in the previous year relevant to A.Y. 2009-10 and in view of the fact that the provision for bad and doubtful debts made in the previous year relevant to A.Y. 2007-08 had not been claimed as deduction in the computation of total income for the A.Y. 2007-08.

16. The ld. DR relied on the order of CIT(Appeals).

17. We have considered the rival submissions and are of the view that the claim of assessee deserves to be accepted. As the facts go to show that in the previous year relevant to A.Y. 2007-08, there was a debit in the profit & loss account and credit in the provision for doubtful debts account, the debts had not been written off in the debtors account. The provision for doubtful debts was, however, reduced from the figure of debtors in the balance sheet. This may amount to a technical write off in the books of account in the A.Y. 2007-08. The point, however, that needs to be taken note of is that the assessee did not claim the bad debts as a deduction in the computation of total income. The assessee added the bad debts written off in the A.Y. 2007-08 to the profit as per the profit & loss account in the computation of total income. In the previous year relevant to A.Y. 2009-10, there has been a write off in the debtors account and this should be sufficient to claim the deduction u/s. 36(1)(vii) of the Act. As far as the approval of Syndicate Bank for write off of the debts is concerned because the assessee was a non-resident, we find that the bank had given approval for write off of the debt as bad debt by its letter dated 21.4.2009. The letter of the Bank permits the write off of the debt as on 31.3.2009. On the one hand, the Revenue takes a stand that write off cannot be permitted unless the competent authority (which is the Bank in the present case) approves the write off. When the approval of the competent authority permitting the write off as on 31.3.2009 is produced, the Revenue takes a stand that since the letter of competent authority is dated 21.4.2009, write off can be

allowed only in the A.Y. 2010-11. This contradictory stand taken by the Revenue cannot be accepted.

18. The accounting treatment given by the assessee to this transaction is as follows. In AY 2007-08, the assessee debited the profit and loss account and gave credit to the provision for doubtful debts account. This was done as the assessee was precluded from writing off the debt, pending completion of formalities and so chose to provide for it. At this stage, one out of the two accounting requirements for a write off was satisfied. Though the profit and loss account had been debited through the expense ledger, the debtors account had not yet been credited. The debit balance in the debtors account continued, but was offset by an equal credit balance in the provision for doubtful debts account.

19. In AY 2009-10, on receiving the bank's approval, the provision for doubtful debts account was debited and credit was given to the debtors account for write off of the amount i.e., the debtor's balance was nullified and the debtor's account closed. At this stage, the second accounting requirement (closing the debtor's account by crediting it) had also been met and the write off was complete.

20. The Revenue's argument is that there is no debit to the profit and loss account in the relevant previous year and that therefore no amount has been written off as shown above, while the fact as stated by the Revenue is correct, its conclusion is erroneous.

21. Considering the accounting principles described above, it cannot be the legislative intent of section 36(1)(vii) to mandate that the debit to the profit and loss account be in the same previous year in which the claim is made there under. While a debit to the profit and loss account is certainly a prerequisite for a write off, such a debit alone does not constitute a write off until the asset being written off is obliterated by a credit to its account. Where this credit has occurred in a subsequent year, the asset can be said to have been written off only in such subsequent year.

22. There has been a write off by squaring off the debtors account only in the previous year relevant to A.Y. 2009-10. This should be sufficient for the Revenue to allow the claim of assessee us/. 36(1)(vii) of the Act. For the reasons given above, we direct the AO to allow claim of the assessee for deduction for the amount of bad debts.

Disallowance of payments to non-residents (Rs.25,46,796)

23. The next issue that arises for consideration is with regard to the disallowance of Rs.25,46,796 which was claimed as a deduction by the assessee under the head 'agency commission' u/s. 40(a)(i). The facts with regard to the aforesaid issue are as follows. In the relevant previous year, the assessee made payments of export commission to its various non-resident agents as follows:-

Name of the Agent	Country	Amount (Rs.)
Arredare	Spain	3,05,854
Duo Textiles	South Africa	6,97,345
Glanvill Furnishings	U.K	3,16,712
Goule Commercial	Brazil	1,11,677
In Common	Sweden	6,78,030
Nuera Trading Ltd.	New Zealand	1,88,719
Overseas Marketers	Australia	1,94,086
Tummers Interior Textiles	Netherlands	59,418
Zanav USA Inc. (Reversal)	U.S.A	(5,045)
Total		**25,46,796**

24. The AO called upon the assessee to show cause as to why the assessee had not deducted at source u/s. 195 of the Act on the payments made to the non-resident. In reply, the assessee contended that payment by the assessee to the non-resident was in the nature of commission for services rendered outside India. The assessee submitted that the agents were paid commission for procuring business to the assessee and that there was no territorial nexus for bringing the commission received by the non-resident to tax in India. The assessee further submitted that if the income of the non-resident is not chargeable to tax in India, then there was no obligation on the part of assessee to deduct tax at source and in this regard relied on the CBDT Circular No.13 dated 23.7.1969. The aforesaid Circular has since been withdrawn, but nevertheless, the assessee placed reliance on the aforesaid Circular, which lays down the correct position in law.

25. The AO, however, held that non-resident has source of income and business connection in India and therefore commission income is

chargeable to tax in India and that the assessee ought to have deducted tax at source at the time of making payment to the non-resident. Since the assessee failed to do so, the AO disallowed the claim of assessee for deduction of a sum of Rs.25,46,796 invoking the provisions of section 40(a)(i) of the Act.

26. On appeal by the assessee, the CIT(Appeals) confirmed the order of the AO. According to the CIT(Appeals), section 9(1)(i) of the Act was applicable and all income accruing or arising, whether directly or indirectly through or from any business connection in India or sources of income in India, shall be deemed to be accrue or arise in India. According to him, the business of the assessee firm is based in India and the parties to whom payment has been made are claimed to be 'commission agents' of the assessee firm. The assessee firm had been making payments to these parties for several years whereby the parties get a regular income from Indian shores resulting in a business connection. As the assessee firm derives income from conducting and running its business in India and since these payments were on account of commission to agents, these parties definitely had business conection in India. According to the CIT(A), since there was a 'business connection, obligation on the part of the assessee to deduct tax at source u/s. 195(1) on commission payment definitely arose. As per Explanation 2 of section 195, obligation to comply with section 195(1) and to make a deduction is applicable and to be extended on all persons, resident or non resident even if the non resident has no residence

or place of business or business connection in India, or any other presence in any manner whatsoever in India.

27. The CIT(A) noted that in the instant case, these non-residents definitely had business connection in India. According to him, even if it was assumed for a moment, that these payments are not through business connection and that these parties do not have a residence or place of business in India or 'Permanent Establishment' (as claimed in the grounds of appeal) in India, still, in view of Explanation 2 of Section 195, the assessee had an obligation to deduct tax at source from the said payments.

28. The CIT(Appeals) accordingly confirmed the order of the AO.

29. Aggrieved by the order of CIT(Appeals), the assessee has filed the present appeal before the Tribunal.

30. The ld. Counsel for the assessee submitted that the facts regarding the transactions are as follows:-

(1) Agreements with all the agents have been entered into on similar lines. These agreements are in Annexure H of the Paper Book.

(2) Briefly, the terms of the agreement are that the agents are granted the right to sell the merchandise specified in the agreement and produced by the principal (the assessee) within the territorial jurisdiction defined by the agreements.

(3) In all these cases, the territorial jurisdiction of these agency rights is restricted to one country or, in some cases, three countries.

(4) No agent is granted rights in India.

(5) In consideration for these sales, commission (usually of 5% or 6%) on the FOB prices of the orders actually booked is paid by the assessee to the agents.

(6) The agreements have been entered into on various dates and are for preliminary terms of three years each but automatically renew from year- to- year.

(7) The sums attracting disallowance represent the commission paid under these agreements.

31. It was submitted that in the light of the above facts, three questions arise for consideration before the Tribunal as follows:-

(1) Is the commission paid to the agents by the assessee chargeable to tax in India either in full or in part at the hands of the agents in the light of the provisions of section 9 and the relevant Double Taxation Avoidance Agreements (DTAAs)?

(2) If the income is so chargeable, is tax deductible at source there from under section 195?

(3) Did the assessee act against the law by not approaching the Income Tax Department in terms of section 195(2)?

32. It was further submitted that as regards chargeability under section 9 of the Act, it is an undisputed fact that all the agents are non-residents. At the hands of non- residents, the charge of income tax under the Act is attracted only in the following cases:-

(i) The income is received in India;
(ii) the income is deemed to be received in India;
(iii) the income accrues in India; or
(iv) the income is deemed to accrue in India in terms of section 9.

33. It is not the contention of the Revenue that the income is received, deemed to be received or even that it accrues in India. The Revenue only contends that the income is deemed to accrue in India in terms of section 9 as the agents have set up a source of income in India by entering into the agency agreements with the assessee.

34. A reading of section 9(1)(i) reveals that it does not cover agency commission of the nature under consideration here and that, only if it arises from any business connection in India or from a source in India, such commission would attract the charge of income tax.

35. In concluding that the source of the commission is in India, the learned CIT (A) has presumed that the source of this commission income is the principal (the assessee). The ratio applied by the learned CIT(A) is that the commission income arises only because of the principal granting the

agency rights to the agent and finally making the sales. The learned CIT(A) has concluded, therefore, that the source is the sale contract arising from the principal and that the source is, therefore, within India. It was submitted that this conclusion is erroneous and deserves to be struck down. The commission is consideration for the services rendered by the agent in identifying customers and obtaining orders for the principal. The source of this commission income, therefore, lies in the markets in which these services are being rendered. Considering that these services are rendered in markets outside India, the source of this commission income is clearly outside India.

36. The ld. Counsel for the assessee also made submissions with regard to the fact that, assuming the income is treated as having accrued to the non-resident in India, in view of DTAA between India and countries of which the non-resident or tax residence, income can be taxed only if there is a permanent establishment in India and since there is no permanent establishment in India, the amount in question cannot be brought to tax in the hands of the non-resident and consequently there would be no liability on the part of assessee to deduct tax at source.

37. The ld. DR relied on the order of the CIT(Appeals).

38. We have considered the rival submissions. The copies of the Agreement between the Assessee and the non-resident (7 out of the 10 non-residents listed in the earlier part of this order) has been filed before us

as Annexure-H in the paper book filed by the Assessee. The main clauses in the agreement needs to be seen to appreciate the contentions of the parties before us.(Agreement between Assessee and M/S.Duo Textiles)

Clause-1, 3 and 4 of the Agreement reads as follows:

> "1. APPOINTMENT:
>
> Principal grants Agent the right to sell the merchandise (stipulated in Article 2) in the territory (stipulated in Article 3) and Agent accepts such appointment.
>
> 3. TERRITORY:
>
> The Territory covered under this agreement is confined to South Africa.
>
> 4. COMMISSION:
>
> Principal shall allow the Agent 5% commission for all Merchandise (based on FOB prices) Commission are not payable later than 2 (two) months after merchandise have been shipped in respect of all orders which have been accepted and executed by Principal. However, that no such commissions shall be payable until Principal receives the full amount of payment due to him."

39. The terms of the Agreement in the case of all the agents are identical. It is clear from the agreements that the non-residents rendered services outside India and the nature of services rendered by them is as agent of and Indian exporter operating in his own country. There is absolutely no territorial nexus with India as far as the non-residents are concerned. The non-resident's source of income outside India and accrues and arises outside India. The Hon'ble Supreme Court in the case of

Carborandum Co. v. CIT (1977) 108 ITR 335, has held that "the carrying on of activities or operations in India is essential to make the non-resident have business connection in India in order that he may be liable to tax in respect of the income attributable to that business connection. The CBDT in Circular No. 17(XXXVII) of 1953 dated 17th July, 1953 has stated as follows:-

> "Foreign agents of Indian exporters – A foreign agent of an Indian exporter operates in his own country and no part of his income arises in India. Usually, his commission is remitted directly to him; and is, therefore, not received by or on his behalf in India. Such an agent is not liable to Indian Income-tax."

The CBDT circular No.786 dated 07/02/2000 regarding taxability of export commission payable to non-resident agents rendering services abroad has stated that "No tax is therefore deductible under section 195 and consequently the expenditure on export commission and other related charges payable to a non-resident for services rendered outside India becomes allowable expenditure." The conclusions of the AO and CIT(A) that the non-resident had a business connection in India in our view is without any basis and cannot be sustained.

40. On applicability of Expln-2 to Sec.195(1) of the Act which was introduced by the finance Act, 2012 w.e.f. 1.4.1962, we are of the view that the said explanation is applicable only when there is accrual of income in India. When the conclusion reached is that there is no accrual of income in India, we fail to see how Expln.2 to Sec.195(1) of the Act are attracted.

41. In view of the above conclusions, we are of the view that there was no obligation on the part of the Assessee to deduct tax at source while making payment to the non-resident. Consequently, no disallowance of commission expenses paid to non-resident could be made invoking the provisions of sec.40(a)(i) of the Act. We hold accordingly and direct the AO to delete the disallowance so made.

42. In the result, the appeal by the Assessee is allowed.

Pronounced in the open court on this 13th day of February, 2015.

Sd/-	Sd/-
(ABRAHAM P. GEORGE) Accountant Member	(N.V. VASUDEVAN) Judicial Member

Bangalore,
Dated, the 13th February, 2015.
/D S/

Copy to:
1. Appellant
2. Respondents
3. CIT
4. CIT(A)
5. DR, ITAT, Bangalore.
6. Guard file

By order

Assistant Registrar /
Senior Private Secretary
ITAT, Bangalore.