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By

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Dear Readers,

Greetings for the season!

In this edition, we bring you an article on the much await judgment by Honourable Supreme Court in the matter of tax withholding obligations for payments for usage of software by residents to non-residents. The decade long litigation, where tax payers argue that the said payments were not in the nature of royalty and where tax authorities claim that payments are in nature of royalty requiring tax payer withholding tax, finally settled in favour of the tax payer. We bring you the article in series of two parts, the first one deals with issues and arguments made by tax payers and tax authorities and in second part, the analysis and conclusions arrived by Honourable Court are discussed.

The next article is on one of the burning issues in GST law, the applicability of tax on guarantees extended by directors to the company. The tax authorities started claiming that said services are taxable under reverse charge mechanism in the hands of company, where tax payers countered stating that the said services form part of shareholder's activity and accordingly not taxable. We have to wait and see how the law unfolds in near future.

I hope that you will have good time reading this edition and please do share your feedback. I will also urge clients to mail us topics or issues on which you want us to deliberate in our future editions, so that we can contribute to the same.

Thanking You,

Suresh Babu S
Founder & Chairman

GST

IMPLICATIONS ON CORPORATE AND DIRECTORS GUARANTEES TO COMPANIES— A FOOD FOR THOUGHT

Contributed by CA Sri Harsha & CA Manindar

Introduction:

It is quite a common phenomenon that banks insist for personal guarantee or surety/security from executive directors of companies in order to extend loans to such companies. These executive directors viz. Managing Director or Whole Time Directors generally owns a controlling interest in such company, and it is in view of this reason, they are generally asked to extend such guarantee. Similarly, in certain cases, such guarantees are extended by group company. Banks insist for guarantee in order to coverup the inadequacies in financial position of the company for which loan is to be approved. In certain instances, such guarantees are sought as part of regulatory requirement as well. Under the GST laws, any activity undertaken between related parties shall be considered as supply even if consideration is not involved.

Considering this legal position, instances are noticed in the recent times where audit officials of Department have taken a view that guarantees extended by executive directors or group companies amounts to supply which attracts GST even in the absence of consideration. Further, Circular No. 34/8/2018-GST dated 01.03.2018 clarified that *the service provided by Central Government/State Government to any business entity including PSUs by way of guaranteeing the loans taken by them from financial institutions against consideration in any form including Guarantee Commission is taxable.*

Instances are noticed where tax officials are proposing to charge GST on guarantees extended by executive directors or group companies by valuing these services in terms of Rule 28 of the CT Rules[1] at 'open market value' by referring to charges usually collected by banks for extending such guarantees. In cases where guarantee is extended by executive directors, tax was demanded from the company under reverse charge by referring to Entry 6 of NN 13/2017-CT(R) dated 28.06.2017. Taking into consideration these developments, an attempt is made in this article to analyze whether such act of executive directors and group companies amounts to 'supply'.

Whether Guarantee extended by Group Companies and Executive Directors amounts to 'Supply'?:

Guarantee or surety or security for the purpose of loan from bank are generally extended by executive directors of company that seek loan from bank. Such executive directors are the spearheads who control the affairs of their company. In terms of explanation to section 15 of the CT Act[2] , persons owning controlling interest in companies are said to be related to such companies. Similarly, group companies viz. holding company having controlling interest in the subsidiary companies shall extend guarantee to such subsidiary for the purpose of bank loans. These are also considered as related in terms of section 15 of the CT Act.

[1]Central Goods and Services Tax Rules, 2017
[2]Central Goods and Services Tax Act, 2017

In terms of section 7 of the CT Act, the term 'supply' is defined in an inclusive manner. It includes all activities undertaken for consideration in the course or furtherance of business. In case of activities specified in schedule I, they will be considered as 'supply' even if they are undertaken for no or inadequate consideration. Clause (2) of schedule I provides that any activity involving exchange of goods or services between related persons shall be considered as supply even if consideration is absent. Schedule III provides for list of activities which shall not be considered as 'supply'. Under this schedule, services provided by an employee to the employer in the course or in relation to his employment is covered. Further, actionable claims are also mentioned in schedule III in order to exclude them from the ambit of 'supply'.

In view of the above, in order to consider guarantee extended by executive directors or group companies as 'supply', the following conditions are required to be satisfied:

- The activity involved should be the one undertaken by one person to another if not for consideration.
- The activity involved should be considered as supply of service.
- The activity involved should be in the course or furtherance of business of supplier.
- The activity involved should not be in the course or furtherance of employment of such executive director.
- The activity involved should not be considered as actionable claim.

Whether Guarantee Extended by Executive Directors and Group Companies are an activity undertaken to Company or One's own self:

Guarantee extended by executive directors or group companies is in order to seek loan from banks to the company in which they have controlling interest. It is an essential activity for undertaking the business of the company. Such executive directors are the spearheads of the business. Apart from managing the operations of their Company, the executive directors also undertake key strategic decisions including the manner in which the funds required for the business are to be arranged. Such activities involved are undertaken for their interest/ownership in the business of the company. Further, the bankers insist them to extend guarantee for the reason that they have controlling interest in the company but not from any other person.

Considering the above, the activity of extending guarantee by executive directors or by group companies is for endeavoring their business objectives i.e., effective conduct of the business of their company to maximize the profits, increase the wealth of the company and thereby increase their own wealth. If they fail to acquire loan for the company, then they are required to arrange the required funds from their own sources. Such being the objective of extending guarantee, a moot question may arise whether such activity is to be considered as an activity undertaken by one person (executive directors/group companies) to another (company) or for one's own self. If it is considered as an activity for one's own self, then such an activity cannot be considered as 'supply' as defined under section 7 of the CT Act for the reason that it must be undertaken by one person to another.

In the context of Income Tax Act, 1961, under the provisions related to transfer pricing arms-length adjustment to be effected for international transactions, the issue whether corporate guarantee extended amounts to service or not is examined by the Ahmedabad ITAT in the case of Micro Ink Limited[3] wherein it was held as under:

*32. As we take note of the above legal position in Canada, it is appropriate to take note of the concept of 'shareholder activities' in the context of corporate guarantees which provides conceptual justification for exclusion of corporate guarantees, under certain conditions, from the scope of transfer pricing adjustments. Taking note of these proposed amendments, 'Transfer Pricing and Intra Group Financing – by Bakker & Levy, IBFD publication (ISBN- 978-90-8722-153-9)' observes that "Proposed subsection 247(7.1) of the ITA provides that the transfer pricing rules will not apply to guarantees provided by Canadian parent corporations in respect of certain financial commitments of their Canadian controlled foreign affiliates to support the active business operations of those affiliates". **As to what could be conceptual support for such an exclusion, we find interesting references in a discussion paper issued by the Australian Tax Officer in June 2008 and titled as "Intra-group finance guarantees and loans"(http://www.transferpricing.com/pdf/Australia_Thin%20Capitalisation.pdf).** The fact that this discussion paper did not travel beyond the stage of the discussion paper is not really relevant for the present purposes because all that we are concerned with right now is understanding the conceptual basis on which, contrary to popular but apparently erroneous belief, the issuance of corporate guarantees can indeed be kept outside the ambit of services. The relevant extracts from this document are as follows:*

> *102. An independent company that is unable to borrow the funds it needs on a stand-alone basis is unlikely to be in a position to obtain a guarantee from an independent party to support the borrowings it needs. Where such a guarantee is given, it compensates for the inadequacies in the financial position of the borrower; specifically, the fact that the subsidiary does not have enough shareholders' funds. .....*
>
> *103. **It would not be expected that a company pay for the acquisition of the equity it needs for its formation and continued viability. Equity is generally supplied by the shareholders at their own cost and risk**.*
>
> *104. Accordingly to the extent that **a guarantee substitutes for the investment of the equity needed to allow a subsidiary to be self-sufficient and raise the debt funding it needs, the costs of the guarantee (and the associated risk) should remain with the parent company providing the guarantee.***

*33. On a conceptual note, thus, there is a valid school of thought that the corporate guarantees can indeed be a mode of ownership contribution, particularly when, as is often the case, "where such a guarantee is given it compensates for the inadequacies in the financial position of the borrower; specifically, the fact that the subsidiary does not have enough shareholders' funds". There can be number of reasons, including regulatory issues and market conditions in the related jurisdictions, in which such a contribution, by way of a guarantee, would justify to be a more appropriate and preferred mode of contribution vis-a-vis equity contribution. It is significant, in this context, that the case of the assessee has all along been, as noted in the assessment order itself, that"**said guarantees were in the form of corporate guarantees/ quasi***

[3] 2015 (12) TMI 143 - ITAT AHMEDABAD

capital and not in the nature of any services". *In other words, these guarantees were specifically stated to be in the nature of shareholder activities. The assessee's claim of the guarantees being in the nature of quasi capital, and thus being in the nature of a shareholder's activity, is not rejected either. The concept of issuance of corporate guarantees as a shareholder activity is not alien to the transfer pricing literature in general. On the contrary, it is recognized in international transfer pricing literature as also in the official documentation and legislation of several transfer pricing jurisdictions.* ***The 'OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations' itself recognizes the distinction between a shareholder activity and a provision for services, when, contrasting the shareholder activity with broader term "stewardship activity" and thus highlighting narrow scope of shareholder activity, it states that"Stewardship activities covered a range of activities by a shareholder that may include provision for services to other group members, for example services that would be provided by a coordinating centre".*** *It proceeded to add, in the immediately following sentence at page 207 of 2010 Guidelines, that "These latter type of non-shareholder activities could include detailed planning services for particular operations, management or technical advice (trouble shooting) or in some cases assistance in day-to-day management".The shareholder activities are thus seen as conceptually distinct from the provision of services. The issuance of corporate guarantee, as long as it is in the nature of shareholder activity, cannot, therefore, amount to a "provision for services".*

In view of the above excerpts of the ITAT judgment, it was held that extending guarantee is a shareholder activity and is in the form of quasi capital. Having said this, the issue was also examined by Delhi High Court in the case of Controls & Switchgear Contractors Limited[4] wherein whether commission paid to directors of a company for extending guarantee was allowable as business expenditure or not was examined. The High Court has held that services provided by directors by extending the personal guarantees would be beyond the scope of the employment.

In view of the above discussion, it is clear that different views are coming out from judgments under Income Tax depending upon the context. Whether the activity involved can be considered as shareholders activity/ activity for one's own self involving capital contribution to pursue their entrepreneurial objectives is required to be examined by courts in the context of GST law as well. Let see how the courts consider this argument.

Whether guarantee extended should be considered as supply of service:

If we proceed on the premise that extending guarantee by executive directors or group companies is an activity undertaken by one person to another, then it is required to examine whether such activity amount to supply of service. As discussed above, in case of related parties, consideration is not a pre-requisite. The term 'services' is defined under section 2(102) to mean anything other than goods, money and securities but includes activities relating to the use of money or its conversion by cash or by any other mode, from one form, currency or denomination, to another form, currency or denomination for which a separate consideration is charged. Given the wide ambit of definition of 'services', the activity done by directors by providing guarantee would fall under the ambit of 'services'.

[4]2014 (6) TMI 46 –Delhi High Court

Whether guarantee extended is in the course or furtherance of business:

Even if we proceed on the premise that guarantee extended by a group company or executive directors to a company for the purpose of loan is said to be undertaken in the course or furtherance of business. The term 'business' is defined under the provisions of section 2(17) of the CT Act in an inclusive manner. It is said to include the following [5]:

- any trade, commerce, manufacture, profession, vocation, adventure, wager or any other similar activity, whether or not it is for a pecuniary benefit.
- any activity or transaction in connection with or incidental or ancillary to sub-clause (a).
- any activity or transaction in the nature of sub-clause (a), whether or not there is volume, frequency, continuity or regularity of such transaction.

In view of the above understanding of the definition given for 'business', it includes any adventure, trade or commerce. As discussed above, the group company or executive directors extend corporate guarantee for the reason to drive their entrepreneurial objectives associated with the company for which they are extending such guarantee. Such activity have attributes to fall under the scope of adventure, trade or commerce.

Whether guarantee extended should be considered as actionable claim

Another important aspect to be examined is whether guarantee extended should be considered as actionable claims as they are covered under schedule III of the CT Act and thereby excluded from the ambit of 'supply' as defined under section 7 of the CT Act.

Section 3 of the Transfer of Property Act, 1882 defines actionable claim to mean *claim to any debt, other than a debt secured by mortgage of immovable property or by hypothecation or pledge of movable property, or to any beneficial interest in movable property not in the possession, either actual or constructive, of the claimant, which the civil courts recognize as affording grounds for relief, whether such debt or beneficial interest be existent, accruing, conditional or contingent.*

From the above, it can be seen that actionable claims are primarily claims that arise with respect to unsecured debts or a beneficial interest in movable property, regardless of whether such debt or beneficial interest be existent, accruing, conditional or contingent. In the present context, guarantee extended gives raise to unsecured contingent debt and this debt can be claimed by banks if the company seeking loan fails to repay. In view of this reason, it can be said that guarantee qualify as actionable claim.

However, in the present context, it is no doubt that guarantee extended by group companies or executive directors create an actionable claim in the hands of bank. Such bank can transfer this right to receive money from the borrowing company including right to enforce guarantee in the event of default by such company to any other bank. Such transfer of right to enforce a recovery of a contingent debt can be considered as transfer of actionable claim.

[5] Definition of 'Business' includes many activities. Only those which are relevant in the present context are considered here.

However, one need to observe is that guarantee extended by group companies or executive directors does not involve any creation and transfer of actionable claim from them to the borrowing company. It creates actionable claim in the hands of bank which is extending loan to the borrowing company. Such guarantee extended by group company or executive directors to the borrowing company cannot as such involve any transfer of actionable claim.

In view of the above discussion, though guarantees extended by group companies and executive directors create actionable claims in the hands of bank, it may not be possible to say that such guarantee extended by group companies or executive directors perse lead to any transfer of actionable claims to borrowing company. Such being the case, the plea that these guarantees are actionable claims and outside the ambit of 'supply' is doubtful.

Whether guarantee extended by executive directors be considered as in the course of employment:

Services in the course of employment are covered under schedule III. As executive directors work as employees of the company by taking remuneration, it is also required to consider whether guarantee extended by such directors are part of their employment and thereby excluded from the ambit of 'Supply'.

As discussed supra, it is observed by Delhi High Court in the case of Controls & Switchgear Contractors Limited that guarantee extended cannot be considered as part of employment services of executive directors. These are generally perceived as shareholders activity and beyond the scope of employment.

However, one can still argue that these are also part of employment undertaken by such executive directors and is factored in the remuneration paid to these directors. In the humble opinion of paper writers, such argument will find force only when the arrangement is in writing and is expressly provided in terms of employment agreed with such directors. In the absence of such express understanding, it would be difficult to successfully plea that the service if any involved in guarantees extended by executive directors is part of their employment with the company.

In view of the above discussion, the issue whether guarantees extended by group companies and executive directors amounts to 'supply' or not require examination of the above discussed facets of the definition of 'supply' as defined under section 7.Thus, it would be interesting to see how this issue would eventually shape up in the times to come.

Whether Valuation in Comparison which Commission Charged by Banks is legally Justifiable:

If we proceed for a moment that these guarantees amounts to supply, then we need to take a look at the manner in which these services are to be valued for charging GST. As no consideration is involved and the transaction is between related parties, the value shall be required to be determined in terms of Rule 28 of the CT Rules read with section 15(1) of the CT Act. Under this rule, in case of supplies between related parties, the value shall be determined as under:

- based on the open market value of the goods
- if the open market value is not available, be the value of supply of goods or services of like kind and quality
- If the value cannot be determined with reference to open market value and value of goods or services of like kind and quality, then the value shall be determined by application Rule 30 or Rule 31.

Rule 30 provides for determination of value based on 110% of cost of goods or services involved. While Rule 31 provides for determination of value using reasonable means consistent with the principles and the general provisions of section 15 and the valuation Rules i.e. Rule 27 to 35 (chapter IV) of CT Rules.

Second proviso to Rule 28 provides that in case where the recipient is eligible to avail full input tax credit, then the value declared in the invoice shall be deemed to be the open market value of the goods or services.

For this purpose, 'Open Market Value' is defined to mean the full value in money, excluding the integrated tax, central tax, State tax, Union territory tax and the cess payable by a person in a transaction, ***where the supplier and the recipient of the supply are not related and the price is the sole consideration, to obtain such supply at the same time when the supply being valued is made;***

In cases where open market value is not available, then the value shall be determined with reference to value of supply of goods or services of like kind and quality which means ***any other supply of goods or services or both made under similar circumstances that, in respect of the characteristics, quality, quantity, functional components, materials, and the reputation of the goods or services or both first mentioned, is the same as, or closely or substantially resembles, that supply of goods or services or both.***

Consider the above definitions, value of supply between related parties can be determined with reference to 'Open Market Value' provided that the supplier involved is engaged in providing similar supply to unrelated parties for consideration solely in monetary terms. In the case of guarantees by group companies and executive directors, they undertake these activities only to their associated companies and not any unrelated party. Thereby, it is not possible to determine the value with reference to 'Open Market Value' in case of guarantees.

Similarly, in order to determine value with reference to 'goods or services of like kind and quality', it is required to compare the supply involved with supply having similar characteristics, quality, quantity, functional components, materials and reputation. Considering this, department is proceeding to determine the value of guarantees extended by group companies and executive directors with reference to usual percentage of commission charged by banks.

In the humble opinion of the paper writers, guarantees extended by group companies and executive directors are for the purpose of overcoming inadequacies in financial position of company which is seeking loan from banks. In these cases, the group company or executive directors extending guarantee are completely taking risk and are liable to repay the loan in the event of default by the company seeking loan. The guarantee extended in these cases is based on relation/financial association with the company seeking loan and is not backed by any security or charge on assets of such company.

Further, as discussed above, the reason for extension of such guarantee is nothing but shareholders activity. If the company involved is unable to obtain loan, then it will obligate these shareholders to fund the required capital through equity or otherwise in order to carry out their business. Thus, a self-interest of group companies, executive directors is also involved in these cases.

Unlike these guarantees, banks extend guarantees on behalf of their customers by charging commission. The guarantees extended are backed by security or charge on any assets of customer. It is for this reason, both the transactions commercially stand on a different footing and thereby value of guarantees extended by group companies and executive directors cannot be compared with guarantees extended by bank. Therefore, determination of value with reference to percentage of commission charged by banks may not be justifiable.

Further, in terms of second proviso, where the recipient company is entitled to full input tax credit, then the value cannot be disputed. In such situations, taxpayers can use this proviso and plead for adoption of nominal value for rate purpose. Further, in cases where this proviso is applicable, it leads to a situation revenue neutrality. In such cases, pleading can be made that there is no intention to evade any tax and thereby no penalty can be demanded for non-payment of tax on guarantees.

Conclusion:

Considering the above discussion, guarantees extended by group companies and executive directors' amount to supply or not require consideration from various facets of 'Supply' definition. For reasons stated above, there is a possibility that the activity involved can be considered as activity for ones' own self, shareholders activity, quasi capital nature etc. Further, considering the peculiarity and commercial objectives involved, it is challenging to determine the value of these guarantees even if they are considered to be of the nature of supplies under GST law to attract tax.

The objective of schedule I is to deem any exchange of goods or services between related parties as supplies even in the absence of consideration with an objective to uphold destination-based consumption tax principle. In other words, this deeming fiction is created with objective to ensure that the State in which recipient is located to receive revenue as goods/services involved are getting consumed even if supplies does not charge any consideration because of their relationship. If this objective is taken into consideration, it would be interesting to see whether this deeming fiction be extended to activities like guarantees which are innately connected to the sourcing of funds/capital for business needs of the company.

Considering all the above discussed factors, it would be interesting to see how the courts are going to consider these guarantees extended by group companies and executive directors. So Let's wait and watch!

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DIRECT TAX

COPYRIGHT – REPRODUCTION V-USAGE – MUCH AWAITED JUDGMENT OF DECADE - PART I

Contributed by CA Sri Harsha

This article is on one of the vexatious issues of taxation on the software payments made by residents to non-residents. The said issue was put to an end by the Honourable Supreme Court in the matter of Engineering Analysis Centre of Excellence Private Limited [1] (for brevity 'EAC') in favour of the tax payer. Let us proceed to understand the core issues, the history involved surrounding the issue, the arguments by and against tax payer, the analysis by Supreme Court and conclusions therein.

Modus Operandi:

Before we proceed to discussion on the subject issue, we wish to bring to attention of the reader, that this article shall be dealt in two parts. Part I deals with framing of issue, history and the arguments put forward by tax payer and tax authorities. In Part II, we shall deal with the analysis of Honourable Supreme Court along with the conclusion. We request the reader to read both the parts to drive home the point. Now, let us proceed with Part I.

Issue:

The issue predominantly revolves around whether the payments made by resident towards various usages of software to non-residents requires withholding obligations under Section 195 of Income Tax Act, 1961 (for brevity 'ITA').

The tax payer's principle assertion (through the payer) is that since the payments were made for usage of software, the same would not fall under the definition of 'royalty' as provided in Explanation 2 to Section 9(1)(vi) of ITA. Further, assuming that the amendment made to Section 9(1)(vi) by inserting Explanation 4 in 2012 with retrospective effect from 1976, to make it clear that granting of license is also included in all or any of the rights involved in a copyright, the tax payer argument was that since the said amendment was not on statute book as on the date of payments to non-resident vendors, the provision cannot be applied to the matters in hand. Apart from the above, the tax payer also argued that he would be covered under the protection of Double Taxation Avoidance Arrangement (for brevity 'DTAA') and thereby there is no income which accrues or arise or deemed to accrue or deemed to arise in India and accordingly the payer is not required to deduct any tax under Section 195 on the payments made. The tax payer argued that what was transferred to end-user was a non-exclusive restricted license to use the software. In other words, a copyrighted article is being sold and not the copyright. The payments which are mentioned either under Section 9(1)(vi) or Article 12 of DTAA are those which cover the payments for transfer of copyrights and not deal with copyrighted article.

[1] [2021] 432 ITR 471 (SC)

The Revenue's principle assertion is that the grant of license of a computer programme, being specifically included in Explanation 4 to Section 9(1)(vi) makes the legislative intent clear to treat such payments to fall under the ambit of 'royalty'. Since the ITA deals with the definition of 'royalty', there is no requirement to look for the meaning under Copyright Act, 1957 (for brevity 'Copyright Act'). Further, all the DTAAs define the 'royalty' to mean payment of consideration for use or right to use the copyright. Since the subject payments are for use or right to use the computer software, the said payments are obviously covered under the DTAA and accordingly the payer is required to withhold tax on the same. Further, the Revenue also stated that the retrospective amendment made qua Explanation 4 is only for removal of the doubts and has to be interpreted not as a new thing. The Revenue argued that derivative product of copyright is also covered under the ambit of Section 9(1)(vi) and thereby payment made for usage of software would mean to accrue or arise or deemed to accrue or deemed to arise in India for the non-resident vendors. The revenue also stated that in certain facts of the appeals, the agreement involved is the distribution agreement with the non-resident, by virtue of entering the distribution agreement the non-resident parted with the rights mentioned in Section 14(b)(ii) of Copyright Act and accordingly the payment would fall under the ambit of 'royalty', since the said payment was a consideration for transfer of all or any of the rights mentioned in Section 14.

With the above in place, let us proceed to examine, the history of the issue and the other aspects connected.

History:

The facts in the matter of EAC, a resident Indian company has purchased an end-user shrink wrapped computer software, directly imported from United States of America (for brevity 'USA'). The payment was made for the shrink wrapped computer software without any deduction of tax at source. The tax authorities opined that the said payment for shrink wrapped computer software involves payment for copyright which attracted the payment of royalty under both Article 12(3) of Indo-USADTAA and Section 9(1)(vi) of ITA. The EAC pleaded that the subject payment is only for usage of the software but does not involve any payment for the copyright and cannot be categorised as royalty, which would required withholding of tax. The Assessing Officer was not convinced with the submissions has upheld the order confirming the withholding of tax. The matter when taken to Commissioner (Appeals) was held against EAC. However, EAC succeeded before the Tribunal. The Tribunal following its earlier judgment in Samsung Electronics Co. Limited has dismissed the order of Commissioner (Appeals) and held that there was no obligation on the EAC to withhold any tax. Aggrieved by this, the Revenue has preferred an appeal to High Court of Karnataka. The High Court of Karnataka hearing the matter of EAC along with other clubbed appeals, framed nine questions of which, two of them deal with issue of copyright.

The High Court after framing of the questions, without venturing into the merits, has concluded that the payments made by end-users for purchase of software requires deduction of tax at source. The High Court has passed the above judgment vide its order dated 24.09.2009. The High Court has majorly placed reliance on the decision of Supreme Court in the matter of Transmission Corporation of AP Limited[2] for arriving the said conclusion. The High Court accepted the submissions by revenue that unless the payer makes an application under Section 195(2) and has obtained a permission for non-deduction of tax, it was not permissible for the payer to contend that the payment made to non-resident did not give rise to income taxable in India.

[2][1999] 007 SCC 266

The above judgment of High Court of Karnataka was appealed before the Honourable Supreme Court in a batch of appeals. The Supreme Court after detailing the facts and analysing the judgment of Transmission Corporation of AP Limited (supra) stated that the High Court of Karnataka has misunderstood the ratio in the matter of Transmission Corporation of AP Limited (supra) and thereby misapplied the same in the matter of Samsung Electrical Co. Limited (supra) and reiterated that every payment made to non-resident would not require deduction of tax at source and only such payments which are chargeable to tax in India would only fall under the ambit of the withholding obligation. This became a landmark judgment by Supreme Court in the matter of GE Technology Centre Private Limited[45] . The said judgment reversed the decision of High Court of Karnataka in the matter of Samsung Electrical Co. Limited[3] and asked the High Court to consider the matter at fresh.

When the matter came for the second time before the High Court of Karnataka, vide its judgment dated 15.10.11 in the matter of Samsung Electrical Co. Limited[6] held that, what was sold by way of a computer software included a right or interest in copyright, which thus gave rise to payment of royalty and would be an income deemed to accrue in India in terms of Section 9(1)(vi) and accordingly obligating the payer to deduct tax. This was challenged before Supreme Court, where the Court has taken EAC as the lead matter for analysing the facts involved and to arrive at a conclusion.

Arguments:

As discussed earlier, the current matter involves a large number of petitions which involve determination of taxation on various usages of software. Based on the facts involved, the apex court has basketed them into four broad categories, which are as under:

Category	Description
I	Computer Software purchased directly by a resident end-user
II	Computer Software purchased by resident Indian distributors/resellers
III	NR[7] Distributors reselling Computer Software to Indian Distributors or end-users
IV	Computer Software is affixed onto Hardware and sold as a unit to resident end-user

Arguments by Tax Payers:

The facts are that the resident Indian Companies are non-exclusive distributors of computer software. They purchase off-the shelf copies of shrink wrapped software from foreign companies for onward sale to Indian end-users under a remarketer agreement.

[3]This was a batch of appeals involving EAC matter also. The judgment was delivered in the name of lead party, which is Samsung Electrical Co. Limited.
[4][2010] 327 ITR 456 (SC)
[5]This was a batch of appeals involving Samsung Electrical Co. Limited matter also. The judgment was delivered in the name of lead party, which is GE Technology Centre Private Limited.
[6][2012] 345 ITR 494
[7]Non-Resident

On Taxation:

The tax payer has asserted that the Indian distributor is not a party to the End User License Agreement (for brevity 'EULA') between the end-user and the foreign supplier. The tax payer's argument was that they simply do not own any right, title or interest in copyright or other intellectual property owned by the foreign supplier and they just market the foreign supplier's software. The end-user pays to the Indian distributors and after retaining certain part as profit, the Indian distributors pays to the foreign supplier. Hence, the amounts paid by the Indian distributor does not partake the character of royalty since the payment is not made for any rights involved. The tax payer also stated that the computer software imported for onward sale constitutes as 'goods' in light of the Supreme Court judgment in Tata Consultancy Services[8] . The tax payer also making reference to DTAAs in place, stated that the DTAAs do not cover the derivatives products of royalties and cover only the core right and assuming that Section 9(1)(vi) covers the current payment as royalty, in terms of Section 90(2), the beneficial provisions of DTAA has to be invoked and accordingly there is no income which would accrue to the foreign supplier in India and accordingly the Indian distributor is not obligated to withhold the tax.

The tax payer has also submitted that the Explanation 4 inserted to Section 9(1)(vi) vide Finance Act, 2012 giving retrospective effect from 1976 also can cover only 'any right, property or information used or services utilised' but cannot be read to expand the definition of 'royalty' as contained in Explanation 2 to Section 9(1)(vi). The tax payer has also challenged that the Explanation 4 cannot be pressed into service since it would compel them to do an impossible task, since at the time of making the payment, the said explanation was not in vogue. Hence, on a retrospect, the revenue cannot ask the payer to withhold taxes.

On Copyright Act:

The tax payer further making reference to the Copyright Act, 1957 (for brevity 'Copyright Act') asserted that there is a difference between copyright in an original work and copyrighted article. Under the remarketer agreement, no copyright would be given by the foreign supplier to the Indian distributor or the end-user. The end-user is only entitled only a limited license to use the product by itself, with no right to sub-license, lease, make copies. Hence, the said limited right parted by foreign supplier would not fall under the ambit of 'royalty'as envisaged in DTAAs.

The tax payer has stated that the amendment to Section 14(b)(ii) of Copyright Act with effect from 2000 by removing the words 'regardless of whether such copy has been sold or given on hire on earlier occasions' is a statutory application of the doctrine of first sale/principle of exhaustion. The amendment made it clear that since no distribution right by the original owner extended beyond the first sale of the copyrighted goods, it can be said that only the goods has been passed to the imported and not the copyrights in the goods.

[8][2005] 1 SCC 308

Arguments by Revenue:

On Taxation:

The Revenue's principal argument was that the introduction of Explanation 4 to Section 9(1)(vi) is only a clarificatory in nature and accordingly the payer was obliged to deduct taxes even such explanation was not on statue book as on the date of payment. The Revenue stressed that importance has to be given to phrase 'in respect of' appearing in Explanation 2(v) of Section 9(1)(vi) to bring home the point that derivate products of copyright are also covered under the ambit of 'royalty'. The Revenue placed reliance on decision on PILCOM[9] , wherein it was held that irrespective of the fact that the payment was chargeable to tax in India, the payer has to withhold tax. The PILCOM judgment was in the context of Section 194E.

On Copyright Act:

The Revenue stated that since in some of the cases, adaptation of software could be made, albeit for installation and use on a particular computer, the same would be possible only if the original owner has parted with his copyrights and asked to consider that such payments would be falling under the ambit of 'royalty'. The Revenue also stated that in terms of Section 52(1)(ad) of Copyright Act, that only making copies or adaptation of a computer programme from a legally obtained copy for non-commercial, personal use would not amount to infringement, and in cases where the same are copied for commercial purpose would constitute infringement and in certain cases, the same were being copied for commercial purposes would result in infringement, thereby meaning that the original owner has parted the rights therein. In light of the above, the Revenue stated that the payments were for royalties and accordingly the payer would have to withheld taxes at source and failing to do so, the tax payers has not met the obligations.

In the next part, we shall deal with analysis by the Honourable Supreme Court and the conclusions.

[9] 2020 SCC Online SC 426

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