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Contents

Ruling of Karanataka High Court

This article summarizes the recent decision of Karnatka High Court in the following cases especially narrating and discussing the case of Samsung Electronics Co Ltd.

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Karnataka High Court in the case of CIT v/s. Samsung Electronics Co. Ltd issued a shocking decision where in it has been held that every person making a payment for import of shrink wrap software is under an obligation to withhold tax at source at the time of payment to the non-resident overseas vendors / suppliers.

Facts of the case - Samsung Electronics Co., Ltd.

Samsung Electronics Co., Ltd. ("the assessee"), is a branch of Samsung Electronics Co Limited, Korea, engaged in the development, manufacture and export of software for use by its parent company, i.e., Samsung Electronics Co., Ltd., Korea. The assessee develops various kinds of software for telecommunication system, for office appliances, for computer systems and for mobile devices, etc. The software developed by the assessee is for in-house use by the parent company.

The assessee imported software products from Tektronix Inc., USA. Similarly, it imported software product, namely, Telelogic Tau TTCN Suite, are readily available software in the market. Hence, it was contended by the assessee that the payment made to the foreign companies cannot be treated as Royalty, as per the provision of Section 9(1)(iv) read with Double Taxation Avoidance Agreements (DTAA) between India and USA.

Status of the assessment at the first stage of assessment (before Assessing Officer)

ITO (TDS) did not agree with the contention of the assessee and held that the assessee was a defaulter by not deducting tax from the remittance made by the assessee for purchase of these software. The assessee's reply was not accepted by the Assessing Officer and it was held by the Assessing Officer that in view of the provision of Section 9(1)(vi) of the Act, the payment made by the assessee is in the nature of Royalty. Hence, the assessee was bound to deduct appropriate amount of tax. Accordingly, it was held by the Assessing Officer that the assessee was a defaulter within the meaning of Section 201(1) of the Act, for non-deduction of tax. Further, the interest under section 201(1A) was also levied by the ITO (TDS).

Status of the appellate proceedings before first appellate authority (before CIT(A))

Against the orders of the Assessing officer, the assessee preferred appeal before the Commissioner of Income (A). CIT (A) had dismissed all the appeals.

Status of the appellate proceedings before second appellate authority (before ITAT)

The Tribunal allowed the appeals of the assessee though the ITAT has concluded in all the cases that it was not incumbent on the assessee to deduct any amount under section 195 of the Act and if so the consequence under section 201 of the Act also does not follow, the tribunal has examined the character of payment in the hands of the non-resident recipient and has held that it is not payment in the nature of royalty for the reason that the payment does not partake the character of royalty in terms of the relevant articles of the DTAA entered into with several countries and relevant for the purpose of each payment.

The ITAT held that the payment for the software purchased cannot be regarded as "royalty" either under the Act or under the concerned DTAA. The ITAT further held that software is "goods" by relying on the decision of the Supreme Court in the case of Tata Consultancy Services (a sales tax case) and therefore, the income earned by the overseas vendors is "business income". Since the overseas suppliers Tektronix Inc., USA did not have a Permanent Establishment ("PE") in India, the business income was not chargeable to tax in India. Accordingly, the ITAT held that the assessee was not under obligation to withhold tax at source under section 195 of the Act from the payments made to the overseas suppliers.

Appeal of Revenue Authority before the High Court

Questions raised by the Revenue Authority

Against these ITAT's orders, the Revenue Authority had preferred appeals before the Karnataka High Court inter alia raising various issues. Theses issues were concerning legal interpretation of the scheme of the provisions of the Act. The High Court has summarized the said issues under 9 different questions of law. For the sake of brevity those questions have not been reproduced here. It would suffice to note here that the questions raised before the High Court in substance challenged the conclusions and the order of ITAT. The Revenue challenged the decision of ITAT and it was contended by the Revenue that the assessee was indeed required to withhold tax at source & the assessee could extinguish its obligation of such withholding only after securing prior order from the tax authorities that would entitle it to make payment to the non-resident without deduction of tax at source.

Contentions of the Revenue Authority

- The Revenue argued that the buyer of shrink wrapped software (i.e. assessee) were obliged to withhold tax under section 195 of the Act at the time of payment to the overseas suppliers. It could not be contended that since the payment was not chargeable to tax in the hands of the overseas suppliers in India, no withholding is required under section 195. The Revenue relied upon the ratio laid down by the Supreme Court in the case of Transmission Corporation Ltd (1999 – 239 ITR 587) & held that the payers will be required to withhold taxes under section 195 unless the Income Tax Authority have specifically reduced such a withholding tax liability under section 195(2) or 195(3) of the Act.

- The payment made by the assessee is in the nature of "software license fees". There is no transfer of the software as the same remains with the software suppliers. The payment for the right to use such software in the form of license fees falls under the definition of "royalty" in the Act and the DTAA. The Revenue further contended that the ITAT was not right in concluding that the payment was towards the purchase of goods by relying on the case of Tata Consultancy Services as that case was in the context of sales tax and not in the context of income-tax.

Contentions of the Assessee

- An obligation of withholding tax under section 195 of the Act arises only when the payments to the overseas suppliers are "chargeable to tax" in India. Therefore, for the purposes of withholding tax under section 195, the payments have to be "chargeable to tax" in accordance with the Act. In determining the chargeability to tax, as per the provisions of section 90 of the Act, if the provisions of the DTAA are more beneficial than the provisions of the Act, then the provisions of the DTAA would prevail since it is more beneficial.
- In the case of Transmission Corporation Ltd., the Supreme Court's decision does not state that even when there is no income chargeable to tax, there is an obligation to withhold tax under section 195(1) of the Act. The assessee contended that the ratio laid down in the judgment of Transmission Corporation Ltd. could not be applied to the facts of this case as the payments in that case were prima facie chargeable to tax. Thus the assessee further contended that the ratio laid down therein must be considered only in light of the factual background and it could not be relied on to say that even when there is no chargeability to tax there was an impending obligation to withhold tax. In fact, this judgment supports the proposition that withholding is required only when the test of chargeability to tax is passed.

Decision of the High Court

Issue	Analysis by / findings of the High Court	Decision of the High Court
Whether the payments towards purchase of software were not liable to tax in India and therefore, there was no withholding of tax required under section 195 (1) ?	• In the case of Transmission Corporation Ltd., the Supreme Court had held that the expression "any sum chargeable under the provisions of this Act" to mean any "sum" on which income-tax is leviable. Thus, the determination of final tax liability of the recipient is not called for the purposes of withholding of tax under section 195 of the Act. • The withholding of tax under section 195 is only a tentative deduction and the rights of the recipient are not adversely affected by the section 195 of the Act. The recipient has to produce proper evidences and submission to demonstrate that no tax is payable in India on the sums receivable by it from India. Such an exercise can be done by way of filing a return of income in India and such a return of income is subject to the process of assessment by the Income Tax Officer.	• If the payment by the resident assessee prima facie bears the character of income in the hands of overseas suppliers, the obligation of withholding tax under section 195(1) of the Act arises. • It was indeed an obligation on the part of the resident payer making a payment, being in the nature of income in the hands of a non-resident, to withhold tax under section 195(1) of the Act. • The ITAT's decision was erroneous in examining the nature of the payments and the availability of the beneficial provisions under a tax treaty. • It is always open for a non-resident to contend its tax liability in India by subsequently filing a tax return.
Whether the Tribunal should have recorded a finding that it is only under section 195(2) and 195(3) of the Act that the chargeability	• Under section 195(2) and 195(3) of the Act, when an application is made by the resident payer to the Income Tax Officer seeking concessions from the liability of withholding tax. The High	• The Tax Authority is not required to determine the income of a non-resident for the purpose of determining the taxes to be withheld. The only method by which a taxpayer can reduce the withholding tax

Issue	Analysis by / findings of the High Court	Decision of the High Court
to tax of the vendor can be decided and having failed to obtain such a decision, the software buyers were bound to withhold tax at source as per the decision of Supreme Court?	court observed that an application under section 195(2) and 195 (3) is not an exercise for assessment of income of the non-resident nor the actual tax liability thereof and the scope of the income tax officer's powers is restricted only to determine the percentage of the payment which bears the character of income. • There will be two versions of the actual tax liability of the non-resident recipient, once in advance on an application under section 195(2) and again at the time of assessment of the return of income filed by the non-resident.	liability imposed under the Act is by making a specific application to the Tax Authority for determination of tax to be deducted at source. • The Taxpayers, in the present case, had not made any specific application to the Tax Authority for determination of tax to be deducted at source. Therefore, the Taxpayers cannot contend that no portion of the payments made to non-residents was chargeable to tax and that there was no liability to deduct tax at source.
Whether the assessee can question order passed under section 201(1) and 201(1A) for the taxability of the recipient? Whether the order orders passed under section 201 are bad in law?	• The Appellate Authorities can examine whether the order under section 201 is erroneous such as - an incorrect description of the resident payer or - incorrect computation of the amount to be deducted from out of the payment made or - an incorrect application of the rates for tax withholding or - other arithmetical errors committed by the Income tax officer in passing the order under section 201.	• The scope of the decision of the appellate authorities, including the ITAT, cannot exceed the items listed. • Hence the assessee can not question the validity of the order passed under section 201(1) of the Act. • The argument that orders passed under section 201 are bad in law cannot be accepted, therefore, the orders passed under section 201 are valid in law.
Whether the Tribunal was correct in holding that the	• The Income Tax Officer erred in examining the nature of the payment as it would be	• The High Court refrained from answering the questions raised in these appeals relating to the

Issue	Analysis by / findings of the High Court	Decision of the High Court
payment partakes the character of purchase and sale of goods and therefore cannot be treated as royalty payment, liable to Income Tax?	assessed in the hands of the non-resident. The Income Tax Officer should therefore, not have embarked on an exercise of determination of the tax liability on the premise that the payment by the resident payers partakes the character of royalty.	actual determination of tax liability of the non-residents since the question does not even arise in the light of the elucidation of the law and therefore answered against the revenue authority. • The High Court has not addressed this specific issue in its ruling.

Conclusions of the Decision of the High Court

- Assessee is liable for withholding tax qua payment made for purchase of software from non-residents.
- The Tribunal was incorrect in holding that since the assessee had purchased only a right to use the copyright i.e., the software, and not the entire copyright itself, the payment cannot be treated as Royalty as per the Double Taxation Avoidance Agreement which is beneficial to the assessee and consequently section 9 of the Act should not be taken into consideration.
- The High Court has not answered the much debated issue of characterization of payment for the import of software.

Comments

This decision of the High Court will have far reaching impact not only on the question of determining the tax incidence of a non-resident supplier in India but also on the way in which the trade & commerce activities are executed between Indian importer & overseas supplier. The combined effect of the recent withdrawal of earlier Circular 23 of 1969 and this decision of the High Court will expose the tax payers to tremendous hardship and avoidable procedural delays, not to mention the additional administrative burden on the tax department. It is respectfully submitted that the Hon'ble High Court has perhaps overlooked the fine distinction between the case where there is surely an element of income embedded in the *sum payable* to the non-resident vis-à-vis the case where there is no iota of doubt that the sum payable to the non-resident is free of any tax liability in India. In the former case surely one will be required to test the ratio of the decision of Supreme Court in the case of Transmission Corporation Ltd. However, in the later case, the payment would not fall within the purview of section 5 / 9 of the Act and consequently the question of determining the quantum of income / taxable profits in the method prescribed under section 195(2)/195(3) would not arise at all.

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