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Taxing the non-taxable: Software imports subject to WHT in India

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In 2006[1], the European Court of Justice was confronted with an interesting question on whether the "freedom to provide services" envisaged in Article 49 of the EC treaty was infringed by certain withholding tax provisions found in the German fiscal law.

Under the impugned law, an exemption from withholding tax granted by a tax treaty could not be taken into account in the withholding procedure by a German resident service recipient when making a payment to a non-resident service provider unless a certificate of exemption issued by the competent tax authority had been presented to him by the latter.

The European Court of Justice ("ECJ") observed that such a restriction was justified by "the need to ensure effectiveness of fiscal supervision, specifically the need to ensure the proper functioning of the withholding procedure". The Court opined that "if the payer were allowed to refrain unilaterally from the withholding of taxes without such certainty, the proper functioning of source taxation would be impaired in cases of error."

In India, the Karnataka High Court recently made similar observations while interpreting the withholding tax provisions found in the Indian income tax law which relates to payments made to non-residents. In a judgment that left the software industry unnerved, the Indian Court held that every person making a payment to a non-resident for import of "shrink-wrapped software" is under an obligation to deduct tax at source on the total amount . In fact, the judgment may even be interpreted to mean that when any payment is made to a non-resident for import of any goods, the payer is bound to withhold tax on such payment regardless of whether the payment is chargeable to tax in India, unless an appropriate clarification is obtained from the tax authorities by the payer or the payee.

The attempt here is to point out the practical difficulties in implementing the Indian Court's ruling and illustrate that such a liberal construction of the Indian withholding tax provisions may cause impediments in international commercial transactions. At a time when foreign direct investment is the need of the hour, it is necessary to have an equitable, progressive and efficient tax system which would project India to be favourable business destination.

I. A brief background

Income tax in India is governed by the provisions of the Income Tax Act, 1961 ("ITA"), which contains elaborate provisions with respect to chargeability to tax, withholding tax obligations, computation of income, transfer pricing, etc. Residence is the most crucial factor in determining the taxability of a person's income in India. Whereas both Indian source income and foreign source income of Indian residents is taxed, non-residents are only taxed on their income which is received or accrued in India or is deemed to accrue or arise in India[2]. The provisions for deduction of tax at source are found in the chapter which deals with "collection and recovery of tax" and in all the instances specified therein, where payments are liable for tax deduction at source, an obligation is cast upon the payer to, inter alia, deduct the prescribed amount from the payment and to pay it to the credit of the central government. The consequences of a failure to deduct when required are grave, insofar as the payer is liable to be treated as an "assessee in default"[3] and the Indian tax authorities ("Revenue") may proceed against the payer to recover the tax. Additionally, the payer may also be required to pay interest on such tax and a penalty if the conditions of its levy are

One such provision of tax deduction at source is section 195 of the ITA which relates to payments made to non-residents. It states that, "any person responsible for paying to a non-resident... *any other sum chargeable under the provisions of this Act*... shall... deduct income-tax thereon at the rates in force..." (emphasis supplied). Although, on a plain reading of section 195, it is clear that

the obligation to deduct tax arises only when the sum in question is chargeable to tax, the Karnataka High Court, in a recent case, seems to have taken a different view.

II. The case concerning shrink-wrapped software: A blow to the software industry[4]

Several Indian software companies were importing shrink-wrapped software packages from suppliers outside India for their business purposes. Since these resident software companies were under a bona fide belief that the payments made for the purchase of software were in the nature of a trading receipt and not chargeable to tax in India in the absence of a permanent establishment in India, the companies did not deduct any tax at the time of the making payments nor did they pose this question of chargeability to the Revenue[5]. However, the Revenue, under the pretext that these payments were in the nature of royalty[6], and consequently chargeable to tax in India, proceeded against the software companies for failure to deduct tax under section 195 of the ITA. While the first appellate authority ruled in favour of the Revenue, the second appellate authority (Bangalore Income Tax Appellate Tribunal, hereon referred to as the "Tribunal") ruled in favour of the software companies ("taxpayer"). Subsequently, numerous appeals were filed before the Karnataka High Court by the Revenue against the order of the Tribunal.

During the proceedings before the High Court, the Revenue claimed that the transaction was in the nature of a license of software and consideration for the same was in the nature of royalty and the software companies were bound to withhold tax on such royalty payments. Later, the Revenue took this argument a step further and asserted that even if the consideration for the software constituted a trading receipt, which may or may not include pure income, there was still an obligation on the part of the payer to deduct tax. In making this argument, the Revenue placed reliance on the Supreme Court's decision in the case of *Transmission Corporation of A.P. Ltd. v CIT*[7], where the Supreme Court had held that the words "sum chargeable under the provisions of this Act" occurring in section 195(1) would include cases where the sum payable to the non-resident is a trading receipt which may or may not include "pure income". On the other hand, Taxpayer contended that withholding obligations only arose when the income was first "chargeable to tax in India". Relying on the Supreme Court case of *Tata Consultancy Services v State of Andhra Pradesh*[8], the Taxpayer argued that the payments were not chargeable to tax as they were made to acquire a copyrighted article as opposed to the copyright itself.

Ruling in favour of the Revenue, the Court observed that the resident payer's liability to withhold tax springs into action the moment there is a payment to be made to a non-resident, if such a payment is per se income in the hands of the recipient. The Court was of the opinion that the payer can be exempted from his obligation to withhold tax, either wholly or partially, only by making an application to the Revenue and demonstrating that the payment does not partake, either wholly or partially, the character of income. However, the Court cautioned that in such cases too, the assessing officer dealing with the application must not embark upon an exercise for assessment of income of the non-resident nor the actual tax liability thereof and the scope of the assessing officer's power is restricted to only determine the percentage of the payment which bears the character of income. Thus, a fundamental principle that seems to have emerged from the Court's ruling was that the obligation to deduct tax on any payment made to a non-resident was not dependant on whether that payment was chargeable to tax in India.

III. Did *Transmission* transmit a wrong message?

In the *Samsung* case[9], the High Court had relied heavily on the ruling of the Supreme Court of India in the *Transmission* case[10]. There, the dispute was whether withholding obligations under section 195 applied even where the sum paid to the non-resident did not wholly represent income and, if it was applicable, whether tax was to be deducted on the gross amount of trading receipts or only in respect of that portion of the trading receipts which may be chargeable to tax under the ITA. The taxpayer had argued that the expression, "any other sum chargeable under the provisions of the Act" conveyed only one meaning that tax at the source could be deducted only when the entire sum paid is total income "chargeable" under the ITA. If the payment was anything more than or other than pure income, it did not answer the definition of the "total income". Thus, where the consideration included cost of materials and other expenses, the obligation to withhold tax would not arise. However, the Supreme Court disagreed with the taxpayer and ruled that the obligation to deduct tax at source arose even where the sum payable to the non-resident was a trading receipt which may or may not include "pure income".

In the *Samsung* case, the High Court had relied on *Transmission* while observing that chargeability to tax was not a precondition for the withholding obligation under section 195. The High Court had observed that this issue was settled by the Supreme Court in the *Transmission* case. However, it is pertinent to note that on a careful reading of the *Transmission* ruling, it is fairly evident that the Supreme Court did not deal with this issue at all. On the contrary, the Court in its ruling had remarked "if the sum that is to be paid

to the non-resident is chargeable to tax, tax is required to be deducted." Nevertheless, in the period following the ruling, tribunals and courts have opined that the Supreme Court in *Transmission* had mandated that chargeability was not a precondition for application of withholding provisions. Thus, in *DCIT v Arthur Anderson & Co. Ltd.*[11], the Mumbai Income Tax Appellate Tribunal, relying on *Transmission*, remarked that, "where there exists a doubt as to chargeability of income to tax, there also tax is to be deducted at source *Ex Abundenti Cautela* (by way of abundant caution). The fact that whether income is eligible to tax or not can only be determined after the assessment." In subsequent cases[12], a similar view was taken by the appellate tribunals. Eventually, the Karnataka High Court adopted the same view in the *Samsung* case. It is unclear as to why such an incongruous interpretation of *Transmission* has been adopted by these tribunals and courts. As enumerated above, if anything, the issue on chargeability was settled in favour of the assessee.

IV. Taxing times ahead for foreign investment?

Although the issue before the Karnataka High Court was in relation to tax withholding obligations on payments made to non-residents for the import of software, the ruling is not restricted to such payments only. The ruling is wide enough to apply to any payment made to a non-resident regardless of whether such payment is taxable in India. The net effect is that any payment whatsoever made to a non-resident, regardless of its whether it is chargeable tax in India, may be subject to a withholding tax. This withheld amount, if regarded as a trading receipt, can be as high as 42.23 percent. Since the consequences of a failure to deduct tax are severe, going forward, more often than not, every payment made to a non-resident will be subject to a withholding tax. The only recourse available to the payer or the payee is to apply to the revenue officer for a clarification, which, as pointed out below, is replete with procedural issues and pro-revenue biases.

The Supreme Court in the *Transmission* case had indicated that since, "Section 195(1) is for tentative deduction of income tax, subject to final assessment, the rights of the parties (payer and payee) are not in any manner adversely affected by the said deduction." However, it is respectfully argued that this view does not take into consideration the practical difficulties arising from the requirement to deposit tax without establishing any basis for taxation. The non-resident recipient is seriously prejudiced insofar as he is confronted with serious cash flow issues where the amount deducted, without any justifiable cause, is as high as 42.23 percent. The complacence of the revenue officers in granting refunds is another factor which would add to the non-resident's cash flow woes.

In the shrink-wrapped software case, the High Court had observed that the rights of the parties (payee and payer) are fully safeguarded insofar as sections 195(2), 195(3) and 197 allow the parties to make an application to the revenue officer to seek a to determine the appropriate chargeable amount. Unfortunately, the current procedural impediments in obtaining a clarification from the revenue do not corroborate the Court's view. The lower tax authorities usually seem to adopt a pro-revenue stance as far as taxability of any sum is concerned thereby leaving little hope for the taxpayer. Even if a nil withholding certificate is granted by the revenue officer, the recent case of *Aditya Birla Nuvo* seems to indicate that there is nothing that prevents the revenue from adopting a different position later. In 2005, Aditya Birla Nuvo ("AB") had purchased the shares of an Indian Company, Idea Cellular ("Idea"), from a Mauritius based company ("AT&T"). Despite the fact that capital gains on the transaction would be subject to tax in Mauritius as per the provisions of the India-Mauritius Tax Treaty, AB approached the revenue officer to obtain a certificate under section 195(2) of the ITA to confirm that AB was not required to deduct tax before making the payment to AT&T. Although a nil withholding certificate was issued by the revenue officer, a few years later the revenue claimed that the transaction was in fact taxable in India. Therefore, the end result was that the exercise of obtaining a clarification from the revenue proved to be futile.

"When a clarification is sought from a revenue officer on whether there is an obligation to withhold tax on any payment made to a non-resident, the revenue officer must not embark upon an exercise for assessment of income of the non-resident nor the actual tax liability thereof and the scope of the assessing officer's power is restricted to only determine the percentage of the payment which bears the character of income." Through these words, the High Court in the *Samsung* case had envisaged a very limited scope of the revenue officer's investigative powers while dealing with a clarification to determine a withholding obligation. However, it is argued that the limited scope of the investigation can turn out to be prejudicial to the taxpayer. For instance, in the *E*Trade* case[13], there was a sale of shares of an Indian listed company by a Mauritius tax resident entity, a transaction which, as per the India-Mauritius Tax Treaty, should have been subject to tax only in Mauritius. However, when the purchaser of the shares approached the revenue officer for a nil withholding tax certificate, the same was refused and the Director of Income Tax ("DIT"), in a summary proceeding, ruled that the Mauritius entity was "simply a façade" and the "capital gains may not have arisen to it but to its US parent". Several fundamental issues such as the denial of treaty benefits in gross violation of Circular 789[14] and the Supreme Court's decision in *Azadi Bachao Adolan*[15] were conveniently unaddressed by the DIT under the pretext that they could

only be resolved later only upon the conclusion of assessment proceedings. Thus, the net effect was that, without a proper representation being offered to E*Trade, an amount of approximately INR240 million was withheld as capital gains tax payable by E*Trade. Considering the number of years taken to resolve a tax dispute in India, it may take up to a decade for E*Trade to obtain a refund post assessment

V. The way forward: Dealing with the uncertainty

As pointed out above, there are several practical impediments that exist in giving effect to the High Court's decision[16]. A rigid withholding tax regime coupled with the uncertainty that has been created by the introduction of the new Draft Direct Tax Code Bill, 2009 and the Revenue's stance in the *Vodafone* case[17], may have the undesirable effect of discouraging investments into India. Recent news reports have suggested that the uncertainty in tax laws in India have caused India to be regarded as an unfavourable destination for doing business. In the *Vodafone* case, the Revenue has argued that the obligation to withhold tax under section 195 also applies to a payer who is a non-resident. If the Karnataka High Court ruling is to be applied in tandem with the Revenue's argument in *Vodafone*, the net effect is absurd. Thus, any non-resident paying a sum of money to another non-resident with no nexus to India whatsoever would be in danger of being prosecuted by the Indian tax department. This uncertainty in the Indian tax system has forced a number of overseas investors to turn to tax-liability insurance covers which provide protection to them in the event of uncertainty in the application of tax laws by India's tax department. In fact, often negotiations get caught on the issue of who will bear the tax liability, a rather unfortunate situation given that parties should be negotiating on commercials of a transaction and not who bears the tax. Negotiation of tax indemnities has become a crucial part of deal structuring and it is advisable to seek appropriate legal advice from a tax lawyer while structuring any deal. Moreover, considering the Bombay High Court's recent ruling[18] prohibiting foreign lawyers from practicing law in India, one would have to be careful when seeking “legal advice” from other professionals such as company secretaries or chartered accounts who are not enrolled to “practice” law as advocates.

Although the Indian Supreme Court has stayed the recovery proceedings that were initiated pursuant to the Karnataka High Court's order, reports have indicated that the revenue officers have already begun a scrutiny of various cross-border transactions. Though the High Court's ruling has left the software industry in Karnataka in a state of dilemma, there may be some light at the end of the tunnel for taxpayers in other states of India insofar as the judgment may not be binding on tax authorities in other states. This is fairly evident when the Mumbai ITAT in a recent case *M/s Mahindra & Mahindra Limited v DCIT*[19] held that the revenue needs to establish the chargeability of a sum to tax before proceeding against a taxpayer for default in withholding obligations.

In *Transmission* and *Samsung*, the Courts were probably concerned that if the payer was allowed to unilaterally ascertain the chargeability to tax of the payment and subsequently refrain from deducting tax on that payment, the proper functioning of source taxation would have been impaired in cases of error. However, it is argued that the current practice, where the payer engages a chartered accountant or obtains a legal opinion to ascertain whether the payment would be chargeable to tax in India, is a sufficient safeguard against cases of error. This procedure is a suitable alternative to making an application to the Revenue which, as point out above, is replete with procedural issues.

It would be interesting see how the Indian Supreme Court deals with this issue of establishing chargeability as a prerequisite for application of withholding provisions. The Court would have to settle the issue once and for all only after giving due consideration to all the practical difficulties that may arise from giving effect to the Karnataka High Court's view.

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NOTES

[1] *FKP Scorpio Konzertproduktionen GmbH v Finanzamt Hamburg-Eimsbüttel.*

[2] Section 5 of the Income Tax Act, 1961.

[3] Section 201 of the ITA.

[4] *CIT v Samsung Electronics Co. Ltd* ITA No. 2808 to 2810 of 2005 and others.

[5] Under section 195(2), 195(3) and section197 if either the payer or the non-resident payee believes that the whole of such sum chargeable to tax would not be income chargeable in the hands of the non-resident payee, either of them may make an application to the assessing officer to determine the appropriate proportion of such sum which is chargeable to tax and, in such a case, tax shall be deducted only on the proportion of the sum which is so chargeable.

[6] Royalty is defined under section 9(1)(vi) of the ITA as well as the applicable tax treaty.

[7] *The Transmission Corporation of AP Ltd. & Anr. v The CIT* AIR 1999 SC 3036.

[8] *Tata Consultancy Services v State of Andhra Pradesh* [2004] 271 ITR 401.

[9] Ibid 3.

[10] Ibid 6.

[11] *DCIT v Arthur Anderson & Co. Ltd* ITA No 9125/Mum/1995, order dated July 29, 2003.

[12] *Poompuhar Shipping Co Ltd. v ITO* (109 ITD 226); *West Asia Maritime Ltd. v ITO* (ITA Nos. 2376 & 2377/Mds/2005 decided on May 19, 2006.

[13] *E*Trade Mauritius Limited v ADIT & Ors* WP. No. 2134 of 2008.

[14] Circular 789 of 2000 issued by the Central Board Of Direct Taxes clarified, inter alia that a "Certificate of Residence" issued by the Mauritian Authorities would constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the India Mauritius Tax Treaty and holders of such a certificate would not be taxable in India on income from capital gains arising in India on sale of shares.

[15] *Union of India and Anr. v Azadi Bachao Andolan and Anr.* 263 ITR 706 (SC).

[16] Ibid.

[17] The transaction between Vodafone and Hutchison essentially involved a transfer of shares of a Cayman Islands company from the Hong Kong-listed Hutchison group to a Vodafone subsidiary resident in the Netherlands. Being completely extra-territorial, the transfer could not have any conceivable tax implications in India, especially considering that the Indian tax authorities had never expressed a concern with hundreds of similar transactions entered into, in the last 50 years. They, however, decided to assume jurisdiction over the Hutchison-Vodafone transaction and issued a notice to Vodafone with the object of recovering a sum of around US$2 billion for failure to withhold tax under section 195 of the ITA.

[18] *Lawyers Collective v Ashurst & Ors Judgement* December 16, 2009, Copy of judgment available on: http://bombayhighcourt.nic.in/data/judgements/2009/OSWP8152695.pdf (last accessed on December 24, 2009 at 2100 IST)

[19] *M/s Mahindra & Mahindra Limited v DCIT* 2009-TIOL-255-ITAT-MUM-SB.

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