

Director Of Income Tax vs Ericsson A.B.,New Delhi. on 23 December, 2011

Author: A.K.Sikri

Bench: Reva Khetrapal, A.K.Sikri

* IN THE HIGH COURT OF DELHI AT NEW DELHI
+ ITA 504/2007, ITA 507/2007
ITA 508/2007, ITA 511/2007
ITA 397/2007

JUDGMENT RESERVED ON:22.7.2011
JUDGMENT DELIVERED ON:23.12.2011

(1)

ITA 504/2007

DIRECTOR OF INCOME TAX
Through:

.....
Mr. Mohan Prasaran
Mr. Sanjeev Sabharwal
Standing Counsel

Versus

ERICSSON A.B.,NEW DELHI.

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Through:

Mr. Soli Dastur, M
Perdiwalla, Ms. Pr
Mr. Sudeep Chatter
Meghna Sudha Panda

DIRECTOR OF INCOME TAX APPELLANT
Through: Mr. Mohan Prasaran, ASG with
Mr. Sanjeev Sabharwal, Sr.
Standing Counsel

Versus

ERICSSON RADIO SYSTEM A.B.,NEW DELHI. .RESPONDENT Through: Mr. Soli Dastur, Mr. Percy Perdiwalla, Ms. Pratibha Singh, Mr. Sudeep Chatterjee and Ms. Meghna Sudha Panda, Advocates DIRECTOR OF INCOME TAX APPELLANT Through: Mr. Mohan Prasaran, ASG with Mr. Sanjeev Sabharwal, Sr. Standing Counsel Versus ERICSSON RADIO SYSTEM A.B.,NEW DELHI. .RESPONDENT Through: Mr. Soli Dastur, Mr. Percy Perdiwalla, Ms. Pratibha Singh, Mr. Sudeep Chatterjee and Ms. Meghna Sudha Panda, Advocates DIRECTOR OF INCOME TAX APPELLANT Through: Mr. Mohan Prasaran, ASG with Mr. Sanjeev Sabharwal, Sr. Standing Counsel Versus ERICSSON RADIO SYSTEM A.B.,NEW DELHI. .RESPONDENT Through: Mr. Soli

Dastur, Mr. Percy Perdiwalla, Ms. Pratibha Singh, Mr. Sudeep Chatterjee and Ms. Meghna Sudha Panda, Advocates.

(5)

ITA 397 of 2007

DIRECTOR OF INCOME TAX
Through:

...
Mr. Sanjeev Sabharwal

Versus

M/S METAPATH SOFTWARE
INTERNATIONAL LTD.
Through:

. . .RE
Mr. R. Satish Kumar
with Mr. Pa
Advocate.

CORAM:

HON'BLE THE ACTING CHIEF JUSTICE
HON'BLE MS. JUSTICE REVA KHETRAPAL

A.K.SIKRI, ACTING CHIEF JUSTICE:

1. The assessee M/s. Ericsson Radio Systems A.B. is a company incorporated in Sweden and is a tax resident of Sweden. The company is a 100% subsidiary of Telefonaktiebolaget L.M. Ericsson. The main business of the assessee company is the supply of hardware and software which is used in the business of rendering telecommunication services and for this purpose, it undertakes projects on turnkey basis. In telecommunication projects, the activities involved are supply of hardware and software, installation and commissioning of the two and after sales service. In the assessment year 1997-97, the assessee company entered into agreements with ten cellular operators collectively called "operators" as follows:-

"1. Huchinston Max Telecom Limited : 07-04-1995

2. RPG Cellular Services Limited : 27-06-1995

3. Bharti Cellular Limited : 15-12-1994

4. Birla AT & T Communication Ltd. : 05-04-1996

5. Cellular Communication India Ltd.

(RPG Cellecom Ltd.) : 29-05-1996

6. J.T. Mobile Limited : 02-07-1996

7. Bharti Televentures Limited : 23-08-1996

8.	Hexacom India Limited	:	25-09-1996
9.	Huchinstom Max Telecom Ltd.	:	29-10-1996
10.	Reliance Telecom Private Ltd.	:	13-02-1997"

2. Pursuant to the aforesaid contracts, the assessee has supplied various hardware and software to the above mentioned cellular operators during the relevant assessment year. In regard to tax liability in India, the assessee claimed that it is not liable to tax under the provisions of the Income-Tax Act, 1961 and the Double Taxation Avoidance Agreement between Sweden and India (the "DTAA"). It is necessary to highlight that the assessee, as stated above, is a wholly owned subsidiary of the L.M. Group of Companies with whom the cellular operators had entered into supply agreements. The Ericsson Telephone Corporation India AB is also a foreign company with a branch in India and is a subsidiary of the parent company of the assessee, viz., Telefonaktiebolaget L.M. Ericsson. There is one more entity, namely, Ericsson Communications Limited, which is an Indian company and is a wholly owned subsidiary of the parent company. For the purpose of brevity, Ericsson Radio System AB is referred to as the assessee, whereas Ericsson Telephone Corporation India AB is referred to as EFC and Ericsson Communications Limited is referred to as ECL and the company Telefonaktiebolaget L.M. Ericsson is referred to as LME.

3. The assessee, a non-resident company, supplies equipment to the operators, while the other two companies (EFC and ECL) are in the business of installation of the equipment and granting marketing support to the assessee. Thus, for the first three months, the work of installation and marketing support was done by the EFC, and for the remaining nine months, the same work was done by ECL. The contracts undertaken by EFC, which were pending on 30th June, 1996 were assigned to ECL, which was incorporated in India.

4. The basic structure of the companies is tabulated by the Assessing Officer as follows:-

Ericsson Radio Ericsson Telephone Ericsson System A.B. Corporation India
Communication (ERA) AB Ltd.

Subsidiary of Subsidiary of LME Subsidiary of LME LME (Installation (Installation (Equipment contractor & contractor & supplier to and marketing support marketing support Indian Customer) to ERA before July after July 1996) 1996) Non-Resident N.R. Company Indian Company Company having Branch in India

5. Before the contract was signed in India, a number of employees of the assessee company and other associated companies visited India for the purpose of network survey and to negotiate the terms of the contract, which was a continuous process spread over a long period of time. It is a matter of record that during the visits of those employees, the branch office of EFC provided office, telephone and other facilities to the aforesaid employees. The employees of the branch office used to

attend the meetings and undertook follow-up work with the customers afterwards. In this regard, there was a market support agreement entered into between the assessee and EFC.

6. The supply of the equipment significantly was a continuous process. In accordance with the contract, the equipment was not to be accepted till it was finally tested through a test known as Acceptance Test (A.T.). Such Acceptance Test was to be carried out by EFC in the first three months and by the ECL in the last nine months of the relevant year. The contracts were signed in India and till delivery to the port in India was the responsibility of the supplier. The supply was on CIP basis and after supply, the defective parts were to be replaced by the assessee.

7. On the aforesaid facts, the Assessing Officer after considering the provisions of the Income-Tax Act, 1961, and in particular Section 9 thereof, held that the assessee had a business connection in India and income of the assessee must be deemed to accrue or arise in India and as such was taxable in India.

8. The Assessing Officer also considered the question whether the assessee's income was taxable in India in view of Article 7 read with Article 5 of the Double Taxation Avoidance Agreement between India and Sweden and concluded as follows:-

"1. The assessee has a permanent establishment in the form of a dependent agent establishment which is EFC.

2. The assessee also has a permanent establishment in the form of a dependent agent PE which is ECI in the later part of the year i.e. after July 1996.

3. It has PE in the form of a branch which was providing a fixed place of business to the assessee.

4. The office of ECI was a fixed place of business for the assessee company.

5. The employees of the assessee company were coming to India and signing contracts and were staying in India and using various facilities which clearly shows that the assessee had a fixed place of business."

9. The A.O. then proceeded to render detailed findings in respect of each of the aforesaid matters, to which we shall presently advert before proceeding to deal with the software supply contract entered between the cellular operator and the assessee and Article 13 of the DTAA between India and Sweden dealing with royalties and fees for technical services. After considering the matter from all angles, the A.O. concluded that the assessee had provided the software to the cellular operators under a license and the income which arose therefrom was to be taxed as royalty as per Article 12 of the Indo-Sweden treaty. Since, however, the assessee had a permanent establishment in India, the same was to be taxed as business profits at a flat rate of 30% as provided in the Indian Income-Tax Act.

10. The A.O. then proceeded to give the computation as follows:-

"The total supplies made during the year for hardware in US \$ 3,80,74,540/- and software is US \$ 1,10,72,708/-. A perusal of the balance sheet filed by the assessee shows that for the year ending 1997, the company has earned a gross margin of 47%. This comes from the annual report for the year 1997 where the assessee has earned 20142157 thousand Swedish Corner gross margin on the net sale of 42797901 thousand Swedish Corner. This is 47% over and above the assessee has claimed selling expenses, administrative expenses and R&D expenses in the global balance sheet. The assessee has submitted that it has reimbursed to the Indian company commission plus other costs which amounts to 21% of the total turnover and therefore out of this gross profit of 47%, 21% is allowed as expenditure directly attributable to Indian Operations. The administrative expenses and R&D expenses are covered under the overall sealing of Section 44C of the I.T. Act and therefore the net taxable income of the assessee is computed as follow:

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1. Total Sales of hardware = US \$ 3,80,74,540/-

converting into INR @ 36.15 = $38074540 \times 36.15 = 137,63,94,621/-$

Taxable profit @ 26% = 35,78,62,601/-

Less:

H.O. expenses allowed u/s 44C @ 5% = 1,78,93,130/-

Taxable Income = 33,99,69,471/-

Tax @ 55% = 18,69,83,209/- I Total consideration for software - US \$ 1,10,72,708/- Converted into INR @ 36.15 - 40,02,78,394/- Tax @ 30% = Rs/12.00.83.513/- II Total tax = (I) + (II) = 30,70,66,727/-

Assessed. Issue necessary forms. Charge interest Penalty proceedings u/s 271 (1) (c) is initiated separately."

11. In an appeal filed against the aforesaid order of the DCIT, Non- Resident Circle, New Delhi on 28.03.2000, the Commissioner of Income-Tax (Appeals) examined the matter. The appellant had taken five grounds of appeal, apart from taking up two additional grounds subsequently as follows:-

(i) Ground No.1 was that the learned A.O. had erred in holding that the income chargeable to tax in India accrued or arose to the assessee. This ground was held to be too general in nature by the CIT(A).

(ii) Ground No.2 dealt with the assessee's business connection in India and the existence of permanent establishment in India. The CIT(A) decided the aspect of business connection against the appellant, but the additional ground taken up by the assessee on 21.07.2000 against existence of PE of the assessee in India, was decided in favour of the assessee.

(iii) Ground No.3 mentioned that the assessee incurred, a loss during the year as certified by Price Water House Cooper, Sweden and, therefore, the A.O. erroneously brought to tax the impugned income of `74,02,47,865/- consisting of business income of `33,99,69,471/- and royalties of `40,02,78,394/-. The CIT(A) partly allowed this ground, and held that while no business profit can be computed in the absence of PE of the assessee in India, the assessee was liable to pay tax on royalties received by it from the operators in India.

(iv) In ground No.4, the assessee assailed the finding of the A.O. that income from licencing of software amounted to receipt of royalty. Without prejudice to this ground, it was mentioned that once it was held that the appellant had PE in India, the royalties obtained the character of business profits. It was also submitted that the A.O. had failed to appreciate that royalties are taxable at the rate of 20% under Article 12 of the DTAA. The CIT(A) decided this ground for treating license fees received by the assessee as royalties against the assessee. However, he directed the A.O. to verify the rate of tax chargeable on the receipt of the royalties and pass a speaking order in this behalf.

(v) Ground No.5 sought to challenge the A.O.'s finding regarding charging of interest under Section 234A and 234B on the ground that the revenues were liable for tax deduction at source. This ground was allowed by the CIT(A).

(vi) The additional ground regarding invalidity of notice issued by the assessing officer under Section 142(1), taken on 05.12.2000, was dismissed. The CIT(A) thus partly allowed the appeal of the assessee.

12. The assessee was not satisfied with the partial relief granted to it by the CIT (A). That part of the order which went against the assessee was challenged by it by filing appeal before the ITAT. Likewise, the Revenue also challenged other part of the order of the CIT (A) whereby the relief was granted to the assessee. These appeals and cross-appeals alongwith cases of other assessee's namely Nokia and Motorola were referred to the Special Bench. The Special Bench has decided the issues in favour of the assessee resulting in dismissal of the appeals of the Revenue and allowing the appeal of the assessee. Challenging that order of the Special Bench, the Revenue has filed appeal which is registered as ITA 507/2007. ITA 508/2007 arises from the order passed by the Tribunal disposing of the cross-objections of the assessee and ITA 511/2007 arises from the order of the Tribunal disposing of the appeal of the Revenue. Thus ITA 507/2007, ITA 508/2007 and ITA 511/2007 relate to one assessment year i.e. 1997-98. In the next assessment year, the ITAT followed the aforesaid order and challenging that order ITA 504/2007 is filed by the Revenue. These first three appeals were admitted on the following questions of law:-

"1. Whether in law, the Ld. Delhi Tribunal was justified in holding that the assessment was invalid inasmuch as it was framed pursuant to a notice issued under Section 142 91)(i) of the Income-Tax Act, 1961, which notice was issued beyond the period of limitation?

2. Whether in law, the Ld. Delhi Tribunal was justified in holding that the assessee did not have a business connection in India?

3. Whether in law, the Ld. Delhi Tribunal was justified in holding that the consideration for supply of software was not a payment by way of royalty, and hence, was not assessable both under Section 9(1)(vi) of the Double Taxation Avoidance Agreement between the government of India and Sweden?"

"1. Whether in law, the Ld. Delhi Tribunal was justified in holding that the assessee did not have a business connection in India.?"

"1. Whether in law, the Ld. Delhi Tribunal was justified in holding that the assessee did not have a permanent establishment in India?

2. Whether in law, the Ld. Delhi Tribunal was justified in deleting the levy of interest charged under Section 234B of the Income Tax Act, 1961?"

13. We may first deal with the two incidental issues before coming to the main issues. First issue pertains to the validity of notices issued under Section 142 of the Income-Tax Act. The Tribunal has concluded that this notice was issued after the end of the assessment year i.e. after 31st March, 1998 and, therefore, it was invalid. Consequently, it held that the Assessing Officer had no jurisdiction to complete the assessment and, therefore, assessment framed by him on 28th March, 2000 was also invalid. However, subsequent to this decision of the Tribunal, by Finance Act, 2006, the Legislature has added proviso in Section 142 (i) of the Act. The effect thereof is that an assessment framed pursuant to a notice issued under Section 142 after the end of the assessment year would also be valid. Conceding this position, it was accepted by the assessed that the notice issue was not beyond the period of limitation. Question No.1 of ITA 507/2007, is thus decided in favour of the Revenue.

14. Second question, which we take up for consideration relates to the levy of interest charged under section 234B of the Act. The Tribunal has deleted this addition and the Revenue is questioning this decision of the Tribunal. The question of law No.2 is framed on this issue in ITA 511/2007. Perusal of the order of the Tribunal would reflect that it has followed its earlier decision of Delhi Bench and Mumbai Bench on the basis of which it is held by the Tribunal that levy of interest was not justified, inasmuch as the assessee had no obligation to pay any advance tax as tax was deductible at source on its income that was chargeable to tax in India. This very issue has been discussed in detail by this Court in CIT Vs. Mitsubishi Corporation in ITA 491/2008. Relying upon the judgment of Bombay High Court in DIT Vs. N.G.C. Network Asia LLC, 313 ITR 187, this Court reached the conclusion that no interest can be levied.

15. The circumstances of the present case are virtually similar. In fact, we may record that there was hardly any resistance by the Revenue to the aforesaid position. We thus answer this question in favour of the assessee and against the Revenue.

16. It is now the stage to deal with the basic issues raised in these appeals which are:-

(1) Whether the assessee has business connection in India?

(2) Whether the assessee has permanent establishment in India?

(We may clarify that if the assessee has business connection in India, then this question may not even need to be considered).

(3) Whether hardware and software components of the equipment can be segregated for the purpose of Section (1)(vi) of the Act?

17. The issue as to whether any income can be brought to tax in terms of the Act is dealt with in paras 103 to 123 of the Tribunal's order. The Tribunal has come to the conclusion that no part of the income accrues or arises in India because having regard to the terms of Article 13 of the Supply Contract it is clear that property in the goods has passed outside India. In this regard, the Tribunal has held that the mere fact that the contract was signed in India is an irrelevant circumstance and the reliance by the revenue on the judgment of the Supreme Court in the case of 20th Century Finance Corporation is misplaced. The Supreme Court in that case was concerned with the issue as to where the situs of the taxable event of a contract to transfer a right to use goods was located. It was in that context that the Supreme Court held that the situs of the taxable event in such a deemed sale was the place where the contract for the transfer of the right to use the goods was made. According to the Tribunal having regard to the provisions of Section 19 and 20 of the Sale of Goods Act, the property in the goods passes when the parties intend it to pass, and the intention of the parties was manifested in Article 13 of the Supply Contract. The Tribunal also held that the mere fact that an Acceptance Test was carried out in India was an irrelevant circumstance and in this regard relied on its earlier decisions as well as in the judgment of the Andhra Pradesh High Court in Additional CIT Vs. Skoda Export Praha, 172 ITR 358. According to the Tribunal, the mere fact that an acceptance test had to be performed did not in any way mean that the title had not passed from the assessee to the Cellular operator outside in India.

18. The Tribunal noted that it was not uncommon that in execution of such large projects the various components of a turnkey project namely planning and designing, supply of equipment, civil works and installation, testing and commissioning of the equipment may be handled by a consortium of companies. Separate agreements would be entered into to carry out each of the aforesaid obligations and each contractor would be responsible for its obligations under its contract although there may be an overall responsibility. Two separate independent contracts were entered into: one between the assessee and the cellular operator for the supply of the goods and the other between the installation contractor and the cellular operator and the Tribunal for the reasons given in para 118 of its order found, on a construction of the relevant provisions of the two agreements,

that the contracts could not be treated as turnkey or a works contract. The Tribunal also did not accept the argument that by virtue of the overall agreement the income that arose to the assessee was chargeable to tax in India. As regards the overall agreement, the Tribunal held that the overall agreement was executed as a matter of commercial prudence as the cellular operator needs to be instilled with confidence that the project would ultimately take off and, therefore, he would insist on a single point responsibility. The Tribunal also noted that this was a common practice and Instruction No. 1829 issued by the Central Board of Direct Taxes which was in force on the first day of the assessment year also takes cognizance of the commercial necessity for having such overall responsibility. The Tribunal further found that no payment accrued either to the assessee or the installation contractor under the overall agreement, but the overall agreement merely ensured supervision and guaranteed the performance of all the contracts in a co-ordinated manner. The Tribunal further noted that the installation contractors and the assessee were separate independent entities and there was no evidence brought on record to disclose that any one is dependent on the other, either financially or in any other manner. The Tribunal further held that the finding of the Commissioner of Income-Tax (A) that the various entities were formed for the purpose of business and were doing business independently as per their instruments of incorporation was not disputed by the Revenue. The Tribunal found that both EFC as well as ECI were separately assessed to tax in India. The Tribunal thus came to the conclusion that there was no business connection with the assessee in India having regard to the nature of the arrangement that the assessee had with either EFC or ECI. Further, as no operations were formed by the assessee in India no income could be charged to tax in India. The Tribunal, therefore, ultimately concluded that no part of the income accrued to the assessee in India and that as the assessee did not have a business connection in India no part of the income could be regarded as deemed to accrue in India also; and that income from the supply of equipment accrues outside India, where the equipment is manufactured outside India and the property therein passes outside India and the place of execution of the contract is not relevant. In this regard reliance was placed by the Tribunal on the judgment of the Supreme Court in Ishikawajima Harima heavy Industries Ltd. Vs. DIT, 288 ITR 408 where the Court has held that the fact that the contract was signed in India is of no material consequence since all activities in connection with the off shore supply were carried on outside India.

19. It would thus be proper to first deal with the issue of business connection.

RE: BUSINESS CONNECTION:

20. Mr. Mohan Parasharan, learned ASG opened the argument on this aspect by submitting that it was an integrated business arrangement for supply of GSM system for which three agreements were entered into viz., the Supply Agreement, the Installation Agreement and the Overall Agreement with JT MOBILES, which together form an Integrated Business Arrangement that is governed by the Overall Agreement. The said Integrated Business Arrangement is for the setting up of a GSM system and the same could not have been set up without the overall supervision, direction and decision making power exercised by the assessee. It was the submission of Mr. Prasaran that a plain reading of the terms and conditions of the three contracts, all entered into on the same day and at the same place in India, viz., Bangalore, indicates that they are all interlinked, inter-twined and inseparable. He pointed out that the assessee and its associated sister concerns had entered into contracts with

the Indian buyers for the setting up of a GSM system in India. For the aforesaid purpose, the hardware and software was to be supplied/licensed by the assessee, the installation through a sister concern of the assessee was to be overseen by the assessee and the overall responsibility of the three contracts also was upon the assessee. He drew our attention to the salient features of the three Agreements which according to him conclusively show that they are, in effect, one integrated business arrangement. He specifically referred to the following features of these Agreements:

Supply Agreement * Preamble: Agreement for supply of hardware and software license.

* Article 5: Scope of the contract. The said clause uses the phrase "turn key basis".

* Article 18: Acceptance Test and Acceptance certificate issued by the Installation Contractor will bind on the assessee.

* Article 20: Provides for the license to use software for the purposes of setting up of a system. * Article 21: Assignment of the contract may be done whereby the hardware may be assigned to anyone by the Indian supplier, but the software may be assigned only after due permission of the assessee. * Article 31: Provides for termination of the supply contract.

Installation Agreement * Preamble: Agreement for installation of hardware supplied and software for which license has already been granted.

* Article 15: Acceptance Test made by the installation contractor includes the integrity of the whole system and certificate binds the assessee.

* Article 17: The installation contractor warrants to rectify defects in both hardware and software (which are provided by the assessee).

* Article 25: Provides for termination of the contract. * Article 29: Assignment of the contract may be done at anytime at the option of the Installation Contractor to any subsidiary company of LME.

Overall Agreement * Preamble: Clearly indicates that the parties are setting up a system and not just supply of goods or installation separately.

* Clause 2: Clearly outlines that the overall responsibility for the supply agreement and the installation agreement rests with the assessee. * Clause 5: Clearly shows that the termination of both the contracts is simultaneous and that where only the installation contract is terminated, the prerogative is that of the assessee to find the replacement for the installation contractor.

* Clause 6: Provides that the Overall Agreement has precedence over the other two agreements and in case of any conflict in interpretation with the other two, will prevail.

21. Mr. Prasaran submitted that in the light of the above, the Assessing Officer as well as CIT (A) were entirely justified in coming to the conclusion that the contracts formed an Integrated Business Arrangement on the part of the assessee to provide the Indian buyers with a GSM system. The assessing officer made the following pertinent findings with respect to the integrated nature of the contract:-

* Overall responsibility was on the assessee for supply, erection and after sales services as evidenced by the Responsibility Matrix between the assessee company and JT MOBILES (as well as the other customers):

Responsibility Matrix between Ericsson and JT MOBILES s per their contract JT Ericsson Mobiles Shipment CIP to agreed port in India x Management of Store x * Site packing in the store x * Delivery of documentation according to Annex 11. x Delivered on CD-ROM only as built documentation, MSC/BSC & BTSs x Delivered as hard copies only correction of remarks on as built documentation x Digitalization of maps (MSI format) x Development of nominal cellplan x Development normal coverage x Preparation of frequency plan x Drive test (when found necessary) for checking * x Suitability of chosen sites, preferably in conjunction with site survey Develop acceptance plan * x Provision of equipment and material x Performance and reliability in accordance to agreed to specifications x * Even if the Installation Contract is terminated, the Supply Contract is not terminated and the assessee is responsible for making an alternative arrangement. However, if the Supply Contract is terminated, the Installation Contract also stands terminated as evidenced by Clause 5.5 of the Overall Agreement, which reads thus:

"5.5 In the event that the Supply Contractor terminates his contract, by notice in writing to JT MOBILES, the Installation Contractor may also terminate his contract by notice in writing to JT MOBILES. In the event that the Installation Contractor terminates his contract by notice in writing to JT MOBILES, the Supply Contractor shall locate a party acceptable to JT MOBILES for taking up the work under the Installation Contract on the same terms and conditions and without any extra expense and JT MOBILES shall sign the Installation Contract with that party."

* The Overall Agreement was "not a matter of comfort, but an overall guarantee provided by the supplier right from the supply upto the testing and proper functioning of the system". In fact, the assessee company thereby took responsibility of the work of installation carried out by the Indian company. The Acceptance Test was, however, to be carried out by the Indian company and the said test was to be binding on the assessee. There was thus an intimate and close relationship between the assessee and its associate company EFC and subsequently between the assessee and the Indian company i.e. ECL.

* The assessee had complete control over the management, affairs and functioning of its associate companies. Neither EFC nor ECL can operate as independent agents on an arms length basis.

22. In the light of above, Mr. Prasaran questioned the findings of the Income Tax Appellate Tribunal regarding the interpretation of the Supply Agreement, Installation Agreement and the Overall Agreement entered into between the assessee, its associate companies and Indian customers. His submission in this behalf was that the scope of the agreement has been decided and interpreted by the ITAT on the basis of the Preambles to the Supply Contract and the Installation Contract, without giving adequate weight to the preamble of the Overall Agreement, which indubitably shows that there was only one integrated agreement whereunder: "The Supply Contractor and the Installation Contractor have agreed to work on a coordinated basis under two separate contracts, being one between JT MOBILES and the Supply Contractor for Hardware and Software Supply and the other between JT MOBILES and the Installation Contractor for the Installation of the system" so as to supply the system and install and commission the system.

23. According to him, another error in the order of the Tribunal was that while interpreting the scope of the contracts, even the other provisions of the Overall Agreement were not given adequate weight especially Article 6 of the Overall Agreement, which reads as follows:-

"6. PRECEDENCE This Agreement shall prevail over the Contracts, notwithstanding anything to the contrary contained therein."

24. His submission was that this clause clearly shows that the Overall Agreement between JT MOBILES (the cellular operator) and the Supply Contractor (the assessee) and the EFC (the Installation Contractor) "concerning some additional terms and conditions due to the Supply and Installation of a Mobile Telephone System" was to prevail over the Supply Contract and the Installation Contract, which, in itself goes to show that it was integrated business arrangement between the parties.

25. Mr. Prasaran further argued that the Income Tax Appellate Tribunal could not have held that the Supplier, i.e., the assessee was not liable for faulty installation in the teeth of the declaration in the Preamble to the Overall Agreement read with Clause 2 of the said Agreement, which vests the responsibility for the proper installation with the assessee:

"And whereas the Supply Contractor and the Installation Contractor have agreed to act in a co-ordinated manner so as to supply the System and install and commission the System.

Now therefore, it is hereby agreed by and between the parties hereto as follows.....

1. Interpretation:

2. Execution: "The Supply Contractor shall have overall responsibility to ensure that the System is supplied in accordance with the Supply Contract and installed in accordance with the Installation Contract and commissioned as per Annex 18 (Time Schedule)."

26. He also stressed that the Income-Tax Appellate Tribunal erroneously held that the responsibility of installing the system was not upon the assessee, and in comparing the responsibility of the assessee under the Overall Agreement to that of the Polish company in the case of CIT vs. Hindustan Shipyard Ltd., 109 ITR 158 (AP), where it was held that the services offered with the contract of sale were merely incidental to the contract by way of guarantee for the efficient working of the products of sale. In the instant case, by no stretch it can be said that the services offered by the Supply Contractor were merely incidental to the sale of hardware and the license to use software. On the contrary, such services were integral to the proper installation of the entire GSM system. The assessee was not merely selling machinery and software but had contracted to provide the full system which required supervision over the Installation Contractor and other services necessary to set up and maintain the GSM System. Accordingly, the ratio of the judgment of the Supreme Court in Hindustan Shipyard Ltd. (supra) is clearly inapplicable. The consequential finding that no income accrued to the assessee either from the Overall Agreement or from the Installation Agreement or from the Marketing and Business Promotion Agreement and thus it cannot be said that there was "intimate connection between the parties" is also erroneous.

27. His next proposition, on this aspect, was that under the above contracts income had accrued and arisen to the assessee in India and therefore it was taxable in India. In this behalf Mr. Prasaran made following submissions:-

(a) Under Section 5 (2) (b) the income of a non-

resident is includible in that income subject to tax under section 4 if the said income accrues or arises or is deemed to accrue or arise in India.

(b) Income is said to accrue or arise in India to an assessee if the assessee had a right to receive the money that can be traced to India.

(c) Whether or not the right to receive the money has arisen in India is dependent on the facts of each case. Relevant factors in this regard will include inter alia the place where the contract is entered into, the place where the contract has to be performed, where a given right can be exercised and what sort of rights are granted in India.

(d) In the present case, it is undisputed that:-

All the vendees are based in India The GSM systems are being set up India. The software is licensed for use in India The hardware is being supplied for setting up of a system in India The acceptance test to confirm the successful installation is done in India. The responsibility to ensure successful installation in India rests with the assessee.

(e) The assessee's obligations therefore cannot be said to end once the title of the goods has passed to the Indian buyer. In addition, valuable rights are granted by the assessee which can only be exercised in India and the relationship between the assessee and its Indian customers is more than just that of mere seller and buyer of goods simpliciter.

(f) In the alternative, income from the contracts amount to a source of the income that constitutes a "business connection" for the purposes of Section 9 (1)(i) of the Income Tax Act, 1961 and therefore income is deemed to accrue or arise in India.

(g) The business connection must be real and intimate and income should arise as a result of the same within the territory of India. Further, such connection must be continuous and not just a one off.

(h) Further, the transfer of a license to use an asset in India, with an agreement to share profits thereof, itself can amount to the existence of a business connection as has been held by the High Court of Bombay in CIT Vs. Metro Goldwyn Mayer, 7 ITR

28. Mr. Soli Dastur, learned Senior Counsel appearing for the assessee refuted the aforesaid submissions of Mr. Prasaran, heavily relying upon the contention that in a well reasoned decision rendered by the Tribunal the factual aspects were rightly culled out from the agreements and the Tribunal was justified in its conclusion that the assessee had no business connection in India and in any case no income had accrued or could be deemed to accrue or had arisen in India which was taxable in this Country. He submitted that the assessee was a non- resident and, therefore, could be subjected to tax only of that income which was covered by Section 5 (2) of the Act. Mr. Dastur argued that the income from the supply of equipment accrues outside India where the equipment is manufactured outside India and the property therein passes outside India and the place of execution of the contract is not relevant.

29. In this regard reliance was placed by him on the judgment of the Supreme Court in Ishikawajima Harima Heavy Industries Ltd. Vs. DIT, 288 ITR 408 where the Court has held that the fact that the contract was signed in India is of no material consequence since all activities in connection with the off shore supply were carried on outside India. This judgment has been followed by the Authority of Advance Rulings in Hyosung Corporation, 314 ITR 343, where the fact situation was even less favourable than the assessee's case.

30. He also submitted that the decision in Ishikawajima's case completely covers the issue as to whether any part of the profit arising from the supply of the equipment by the assessee is chargeable

to tax. He further submitted that in the instant case the title to the system as well as risk therein passed to the cellular operator at the part of establishment in Sweden and in fact this position was not seriously disputed by the Revenue at the time of arguments. He relied upon Section 19 of the Sale of Goods Act which makes it clear that property in goods passes when the parties intend it to pass and in the present case, according to him, the intention of the parties was manifested in Article 13 of the Supply Contract and the provisions of Article 15 relating to the Acceptance Test could not militate against such intention.

31. Refuting the contention of Mr. Prasaran that merely because the acceptance test of the GSM system was carried out in India by ECI/EFC, the income must be regarded arising in India, Mr. Datur submitted that the fact that the acceptance test was performed in India by the installation contractor is not relevant for determining where the title in the equipment passes and consequently where income accrues. The terms of the contract make it clear that the acceptance test is not a material event for the passing of the title and risk in the equipment supplied. The acceptance test is an act which is performed for the benefit of the cellular operator and although the assessee would be bound by such test performed by the installation contractor, the same is not an act on behalf of the assessee. According to Mr. Datur, the overall agreement entered into between the parties also does not in any manner result in the accrual of income in India. The overall agreement does not result in any income accruing in India as no income arises to the assessee in terms of the overall agreement. The overall agreement merely casts a responsibility on the assessee to ensure the functioning of a duly installed system even though different obligations are to be undertaken by different parties.

32. Referring to the provisions of Section 9(1)(i) of the Act, he submitted that it provides that income accruing or arising whether directly or indirectly through or from any business connection in India is deemed to accrue or arise in India. Clause (a) Explanation-1 further provides that in the case of a business of which all the operations are not carried out in India, the income of the business that is deemed to accrue or arise in India in terms of clause (i) shall be only such part of the income as is reasonably attributable to operations carried out in India. It is submitted that the assessee has no business connection in India and in any event has not earned any income in India through or from any business connection. The cellular operators, who are independent contracting parties, can never be regarded as the assessee's business connection. The law is well settled that there must be something more than a mere transaction of sale and purchase between principal and principal to spell out a business connection such as management control or financial control or by way of sharing of profits for a business connection to come into existence. In support, he referred to the decision in the case of CIT Vs. Hindustan Shipyard Ltd. 109 ITR 158, CIT Vs. Gulf Oil Great Britain Ltd. 108 ITR 874 and Circular No.23 dated 23rd July, 1979.

33. His further submission was that the installation contractor also cannot be regarded as a business connection through which the assessee has earned any income in India, as the income of the assessee arises as a consequence of the supply contracts entered into with the cellular operator. There is no contract between the assessee and the installation contractor and, therefore no profit arises therefrom. The mere fact that the installation contractor is a subsidiary of the assessee's holding company would not, by itself, give rise to a business connection of the assessee as held in Gulf Oil Great Britain Ltd. (supra).

34. His alternate submission was that even assuming the assessee is regarded as having a business connection in India, either in the form of the installation contractor or in the form of the cellular operators, nevertheless, by virtue of clause (a) of Explanation-1 to Section 9 (1) (i) no part of the income arising to the assessee from the supply of equipment can be deemed to accrue or arise in India as the material operations in connection with such supply viz, the manufacture and the transfer of property of the goods supplied, were completed outside India.

35. Mr. Dastur went to the extent of arguing that even if one treats the contracts as a composite contract, as alleged by the Revenue, the consideration attributable to the work performed in India, namely, the marketing activity and the installation activity is already assessed to tax in India in the assessments made on EFC and ECI and as no authority has disputed that the installation contractor and the marketing agent are remunerated on an arm's length basis the charge to tax, if any, in India would stand exhausted. In support, he relied upon the judgment of this Court in DIT Vs. Galileo International Ltd. 224 CTR 251.

36. In order to decide the issue at hand, let us recapitulate some of the salient features. The assessee is a foreign Company. Its activities involved supply of hardware and software as well as installation and commissioning of the two and also after sale services. It entered into agreements with various Cellular Operators and entered into three contracts with them namely (1) Overall Agreement, (2) the Supply of Agreement and (3) the Installation Agreement.

37. In the present case, we are concerned with the income earned by the assessee as a result of supply of hardware and software licence under the Supply Agreement. If this Supply Agreement is taken as standalone Agreement, the facts on record show that such supplies under this agreement were made overseas. The property in goods had passed on to the buyer under the Supply Contract outside India where the equipment was manufactured. As per the judgment of Supreme Court in Ishikawajima's (supra), such agreement would not be taxable in India. In Ishikawajima's, the Supreme Court held that no part of profit arising from the supply of equipment outside India would be chargeable to tax in India. Mr. Dastur is right in his analysis of the present case on the basis of the ratio of Ishikawajima's inasmuch as:-

(i) In both the cases the property in the equipment passed outside India and in the assessee's case even the risk passed outside India;

(ii) In the case of Ishikawajima's even though it was to perform onshore services including the erection and commissioning of the equipment supplied by it, nevertheless, the Supreme Court held that no part of the profit on the offshore supply of the equipment was taxable in India as a consequence of the performance of such activities in India. In the assessee's case the assessee does not perform any service in India in connection with the installation of the equipment or otherwise;

(iii) the performance of the acceptance test in India was not considered a relevant circumstance whilst determining whether any part of the profit on the offshore supply was chargeable to tax in India in the case of Ishikawajima, so also in the

assessee's case.

(iv) although admittedly a permanent establishment existed in the case of Ishikawajima, nevertheless, the Court held that no part of the profit arising from the supply of the equipment was chargeable to tax in India as the permanent establishment had no role to play in the transaction sought to be taxed as it took place abroad, whilst in the case of the assessee, it has been found as a fact by both the appellate authorities that no permanent establishment existed;

(v) the mere signing of the contract pursuant to which the supply was made in India, in both cases does not result in giving rise to a tax liability in India;

(vi) the existence of the overall responsibility clause was held to be irrelevant in Ishikawajima's case and likewise the overall agreement executed in the assessee's case should not make any difference to the taxability of the equipment supplied;

(vii) giving the nomenclature of a turnkey project or works contract is not relevant in determining whether any profit arising from the supply of equipment pursuant to such contract was chargeable to tax in India;

(viii) the Supreme Court relied upon Instruction No. 1829 to come to the conclusion that the existence of an overall responsibility clause was not material in determining the tax liability arising from the offshore supply of equipment and as the said instruction continues to be in force for the assessment year relevant to the present appeals, the existence of an overall agreement should make no difference to the taxability of the equipment supplied by the assessee.

38. We may add that Section 19 of the Sale of Goods Act makes it clear that property in goods passes when the parties intend it to pass and in the present case, the intention of the parties is manifested in Article 13 of the supply contract and the provisions of Article 15 in no manner militate against such intention. Further, there is nothing in the conduct of the parties which would suggest that the express provisions of Article 13 have been given a go-by.

39. No doubt, the contract in question was signed in India. However, that may not be a relevant circumstance to determine the taxability of such an income in view of the judgment of Andhra Pradesh High Court in Skoda Export (supra).

40. We may point out that the learned Additional Solicitor General was conscious of the aforesaid legal position and, therefore, the limitation of Revenue's case if the same was to be determined on the examination of the Supply Contract per se and de hors the Installation Agreement and Overall Agreement. It is for this reason that his line of argument proceeded on the basis that the three agreements are to be taken to form an „Integrated business arrangement“ between the parties which was governed by the Overall Agreement. As noticed above, this submission proceeded on the basis that the assessee had entered into contracts with cellular operators in India for setting up of

GSM system in India, the hardware and software for which was supplied by the assessee, and the installation thereof was also over-seen by the assessee who was to ensure that it was carried out to the satisfaction of Indian buyer in accordance with the terms of the contract. Various clauses of Overall Agreement as well as Installation Agreement have been relied upon as already noticed above. Article 15 of the Installation Agreement deals with acceptance test made by the Installation contractor which "includes the integrity of whole system and certificate binds the assessee". Article 17 provides warranties to rectify the defects in both hardware and software provided by the assessee. On this basis it was argued that the Assessing Officer rightly concluded that overall responsibility was on the assessee for supply, erection and after sale services and the assessee had complete control over the management, functions and the associates. The question that falls for consideration is as to whether this acceptance test, which was performed in India, would be relevant for determining as to whether income accrued in India in terms of Section 5 (2)(b) of the Act.

41. We, find that the terms of contract make it clear that acceptance test is not a material event for passing of the title and risk in the equipment supplied. It is because of the reason that even if such test found out that the system did not conform to the contractive parameters, as per article 21.1 of the Supply Contract, the only consequence would be that the Cellular Operator would be entitled to call upon the assessee to cure the defect by repairing or replacing the defective part. If there was delay caused due to the acceptance test not being complied with, Article 19 of the Supply Contract provided for damages. Thus, the taxable event took place outside India with the passing of the property from seller to buyer and acceptance test was not determinative of this factor. The position might have been different if the buyer had the right to reject the equipment on the failure of the acceptance test carried out in India. In Skoda Export (supra), the Andhra Pradesh High Court dealt this issue in the following manner:-

"We may also mention that learned standing counsel for the Department challenged the finding of the Tribunal that the sale of machinery was completed outside India; According to him, the sale was completed only in India, inasmuch as the assessee was entitled to inspect and satisfy itself about the quality and standard of the machinery supplied. We do not see any substance in this contention. The various clauses in the agreement referred to above make it clear that the sale of machinery was F. O. B., European port, and the time of fulfilment of delivery was prescribed as the date of the bills of lading. The payment was also to be made outside India. The agreement further makes it clear that the insurance risk during the course of the journey was that of the assessee and it paid for the same : even the freight charges from the European port to the place of destination were paid by the assessee. Thus, judged from any angle, the sale of machinery, which are "goods" within the meaning of the Sale of Goods Act, was completely outside India. A mere provision in the agreement that the assessee is entitled to satisfy itself about the quality and standard of the machinery in India cannot, in the circumstances of this case, detract from the fundamental position that the sale took place outside India. In such a situation, one has to apply the test of predominance and decide where the sale took place ? On a combined reading of the clauses of the agreement, we have no doubt that the sale of machinery did take place outside India."

42. We may also usefully referred to the judgment of the High Court in Mahavir Commercial Company Vs. CIT, 86 ITR 147 wherein following principle was enunciated:

"Even though the property in the goods may pass to the buyer when the documents are handed over, the buyer may yet retain the right to examine and repudiate the goods but this right generally which a buyer has in c.i.f. contract does not by itself indicate that the property in the goods has not passed to him. This supposed incongruity was sought to be explained per curiam in *Kwei Tek Chao v. British Traders and Shippers Ltd.* (1954) 2 K.B. 459. that if property passed when the documents are transferred that property is subject to the condition that the goods should re-vest in the seller if on an examination by the buyer he finds them not to be in accordance with the contract. It is not necessary to consider this aspect because in any case the ascertainment of the obligations under the contract will determine to what extent the transfer of property is subject to a condition or if the property passes conditionally whether the ownership left in the seller is the reversionary interest in the property in the event of the conditions subsequent operating to restore it to him. In any case where the performance of some condition is imposed upon the buyer but is not made a condition of the transfer of the property, the property once passed is not re-vested in the seller by the buyer's subsequent default."

43. Thus, Overall Agreement does not result the income accruing in India. The execution of an overall agreement is prompted by purely commercial considerations as the India Cellular Operator would be desirous of having a single entity that he could liaise with, a fact which even the Board has noted in its Instruction No.1829 dated 21 st September, 1989. Although Instruction number 1829 stands withdrawn by virtue of Circular No.7/2008 dated 22nd October, 2009, such withdrawal can have no retrospective effect and the principle laid down in Instruction No. 1829 must continue to govern the assessment for the relevant year.

44. The aforesaid analysis will bring forth the legal position that the place of negotiation, the place of signing of agreement, or formal acceptance thereof or overall responsibility of the assessee are irrelevant circumstances. Since the transaction relates to the sale of goods, the relevant factor and determinative factor would be as to where the property in the goods passes. In the present case, the finding is that property passed on the high seas. Concededly, in the present case, the goods were manufactured outside India and even the sale has taken place outside India. Once that fact is established, even in those cases where it is one composite contract (though it is not found to be so in the present case) supply has to be segregated from the installation and the only then would question of apportionment arise having regard to the expressed language of Section 9 (1) (i) of the Act, which makes the income taxable in India to the extent it arises in India.

45. The judgment of the Supreme Court in *Performing Rights Society Ltd. Vs. CIT* 106 ITR 11 has no relevance for determining where the profits on the supply of equipment accrues when title to the goods passes outside India. In the case before the Supreme Court the activity which gave rise to the income, namely, the activity of broadcasting took place in India, and it was in these circumstances the Court held that the royalty earned by the assessee therein accrued in India even though the

agreement pursuant to which such royalty was earned was executed in England. Merely because the activities, namely, the supply activity and the installation activity are to be carried out by two separate Companies who are part of the same Group cannot result in the transaction being treated as one composite transaction. This is more so when both the entities perform their own independent obligations, receive appropriate separate remuneration and, as found by the Tribunal, are not financially or technically dependent on each other.

46. Further, all of them are assessed in respect of the income that has accrued to them and even the Revenue has, in the course of its arguments, accepted that it is not their case that only one assessment has to be made treating the transaction as one works contract.

47. Section 9 (1) (i) of the Act as it stood before the amendment to it by the Finance Act, 2010 provides that income accruing or arising, whether directly or indirectly, through or from any business connection in India is deemed to accrue or arise in India. The Department has not stated that the assessee has any business connection in India, inasmuch as the cellular operators are independent contractee parties and action cannot be held to be assessee's business connection. In such circumstance, the case would be covered by Explanation-1 to Section 9 (1) (i) of the Act. Clause (a) of Explanation-1 lays down that in the case of business if all the operations are not carried out in India, the income of business that is deemed to accrue or arise in India would be only such part of the income as is reasonably attributable to operations carried out in India. In view of the aforesaid discussion, it is clear that under the Supply Contract, the assessee has not earned any income in India through or from any business connection.

48. Insofar as Installation Contract is concerned, that is between the installation contractee and the cellular operators. There is no contract between the assessee and the installation contractor and no profit arises therefrom insofar as assessee is concerned. We are in agreement with the submissions of Mr. Dastur that merely because the installation contractor is a subsidiary of the assessee holding company would not, by itself, give rise to a business connection. In Gulf Oil (supra) this very issue was dealt with, referring to CBDT Circular No.23 of 1969 in the following manner:-

"Under item (ii) above, the Board has clarified that where a non-resident parent company sells goods to its Indian subsidiary, the income from the transaction will not be deemed to accrue or arise in India under section 9, provided three conditions are satisfied :

(i) the contract to sell are made outside India which on the finding of the Tribunal has been found in the instant case in favour of the non-resident company;

(ii) the sales are made on a principal-to-principal basis and at arm's length - an aspect on which Mr. Joshi wanted us to consider the matter in the light of the facts and circumstances of the case; and

(iii) the subsidiary does not act as an agent of the parent - again an aspect which will have to be considered in view of the facts and circumstances obtained in the instant

case. There is no doubt that the Indian subsidiary is a hundred per cent. subsidiary of the non-resident, but the Tribunal has found as a fact that all the contracts regarding the have been made in U.K. principally on the basis that the indents which were placed by the India subsidiary with the non-

resident company were accepted by the non-resident company in U.K."

PERMANENT ESTABLISHMENT (PE):

49. We, therefore, hold that the assessee did not have any business connection in India. In view of this, it is not necessary to go into the issue whether the assessee had any Permanent Establishment in India or not during the relevant period in India or not.

WHETHER THE INCOME FROM THE SUPPLY CONTRACT CAN BE TREATED AS 'ROYALTY' UNDER SECTION 9(1)(vi) OF THE ACT:

50. Section 9 (1) (i) of the Act which deals with the taxability of „royalty income reads as under:-

"Section 9 .INCOME DEEMED TO ACCRUE OR ARISE IN INDIA.

(1) The following incomes shall be deemed to accrue or arise in India :-

(i) All income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India"

51. The submission of Mr. Prasaran, learned ASG was that software part of the equipment supply would attract royalty as copy right of the said software programme still vests with the assessee. Therefore, payments made for the licence to use the software programme give rise to „royalty for the purposes of both the Income-Tax Act as well as DTAA entered into between Sweden and India. Referring to Explanation-II (v) to Section (1) (vi) of the Act as well as Article 13, para-3 of DTAA, it was argued that for the purposes of Income-Tax law, royalty is essentially a payment received as consideration for the use or right to use a particular integral property right, whether partially or entirely.

52. We find that the Tribunal has held that there was no payment towards any royalty and this conclusion is based on the following reasoning:-

(i) Payment made by the cellular operator cannot be characterized as royalty either under the Income Tax Act or under the DTAA.

(ii) The operator has not been given any of the seven rights under S.14 (a) (i) to (vii) of the Copyright Act, 1957 and, therefore what is transferred is not a copyright but

actually a copyrighted article

(iii) The cellular operator cannot commercially exploit the software and therefore a copyright is not transferred.

(iv) Further, the parties to the agreement have not agreed upon a separate price for the software and therefore it is not open for the income tax authorities to split the same and consider part of the payment for software to be royalty

(v) The bill of entry for importing of goods shows that the price has been separately mentioned for software and that this was only for the purposes of customs. There is no evidence to show that the assessee was a party to the fixation of value for the customs duty purposes

(vi) The software provided under the contract is goods and therefore no royalty can be said to be paid for it.

53. Mr. Prasaran, countered the aforesaid reasoning arguing that Clause 20 of the Supply Contract uses the term „licence and the same term is used in the context of software throughout the three Agreements, indicating that it is not an outright sale of goods, or a full transfer of rights from the assessee to the Indian company. He also submitted that the software is a computer programme, which is treated differently from a book, not only in the Copyright Act, 1957 but also the Income Tax Act itself. His submission was that Section 52(1) (aa) of the Copyright Act only deems that certain acts will not amount to infringement in the light of various concerns, where otherwise such acts would amount to infringement under Section 51 of the Copyright Act. The provision cannot by itself be used to hold that no right exists in the first place, since the scope of the right has to be understood only from the provisions of Section 14 of the Copyright Act, 1957. He also argued that the ITAT has misinterpreted the provisions of the DTAA, specifically Article 13, para 3 of the DTAA (Article 12, para 3 of the Model Convention) which defines royalties to mean "payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work". The ITAT, it was submitted, has not appreciated that the royalty is for the use or right to use any copyright. According to him, since title of the software continued to vest with the assessee as provided in clause 20.2 of the Supply Agreement and the assessee was free to grant non-exclusive licenses to other parties, it follows that there was no full time transfer of copyright but it was only a case of right to use the software, and thus payment for use of software is to be treated as royalty. He further argued that reference to OECD Commentary was not apposite as it could not be used to interpret the scope of the relevant provisions of DTAA.

54. It is difficult to accept the aforesaid submissions in the facts of the present case. We have already held above that the assessee did not have any business connection in India. We have also held that the supply of equipment in question was in the nature of supply of goods. Therefore, this issue is to be examined keeping in view these findings. Moreover, another finding of fact is recorded by the Tribunal that the Cellular Operator did not acquire any of the copyrights referred to in Section 14

(b) of the Copyright Act,1957.

55. Once we proceed on the basis of aforesaid factual findings, it is difficult to hold that payment made to the assessee was in the nature of royalty either under the Income-Tax Act or under the DTAA. We have to keep in mind what was sold by the assessee to the Indian customers was a GSM which consisted both of the hardware as well as the software, therefore, the Tribunal is right in holding that it was not permissible for the Revenue to assess the same under two different articles. The software that was loaded on the hardware did not have any independent existence. The software supply is an integral part of the GSM mobile telephone system and is used by the cellular operator for providing the cellular services to its customers. There could not be any independent use of such software. The software is embodied in the system and the revenue accepts that it could not be used independently. This software merely facilitates the functioning of the equipment and is an integral part thereof. On these facts, it would be useful to refer to the judgment of the Supreme Court in TATA Consultancy Services Vs. State of Andhra Pradesh, 271 ITR 401, wherein the Apex Court held that software which is incorporated on a media would be goods and, therefore, liable to sales tax. Following discussion in this behalf is required to be noted:-

"In our view, the term "goods" as used in Article 366(12) of the Constitution of India and as defined under the said Act are very wide and include all types of movable properties, whether those properties be tangible or intangible. We are in complete agreement with the observations made by this Court in Associated Cement Companies Ltd. (supra). A software programme may consist of various commands which enable the computer to perform a designated task. The copyright in that programme may remain with the originator of the programme. But the moment copies are made and marketed, it becomes goods, which are susceptible to sales tax. Even intellectual property, once it is put on to a media, whether it be in the form of books or canvas (In case of painting) or computer discs or cassettes, and marketed would become "goods". We see no difference between a sale of a software programme on a CD/floppy disc from a sale of music on a cassette/CD or a sale of a film on a video cassette/CD. In all such cases, the intellectual property has been incorporated on a media for purposes of transfer. Sale is not just of the media which by itself has very little value. The software and the media cannot be split up. What the buyer purchases and pays for is not the disc or the CD. As in the case of paintings or books or music or films the buyer is purchasing the intellectual property and not the media i.e. the paper or cassette or disc or CD. Thus a transaction sale of computer software is clearly a sale of "goods" within the meaning of the term as defined in the said Act. The term "all materials, articles and commodities" includes both tangible and intangible/incorporeal property which is capable of abstraction, consumption and use and which can be transmitted, transferred, delivered, stored, possessed etc. The software programmes have all these attributes."

xxxxxxx "In Advent Systems Ltd. v. Unisys Corpn, 925 F. 2d 670 (3rd Cir. 1991), relied on by Mr. Sorabjee, the court was concerned with interpretation of uniform civil code which "applied to transactions in goods". The goods therein were defined as "all things (including specially

manufactured goods) which are moveable at the time of the identification for sale". It was held :

"Computer programs are the product of an intellectual process, but once implanted in a medium are widely distributed to computer owners. An analogy can be drawn to a compact disc recording of an orchestral rendition. The music is produced by the artistry of musicians and in itself is not a "good," but when transferred to a laser-readable disc becomes a readily merchantable commodity. Similarly, when a professor delivers a lecture, it is not a good, but, when transcribed as a book, it becomes a good.

That a computer program may be copyrightable as intellectual property does not alter the fact that once in the form of a floppy disc or other medium, the program is tangible, moveable and available in the marketplace. The fact that some programs may be tailored for specific purposes need not alter their status as "goods" because the Code definition includes "specially manufactured goods."

56. A fortiori when the assessee supplies the software which is incorporated on a CD, it has supplied tangible property and the payment made by the cellular operator for acquiring such property cannot be regarded as a payment by way of royalty.

57. It is also to be borne in mind that the supply contract cannot be separated into two viz. hardware and software. We would like to refer the judgment of Supreme Court in CIT Vs. Sundwiger EMFG Co., 266 ITR 110 wherein it was held:

"A plain and cumulative reading of the terms and conditions of the contract entered into between the principal to principal i.e., foreign company and Midhani i.e., preamble of the contract, Part-I and II of the contract and also the separate agreement, as referred to above, would clearly show that it was one and the same transaction. One cannot be read in isolation of the other. The services rendered by the experts and the payments made towards the same was part and parcel of the sale consideration and the same cannot be severed and treated as a business income of the non-resident company for the services rendered by them in erection of the machinery in Midhani unit at Hyderabad. Therefore, the contention of the Revenue that as the amounts reimbursed by Midhani under a separate contract for the technical services rendered by a non-resident company, it must be deemed that there was a "business connection", and it attracts the provisions of Section 9(1)(vii) of the Income Tax Act cannot be accepted and the judgments relied upon by the Revenue are the cases where there was a separate agreement for the purpose of technical services to be rendered by a foreign company, which is not connected for the fulfillment of the main contract entered into principal to principal. This is not one such case and thus the contention of the Revenue cannot be accepted in the circumstances and nature of the terms of the contract of this case."

58. No doubt, in an annexure to the Supply Contract the lump sum price is bifurcated in two components, viz., the consideration for the supply of the equipment and for the supply of the software. However, it was argued by the learned counsel for the assessee that this separate specification of the hardware/software supply was necessary because of the differential customs duty payable.

59. Be as it may, in order to qualify as royalty payment, within the meaning of Section 9(1) (vi) and particularly clause (v) of Explanation- II thereto, it is necessary to establish that there is transfer of all or any rights (including the granting of any license) in respect of copy right of a literary, artistic or scientific work. Section 2 (o) of the Copyright Act makes it clear that a computer programme is to be regarded as a „literary work . Thus, in order to treat the consideration paid by the cellular operator as royalty, it is to be established that the cellular operator, by making such payment, obtains all or any of the copyright rights of such literary work. In the present case, this has not been established. It is not even the case of the Revenue that any right contemplated under Section 14 of the Copyright Act, 1957 stood vested in this cellular operator as a consequence of Article 20 of the Supply Contract. Distinction has to be made between the acquisition of a "copyright right" and a "copyrighted article".

60. Mr. Dastur is right in this submission which is based on the commentary on the OECD Model Convention. Such a distinction has been accepted in a recent ruling of the Authority for Advance Ruling (AAR) in Dassault Systems KK 229 CTR 125. We also find force in the submission of Mr. Dastur that even assuming the payment made by the cellular operator is regarded as a payment by way of royalty as defined in Explanation 2 below Section 9 (1) (vi), nevertheless, it can never be regarded as royalty within the meaning of the said term in article 13, para 3 of the DTAA. This is so because the definition in the DTAA is narrower than the definition in the Act. Article 13(3) brings within the ambit of the definition of royalty a payment made for the use of or the right to use a copyright of a literary work. Therefore, what is contemplated is a payment that is dependent upon user of the copyright and not a lump sum payment as is the position in the present case.

61. We thus hold that payment received by the assessee was towards the title and GSM system of which software was an inseparable parts incapable of independent use and it was a contract for supply of goods. Therefore, no part of the payment therefore can be classified as payment towards royalty.

EFFECT OF AMENDMENT TO SECTION 9 OF THE FINANCE ACT, 2010:

61. We have to determine as to whether amendment made to Section 9 of the Finance Act, 2010 whereby Explanation to sub-Section (2) has been inserted has the effect of turning around the result. Vide Finance Act, 2010 the following amendment was made to sub-Section (2) of Section 9:-

"Explanation- For the removal of doubts, it is hereby declared that for the purposes of this section, income of a non-resident shall be deemed to accrue or arise in India under clause (v) or clause (vi) or clause (vii) of sub section (1) and shall be included in

the total income of the non-resident, whether or not,-

(i) the non-resident has a residence or place of business or business connection in India; or

(ii) the non-resident has rendered services in India."

62. We may place on record that initially the Finance Act, 2007 inserted an Explanation at the end of Section 9 to provide that "for the removal of doubts, it is hereby declared that for the purposes of this section, where income is deemed to accrue to arise in India under clauses

(v), (vi), and (vii) of sub-Section (1), such income shall be included in the total income of the non-resident, whether or not the non-resident has a residence or place of business or business connection in India." This Explanation was inserted ostensibly to get over that part of the judgment of the Supreme court in the case of *Ishikawajima (supra)* where the Supreme court had observed that for Section 9(1) (vii) to be applicable it is necessary that the services should not only be utilized in India but should also be rendered in India. As this Explanation did not achieve the purpose it was intended to serve, as was pointed out by the Karnataka High Court in its judgment titled *Jindal Thermal Power Company Limited Vs. Deputy Commissioner of Income-Tax (ITA 3021/2005 and other connected matters decided on 16.3.2009)* the Legislature once again amended the Explanation below Section 9 by the Finance Act, 2010 with retrospective effect from 1st June, 1976.

63. Based on the aforesaid amendment, the submission of the Revenue is that this amendment has been introduced by the Legislature to undo the effect of *Ishikawajima (supra)* and makes the Legislative intent clear by providing "source rule" that is, income which has arisen in India as taxable under Section 9 of the Act. It was argued that even the plain wording of Section 9 was clear, namely, if the income has its source in India, it would be taxable in India. However, since *Ishikawajima (supra)* had not interpreted the provision as containing the "source rule" in order to rectify this situation created by the aforesaid judgment, the Parliament introduced the aforesaid Explanation to clarify that irrespective of where the services were actually rendered, so long as they were utilized in India, income obtained from such services by a non-resident would be treated as income accruing or arising in India.

64. To buttress this submission, the learned counsel for the Revenue relied upon the Memorandum explaining the following provisions in the Finance Bill, 2010:-

"Vide Finance Act, 1976, a source rule was provided in Section 9 through insertion of clauses (v), (vi) and

(vii) in sub-section (1) for income by way of interest, royalty or fees for technical services respectively. It was provided, inter alia, that in case of payments as mentioned under these clauses, income would be deemed to accrue or arise in India to the non-resident under the circumstances specified therein. The intention of introducing the source rule was to bring to tax interest, royalty and fees for technical

services, by creating a legal fiction in section 9, even in cases where services are provided outside India as long as they are utilized in India. The source rule, therefore, means that the situs of the rendering of services is not relevant. It is the situs of the prayer and the situs of the utilization of services which will determine the taxability of such services in India.

This was the settled position of law till 2007.

However, the Supreme Court in the case of *Ishikawajima-Harima Heavy Industries Ltd. Vs. DIT* (2007) [288 ITR 408], held that despite the deeming fiction in section 9, for any such income to be taxable in India, there must be sufficient territorial nexus between such income and the territory of India. It further held that for establishing such territorial nexus, the services have to be rendered in India as well as utilized in India.

This interpretation was not in accordance with the legislative intent that the situs of rendering service in India is not relevant as long as the services are utilized in India. Therefore, to remove doubts regarding the source rule, an Explanation was inserted below sub-Section (2) of Section 9 with retrospective effect from 1st June, 1976 vide Finance Act, 2007. The Explanation sought to clarify that where income is deemed to accrue or arise in India under clauses (v), (vi) and (vii) of sub-section (1) of Section 9, such income shall be included in the total income of the non-resident, regardless of whether the non-resident has a residence or place of business or business connection in India. However, the Karnataka High Court, in a recent judgment in the case of *Jindal Thermal Power Company Ltd. Vs. DCIT (TDS)*, has held that the Explanation, in its present form, does not do away with the requirement of rendering of services in India for any income to be deemed to accrue or arise to a non-resident under Section 9. It has been held that on a plain reading of the Explanation, the criteria of rendering services in India and the utilization of the service in India laid down by the Supreme court in its judgment in the case of *Ishikawajima Harima Heavy Industries Ltd.* (supra) remains untouched and unaffected by the Explanation.

In order to remove any doubt about the legislative intent of the aforesaid source rule, it is proposed to substitute the existing Explanation with a new Explanation to specifically state that the income of a non-resident shall be deemed to accrue or arise in India under clause (v) or clause (vi) or clause (vii) of sub section (1) of Section 9 and shall be included his total income, whether or not, (a) the non-resident has a residence or place of business or business connection in India; or

(b) the non-resident has rendered services in India. This amendment is proposed to take effect retrospectively from 1st June, 1976 and will, accordingly, apply in relation to the assessment year 1977-78 and subsequent years."

65. It was argued that a plain construction of the Explanation shows that income received by a non-resident from interest, royalty, or fees for technical services will be deemed to accrue or arise in India in accordance with Section 9 (1) (i) irrespective of the place of business, residence or presence of business connection in India. Moreover, in the specific context of royalty and fee for technical service, the second half of the Explanation makes it clear that services for which royalty or fee is

being paid need not be rendered within the territory of India in order to be deemed as income accruing or arising in India. As per the learned counsel for the Revenue the scope of the said provisions is made clear when one examines the relevant Notes on Clauses that accompanied the Bill in its passage in Parliament:

"Clause 4 of the Bill seeks to amend section 9 of the Income-Tax Act relating to income deemed to accrue or arise in India.

The existing provisions contained in the Explanation occurring after sub-section (2) of the aforesaid section provide that, for the removal of doubts, for the purposes of the said section, where income is deemed to accrue or arise in India under clauses (v), (vi) and

(vii) of sub-section (1), such income shall be included in the total income of the non-resident, whether or not, the non-resident has a residence or place of business or business connection in India.

It is proposed to substitute the said Explanation so as to provide that the income of a non-resident shall be deemed to accrue or arise in India under clause (v) or clause (vi) or clause (vii) of subsection (1) and shall be included in the total income of the non-resident, whether or not,-

the non-resident has a residence or place of business or business connection in India; or the non-resident has rendered services in India. This amendment will take effect, retrospectively, from 1st June, 1976 and will, accordingly, apply in relation to the assessment year 1977-78 and subsequent years."

66. On the other hand, argument of the learned counsel for the assessee is that this amendment does not impact the present case. It was argued that the Explanation as initially inserted in the year 2007 sought to clarify as to when income received by way of interest, royalty or fees for technical services, can be regarded as deemed to accrue or arise in India. The subsequent amendment made in the Explanation by the Finance Act, 2010 enacts a further clarification (by effectively adding clause (ii) in the Explanation) in so far as the taxability of fees for technical services are concerned. The Supreme Court in *Ishikawajima* (supra) has held that if the transfer of property in goods as well as the payment were both made outside India, the transaction of supply was not chargeable to tax in India in spite of the fact that the contract was signed in India. The Court has further held that under the DTAA even if the non-resident has a permanent establishment in India, the income accruing from the supply would not be chargeable to tax in India if the permanent establishment is not involved in that activity. In the present case the finding of the Tribunal is that both the transfer of the property in goods as well as risk has passed outside India and, therefore, having regard to the provisions of the Act, the consideration receivable for the supply of such equipment is not chargeable to tax in India. According to the assessee, the judgment of the Supreme Court in the case of *Ishikawajima* insofar as it deals with the taxability of the offshore supplies is in no manner affected by the amendment made to section 9 by the Finance Act, 2010 as it only impacts the issue as to when income by way of fee for technical services can be deemed to accrue or arise in India. As

it is nobody's case that the respondent has rendered technical services which are deemed to accrue or arise in India when it supplies the equipment or the software, the insertion of the Explanation below section 9 and the addition of clause (ii) in the said Explanation by the Finance Act, 2010 has no relevance insofar as the appeals before this Court are concerned.

67. In our opinion on the facts of this case, it may not even be necessary to go into this issue for the reason that in respect of clauses

(v),(vi), and (vii) of sub Section (1) of Section 9, once it is held that payment in question is not royalty which would come within the mischief of clause (vi), the Explanation will have no application.

68. Therefore, it is not necessary to go into the question as to whether the purpose of this amendment was to undo the effect of Ishikwajima (supra) by providing "source rule" as taxable under Section 9 of the Act. In the present case, once it relates to supply of goods and further in any case, where both the transfer of the property in goods or risk passed outside India, the conclusion is that no taxable event took place in India. The question of applicability of the Explanation would arise only when payment is to be treated as "royalty" within the meaning of clause (vi) or "fee for technical services" as provided in clause (vii) of the Act.

69. The result of the aforesaid discussion would lead to the answer to questions framed in favour of the assessee and against the revenue and would result in the dismissal of the appeals of the Revenue.

70. This appeal was admitted on the following questions of law:-

"1. Whether Ld. ITAT in the facts and circumstances of the case erred in holding that such software supplies were „sale and hence business income and not Royalty in terms of Indo- UK Treaty?

2. Whether Ld. ITAT was correct in law in confirming decision of the Ld. CIT (A) by limiting income from hardware sales at 8%?

3. Whether Ld. ITAT erred in holding that Assessee is not liable for interest under Section 234A and 234B of the Income Tax Act, 1961?"

71. It was agreed that the result of the aforesaid questions would depend upon the outcome of the ITA 504/2007 and other connected matters.

72. In view of our decision in ITA 504/2007, whereby appeals of the revenue have been dismissed, the questions of law stand answered against the revenue in this appeal. This appeal is also dismissed.

ACTING CHIEF JUSTICE (REVA KHETRAPAL) JUDGE DECEMBER 23,2011 skb