Karnataka HC Decision on TDS under Section 195 – An Analysis

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THE Karnataka High Court's judgement in CIT (International Taxation) v. Samsung Electronics Co. Ltd reported in TIOL 2009-TIOL-629-HC-KAR-IT, disposing off about 30 cases in one go, is bound to rattle importers of goods and services alike. I cannot think of any High Court judgement, over the last few years, delivering a judgement of similar far reaching consequences.

Firstly, the facts of the case, in brief….

Certain importers of software licenses had taken a view that the payments made for software imports would not attract the provisions of Section 195 of the Income tax Act, necessitating the deduction of tax at source, since such payments would not constitute taxable income in the nature of royalty or scientific work, in the hands of the non-resident, in terms of Section 9(1)(vi) read with the DTAA. The First and Second Appellate Authorities had upheld the importers' contention that, when the payments would be for acquiring a right to use a copyright and not the copyright itself and consequently would not get treated as royalty payments in terms of the DTAAs and hence, there was no need for deducting at source under Section 195. The Tribunal had also upheld the importers' contention that the import of software licenses would be in the nature of a transaction involving import of goods, in the light of the precedents set by the various Courts including the Hon'ble Supreme Court in the TCS case. The Revenue contended that software is a 'scientific work' and payments for import of software would be covered under Section 9(1)(vi) of the Act and that the importer cannot contend that the payment made by him would not constitute income in the hands of the non-resident recipient and that, the importer was duty bound to deduct tax at source under Section 195.

Secondly, the gist of the judgment……

In a sweeping judgement, which is perhaps the first judgement from a High Court on the contentious issue related to the applicability of Section 195 on software imports, the Karnataka HC has rejected, in toto , the decisions of the Bangalore Tribunal in various similar judgements and has held that the importer was duty bound to deduct tax at source under Section 195 for import of software licenses, based almost exclusively, on the Apex Court's judgment in the Transmission Corporation Limited Vs. CIT2002-TIOL-471-SC-IT. The High Court judgement leads to the premise that the obligation to deduct tax at source under Section 195 has nothing to do, with the actual liability of the non-resident to tax under the provisions of the Act, including the quantum thereof. The importer could take recourse

to the provisions of Section 195(2) of the Act if he is of the view that only a part of the payment made by him would bear the character of income in the hands of the non-resident.

Thirdly, the implications arising out of this judgement (with due regards and respects to the Hon'ble High Court)…

++ In terms of this judgement, the importer has only two options before him, vis-à-vis the payments to be effected to the non-resident, viz. either to deduct tax at source under Section 195 or to make an application to the Department under Section 195(2). In my view, in terms of the judgement, this principle would apply equally to import of goods or to import of services or for transactions involving import of goods and services as in the case of a works contract.

++ It would look like that importer cannot get into issues related the applicability of Section 9(1) or to provisions of the Double Taxation Avoidance Agreements for purposes of discharging his liability under Section 195. In other words, in terms of this judgement, the provisions of Section 195 are quite draconian, requiring the resident payer to deduct tax at source without getting into issues related to the taxation of the receipts, in the hands of the non-resident.

++ At the cost of repetition, I would reiterate that the judgement would lead to the conclusion that Section 195 would cover all payments made for imports including transactions involving pure imports of goods and materials, which, we all know, is totally outside the levy of tax under the provisions of the Income tax Act. Given the fact that most import transactions are on a 'net of tax' basis, vis-à-vis the non-resident, wherein the nonresident quotes his price on the basis of the net amount received/receivable by him, the importer would be left to bear the additional burden in terms of the withholding tax to be paid under Section 195.

++ The judgement would seem to override the various Circulars issued by the CBDT, in which, a clear view has been taken that no withholding tax is necessary in the case when commission is paid to a non-resident who carries out a commission business abroad and in the case of a transaction involving import into India, of goods bought in a foreign country. Though some of these Circulars including widely quoted Circular No. 23 of 1969 have recently been withdrawn by the CBDT vide Circular No. 7/2009 issued in October 2009, the principle has nevertheless remained that the Board had never sought to bring transactions involving import of goods and services rendered outside of India, into the TDS net under Section 195.

++ Most of the current discussions on the issue concerning levy of withholding taxes on import transactions have centered on whether the transaction involves goods or services, with the latter being subjected to TDS. With the stroke of the pen, this judgement would seem to have rendered the distinction between 'goods' and 'services' irrelevant, for purposes of TDS to be effected for purposes of Section 195. Hence, the logic seems to be that, tax would need to be

deducted and paid on import of goods and services alike, with the distinction between goods and services becoming relevant only for the levy of tax on the non-resident upon returns being filed.

++ There has been a widespread belief that the judgement leads to levy of withholding taxes on import of software licenses. At least, this is what most national newspapers had written about. The truth is much bitterer. In my strong view, the judgement covers all imports including, of course, software licenses. To this extent, the software importers will need to sail in the same boat, with other importers.

++ As regards the applicability of Section 195(2), recourse to which the Karnataka HC says, is mandatory for residents effecting payments to non-residents not wanting to deduction tax at source under Section 195, there are several judicial pronouncements holding that, the resident is under obligation to apply under section 195(2) arises only when he feels that the sum is only partly chargeable (embedded or hidden income), in order to determine the appropriate fraction of the income hidden or embedded therein. In other words, recourse to Section 195(2) is not required when the resident feels that there is no embedded or hidden income arising or accruing to the non-resident. This judgement would seem to unsettle this settled law.

++ As we know, Section 195 covers all payments to non-residents and hence, would cover even payments by one non-resident to another non-resident. It would be impracticable to implement this judgements in respect of transactions between non-residents.

Fourthly, the way to go forward…….. (with due respects and regards to the High Court of Karnataka).

++ The judgement, as aforesaid, is almost exclusively based on the Apex Court's decision in the Transmission Corporation case. A recall of this judgement, rendered in 1999, would perhaps help us better understand the issues involved…In this judgement, the Apex Court had held that the scheme of tax deduction at source applies not only to the amount paid which wholly bears 'income' character such as salaries, dividends, interest of securities, etc., but also to gross sums, whole of which may not be income or profits of recipient, such as payment to contractors and sub-contractors andpayment of insurance commission . The Apex Court had further held that the expression 'any other sum chargeable under the provisions of this Act' would mean 'sum' on which income-tax is leviable and that, the expression 'any other sum chargeable under the provisions of this Act' would include cases where any sum payable to the non-resident is a trading receipt which may or may not include 'pure income'. The Apex Court had further held that the assessee who makes payments to non-residents under contract entered into is under obligation to deduct tax at source under section 195 and the obligation is limited only to appropriate proportion of income chargeable under the Income tax Act.

++ Several High Courts have had the opportunity to decide on cases involving Section 195, post the Apex Court's judgement in the Transmission Corporation case. To cite a few of these cases… Bombay HC's decision in CIT v. Mahindra and Mahindra Ltd (2003) 263 ITR 481 (BOM)

Calcutta HC's decision in Timken India Ltd v. CIT = 2003-TIOL-331-HC-KOL-IT

Delhi High Court's decision in Director of Income tax v. Paper Products Ltd (2002) 257 ITR 1

(DELHI)

In all of these judgements and in the other judgements not cited above, which have all been rendered after 1999, we find that the liability under Section 195 is invariably linked to the provisions of the relevant Double Taxation Avoidance Agreements and the other provisions of the Income tax Act, notably Section 9(1)(vi). To this extent, with due respects to the Karnataka High Court, one finds that the latest judgement which seeks to de-link the DTAA from the process of arriving at the liability to withhold tax under Section 195 conflicts with those of the other High Courts, post the Apex Court's judgment in the Transmission Corporation case.

In my view, the judgement will have applicability only in the state of Karnataka, as assessees in other states would be bound by the judgements of the respective High Courts, which, as we discussed, are not in consonance with the Karnataka HC's decision.

++ With specific regard to the applicability of TDS on import of software, it seems that the

Court's attention was not drawn to the provisions of Circular No, 588 dated 2-1-1991, which was based on the announcement made by the Finance Minister in Lok Sabha on 7-9-1990. The then FM had made a statement that, when a tax-payer, engaged in the business of export of software for computer applications, imports any systems software, supplied by the manufacturer of computer hardware, along with the hardware itself, the lump-sum payment made to the foreign supplier for acquisition of any right to, or for use of, such systems software will not be liable to tax in India by way of royalty or otherwise. The FM had further stated that, such lump-sum payments will, henceforth, be allowed to be made without deduction of tax at source under Section 195(1) of the IT Act. Taking this reasoning forward, it could have been argued before the High Court that, Section 195 cannot be invoked for lump-sum payments related to software imports.

++ Unfortunately, the question of taxability of non-residents for payments received from residents, for transfer of right to use software, is still open. This judgement does not answer directly answer this very important issue, other than stating that, payments for import of software would have to suffer TDS.

Before parting…

++ As a student of the Karma theory, I am exposed to the thinking that, against an action, a result falling under three different categories can be expected, viz.

- a result which is equivalent to the expectation.

- a result which is against the expectation

- a result which is better than the expectation.

The Income tax Department, which went on appeal, would not, perhaps, have expected this kind of a totally unexpected positive result, which falls under category No. 3 stated above. The IT Department had only expected the High Court to hold that software imports were covered by Section 195. But, it has ended up with this decision which would bring all imports into the mischief of Section 195.

++ I am sure, the litigation would be carried forward to the Hon'ble Supreme Court. A prayer would need to be made to the Apex Court for a stay of this decision. As we know, the judgement in the Transmission Corporation case was rendered far back in 1999, and the law on taxation of non-residents has considerably moved forward. The fact that the Karnataka High Court has not referred to the decisions of the other High Courts on Section 195, post 1999, could be a further justification for a stay, till the Supreme Court decides on the issue.

++ On a re-reading of the Apex Court's judgement in the Transmission Corporation case, I find it extremely difficult to understand as to how this judgement could lead to a conclusion that transactions which do not involve any element of 'income' in the hands of the nonresident, eg. import of goods, etc. would require deduction of tax at source under Section 195 or for that matter, require an application to be made under Section 195(2)?

++ The decision will play havoc with the Indian economy, as a whole. Even the Government, would not desire that imports of purchases should be subjected to the levy of TDS. The Government could think of issuing a circular clarifying its view on the applicability of the judgement on goods imports.

++ Effective July 1, 2009, the Government has made it mandatory for Form No. 15CBs to be filed electronically for deduction of tax at source, while effecting payments to nonresidents. This new format links the clauses of DTAA for purposes of deduction of tax at source under Section 195. This being the view of even the Government, the decision of the Karnakata HC is baffling, to say the least. Providing of certification under Form No. 15CB would now become a nightmare (I wonder if the format of the Form No. 15CB was produced to the Hon'ble High Court during deliberations).

++ It would seem that this judgment from the Karnataka HC is in complete variance with its own judgement in the Jindal Thermal Power Co Ltd case (2009-TIOL-302-HC-KAR-IT), wherein, the High Court had given an excellent ruling holding that the judgement of the Supreme Court in the Ishikawajma Harima Industries case would continue to be good law, even after the retrospective amendment to Section 9(1). It seems that its own earlier judgment was not referred to by the Karnataka High Court.

++ The judgement of the Karnataka High Court talks of Section 195 being a 'guided' missile. With due regards to the Karnataka High Court, I would prefer to agree with TIOL, which called this judgement, an 'unguided missile', which it indeed is.

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