Broker assuming all risks without any right to conclude contracts on behalf of NR can't be treated as agency PE

Summary – The Chennai ITAT in a recent case of Financial Software & Systems (P.) Ltd., (the Assessee) held that payment made to non-resident companies for procuring standard and copyrighted software products, for distribution or re-sale purpose on principal to principal basis could not be treated as payment towards royalty. Where assessee company was working on a principal-to-principal basis, bears risk of failure of contracts and also functions on independent basis, it could not be said to be a PE of non-resident in India.

Facts

- The assessee, Financial Software and Systems Private Limited (FSS), was an Indian company. It was engaged in providing software and related services in Banking and Financial Service Sector. The assessee company had made payments to two non-resident entities. They were ACI Singapore and IRPL Australia. The former company, ACI Singapore was a resident of Singapore and the latter company, IRPL Australia was a resident of Australia.
- The assessee company had made payments to these two non-resident companies towards procurement of standard software. The assessee company operates under a distribution model, wherein software products were procured from the two non-resident companies namely, ACI Singapore and IRPL Australia and in turn, supply those software products to various customers in India. But while making payment it did not deduct tax at source. It stated that distribution model did not generate taxable income for the non-resident companies in India and therefore, there was no necessity to deduct tax at source while making the payments.
- The Assessing Officer was of the view that the payments made by the assessee company to the non-resident companies were in the nature of Royalty. Royalty generates taxable income in the hands of the non-resident companies, in India. Therefore, he held that the assessee was under an obligation to deduct tax at source, while making the payments, and as no such TDS had been made, the assessee is liable for the consequence of provisions of section 40(a)(i). Accordingly, the Assessing Officer disallowed those payments incurred for procurement of software claimed by the assessee company as expenditure, while computing its taxable income.
- It was also considered by the Assessing Officer that even otherwise the assessee was liable for deducting tax at source under section 195 on the ground that the assessee company being a distributor of software products of the non-resident companies, had to be treated as a Permanent Establishment (PE) of the non-resident companies. He held that the assessee was bound to deduct tax at source as the non-resident companies had a PE in India.
- On appeal, the Commissioner (Appeals) upheld the order of the Assessing Officer.
- On second appeal, to the Tribunal the assessee submitted that the assessee company purchases software products from non-resident vendors and re-sells such products to its customers in India. It was a pure trading transaction therefore, no withholding tax would be required. Software products purchased were only copyrighted articles and the assessee did not have any right to copy the

products purchased from ACI Singapore and IRPL Australia. The relationship between the assessee company and the non-resident companies was on a principal-to-principal basis.

Held

- The assessee company has entered into agreements with ACI Singapore and IRPL Australia for supply of standard software products, which in turn, are to be sold in India to the customers of the assessee company mainly, Banks and Financial Institutions. The software transmitted to the assessee company is installed on a server with identifying location and machine No. of the customer. As per the terms of agreements, the assessee company do not have any exclusive right to distribute the software products. It obtains orders on its own account for customers in India and thereafter places orders with non-resident companies. When the products are delivered to the assessee, it sells the products to the customers in India. The non-resident companies raise invoices on the assessee company and in turn, the assessee company raises separate invoices on the end users. It is to be seen that the orders are placed by customers and banks in India with the assessee company on a need based arrangement. The supply of the products are made by the non-resident companies only after approving the technicality of the software module and other necessary particulars. The software products are delivered to the assessee on a CD/any other media specified in the invoices. It is seen that the assessee does not have ownership in the copyright supplied by the non-resident companies. It is also to be seen that the assessee does not have any right to make copies of software or use the software anywhere else. The software is carefully marked for that particular customer to whom the assessee has sold the software product. From the above features, it is clear that the relationship subsisted between the assessee company and the non-resident companies was on a principal-to-principal basis. The risk of the failure of the software product is borne by the assessee company. The assessee company does not have any right to make changes in the software supplied by ACI Singapore and IRPL Australia. The assessee company is permitted to make only nominal/cosmetic modifications for the purpose of installing the software and running the software product in the system of customers. The software transferred by the non-resident companies is a standard software.
- The services rendered by the assessee in installing the software products in the system of its customers are in the nature of making the software compatible to the environment of the individual customers. The assessee company never becomes the owner of the software. The intellectual property in the software products always remains with the ACI Singapore and IRPL Australia.
- The decisions cited by the counsel appearing for the assessee support the above stated position of the case. In the decisions of *Dassault Systems K.K.* [2010] 322 ITR 125/188 Taxman 223 (AAR - New Delhi), *CIT* v. *Dynamic Vertical Software India (P.) Ltd.* [2011] 332 ITR 222/201 Taxman 78 (Mag.)/12 taxmann.com 431 (Delhi), *DIT* v. *Ericsson A.B.* [2012] 343 ITR 470/204 Taxman 192/[2011] 16 taxmann.com 371 (Delhi), the courts have held that where the assessee is purchasing software from the vendor and selling the same further in Indian market, the consideration paid for such purchase

could not be termed as "royalty". It is held that in order to constitute royalty, what is contemplated, is a payment that is depending on user of copyright and not a lump sum paid for the acquisition of copyrighted article.

- In the present appeals also, what has been purchased by the assessee from ACI Singapore and IRPL Australia was only copyrighted articles and not copyright, proper. Within the meaning of Indian Copyright Act, 1957, a copyright is an exclusive right to reproduce software including storage of the same in electronic machines with exclusive right to sell it. In the present case, the assessee does not have ownership of the software and does not have right to reproduce the said software. It is in fact only procuring copyrighted software product meant for a particular customer in India. The technical role of the assessee is limited in installing and running the software product in the system of customers in India. Therefore, the assessee is right in its contention that the payments made by the assessee company in the previous year relevant to the assessment years under appeal to non-resident companies are only purchase consideration for procuring copyrighted software products. They were not in the nature of Royalty.
- The assessee has procured copyrighted articles from the non-resident companies, ACI Singapore and IRPL Australia and payments made by the assessee company to those companies were not in the nature of Royalty, within the provisions of Indian Income-tax Act itself, it is necessary to dwell upon the detailed arguments made by the learned counsel appearing for the assessee, to examine the issue in the light of the provisions of the Act vis-à-vis terms of Indo-Singapore DTAA and Indo-Australia DTAA.
- In the instant case, there is a subsequent amendment with retrospective effect. In such cases, the assessee is constrained by impossibility of performance. The dictum *impossibiliun nulla obligation est,* states that there is no obligation to do impossible things. It is to be seen that the law does not compel to do the impossible as enshrined in the principle *lex non cogit ad impossibilia.* The jurisprudence has also accepted as a basic dictum, *impotentia excusat legem,* that impossibility is an excuse in law.
- When the assessee is constrained with the impossibility of performance, it is futile to argue that the assessee ought to have deducted tax at source in the assessment years earlier to amendment brought in section 9(1)(vi) by Finance Act, 2012. It is not possible to do or undo or to bell or unbell the past.
- Therefore, there was no requirement on the part of the assessee company to deduct tax at source as provided under section 195 of the Act. Accordingly, the assessing authority is not justified to invoke section 40(a)(i) and make disallowance in respect of the amounts paid by the assessee company to ACI Singapore and IRPL Australia. The disallowances are therefore, deleted.
- This issue raised by the assessee for all the assessment years regarding the disallowance under section 40(a)(i) is decided in favour of the assessee.
- The next issue raised by the assessee company, is that the lower authorities erred in concluding that ACI Singapore and IRPL Australia have Permanent Establishment (PE) in India and despite the

controversy regarding the payment as Royalty or not, those non-resident companies are liable to tax in India and as such, the assessee company was liable for deducting tax at source.

- The business model followed by the assessee company has already been explained in earlier paragraphs while considering the issue relating to the nature of payments made by the assessee company to non-resident companies. The assessee company, first obtains purchase orders from Indian customers and the assessee company places orders before the foreign suppliers. Once the foreign suppliers approve the requirements, copyrighted products are supplied by them and invoices are raised on the assessee company. In turn, the assessee company raises invoices on customer banks and deliver the software products to them as end users. It is stated in the relevant DTAAs that an enterprise of one of the Contracting States shall not be deemed to have a PE in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, where that person is acting in the ordinary course of the person's business as such a broker or agent. Another criteria to be considered is whether the entrepreneurial risks are to be borne by the person or by the enterprise the person represents. In the present case, the assessee company is carrying on business on its own status as an independent entity and the transactions entered into between the assessee company and non-resident companies are on a principal-to-principal basis. It is already stated in earlier paragraphs of the order that the assessee company bears the risk of failure of the contracts. The assessee functions on an independent basis. The non-resident companies transfer all the risk and rewards associated with software to the assessee company. As per the agreement, the assessee does not have any authority to procure/conclude contracts on behalf of ACI Singapore and IRPL Australia. The assessee company is also not engaged in identifying customers or securing contracts in India for foreign suppliers.
- In the above circumstances, it is very difficult to hold that the assessee is a dependent agent of ACI Singapore and IRPL Australia. The result is that the assessee company does not create a PE in India for ACI Singapore and IRPL Australia.
- Thus, the issue of PE is decided in favour of the assessee by holding that Singapore Company and Australian Company do not maintain any PE in India through the medium of the assessee company.