

IN THE HIGH COURT OF JUDICATURE AT MADRAS**DATED : 23.10.2018****CORAM****THE HONOURABLE MR.JUSTICE T.S.SIVAGNANAM
and
THE HONOURABLE MRS.JUSTICE V.BHAVANI SUBBAROYAN**Tax Case (Appeal) Nos.961 and 962 of 2008

M/s.Polaris Consulting & Services Ltd.,
(formerly known as M/s.Polaris Software Lab Limited),
No.34, IT Highway,
Navalur,
Chennai-603 103.

... Appellant in both
the Appeals

Cause title amended, vide order
dated 23.10.2018 in TCA
Nos.961 and 962 of 2008

vs.

The Deputy Commissioner
of Income Tax,
Company Circle V(2),
4th Floor, Main Building,
121, Nungambakkam High Road,
Nungambakkam,
Chennai-600 034

... Respondent in both
the Appeals

Tax Case Appeals filed under Section 260-A of the Income Tax Act, 1961 against the common order of the Income-Tax Appellate Tribunal, Chennai "B" Bench, dated 19.12.2007 in ITA Nos.394 and 395/Mds/2006, for the assessment years 2001-02 and 2002-03, respectively.

For Appellant : Mr.N.V.Balaji in both cases

For Respondent : Mrs.R.Hemalatha, in both cases

COMMON JUDGMENT

[Delivered by T.S.Sivagnanam, J.]

These appeals by the assessee are directed against the common order passed by the Income Tax Appellate Tribunal, Chennai "B" Bench, in ITA Nos.394 and 395/Mds/2006, for the assessment years 2001-02 and 2002-03, respectively.

2.The Appeals have been admitted, by the order dated 29.09.2008, on the following Substantial Questions of Law:

"1.Whether on the facts and in the circumstances of the case, the Tribunal was right in upholding the exclusion of expenditure incurred in foreign currency in export of software, from the purview of 'Export Turnover' for the purpose of computation of deduction under Section 10A of the Income Tax Act?

2. Whether on the facts and in the circumstances of the case, the Tribunal was right in law in directing the inclusion of the component of unrealised sale proceeds in total turnover while directing the exclusion of the same from export turnover?

3. Whether on the facts and in the circumstances of the case, the Tribunal was right in law in not directing the simultaneous exclusion or the inclusion of the sale proceeds in both the export as well as the total turnover in keeping with the principles of parity?

4. Whether on the facts and in the circumstances of the case, the Tribunal was right in law in setting aside the issue of deduction of expenditure in connection with the earning of dividend income and not allowing the same in full since all the required details to decide the same were before the Tribunal?

5. Whether on the facts and in the circumstances of the case, the Tribunal was right in law in not noting that the amendment to Section 14A of the Income Tax Act granting the

assessing officer the power to estimate expenditure incurred with the earning of income that was not taxable was prospective and not applicable to assessment years prior to 01.06.2007?"

3.We have heard Mr.N.V.Balaji, the learned counsel for the appellant/assessee and Mrs.R.Hemalatha, the learned Senior Standing Counsel for the respondent/Revenue.

4.First we take up the Substantial Question of Law Nos.2 and 3. The learned counsel for the Revenue submits that these questions have been answered by the Hon'ble Supreme Court in the decision of **the Commissioner of Income Tax, Central-III vs. HCL Technologies Ltd. [(2018) 93 Taxmann.com 33 (SC)]**, wherein, the Hon'ble Supreme Court has held as follows:

"14.In the above backdrop, we are of the opinion that the definition of total turnover given under Sections 80HCC and 80HHE cannot be adopted for the purpose of Section 10A as the technical meaning of total turnover, which does not envisage the reduction of any expenses from

the total amount, is to be taken into consideration for computing the deduction under Section 10A. When the meaning is clear, there is no necessity of importing the meaning of total turnover from the other provisions. If a term is defined under Section 2 of the IT Act, then the definition would be applicable to all the provisions wherein the same term appears. As the term 'total turnover' has been defined in the Explanation to Section 80HHC and 80HHE, wherein it has been clearly stated that "for the purposes of this Section only", it would be applicable only for the purpose of that Sections and not for the purpose of Section 10A. If denominator includes certain amount of certain type which numerator does not include, the formula would render undesirable results."

5. In the light of the decision rendered by the Hon'ble Supreme Court in **HCL Technologies Ltd., (supra)** the Substantial Question of Law Nos.(2) and (3) are answered in favour of the assessee.

6. Next we take up the Substantial Question of Law No.(1). We are called upon to decide as to whether the Tribunal was right in

confirming the orders passed by the Assessing Officer and the Commissioner of Income Tax (Appeals) (in short 'CITA'), excluding the expenditure incurred in foreign currency in export of software, from the purview of 'Export Turnover', for the purpose of computation of deduction under Section 10A of the Income Tax Act (the 'Act' for short).

7. The assessee is engaged in the business of software development and has set up its units in Software Technology Parks of India ('STPI' for short). For the assessment years 2001-02 and 2002-03, the assessee filed its return of income on 30.10.2001 and 29.01.2002 returning taxable income of Rs.1,00,01,129/- and Rs.9,17,13,730/-, respectively, after claiming deduction under Section 10A of the Act for an amount of Rs.53,04,24,403/- and Rs.45,80,46,512/- towards development of software business. The assessee claimed that they had incurred expenditure for an amount of Rs.45,43,07,883/- for the assessment year 2001-02 and Rs.64,27,91,100/- for the assessment year 2002-03, respectively, in foreign currency towards onsite software development projects. The Assessing Officer, while determining the deduction under Section 10A of the Act, excluded the expenditure incurred in foreign currency from

'export turnover' by alleging that the same was incurred for the purpose of rendering 'technical services'. The assessee's case was that the expenditure was incurred in connection with the onsite software development services performed by them. The stand taken by the assessee was not accepted by the Assessing Officer and he completed the assessments and adopted the foreign currency expenses from the notes to accounts in the financial statements and excluded the same from the term 'export turnover' to compute deduction under Section 10A of the Act, on the ground that the expenditure incurred on 'onsite development' was 'technical services'. The other issue pertains to allowability of expenses incurred in earning tax free income and the assessee contended that an adhoc estimation should not have been made and in this regard, the assessee referred to the power under Section 14A of the Act. We will deal with this issue while answering the Substantial Question of Law Nos.(4) and (5)

8.Reverting back to the order of the Assessing Officer in excluding the foreign currency expenses from the 'export turnover' on the ground that it was for 'technical services', the assessee preferred an appeal before the CITA. The CITA, by its order dated 29.11.2005, rejected the appeal and confirmed the finding of the Assessing Officer.

The assessee carried the matter to the Tribunal, by way of appeal, which was dismissed by the impugned order in so far as this issue is concerned.

9. We have perused the order passed by the Tribunal and the finding on this issue is in paragraph No.8. The Tribunal referred to clause (iv) to Explanation (2) to Section 10A of the Act, which defines 'export turnover' and referred to Explanation (2) to Section 10A of the Act, which defines the term 'computer software' and held that 'technical services' include development of software, testing of software, domestication of software and since the assessee is engaged in developing and providing software to meet the need base of their customers, the software development cannot be done without technical services and technical services is part and parcel of software development. The Tribunal proceeded to add that software is 'goods' and involve technical services and is part and parcel of rendering services; no software development is possible without technical services; software development and technical services are two faces of one coin and there cannot be software without rendering technical services and hence held that the finding of the Assessing Officer is justified as well as that of the CITA.

10.To be noted that the assessee, while contesting the appeal before the CITA as well as before the Tribunal, placed the entire materials as regards the development of the computer software. The assessee contended that they are engaged in the development of computer software programme, which is distinct from rendering of pure technical services, which would comprise of advice/consulting in relation to computer programmes. They are registered with STPI and as per the Registration Certificate, the assessee's activity is developing computer software and they are not considered as an exclusive technical service provider, as understood in the software industry parlance. The assessee proceeded to explain its activities, as per the agreement with its clients, for developing software, which consisted of eight steps, they are as follows:

"1.Scope-Ascertaining the requirement of the customer and undertaking an indepth study on the proposal.

2.Requirements definition –
Specification of the basic concepts and operation design, in relation to the final deliverable.

3.Designing-Designing of the deliverable, from a macro (overall flow of the integrated software) and micro perspective (designing of each module of the programme).

4.Application development – Developing the application (i.e. The modules and the related computer programmes and codes) as per the requirements of the customer.

5.Testing – Developer Integration Testing, System Integration testing and User Acceptance Testing; to ensure that the software developed works as required.

6.Defect fixing – Rectifying errors that have arisen during the testing process.

7.Production parallel run-Undertaking a dry run of the developed software system.

8.Customer user acceptance – Final acceptance of the Software developed.”

11.The assessee's contention was that activity No.7 (supra) is usually undertaken onsite at the client's location. Activity Nos.4 to 6 and 8 can happen offshore and/or onsite. The need to send the personnel of the assessee to clients' location arises based on the nature of project, its size and complexity and the requirements of the

client. Further they reiterated that all the activities are integral part of software development process and what is finally delivered to the client is computer software, which is essentially a computer programme and the deliverable does not comprise of any advice on the computer software/programme. The assessee produced copy of the Registration Certificate given by the STPI, sample contract for development of computer programme, sample Statement of Work (SOW) in relation to the sample contract, copies of filing with the STPI and some sample invoices and related SOFTEX filings. Thus, by placing heavy reliance on these materials, the assessee contended that it can be inferred that their business does not include rendering of any technical services on 'standalone basis'. Further, any service rendered, such as installation/training etc., is purely incidental to the activity of development of the computer programme, akin to a seller of an advanced machinery installing the same and training the user. The assessee placed reliance on the decision of the Hon'ble Supreme Court in the case of **TATA Consultancy Services vs. State of Andhra Pradesh [(2004) 271 ITR 401]**. By placing reliance on the said decision, the assessee contended that both branded software and unbranded/customised software have been held to be 'goods' by the Hon'ble Supreme Court and the computer software would be in the

nature of 'goods' and hence it will be erroneous to consider them as a provider of 'technical services'. Further, by referring to the customer contract and related statements of work and invoices, the assessee contended that it is engaged only in the activity of developing computer software and is not a technical services provider. The assessee also contended that there is a distinction in law between development of computer programme and rendering of technical services and in this regard referred to Section 10AA of the Act, defining 'export turnover'.

12. From the order passed by the CITA, we are able to see that the submissions made by the assessee, in the form of paper book, was forwarded to the Assessing Officer and a report was called for and the the Assessing Officer has also submitted his report, but we do not find any reference to such report in the order of the CITA nor it is clear whether the assessee was favoured with a copy of the report of the Assessing Officer.

13. Be that as it may. We may point out that the CITA did not endeavour to examine the scope of the agreement. In fact, certain observations made by the CITA would enure in favour of the assessee.

By way of illustration, in paragraph No.10(c) of the Order of the CITA, he would state that computer software cannot be defined or understood in a narrow sense of the term to mean only software in the form of product/goods as claimed. As the assessee is engaged in developing, transmitting and providing software to meet the needs and requirements of the clients, it encompasses providing all the relevant technical services necessary and attendant with the development and export of computer software. If this was the finding of the CITA, the resultant conclusion should have been that the assessee is only engaged in the development of the computer software and not rendering any technical services on 'standalone basis'. However, we find that the conclusion arrived at by the CITA stating that the assessee is rendering technical services is an incorrect conclusion not supported by any reasons. We would add by stating that the CITA was required to examine the documents produced by the assessee to find out as to whether there was any technical services rendered on 'standalone basis'. This is more so because, the CITA accepted that the 'development of software' encompasses 'providing of technical services'. Therefore, unless and until there was a material available in the hands of the CITA or the Assessing Officer to come to a conclusion that there is technical services on 'standalone basis' rendered by the

assessee, the Assessing Officer and the CITA were not justified in coming to a conclusion that the technical services were rendered by the assessee and the amounts paid need to be excluded.

14. Before the Tribunal, the assessee reiterated the submissions raised before the CITA and produced the technical documents as well as the scope of the work and the contract. However, the Tribunal, in our considered view, did not make an endeavour to examine as to whether the interpretation of CITA was just and proper and whether the relevant clauses in the agreement and the other documents were examined or not, but made a standalone statement that software development and technical services are two faces of one coin. We fail to understand as to whether the above is a statement made out of the personal knowledge of the Tribunal or whether it is a statement of law. If it is the statement of law, it should have been duly supported by reasons and we find none.

15. Admittedly, the decision of the Tribunal should revolve on the facts of a particular case. The Tribunal has not been established to give declaratory reliefs sans facts. Therefore, the primordial

requirement for the authorities as well as the Tribunal is to examine the nature of contract between the parties i.e. the assessee and the foreign entity.

16. On a perusal of the nature of the contract and the various steps, which have been enumerated therein, we find that the element of 'technical services', have been rendered as integral part of the software development process. There was no material available before the Assessing Officer to split up the transaction into two or to bisect the transaction to find out an element of 'technical services'. As rightly pointed out by the assessee, this exercise has been done by the Assessing Officer based on the notes to the accounts in the financial statements, which would be impermissible. What is required to be examined is the nature of services rendered by the assessee to the foreign entity. Thus, we are fully satisfied that the 'technical services' rendered by the assessee is not on a 'standalone basis', but it is an integral part of the software development and up to step No.(8), as mentioned above, the assessee is bound to render all assistance to the foreign entity. Therefore, the artificial split up of the transaction by the Assessing Officer, that too without any materials on his file, is wholly unsustainable.

17. For the above reasons, we are constrained to set aside the order passed by the Tribunal and answer the Substantial Question of Law No.1 in favour of the assessee.

18. With regard to Substantial Question of Law Nos.(4) and (5) are concerned, they pertain to whether the Tribunal was right in law in setting aside the issue of deduction of expenditure in connection with the earning of dividend income and not allowing the same in full, since all the required details to decide the same were not before the Tribunal. The substantive issue arises out of the above issue is whether the Tribunal was right in law in not noting that amendment to Section 14A of the Act, by insertion of Sub-Section (2), granting power to the Assessing Officer to estimate expenditure incurred with the earning of income was not taxable as it was introduced only with effect from 01.04.2007, by Finance Act, 2006.

19. On this issue, the Assessing Officer had directed the assessee to furnish the amount of expenditure incurred in relation to the dividend income or show cause as to why certain amount of expenditures should not be disallowed against its expenditure claim.

The assessee, vide letter dated 22.03.2005 submitted that the decision making powers towards investments are delegated to an investment committee comprising of one senior executive, non executive director and the tax consultant. It further stated that the committee meets once in quarter to consider the advice given by the investment consultant. The Assessing Officer took note of the decision of the Calcutta Bench of the Tribunal in the case of **DCIT vs. S.G.Investment & Industries Limited [(89 ITD 44)]**, wherein 5% of the gross dividend was allocated as expenses incurred by the company for the purpose of earning dividend, to calculate the deduction under Section 80M of the Act. The Assessing Officer also relied on the decision of the **Chennai Bench of the Tribunal in the case of Sundaram Finance Ltd., (I.T.A.Nos.845, 846 and 847/Mds/98)**, which is with regard to the proportion of their investments, dividend receipts Vis-a-Vis other investments, which are not immediately ascertainable. After considering the reply and taking note of the decision of the Tribunal, the Assessing Officer fixed 10% of the managerial remuneration as expenditure that was incurred in relation to earning of dividend income and accordingly, disallowed the expenses towards earning of exempt dividend income and the amount of Rs.6,76,598/- was disallowed under Section 14A of the Act as

expenditure incurred towards earning the exempt dividend income. On appeal before the CITA, the Appellate Authority took note of the decision of the Hon'ble Supreme Court in the case of **United General Trust (200 ITR 488)** and directed the Assessing Officer to restrict the dis-allowance to 2% of the dividend income, which would be 2% of Rs.2,61,75,567/- (Rs.5,23,511/-). Accordingly, the balance amount of Rs.1,54,087/- (Rs.6,76,598/- - Rs.5,23,511/-) was deleted. On appeal before the Tribunal, the Tribunal took note of the decision of the Special Bench, Chandigarh, in the case of **Panjab State Industrial Development Corporation Ltd., vs. DCIT (102 ITD 10)**, wherein it was held that only actual expenditure incurred in earning exempted income to be disallowed on actual basis and not on adhoc estimate basis. Accordingly, the finding rendered by the Assessing Officer was set aside and the matter was remanded to the Assessing Officer to disallow only actual expenditure incurred in connection with the earning of exempted dividend income. Thus, the order passed by the Tribunal is a remand order to the Assessing Officer for fresh examination.

20.Considering the facts of the case as well as the stand taken by the assessee before the Assessing Officer, vide letter dated

23.05.2005, we are of the view that there is no error in the order passed by the Tribunal in remanding the matter to the Assessing Officer for a fresh look.

21. The learned Counsel for the Assessee contended that Section 14A(2) could not have been invoked, as during the relevant assessment year there is no power vested with the Assessing Officer on account of the fact that Section 14A(2) of the Act was inserted by Finance Act, 2006, with effect from 01.04.2007. Therefore, it is the submission that this provision cannot be made applicable to the assessment years prior to the said date. We find that such a ground was never canvassed either before the Assessing Officer or before the CITA or before the Tribunal. However, we do not wish to foreclose the rights of the assessee since it is a jurisdictional issue touching upon the jurisdiction of the Assessing Officer to invoke such a power. Thus, while confirming the order passed by the Tribunal in remanding the matter for fresh consideration to the Assessing Officer, we direct the assessee to raise the contention which was raised before us with regard to the jurisdiction of the Assessing Officer to invoke Section 14A(2) of the Act and the same shall also be considered by the Assessing Officer along with other points in accordance with law.

22. In the result, the Substantial Question of Law Nos.(4) & (5) are left unanswered and the Assessing Officer is directed to take a fresh decision in the matter.

In fine, the appeals are partly allowed and the Substantial Questions of Law are answered as under:

(1) Substantial Question of Law (1) is answered in favour of the assessee and it is held that the Tribunal was not right in law in excluding the expenditure incurred in foreign currency in export of software, from the purview of 'Export Turnover' for the purpose of computation of deduction under Section 10A of the Income Tax Act, 1961.

(2) Substantial Question of Law Nos.(2) and (3) are answered in favour of the assessee in terms of the decision of the Hon'ble Supreme Court in the case of **Commissioner of Income Tax, Central-III vs. HCL Technologies Ltd., [(2018) 93 Taxmann.com 33 (SC)]**.

(3) For the reasons assigned in the preceding paragraphs, the order of remand passed by the Tribunal is confirmed, giving liberty to the assessee to raise the contention with regard to the jurisdiction of the Assessing Officer to invoke Section 14A(2) of the Act along with other issues for which the Tribunal has remanded. Accordingly, Substantial Question of Law Nos.(4) and (5) are left open.

No costs.

msk

Index:Yes/No

To

The Income-Tax appellate Tribunal Chennai "A" Bench
Chennai.

[T.S.S., J.] [V.B.S., J.]
23.10.2018

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**T.S.Sivagnanam, J.
and
V.Bhavani Subbaroyan, J.**

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