



IN THE HIGH COURT OF KARNATAKA AT BENGALURU

Dated this the 29th day of July, 2015

Present

THE HON'BLE MR JUSTICE VINEET SARAN

&

THE HON'BLE MR JUSTICE ARAVIND KUMAR

Income Tax Appeals 263 – 264 / 2014

Between

- 1 Commissioner of Income Tax III
Central Revenue Buildings
Queens Road, Bangalore 1
- 2 Deputy Commissioner of Income Tax
Circle 12 (1), Bangalore

Appellants

(By Sri E I Sanmathi, Adv.)

And

M/s Mphasis Software & Service India Pvt Ltd
Bangalore 560 093

Respondent

(By Sri T Suryanarayana a/w Ms Tanmaye
Rajkumar, Adv. For M/s King & Patridge, Adv.)

Appeals are filed under S.260 A of the Income Tax Act praying to set aside the order dated 20.12.2013 in ITA 1209 & 1168/Bang/12 by the ITAT, A Bench, Bangalore for the assessment year 2007-08.

Appeals coming on for hearing this day, ***Vineet Saran J***, delivered the following:

JUDGMENT

The moot question in these appeals is whether an assessee can sub-contract a part of its software development work to an agency outside India and yet claim the income there-from as its income eligible for deduction under Section 10A of the Income Tax Act, 1961 (for short 'Act').

These appeals are filed by the Revenue challenging the order of the Income Tax Appellate Tribunal by which the assessee/respondent has been held eligible for deduction under Section 10A of the Act.

The assessee company is engaged in the business of development of software and is also rendering business process outsourcing services. For relevant assessment year 2007-08, the assessee had declared an income of Rs.2,52,18,171/-. However, during the assessment proceedings under Section 143(3) of the Act, the Assessing Officer found that the assessee had claimed a sum of Rs.14,58,39,507/- as deduction under Section 10A of the Act in respect of its Mumbai unit. The Assessing Officer, in its assessment order, disallowed a portion of the deduction claimed by the assessee.

Out of the total earned revenue of Rs.81,33,03,687/- declared by the assessee during the assessment period, a sum of Rs.9,02,91,219/- was domestic revenue and balance of Rs.72,30,12,268/- was from export of computer software. The Assessing Officer had disallowed certain claims under section 10A of the Act on account of 'on-site' work sub-contracted to Associated Enterprise (for short 'AE') and also exclusion of telecommunication and traveling expenses incurred in foreign currency towards delivery of software in export term. In appeal filed by the assessee, the appellate Commissioner, after following Judgment of this court in the case of ***Commissioner of Income Tax Vs Tata Elxsi Ltd. - (2012) 349 ITR 98 (Kar)***, directed the Assessing Officer to exclude telecommunication and traveling expenses incurred in foreign currency towards delivery of software in export term under Section 10A of the Act. The disallowance under Section 10A claimed by the assessee on account of 'on-site' work sub-contracted to AE, was confirmed by the appellate Commissioner. Challenging the said order, Revenue filed an appeal before the Tribunal with regard to the relief which was granted by the appellate Commissioner. Another appeal was filed by the assessee against the confirmation of disallowance made by the Assessing Officer. The Tribunal dismissed the appeal of the Revenue and allowed the claim of the assessee and granted benefit under

Section 10A for the 'on-site' work carried out by the assessee through its sub-contractor i.e., AE. Aggrieved by the said order, these appeals have been filed, which have been admitted on the following question of law:

“Whether on the facts and in the circumstances of the case, the Tribunal was justified in law in holding that the income earned by the assessee through the development of the software by the Associated Enterprise of the assessee is eligible for deduction under Section 10A without appreciating the detailed findings of the Assessing Officer on the issue?”

We have heard Sri E I Sanmathi, learned counsel for appellant-Revenue as well as Sri T Suryanarayan, learned counsel for respondent/assessee at length and have perused the record.

Briefly the work carried by the respondent/assessee is of two types, which is described as under:

- (a) **Type-1** - Composite contracts for performing both offshore and onsite services entered by AE with the end customer and offshore work sub-contracted to the company. The company has earned an amount of Rs.70,64,43,329/- under this model.

*(b) **Type-2** – Composite contracts for performing both offshore and onsite services entered by the company with the end customer and onsite work sub-contracted to AEs. The company has earned an amount of Rs.1,65,69,138/- under this model”.*

For clarity, it may be explained here that ‘off-shore’ activities of the assessee are those which the assessee carries out at the specified place of work in India; whereas ‘on-site’ activities are those which the assessee performs or carries outside India at the site of the end customer.

As regards Type-1, there is no dispute in this appeal. However for the sake of clarity we may mention that in Type-I cases, the AE procures the contract from the end customer and sub-contracts a part of the same to the assessee company and such part of the contract is performed by the assessee company in India as its ‘off-shore’ activity and remaining work is carried out by the AE at its own end. For such part of the contract which has been performed by the assessee in India as its ‘off-shore’ activity, it has been given benefit under Section 10A of the Act, regarding which there is no dispute.

It is the earning from Type-2 contracts which is in question in this appeal. In such contracts, the assessee enters into agreement with the end customer according to which, after performing the 'off shore' activities in India, the assessee sub-contracts part of the contract to the AE situated outside India for 'on-site' activities. In the present case, the assessee company has earned an amount of Rs.1,65,69,138/- under this Type-2 contract which is under consideration in this appeal.

Section 10A of the Act provides for deduction of such profits and gains as are derived from export of articles or things or computer software which shall be allowed from the total income of the assessee. Sub-section (2) of Section 10A provides for the applicability of Section only when certain conditions are fulfilled. Explanation-2 of the said Section gives definition of certain phrases and Explanation-3 clarifies that the profits and gains derived from 'on-site' development of computer software outside India shall be deemed to be profits and gains derived from export of computer software outside India. Sub-section (1) of Section 10A and relevant portion of sub-section (2) as well as Explanation-3 are reproduced below:

Section 10A

Sub-section (1)

“Subject to the provisions of this section, a deduction of such profits and gains as are derived by an undertaking from the export of articles or things or computer software for a period of ten consecutive assessment years beginning with the assessment year relevant to the previous year in which the undertaking begins to manufacture or produce such articles or things or computer software, as the case may be, shall be allowed from the total income of the assessee.”

Sub-section (2)

“This section applies to any undertaking which fulfils all the following conditions namely:

(i) it has begun or begins to manufacture or produce articles or things or computer software during the previous year relevant to the assessment year-

- (a) commencing on or after the 1st day of April, 1981, in any free trade zone; or*
- (b) commencing on or after the 1st day of April, 1994, in any electronic hardware technology park, or, as the case may be, software technology park;*
- (c) commencing on or after the 1st day of April, 2001 in any special economic zone;*

Explanation 3 – *For the removal of doubts, it is hereby declared that the profits and gains derived from on site development of computer software (including services for development of software) outside India shall be deemed to be the profits and gains derived from the export of computer software outside India.”*

Submission of learned counsel for appellant/Revenue is that though there is a finding that supervision and control of the work carried out by the AE for the ‘on-site’ work remains with the assessee as per the Master Service Agreement (for short ‘MSA’) entered into between the assessee and AE, but as the ‘on-site’ development work outside India was not carried out by the assessee through its own personnel, the assessee would not be entitled to the benefit of Section 10A with regard to such portion of ‘on-site’ work. It is contended that unless the manufacture or production is done by the assessee at the free trade zone, it would not be entitled to any benefit under the said Section because ‘on-site’ work, in the present case, has been carried out by the assessee through its AE outside India, without involvement of any of its own (assessee) personnel. Sri Sanmathi, learned counsel for appellant has stated that the assessee has, in its written statement, admitted that the entire ‘on-site’ work had been transferred to AE and the assessee only

retained supervision and control (not manufacture and production) with itself. Learned counsel has relied on the findings recorded by the Assessing Officer as well as appellate Commissioner in this regard and has submitted that such findings which have been recorded by the Tribunal are against the facts on record and that the findings of the Assessing Officer and the appellate Commissioner be confirmed. He has contended that the conditions laid down in sub-section (2) of Section 10A are not satisfied in the present case, and for this reason also the benefit of said Section cannot be given to the assessee. He contends that the provision of Section 10A would apply only in case of the assessee manufacturing or producing in its unit in India and if the benefit is extended any further, it would disturb the whole concept and purpose of said Section. In support of his contention, he also relies on the Circulars issued by Central Board of Direct Taxes (CBDT) on 23.11.1994 and 17.01.2013, which shall be dealt at the time of considering the submissions. Sri Sanmathi, learned counsel for appellant has submitted that for granting the benefit of Section 10A, unless the assessee fulfils the conditions, which are to be strictly construed, no benefit could be granted to the assessee.

Per contra, Sri Suryanarayana, learned counsel for respondent/assessee has submitted that it is wrong for the Revenue to assume that nothing under the contract was performed by the assessee in India. He contends that the dispute in the present case is with regard to such part of the contract which was performed 'on-site' by the AE outside India and not with regard to 'off-shore' work carried out by the assessee in India. It has been submitted that the object of introducing Section 10A of the Act was to encourage exports for generating foreign exchange, as would be clear from the Budget Speech delivered by the then Finance Minister at the time of introduction of Section 10A of the Act and since by the 'off-shore' work carried by the assessee and as well as 'on-site' work through the AE, would both generate foreign exchange or bring foreign exchange to the country, assessee would be entitled to benefit of Section 10A of the Act and same would not disturb the concept or the purpose of the said Section, as has been contended by learned counsel for appellant/Revenue, because in either case, the foreign exchange would be earned for the country. He has submitted that Circulars of 1994 and 2013 issued by the CBDT are in favour of the assessee and not against it, as neither in the Section nor in the Explanation or the Circulars has it been anywhere mentioned that 'on-site' work has to be carried out by the assessee through its own

personnel, and in this regard, the contention is, that nothing should be read into the said Section by the authorities or this Court while interpreting Section 10A of the Act. It has been submitted that the assessee fulfils all the conditions laid down under Section 10A, which are undisputedly liable to be construed very strictly, but once the conditions are fulfilled by the assessee, a liberal interpretation has to be given by Courts for granting the benefit under the Section.

Section 10A of the Act is a beneficial piece of legislation i.e., it is for the benefit of the assessee, in order to encourage setting up of businesses which earn foreign exchange. Same has been introduced by the legislature in the year 1981 with the clear intention to grant benefit under the Income Tax Act to such units which earn foreign exchange. The Finance Minister while introducing the bill for insertion of a new Section 10A for granting a complete tax holiday for industrial units in the free trade zones had stated that it was “*with a view to encouraging the establishment of **export-oriented industries** in the free trade zone, the Finance Act has inserted a new section 10A in the Income-tax Act which makes special provision in respect of newly established industrial undertakings in free trade zones.*”

While interpreting a beneficial piece of legislation, though this Court has to be very strict in ensuring the compliance of the conditions laid down for granting such benefit, but once the Court arrives at a conclusion that the assessee fulfils the conditions, the same being for the benefit of the assessee, should be interpreted liberally and endeavour of the Court should always be to grant the benefit and not to deny the same.

Much emphasis has been laid by learned counsel for the Revenue that the entire contract in question was transferred by the assessee to the AE and thus, according to the Revenue, the entire work was carried 'on-site' by the AE and only the supervision and control remained with the assessee and no work was carried out by the assessee 'off-shore' in India to claim benefit under section 10A of the Act. He thus contends that under Type-2 contract, when no work is carried out by the assessee in India, it would not be entitled to the benefit of Section 10A of the Act for the simple reason that the assessee would then be a mere trader or broker who gets the contract and passes it on to the AE and nothing is done by it as its 'off-shore' activity in India. Sri Sanmathi, learned counsel for appellant could, however, not point out from the order of Assessing Officer or the appellate Commissioner that in performance of

the contract, no 'off-shore' activity was carried out by the assessee in India.

We may notice here that the assessee was given a notice by the Assessing Officer, in which the assessee was asked to explain with regard to such part of the software development which was undertaken by the AE for 'on-site' development. The relevant extract of the notice dated 20.12.2010 is reproduced below :

"Your company followed two Business models. One among the two models is such that the onsite software development activity is given on sub-contract to your AEs and other companies. Accordingly, the Mumbai unit reflects such export proceeds in its turnover. It was stated that onsite entity operates purely as a contract services provider, without assuming any related risks and functions attached to the contractors. You have also submitted that sub-contractor charges were paid by this unit in foreign currency vide letter dt.15.12.2010. The relevant financials are given as under:-

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From the above chart, it is clear that the some part of software development (onsite part) has been

undertaken by the AEs. Accordingly, parts of the turnover of the Mumbai unit were arrived on account of the work executed by the AEs. In other words, you have not carried out the software development at various client locations involving your employees. Admittedly, it is a software sub-contract work. In that situation the profit shown in these units cannot be stated as profits derived by you out of the export turnover related to computer software development in terms of explanation 3 under section 10A of the IT Act, 1961.

In view of the above, you are asked to show cause as to why proportionate profits (in the proportion of sub-contract charges out software expenses) should not be excluded from eligible profits of each unit for computing 10A deduction.”

A plain reading of the said notice would make it clear that the Assessing Officer has himself accepted that it was only some part of the software development which was carried out ‘on-site’ by the assessee, meaning thereby that the other part of the contract was carried out by the assessee ‘off-shore’ i.e., at its site or workplace in India. Such being the position, we are of the clear opinion that it was not the entire contract which was passed on to the AE by the assessee but some part of

it was done by the assessee itself in India as 'off-shore' work and the remaining part was sub-contracted to the AE for 'on-site' work. It may be relevant to notice here that the sub-contracted part carried out 'on-site' outside India by the sub-contractor, did not have the personnel of the assessee but admittedly the supervision and control (with regard to the quality and specifications of the work to be done) was with the assessee through its Project Manager, as would be clear from the terms of the MSA. In fact, assessee had also right to reject such activities of AE, if it did not conform to specification agreed to it under the contract.

We have also gone through the provisions of Master Service Agreement which was entered into between the assessee and the AE, which admittedly was a group company of the assessee. The terms of the MSA relate to the 'on-site' work which was to be carried out by the AE, on behalf of the assessee. In such agreement, the task order was to be given by the assessee to the AE, for which the responsibility was of the AE, subject to the supervision and all pervasive control of the assessee. The product which was to be delivered would be that of the assessee, after payment was made to the AE. As such, it is clear that the AE was carrying on the work under the supervision and control of the

assessee, as well as on behalf of the assessee. The proprietorship of the product was also to remain with the assessee.

We may explain the transaction with an example. If a total contract (Type II Model) was procured by the assessee, say for an amount of Rs.10 crores, for carrying on the work of the end customer, out of which 'off shore' work was to be carried out by the assessee to the extent of, say Rs.8 crores and the remaining 'on-site' work of Rs.2 crores was sub-contracted to the AE, then, the question for consideration would be with regard to the profits earned from 'on-site' development work of Rs.2 crores which had been sub-contracted to the AE. There is, admittedly, no dispute with regard to profits earned from 'off-shore' work carried out by the assessee, amounting to Rs.8 crores. For such 'on-site' development work, the assessee has an option of sending its own personnel for which it will have to have an establishment at the place of the end customer situate outside India, for which it may have to incur traveling and other expenses for its personnel to go 'on-site' outside India for performing such work; or on the other hand, another option for the assessee is of sub-contracting the 'on-site' work to an AE which has to work under the supervision and all pervasive control of the assessee and carry out the 'on-site' work on behalf of the assessee at the

place of the end customer. The payment for 'on-site' work done would, in such a case, be made by the assessee to the AE and not by the end customer, who would make the entire payment of Rs 10 crores to the assessee. There could be a marginal difference in the expenses which the assessee would have incurred if it would have carried out the 'on-site' work through its own personnel as against the payment which is made to the AE for doing such work, but such decision of passing on part of the work to be done by a sub-contractor (AE) or not, has to be taken by the assessee as a prudent businessman keeping in view the business necessities and the comparative cost effectiveness and it is not for the Courts or the Income Tax authorities to decide the same. Even by executing the contract as per the given example, the benefit of foreign exchange being brought into the country would still be there and thus the object of insertion of Section 10A would be achieved.

The question which now remains to be answered by this Court is that would it be permissible for the benefit under Section 10A to be given to the assessee if the 'on-site' work carried outside the country is not done through its own personnel. For this, we may refer to Explanation-3 to Section 10A, which is clarificatory in nature and does not limit the benefit provided by Section 10A but only enlarges its

scope. In the said explanation, it is provided that the profits and gains derived from 'on-site' development of computer software outside India would be deemed to be profits and gains from the export of computer software outside India. By this explanation, it is clear that the profits and gains which are derived from 'on-site' development of computer software would also be covered under Section 10A of the Act. What we notice is that the main Section 10A nowhere provides that the 'on-site' work of software development should be carried out by the own personnel of the assessee. As such, it would be wrong to deny the benefit under the said section merely because the 'on-site' work was not done by the personnel of the assessee as we are of the firm view that authorities or Courts are not to read something into the provision of law which is not there in the Section or its Explanation; more so, in the case of a beneficial piece of legislation, as is the present one.

With regard to denial of benefit of Section 10A because of the personnel of the assessee having not performed the 'on-site' work, emphasis has been laid by the learned counsel for Revenue on the Circular No.694 dated 23.11.1994 issued by the Central Board of Direct Taxes (CBDT). The relevant paragraph 7 of the said Circular is reproduced below:

“Similarly, for the purpose of s.10A or 10B, as long as a unit in the EPZ/EOU/STP itself produces computer programmes and exports them, it should not matter whether the programme is actually written within the premises of the unit. It is, accordingly, clarified that, where a unit in the EPZ/EOU/STP develops software sur place, that is, at the client’s site abroad, such unit should not be denied the tax holiday under s.10A or 10B on the ground that it was prepared on site, as long as the software is a product of the unit, i.e., it is produced by the unit.”

In our view, the said Circular is in favour of the assessee and not against it. Learned counsel for Revenue has laid much stress on the wordings that the assessee unit should have produced the computer programme by itself or that it should be produced by the unit of the assessee itself. There is no denial of the fact that even the ‘on-site’ work of computer software development has been done under the direct supervision and control of the assessee through the AE, which would be nothing but on behalf of the assessee ‘itself’. As indicated in the said Circular, ‘itself’ would not mean that personnel of the assessee will have to carry out the work. However, it should be the product of the assessee and since in the present case, the ownership of the product (software), after payment by the assessee for the work done by the AE, would be of

the assessee, the same would be nothing but the product of the assessee and not a product of AE. The other Circular dated 17.1.2013 on which the learned counsel for Revenue has relied upon, also does not anywhere specify that the personnel of the assessee should only be deputed for carrying on the work. Even otherwise, the Circulars issued by the CBDT cannot override the provisions of the Act. If the main Section of the Act does not provide for the benefit to be given only to such units or exporters who carry out 'on-site' work through its own personnel, the same cannot be read into the provisions of Section 10A of the Act.

The sole ground for denying the benefit of section 10A by the Assessing Officer or the appellate Commissioner is that 'on-site' development of computer software has not been executed by the assessee itself through its own personnel. Such interpretation of the Section cannot be accepted because what is not there in the Section or the Explanation, cannot be read into by the authorities or by this Court.

Learned counsel for the Revenue has also submitted that the conditions laid down in sub-section (2) of Section 10A of the Act have not been fulfilled by the assessee, which have to be strictly construed and as such, the assessee would not be entitled to the benefit of Section

10A. According to the learned counsel for the Revenue, the production or manufacture should be in any free trade zone and if the same is not done in the free trade zone, the assessee would not get benefit of such manufacture or produce. The benefit is site specific and not project specific. According to him, only such production or manufacture which is carried at the site of the assessee's unit in the free trade zone would alone be eligible for the benefit under section 10A and not such production or manufacture which has been carried outside or by a third party. A mere reading of sub-section (2) would not be sufficient. The entire section has to be read in conjunction with Explanation-3, which clarifies that profits and gains derived from 'on-site' development of software outside India shall also be deemed to be profits and gains derived from the export of software outside India, and same would also be entitled to such benefit. If the interpretation, as contended by the Revenue is accepted, the very purpose of inserting Explanation 3 to Section 10A of the Act would be lost or frustrated.

Lastly, learned counsel for the Revenue has contended that there is no nexus between 'off-shore' production by the assessee in India and 'on-site' production by the AE outside India. He relies on the finding of the Assessing Officer given in this regard, which is as under:

*“Hence the profits and gains derived from Model No.2 cannot be deemed to be the profits and gains of the assessee company w.r. to export of computer software outside India. To be precise, the deduction is available only if the on-site development of computer software is **executed by the assessee itself through its own personnel**. The sub-contracting of “On site” part of the software development to other entity and the resultant profit is not covered in Explanation 3 to Section 10A of IT Act and such profits and gains would not qualify for deduction under section 10A of IT Act.*

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From the discussion on relevant paras of the MSA, it is further brought on record that the execution of off-shore part of the contract had got nothing to do with the on site work executed from abroad by the AEs. The execution of off shore part of the contract was on a separate channel and the AEs were never involved in any implementation of the product developed by the assessee in India. The AEs worked independently with its own personnel and created its own intellectual properties i.e., software product (Deliverables).

Hence it is abundantly clear that the assessee never involved either directly or indirectly in the on-site software development activity executed by the AEs. Even if it is involved administratively for co-ordination

between the AEs and its clients in getting the contract executed, the assessee shall not be eligible for deduction since the core function of software development function was executed by the AEs. Neither the plant and machinery nor the employees of the STP Unit were utilized in developing the software in On-site Locations abroad. The Sub-contract work executed by AEs did not have any Indian connection on these works executed by it. The assessee has attempted to claim exemption on the work executed by a foreign entity over which the provisions of Indian Income Tax Act, 1961 are not applicable.”

The Tribunal has considered this aspect and has come to the conclusion that the assessee company was solely responsible for the risks and rewards arising out of the sub-contract to the AE. It has given a clear finding that *“the assessee is solely responsible for the discharge of its obligations under the contract to the customer and the sub-contractor has no say in the matter. It is seen from the Master Services Agreement that it is the assessee which is under an obligation to discharge its obligation of specific requirement of the customer and in pursuance thereof, to pass on the specification of the products to the AE and also to reserve right to reject the product if the AE does not produce the product in conformity with the product as given in the task order.*

Therefore, it can be safely concluded that the development of the software by the AE is under the supervision and control of the assessee”.

From the record it is not borne out that the entire ‘on-site’ work has been sub-contracted to the AE. The MSA provides for the AE to work under total supervision and control of the assessee. The software to be produced by the assessee during its ‘on-site’ development has to be as per the specifications given by the assessee. The AE has no concern or direct dealing with the end customer. The assessee provides all relevant information and inputs to the AE on behalf of the end customer. The AE is admittedly answerable to the assessee and not the end customer. In such nature of the work which is carried on by the AE on behalf of the assessee, it cannot be said that there is no nexus between ‘off-shore’ development and ‘on-site’ development.

In view of the above discussion, we are of the opinion that in the facts of the present case, the income earned by the assessee through ‘on-site’ development of software by the AE on behalf of the assessee, would be eligible for deduction under Section 10A of the Act.

The substantial question of law is, thus, answered in favour of the assessee and against the Revenue.

The appeals stand dismissed. No order as to costs.

Sd/-
Judge

Sd/-
Judge

Sbn/An