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E-PUBLICATION ON TECHNOLOGY INDUSTRY

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Foreword

Since the evolution of the technology industry, we Chartered Accountants have embraced and equipped ourselves in providing the best of services to industry. In the past one year, the digital wave has become stronger and the business case for the adoption of new technologies has gained further momentum. This is an ongoing process and there is little doubt that the technology industry will continue to shape and evolve all aspects of our professional lives over the coming years.

Consumption of IT related products – hardware and software – are increasing exponentially indicating continuous growth for companies in this sector. The speed of growth has also attracted a large number of investments at both the individual as well as business/corporate level.

With growth comes accountability and our expertise plays a vital role towards ensuring that expansion takes place in a systematic manner, keeping in mind compliance with relevant notifications and updates as per the Government.

Considering members' interest in this industry and looking at the size of the industry, I am pleased to present this e-publication on the 'Technology Industry' whereby members working with this industry or providing consultancy services will be immensely benefited by understanding the nuances, intricacies and applicability of various laws to this industry.

I would like to thank CA Anand Jakhotiya, Treasurer, WIRC and CA Umesh Sharma, RCM, WIRC, for contributing their valuable time and expertise for co-ordinating and finalising this publication.

We take this opportunity to acknowledge our sincere gratitude to the entire contributing team comprising CA Ravi Kumar Somani, CA Neelesh Khandelwal, CA Chandrashekhar Sarda, CA Chandan Lahoti, CA Saket Rathi, CA Gokul Rathi, CA Arpit Sodhani, CA Manoj Malpani, CA Anket Dodya, CA Shubham Charkha, CA Sachin Parkale and CA Karan Chandwani for their ceaseless efforts for making this very insightful publication amidst tight deadlines.

I recognize the contributions and efforts put in by Rajkot, Sangli, Nashik and Pune Branch of WIRC, by engaging in research activity and submitting the research papers to WIRC, to be referred for this publication.

I am sure that our members, students as well as finance professionals will find the content printed here very helpful and would derive maximum benefit from this e-publication.

CA. Lalit Bajaj
Chairman, WIRC

Preface

Respected Readers,

Season's Greetings !!!

It gives us immense pleasure to launch the third sector specific e-publication and the subject is "Technology" as conceptualised by our Chairman CA Lalit Bajaj.

This publication is possible only because of the hardworking team of contributors. It is rightly said "When Team works...Dreams work". Only because of hard, untiring efforts of all contributors inspite of pressure of deadlines today we are in position to get thorough knowledge on this subject through this e-publication.

I am highly grateful for the untiring efforts of my colleagues RCM CA Umesh Sharma and Publication Team Leader CA Ravi Kumar Somani well supported by contributors CA Neelesh Khandelwal, CA Chandrashekhar Sarda, CA Chandan Lahoti, CA Saket Rathi, CA Gokul Rathi, CA Arpit Sodhani, CA Manoj Malpani, CA Anket Dodya, CA Shubham Charkha, CA Sachin Parkale and CA Karan Chandwani.

This Team has covered all crucial aspects impacting the Sector and has given us a holistic view in a crisp manner.

Wishing everyone Happy Learning and a Healthy Life !!!

CA. Anand R. Jakhotiya
Treasurer, WIRC

Preface

"The advance of technology is based on making it fit in so that you don't really even notice it, so it's part of everyday life." Remarkable words by Mr. Bill Gates, make us realize how we have evolved around technology so efficiently, that we don't even realize how much we have developed & come far from the traditional way of living. Same goes with our work life. Technology is an ocean today, out of which you need to choose what is exactly required by you, and what is not.

In our CA Fraternity as well, one needs to have thorough knowledge of using technology for staying updated with the processes, and if one is not able to cope up with technology, will anyways be outdated in the industry. We all have cursed the COVID times, but we need to accept it taught us all one thing, that the world stops for none, and work should stop for none as well. Technology can do miracles, we just need to know our way through it. The Artificial Intelligence will boost auditors process to analyze critical data, errors & frauds therein. Automation of process will reduce the paper-work, and take the society to an eco-friendly world, easing the process flow as well. There will be no boundaries to work, as all the data will be available on your fingertips with the help of internet.

I appreciate the efforts of my CA colleagues who have taken the efforts of enlightening us with this e-publication on technology of WIRC, & take us further in this technological journey.

CA Umesh Sharma
RCM, WIRC

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BACKGROUND AND INTRODUCTION:

The Effects of Technological Change on the global economic structure are creating immense transformations in the way companies and nations organize production, trade goods, invest capital, and develop new products and processes. Sophisticated information technologies permit instantaneous communication among the far-flung operations of global enterprises. New materials are revolutionizing sectors as diverse as construction and communications. Advanced manufacturing technologies have altered longstanding patterns of productivity and employment. All this has both created and mandated greater interdependence among firms and nations. The rapid rate of innovation and the dynamics of technology flows mean that comparative advantage is short-lived. To maximize returns, arrangements such as transnational mergers and shared production agreements are sought to bring together partners with complementary interests and strengths. This permits both developed and developing countries to harness technology more efficiently, with the expectation of creating higher standards of living for all involved. Rapid technological innovation and the proliferation of transnational organizations are driving the formation of a global economy that sometimes conflicts with nationalistic concerns about maintaining comparative advantage and competitiveness. It is indeed a time of transition for firms and governments alike.

Throughout the pandemic, there has been a hunger for normalcy. Whether it is a desire to return to normal or an attempt to define the new normal, people have been searching for some semblance of stability. At some point—possibly during 2021—there will be fewer hoops to jump through directly related to COVID-19. For businesses thinking about the long term, though, the concept of an established pattern will be more elusive. Instead of setting hard rules for how the business will operate, organizations must now juggle a multitude of options, from employee locations to supply chain components to customer demands. In some ways, companies can wipe the slate clean and consider how they want to structure things now that there are new options available. On the other hand, too much reliance on structure can quickly become a liability if the landscape changes again. Overall, business should be focused on two key qualities. First is flexibility, building an architecture and a workflow that can adapt to any number of changes in the future. Second is resilience, being able to withstand disruptions from any angle. These two qualities are not new by any means, but they have become more important than ever for digital organizations.

GLOBAL SCENARIO – CLOUD IS KING:

As we enter a new decade, one thing is certain: **cloud adoption** will continue to rise as companies embrace flexible consumption through both hybrid and multicloud environments.

For many companies, the **hybrid-cloud** approach serves as an interim step in the long process of digital transformation. Due to several factors, including a reliance on legacy systems and the need to comply with corporate regulations, many organizations have opted to place their workloads on both private and public clouds. In fact, Gartner predicts that by 2020, 90 percent of organizations will adopt hybrid infrastructure management.

In addition to hybrid cloud, enterprises are increasingly adopting multicloud solutions that combine cloud services from multiple providers. According to a 2019 Kentik report, 58 percent of businesses are already using a combination of Amazon Web Services (AWS), Microsoft Azure, and Google Cloud in their multicloud networks.

This growing concern about **cloud security** presents providers with a unique opportunity. In many cases, cloud providers possess far greater security capabilities and expertise than most businesses could ever hope to develop themselves. For this reason, security has become a key driver of hybrid cloud adoption. Cloud-based security solutions continue to gain traction across many industries, especially in financial services, government, and other highly regulated sectors.

Cloud-based solutions also provide the most popular path for acquiring **AI capabilities.** Increasingly, enterprises are viewing AI as essential to their continued innovation and growth. The percentage of executives rating AI as "critically important" is expected to surge globally over the next two years. As a result, they're investing in AI—and getting a return. In fact, 51 percent respondents to a survey conducted by Deloitte expected to boost their AI investments by 10 percent or more in 2020, and 80 percent indicated that their AI investments had driven return on investments (ROI) of 10 percent or more.

With the explosion of Internet of Things (IoT) devices, combined with the increased portability of computing power and AI-driven tools, the time is right for **edge computing** to experience significant growth. Consider this: according to Gartner, companies generated a modest 10 percent of their data outside a data center or cloud in 2019; this amount is expected to reach 75 percent in the next six years. As a result, IDC predicts that in three years, 45 percent of IoT-generated data will be stored, processed, analyzed, and acted upon close to or at the edge of networks. This will largely be driven by IoT applications across industries like manufacturing, retail, healthcare, energy, financial services, logistics, and agriculture.

We expect to see more and more portable and fixed networks with local high-capacity, low-latency (real-time) processing capabilities that embed analytics and AI to transform the customer experience. The benefits of edge computing can extend to factories, distribution facilities, autonomous vehicles—essentially any situation where data must be processed locally versus sending it to the cloud or a data center.

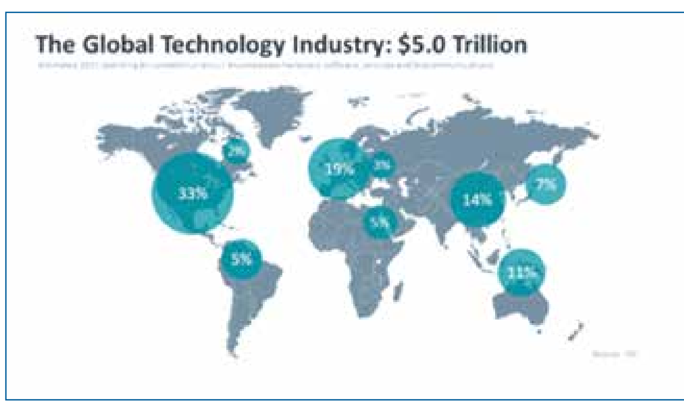
For 2021, cloud is back and no longer needs to share the spotlight with other trends. There has been no question over the past few years that cloud systems are a key ingredient to any IT strategy. Security assessments, integration requirements and provider comparisons will be par for the course rather than viewed as clunky overhead, and cloud will be the foundation for rebuilding efforts.

INDUSTRY OVERVIEW AND STATISTICS:

In 2020, the global information technology industry took a small step back in terms of overall revenue. As of August 2020, the research consultancy IDC was projecting global revenue of $4.8 trillion for the year, compared to their original estimate of $5.2 trillion. While the tech sector fared better than many other industries during the pandemic, it was not immune to cutbacks in spending patterns and deferment of major investments.

Moving forward, IDC projects that the technology industry is on pace to reach $5 trillion in 2021. If this number holds, it would represent 4.2% growth, signaling a return to the trend line that the industry was on prior to the pandemic. Looking even further into the future, IDC expects the pattern to continue, estimating a 5% compound annual growth rate (CAGR) for the industry through 2024.

The United States is the largest tech market in the world, representing 33% of the total, or approximately $1.6 trillion for 2021. In the U.S., as well as in many other countries, the tech sector accounts for a significant portion of economic activity. CompTIA's Cyberstates report reveals that the economic impact of the U.S. tech sector, measured as a percentage of gross domestic product, exceeds that of most other industries, including notable sectors such as retail, construction and transportation.

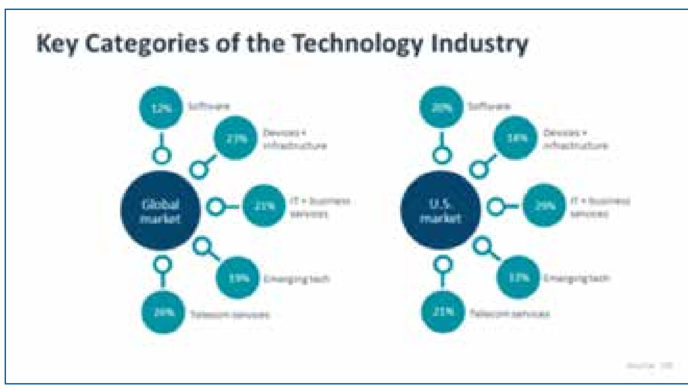


Despite the size of the U.S. market, the majority of technology spending (67%) occurs beyond its borders. Spending is often correlated with factors such as population, GDP and market maturity. Among global regions, western Europe remains a significant contributor, accounting for approximately one of every five technology dollars spent worldwide. However, as far as individual countries go, China has clearly established itself as a major player in the global tech market. China has followed a pattern that can also be seen in developing regions, where there is a twofold effect of closing the gap in categories such as IT infrastructure, software and services, along with staking out leadership positions in emerging areas such as 5G and robotics.

The bulk of technology spending stems from purchases made by corporate or government entities. A smaller portion comes from household spending, including home-based businesses. With the blurring of work and personal life, especially in the small business space, it can be difficult to precisely classify certain types of technology purchases as being solely business or solely consumer.

There are a number of taxonomies for depicting the information technology space. Using the conventional approach, the industry market can be categorized into five top level buckets. The traditional categories of hardware, software and services account for 56% of the global total. The other core category, telecom services, accounts for 26%. The remaining 19% covers various emerging technologies that either don't fit into one of the traditional buckets or span multiple categories, which is the case for many emerging as-a-service solutions that include elements of hardware, software and service, such as IoT, drones and many automating technologies.

The allocation of spending will vary from country to country based on a number of factors. In the mature U.S. market, for example, there is robust infrastructure and platforms, a large installed base of users equipped with connected devices, and available bandwidth for these devices to communicate. This paves the way for investments in the software and services that sit on top of this foundation.



Tech services and software account for nearly half of spending in the U.S. technology market, significantly higher than the rate in many other global regions. Countries that are not quite as far along in these areas tend to allocate more spending to traditional hardware and telecom services. Building out infrastructure and developing a broad-based digital workforce does not happen overnight. Scenarios do exist, however, whereby those without legacy infrastructure – and the friction that often comes with transitioning from old to new – may find an easier path to jump directly to the latest generation of technologies.

Although IDC is predicting a return to solid growth, the environment is more uncertain than any in recent memory. Several factors could swing actual spending in either direction. On the upside, technology firms are planning to capitalize on the ongoing digitalization of business, whether that is expanding engagements with their current customer base or reaching into new segments. Additionally, technology firms are applying lessons learned from a challenging year and placing the spotlight on their internal operations, including sales and marketing efforts.

For the most part, negative sentiment is driven by uncertainty. Top of mind are any continued business struggles as the COVID epidemic drags on. Beyond that, the specter of some unexpected event feels more real after the events of last year. Ultimately, customers may postpone purchases or IT projects even further as they deal with uncertainty in their own space. Typical hurdles such as the availability of skills are still in the picture, but for most companies, the plans for 2021 are defined more by the unknown than quantifiable challenges.

Economies, jobs, and personal lives are becoming more digital, more connected and more automated—a trend that is only accelerating after recent events. The platform for computing has become much more stable, with access to technology no longer limited by location or constrained to certain activities. As a result, more energy is pouring into creative solutions, further expanding the opportunities for both IT professionals and IT channel firms.

TECH BUSINESS MODELS:

Understanding the growing importance of partnerships as a strategic tool that every technology company should employ. Until recently, strategic discussions typically began with the following question: "Should I buy or build?" As we head into 2020, that question should be modified: **"Should I buy, build, or partner?".**

With fast-paced developments in emerging technologies, partnerships can be critical for tech companies looking to enhance their existing solutions or provide more targeted offerings. Based on the key strengths and expertise of partners, companies can pursue research and development; offer more integrated solutions across their hardware, network, platform, or software stack; or target different markets altogether. Tech companies have leveraged this model extensively to offer improved products and services across areas like AI, cloud, and processing.

For many companies, this approach will require a permanent shift in their overall mindset. But today's ultra-competitive, highly complex technology environment demands nothing less. After all, why buy an asset that's not best-in-breed when you can team with someone who has the specific capabilities you need? Partnering represents a more efficient use of capital and will probably drive better outcomes.

This "partnership" concept also extends to **multiplayer alliances**—complex ecosystems of providers who combine best-of-breed assets to create end-to-end solutions for clients. Successful ecosystems are those that simplify issues like systems integration and contractual obligations so that the customer experience is transparent.

When it comes to strategies for developing and expanding their cloud business, many tech companies are increasingly shifting toward the **everything-as-a-service (XaaS) model,** which encompasses capabilities such as platform-as-a-service (PaaS), infrastructure-as-a-service (IaaS), and software-as-service (SaaS).

Within the PaaS environment, database and application platform services represent the largest market segments, with blockchain, digital experience, serverless, and AI/machine learning platform services the most recent offerings. The global IaaS market is mainly driven by advantages such as improved disaster recovery, ease of deployment, and platform scalability. Larger than PaaS and IaaS, the worldwide SaaS market features solution providers that leverage microservices to offer customizable end-to end solutions, increased agility, and better ROI measurement.

Tech companies are also offering new solutions like **security-as-a-service, data-as-a-service, and device-as-a-service** to help companies deliver XaaS benefits, such as operational efficiency and faster innovation.

In the new world of XaaS, tech companies should deliver highly tailored solutions that reflect a deep understanding of each customer's business and desired outcomes. Most tech firms can't do this on their own: They have long relied on indirect channel partners to help drive their business growth. And with the shift to XaaS, tech companies will likely continue to depend on partners' domestic presence and localized knowledge to serve customers across regions.

Some channel partners are changing their business models to match tech companies' XaaS transformation efforts and deliver new forms of value. But many partners are struggling to adapt their business approach for the new as-a-service world. Their concerns range from a lack of specialized talent to worries about the near-term financial implications of transforming their business models.

To address this situation, tech companies should invest the time required to make their channel partners an integral part of the XaaS transformation journey. This includes providing a clear XaaS transformation vision to partners, as well as articulating the potential long-term benefits. Some major tech companies are already investing to strengthen their indirect channels in areas such as understanding customer requirements, recommending services, deployment, integration, and simplifying billing and management of diverse cloud services.

Of course, mergers, acquisitions, and divestitures (M&A&D) will remain a viable growth strategy for tech companies in the coming year, with revenue growth, tech assets, and IP expected to be the top drivers. However, companies are looking to do more than simply enhance technology through M&A&D. Increasingly, they're employing this strategy to expand into new markets and build their consumer bases. In particular, divestitures can be important where best-of-breed assets are becoming a drain on capital and partnering is a preferable alternative.

One other strategy that no tech company can afford to overlook is building a diverse workforce. There is empirical evidence that inclusive companies generate up to 30 percent higher revenue per employee, are more profitable than competitors, and are eight times more likely to achieve positive business outcomes. Diversity in the workforce and among partners can also promote ethical use of AI by reducing the potential for bias in certain applications.

CONCERNS IN TECH:

In 2020, the regulatory arena promises to become even more complex as various jurisdictions continue to develop their own laws and guidelines. Given the lack of a consistent global regulatory standard, tech companies must closely monitor developments in this space; the price for not doing so can be steep, including potential audits and monetary penalties that can impact brand reputation.

While AI delivers a host of potential benefits, it also brings its share of risks—particularly in the area of AI ethics. These ethical concerns typically fall into four areas:

- **Privacy:** Collection of data and usage of facial recognition technology without consent
- **Lack of transparency:** Insufficient visibility into the “secret logic” used by AI algorithms to make critical business decisions
- **Bias and discrimination:** Underlying data set reflects biases that taint decision-making
- **Lack of governance and accountability:** Who is accountable for data and AI systems, ethical norms, and unethical practices?

How companies use AI ethically and build trust with their customers, partners, and the general public will likely be key differentiating factors now and in the future. A 2019 Edelman Trust Barometer study shows that 86 percent of respondents report more loyalty to ethical companies, whereas 93 percent say that companies have a responsibility to positively impact society.

To ensure ethical use of AI, it is important to include a broad set of employees and partners in ethics-related conversations. Major tech companies have begun to introduce AI ethics boards, but there has been a substantial amount of concern raised about the lack of diversity in some of those groups.

Another area of concern for both tech companies and enterprises is **cybersecurity**—including AI-enabled attacks that are becoming more advanced and serious. Adversarial AI can be used, for example, to reverse-engineer an algorithm to produce damaging output. Bad actors can also employ AI to intensify cyber-attacks by impersonating trusted users, then blending into the background/environment, and executing faster attacks. In addition, AI's machine learning and natural language processing can be hijacked to create highly targeted phishing emails.

However, AI also has the potential to **protect against existing cyber threats and identify new ones.** For example, AI applications can create smarter event-monitoring and incident-response systems. Firewalls with embedded machine learning capabilities can identify patterns in network traffic and flag potential threats. AI-enhanced systems can also enable next-generation identity and access management that tracks users' activities based on their roles and privileges. In the case of any exceptions, such systems can ask for added authentication based on biometric evidences.

Last, but certainly not least, is the area of **data**—or, more specifically, the imperative for companies to become more "data-centric." To enable digital transformation and truly leverage AI's capabilities, companies should develop strategies that treat data as a crucial asset. However, many companies seem to face obstacles that prevent them from developing a "data culture." According to NewVantage Partners' 2019 Big Data and AI Executive Survey, 72 percent of companies report that they've been unable to forge a data culture, and 69 percent say that they haven't created a data-driven organization. In addition, 53 percent say they are not yet treating data as a business asset.

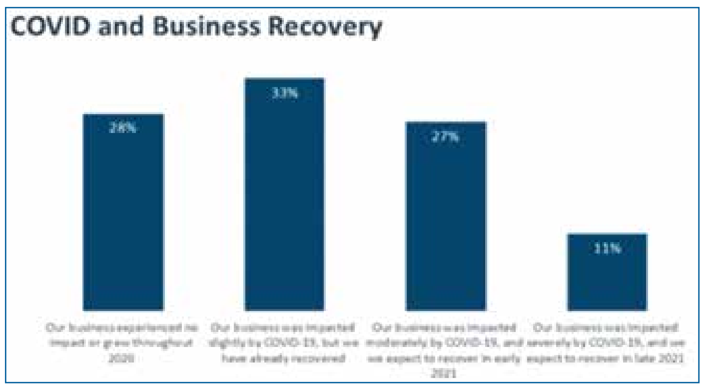
AI systems are likely to make erroneous or biased decisions if the data entered into them is error-prone, inconsistent, incomplete, or outdated. Hence, data preparation and standardization is an important first step for AI technologies to deliver their true business value.

Simply put, "You can't analyze what you can't see." To thrive in the next decade, companies will likely need the ability to harvest data and visualize its implications across the enterprise. New enterprise resource planning (ERP) systems can help with harvesting "one version of the truth" for companies, but this technology should be complemented by transformed processes that enable the system to work across an entire company.

WHAT NEXT?

Twenty years ago, the technology industry was dominated by a handful of key infrastructure players such as IBM, Hewlett-Packard and Cisco, along with Microsoft on the software side of the house. They ruled the roost! At the time, the supply chain was quite linear: vendor to distributor to partner to customer. Most resellers also tethered their worth and brand to the vendors whose products they sold. It was their calling card in every sales pitch. Business cards (remember them?) were emblazoned with logos touting Gold or Platinum Certified status with a certain vendor, while partner websites touted expertise in said vendor's products over almost all else. Times have now changed and the main shift is in the supply chain relationship dynamic.

The power equation has morphed – and will continue to in the future – from one in which vendors once held all the cards to one in which partners have more leverage. It's not adversarial, but rather more balanced. For decades, partners have served as extended sales forces for vendors and as such were beholden to sets of incentive goals and other requirements in order to move up the ranks of a tiered partner program system of benefits. Today, the balance is much more even and the partner journey more nuanced. Much of this is due to the emergence and staying power of cloud computing and the as-a-service nature of how channel firms do business today. Customers rely more on their providers of technology, aka channel partners, because with cloud, much of the actual vendor technology is abstracted from their view. For partners, that means their calling card is no longer the vendors they sell or work with, but rather their own branding, marketing and value. As a result, in 2021, there will be much more emphasis by vendors on providing an optimal partner experience via ease of doing business, communications, incentives and support, and other new demands that channel firms place on the relationship.

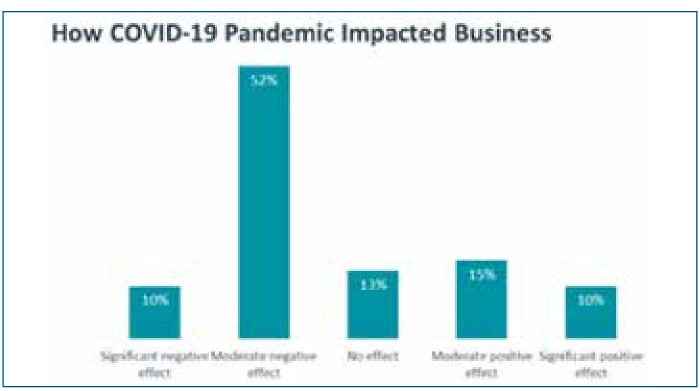


For the many small businesses, the struggle to stay afloat in 2020 was reminiscent of the last economic calamity—the great recession of 2008. Back then, many firms did not survive, while others were forced to downsize significantly. Others made it through by a combination of resourcefulness, adequate cash reserves and innovation. Many small organizations are facing these same tough times now. A major part of the problem is that most companies serve SME-sized customers, who themselves are floundering under the restrictions mandated by the pandemic. Some of those customers are going out of business; others are putting the brakes on spending. From a business model perspective, a new focus around business consulting skills is one way to maintain value to customers. Helping them prioritize initiatives during a down time and showing them how to use a cloud foundation to automate their organizations, cut costs and increase efficiencies will be key in 2021 and beyond. Ironically, the pandemic has opened some opportunities in the area of remote work support. As businesses across the economy need to support a new army of workers from a home environment, demand has grown for device sales such as laptops and other networking infrastructure, as well as all-important security services. Businesses in the coming year will need to assess their own offerings and capabilities in direct relation to customer needs in this new, uncertain environment.

Much like IT professionals, companies in the business of technology are also facing a host of opportunities, challenges and change in the year ahead. Some firms have taken a serious economic hit due to the COVID-19 pandemic, including some that have gone out of business. Other channel firms have found opportunity in various silver linings that have come from activities such as supporting the technology needs required in the massive move to remote working.

Technology and the business of selling it continues to grow more complex. What was once a fairly stable set of infrastructure products in a channel provider's portfolio has, in the cloud age, morphed into myriad choices around software-as-a-service applications, data tools and a stack of emerging technologies. This, of course, is a far cry from straight-up hardware device sales. Additionally, business and tech consulting and pure influencing roles have been rapidly establishing themselves as legitimate – often lucrative – channel business models.

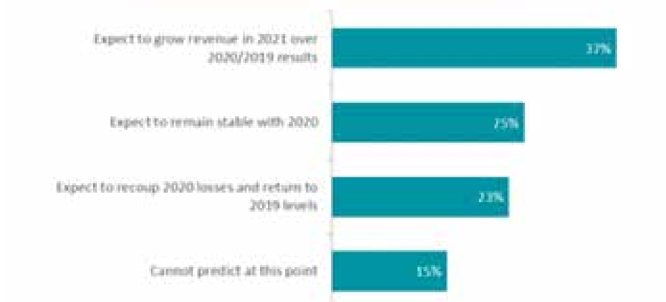
Looking ahead to 2021, firms that manage to thrive will be making investments in skills training, expanding their market reach to new customers and verticals, partnering with potential competitors, and embracing emerging tech. For many, that means getting out of their comfort zone.



To ensure positive growth in 2021, channel firms are first looking to rely on what they already have. The No. 1 factor respondents say will move the needle optimistically next year is a pick-up in business from existing clients. This makes sense in the current economic climate where finding new customers may be challenging, considering that many of the SME customers the channel targets have been existing in cost-cutting or frozen-budget mode during the pandemic. That said, mining existing customers for additional revenue rings especially true with managed services providers for whom upselling additional types or tiers of services is often the key to growing revenue and profit margin.

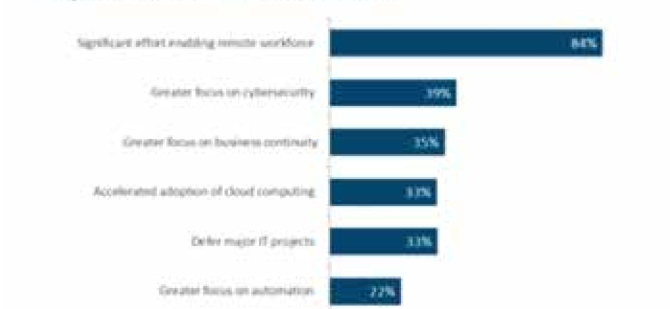
Other areas where firms place value include reaching new customer segments. Opportunities there range from enticing new clients with any of the emerging technology solutions on the market to offering up a specialization in a particular industry vertical. Four in 10 respondents said they'd choose to specialize in a vertical if they could do so today. From a practical perspective, companies also see potential benefit in the year ahead from streamlining their operations internally. Process efficiency and cost containment, while not the most exciting, are necessary for optimal profitability. They also represent best practices to enforce before investing in new market expansion and new customer acquisition. Running a tight ship took on new meaning in this past year and is likely to continue well into 2021.

Expectations for Performance in 2021 vs. 2020



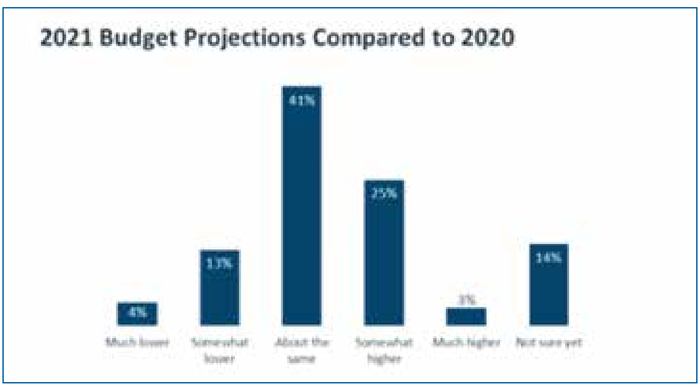
What could derail 2021? There's one primary answer: continued effects of COVID-19. Last year, the channel's top worries were labor costs and the ability to hire employees with skills that map to today's complex technology demands, including emerging tech acumen. This year, it's all about outside forces, whether it is the virus and its impact on business viability, especially in the case of additional lockdowns, or other unexpected factors such as natural disasters or an unforeseen, non-COVID-related financial crisis. Channel firms also worry about customers pumping the brakes on purchasing, which typically correlates to overall market conditions. The effect COVID-19 has had on business in the channel is undeniable, with roughly half of companies reporting some downside impact in the past year. Smaller firms are more likely than larger to have been affected, given that their customer base also tends to be in the SME space, a demographic most negatively hurt by business lockdowns and restrictions on capacity (think restaurants and other hospitality-oriented outfits). But a recent study by McKinsey

Responses to COVID-19 Pandemic



also shows that the pandemic has accelerated digitalization efforts by many companies, especially as they relate to interactions with customers. This phenomenon, along with the aforementioned need to support the shift to remote work, provides some clear avenues of opportunity for channel firms looking to assist customers in these efforts.

From a revenue perspective, fingers are crossed. The half glass full crowd (37%) expect that they will grow revenue in 2021 in excess of both 2020 and 2019 results. Another quarter expects to remain stable with 2020, though that could be a revenue level that was less than 2019 for those firms. Nearly another quarter of respondents acknowledge that 2020 led to lost revenue, but they predict a return to 2019 levels this coming year. The optimism is likely predicated on a number of factors. Many channel firms are pivoting to services-based businesses, emerging tech opportunities, and verticals, while at the same time taking advantage of some of the new needs of the pandemic work environment. Other firms are doubling down on what is now even more critical than ever: security expertise.



One of the key questions to think about heading into 2021 is how to budget. More than last year? Less? The same? Given the volatility of 2020, annual budgeting is a top of mind issue for many channel firms as they attempt to forecast sales, ponder new markets, or fight to keep their business afloat.

The approach taken to budgeting for 2021 would fall into the cautious optimism category. Four in 10 anticipate keeping funding at 2020 levels, with a quarter predicting somewhat higher allocation and 13% somewhat lower. On the far extremes – much higher or much lower – the percentages are only in single digits. It seems many firms are playing it safe. Budgets, after all, can be adjusted as the year goes on, depending on circumstances positive or negative. Another sign of the uncertain times, 14% of companies report not being sure yet about their budget projections for 2021, indicative of the difficulty of forecasting accurately right now.

The business model, technology focus, and type of customers served will greatly influence the staffing needs of the typical channel firm. For example, a managed services provider may well need more tech staffing now that a majority of its customers are working from home instead of a central office location. Other companies are grappling to fill staffing holes because some of their employees needed to leave the workforce to tend to school-age children at home during the pandemic. Other channel firms are using their solid financial base and positive cash flow to dive into new markets and grow during this uncertain time.

For many firms, hiring from outside is not their path. Three in 10 channel firms are retraining existing staff for open positions or to address new areas of focus, for example. For those hiring externally, some are conducting recruitment efforts that seek out a more diverse applicant pool. Others have eliminated the four-year college degree requirement altogether, focusing instead on skills aptitude and culture fit.

BUZZWORDS:

Terms expected to feature in headlines throughout 2021, but the practical applications may be different from the hype.

5G: Featured everywhere from telecom carrier commercials to the new iPhone launch, this next generation of cellular networking will definitely add new platform potential, but disruptive applications still need to be built.

Remote workforce: Every company had to embrace a remote workforce quickly, but it's less clear how companies will handle the remote option when it's not forced.

Extended Reality (XR): This umbrella concept, including both virtual reality (VR) and augmented reality (AR), may advance beyond niche applications as the technology continues to improve and user behavior adapts.

Robotic Process Automation (RPA): Thanks to a high degree of integration between individual systems and the use of new techniques such as machine learning and natural language processing, RPA is a key ingredient for many automation efforts.

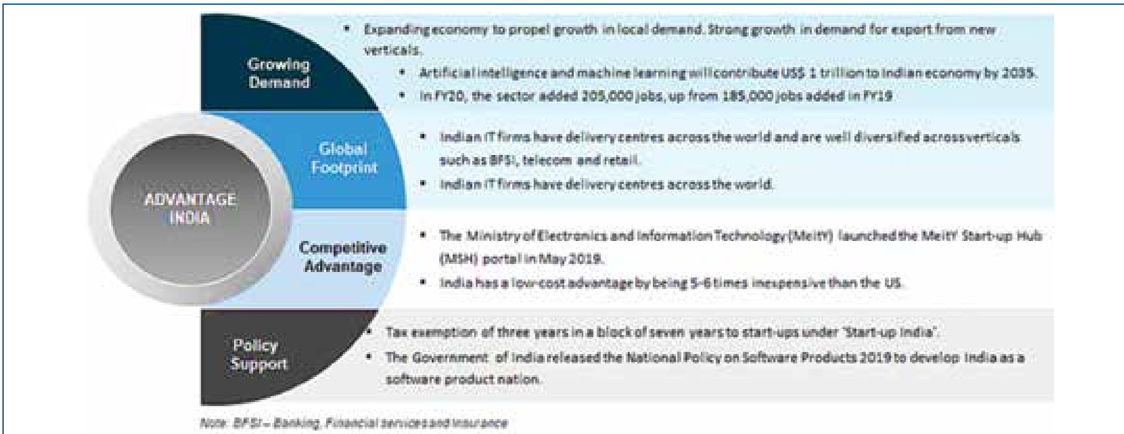
No code or low code: As software usage expands more and more, there are opportunities to use these simpler approaches that are less feature-rich but also require less technical skill, allowing rapid development by a wide range of users.

Ambient computing: Sensors, wearables and natural language processing are some of the main ingredients in building systems that are integrated into everyday life and bring digital enhancements to common tasks.

Social engineering: With humans as the weak link in the cybersecurity chain, cyber criminals are constructing attacks that leverage personal data to appear legitimate, leading to identity theft or additional data harvesting.

Sustainability: Taking the concepts of Green IT to a new level, tech companies are placing a high priority on ensuring that their products and their operations have minimal impact on the environment.

IT & BPM INDUSTRY IN INDIA:



The global sourcing market in India continues to grow at a higher pace compared to the IT-BPM industry. India is the leading sourcing destination across the world, accounting for approximately 55% market share of the US$ 200–250 billion global services sourcing business in 2019–20. Indian IT & BPM companies have set up over 1,000 global delivery centres in about 80 countries across the world. India has become the digital capabilities hub of the world with around 75% of global digital talent present in the country.

IT-BPM industry's revenue was estimated at around US$ 191 billion in FY20, growing at 7.7% y-o-y. It is estimated to reach US$ 350 billion by 2025. Moreover, revenue from the digital segment is expected to form 38% of the total industry revenue by 2025. Digital economy is estimated to reach Rs. 69,89,000 crore (US$ 1 trillion) by 2025. The domestic revenue of the IT industry was estimated at US$ 44 billion and export revenue was estimated at US$ 147 billion in FY20.

Total number of employees grew to 1.02 million cumulatively for four Indian IT majors (including TCS, Infosys, Wipro, HCL Tech) as on December 31, 2019. Indian IT industry employed 205,000 new hires and had 884,000 digitally skilled talents in 2019.

Indian IT's core competencies and strengths have attracted significant investment from major countries. The computer software and hardware sector in India attracted cumulative Foreign Direct Investment (FDI) inflow worth US$ 44.91 billion between April 2000 and March 2020. The sector ranked second in FDI inflow as per the data released by Department for Promotion of Industry and Internal Trade (DPIIT).

Leading Indian IT firms like Infosys, Wipro, TCS and Tech Mahindra are diversifying their offerings and showcasing leading ideas in blockchain and artificial intelligence to clients using innovation hubs and research and development centres to create differentiated offerings.

MAJOR DEVELOPMENTS IN THE INDIAN IT AND ITES SECTOR:

- In July 2020, Infosys won a multiyear deal worth US$ 1.5 billion from investment management company, Vanguard
- In July 2020, HCL Technologies signed a five-year deal worth US$ 600 million with telecom equipment maker Ericsson
- In February 2020, Tata Consultancy Services bagged a contract worth Rs 10,650 crore (US$ 1.5 billion) from pharma company Walgreens Boots Alliance.
- UK-based tech consultancy firm, Contino, was acquired by Cognizant.
- In June 2019, Mindtree was acquired by L&T.
- NASSCOM has launched an online platform which is aimed at up-skilling over 2 million technology professionals and skilling another 2 million potential employees and students.

MAJOR GOVERNMENT INITIATIVES TO PROMOTE IT AND ITES SECTOR IN INDIA:

- On May 2019, the Ministry of Electronics and Information Technology (MeitY) launched the MeitY Startup Hub (MSH) portal.
- In February 2019, Government released the National Policy on Software Products 2019 to develop India as a software product nation.
- The Government has identified Information Technology as one of 12 champion service sectors for which an action plan is being developed. Also, the Government has set up a Rs. 5,000 crores (US$ 745.82 million) fund for realizing the potential of these champion service sectors.
- As part of Union Budget 2018–19, NITI Aayog was to set up a national level programme to enable efforts in AI^ and leverage AI technology for developing the country.
- In the Interim Budget 2019–20, the Government announced plans to launch a national programme on AI and setting up of a National AI portal.

- National Policy on Software Products-2019 was passed by the Union Cabinet to develop India as a software product nation.
- India is the topmost offshoring destination for IT companies across the world. Having proven its capabilities in delivering both on-shore and off-shore services to global clients, emerging technologies now offer an entire new gamut of opportunities for top IT firms in India. The industry is expected to grow to US$ 350 billion by 2025 and BPM is expected to account for US$ 50 55 billion of the total revenue.

References:

Media Reports, Press Information Bureau, Department for Promotion of Industry and Internal Trade, Department of Information and Technology, Union Budget 2020–21.

Sources:

Surveys and Reports by Deloitte, CompTIA, IBEF.

GOODS AND SERVICE TAX

1. Introduction

Prior to the introduction of the Goods and Services Tax Act, the taxability of 'Software' in the past has been a soft target of multiplicity of indirect taxes including Excise duty, VAT, Service tax and Customs wherein with the invasion of negative list regime, many activities such as development, design, implementation, customization, programming, adaption, upgradation or enhancement of information technology software were brought under the service tax net as 'declared services'. Further, the goods element (including intangible goods) when manufactured was leviable to excise duty with the import of goods being subjected to Customs duty. Needless to say that the sale of goods (software) was also liable to VAT.

The traditional meaning of the word 'goods' has undergone a radical change. This is due to the technological and scientific development in the last decade. Sales tax is also leviable on intangibles such as software. Thus, lottery tickets, copyright, software licenses, SIM card, trade mark etc. have been held as goods liable to sales tax. In case of new age transactions such as leasing of server space/transponder space, e-commerce, it has to be determined whether there it is a sale of goods or a deemed sale by way of transfer of right to use such goods or is it a service.

Upon introduction of the GST law, meaning of the term 'Goods' and 'Services' have been defined in a broad manner as under:

Section 2(52) "Goods" *means every kind of movable property other than money and securities but includes actionable claim, growing crops, grass and things attached to or forming part of the land which are agreed to be severed before supply or under a contract of supply.*

Section 2 (102) "Services" means anything other than goods, money and securities but includes activities relating to the use of money or its conversion by cash or by any other mode, from one form, currency or denomination, to another form, currency or denomination for which a separate consideration is charged.

From the above definition of the term 'Goods' and 'Services', it can be noted that every kind of movable property has been termed as 'Goods' and the term 'Service' is defined in a very broad manner to cover anything other than 'Goods'.

Now, since there is a very thin line of distinction in case of software as to when it constitute 'Goods' and when it takes the colour of a service, therefore

Schedule II was introduced in the GST Act, to clarify whether a particular transaction can be termed as a 'Goods' or a 'Service'. In this regard, following entries in the schedule II would be relevant in respect of the IT/ ITES sector:

- *Entry 1 (a): any transfer of the title in goods is a supply of goods;*
- *Entry 5(c): temporary transfer or permitting the use or enjoyment of any intellectual property right;*
- *Entry 5(d): "development, design, programming, customization, adaptation, upgradation, enhancement, implementation of information technology software" would be a supply of service.*
- *Entry 5(f): transfer of the right to use any goods for any purpose (whether or not for a specified period) for cash, deferred payment or other valuable consideration" would be a supply of service.*

These wordings are a reflection of the way in which meaning of the term 'Information Technology Software Service' was defined in the service tax law. Hence, the said entry is essentially about the activities involved in developing, designing, implementation of the software and not about software per se. Further, in the case of **LML Ltd. V. CC - 2010-TIOL-75-SC-CUS,** it was stated that "Software is a set of instructions that allows physical hardware to function and perform computations in a particular manner, be in word processor, web browser or the computer's operating system. These expressions are in contrast with the hardware which are the physical components of a computer system."

Also, this entry is required to be read in consonance with the definition of 'Goods' in the CGST Act. There is a prevalent notion that all types of software would be categorized as a service in schedule II of the CGST Act 2017, however this understanding may not be correct. Various issues in the context of whether the software constitutes 'Goods' or 'Service' is discussed below.

2. RELEVANT CLASSIFICATION AND TAX RATES:

HSN	Rate	Description of Goods/ Services
		Services
Heading 9983		**Other professional, technical and business services**
Heading 9983 or any other Heading of Chapter 99	Nil	Taxable services, provided or to be provided, by a Technology Business Incubator or a Science and Technology Entrepreneurship Park recognized by the National Science and Technology Entrepreneurship Development

HSN	Rate	Description of Goods/ Services
		Board of the Department of Science and Technology, Government of India or bio-incubators recognized by the Biotechnology Industry Research Assistance Council, under the Department of Biotechnology, Government of India.
Group 99831		**Management consulting and management services; information technology services**
998311	18	Management consulting and management services including financial, strategic, human resources, marketing, operations and supply chain management.
998312	18	Business consulting services including public relations services
998313	18	Information technology (IT) consulting and support services
998314	18	Information technology (IT) design and development services
998315	18	Hosting and information technology (IT) infrastructure provisioning services
998316	18	IT infrastructure and network management services
998319	18	Other information technology services
Group 99834		**Scientific and other technical services**
998345	18	Weather forecasting and meteorological services
998346	18	Technical testing and analysis services
998349	18	Other technical and scientific services n.e.c.
Group 99836		**Advertising services and provision of advertising space or time**
998365	18	Sale of Internet advertising space
998366	18	Sale of other advertising space or time (except on commission)
Group 99839		**Other professional, technical and business services.**
998399	18	Other professional, technical and business services n.e.c.

HSN	Rate	Description of Goods/ Services
Heading 9984		**Telecommunications, broadcasting and information supply services**
998431	05	Supply consisting only of ebook
		Explanation.- For the purposes of this notification, "e-books" means an electronic version of a printed book (falling under tariff item 4901 in the First Schedule to the Customs Tariff Act, 1975 (51 of 1975)) supplied online which can be read on a computer or a hand held device
Group 99841		**Telephony and other telecommunications services**
998411	18	Carrier services
998412	18	Fixed telephony services
998413	18	Mobile telecommunications services
998414	18	Private network services
998415	18	Data transmission services
998419	18	Other telecommunications services including Fax services, Telex services n.e.c.
Group 99842		**Internet telecommunications services**
998421	18	Internet backbone services
998422	18	Internet access services in wired and wireless mode
998423	18	Fax, telephony over the Internet
998424	18	Audio conferencing and video conferencing over the Internet
998429	18	Other Internet telecommunications services n.e.c.
Group 99843		**On-line content services**
998431	18	On-line text-based information such as online books, newspapers, periodicals, directories etc
998432	18	On-line audio content
998433	18	Online video content
998434	18	Software downloads
998439	18	Other on-line contents n.e.c.

HSN	Rate	Description of Goods/ Services
Group 99846		**Broadcasting, programming and programme distribution services**
998461	18	Radio broadcast originals
998462	18	Television broadcast originals
998463	18	Radio channel programmes
998464	18	Television channel programmes
998465	18	Broadcasting services
998466	18	Home programme distribution services
Heading 9985		**Support services**
Group 99859		**Other support services**
998591	18	Credit reporting & rating services
998593	18	Telephone-based support services
998598	18	Other information services n.e.c.
998599	18	Other support services n.e.c.
Heading 9987		**Maintenance, repair and installation (except construction) services**
Group 99871		**Maintenance and repair services of fabricated metal products, machinery and equipment**
998712	18	Maintenance and repair services of office and accounting machinery
998713	18	Maintenance and repair services of computers and peripheral equipment
998716	18	Maintenance and repair services of telecommunication equipment and apparatus
Group 99873		**Installation services (other than construction)**
998733	18	Installation services of office and accounting machinery and computers
998734	18	Installation services of radio, television and communications equipment and apparatus
Heading 9981		**Research and development services**
Group 99814		**Research and development originals**
998144	18	Research and development originals in computer-related sciences
Heading 9973		**Leasing or rental services with or without operator**

HSN	Rate	Description of Goods/ Services
Group 99733		**Licensing services for the right to use intellectual property and similar products**
997331	18	Licensing services for the right to use computer software and databases
997338	18	Licensing services for right to use other natural resources including telecommunication spectrum
997339	18	Licensing services for the right to use other intellectual property products and other resources n.e.c
		Goods
Heading 8523		**Discs, Tapes, Solid-State Non-Volatile Storage Devices, "Smart Cards" And Other Media for The Recording Of Sound Or Of Other Phenomena, Whether Or Not Recorded, Including Matrices And Masters For The Production Of Discs, But Excluding Products Of Chapter 37**
8523 49 10	18	Compact Disc (Audio)
8523 49 20	18	Compact Disc (Video)
8523 49 40	18	DVD
8523 52 10	18	Memory Cards
8523 52 20	18	Sim cards
Heading 8528		**Monitors and Projectors, Not Incorporating Television Reception Apparatus, Reception Apparatus for Television, Whether Or Not Incorporating Radio-Broadcast receivers Or Sound Or Video Recording Or Reproducing Apparatus**
8528	18	Television set (including LCD or LED television) of screen size not exceeding 32 inches*
8528	18	Computer monitors not exceeding 32 inches, Set top Box for Television (TV)*
8528	28	Monitors and projectors, not incorporating television reception apparatus; reception apparatus for television, whether or not incorporating radio-broadcast receiver or sound or video recording or reproducing apparatus

HSN	Rate	Description of Goods/ Services
		[other than computer monitors not exceeding 32 inches, set top box for television and Television set (including LCD and LED television) of screen size not exceeding 32 inches]*
**Comment: The entries have been amended vide Notification No 24/2018 CT rate dated 31.12.2018, w.e.f. 01.01.2019, TV or computer monitors > 32 inches attract the rate of 28% and < 32 inches attract the rate of 18%*		
Heading 8529		**Parts Suitable for Use Solely Or Principally With The Apparatus Of Headings 8525 To 8528**
8529 90		**Other**
8529 90 10	18	For communication jamming equipment
8529 90 20	18	For amateur radio communication equipment
8529 90 90	18	Other
8529 10 11	18	Dish Antenna for communication jamming equipment
Note: Above details are mentioned as per the law applicable as on 30-11-2020.		

3. RELEVANT EXEMPTIONS & CONCESSIONS:

IT and ITES industry has been more inclined towards export incentives rather than availing exemption benefits on goods and services since upon export the supplies are treated as 'Zero rated supply' and the input tax credits can be claimed as refund which is not so in the case of exempt supplies. As defined u/s 2(47) of CGST act, exempt supplies comprise of Nil rated, wholly exempted and non-taxable supplies. Various exemptions that are relevant for the IT/ ITES sector are as below:

(A) Supply of services to overseas branches for the period between 01.07.2017 to 25.07.2018:

For a supply to be considered as an export of service, it should satisfy the following conditions laid down in section 2(6) of the IGST Act:

a. the supplier of service is located in India;

b. the recipient of service is located outside India;

c. the place of supply of service is outside India;

d. the payment for such service has been received by the supplier of service in convertible foreign exchange or in Indian Rupees as approved by RBI; and

e. the supplier of service and the recipient of service are not merely establishments ***of a distinct person in accordance with Explanation 1 in section 8.***

As per Explanation 1 to section 8 of the IGST Act,2017, for the purpose of this act, where a person has,

a. an establishment in India and any other establishment outside India;

b. an establishment in a State or Union territory and any other establishment outside that State or Union territory; or

c. an establishment in a State or Union territory and any other establishment being a business vertical registered within that State or Union territory,

then such establishments shall be treated as establishments of ***distinct persons.***

Hence, as per the above explanation, the head office in India and the overseas branch would be treated as distinct persons and hence, even if the other conditions of export of service are satisfied, the same would not qualify as export.

Basis above, it is clear that any entity providing services to overseas branch would be required to discharge GST at the applicable rate, which would end up being a cost to the Company.

Valuation for this purpose would be the open market value as per rule 28 of the CGST Rules. For Eg. A company in India provides services to its branch in Belgium for a value of Rs.1,00,000/-. In this case, the company would be required to discharge GST of Rs.18000. (Rs.1,00,000 *18%).

(B) Supply of services to overseas branches w.e.f. 26.07.2018:

As per Notification No. 15/2018 Integrated Tax (Rate) dt. 26.07.2018, services supplied by an establishment of a person located in India to any establishment of that person outside India, which are treated as establishments of distinct persons in accordance with Explanation 1 in section 8 of the Integrated Goods and Services Tax Act, 2017 would be exempt from GST provided the place of supply of the service is outside India in accordance with section 13 of the IGST Act,2017.

Hence, by virtue of the above notification, any services provided to overseas branch would be exempt from tax, if the place of supply is outside India. However, in case of an exempt supply, the point to be considered is the impact of ITC on account of such exempt supply.

As per section 17(2) of the CGST Act, 2017 where the good or services or both are used by the registered person partly for effecting taxable supplies including zero-rated supplies and partly for effecting exempt supplies, the amount of credit shall be restricted to so much of the input tax so attributable to the said taxable supplies including zero-rated supplies.

Hence, the entity would be required to reverse input tax credit attributable to the exempt supply and other common input tax credit in proportion to the total turnover.

(C) Taxable services, provided or to be provided, by a Technology Business Incubator or a Science and Technology Entrepreneurship Park:

Chapter	Description of Services exempted from tax
Heading 9983 or any other Heading of Chapter 99	Taxable services, provided or to be provided, by a Technology Business Incubator or a Science and Technology Entrepreneurship Park recognized by the National Science and Technology Entrepreneurship Development Board of the Department of Science and Technology, Government of India or bio-incubators recognized by the Biotechnology Industry Research Assistance Council, under the Department of Biotechnology, Government of India.

(zh) "incubatee" means an entrepreneur located within the premises of a Technology Business Incubator or Science and Technology Entrepreneurship Park recognized by the National Science and Technology Entrepreneurship Development Board (NSTEDB) of the Department of Science and Technology, Government of India and who has entered into an agreement with the Technology Business Incubator or the Science and Technology Entrepreneurship Park to enable himself to develop and produce hi-tech and innovative products.

4. RELEVANT STATUTORY PROVISIONS:

A. Registration requirement for IT/ITES:

Section 22 of the CGST Act, 2017 provides for the requirement of registration under the GST law. It states that every supplier shall be liable to be registered under this Act in the State or Union territory (other than special category States), from where he makes a taxable supply of goods or services or both, if the aggregate turnover in a financial year exceeds Rs. 20 lakhs. (In case of special category states – Rs. 10 lakhs).

It must be noted that Government may, at the request of a State enhance the above threshold to Rs. 40 lakhs and Rs. 20 lakhs (In case of special category states) respectively. (Each state can issue the notification separately).

Further, apart from above, section 24 provides for various scenarios when a person is required to take mandatory registration even if the turnover does not exceed the above threshold limit, relevant entries for IT/ ITES are as under:

a. Persons making any inter-State taxable supply;

b. Persons who are required to pay tax under reverse charge;

c. Input Service Distributor, whether or not separately registered under this Act;

d. Persons who supply goods or services or both, through such electronic commerce operator who is required to collect tax at source under section 52;

e. Every electronic commerce operator who is required to collect tax at source under section 52;

f. Every person supplying online information and database access or retrieval services from a place outside India to a person in India, other than a registered person.

Apart from above, voluntary registration is always an open option for any person to get registered under GST.

Mandatory registration for Online information and database access or retrieval services:

If a person supplies information and database access or retrieval services (i.e. OIDAR) from a place outside India to a person in India, other than a registered person, then such supplier needs to mandatorily obtain a registration without any threshold limit. OIDAR services are such that it can be provided online from a remote location outside the taxable territory. The overseas suppliers of such services would have an unfair tax advantage if the services provided by them be left out of the tax net. At the same time, since the service provider is located overseas and may not be having a presence in India, the compliance verification mechanism become difficult. It is in such circumstances, that the Government has brought a simplified scheme of registration for such service providers located outside.

Thus, in case OIDAR services are provided from outside India to any registered person (mostly in cases like HO-Branch-HO transactions), the recipient is liable to pay IGST under reverse charge mechanism and in case such services are provided to non-registered entity then the supplier is mandatorily required to take registration either himself or an intermediary or by appointing an agent and IGST on such supply of services must be paid.

Mandatory registration for E-commerce operator services:

Another important provision which requires mandatory registration under GST is in case where services are supplied through any e-commerce operator and also the e-commerce operator itself. It is to be noted that as per section 2(45) of the CGST Act, *"Electronic commerce operator' means any person who owns, operates or manages digital or electronic facility or platform for electronic commerce." Further section 2(44) defines "electronic commerce as the supply of goods or services or both, including digital products over digital or electronic network."*

Therefore, if e-commerce operator like Just dial, Urban clap, Ola, Uber, etc. who owns or operates or manages an e-commerce platform need to mandatorily take registration without any threshold limit of turnover as mentioned above. Similarly, even the assesee who supplies the goods or services through an e-commerce platform or facility owned by others also need take a mandatory registration.

However, it is pertinent to note that the requirement of mandatory registration comes only where the tax is required to be collected at source. In other words, the requirement of mandatory registration does not apply if it is not mandatory for the e-com operator to collect tax at source. For ex: In case where the supplies are exempted or in case where the entire consideration for the supply is directly to be received by the supplier, then there is no requirement to collect tax at source, hence no question of mandatory registration.

B. Special provision for Online Information and Database Access & Retrieval Services (OIDAR):

One of the prominent services that is availed from outside India by the IT/ ITES companies are in respect of OIDAR services. Before understanding the GST implication on OIDAR services, it is important to understand the various services that are covered under the term OIDAR.

As per section 2(17) of IGST act, "Online information and database access or retrieval services" means services whose delivery is mediated by information technology over the internet or an electronic network and the nature of which renders their supply essentially automated and involving minimal human intervention and impossible to ensure in the absence of information technology and includes electronic services such as, -

i. advertising on the internet;

ii. providing cloud services;

iii. provision of e-books, movie, music, software and other intangibles through telecommunication networks or internet;

iv. providing data or information, retrievable or otherwise, to any person in electronic form through a computer network;

v. online supplies of digital content (movies, television shows, music and the like);

vi. digital data storage; and

vii. online gaming.

Now, as it can be seen from above, the Online Information and Database Access & Retrieval Services (commonly known as OIDAR services) are such that it can be provided online from a remote location. A similar service provided by an Indian service provider from within the taxable territory, to recipients in India would be taxable. Further, such services received by a registered entity in India would also be taxable under reverse charge. However, the overseas suppliers of such services were having an unfair tax advantage should the services provided by them be left out of the tax net.

At the same time, since the service provider is located overseas and may not be having a presence in India, the compliance verification mechanism becomes difficult. It is in such circumstances, that the Government has come out with a simplified scheme of registration for such service providers located outside and comply with the GST law in India.

Considering the wide amplitude of OIDAR services that these expenses are very common for the IT companies and as per section 13(12) of the IGST Act, the place of supply of these services shall be the location of the recipient of service. However, as per section 14 of IGST Act, on supply of OIDAR services by any person located in a non-taxable territory and received by a non-taxable online recipient, the supplier of services located in a non-taxable territory shall be the person liable for paying integrated tax on such supply of services.

Further, if an intermediary located outside India arranges or facilitates supply of such service to a non-taxable online recipient in India, the intermediary would be treated as the supplier of the said service, except when the intermediary satisfies the conditions laid down in the proviso to section 14 of IGST Act.

Thus Notification 10/2017 Integrated Tax (Rate) Dated 28.06.2017 was issued which provides that where any service is supplied by a person located in a non-taxable territory to any person in the taxable territory (other than non-taxable online recipient) then the said service is liable to tax under reverse charge.

However, if OIDAR services supplied by a person outside the taxable territory, to a non-taxable online recipient, then the special procedure for payment of GST is contained in Section 14 of the IGST Act, according to which the liability to pay GST is on the supplier of service, as the case may be.

Therefore, it can be said that above provisions are made to ensure that when OIDAR services are provided to any non-business entity, the supplies do not escape from the tax net. In case of supply to business entity, the said must pay taxes under RCM.

There has been a lot of confusion on understanding as to what exactly would get covered within the ambit of this service. Therefore, in order to understand the meaning of the term "Online information and database access or retrieval service" in detail and the scope of various services that would be covered therein, then reference must be made to the clarification issued by **CBIC vide Circular No. 202/12/2016-S.T., dated 9-11-2016,** in the erstwhile service tax regime which states as below:

Nature of Supply	Service is mediated by IT over internet or an e-network	Automated and not possible to ensure in the absence of IT	OIDAR service
Pdf document manually emailed by provider	Yes	No	No
Pdf document automatically emailed by provider's	Yes	Yes	Yes
Pdf document automatically downloaded from site	Yes	Yes	Yes
Stock photographs available for automatic download	Yes	Yes	Yes
Online course consisting of pre-recorded videos and downloadable pdfs	Yes	Yes	Yes

Nature of Supply	Service is mediated by IT over internet or an e-network	Automated and not possible to ensure in the absence of IT	OIDAR service
Online course consisting of pre-recorded videos and downloadable pdfs plus support from a live tutor	Yes	No	No
Individually commissioned content sent in digital form. For eg: photographs, reports, medical results	Yes	No	No

Indicative List of OIDAR services:

1. Website supply, web-hosting, distance maintenance of programmes and equipment:
   a. Website hosting and webpage hosting;
   b. automated, online and distance maintenance of programmes;
   c. remote systems administration;
   d. online data warehousing where specific data is stored and retrieved electronically;
   e. online supply of on-demand disc space.
2. Supply of software and updating thereof:
   a. Accessing or downloading software (including procurement/ accountancy programmes and anti-virus software) plus updates;
   b. software to block banner adverts showing, otherwise known as Banner blockers;
   c. download drivers, such as software that interfaces computers with peripheral equipment (such as printers);
   d. online automated installation of filters on websites;
   e. online automated installation of firewalls.
3. Supply of images, text and information and making available of databases:
   a. Accessing or downloading desktop themes;

b. accessing or downloading photographic or pictorial images or screensavers;

c. the digitised content of books and other electronic publications;

d. subscription to online newspapers and journals;

e. weblogs and website statistics;

f. online news, traffic information and weather reports;

g. online information generated automatically by software from specific data input by the customer, such as legal and financial data, (in particular such data as continually updated stock market data, in real time);

h. the provision of advertising space including banner ads on a website/ webpage;

i. use of search engines and Internet directories.

4. Supply of music, films and games, including games of chance and gambling games, and of political, cultural, artistic, sporting, scientific and entertainment broadcasts and events:

   a. Accessing or downloading of music on to computers and mobile phones;

   b. accessing or downloading of jingles, excerpts, ringtones, or other sounds;

   c. accessing or downloading of films;

   d. downloading of games on to computers and mobile phones;

   e. accessing automated online games which are dependent on the Internet, or other similar electronic networks, where players are geographically remote from one another.

5. Supply of distance teaching services:

   a. Automated distance teaching dependent on the Internet or similar electronic network to function and the supply of which requires limited or no human intervention, including virtual classrooms, except where the Internet or similar electronic network is used as a tool simply for communication between the teacher and student;

   b. workbooks completed by pupils online and marked automatically, without human intervention.

Indicative list of services that would not be covered in the OIDAR services:

1. Supplies of goods, where the order and processing is done electronically Supplies of physical books, newsletters, newspapers or journals;

2. Services of lawyers and financial consultants who advise clients through email;

3. Booking services or tickets to entertainment events, hotel accommodation or car hire;

4. Educational or professional courses, where the content is delivered by a teacher over the internet or an electronic network (in other words, using a remote link);

5. Offline physical repair services of computer equipment;

6. Advertising services in newspapers, on posters and on television.

Judicial Precedents in respect of Online Information and Database Access & Retrieval Services:

Case Study 1: Whether permitting the download of images through website amounts to OIDAR services?

Facts: *In this case appellant has made available various images or photographs visible on his website. Those images and photographs are visible to a person who logs on to its website and are permitted to be downloaded by the appellant on payment of price. Thus, the appellant may not be charging anything for having access to its website but the appellant is charging its customers for downloading of the digital contents (photographs) hosted on the website. Appellant contended that he has got copyright over the photographs which are visible on its website and hence, the appellant charges the amount for copyright. The submission was that as the amount charged is for copyright, it will not be a service rendered falling under the category "Online Information and Database Access or Retrieval".*

Decision: *It was held by the Hon'ble Bombay High Court in the case of* ***PHOTOLIBRARY INDIA PVT. LTD. Versus COMMR. OF SERVICE TAX, MUMBAI-II 2017 (7) G.S.T.L. 386 (Bom.),*** *that appellant's website allows access and retrieval of data or information contained therein which are free for the purpose of viewing on the monitor. However, the customer has to pay for downloading the data in the form of images for commercial use and that the copyright of the images becomes incidental as the main activity is of making the information available.*

Case Study 2: Whether providing of online training and coaching service through internet with the use of technology amounts to OIDAR services?

Facts: *In this case appellant has provided Computer education via "online" and "Real time centres". The "real time centres" are the traditional computer coaching centres, some of which are owned by the appellants and the remaining are managed through franchisees (who represent the Appellants) and accordingly the online coaching centres were run the at various places in India. The main activity of the Appellants, however, was online computer education through the medium of internet i.e. through an interactive website. The main point of dispute is as to whether the activity of providing "online computer training" is classifiable as "commercial Training or Coaching" or is classifiable under "online information and data base access and/or retrieved service".*

Decision: *It was held by the Hon'ble CESTAT in the case of* ***Dewsoft Overseas Pvt. Ltd. v. Commissioner — 2008 (12) S.T.R. 730 (Tribunal)****, The activity of providing online computer courses is not simply providing online access to data or information. What is being provided to the clients is online lessons on various topics in computer hardware and software and besides this, the clients are also provided the facility of online interactive chat with other students, faculty and external experts and the clients can also give online test. Thus, the essential character of service being provided is online training or coaching or in other words e-education and not mere the facility of access or retrieval of data or information. Thus, online coaching or training classes through an interactive website is a well-established mode of teaching/coaching and the only difference between traditional coaching and online coaching is the medium. Moreover online coaching or teaching is an interactive process and the same cannot be compared with mere "online information and database access and/or retrieval" - the difference between the two is same as the difference between teaching some students in a classroom and providing library access to the students. We, therefore, hold that the Appellant's activity of providing online computer courses is covered under the entry "commercial training or coaching".*

Case Study 3: Whether sale of commodities vis Online E-Sell auctions amounts to OIDAR Service?

Facts: *Assessee is running website through which the interested steel manufacturer/trader are making trade and are engaged in the business of conducting Online E-Sale auctions for various commodities such as MS/SS Steel, etc. for a commercial consideration. In respect of the trading, assessee is getting margin from both buyer and seller for the sale and purchase made. Assessee contended that their service is classified under the category of "Online information and database access or retrieval services" as they provide the access to information over the website.*

Decision: *In the case of* ***COMMISSIONER OF SERVICE TAX, MUMBAI Versus CLICK FOR STEEL SERVICES LTD,*** *it was held that Buyer of goods not accessing any information or data on assessee's site but only interested in sale and purchase of steel products therefore margin from sale and purchase from such trading received by assessee is in the nature of e-commerce in respect of steel products and not online information or database access or retrieval services.*

C. Special Provision for E-commerce industry:

In recent years, e-commerce in India has managed to capture the eye-balls and also the mind-space of the consumers at large. With the second highest population, India has also become the second largest market for e-Commerce. Over the past years, India has changed the way it shops and trades. The unprecedented growth of the e-commerce sector has been largely driven by rapid development in technology and easy access to the internet. In GST, meaning of the term e-commerce is defined as under:

Section 2(44) states **'electronic commerce'** means supply of goods or services or both including digital products over digital or electronic network.

Section 2(45) states that **'electronic commerce operator'** means any person who owns, operates or manages digital or electronic facility or platform for electronic commerce.

Taxability in the hands of E-commerce operator on certain supplies:

As per the provision of Section 9(5), the Government of India, vide Notification No. 17/2017-C.T. (Rate), the following services through the electronic commerce operators, tax to be paid by such e-commerce operator.

a. Transportation of passenger services by a radio-taxi, motorcab, maxicab and motor-cycle – **Tax to be paid by the e-commerce operator viz., Ola, uber, etc.**

b. Accommodation in hotels, inns, guest houses, clubs, campsites or other commercial places meant for residential or lodging purposes, except where the person supplying such service through e-commerce operator is liable for registration u/s 22(1) of the CGST Act. – **Tax to be paid by the e-commerce operator viz., OYO, Trivago, Goibibo, makemytrip etc.**

c. House-keeping, such as plumbing, carpentering services etc., except where the person supplying such service through e-commerce operator is liable for registration for registration u/s 22(1) of CGST Act – Tax to be paid by the e-commerce operator viz., **urbanclap** etc.

It is very important to note here that liability to pay tax would be on the e-commerce operator only for the service provided through such operator and this is not for supply of goods. In brief, the aggregator is made liable to discharge the GST in afore-mentioned cases. This comes as a big relief to a large number of taxi drivers who would have otherwise needed to take GST registration. The decision on how to charge the GST would depend upon the companies pricing policy. If they intend to offer all inclusive price, Rs.7 per KM (taxes included), then drivers would have to eventually bear the additional tax burden if company passes it on them. However, the companies generally set prices exclusive of taxes to pass on the tax burden on the ultimate cab consumer, however that will result in the fare.

Collection of TCS by e-commerce operators:

As per Section 52 of CGST Act, 2017, E-commerce operator is required to collect an amount calculated at 1% of the net value of the taxable supplies made through it by the suppliers, where the consideration with respect to such supplies is to be collected by such operator. At this juncture, it is important to note that the credit of TCS collected by the e-commerce operator is directly available to the supplier in the form of balance in electronic cash ledger which can be used by them for paying taxes on outward supplies or reverse charge.

Relevant FAQ's on collection of TCS issued by CBIC for E-Commerce Sector:

Question 1: *There are transactions in which two or more ECOs are involved. In such cases who would deduct the TCS?*

Answer: *In such cases, each transaction needs to be treated separately and examined according to the provisions of Section 52 of the CGST Act, 2017. The TCS will be deducted accordingly.*

Question 2: *There are cases in which the ECO does not provide invoicing solution to the seller. In such cases, invoice is generated by the seller and received by the buyer without ECO getting to know about it. The payment flows through the ECO. In such cases, on what value is TCS to be collected? Can TCS be collected on the entire value of the transaction?*

Answer: *Section 52(1) of the CGST Act, 2017 mandates that TCS is to be collected on the net taxable value of such supplies in respect of which the ECO collects the consideration. The amount collected should be duly reported in GSTR-8 and remitted to the Government. Any such amount collected will be available to the concerned supplier as credit in his electronic cash ledger.*

Question 3: *There are sellers who are selling exempted or zero-tax goods like books through ECOs. Will marketplaces be required to collect TCS on such* supplies?

Answer: *As per Section 52(1) of the CGST Act, 2017 TCS is to be collected on "the net value of taxable supplies" made through an ECO. When the supply itself is not taxable, the question of TCS does not arise.*

Question 4: *I am a supplier selling my own products through a website hosted by me. Do I fall under the definition of an "electronic commerce operator"? Am I required to collect TCS on such supplies?*

Answer: *As per the definitions in Section 2(44) and 2(45) of the CGST Act, 2017, you will come under the definition of an "electronic commerce operator". However, according to Section 52 of the Act ibid, TCS is required to be collected on the net value of taxable supplies made through it by other suppliers where the consideration is to be collected by the ECO. In cases where someone is selling their own products through a website, there is no requirement to collect tax at source as per the provisions of this Section. These transactions will be liable to GST at the prevailing rates.*

Question 5: *We purchase goods from different vendors and are selling them on our website under our own billing. Is TCS required to be collected on such supplies?*

Answer: *No. According to Section 52 of the CGST Act, 2017, TCS is required to be collected on the net value of taxable supplies made through it by other suppliers where the consideration is to be collected by the ECO. In this case, there are two transactions - where you purchase the goods from the vendors, and where you sell it through your website. For the first transaction, GST is leviable, and will need to be paid to your vendor, on which credit is available for you. The second transaction is a supply on your own account, and not by other suppliers and there is no requirement to collect tax at source. The transaction will attract GST at the prevailing rates.*

**[Issued by Directorate General of Taxpayer Services on 31-7-2017]*

Recent Advance Rulings on the context of E-Commerce:

Case study 1: *Whether the E-commerce platform like carpool, sride, etc. which provide a platform to connect a rider with a co-passenger or a driver with the consumer are required to collect GST as per provisions of Section 9(5)?*

Ruling: *The answer to the question would definitely vary as per the exact business module. One such issue was addressed by* ***Karnataka AAR in case of Humble Mobile Solutions Ltd. [2019 (31) G.S.T.L. 653].*** *The case in the said judgement was of pure provision of drivers only through E commerce operator. In the said judgement, applicant was considered as intermediary between consumer and driver. The said intermediary service was distinguished from the* transportation *service and accordingly applicant was held not liable to pay GST as per section 9(5). It was analysed that the drivers were not employees of the applicant and were also not hired by the applicant. They were only listed on the portal of the applicant and were providing their services on principal-to-principal basis. Further, the drivers were not supplying the services in their vehicles but were driving the vehicles belonging to the recipients of services. Hence it was held that there was no provision of "services of transportation of passengers by a radio-taxi, motorcab, maxicab and motor cycle" but merely providing manpower services namely "driving a motor vehicle services" which is not covered under item (i) of the Notification No. 17/2017-Central Tax, dated 28-6-2017.*

Case study 2: *In yet another AAAR, in case of* ***Opta Cabs Pvt. Ltd. 2019 (20) G.S.T.L. 161 (App. A.A.R. - GST),*** *applicant supplying the services of aggregator like OLA, Uber pleaded that he was not liable to pay GST u/s 9(5) for two factual difference in its module. First being the applicant did not collect the charges and it were directly paid to the drivers by customer and second being the submission of applicant that transportation services were not 'supplied' through it but merely 'booked' through it?*

Ruling: *The Appellate authority upholding the original AAR, held that whether or not consideration was received by the applicant is irrelevant because there is a deeming fiction that in such case E commerce /operator has provided a service as per Section 9(5) read with Notification No.17/2017 Central Tax (rate) and argument of difference between 'booking' and services 'through' it was feeble argument merely to circumvent the legal provision as without 'booking' services could not be provided at all. It was upheld that applicant was liable to pay GST u/s 9(5).*

D. Relevant Statutory Provisions relating to Export of IT/ ITES:

'Export of goods' simply means taking goods out of India to a place outside India. In case of goods, due to their tangibility and movement being tightly regulated by Customs authorities, one can easily track the exports which is nothing but taking the goods outside India. However, due to its inherent nature of intangibility, it becomes very difficult to ascertain the element of export of services. Thereby, in order to determine whether or not the transaction is to be treated as an export of services. there are five meticulous conditions which needs to be satisfied. Therefore, unless all the said conditions are satisfied, the supply of service cannot be regarded as an 'export of service' and thus shall be abandoned from the exports benefits as well.

Meaning of the term **'Export of services'** has been defined in Section 2(6) of the IGST Act, 2017 to mean that "export of services" means the supply of any service when:

1) The supplier of service is located in India;

2) The recipient of service is located outside India;

3) The place of supply of service is outside India;

4) The payment for such service has been received by the supplier of service in convertible foreign exchange or in Indian rupees wherever permitted by the Reserve Bank of India; and

5) The supplier of service and the recipient of service are not merely establishments of a distinct person in accordance with Explanation 1 in section 8.

The first three conditions of definition of 'export of service' as stated above are prominent, i.e. location of the supplier must be within India and the location of the recipient and place of supply must be outside India. Since, Place of supply can be termed as proxies of situs in any tax statute, we shall understand the critical issues in the context of place of supply and its implication on the IT/ ITES sector.

Situs/ Place of Supply of IT services:

Software being intangible, does not have a unique existence and can exist on different servers at the same point in time. Therefore, determining the place of supply of development, design, programming, customization, adaptation, upgradation, enhancement, implementation of information technology software is not only crucial but equally tedious when complex transactions are entangled in each other. In light of such complexity, it is necessary to define the place of supply of service in specific transactions.

In case where the location of service recipient or service provider is out of India, then as per Section 13 (2) of IGST Act, the place of supply shall be the location of the recipient of services i.e. in case of export transactions generally it shall be outside India which is also based on the general principle that GST is a destination based consumption tax. Therefore, as a general principle, the place of supply shall be the location of the customer/ recipient of service. However, in some specific cases, the place of supply shall be different. We shall discuss the same in the issues section.

E. Refunds for IT/ ITES Companies:

Export of IT product is merely the first leg of the beneficial scheme, the second and tangible leg is the refunds in case of export. Now once the transaction qualifies as an export, then as per section 16 of the IGST Act, 2017, the transaction shall be treated as Zero Rated supply meaning thereby that the assessee is having an option to supply the goods or services without charging GST under the cover of a LUT. In such a scenario, the input tax credit accumulated on the various expenses incurred cannot be utilized.

Therefore, practically, the benefit of zero rating in itself is not sufficient enough, the IT companies must be entitled to and actually avail the full refund of the accumulated credits to truly take the benefit of exports. Government has always laid preferential policies and beneficial schemes in the tax laws for exporters since they bring in the precious foreign exchange which helps boosts economy in multiple ways. It is not the case that once a supply of software qualifies as an export, the refund is automatic. The exporter have to comply with and fulfil the various conditions, limitations and procedures laid down therein to truly enjoy the benefit of refunds.

"Zero rated supply" is defined u/s 16 of IGST act which is reproduced below:

16. (1) "zero rated supply" means any of the following supplies of goods or services or both, namely:–

a. export of goods or services or both; or

b. supply of goods or services or both to a Special Economic Zone developer or a Special Economic Zone unit.

Further, a registered person making "zero rated supply" shall have either of the following options:

a. Supply of goods or services or both under bond or LUT **without payment** of integrated tax and claim refund **of unutilized input tax credit;** or

b. Supply goods or services or both **on payment of** integrated tax and claim refund of **such tax paid** on goods or services or both supplied,

Thus, IT companies have option either not to pay any taxes and claim refund of 'unutilized ITC' or to make payment of IGST and claim refund of the same.

As per section 54, except for the refund application in case of balance in Electronic cash ledger, time limit prescribed under the said section is within 2 years from the relevant date. Further, as per section 54(3), entire unutilized input tax credit can be claimed as refund by the exporters.

5. Key GST legal issues & challenges in IT/ ITES sector:

In order to understand the taxability of various elements of the software, let us first list out the various types of transactions and arrangements that are prevalent in the industry as under:

- Canned/Pre-packaged Software;
- Onsite / Off-Site Customised Software development & Implementation (Also called as “Bespoke Software Development”);
- Standardised/ pre-developed software with partial customization:
- Sale of Licenses (Software Renewal)/ End user license agreements;
- Transfer of IPR relating to software;
- Twitching / Patching to existing software;
- Software offered as solution (SaaS Model);
- Supplying Technical Staff for software development to BPO/KPO’s viz, Java, C++ professionals, coders etc;
- Technical testing of software;
- Cloud Computing;
- AMC Contracts & other post supply/ implementation support services;

With this background, we shall now understand the tax implication and various intricacies thereof in respect of the above transactions/ arrangements of GST.

A) Sale Canned/ Pre-packaged Software:

‘Canned software’ means a software that is designed and created for sale to more than one person and it is designed in such a way that large number of people can use it on a variety of hardware and it is also called as “Packaged Software” or “Standard Software” or “Branded Software”. Software such as Lotus, Tally, Oracle etc. are the examples of ‘Canned software’.

In the landmark judgment of **Tata Consultancy Services v. State of Andhra Pradesh – 2004-TIOL-87-SC-CT-LB,** it has been held that canned software i.e. computer software packages sold off the shelf (like Oracle, Lotus Master-Hey etc.) are in the nature of ‘goods’. The copyright in the program may remain with originator of the programme, but the moment copies are made and marketed, they become ‘goods’. *It was held that test to determine whether a property* *is 'goods' for purpose of sales tax, is not whether the property is tangible or intangible or incorporeal. The test is whether the concerned item is capable of abstraction, consumption and use, and whether it can be transmitted, transferred, delivered, stored, possessed etc.*

Even intellectual property, once it is put on a media, whether it be in form of books or canvas (in case of painting) or computer discs or cassettes and marketed would become goods. In all such cases, intellectual property has been incorporated on a media for purpose of transfer. The buyer is purchasing the intellectual property and not the media, i.e. the paper or cassette or discs or CD. There is no distinction between 'branded' and 'unbranded' software. Unbranded software can also be goods. In both cases, the software is capable of being abstracted, consumed and used. In both the cases, the software can be transmitted, transferred, delivered, stores, possessed etc. ***[SC upheld decision of AP High Court reported in Tata Consultancy Services v. State of AP (1997) 105 STC 421 (AP HC DB)].***

Further, in the case of **Bharat Sanchar Nigam Ltd. V. UOI – 2006-TIOL-15-SC-CT-LB** *(SC 3 member bench),* following extract from decision in case of Tata Consultancy Services v. State of Andhra Pradesh was quoted with approval and adopted. 'A goods' may be a tangible property or an intangible one. It would become goods provided it has the following attributes as under:

(a) Utility;

(b) Capable of being bought and sold; and

(c) Capable of being transferred, delivered, stored and possessed.

If a software, whether customized or non-customized satisfies these attributes, the same would be goods'.

Determining whether the software is a goods or a service has been a part of very controversial subject for a long time. However, the issue got settled in the landmark judgment of Tata Consultancy Services (TCS) vs. State of Andhra Pradesh wherein it was held that 'canned software' in the packaged form amount to 'Goods' and the same shall be liable to sales tax.

However, the judgment states that the canned software shall be treated as goods on the basis that intangible goods are also goods. However, the important question which arises is what shall be the tax treatment in case the canned software is sold through an internet download (without any physical media) or if the canned software is updated online by way of patches. In this regard, reference must be placed to the **FAQ's issued by CBIC** which states as under:

Question 1: *Whether software is regarded as goods or services in GST?*

Answer: *In terms of Schedule II of the CGST Act 2017, development, design, programming, customisation, adaptation, upgradation, enhancement, implementation of information technology software and temporary transfer or permitting the use or enjoyment of any intellectual property right are treated as services.* ***But, if a pre-developed or pre-designed software is supplied in any medium/storage (commonly bought off-the-shelf) or made available through the use of encryption keys, the same is treated as a supply of goods classifiable under heading 8523.***

From the above, it is clear that canned or pre-packaged software must be treated as 'Goods' and classified accordingly only when it is supplied in any medium/storage (commonly bought off-the-shelf) or made available through the use of encryption keys. In other words, if a canned/ pre-packages software is not supplied in any medium/ storage or through use of encryption keys, then it must be classified as an **'Information technology software service'.**

B) Onsite / Off-Site Customised Software development & Implementation (Also called as "Bespoke Software Development"):

'Customised Software' means the software created for a single person or a specific customer to meet his specific requirement and it is also called as "Tailor-made Software" or "Specific Software". In this case, the IT company undertakes the activity of developing and implementing a software understanding the customised needs and requirement of the customer. The implementation of the customised software undergoes various sub-processes which includes design, development, programming, customisation, testing & implementation of the software. Various activities would be performed either at offsite or at an onsite client location.

From entry 5(d) of the schedule II above, it can be stated that Customisation of an information technology software is to be classified as a service. However, a question may arise as to whether the customized software so developed is delivered to the client on media like a CD, then whether the transaction would be treated as a supply of goods or it shall be treated as a supply of service.

Reference here can be placed on the judgment of the Apex Court in the case of **Tata Consultancy Services (TCS) vs. State of Andhra Pradesh,** which stated as under:

"Indian law does not make any distinction between tangible property and intangible property. A 'goods' may be a tangible property or an intangible one. It would become goods provided it has the attributes thereof having regard to (a) its utility; (b) capable of being bought and sold; and (c) capable of transmitted,

transferred, delivered, stored and possessed. If a software ***whether customized or non-customized*** *satisfies these attributes, the same would be goods".*

In the above judgment it was stated that, even a customized software would be treated as 'goods', if certain attributes are fulfilled. However, it must be noted that we cannot directly place reliance on the above judgment, since these were only the remarks of the court and no conclusive opinion or judgment was formed by the apex court in the above case from the context of customized software as to determine whether or not it also be treated as 'Goods' especially in a scenario when it is loaded on to a media. Further, reference must be placed to the education guide on service tax issued by CBIC in 2012, wherein in para 6.4.5, it was clarified as under:

6.4.5 In case contract is given for customized development of software and the customized software so developed is delivered to the client on media like a CD then would the transaction fall in this declared entry or would it be covered by the TCS Judgement?

In such a case although the software is finally delivered in the form of goods, since the contract is essentially for design and development of software it would fall in the declared list entry. Such a transaction would be in the nature of composite transaction involving an element of provision of service, in as much as the contract is for design and development of software and also an element of transfer of title in goods, in as much as the property in CD containing the developed software is transferred to the client. However, the CD remains only a media to transmit or deliver the outcome of which is essentially and pre-dominantly a contract of service. Therefore, such a transaction would not be excluded from the ambit of the definition of 'service' as the transaction does not involve 'only' transfer of title in goods and dominant nature of the transaction is that of provision of service.

It was held by the European Court of Justice, in case of **Levob Verzekeringen BV and OV Bank NV v. Secretary of State for Finance, Netherlands [2012] 22 taxmann.com 174 (ECJ)** that Supply of basic software along with subsequent customisation thereof to meet requirements of customer and training to his employees under a single contract is a single indivisible supply of service based on the Dominant nature test.

Thus, in case of supply of customised software along with goods, we need to ascertain the dominant nature of the transaction and if the supply of goods is key element with software inbuilt being an ancillary element, then it would amount to supply of goods. However, if providing a software is a main requirement along-side the media which is only ancillary, then it can safely be classified as a supply of 'Information Technology software' service.

C) Standardised/ pre-developed software with partial customization:

Practically, in a real commercial world, it is very much acceptable transaction wherein the IT company would develop a standard software, however, due to various reasons, it is not possible to apply/ implement the standard software as it is and therefore based on the customised requirement of each customer or based on their business model, certain level of customisation is be carried out to make the technology implementable. The issue that arises from the taxation standpoint in this scenario is whether it needs to be classified as a packaged software i.e. Goods or as a Customized software i.e. Service.

In this regard, reference must be given to the case of **Infosys limited v/s CCEx 2018 (12) G.S.T.L. 333 (Tri. - Bang.)** wherein it was held that *"it appears to us that the appellant has designed and developed Finacle Software as a platform which finds use exclusively in the banking sector. Before supply of such Finacle Software to any particular bank, the appellant undertakes various activities such as discussion with the customer to ascertain the exact requirements such as the number of computers/branches, offices/user units of the bank; whether installation is required; total number of branch software licence required; the nature of other 3rd party software being used by the customer, etc. After taking into consideration the exact requirements of the customer, the Finacle Software is customised for a given user, installed, integrated and implemented for the use of the customer bank.... we observe that in respect of Finacle Software, there is an element of supply of software developed to meet the needs of a variety of users. Since Finacle Software is not developed, ab initio, for supply to each and every customer, we are inclined to uphold the view taken by the adjudicating authority that such* ***Software falls within the category of packaged or canned software.*** *Such software cannot be considered as customized software designed and developed for a specific user.*

From the above judgment, it can be deduced that if platform or a standardized software is largely ready and minor customization is carried out such as additional reports, assessing the client's capacity, volume/ no's etc. then such mere minor customization does not change the colour of the transaction and it would continue to be classified as a canned software only. However, if a major change is carried out in the software i.e. the source code is re-written or is substantially updated, then the above view may not hold good and the software would be classified as a customized software.

D) Sale of Licenses (Software Renewal)/ End user license agreements:

Upon development of the software, the IT company would prefer to exploit the same on a mass basis in the open market. In real commercial sense, the developer does not sell or transfer the exclusive rights to use the software but instead allows the usage of the software only on the license basis to the end user subject to various terms and conditions of the usage. If the end user agrees to the terms and conditions, then such end user is given "non-exclusive right to use" (install, run, use and get updates) the software within the limits prescribed. At no stage, an end user who runs the software installed in his computer becomes absolute owner of the software. The end user cannot tamper or modify, cannot improve and also cannot rectify errors in the software and the end user should not sell the software to another person for commercial exploitation.

It is relevant to note that the copyright in the software is protected and always remains the property of the creator and what is sold is the right to use the software. The sale is with a condition for exclusive use of the software by the customer at the exclusion of others and it gives absolute possession and control to the user of the right to use the software. End User Licence Agreement (EULA) is also a legal contract between a software application author or publisher and the user of that application governing the usage. The agreement is renewable and/or could be amended from time to time.

In the case of **Infotech Software Dealers Assn. v. UOI – 2010-TIOL-620-HC-MAD-ST,** *it has been held that whether the transaction would amount to sale or service would depend upon the individual transaction. A transaction can be exclusive sale or exclusive service or a case where both elements of sales and service is involved, depending on End User License Agreement with ultimate customer of software. It was observed that when software is sold through medium of internet in form of downloadable, it does not fit in ambit of 'IT software of any media' and then when only password is given and not CD, it does not satisfy requirement of being goods. Regardless of being a "goods" or "service," there is a third category wherein, the original manufacturer, who creates the software, only licenses the software for the private use of the end user subject to the terms and conditions. At no stage an end user becomes the absolute owner of the software. The end user simply agrees to the terms and conditions, runs the software and gets it installed onto its operating system and also gets updates of the same.*

Reference must also be given to the **FAQ's issued by CBIC** in this regard, which states as under:

Question: *When would it be construed that I have made a supply of services involving temporary transfer or permitting the use or enjoyment of any intellectual property right?* ***Answer:*** *Generally, the End User Licence Agreement (EULA) is the legal contract between a software application author or publisher and the user of that application governing the usage. The agreement is renewable and/or could be amended from time to time. To find out as to whether there is an element of supply involved when software is delivered to its customer, the terms* *and conditions of EULA are material. The contract for supply therefore assumes significance in this test to decide whether or not there has been 'temporary transfer or permitting the use or enjoyment of any intellectual property right'.*

It is pertinent to note that only rights to use of software is given by way of the licensing agreement, but the extent of rights transferred determines the true nature of the transaction. Therefore, merely because a software is sold under the end user licensing arrangement does not by itself makes it a supply of service. One must take cognizance of the nature of software being sold i.e. canned or customized and depending upon the other terms of the agreement between the parties, the true nature of transaction, the tax treatment must be accorded. For instance, if a canned software is sold on a licensing basis, then it continuous to be a supply of goods as long as it meets the requirements of the schedule II of the CGST Act, 2017 read with the scheme of classification and the relevant explanatory notes.

E) Transfer of Intellectual Property Right (IPR) relating to software:

Section 2 (ffc) of the Copyright Act, 1957 defines the expression "Computer programme" as a set of instructions expressed in words, codes, schemes or in any other form, including a machine readable medium, capable of causing a computer to perform a particular task or to achieve a particular result. Thus, Software is a set of one or more computer programmes which performs the function of the program, either by directly providing instructions to the computer hardware or by serving as input to another piece of software. Further, software is an **intellectual property** as per the Copyright Act, 1957.

In the Landmark Judgement of TCS, Hon'ble SC held as under:

"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.*

Therefore, in various arrangements that are in the form of licencing or otherwise, the developer transfers the intellectual property in the software to the customer. However, based on the extent of rights transferred, the nature of transaction must be ascertained. One must note that the classification of IPR as goods or service in the GST law depends on whether or not the transfer of such IPR is temporary or permanent. Reference can be placed to the various entries in the rate classification as under:

- Notification No. 1/ 2017 which provides for the rate of GST on Goods provides that *"Permanent transfer of Intellectual Property (IP) right in respect of Information Technology software".*
- Notification No. 11/2017 – Central Tax (Rate) which provides for the rate of GST on Services provides that *"Temporary or permanent transfer or permitting the use or enjoyment of Intellectual Property (IP) right in respect of Information Technology software."*
- Further, entry 5(c) of the schedule II states that *"temporary transfer or permitting the use or enjoyment of any intellectual property right" shall be treated as a supply of service.*

Combined reading of the above rate notifications along with the principles of classification of goods and service as given in schedule II, it can be said that permanent transfer of IPR would amount to goods and where only the temporary transfer is made or usage is permitted, it would tantamount to be a service.

Therefore, in order to understand as to whether or not the permanent transfer in the IP of the information technology software is made, we need to understand the meaning of the term 'Information Technology Software'. The term 'Information Technology Software is defined in explanation (v) to Notification No. 11/2017 – Central Tax (Rate) as under:

"Information technology software" *means any representation of instructions, data, sound or image, including source code and object code, recorded in a machine readable form, and capable of being manipulated or providing interactivity to a user, by means of a computer or an automatic data processing machine or any other device or equipment.*

The **European Court of Justice (ECJ)** in 2012 decided the case of **UsedSoft GmbH v Oracle International Corp** essentially ruled that: downloaded software with a perpetual licence was the "functional equivalent" of a physical product and as such the rights holder's ability to control subsequent distribution was exhausted as in effect a sale had taken place.

From the above, it can be noted that software also includes source or the object code which is recorded in a machine and is capable of being manipulated. Therefore, when a transfer to use the IPR in a software is made without access to the source code or the capability to manipulate the same, then it is surely not a permanent transfer of IPR in a software. To the contrary, if the entire source code, object code and the capability of its manipulation is permanently transferred to the customer, then it is an apt scenario of a permanent transfer of the IPR in a software and must be treated as a 'Goods' and not a 'Service'.

It is important to note that the classification of a transaction into 'Goods' or 'Service' is very important in GST in as much as the manner of determination of the place of supply, time of supply, HSN classification etc. is different in both the cases. Reference here can be placed on the FAQ's issued by CBIC which states as under:

Question: *What are the implications of recognising the development, design, programming, customisation, adaptation, upgradation, enhancement, and implementation of information technology software as a service?*

Answer: *The primary implication is that the place of supply rules applicable to services would apply in determining taxability of the supply of software services. The same would be applicable in situations of supply of services involving a temporary transfer or permitting the use or enjoyment of any intellectual property right. The other implication is that the supplier of software services would not be eligible for the composition scheme.*

F) Twitching / Patching to existing software:

Twitching/ patching to the existing software is necessary to provide the continues updates and upgrade the existing version of the software. Generally, in case of the licensed software, no separate amount is charged and all the updations/ patches would be covered in the license fee originally charged. However, in some cases the license to use a particular version of a software would be transferred for a perpetual period with a separate charge for any updations/ upgradations, therefore in such scenarios if the patch is made on the customer owned software with the transfer of source codes, then it would amount to sale of goods, however when only the rights to use is transferred with complete source codes and capability to its manipulation held with the developer, then it would amount to a supply of service. However, based on the facts of each transaction, the tax treatment must be derived.

G) Software offered as a solution (SaaS Model):

Sometimes it is possible that requirement of the customer is not restricted merely to a supply of a software. In fact, a mere supply of software does not serve the purpose of the client and they would expect a complete solution whereby necessary hardware and the software are supplied together and are working in sync with each other to provide an entire solution. In such scenario, a general expectation of the customer would be to receive a complete solution and not just a supply of a software. For ex: In the process of installation of the CCTV cameras in office, a license in the software is also given to access the app/ cloud based server and view the recordings or live footage wherein the requirement of the customer is not merely a supply of the cameras nor just a access to the APP/ cloud based software but it is to provide a solution of CCTV cameras duly installed and having a feature of providing live video along with recordings in a running condition.

It must be noted that this is a situation of a composite supply wherein both supply of hardware and a software are supplied together in combination with each other and accordingly based on the dominant nature test, one has to derive the true nature of supply.

For instance, in the case of **VEDANT SYNERGY PVT. LTD. 2019 (27) G.S.T.L. 149 (A.A.R. - GST)** *Applicant is supplying goods viz. Central MCU and other equipment like speakers, cameras, etc. to Government of Karnataka for its project to connect village panchayats via Video Conferencing - In addition, suitable manpower for installation and maintenance of said goods is also being supplied - Since, said activity not resulting in emergence of any immovable property, supply is not covered under works contract - However, entire supply is a composite supply as goods and services being supplied are naturally bundled - Principal supply for this composite supply is service of 'Video Conference software/solution' which is nothing but Information Technology Infrastructure and Network Management Service classifiable under HSN 9983 16.*

Therefore, in all cases where the terms of the contract demands a solution rather than just a sale of goods, then such transaction cannot be called as a 'sale simplicitor' since the chattel is not given as a chattel and instead it is offered as a solution which is also commonly known as SaaS model i.e. Software as a part of sale/ service. Therefore, based on substance of the solution, one must derive the class of the transaction.

H) Supplying Technical Staff for software development to BPO/KPO's viz, Java, C++ professionals, coders etc.

Many times, it is possible that the IT companies enter into an arrangement wherein the support is given to the clients by deputing the technical staff or other skilled staff. The deputed staff would be working under the supervision or control of the client i.e. under the directions or instructions of the client. Based on the skill sets of the deputed staff, the client would get various jobs performed i.e. viz., Coding, Customer support, internal tech support, testing or any other function in the software development life cycle. The role of IT company would be only to depute the human resources and there is no further deliverables or other responsibility casted on them. Generally, the billing is done based on the no. of hours/ days of deputation. The important question that arises in this arrangement is whether the said services rendered by the IT company would fall within the ambit of Information Technology Software service.

In this regard, it must be noted that unlike an arrangement where the IT company is casted with the responsibility of developing a software, there is no such obligation casted and the scope of work is restricted merely up to supply of the skilled manpower. Therefore, the services would appropriately get classified as a Supply of manpower services instead of a Supply of Information Technology Software service.

In the case of **SIX SIGMA SOFT SOLUTIONS (P) LTD. Versus COMMR. OF SERVICE TAX, CHENNAI 2018 (18) G.S.T.L. 448 (Tri. - Chennai),** *it was held that Appellant supplying skilled work force to IT Companies for development of software either at premises of said companies or at premises of their clients - Personnel working under supervision and control of said IT companies - Appellant's plea that said service covered under Information Technology service, not acceptable in view of precedent decision in an identical matter in 2010 (18) S.T.R. 308 (Tri. - Chennai) holding classification of such services under Manpower Recruitment or Supply Agency service*

Further, in the case of **FUTURE FOCUS INFOTECH PVT. LTD. Versus COMMR. OF C. EX. (S.T.), CHENNAI-IV, 2018 (18) G.S.T.L. 441 (Tri. - Chennai),** *Services of selected employees offered for work on development, implementation and maintenance of specific projects to be identified and allocated by TCS - Assessee only providing manpower, albeit those having software technology skills, to organizations like TCS, Infosys, etc. but information technology development was not done by it nor was it contracted for it - Software or IT development was done only by TCS, Infosys, etc., by utilizing manpower supplied by assessee and as per their requirements, allocation and control - Assessee fell within scope of "Manpower Supply or Recruitment Agency Service" as defined in Section 65(105) (k) of Finance Act, 1994.*

I) Software testing service:

Upon development of the software, one of the essential activity to be performed is its testing so that any hidden bugs/ errors in coding etc. are identified and corrected. Software testing may be for functional, automation, regression or load testing. Testing is a continuous process and is needed not only in the development of a new software but also in the improvement to the existing software. Software companies apart from undertaking internal testing, they would also outsource the testing activity to specialised companies since the domain of software testing in itself is a big industry/ sector. Outsourcing to independent third party also helps in getting a critical feedback of the software's functionality.

The issue that arises is whether the software testing gets classified as an 'Information Technology software service' or as 'technical testing and analysis service'. In the case of **M/s. SQS INDIA BFSI LTD vs COMMISSIONER OF SERVICE TAX CHENNAI 2018-TIOL-2675-CESTAT-MAD,** it was held that *"Assessee have been held liable to service tax for testing customers software under category of "Technical Testing and Analysis Services" for the period 01.07.2003 to 31.12.2005. The Tribunal in case of M/s. Relq Software Pvt. Ltd. has dealt with an identical issue and has categorically held that Testing and Analysis of Software was not a taxable service prior to 16.05.2008. The period is prior to 16.05.2008 and as the testing of Information Technology Software was specifically brought under the category w.e.f. 16.05.2008, no justifiable reason found to uphold the demand."*

Further, to strengthen this view, one can also place reliance on how historically this service was classified in the erstwhile indirect taxes viz., service tax law. Reference must be given to the definition of Technical testing and analysis service in section 65(106) of the Finance Act, 1994 was as under:

"Technical testing and analysis *means any service in relation to physical, chemical, biological or any other scientific testing or analysis of goods or material or* ***information technology software*** *or any immoveable property but does not include any testing or analysis service provided in relation to human being or animals".*

As per general rules for the interpretation of the Harmonized System, classification of goods in this scenario shall be governed by the following principle i.e. ***"The heading which provides the most specific description shall be preferred to headings providing a more general description."*** In the given case, technical testing and analysis service is a specific head and up on reading of all the entries in this heading, it is clear that all the testing's as specifically mentioned and any other testing and analysis not elsewhere mentioned would get classified under this heading being a more specific one.

The only closest entry is the IT support service, but the scope of the service is restricted to customer support that are linked to problem solving of a client viz., trouble shooting of hardware, software and only merely states to cover testing and routine cleaning of hardware. Since the term 'support' being general in nature cannot be interpreted to give a wider meaning.

Thus, taking view from erstwhile service tax law, the scope and coverage of technical testing and analysis services and information technology consulting and support service in the CPC coding, it can be stated that the testing services rendered would more specifically fall within the ambit of 'Technical Testing and analysis service.' It is pertinent to note that in the foreign trade policy, there are various benefits which are available for testing services when exported as against the information technology software service, therefore the appropriate classification can help businesses in properly leveraging upon the various schemes and incentives of the Government.

J) AMC Contracts & other post supply/ implementation support services:

It is very common that the IT company supplies the goods, service, solution etc. to a customer also provides the maintenance support or implementation support to ensure that the applications are working smoothly without any hassle. The issue is whether the maintenance, implementation, support functions also fall under the Information technology software service. It must be noted that sometimes the aspect of maintenance, support etc. is not bundled with the main contract and the same is separately agreed upon, in such a scenario, the said service would get classified as an Information Technology support service.

However, if a composite contract is entered involving multiple supplies, then the transaction must be classified based in the supply that is a principal constituent in the contract. For ex: If a contract for supply & maintenance of the CCTV cameras is given for a single price, then the principle supply in this case would be the supply of cameras and the transaction must be classified accordingly.

(i) In the case of ***Agra Computers v. Commissioner - 2015 (39) S.T.R. J31 (S.C.),*** *it was held by the Apex court the respondent was operating spot billing centers and for that purpose had to maintain necessary software. The Tribunal for identifying the essential characteristics after considering the obligations of the respondent, weightage of consideration attributable to activity of processing of bills and maintenance of software, general tenor of the contractual obligations, core expectation, held that the services are classifiable as Business auxiliary and not Information technology (IT services). In case of IT services, the designing or development of software or system networking should be primary rather than adjunct of other substantial raft of services.*

(ii) Further, in the case of ***Ansys Software Pvt. Ltd 2019 (30) G.S.T.L. 563 (A.A.R. - GST).,*** *Applicant was providing 24x7 after sales troubleshooting and Technical Support services to end-customers on behalf of supplier of software located abroad. Such services being supplied either through e-mail or through telephone or through web-support for which consideration being paid by supplier of software. Accordingly, said supplier abroad becomes*

recipient of services notwithstanding that services are actually being given to customers in India. Said service appropriately classifiable under SAC 9983 13 as Information Technology Consulting and Support services in view of explanatory note to said SAC.

K) Taxability in Cloud Computing:

'Cloud computing' are the software on demand, available anywhere, at anytime subject to availability of an internet connection and they are scalable as per the needs of the user. There are three major models of delivering 'clouding computing' services to businesses as follows:

i) **Infrastructure as a Service (IaaS) Model** - Under this model, IT infrastructure in the form of data center's, virtual servers, network infrastructure, equipment, etc are sourced as a service from third party service providers. The customer does not manage or control the underlying cloud infrastructure, but has control over the operating system, storage, and deployed applications, and may be given limited control of select networking components.

ii) **Platform as a Service (PaaS) Model** - Provides a computing platform and programming tools as a service for software developers. The client does not control or manage the underlying cloud infrastructure, including the network, servers, operating systems, or storage, but has control over the deployed applications.

iii) **Software as a Service (SaaS) Model** - Service provider hosts several software applications for consumers to use as and when required thereby eliminating the need to install and run the software application on the consumer's own infrastructure. It can be provided either to business customers (B2B) or to individual customers (B2C).

Generally, in cloud computing transactions, the control and possession of the server is not transferred, instead, only a place is provided on the server to use against a payment but the user is not authorized to control the server itself. For instance, in some cases, the agreement states that the 'user has the right to dictate the type of hardware to be used' or 'the right to control over the space allotted'. Tremendous dispute is possible on determining the nature of supply if the contracts are not properly drafted and whether the same involves leasing of hardware/ equipment's or transfer of right to use goods or an information technology software service as a whole. Therefore, one needs to understand the true nature of supply and the terms of agreement needs to be carefully reviewed and the clauses loosely drafted and the litigative ones needs to be chalked out to avoid any unnecessary intrusion of issues therein.

L) Recipient of service in case of tripartite agreements:

In case of IT industry, the development of an IT product may not take place only at one place by one vendor. The entire project may be segregated into different units and each unit may be developed by different vendors. Thus, there can be different views onto who is ultimate recipient of the service. The question is even more important as place of recipient of service shall determine whether or not supply qualifies as export and its benefits. Therefore, it is crucial to first determined who is the recipient for 'export of service' in case of multiple users of IT services provided by the IT company.

Example 1: *A client from Finland contracts with an IT firm in Pune to deliver a part of the project to another IT firm in Bangalore for further development and completion. In such a case, practically the IT product is delivered to Bangalore as per the direction of client having his office in Finland.*

Example 2: *In another instance, assume a client in USA has placed an order to develop a hardware for a Robot to a vendor in Japan and at the same time placed an order to develop its corresponding programme to be embedded in the Robot to a developer in India. In such case for smooth implementation of the programme and compatibility with the Robot, USA client appoints an agent who has all the rights to coordinate and deliver the programme directly to Japan vendor from the Indian Developer.*

At this stage it is imperative to mention that 'recipient of supply of service or goods' is not a general term but a legal term which is defined u/s 2(93) of CGST Act as under:

"Recipient" *of supply of goods or services or both, means—*

(a) where a consideration is payable for the supply of goods or services or both, the person who is liable to pay that consideration;

(b) where no consideration is payable for the supply of goods, the person to whom the goods are delivered or made available, or to whom possession or use of the goods is given or made available; and

(c) where no consideration is payable for the supply of a service, the person to whom the service is rendered, and any reference to a person to whom a supply is made shall be construed as a reference to the recipient of the supply and shall include an agent acting as such on behalf of the recipient in relation to the goods or services or both supplied.

In the first example if as per the agreement the USA/Finland client is liable to release the payment to Indian developer then it is to be considered as recipient and supply shall be regarded as 'export of service' subject to other conditions. However, in the second example if the agent in India is liable to make the payment then such Indian agent shall be the recipient of service and the transaction shall be treated as a domestic supply.

Relevant Case law:

a) In the case of COMM. OF ST MUMBAI-VI VERSUS GUPSHUP TECHNOLOGY INDIA PVT. LTD. [2018 (9) GSTL 305 Tri. Mumbai], The Respondent were liable to provide the SMS Aggregator service to M/s. Facebook i.e. Application programming Interface (API) connected with Facebook Server. The Respondent were working on directions and Instructions of Facebook. The Facebook used to initiate the transmission of SMS from their server located outside India through Respondent's API connectivity and respondent provided the services to M/s. Facebook by sending or receiving SMS to subscribers of Facebook located in India. It was observed that the Respondent were thus working as aggregator/facilitator. It was held that the services were not provided to any Indian Subscriber by the respondent. The Respondent had no Connection/ Interaction or relation with the Indian subscribers of the facebook. The services were provided under the terms and conditions of the agreement made between M/s. Facebook Ireland and the Respondent. The Respondent were not charging any service charges or part thereof from the Indian subscribers. Hence, the recipient of service is Facebook, Ireland and its correctly treated as an 'export of service'.

M) Lack of export impetus in case when coding, development etc. mandates the physical presence of the hardware over which the software is to be installed:

In IT & ITES industry, there can be two scenarios. i.e. in one case the presence of the hardware for developing the programme or software for the said hardware is needed in order to develop the software. However, in certain other cases the software could be independently developed and then later embedded into the hardware. As per section 13(3) of the IGST Act, 2017 Place of supply in case of services supplied in respect of goods which are required to be made physically available by the recipient of services to the supplier of services, or to a person acting on behalf of the supplier of services in order to provide the services shall be location where services are actually performed.

Therefore, in the former case, place of supply shall be the place of performance of service, unless the service is provided remotely in case of which it shall be the place of goods and in the latter case, the place of supply shall be determined based on the general rule i.e. it shall be the location of the recipient of service. For instance, a developer in Pune can develop the program for ATM machine of Barclays situated in USA. The entire development of the program can be done remotely without bringing the ATM machine at developer's place even once. In such case, place of supply shall be the place of ATM machine i.e. USA. In the same example, if prototype of the ATM machine is made available at Pune and entire development of software program is done on the prototype machine then place of supply shall switch to India.

However, said provision does not apply in the case of services supplied in respect of goods which are temporarily imported into India for repairs and are exported after repairs without being put to any other use in India. In such cases, place of supply shall be determined predominantly based on the residuary principle i.e. location of recipient of service. Practically it may happen that any IT product already sold and delivered to foreign country encounters some issue, for which it is reimported. In such case, if it is re-exported merely after repair work, then export benefit can be claimed.

Relevant Case law:

a) ***In the case of M/S SUREPREP (INDIA) PVT. LTD. VERSUS COMMISSIONER OF CGST, MUMBAI WEST, 2019 (2) TMI 384 - CESTAT MUMBAI,*** *the appellant rendered services to SurePrep LLC, USA in relation to preparation of Income Tax returns and Software Development & Support services to the said overseas client. The entire services rendered by the appellant to the overseas customers have been consumed in the foreign territory. The finding of the learned adjudicating authority, as confirmed by the Commissioner (Appeals) was that, the relevant data was processed in India and ultimately sent to the foreign company, hence not would not qualify as export service as per Rule 4 of Place of provision of service Rules, 2012. The Hon'ble tribunal emphasised on the fact of ultimate consumption of the service and based upon the same held that the place of provision of a service shall be the location of the recipient of service where actually services were consumed. Therefore, services would qualify as export of service and the refund should be allowed.*

N) Taxability in case of Intermediary transactions – Arrangement or facilitation services:

'Intermediary services' can be regarded backbone of entire IT and ITES industry. It the very crucial link between the offshore and onshore entities and the business between them. The term 'Intermediary' as defined under section 2(13) of IGST Act means "a broker, an agent or any other person who arranges or facilitates the supply of goods or services or both between two or more persons, but does not include a person who supplies such goods or services on his own account." Place of supply in case of Intermediary is the location of supplier. In other way, an intermediary situated in India, would not be eligible for export benefits. Therefore, it is always a revenue's prerogative to treat a transaction as in the nature of the intermediary which may obstruct the benefit of export to the taxpayer.

As stated above, the term 'Intermediary' is defined to mean a broker or agent. Now, meaning of the term 'Agent' is specifically defined under IGST act , as a person, including a factor, broker, commission agent, arhatia, del credere agent, an auctioneer or any other mercantile agent, by whatever name called, who carries on the business of supply or receipt of goods or services or both on behalf of another. Further **Circular No. 57/31/2018-GST Dated the September 4th, 2018** has also clarified as as to when the relationship is to be construed as principle-agent. Two key elements mentioned in the said circular in definition of agent are mentioned below:

(a) 'agent' is defined in terms of the various activities being carried out by the person concerned in the principal-agent relationship; and

(b) the supply or receipt of goods or services has to be undertaken by the agent on behalf of the principal.

Thus, in case one does undertake a business transaction in his capacity as an an agent, the service cannot be termed that of 'Intermediary'.

In order to overcome the ambiguity revolving around, Department issued a Circular 107/26/2019-GST titled 'Clarification on doubts related to supply of Information Technology enabled services (ITeS services)'. However, the said circular was withdrawn vide Circular No. 127/46/2019-GST dated 4th December 2019. Therefore, the conundrum of what constitutes a transaction in the nature of an 'intermediary' continues to be one of the contentious issue Therefore, we shall now understand the context of 'intermediary' with the help of various rulings and judicial precedents therein.

Relevant Advance Rulings & Judicial Precedents:

a) *The Maharashtra Authority for Advance Ruling had passed an order in the matter of **VservGlobal PrivateLimited - 2018-TIOL-263-AAR-GST** holding that the back office support services provided by the Applicant were in the nature of 'Intermediary Services' and consequently the Place of Supply was in India and, as a result, these services would not come under ambit of Export of Services. Following the ruling, if such services are classified as Intermediary Services and thus are not held to be 'Export of Services', then it would blunt the competitive edge available for the said service provider as the said* *services shall be costlier due to lack of export incentives. The said order was upheld by Maharashtra AAAR, reaffirming the view that back office services would come under ambit of 'Intermediary'.*

b) *At this juncture, reference is made to the Maharashtra AAAR, in case of Five Star Shipping, where the authority has mentioned in its Order No. Mah/AAAR/SS-RJ/11/2018-19 23rd October 2018 the necessary conditions for any activity to be an intermediary service as under:*

- *There should be supply of goods or services or both;*
- *There should be the involvement of three persons (i) the supplier of the goods or services or both (ii) the receiver of the supply of the goods or services or both and (iii) the intermediary who arranges or facilitates the said supply of goods or services or both subject to the condition the said supply is not made by the intermediary himself on his own account.*

c) *Authority for Advance Ruling in the* ***State of Karnataka in the case of M/s. Toshniwal Brothers (SR) PVT. Ltd. 2018-TIOL-197-AAR-GST,*** *wherein the authority has held soliciting Customer, negotiating price, terms etc. on behalf of the principal and commission payable being tied to amount of sales as grounds for holding the applicant as an 'intermediary'.*

d) *Advance Ruling pronounced by the Authority on Advance Rulings under the erstwhile Service Tax provisions in the case of* ***GoDaddy India Web Services (P.) Ltd (Ruling No. AAR/ST/08/2016, Application No. AAR/44/ST/15/2014)*** *had clearly demarcated the meaning of intermediary services and ruled that pure marketing and promotion services would not be intermediary services.*

Thus, in absence of any clarification and the flawed rulings rendered by the authority of advance rulings, the issue as to what constitutes an intermediary shall be tested with time. In our view, the ruling issued in the case of GoDaddy as above gives the correct view. However, driving force to exit the ambit of intermediary can be stated as the degree of supply of services on his own account i.e. opposite to the concept of an agent. Still, the ultimate clarity on the issue by the Department shall benefit the entire IT and ITES industry.

O) Transactions of supplying IT services between Holding & Subsidiary companies:

In IT and ITES industries there are multiple MNCs, having its HQ in one country and branches in other countries. The branches situated in India provide the services to HQ abroad. In such case, if the ambit of distinct person is stretched so wide then it might hit the entire Industry too hard. Amongst several models in IT and ITES, one of the popular model is to export the services to holding company by a subsidiary situated in India. If export benefits are denied to such genuine exports, then it may lead to undue hardship to the Industry as a whole.

As per Explanation 1 to section 8(2) of IGST act where a person has an establishment in India and any other establishment outside India then such establishments shall be treated as establishments of distinct persons. Further, the last condition for supply of service to qualify as 'export of service' is such that the supplier of service and the recipient of service should not merely be the establishments of a distinct person in accordance with Explanation 1 in section 8. Reference here must be placed on section 25(4) of the CGST Act, which states that *"A person who has obtained or is required to obtain more than one registration, whether in one State or Union territory or more than one State or Union territory shall, in respect of each such registration, be treated as distinct persons for the purposes of this Act."*

From the above it can noted that the concept of 'distinct person' is qua a 'person' and when two 'persons' are involved, they would not be treated as distinct persons as they are any way different persons and there is no question of bringing them within the meaning of the term 'distinct persons'. Therefore, it must be noted that holding company and the subsidiary being two different and distinct legal entities would not get barred by the above condition.

P) Receipt of monies in convertible foreign exchange & its practical dissection may pose complexities:

One of the requirements to be fulfilled for a transaction to be treated as an export of service is that the payments for supply of service should have been received in convertible foreign exchange or in Indian rupees wherever permitted by the Reserve Bank of India. The later part 'Indian Rupees whenever permitted by RBI' is added vide IGST Amendment Act 2018. Thus, even receipt in Indian Rupees shall qualify the supply as export, if concluded within the guidelines of RBI which is allowed for certain exports only.

While the receipt of monies in convertible foreign exchange is one of the important conditions to be fulfilled to claim the benefit of exporting. However, one of the biggest issue is to prove the same at exact rupee level and having adequate proofs in documentation to substantiate the same. Generally, the Foreign Inward Remittance Certificates (FIRC's) or Bank Remittance Certificates (BRC's) are issued by the authorised dealer i.e. Banks which acts as a basis for claiming the receipt of monies in the convertible foreign exchange. However, in reality various other challenges are posed before the exporters in as much as that the final settlement of dues may get be concluded on net basis after considering the overall receivable and payable accounts between the exporter and foreign customer or the payment might be routed from different ways and ultimately credited to the bank account. Few of such practical scenarios are discussed below:

(a) ***Case Study 1:*** *ABC Ltd. India has received an order for supply of services amounting to $ 5,00,000/- to a US based client. ABC Ltd. India is unable to supply the entire services from India and asks XYZ Ltd. Mexico (who is not merely an establishment of a distinct person viz. ABC Ltd. India, in accordance with the Explanation 1 in Section 8 of the IGST Act) to supply a part of the services (say 40% of the total contract value). The invoice for the entire amount is raised by ABC Ltd. India. To avoid duplication, ABC Ltd. asks US based client to release the payment of 40% of contract value directly to XYZ Ltd. Mexico and balance 60% to self. In such case, 100% consideration could have been received first and then 40% could have been paid to XYZ Ltd. Mexico, however amount is split at first instance only.*

(b) ***Case Study 2:*** *In above case, assume ABC Ltd. India had not outsourced the any portion of the work and had agreed to provide the final product at the end of one year from signing the agreement. However, ABC Ltd could not honour the commitment and the project got delayed by 3 months leading to commercial losses to US based client. As per the agreement entered, US based client was entitled to receive 5% of the contract value against the said delay of 3 months. During the final settlement, US based client releases the payment equivalent to 95% of the contract value only netting off the 5% with 100% value.*

(c) ***Case Study 3:*** *Hitech Ltd, India has received an order to implement a project at agreed contract value of $ 1,00,000/- to a US based client. For successful implementation of the project, Hitech Ltd. hired Cloud Ltd, India to provide high capacity server to Hitech Ltd at the agreed rental price of say $ 10,000. For some reason, after 3 months Cloud Ltd, India discontinued to provide the agreed services to Hitech Ltd. Upon deliberation with US based client, the client agreed to provide the same service at $ 7,500 to Hitech Ltd. Finally, the dues were settled after netting off $ 7,500.*

Thus, there can be various scenarios wherein, the agreed payment of IT company can be settled in distinct ways by sorting to 'netting of' treatment. In such scenarios entire amount of foreign exchange is not received by the IT company directly, although in substance it is settled completely after netting of against other receivables from the company. In such scenarios, question may arise as whether or not to consider that portion of foreign exchange for export benefits which was not received by the IT company but paid by the client on behalf of it. In case it is not considered as receipt of foreign exchange then export benefits to that extent shall be not be available, i.e. refund to that extent shall be denied.

In this regard it is pertinent to note that, the intention of the government is not to export duties and taxes. The requirement of receipt of money in foreign exchange should be interpreted liberally in cases where it has been established that the services have indeed been exported. In cases of interpreting the provisions of export of services, harmonious construction of the legal provisions should be adopted. The entire scheme of refund through export is to boost export and enable India to earn foreign exchange. Considering the same, in above scenarios one can argue that reduction in foreign payment is as good as earning foreign exchange.

The Board vide their **Circular No. 78/52/2018-GST, dated 31-12-2018** clarified as under:

a) *"Even if the full consideration for the services as per the contract value is not received in convertible foreign exchange in India due to the fact that the recipient of services located outside India has directly paid to the supplier of services located outside India (for the outsourced part of the services), that portion of the consideration shall be treated as receipt of consideration for export of services in terms of Section 2(6)(iv) of the IGST Act" provided the Integrated Tax has been paid by the supplier located in India for import of services on that portion of the services which has been directly provided by the supplier located outside India to the recipient of services located outside India"*

b) *In case an exporter of services outsources a portion of the service contract to another vendor located outside India at 40 % of the contract value with the client and payment to such vendor is made by the client directly and balance 60% of the payment is released to the exporter. In such case, 100% of the contract value shall be considered as export if requisite RBI guidelines are followed and the subcontracted portion is treated as import of service by the exporter with payment of IGST on the same under RCM."*

Relevant Judicial Precedents in the context of Export Proceeds:

(a) In case of ***Kishor Kumar Co. P Ltd. [2018 (10) TMI 973 - CESTAT BANGALORE],*** the Appellant acted as agent of foreign buyers and arranged the Indian exporters to export goods to them. The commission of the Appellant agent was paid to the exporters directly along with their own sale proceeds. Exporters in turn converted the entire foreign remittance received by them and paid the portion of commission back to the Appellant agent. Department took the stand that as Appellant did not receive the consideration in foreign exchange, service would not qualify as export of service as per the then Rule 3(2) of Export of Service Rules, 2005. Hon'ble Tribunal considering the harmonious construction of legal provisions of export of service over the years, held the provisions of service as export of service in substance.

(b) Tribunal in the case of ***Nipuna Services Ltd. Vs. Commr. of C.Ex., Cus. & S.T. (A-II), Hyderabad, 2009 (14) STR 706 (Tri. Bang.)*** has observed that revenue was denying the refund for the simple reason that the appellant themselves had not directly received the payment in foreign currency but instead received by its agent. The agent then converted the foreign currency into Indian Rupees and paid the same to Appellant. If Revenue's contention were accepted, it would have amounted to levying Service Tax on services exported. Denying the refund would have violated this fundamental principle of taxation. Therefore, the Appellant would be satisfying the condition of receipt of foreign exchange by a liberal interpretation of the notification.

(c) Tribunal in case of ***National Engineering India Ltd. Vs. Commr. of C.Ex. Jaipur, 2009 (15) STR 68 (Tri. Del.)*** has observed that in the appellant's own case, reported in 2008-TIOL-939-CESTAT-Del. it was held that just because commission was received by the appellant through India Railways in Indian rupees as Indian Railways made payment to GMC USA (foreign client) in foreign currency after deducting the commission payable to GMC, it cannot be said that the service provided by the appellant to GMC USA is not export of service.

(d) In the case of ***ETA Travel Agency Pvt. Ltd. Vs. CCE, Chennai, 2007 (7) STR 454 (Tri. Bang.),*** the offshore service receiver had an office in India and the commission had been received from the bank account of such local office of the offshore service receiver and in view of the facts of the case, the Tribunal held that the service has been provided and received in India and it was not a case of export of service.

It is amply clear from the above that, there can be different variants for payment to be made in foreign exchange. Utmost precautions are to be taken in routing the payment of foreign exchange to avoid unnecessary future litigations. A complicated structure of payment might invite unnecessary trouble in the refund benefits for Export of IT services.

Q) Taxability in case of monies not received in convertible foreign exchange:

As discussed above, a supply qualifies to be an 'export of services' only upon fulfilment of all the conditions mentioned in Section 2(6) of the IGST Act, 2017. However, consequences of non-fulfilment of any condition is not prescribed explicitly anywhere, the question that arises is whether the benefit of export would be taken away if any of the conditions are not fulfilled:

Reference in this regard can be made to the judgement of erstwhile law in the case of ***Indian Association of Tour Operators Vs UOI and Anr [2017 (9) TMI 98 Delhi High Court].*** wherein it was held that *"Section 94 (2) (f) or (hhh) of the FA does not empower the central government to decide taxability of the tour operator services provided outside the taxable territory. They only enable the central government to determine what constitutes export of service, the date for determination of the rate of service or the place of provision of taxable service. Section 66C of the FA enables the central government only to make rules to determine the place of provision of taxable service but not non-taxable service."*

Although, it appears that Government lacks the inherent jurisdiction to levy GST on exports of service in absence of receipt of foreign exchange, however, in light of lack of clarity on the issue, proper clarification in this regard would be highly appreciated.

R) Refund on the Capitalized expenses - Huge infrastructure costs:

IT companies incur huge capital cost in terms of office buildings, furniture & fixtures, electricals and installations, high end computers & laptops, sophisticated servers, server rooms, licensed software, royalties, network infrastructure and IT security tools etc. As per the prescribed rules as explained above, the formula for determination of refund under rule 89(4) of the CGST Rules, 2017 excludes the ITC on such capital goods for claiming the benefit of refund which interalia means that the entire element of GST (average 18% of the value) on such expenses adds to the costs although there has been no proper reasoning or justification provided by the Government for denial of these credits, however this is the law carried from the past service tax regime and exporters in IT industry are taking a big hit due to the legacy issues.

However, there exists a silver lining in this case wherein as stated above, exporters have two options to claim the refund i.e. with payment of taxes or without payment of taxes under LUT. While an exporter who opts to export without payment of taxes is governed by rule 89(4) of the CGST rules and is there by restricted to claim the credit on capital goods. However, surprisingly no such restriction is placed in case where the exporters choose the option of exporting goods/ services with payment of taxes.

In other words, where an exporter exports the goods/ services with payment of taxes, then it can utilise the entire accumulated credits irrespective of classification into inputs, input services or capital goods. Therefore, in cases where IT company has huge balance of ITC pertaining to capital goods, the company can prefer to raise a billing on the customer with payment of taxes in order to maximize the refund claim.

Looks easy, but in reality this option may not be always practical because there would not be huge ITC in the IT companies and this option involves huge cash outflow. Although it promises heavy refund, but as discussed above delay in refund is an expected phenomenon. Thus, every IT company has to evaluate the net benefit in case of huge cash outflow with higher refund amount as against lesser refund claim with nil cash outflow. Needless to say that the decision must be taken based on facts in each case.

Possibly, the most practical way to tackle this issue would be to choose a hybrid approach, since there is no provision in the GST law which mandates a particular option once choosen. Therefore, IT companies can plan the option to be adopted for each tax period based on the cash flows and credit availability. To say otherwise, IT companies as per the circumstances in each month may opt from one option to another in order to maximize the claim of refund, i.e. say in January or Q1 refund claim can be made without payment of taxes and in February or Q2 it can be claimed with payment of taxes. Duplication of refund claim in such cases is the possible threat that might need special attention.

However, undoubtedly there can be practical difficulties faced in choosing various options at various times and considering the huge cash outflow. Therefore, from the legal standpoint assessee must be legally eligible to claim the refund on the entire accumulated credits (inclusive of capital goods) even in case where supplies are exported without payment of taxes.

Section 54(3) as explained above clearly states that in case of zero rated supplies, the exporter can claim the entire refund of the unutilized input tax credit. While the law is clearly laid out to provide for full refund to the exporters (inclusive of capital goods), it is the artificial fetters drawn in the formula as laid out in the rules which indirectly bring these restrictions of credit on capital goods. The definition of input tax credit makes no such distinction specifically for capital goods. It is needless to say that the executive by virtue of their rule making power cannot make the rules that travel beyond the statutory provisions of the act and more so contradicting the same. Plethora of judgements have been pronounced in this regard like ***Kunj Bihari Lal Butail vs. Stat of H.P. [2000(3) SCC 40], Addl. District Magistrate (Rev.) Delhi Admn. v. Siri Ram, (2000) 5 SCC 451, State of Tamil Nadu & Anr vs P. Krishnamurthy & Ors. (2006) SCC 517,*** etc.

It must be noted that the above legal position although being a correct position of the law, could be disputed by the tax authorities for reasons known better to them.

Before concluding, it would be imperative for us to explain the concept of capital goods in GST law which ss defined u/s 2(19) of the CGST Act. Unlike the past Cenvat credit rules, where the meaning and scope of 'Capital goods' was linked to the HSN classification, in GST law, Capital Goods have been defined to mean the goods that are capitalised in the books of accounts meaning thereby that the determination of any expense to be a capital goods is now linked to the way and manner in which it is accounted. This is very important aspect and there are plethora of judgements in the Income tax law, on deciding whether an expense qualifies as capital expense or revenue.

Therefore, considering the accounting standards, various judicial precedents, due care can be taken by the IT companies while determining the accounting treatment of certain expenses in books of account to maximize the refund claim and avoid unnecessary litigation.

S) Eligibility of claiming refund of transitional credits transferred from erstwhile tax law i.e. Central Excise, Service Tax, VAT:

Like others, IT companies also have migrated their registrations from the erstwhile tax laws to the GST regime. There are chances that while migrating to GST, balance of earlier taxes were carried forward in GST as Transitional credit by filing Form TRAN-1. Thus, balance of CENVAT credit or even state VAT credits must have been dropped into the electronic credit ledger in GST regime. However, it is to be noted that the refund of the transitional credit is being denied by the department on the premise that the same does not take the colour of 'Input Tax Credit'. CBIC has also issued a clarification in this regard vide its Circular No. 125/44/2019-GST, dated 18-11-2019 as under:

"Refund of unutilized input tax credit is allowed in two scenarios mentioned in sub-section (3) of section 54 of the CGST Act. These two scenarios are zero-rated supplies made without payment of tax and inverted tax structure. In sub-rule (4) and (5) of rule 89 of the CGST Rules, the amount of refund under these scenarios is to be calculated using the formulae given in the said sub-rules. The formulae use the phrase 'Net ITC' and defines the same as "input tax credit availed on inputs and input services during the relevant period other than the input tax credit availed for which refund is claimed under sub-rules (4A) or (4B) or both". ***It is clarified that as the transitional credit pertains to duties and taxes paid under the existing laws viz., under Central Excise Act, 1944 and Chapter V of the Finance Act, 1994, the same cannot be said to have been availed during the relevant period and thus, cannot be treated as part of 'Net ITC' and thus no refund of such unutilized transitional credit is admissible."***

In case of IT companies that have 100% exports, this clarification would have large scale implication in so much so that the transitional credit although part of the electronic credit ledger but still becomes a dead rubber and remains only as a book entry. One may surely look towards the option of supplying goods/ services with payment of taxes to encash the credits through outward refund route.

Easier said than done, the law as laid out vide Rule 96(10) imposes certain restrictions on the exporters to opt for the route of claiming refund with payment of taxes i.e. exporters should not have received the inward supplies that are treated as deemed exports or merchant exports at concessional tax rate of 0.10%,

However, a scheme of the law has to be read in a wholistic manner and its application must be given effect to achieve the very purpose and objective with which it was formed i.e. to allow seamless flow of credits without any cascading effect. On one hand, the benefit of transferring the credits has been given and on the other hand the same benefit is snatched away by way. This being so, then the very intent of allowing the transfer of credit in first place is a matter of big question.

It must be noted that the past laws have been transitioned into the GST law and if the meaning of the term 'Input tax credit' is read in a restrictive sense, then it would hurt department twice as hard as it is to assesee's in so much so that no demands for past issues can be raised under the garb of section 73 of the CGST act as the said section also deploys the term 'input tax credits'. Therefore, while demand notices for the past credits are being issued taking cover of section 73 of the CGST act read with the transitional provisions but when it comes to the refund claim, the very term is being given a narrow meaning to deny the benefit.

In authors view, this is an incorrect interpretation of the law as there is nothing like transitional credits in the GST law and once transferred the past credits take the colour of input tax credits and all the provisions of the GST law shall be applicable to them as any other credits. The law makers in the course of drafting the law did not intended to create any distinction between them (i.e. ITC and transitional credits) and if that be so, it would have been brought out by way of an express provisions in the law, which is not the case.

T) No refunds for export if branch IT company exports services to its HO company situated outside India:

In IT and ITES industry, there are multiple MNCs, having headquarters in one country and branches in other countries. The branches situated in India provide the services to HQ's abroad or vice a versa. Amongst several models in IT and ITES sector, one of the popular model is to export the services to holding company through a subsidiary situated in India. Refund in case of export of services between the HO & branch is not allowed by placing a condition in the definition of the term 'export of service' that a person having an establishment in India and any other establishment outside India, shall be treated as establishments of distinct persons and a transaction between distinct persons would not be treated as an export of services.

Although, there is no reason provided for disallowing such benefit, but it must be noted that the scope of this restriction is limited to a transactions between HO & the branch offices i.e. many times it happens that the company floated would not be a foreign branch of a HO and instead it would be a separate legal entity formed based on the local laws of the foreign country. For example, if any subsidiary company of a foreign arm is formed in the India, then it does not amount to branch of a foreign company and instead it would be treated as an Indian company having a separate legal presence and in this scenario the relationship between the Indian subsidiary company and a foreign holding company do not qualify within the meaning of the term 'distinct persons' and thereby the above restriction placed would not be applicable.

U) Import of services from the HO, branch or associated enterprises located outside India:

As per schedule I of the CGST Act, any import of service without consideration by a taxable person from related person or from any of his establishment outside India, in the course or furtherance of business. In a normal course of business, IT companies would avail various services from the HO/ associated enterprise located outside India. As mentioned above, supply of goods or services between related persons or between distinct persons as specified in section 25 shall constitute as supply even when made without consideration. In IT industry, the companies are correlated with each other not less than any complicated web structure.

An enterprise which participates, either directly or indirectly, through one or more intermediaries, in the management, or control or capital of the other enterprise becomes an associated enterprise. In the present context, when an associated enterprise is situated outside India any provision of service by it shall be liable to be taxed under RCM and IT company in India shall be liable to pay GST under RCM.

Further, in such cases, the time of supply will be the earlier of date of entry in the books of account of the recipient of supply or the date of payment. Thus, in above instances even in case branch or associated enterprise does not receive any consideration, it appears that it shall be liable to pay GST under RCM on the market value of the provision of such services. However, practical application of the same is highly difficult.

Since there are multiple provisions of the law which has to be simultaneously applied, in order to assess the liability of tax in transactions with related/ associated foreign enterprises, hence we shall understand the same by way of the following case studies.

Practical Case Study:

Facts of the case: *ABC. Ltd is a subsidiary of XYZ Inc. (USA) being the parent company. XYZ Inc. has provided IT support service for ABC Pvt ltd. XYZ Inc. creates a cost center for cost allocation, although this is only for reporting purposes and no actual expenses are incurred by ABC Pvt Ltd. No accounting entry in the books of ABC Pvt Ltd.*

Queries:

1. *Whether the above is an import of service under GST?*
2. *If yes, what would be the time of supply for such transaction?*

GST Provisions:

- *Section 5(3) IGST Act – Levy under IGST Act on services which will be liable under reverse charge – listed in notification 10/2017. Notification 10/2017-Integrated tax(rate) – Includes import of services liable under reverse charge.*
- *Section 15(5) CGST Act – Explanation – Related person includes - one of them directly or indirectly controls the other.*
- *Schedule I clause 2 – Activities to be treated as supply even if made without consideration - includes transactions with related parties.*
- *Section 15 r/w Rule 28 CGST law – Valuation for transaction between related party. (open market value if available to be considered)*
- *Section 13(3) of CGST Act –*
    - o *Time of supply for reverse charge would be the date of payment (to supplier), or 61st day from the date of invoice when payment is not made.*

      (Where not covered above, the date of entry in the books of the recipient.)

  - *For associated enterprises where supplier is outside India, the time of supply will be based on the date of entry in the books of the recipient.*

- *Section 13(5) of CGST Act – Where the time of supply cannot be ascertained under other subsections, it would be - in a case where a periodical return has to be filed, be the date on which such return is to be filed;*

- *Section 13(2) of IGST Act – As such services are not specifically covered in any of the specified entries, therefore the residual entry in this section would be applicable and the place of service shall be the location of recipient of service.*

Conclusion:

a. *Levy – Liable which is established based on Schedule I as services are from related person.*

b. *Valuation – Open market value would generally not be available, actual cost center allocations could be used.*

c. *Place of supply – In India in terms of Section 13(3) (a), therefore, satisfying Import of Service definition*

d. *Time of Supply – Although they are related parties/associated enterprises, there is no entry in the books of ABC Pvt Ltd, thus Section 13(3) for time of supply would not be applicable. Although, Section 13(5) would be applicable, and the liability would be 20th of every month, i.e. GSTR 3B due dates. (subject to extensions). Therefore, here is a case where no payment is made, no accounting entry is recorded although the activity is liable as an import of service under GST.*

V) Transfer of Intellectual Property Rights by associated enterprise from outside India:

There is a practice to charge for intellectual property rights by a holding company outside India wherein it agrees to provide right to intellectual property in terms of goods and/or IT software and other related services. Under erstwhile VAT laws, it was understood that where the transaction involves granting the right to use trademarks, patents, technical know-how or technology right etc., then it would be construed as transaction in goods. Transfer of technical know-how was accepted as 'goods' and constituted as sale under VAT as provided in case ***Mechanical Assembly System Vs State of Kerala [2006, 144 STC 536].*** As per Supreme Court decision in ***TATA Consultancy Services vs. State of Andhra Pradesh,*** the canned software is 'goods' for the purpose of levy of VAT.

Under GST regime, temporary transfer or permitting the use or enjoyment of intellectual property right constitutes supply of service as per Schedule II r/w Section 7(1A) of CGST Act. Following are the rates applicable for IPR based on HSN:-

HSN	Rate of Tax	Description of Service
99733	12%	Temporary or permanent transfer or permitting the use or enjoyment of intellectual property (IP) right in respect of goods **other than information technology software.**
997331	18%	Temporary or permanent transfer or permitting the use or enjoyment of intellectual property (IP) right in respect of **information technology software.**
998599	18%	**Other support services**- management services for rights to industrial property (i.e. trademarks, franchises, etc.).

Therefore, if any services relating to transfer of IPR is provided by a foreign supplier to a company in India, then the same would be liable for GST under reverse charge in the hands of Indian company. Further, based on agreement entered between service provider and recipient, analysis can be done with respect to treatment of usage of Intellectual property right to ascertain if such right is in respect of goods or information technology software. Accordingly, the rate of tax can be determined as above.

W) Royalty payable by Indian IT company to a foreign client:

Depending upon case to case basis, it is possible that to develop an IT product for client, the client may provide access to its own resources including patent software, programs, servers, etc. to the IT company. For such access, either there can be fixed charges or it may be already included in the agreement. It is also possible that the agreement value is arrived after deducting certain agreed charges for such access. For instance, the entire agreement is valued as say $1.2 billion, however in case IT company wishes to access resources from clients instead of other vendors, then $0.2 billion shall be appropriated against said access. Such charges are akin to royalty charges. In such case, even though practically the agreement stands at $1 Billion, however for GST purpose there exists export of $1.2 Billion and import of $0.2 Billion for which GST is to be paid under RCM.

X) Import of online/web-based training services from outside India:

There are instances where, at the beginning of project or under requisite circumstances the foreign HO offers training to the employees of IT company in India. It must be noted that the online training service would not be construed as an online information of database access or retrieval service and therefore the place of supply is to be ascertained based on the general rule i.e. the location of the recipient of service which is in the taxable territory. Therefore, in the given case the service would be classified into commercial training and coaching service and the place of supply shall be location of recipient company in India and therefore the transaction shall be liable for tax under reverse charge.

Y) Procurement of supplies from Associated enterprises outside India:

It is important to note that when any supplies are procured from associated enterprises outside India, then the time of supply shall be the date of entry into the books of accounts of the recipient of supply or the date of payment, whichever is earlier. [Second Proviso to section 13(3) of CGST Act].

As per section 13(3) of CGST Act the time of supply in case of RCM shall be the earlier of following dates:

a) the date of payment as entered in the books of account of the recipient or the date on which the payment is debited in his bank account, whichever is earlier; or

b) the date immediately following sixty days from the date of issue of invoice or any other document, by whatever name called, in lieu thereof by the supplier

Where it is not possible to determine the time of supply under clause (a) or clause (b), the time of supply shall be the date of entry in the books of account of the recipient of supply [First Proviso to section 13(3) of CGST Act].

Practical Case Study:

M/s. ABB & Co. (Indian Company) has a holding company M/s. SS & Co. which is Germany based company. M/s. ABB & Co. makes royalty payment towards use of intellectual property right in respect of "brand name" of holding Company. Let us assume payment is made on quarterly basis amounting to Rs. 6,00,000/- (April-June).

Date of entry in the books of the recipient (a)	***Date of payment (b)***	***Time of Supply (a)/ (b) which is Earlier***	***GST to be discharged under RCM***
30.04.2018 *(Provision entry passed amounting to ₹ 2 lakh)*	*25.06.2018*	*30.04.2018 GST to be paid in April 2018 GSTR 3B*	*GST to be discharged =12%*2,00,000 = ₹ 24,000*

Date of entry in the books of the recipient (a)	***Date of payment (b)***	***Time of Supply (a)/ (b) which is Earlier***	***GST to be discharged under RCM***
31.05.2018 *(Provision entry passed amounting to ₹ 2.5 lakh)*	*25.06.2018*	*31.05.2018 GST to be paid in May 2018 GSTR 3B*	*GST to be discharged* =12%*2,50,000 = ₹ 30,000
Invoice received on 23.06.2018 *(Amounting to ₹ 6 lakh)*	*25.06.2018*	*23.06.2018 GST to be paid in June 2018 GSTR 3B*	*GST to be discharged =12%*1,50,000 (6 lakh – 2 lakh-2.5 lakh) = ₹18,000*

Note:

- *The time of supply provision of 60 days for payment to vendor/ 61st day if unpaid would not be applicable here.*
- *ITC on the GST paid under reverse charge would be eligible in the same month.*
- *In the instance that, the Invoice value for the quarter is lesser than RCM paid based on 2 months provisions, there would be no requirement to reverse RCM paid or ITC claimed, as it has a NIL revenue impact.*

Relevant Case laws:

1) Habufa Meubelen B V (2018) 02 CCHGST 0136 AAR-Raj; 2018 (14) GSTL 596 (AAR – GST) (Rajasthan)

Facts: *The applicant is an Indian Office of M/s. Habufa Meubelen B.V. (HO) which is established as a Liaison Office with the prior permission of RBI subject to various conditions. This office does not have any revenue or independent clients. Salaries of Liaison office is remitted by HO and all other expenses incurred by the office are reimbursed by HO.*

Issues:

(i) Whether the reimbursement is liable to GST as supply of service, especially when no consideration for any services is charged/paid?

(ii) *Whether the applicant, i.e, the Liaison Office is required to get registered under GST?*

Decision: *HO and Liaison Office cannot be treated as separate persons, there being no flow of services between them as one cannot provide service to self and therefore reimbursement of expenses and in the case of salary paid by HO to the Liaison Office, established in India, is not liable to GST and the applicant is not required to get registered.*

This is contrary to cl (4) of Schedule I of CGST Act as per which import of services from an establishment outside India would be considered as supply. However, merely fund transfers would not be liable to tax.

2) *Commissioner v. Nissin Brake India Pvt. Ltd. - 2019 (24) G.S.T.L. 563 (Tri-Del)*

Facts: *The appellant had entered into dispatch agreement with its parent company located in Japan for payment of salary and other perks of the employees deputed from such foreign company. The Department entertained the view that the services provided by the parent company in Japan to the appellant should be classifiable under the taxable category of "manpower recruitment or supply agency service" and the appellant being the recipient of service, is liable to pay service tax under reverse charge mechanism.*

Issues:

(i) *Whether the said transaction would cover under the manpower recruitment or supply agency service?*

(ii) *Whether the said transaction would be liable to tax under RCM in the hands of the Appellant?*

Decision: *The Hon'ble tribunal held that the employees deployed by the parent company were working under the control, direction, and supervision of the appellant. The appellant also deducted tax at source from the salary and other perks given to the employees further the appellant did not pay any direct/indirect consideration to its parent company towards deployment of the employees. Thus, it cannot be said that there is any agency and client relationship between the parent company and the appellant. Rather, the terms of the agreement makes the position clear that the relationship between the appellant and the manpower deployed by the parent company is of employer/employee, and as such, it cannot be considered as the taxable service under the category of manpower recruitment or supply agency service. The hon'ble tribunal held that when the employee/employer relationship* *exists, the method of disbursement of salary cannot determine the nature of transaction. The above decision was maintained by the hon'ble Supreme Court vide [Commissioner v. Nissin Brake India Pvt. Ltd. - 2019 (24) G.S.T.L. J171 (S.C.)]*

3) *In the case of* ***Hyundai Motor India Ltd Vs CGST & CE 2018-TIOL-3703-CESTAT-MAD -***

Facts: *The appellants sold their spare parts business division to Mobis India Ltd. under a Business Transfer Agreement as a going concern. The consideration for the said transfer was agreed at ₹ 425.25 crores. Goodwill was valued at ₹ 80.29 crores. Department entertained the view that 425.25 crores include the value of goodwill.*

Issue: *Whether transfer of goodwill fall within the definition of "transfer of intellectual property right service" as defined under section 65(55b) of Finance Act,1994 and thus be liable to service tax?*

Decision: From the definition of intellectual property right laid in Section 65(55a), it is clear only IPR which comes under any law in force would come within the ambit of the definition. Though goodwill may be in the nature of intangible right, there is no law which recognizes it as an intellectual property right. In fact, goodwill is attached to an ongoing business whereas IPR is not always so. Goodwill of a company may include the value of IPR held by him but not the vice versa. The Tribunal in the case of ***Alstom T&D [2018 (2) TMI 148 - CESTAT CHENNAI]*** held that the transfer of such trademark which has not been recognized or registered within India will not fall within the ambit of Intellectual Property Right Service. Thus, transfer of goodwill will not fall within the definition of IPR service as stated in Section 65(55b) of Finance Act, 1994.

SEZ & STPI - Introduction & Compliances

The Special Economic Zone (SEZ) policy in India first came into inception on April 1, 2000. The prime objective was to enhance foreign investment and provide an internationally competitive and hassle free environment for exports. The idea was to promote exports from the country and realizing the need to uplift the domestic enterprises and manufacturers to be competitive globally.

A SEZ is defined as a "specifically demarked duty-free enclave and shall deemed to be foreign territory (out of Customs jurisdiction) for the purpose of trade operations and duties and tariffs". The SEZ Act, 2005, supported by SEZ Rules, came into effect on 10th February, 2006. In other words, SEZ is a geographical region that has economic laws different from a country's typical economic laws.

The SEZ Act 2005 envisages key role for the State Governments in Export Promotion and creation of related infrastructure. A Single Window SEZ approval mechanism has been provided through a 19 member inter-ministerial SEZ Board of Approval (BoA). The applications duly recommended by the respective State Governments/UT Administration are considered by this BoA periodically. All decisions of the Board of approvals are with consensus.

In 2005, the Department of Commerce, Ministry of Commerce & Industry, Government of India has enacted the Special Economic Zone (SEZ) Act, with an objective of providing an internationally competitive and hassle free environment for exports.

The SEZ Rules provide for different minimum land requirement for different class of SEZs. Every SEZ is divided into a processing area where alone the SEZ units would come up and the non-processing area where the supporting infrastructure is to be created.

Concept of Processing and Non-Processing Zones: The areas falling within the Special Economic Zones may be demarcated by the Central Government or any authority specified by it as-

a. The processing area for setting up Units for activities, being the manufacture of goods, or rendering services; or

b. The area exclusively for trading or warehousing purposes; or

c. The non-processing areas for activities other than those specified under clause (a) or clause (b).

The SEZ Rules: The SEZ Act 2005, through The SEZ Rules provide for:

- Simplified procedures for development, operation, and maintenance of the Special Economic Zones and for setting up units and conducting business in SEZs;

- Single window clearance for setting up of an SEZ;
- Single window clearance for setting up a unit in a Special Economic Zone;
- Single Window clearance on matters relating to Central as well as State Government's;
- Simplified compliance procedures and documentation with an emphasis on self-certification.

SEZ for IT/ ITES Sector:

A Special Economic Zone may be established under this Act, either jointly or severally by the Central Government, State Government, or any person for manufacture of goods or rendering services or for both or as a Free Trade and Warehousing Zone.

Therefore, unlike STPI, there is no industry limitation in SEZ. It widens its scope to almost all the manufacturing or service industries. SEZ Act provides list of activities which are authorized to be undertaken by a SEZ Unit, these activities are called as "Authorized Operations".

Ministry of Commerce and Industry (SEZ Section) has issued instructions vide F. No. D12/19/2013-SEZ dated January 2, 2018 after referring to letters previously issued in 2013 and 2014. The letter provides with a uniform list of services to be followed in SEZs. These services also include "Information Technology Software Services".

Therefore, it is clear that export oriented IT/ ITES industries can avail benefits by operating either through SEZ or through STPI. One must have a holistic view to opt between SEZ and STPI. Same can be understood through the differences between SEZ and STPI which are covered in later part of this article.

In case of IT industry, for various start up's the above threshold can be very useful, since at the initial phase of the business, the start-ups would not have substantial sales but a lot of time and efforts are spent towards research or development of the software and thereby the hassle of compliances under GST can be avoided. However, practically it is seen that taking registration at the initial phase of the commencement of the business itself on a voluntary basis instead of waiting for the turnover to cross the above threshold limit is more beneficial especially in case of IT companies when the first few years does not see great profits and a tremendous amount of investments is made towards research, development, marketing, promotion etc. In such a scenario, if a company takes GST registration, they can avail input tax credit on such expenses incurred even if there is no outward supplies or less outward supplies in the first few years. The credit availed can save the initial cost to the tune of 18% (average of GST rate) which can be capitalised as asset in the books and can be utilised once the venture becomes profitable.

Therefore, the notion that one can claim input tax credit only if there is an outward supply is not correct and IT companies can avail the input tax credit for the expenses as long as they are incurred for the purpose of business. Therefore, start-up's can keep on availing the credits which can be utilised later (there is no time limit in the law for utilisation of the credits).

One must note that the entries specified in section 24 of the CGST Act as listed above are very important as in these circumstances, the requirement of registration becomes mandatory and there would not be any option with the IT companies to wait till the threshold limit. Some of the important aspects to be considered by the IT companies in the context of registration are as under:

1) **Cross border expense/ legal expenses etc. triggers registration:**

   It is possible that in the initial set up of the company certain expenses are incurred towards contract structuring wherein the legal services of advocates is availed or certain online services are to be imported viz., software or online content or target marketing database or any other services availed from a supplier located outside the taxable territory. It must be noted that these services are covered under reverse charge and would immediately trigger registration. Further, once the levy under reverse charge is triggered, the recourse of the threshold limit cannot be taken and even if the turnover is less than the threshold limit or for that reason no turnover, even then the mandate to take registration gets attracted.

2) **Export of Software triggers mandatory registration:**

   Generally, in case of IT companies the cross-border export supply transaction is very common viz., supporting the foreign entity in the development life cycle of the software or selling the software to the targeted customers outside India. From the point of view of taxation, it is important since if a transaction takes a colour of an inter-state supply, then section 24 mandates compulsory registration irrespective of a threshold limit. Therefore, in case any software is exported either as goods or as service (practically export of services can happen online on a click of a button), the start-up entrepreneurs must immediately apply for registration. In other words, if a company makes even a single export transaction, the requirement of registration would get attracted. This is clarified by CBIC in the FAQ issued in this regard.

3) **ISD registration for distribution of credits by Support centres to Operational centres:**

   IT companies would be having premises at multiple locations, then it is possible that a particular office or a fixed establishment is performing only administration functions or research and development activity, or it is formed to provide various support functions (viz., HR, Accounts, Payroll etc.) to other offices. In this situation, the input tax credit availed in such premises cannot be utilised because there is no outward supply leading to the accumulation of input tax credit. Therefore, the IT companies can explore the possibility of taking the ISD registration and any credit which is accumulated in search premises can be distributed to other locations having regular GST registration. Assessee can also look at the option of cross billing to other location instead of taking ISD registration which can reduce the compliance burden. However, it must be noted that cross billing is not an option per se and the same can be exercised only if there is a supply of service from the branch office to HO or vice-versa.

4) IT companies having a unit in a Special Economic Zone:

Section 25 of the CGST Act states that a person having a unit in a Special Economic Zone or being a Special Economic Zone developer shall have to apply for a separate registration, as distinct from his place of business located outside the Special Economic Zone even if the said unit is in the same State or Union territory. This provision has led to increase in compliance burden as all compliances related to filing of returns, audits, assessments would be separate. Need of LUT would arise for supply of services from a DTA unit to SEZ unit of same entity because of separate registration.

5) Whether separate registration required for IT companies situated in STPI:

It is generally observed that tax benefits and policy decisions are made in similar fashion for SEZ, EOU, STPI, EHTP, etc. unless otherwise required. However, aforesaid provisions are exclusively applicable to a unit in SEZ and SEZ developer. One must note that the term 'SEZ' is defined under clause (za) of section 2 of the Special Economic Zones Act, 2005 as 'Each Special Economic Zone notified under the proviso to sub-section (4) of section 3 and sub-section (1) of section 4 of SEZ Act 2005 (including Free Trade and Warehousing Zone) and includes an existing Special Economic Zone'. However, STPI on the other hand is an autonomous Society set up by the Ministry of Electronics and Information Technology (MeitY), Government of India in 1991, with the objective of encouraging, promoting and boosting the Software exports from India. Thus, in the absence of any specific mention of STPI (or allied units), the said provision would not be applicable as such to the units other than SEZ. However, in a case where any STPI qualifies as unit in SEZ then separate registration is needed.

Implications for SEZ in GST Act:

GST Act draws special attention to SEZs by stating separate provisions regarding-Registration under GST, covering 'Supply to SEZ' in the definition of 'Zero-Rated Supply', refund of Input Tax Credit, etc.

(a) Separate Registration under GST Act:

GST Act requires a separate registration for units or developers under Special Economic Zones. Relevant provisions as follows:

As per Proviso 1 to Section 25 (1) of CGST Act 2017, *a person having a unit, as defined in the Special Economic Zones Act, 2005, in a Special Economic Zone or being a Special Economic Zone developer shall have to apply for a separate registration, as distinct from his place of business located outside the Special Economic Zone in the same State or Union territory.*

There may be a situation wherein an entity would have both DTA and SEZ units in same campus or same state. Second Proviso to Section 25 of CGST Act 2017 as amended Central Goods and Services Tax (Amendment) Act, 2018 w.e.f. 01.02.2019 warrants separate registration for DTA and SEZ units in such cases as business verticals. This provision has led to increase in compliance burden as supplies between these distinct persons would be subject to GST even without consideration in terms of Section 7 of CGST / SGST law. In addition to this, all compliance related to return filings, audits, assessments would be separate. Need of LUT would arise for supply of services from a DTA unit to SEZ unit of same entity because of separate registration. Some relaxation could be provided by the government in such cases to make the law more business friendly.

(b) Supply of Goods to SEZ is treated as "Zero rated supply":

Section 16 (1) of IGST Act, defines "Zero rated supply" as:

a. Export of goods or services or both; or

b. Supply of goods or services or both to a Special Economic Zone developer or a Special Economic Zone unit.

Therefore, by zero rating, it is meant that the entire supply chain of a particular zero-rated supply is tax free i.e. there is no burden of tax either on the input side or on output side

(c) Refund of ITC in GST:

The objective of zero rating of exports and supplies to SEZ is sought to be achieved through the provision contained in Section 16(3) of the IGST Act, 2017, which mandates that a registered person making a zero rated supply is eligible to claim refund in accordance with the provisions of section 54 of the CGST Act, 2017, under either of the following options, namely:

a. He may supply goods or services or both under bond or Letter of Undertaking, subject to such conditions, safeguards and procedure as may be prescribed, without payment of integrated tax (IGST) and claim refund of unutilised input tax credit; or

b. He may supply goods or services or both, subject to such conditions, safeguards and procedure as may be prescribed, on payment of integrated tax and claim refund of such tax paid on goods or services or both supplied.

If refund is on account of supplies made to SEZ, the DTA supplier will have to file the refund claim in such cases. The second proviso to Rule 89(1) stipulates that in respect of supplies to a Special Economic Zone unit or a Special Economic Zone developer, the application for refund shall be filed by:

a. Supplier of goods after such goods have been admitted in full in the Special Economic Zone for authorised operations, as endorsed by the specified officer of the Zone;

b. Supplier of services along with such evidence regarding receipt of services for authorised operations as endorsed by the specified officer of the Zone. Thus, proof of receipt of goods or services as evidenced by the specified officer of the zone is a pre-requisite for filing of refund claim by DTA.

In terms of Section 16(3) of IGST Act, small suppliers who would not be able to execute LUT for any reasons could explore the option of charging IGST. Such IGST charged needs to be claimed as refund by the suppliers. Supplier may also charge IGST and ask the SEZ unit to claim refund instead if claim of refund is cumbersome for supplier. This option was not clearly envisaged anywhere in law in the initial days.

Recently for SEZ exporters, Rules prescribed separate table in order to enable them for claiming the refund. However, GST portal yet to enable such refund application type.

SEZs would not be able to procure any goods or services from dealers who have opted for composition scheme. This is because any supplies to SEZ would always be treated as inter-state supply and composition dealers are restricted from making inter-state outward supply. This would put the composition dealers in disadvantage which needs to be addressed.

(d) Exemption only for authorized operations:

For claim of refund towards supplies to SEZ, the supplier has the obligation to prove that the supplies made without GST or with refund option are for authorized operations of SEZ. In service tax, there was a readymade list of approved services for exemption. However, in GST such list is not available. There is no prescribed mechanism to understand what constitutes authorized operations. Department could always question the suppliers for this.

Therefore, on a precautionary note, suppliers could request SEZ units to share the list of authorized operations which is issued by Board of Approval at inception of SEZ units. A simple declaration stating that goods / services supplied are for authorized operations could avoid future litigations. Whenever in doubt, suppliers could consider the option of charging GST asking customer to claim refund / credit. Government also needs to provide some clarity on this option as such option is not clearly laid down in law.

(e) Importation of goods or services by SEZs:

Goods imported by SEZs were exempted from basic customs duty, CVD (levied in lieu of central excise duty) and SAD (levied in lieu of VAT). After the introduction of GST, SEZ transactions are liable for IGST. Customs Notification No.64/2017 has been issued to exempt import of goods from levy of IGST for SEZ operations. IGST Notification No.18/2017 also exempts levy of IGST on import of services by SEZs for authorized operations.

(f) Other important aspects:

Some other important benefits which would make the supplies to SEZ Units or SEZ Developers as follows:-

- Seller of goods in DTA to SEZ Unit/SEZ Developers is eligible for Duty Drawback benefits. The procedure prescribed in SEZ Act, 2005 has to be followed.
- Tax invoice issued in terms of GST Law will be treated as bill of export for refund claim. Even SEZ Units/Developers can claim the above benefit in respect of their procurements from DTA Market. However, the Duty Drawback benefit will be given either to supplier or SEZ Unit.
- Now Units in SEZ are also eligible for Merchandise Exports India Scheme (MEIS) for their exports to foreign country.

6.1.3 Relevant FAQ's issued by CBIC for IT-ITES & E-Commerce Sector:

Question 1: 'A' is a dealer in Computers and Computer parts having turnover of Rs. 8 lakh in a year; does 'A' have to register under GST?

Answer: *Every supplier located in a State or Union territory, whose "aggregate turnover" in a financial year exceeds twenty lakh rupees, is liable to be registered under GST. This limit of turnover for a special category State is ten lakh rupees. 'A', whose aggregate turnover is only Rs. 8 lakh in a year, is therefore not liable to registration.*

Question 2: *I have more than one SEZ unit in different States; do I need to take separate registrations? Also, I have two SEZ units in one State. Can I take a single registration?*

Answer:

(1) Yes. Under GST, every entity shall take GST registration in each State from which it makes taxable supplies. However, a single registration can be taken for all your SEZ units within a State, whether located in one SEZ or more than one SEZ.

(2) A person having unit(s) in a Special Economic Zone as well as outside the SEZ in a State shall make a separate application for registration for SEZ unit(s) as a business vertical distinct from his other units located outside the Special Economic Zone in that State (Refer Rule 8(1) of CGST Rules, 2017).

Question 3: *I have a unit in the DTA and another in the SEZ; can I take a common registration?*

Answer: *No. A person having unit(s) in a Special Economic Zone as well as outside the SEZ in a State, shall make a separate application for registration for SEZ unit(s) as a business vertical distinct from his other units located outside the Special Economic Zone in that State (Refer Rule 8(1) of CGST Rules, 2017).*

Question 4: *I am a software provider, registered at Mumbai. I supply software to my clients in Bangalore-would I be required to take a registration in Karnataka?*

Answer: *No. The supplies would be treated as inter-State supplies and IGST is chargeable on the same.*

Question 5: *The sellers supplying goods through e-Commerce operators (ECO) may have common places of business, especially if their goods are stored in a shared facility operated by the ECO. This will result in the same additional place of business being registered by multiple suppliers. Is this allowed?*

Answer: *Yes, this is allowed. Any registered person can declare a premises as a place of business if he has requisite documents for use of the premises as his place of business (like ownership document, agreement with the owner etc.) and there is no restriction about use of a premises by multiple persons. The registered* *person shall have to comply with the requirements of maintaining records as per Section 35 of the CGST Act, 2017 and Rules 56 to 58 of the CGST Rules, 2017.*

6.2 Software Technology Parks of India (STPI)

Introduction:

Software Technology Parks of India (STPI) is a society set up by the Ministry of Electronics & Information Technology (MeitY), Government of India, with the objective of encouraging, promoting and boosting software exports from India. STPI is statutory body, internet and incubation service provider.

STPI is a statutory body for providing Single Window Clearance to software exporters. The STP Scheme provides these units with lucrative incentive.

The Software Technology Park (STP) Scheme:

STP Scheme is a 100 percent Export Oriented Scheme for the development and export of computer software, including export of professional services using communication links or physical media.

Mandatory compliance in STPI for IT/ITES Exporters:

As per the prevailing RBI Master Circular No. RBI/2013-14/14 dated 1st July 2013 (Para B 15), RBI Circular No.80 dated 15th February 2012 and RBI Circular No.43 dated 13th September 2013, ***any company who undertakes IT/ITES exports through Data communication links needs to submit the SOFTEX Form for certification.***

For getting the SOFTEX certification by STPI (which is the Designated Authority), the companies have to become STP members by either registering under STP scheme or as NON-STP unit with STPI. ***Therefore, registration with STPI and certification of SOFTEX Forms is mandatory for IT/ ITES Exporters.***

Nevertheless, the companies registered under STP scheme will have other benefits apart from getting their Software Exports certified.

Benefits under STP Schemes:

Following benefits are available only to the STP Units. Non STP Units are not eligible for these.

- Approvals are given under single window clearance scheme;
- A company can set up STP unit anywhere in India;
- 100% Foreign Equity is permitted;

- All the imports of Hardware & Software in the STP units are completely duty free, import of second hand capital goods also permitted;
- Re-Export of capital goods is also permitted;
- Simplified Minimum Export Performance norms i.e., "Positive Net Foreign Exchange Earnings";
- Use of computer system for commercial training purposes is permissible subject to the condition that no computer terminals are installed outside the STP premises;
- 100% depreciation on Capital Goods over a period of five years;
- Domestic purchases by STP units are eligible for the benefit of deemed exports to the equipment suppliers;
- The sales in the Domestic Tariff Area (DTA) shall be permissible up to 50% of the export in value terms;
- The items like computers and computer peripherals can be donated to recognize the non-commercial educational institutions, registered charitable hospitals, public libraries, public funded research and development establishments, organizations of Govt. of India or Govt. of a State or Union Territory without payment of any duties after two years of their import;

Apart from above benefits, there are few more benefits which are given by state governments through respective state's IT ITES Policies. For instance, Maharashtra's IT ITES Policy provides additional benefits. Few of the benefits are:

- Additional FSI and space utilization of IT Parks;
- 100% Stamp Duty exemption;
- Exemption from payment of Electricity Duty;
- Certain capital subsidies, etc.

Procedure for registration:

Steps involved for registration of setting up a STPI unit:

a. File an application with the office of STPI authority along with the forms and documents as prescribed. Forms and documents can be accessed on http://www.mah.stpi.in/;

b. Execute the legal agreement along with the payment of fees as per relevant slab;

c. Obtain Letter of permission (LoP) from STPI;

d. Enter into Legal Undertaking with STPI;

e. Obtain Green Card from STPI;

f. Enter into B17 bond with Jurisdiction Customs Authorities;

g. Approach Customs Authorities to avail duty concessions.

Compliances for STP/ NSTP Units:

a. Certification of SOFTEX Forms regularly;

b. Submission of Monthly Progress Reports (MPRs);

c. Submission of Quarterly Progress Reports (QPRs);

d. Submission of Annual Progress Report- Provisional and Audited (APR).

Failure in SOFTEX certification

In case exporter has not filed for SOFTEX certification within time limits and exports proceed is obtained, the remittance received is treated as 'general services' or not as an export proceed. In addition, the Bank could also freeze an account, in case SOFTEX forms are not filed on time.

Whether "SEZ" also includes "STPI" under GST?

While deciding Export oriented IT/ ITES companies to go for SEZ or with STPI, if is very important to understand if the perquisites given to SEZ under GST law are also applicable to STPI or not.

As per section 2(19) of IGST Act, *"Special Economic Zone" shall have the same meaning as assigned to it in clause (za) of section 2 of the Special Economic Zones Act, 2005.*

If we trace back to SEZ Act, 2005, Section 2(za) which defines "special Economic Zone" as "Special Economic Zone" means each Special Economic Zone notified under the proviso to sub-section (4) of section 3 and sub-section (1) of section 4 (including Free Trade and Warehousing Zone) and includes an existing Special Economic Zone.

Above definition in SEZ Act, 2005, does extends its meaning of "Special economic Zone" to STPI/ EOU/ EHTP or others.

Therefore, the requirement of separate registration as laid out for SEZ in GST is not applicable for STPI. It can be concluded that, relevant provisions under GST Act are strictly applicable to SEZ Units only and does not extend to STPI.

Few major differences in SEZ and STPI:

There are many operational differences in SEZ and STPI. Few major differences are as follows:

S. No.	SEZ	STPI
1.	SEZ is not industry specific. This scheme covers wide range of authorized operations	STPI is restricted to IT/ ITES Industry only
2.	SEZ Unit can be set up only in designated SEZ parks	STPI Unit can be set up anywhere in India
3.	100% Income Tax exemption for first five years and 50% for next five years subject to few conditions	Income Tax exemption has been withdrawn from April 2011
4.	DTA Sales allowed subject to payment of applicable duties	DTA sales allowed (Maximum 50% of total export revenue) subject to achieving positive Net Positive Foreign Exchange

DIRECT TAXES

No	Chapter
1	Scope of Total Income
2	"Royalty" & 'Fees for technical services' as per section 9
3	Significant Economic Presence
4	Tax Deduction at Source
5	Section 90 and Article 23 for foreign tax credit
6	Patent Box Regime : Section 115BBF
7	Revenue Recognition as per "ICDS"
8	Exemption under Section 10AA
9	Deduction under Section 35(2AB):
10	Taxation on Buy back of shares
11	Section 56(2) - Angel Tax
12	Rule 37BC
13	ESOP
14	Warranty
15	Equalisation Levy
International Taxation	
16	Tax residency of Company, POEM & PE
17	Provisions of Section 195
18	Article 12 of DTAA
	— "Use" or "Right to Use"
	— "FTS" & "FTS + Make available"
19	OECD Commentary
20	FTS Vs Royalty – Typical Software Transactions
21	Form 15CA / Form 15CB
22	Important Judgement

Chapter 1
SCOPE OF TOTAL INCOME

- Taxability of software related transactionsposes unique challenges in view of the way software is licensed and distributed. Taxability depends upon nature of right granted or transferred

- There are no specific provisions under the Act that specifically deals with the taxability of income arising from software related transactions. The taxability of income in relation to software arising in an international transaction is governed by general taxation principles, concepts and provisions of the Act.

- Due to the nature of its business, complexities involved to decide whether income accrue or arise in India or whether it particular transaction is Royalty or fees of technical services. This is a major area of discussion / dispute in taxation of IT & ITes.

- Typically, in software's the buyer gets the license to use the software. Buyer pays for license fees and is binded by an agreement with terms such as buyer cannot resell it, exploits it, uses it only for his own purposes etc. So the buyer gets limited RIGHTS TO USE the software. With this analogy software licenses are taxed as "Royalty" in India.

- Section 5 of the Act provides for charge of income-tax on the total income of every person. While residents are taxed on their worldwide income, non-residents, are only taxed on income (i) received/deemed to be received in India and (ii) income accruing/arising or deemed to accrue/ arise in India.

- section 5, which defines scope of total income, is subject to other provisions of the Act, which would include section 9, and the income deemed to accrue or arise in terms of section 9 gets covered under section 5. Income does not have to actually accrue or arise in India to be deemed to accrue or arise in India.

Chapter 2
'ROYALTY' & 'FEES FOR TECHNICAL SERVICES' AS PER SEC 9

- Section 9(1)(vi)/(vii) of defines accrual of income in India w.r.t. "Royalty" and "Fees for Technical Service(FTS)". Royalty/FTS for non residents are taxable in India if sourced in India. Therefore it is ***source based taxation*.**

- The intention of introducing the source rule was to bring to tax interest, royalty and fees for technical services by way of creating a legal fiction in section 9. The source rule would mean that irrespective of the situs of the services, the situs of the payer and the situs of the utilization of services will determine the tax jurisdiction.

- Explanation 2 to section 9(1)(vi) defines "Royalty" and Explanation 3 to section 9(1)(vii) defines "Computer Software". Relevant text is reproduced below:-

9(1)(vi) – Royalty **9(1)(vii)**	to accrue or arise in India where it is **payable by** — **the Government** — **by <u>resident</u>** unless it is payable in respect of any right, property or information used or services utilized: a) **for the purpose of or in the business or profession** carried on by such resident **outside India** or b) for the **purpose of making or earning any income from any source outside India** — Payable by **<u>non-resident</u>** only if it is payable in respect of any right, property or information used or services utilized: a) **for the purpose of or in the business or profession carried on by such non-resident in India** or b) **for the purposes of making or earning any income from any source in India**
Explanations to Section in brief 9(1)(vi)	Explanation 2 : Definition of "royalty"
	Explanation 3 : Defines "Computer Software"
	Explanation 4 : Covers "right to use software"

	Explanation 5 : Irrespective of possession, utilization & location of underlying asset is included in royalty
	Explanation 6 : Transmission by satellite included
Explanation 2 to section 9 (1) (vi) of Income Tax Act	**"Royalty" means** consideration (Including - any lump sum consideration) but excluding - any consideration which would be the income of the recipient chargeable under the head Capital gains for:
	• Clause (i): The **transfer of all or any rights** (Including the granting of a license) in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property;
	• Clause (ii):The **imparting of any information** concerning the working of, or the use of, a patent, invention, model, design, secret formula or process or trade mark or similar property;
	• Clause (iii): The **use of any patent**, invention, model, design, secret formula or process or trade mark or similar property;
	• Clause (iv): The **imparting** of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill;
	• Clause (iva): The **use or right to use** any industrial, commercial or scientific equipment but not including the amounts referred to in section 44BB;
	• Clause (v): The **transfer of all or any rights** (including the granting of a license) in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, excluding consideration for the sale, distribution or exhibition of cinematographic films ; or
	• The rendering of any **services in connection with the activities referred** to in sub-clauses (i) to (iv), (iva) and(v).
Explanation 3, 4,5 & 6 to section 9 (1) (vi) of Income Tax Act	Explanation 3 - "Computer software" means any computer programme recorded on any disc, tape, perforated media or other information storage device and includes any such programme or any customized electronic data.

	Computer software means-
	i) any **computer programme recorded** on any disc, tape, perforated media or other information storage device; or (ii) any **customised electronic data** or any product or service of similar nature as may be notified by the Board,which is transmitted or exported from India to a place outside India by any means. Explanation 4- For the removal of doubts, it is hereby clarified that the transfer of all or any rights in respect of any right, property or information includes and has always included transfer of all or any right for use or right to use a computer software (including granting of a license) irrespective of the medium through which such right is transferred. Explanation 5 - For the removal of doubts, it is hereby clarified that the royalty includes and has always included consideration in respect of any right, property or information, whether or not— (a) the possession or control of such right, property or information is with the payer;(b) such right, property or information is used directly by the payer; (c) the location of such right, property or information is in India.
	Explanation 6 - For the removal of doubts, it is hereby clarified that the expression “process” includes and shall be deemed to have always included transmission by satellite (including up-linking, amplification, conversion for down-linking of any signal), cable, optic fiber or by any other similar technology, whether or not such process is secret;”
Explanation 2 to section 9 (1) (vii) of Income Tax Act	For the purposes of this clause, “fees for technical services” means any consideration (........) for the rendering of any managerial, **technical or consultancy services** (including the provision of services of technical or other personnel) but does not include consideration for any construction, assembly, mining or like project undertaken by the recipient or ....]

- So in a nutshell, royalty Income of the following types will be deemed to accrue or arise in India:

  (a) Royalty payable by the Central Government or any State Government;

  (b) Royalty payable by a resident, except where the payment is relatable to a business or profession carried on by him outside or to any other source of his income outside India; and

  (c) Royalty payable by a non-resident, if the payment is relatable to business or profession carried on by him in India or to any other source of his income in India.

  In view of the above, royalty income (including lump sum consideration) for the transfer outside India of, or the imparting or information outside India in respect of, any data, documentation, drawing or specification relating to any patent, invention, model, design secret formula or processor trade mark or similar property, will become chargeable to tax in India.

- However, in the case of Ishikawajma-Harima Heavy Industries Ltd. v Director of Income Tax (2007) 288 ITR 408 (SC), it was held that despite the deeming fiction in the said section, for any such deemed income to be taxable in India, there must be sufficient territorial nexus between such income and the territory of India. Further, it was Held that where any sum is payable to a non-resident by a resident, the deeming sweep of the said section cannot bring to tax, any income of a non-resident received outside India from Indian concerns for services rendered outside India. In regard to fees for technical services, it has been specifically held that for the fees to be taxable in India, the services have not only to be utilized in a business in India, but also have to be rendered in India.

- Legislative intent for introduction of clauses (vi) and (vii) was to give legal sanctity to the source rule. This source rule is also recognized in India's Double Taxation Avoidance Agreements. Hence, for removal of doubts, an Explanation under section 9 was inserted to specifically reaffirm the source rule provided in that section. The Finance Act, 2010 substituted 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 section9(1)(v) (relating to interest paid outside India) or section 9(1) (vi) (relating to royalty paid outside India) or section 9(1)(vii) (relating to fee for technical services paid outside India) and shall be included in his total income, 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.

- The amendments are to counter some judicial decisions that have interpreted definition of royalty in a manner which has raised doubts and there was need to resolve the following issues:

  (1) Is the consideration for use of computer software a royalty?

  (2) Is it necessary that the right, property or information for which royalty is paid has to be used directly by the payee?

  (3) Is it necessary that the right, property or information has to be located in India or control or possession of it has to be with payer?

  (4) What is the meaning of term "process"?

Judicial pronouncements

- Whenever a software is assigned or licensed for use, there is involved an assignment of right to use embedded copyright in software or a license to use embedded an assignment of right, the intellectual property right in software, it is not possible to divorce software from intellectual property right of creator of software embedded therein, therefore the payments received by applicant from distributor for sale of software product is in nature of royalty within the meaning of section 9(1) (vi) and consideration paid for right to use acopy right from distributor is to be treated as royalty within the meaning of Article 12.

  Citrix Systems Asia Pacific Pty Ltd, In re (2002) 205 Taxman 320 (AAR). ***See also*** *CIT v Customer Asset India (P.) Ltd. (2014) 222 Taxman 37 (Karn) (Mag)]*

- Assessee, an Indian company, entered into 'secondment agreement' with overseas companies and sought some employees on 'secondment' from overseas entities. Delhi High Court by impugned order held that since employees of those companies used their technical knowledge and skills while assisting assesse in conducting its business of quality control and management, amounts reimbursed by assesse to overseas companies towards salaries of seconded employees amounted to 'fee for technical services' liable to tax in India.

  [Centrica India Offshore (P.) Ltd. v CIT (2014) 224 Taxman 122 (Del)] Special leave petition filed against impugned order was also dismissed. [Centrica India Offshore (P.) Ltd v CIT (2014) 51 taxmann.com 386 (SC)]

- Subscription fee received by non-resident applicant from customers who are users of data base not in nature of royalty and hence not taxable in India as royalty. Such subscription fee can be taxed only as business income of at all it is found by department that an agency permanent establishment exists.

  [Factset Research System Inc., in re (2009) 182 Taxman 266 (AAR-New Delhi)]

Chapter 3
SIGNIFICANT ECONOMIC PRESENCE

- For a long time, nexus based on physical presence was used as a proxy to regular economic allegiance of a non-resident. However, with the advancement in information and communication technology in the last few decades, new business models operating remotely through digital medium have emerged. Therefore, the existing nexus rule based on physical presence do not hold good anymore for taxation of business profits in source country.

- The scope of existing provisions of clause (i) of sub-section (1) of section 9 is restrictive as it essentially provides for physical presence based nexus rule for taxation of business income of the non-resident in India. Therefore, emerging business models such as digitized businesses,which do not require physical presence of itself or any agent in India, is not covered within the scope of clause (i) of sub-section(i)of section9 of the Act.

- In view of the above, Finance Act 2020 amended Explanation 2A to section 9(1)(i) of to provide that 'SIGNIFICANT ECONOMIC PRESENCE' in India shall also constitute 'business connection'.

  Explanation 2A. — *For the removal of doubts, it is hereby declared that the significant economic presence of a non-resident in India shall constitute "business connection" in India and* ***"significant economic presence"*** *for this purpose, shall mean—*

  (a) transaction in respect of any goods, services or property carried out by a non-resident ***with any person in India including provision of download of data or software in India,*** *if the aggregate of payments arising from such transaction or transactions during the previous year exceeds such amount as may be prescribed; or*

  (b) systematic and continuous soliciting of business activities or engaging in interaction with such number of users in India, as may be prescribed:

  Provided that the transactions or activities shall constitute significant economic presence in India, whether or not—

  (i) the agreement for such transactions or activities is entered in India; or

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

  (iii) the non-resident renders services in India:

- The new Explanation 2A is made effective from 1st April 2022 (AY 2022-23). The threshold of "revenue" and the "users" in India will be decided after consultation with the stakeholders. Further, it is also clarified that unless corresponding modifications to PE rules are made in the DTAAs, the cross border business profits will continue to be taxed as per the existing treaty rules.

Chapter 4
TAX DEDUCTION AT SOURCE

- Following payments are liable for TDS under section 194J

  1. Fees for professional services,
  2. Fees for technical services,
  3. Royalty,

Explanation (b) to Section194J provides that "fees for technical services" shall have the same meaning as in Explanation 2 to clause (vii) of sub¬section (1) of section 9

Explanation (ba) to Section194J provides that "royalty" shall have the same meaning as in Explanation 2 to clause (vi) of sub-section (1) of section 9

Based on the above purchase of software, software licenses, customisation of software are liable for TDS under section 194J.

The Central Board of Direct Taxes has issued Notification No.21/2012 dated 13 June 2012 to provide that no tax shall be deducted at source under section 194J on payment by a person (hereafter referred to as the transferee) for acquisition of software from another person, being a resident, (hereafter referred to as the transferor) if following **conditions** are satisfied:

i) The software is acquired in a subsequent transfer and the **transferor has transferred the software without any modification,**

ii) **Tax has been deducted for any previous transfer-**

   (a) under section 194J on payment of such software; or

   (b) under section 195 on payment of such software from a non-resident, and

iii) The **transferee obtains a declaration from the transferor** that the tax has been deducted either under sub-clause (a) or (b) of clause (ii) along with the Permanent Account Number of the transferor.

Whether TDS u/s 194J is also deductible on reimbursements?

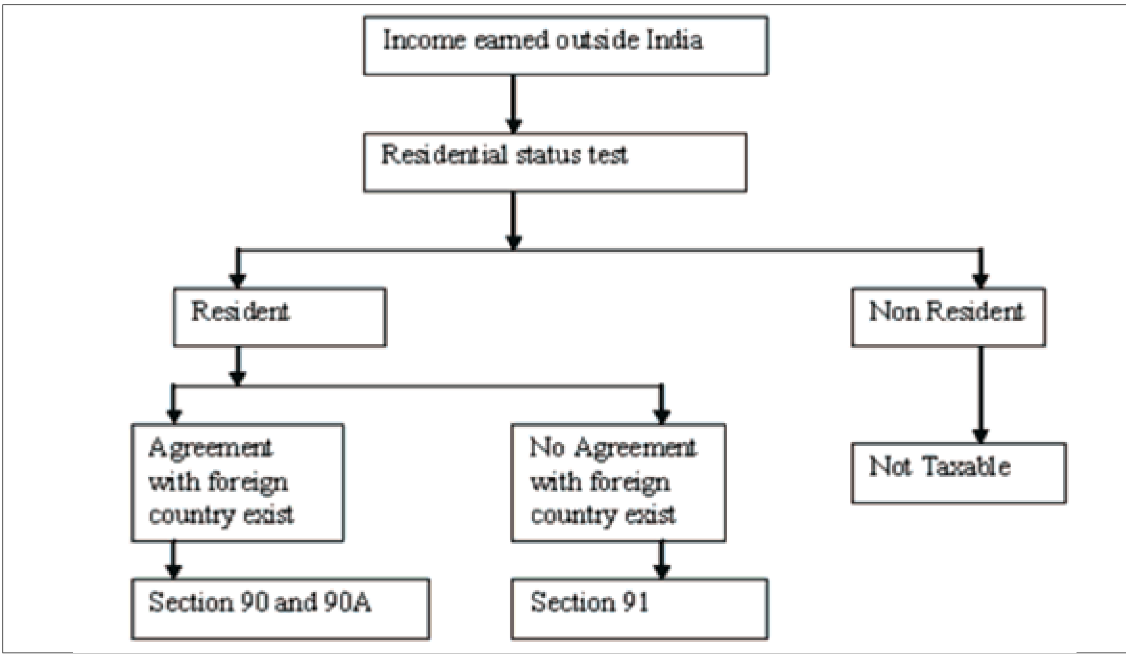
Circular No. 720 dated 30/8/1995 provides that the provision of sec 194 C &194J is not applicable – where bills were raised separately by the consultants for reimbursements of actual expenses incurred by them

Refer judgement: -

In the context of ambiguity whether TDS for a particular transaction is covered u/s.194C or 194J, it would be relevant to take a note of the order Pidilite Industries Ltd, Mumbai vs Ito Tds 2(5), Mumbai on 31 January, 2018, Income Tax Appellate Tribunal - Mumbai

Chapter 5
FOREIGN TAX CREDIT SECTION 90 r/w ARTICLE 23

- Section 90 provides about relief from double taxation of income from the country with which India has entered into tax treaty. India has Double Taxation Avoidance Agreement (DTAA) with __ Countries.
- Refer following chart for scenarios in which section 90 is relevant



- Article 23 of the DTAA

  In the existing conventions, two leading principles are followed for the elimination of double taxation by the State of which the taxpayer is a resident.

  i) **Exemption method**

  A particular income is taxed in one of the both countries and exempted in the other country.

  ii) Tax Credit method

  The income is taxed in both the countries as per the treaty and the country of residence will allow the tax credit / reduction for the tax charged in the country ofsource.

For IT &ITeS Tax credit method is relevant. Note the following about the tax credit methods

iii) A characteristic of the credit methods compared with the exemption methods is that State R (**S**tate of **R**esidence) is never obliged to allow a deduction of more than the tax due in State S (State of Source).

iv) Where the tax due in State S is lower than the tax of State R appropriate to the income from State S (maximum deduction), the taxpayer will always have to pay the same amount of taxes as he would have had to pay if he were taxed only in State R, i.e. as if his total income were derived solely from State R.

v) The Same result is achieved, where the tax due in State S is the higher while State R applies the full credit , at least as long as the total tax due to State R is as high or higher than the amount of the tax due in States.

vi) Where the tax due in State S is higher and where the credit is limited (ordinary credit), the taxpayer will not get a deduction for the whole of the tax paid in State S. In such event the result would be less favorable to the taxpayer than if his whole income arose in State R, and in these circumstances the ordinary credit method would have the same effect as the method of exemption with progression.

Here is an example for (iv) above

The total income to be 100,000 of which 80,000 is derived from one State (State of Residence R) and 20,000 from the other State (State of Source S). Assume that in State R the rate of tax on an income of 100,000 is 35 percent.

Assume further that in State S the rate of tax is either

case(i) :20 percent - tax payable therein on 20,000 is 4,000

case (ii) :40 percent - tax payable therein on 20,000 is 8,000

Relief if DTAA permits “Full Credit”

	Case I	**Case II**
Tax in State R, 35% of 100,000	35,000	35,000
Less tax in State S	- 4,000	-8,000
Tax Due	31,000	27,000
Relief in State R	4,000	8,000
Total tax outflow	35,000	35,000

Relief if DTAA permits "Ordinary credit"

State R computes tax on total income of 100,000 at the rate of 35 percent and allows the deduction of the tax due in State S on the income from S, but in no case it allows more than the portion of tax in State R attributable to the income from S (maximum deduction). The maximum deduction would be 35 percent of 20,000 = 7,000.

	Case I	**Case II**
Tax in State R, 35% of 100,000	35,000	35,000
Less: Tax paid in State S	- 4,000	
Less: Tax paid in State S (restricted to 35% of Rs.20,000)		-7,000
Tax Due	31,000	28,000
Relief in State R	4,000	7,000
Total tax outflow	35,000	36,000

So, typically, based on the provisions of the Article 23, the calculation of Foreign tax credit in India would involve the following steps:

- Step 1 : Calculate Indian Tax (including surcharge) on net income from source country.
- Step 2 : Calculate Indian tax (including surcharge) on total income, before allowing tax credit.
- Step 3 : Reduce tax paid in source state, or tax calculated in Step 1 above, whichever is less, from the tax calculated in Step2 above.

Refer notification number 57 of 2016 and Form 67 which has given in detail the procedure for claiming Foreign Tax Credit.

Chapter 6
PATENT BOX REGIME (Section 115BBF)

- Section 115BBF of the Finance Bill, 2016[1] introduced the Patent Box Regime in India. Patent Box Regime is an effort which enables an inventor to benefit through tax concessions on the royalty income.
- Section 115BBF of the Income Tax Act provides that where royalty income is a part of assessee's income, the income tax on the royalty income shall be calculated at a concessional rate of 10%, provided that the patent is developed as well as registered in India.
- Section 115BBF was introduced for following reasons
  — existing regime which provided front end incentive was not sufficient to encourage patenting and innovations in India
  — Investment linked deductions were to be phased out by the government
  — To encourage the 'Make in India' project
- The assessee would not be eligible to any other benefit in respect of any other expenditure or allowance if he chooses to benefit under Section 115BBF.
- Salient features of Section 115BBF is provided below:-
  — Applicable to Indian resident who is a patentee (eligible taxpayer);
  — Only such patents which are granted under Patents Act, 1970 are considered
  — Patentee is any person who is the true and first inventor of the invention, whose name is entered on the patent register as the Patentee as per Patents Act, 1970 (Patent Act) and also includes joint true and first inventor
  — Total income of eligible taxpayer must include income by way of royalty
  — Royalty income is in respect of patent developed and registered in India
  — At-least 75% of the expenditure is incurred in India by eligible taxpayer for invention
- Form 3CFA
  — Eligible taxpayer choosing to avail Section 115BBF benefit, is required to furnish Form No. 3CFA

- Form 3CFA shall be complete in all respects and be filed on or before due date for furnishing the return of income under Section 139(1)
- Form 3CFA requires certain general details (such as name, PAN, address of taxpayer etc), details of patent (such as description of patent, patent number, date of grant of patent, whether granted to single person or in joint) and details of royalty income and also expenditure incurred in India and Outside India
- Particulars of each eligible patent should be reported separately along with royalty income and expenditure details
- Terms 'invention', 'Patent', 'patented article', 'patented process' and 'true and first inventor' shall have the meaning assigned to them in Patents Act

• Once an option to avail the benefit of Section 115BBF is exercised in any year, eligible taxpayer is required to continue to avail the benefit for next 5 years. In case option is not exercised in any of such 5 years, eligible taxpayer will not be eligible to take the benefit under section 115BBF for the next 5 years following such year in which option is not exercised.

Chapter 7
REVENUE RECOGNITION AS PER "ICDS"

INCOME COMPUTATION AND DISCLOSURE STANDARDS (ICDS)

ICDS IV - Revenue Recognition

When we speak of IT or ITes, we majority of the times speak of provision of services viz to development of software, call centers, payrolls, platform provisioning for advertisement, geographical information systems, web services etc. Revenue from royalty is within the scope of ICDS IV.

Consequently ICDS IV has a bigger role to play when it comes to revenue recognition of the aforementioned services. The following is the point of recognition of service as per ICDS IV:

Sr. No.	Relevant Para	Type of service provisioning	Time of revenue recognition
1	Para 5	Revenue from service transactions except mentioned in point 3 below	Percentage Completion Method
2	Para 6	When services are provided by indeterminate (not exactly known, established or defined) number of acts over a specific period of time	On a straight line basis over the specific period.
3	Para 7	Service contracts with duration < 90 days	When the rendering of services is completed or substantially completed

ICDS IV, para 9 provides that the royalty income shall accrue in accordance with the terms of the relevant agreement and shall be recognized accordingly.

In ICDS, Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim for escalation of price and export incentives, revenue recognition in respect of such claim shall be postponed to the extent of uncertainty involved.

a) Percentage Completion Method

Under percentage of completion method, profit or loss proportionate to the work completed is computed. This is done by estimating the revenue which is attributable to the work completed and matching it with the costs and expenses incurred to reach the stage of completion at the end of the previous year.

b) Substantial Completion:

In completed contract method, which is also known as project completion method, the revenue and expenses are recognized at the time of substantial completion of the project. The substantial completion of the project means the project should be completed by and large, except to some ancillary and minor/ miscellaneous work, which can be completed in subsequent years. The another feature of project completion method is that, in this method, the financial statements, that is, profit and loss account and balance sheet is prepared once in the life of the project therefore it is necessary to make the provision in the books of accounts for expenses like ancillary and minor/miscellaneous work, which are yet to be completed or to be completed in subsequent years.

In absence of specific definition of the word specific completion in ICDS the meaning of the same can be derived from case laws.

However the view of relevant tax authorities in application of the term "substantial completion" for the purpose of ICDS IV which can be applied for Revenue Recognition of Software development contracts needs to be looked into based on related judicial pronouncements that will arise in years to come

Chapter 8
Exemption under Section 10AA

Introduction

In order to boost exports and investments in export sectors, the Government of India enacted the Special Economic Zones Act, 2005 ('SEZ Act') alongwith the Rules in 2006. Consequently, to provide tax incentives to units being set-up in these zones, Section 10AA of the Income-tax Act, 1961 ('the Act') was introduced to provide certain incentives to certain persons setting up their businesses in Special Economic Zones in India. Below, we attempt to delve into the salient features of this section and certain controversies arising out of practical application of the same along-with certain landmark judicial precedents.

❖ **Applicability:**

Benefit under this section is available to

- an entrepreneur as referred to in **clause (j) of section 2 of the SEZ Act;**
- engaged in manufacture or produce of articles or things or provision of any services;
- Such activities should be undertaken from a Unit set up in a SEZ in India;
- the manufacture/production/provision of services should take place during the assessment year falling between **1st April, 2006 to 31st March, 2021;**
- it is not formed by the splitting up, or the reconstruction, of a business already in existence (apart from re-establishment, reconstruction or revival of the business of any such undertaking as is referred to in section 33B, in the circumstances and within the period specified in that section)
- It is not formed by transfer of any plant or machinery previously used, to a new business.

Further, section 2(j) of the SEZ Act provides that *"entrepreneur" means a person who has been granted a letter of approval by the Development Commissioner under sub-section (9) of section 15.*

Thus, an essential condition for claiming deduction under section 10AA of the Act is that the person claiming the deduction should have been granted a letter of approval under the SEZ Act.

❖ **Amount of deduction available:**

- A person who fulfils the above conditions would be eligible for the following deduction:

Phase	Particulars	Amount of deduction
1	First five consecutive years beginning from the assessment year when the Unit begins manufacture/production/provision of services (Year 1 to 5)	100% of profits and gains derived from export of goods or services
2	Next five consecutive years (Year 6 to 10)	50% of profits and gains derived from export of goods or services
3	Last five consecutive years (Year 11 to 15)	50% of profits and gains credited to the 'Special Economic Zone Re-investment Reserve Account' which is to be utilised for the purposes of the business of the assessee as mentioned in the section

- Legal conditions for claiming deduction under Phase 3:

1. Amount of profits should be debited in the Profit and Loss account and credited to the Special Economic Zone Reinvestment Reserve Account ('the Reserve')

2. The amount credited to the Special Economic Zone Reinvestment Reserve Account should be utilised as under:

   i. For purchase of plant and machinery which is put to usewithin three years beginning from the year following the year of creation of the Reserve; and

   ii. In the intervening period, i.e. till the date the amount is so utilised, for the purposes of business of the undertaking , apart from

      a. for distribution as dividends or profits, or

      b. for remittance outside India as profits, or

      c. for creation of asset outside India.

3. The particulars of the amount so utilised needs to be furnished in Form 56FF along with the return of income for the assessment year in which such plant or machinery was first put to use.

- **Consequences of violating the conditions in Phase 3**

Action	Consequence
If the amount credited is utilised for any other purposes	The amount so credited would be deemed to be the profits of the year **in which the amount is so utilised**
If the amount credited is not utilised within the time limit specified	The amount so credited would be deemed to be the profits of the year **immediately following the period of three years**

❖ **Interplay with other provisions providing for a similar deduction:**

The Act contains many other sections which provide for incentives in case of undertakings engaged in export of certain goods or services. In order to ensure that taxpayers do not end up taking double deduction, the legislators have carved in specific provisions under section 10AA of the Act. The same are as under:

a. Where **an undertaking being the Unit** has already claimed deduction under section 10A of the Act, it shall be eligible to deduction under Phase 1 and Phase 2 of section 10AA of the Act only for the balance period out of the ten assessment years and deduction under Phase 3 for the balance five assessment years.

b. Where an undertaking, being the Unit, had already availed, before the commencement of the Special Economic Zones Act, 2005, the deductions in section 10A for ten consecutive assessment years, such Unit shall not be eligible for deduction from income under this section. **This implies that deduction of 50% of amount credited to the Reserve shall also not be available for such undertakings.**

c. Where a Unit initially located in any free trade zone or export processing zone is subsequently located in a Special Economic Zone by reason of conversion of such free trade zone or export processing zone into a Special Economic Zone, **the period of ten consecutive assessment years shall be calculated from the assessment year in which the Unit began to manufacture, or produce or process such articles or things or services**

in such free trade zone or export processing zone and if the period of ten years has already been completed, no deduction shall be available.

❖ **Some important definitions:**

i. **Export turnover** means the consideration in respect of export by the undertaking, being the Unit, of articles or things or services received in, or brought into, India by the assessee but does not include freight, telecommunication charges or insurance attributable to the delivery of the articles or things outside India or expenses, if any, incurred in foreign exchange in rendering of services (including computer software) outside India;

It has been specified that 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.

ii. **Export in relation to the Special Economic Zonesmeans** taking goods or providing services out of India from a Special Economic Zone by land, sea, air, or by any other mode, whether physical or otherwise;

iii. **Manufacture:** It shall have the same meaning as assigned to it in clause (r) of section 2 of the Special Economic Zones Act, 2005;

Section 2(r) of the SEZ Act defines "manufacture" as

to make, produce, fabricate, assemble, process or bring into existence, by hand or by machine, a new product having a distinctive name, character or use and shall include processes such as refrigeration, cutting, polishing, blending, repair, remaking, re-engineering and includes agriculture, aquaculture, animal husbandry, floriculture, horticulture, pisciculture, poultry, sericulture, viticulture and mining.

❖ **Other miscellaneous provisions :**

a. **In case of an amalgamation or demerger (fulfilling conditions specified in the Act):** the deduction shall be available to the amalgamating or demerged Unit as if the amalgamation or demerger had not taken place. Further no deduction shall be available for the previous year when the amalgamation or demerger takes place.

b. Loss sustained in the Unit shall be allowed to be carried forward and set off as per section 72(1) of the Act.

c. Transfer pricing provisions shall be applicable in case of inter-unit as well as inter-business transfers as provided for in section 80IA(8) and 80IA(10) of the Act respectively.

d. Where a deduction is claimed under this section for a specified business under section 35AD(8)(c) of the Act for any assessment year, no deduction under section 35AD of the Act shall be allowed.

Profits derived from export of article or things or services =
<u>Revenue from export of goods or services</u>
Total turnover of the business or undertaking

e. The deduction shall not be available if audit report as specified in section 10A (5) of the Act is not furnished **before the date specified in section 44AB of the Act (amended by Finance Act, 2020 w.e.f. 01st April, 2020)**

f. Provisions of section 10A(6) providing for computation mechanism after the expiry of fifteen years shall apply to section 10AA as well

g. The deduction shall be allowed from the total income of the assessee computed in accordance with the provisions of the Act before giving effect to the provisions of the section 10AA and the deduction under section 10AA shall not exceed the said total income.

❖ **Controversies and Judicial pronouncements:**

1. Condition regarding new business not to be formed by reconstruction of existing business

- **Issue in dispute:**

  One of the conditions for claiming deduction u/s. 10AA is that the business should not be formed by reconstruction of any existing business. To fulfil this condition, whether the unit availing deduction should be formed by entirely new funds or shift from existing business is allowed?

- **Judgements:**

  — The above issue is addressed by the Supreme Court of India in the case of ***Principal Commissioner of Income-tax, Central v.Green Fire Exports[2019] 106 taxmann.com 33 (SC).***

  — In the above mentioned case, part investment by a partner in the new firm was made from his proprietary concern. The Assessing Officer was of the view that the new unit was not formed from fresh funds but merely reflected shift of money from the original business i.e. proprietary concern to the new firm. The said case was reconstruction of business and no exemption under section 10AA was allowed.

— The Hon'ble Supreme Court of India held that the capital brought in by the partner out of the proprietary concern was only a part investment whereas huge investments were made in addition to the above which clearly have shown that new capital was introduced to the new unit. Also, assets appearing in the balance sheet of old concern were not shifted to new unit but were lying as it were. Hence, the above case cannot be said to be the case reconstruction of the business and claim of deduction u/s 10AA was allowed.

2. Deduction of freight, insurance and other charges from total turnover:

- **Issue in dispute:**

  Whether while computing deduction under section 10AA, amounts reduced from export turnover, should also be proportionately reduced from total turnover?

- **Judgements:**

  — The said issue is addressed by the Supreme Court of India in the case of ***Principal Commissioner of Income Tax, Jaipur-IIv.Vedansh Jewels (P.) Ltd. [2018] 97 taxmann.com 521 (SC)/[2018] 258 Taxman 154 (SC)***

  In the above case, the Ld. A.O. disallowed the deduction u/s. 10AA in respect of the amount comprising surplus of freight, insurance charges and miscellaneous balances written off on the allegation that the same constituted indirect income not derived from export of goods.

  The Hon'ble Supreme Court dismissed Special Leave Petition leaving the question of law open. The Hon'ble High Court of Rajasthan held that the exclusion from the export turnover may not have any effect as where the freight or insurance charges are reduced from the export turnover, the same have to be reduced from the total turnover as well. Allowance of exemption under section 10AA in respect of freight and insurance excess receipts was confirmed.

3. **Deduction of travel expenses, IT and technical support services, etc. in foreign currency from 'export turnover':**

- **Issue in dispute:**

  Whether certain expenses such as travel expenses, IT and technical support services etc. incurred in foreign currency be deducted from 'export turnover', if the same had not been incurred for rendering any services outside India since definition provided under section 10AA of the Act, only specifically excludes the same if they are incurred for services rendered outside India.

- **Judgements:**

  The above issue is addressed by the High Court of Madras in the case of ***Renault Nissan Technology & Business Centre India (P.) Ltd. v. Commissioner of Income Tax [2020] 118 taxmann.com 279 (Madras).***

  The Hon'ble High Court held that if it were to be established that no services had been rendered outside India and the assessee had been reimbursed the actual cost only, the question of exclusion from the 'export turnover' would not arise.

4. **Deduction u/s. 10AA on disallowances made during assessments**

- **Issue in dispute:**

  Where during the course of scrutiny proceedings, certain disallowances are made, which increase the total business income of the assessee, whether deduction u/s. 10AA is allowable on such enhanced income?

- **Judgements:**

  — The above issue is addressed by the High Court of Gujarat in the case of ***ITO. v. Kewal Construction [2013] 33 taxmann.com 277 (Gujarat),*** thoughin the context of section 80IB of the Act, which provides for similar deduction.

  — The Hon'ble High Court held that even if an expenditure which was incurred by assessee for purpose of developing a housing project was not allowable for non-deduction of TDS under law, such disallowance would ultimately increase assessee's profit from business of developing housing project; ultimate profit of assessee after computing disallowance under section 40(a)(ia) would qualify for deduction under section 80-IB

— Similar view was held by the Hon'ble Bombay High Court in the case of **CIT v. Sunil Vishwambharnath Tiwari [2015] 63 taxmann.com 241 (Bombay)**

The CBDT had issued a circular no. 37/2016 dated 2ndNovember, 2016 stating that deduction under Chapter VI-A would be admissible on profits enhanced by way of disallowance.

— Applying the same analogy to deductions u/s. 10B, being a profit-linked incentive, the Bombay High Court in the case of ***CIT v. Gem Plus Jewellery India Ltd. [2010] 194 Taxman 192 (Bombay)*** held that where Assessing Officer had enhanced income by disallowing employer's as well as employee's contributions towards provident fund/ESIC, exemption under section 10A had to be granted on such enhanced income.

— Thus, a view can be taken that similar deduction should be available section 10AA of the Act.

Chapter 9
Deduction under Section 35(2AB)

Introduction

In the dynamic and ever-changing global environment today, research activities play a pivotal role in the development of all economies.The Government of India, has hence provided for many tax incentives to companies involved in or investing in scientific research, vide section 35 of the Income-tax Act, 1961 ('the Act').

Companies in the Information Technology sector often invest huge funds in scientific research involved in software development. Below, we discuss the applicability of deduction under section 35(2AB) of the Act to expenditure on scientific expenditure incurred by companies on software development.

➢ **Taxability as per Income Tax Act, 1961 ('the Act'):**

✓ **Amount of deduction available:**

- The deduction available under the said section is tabulated hereunder:

Section	Sums covered under the section	Amount of deduction
35(2AB)	Expenses (by a company) on an approved in-house research unit	• 150% of actualcontribution forthe assessment years 2018-19to 2020-21
		• 100% of actualcontributionfrom theassessment year2021-22

✓ **Availability of deduction to software manufacturing companies:**

- The provisions of Sec. 35(2AB) of the Act, provides that where a company engaged in the **business of manufacture or production of any article or thing** incurs any expenditure on in-house **scientific research** and development facility as approved by the prescribed authority, then there shall be allowed a **deduction equal to 150% of such expenses incurred by the assessee** for in-house research and development facilities, other than on land or building, **up-to Assessment Year 2021-22.** Thereafter the actual expenditure incurred shall be allowed as a deduction from AY 2021-22.

- In this regard, the term 'scientific research' is definedby section 43(4) of the Act as under

  (i) "scientific research" means any activities for the extension of knowledge in the fields of natural or applied science including agriculture, animal husbandry or fisheries;

  (ii) references to expenditure incurred on scientific research include all expenditure incurred for the prosecution, or the provision of facilities for the prosecution, of scientific research, but do not include any expenditure incurred in the acquisition of rights in, or arising out of, scientific research;

  (iii) references to scientific research related to a business or class of business include—

    (a) any scientific research which may lead to or facilitate an extension of that business or, as the case may be, all businesses of that class;

    (b) any scientific research of a medical nature which has a special relation to the welfare of workers employed in that business or, as the case may be, all businesses of that class;".

- The term 'scientific research' is defined inclusively. Manufacturing or production of computer software was not considered as a scientific research before. However, on 8th February, 2000; CBDT has vide notification S.O. 452 has notified thatmanufacturing or production of computer software will also be said to be scientific research for the purpose of section 35(2AB).

- Further, 'In-house research' refers to conducting an activity or operation within a company, instead of relying on outsourcing. An in-house operation is an activity performed within the same business, using the company's assets and employees to perform the necessary

✓ **Conditions for availing deduction:**

- Where a deduction is claimed under section 35(2AB) of the Act, no deduction shall be allowed in respect of the same expenditure under any other provision of the Act.

- The company claiming the deduction needs to enter into an agreement with the **prescribed authority*** for co-operation in such research and development facility as maybe prescribed. Rule 6 of the Income-tax Rules, and fulfil such conditions with regard to maintenance of accounts and audit thereof and furnishing of necessary reports in Form No. 3CK.

  *** Prescribed authority for the purposes of section 35(2AB) of the Act is the Secretary, Department of Scientific and Industrial Research ('DSIR')**

- The DSIR shall, if he is satisfied that the conditions provided in this rule and in section 35(2AB) of the Act are fulfilled, pass an order in writing in Form No. 3CM and will submit the same to the Principal Chief Commissioner or Chief Commissioner or Principal Director General or Director General. Reasonable opportunity of being heard will be provided to the assessee before rejecting any application.

- Further, sub-rule 7A of Rule 6 provides for the approval granted by the DSIR on expenditure incurred on in-house facility to be subject to certain conditions which are provided as under:

  - The facility should not relate **purely to** market research, sales promotion, quality control, testing, commercial production, style changes, routine data collection or activities of a like nature

  - The DSIR shall furnish electronically

    a. its report for approval of in-house research and development facility in **Part A;** and

    b. for quantifying the expenditure incurred on in-house research and development deduction and eligible for weighted deduction in **Part Bof Form No. 3CL**

  - The report in Form No. 3CL shall be furnished electronically by the DSIR to the Principal Chief Commissioner of Income-tax or Chief Commissioner of Income-tax or Principal Director General of Income-tax or Director General of Income-tax submitted within **one hundred and twenty days,** of-

    i. the grant of the approval, in a case referred to in (a) above;

    ii. of the submission of the audit report, in a case referred to in (b) above.

  - Separate account for each approved facility is required to be maintained by the company; which shall be audited annually and a report of audit in **Form No.3CLA** is required to be furnished electronically to the Secretary, Department of Scientific and Industrial Research on or before the due date for filing return of income under section 139(1) of the Act.

  - Assets acquired in respect of development of scientific research and development facility shall not be disposed of without the approval of the Secretary, Department of Scientific and Industrial Research.

- **Guidelines issued by the Department of Scientific and Industrial Research ('DSIR') in relation to the approval under section 35(2AB) of the Act:**

  Certain Guidelines have been issued by the DSIR with respect to companies having in-house Research and Development Centres. Salient features of these guidelines are as under:

  - Companies having In-house R&D centers, which satisfy the following conditions, are eligible to apply for approval of the 'Prescribed Authority':
    - ✓ Well defined R & D Programs along with proper documentation,
    - ✓ Holding valid recognition of DSIR,
    - ✓ Engaged in business of biotechnology or manufacturing or production of any article other than those mentioned in Eleventh Schedule,
    - ✓ Maintains separate accounts for the R&D expenditures and reports the capital & recurring expenditures after duly audited by Statutory Auditors,
    - ✓ The in-house R & D centre is located in a separate earmarked area/ building and has manpower of its own,
  - The approval given by the DSIR will be subject to the following conditions:
    - ✓ Company should have necessary valid permits / licences, if these are required, from statutory authorities and the same should be renewed from time to time
    - ✓ If company has applied for more than one in-house R & D centre, then a valid recognition from DSIR should be present for each centre,
    - ✓ If deduction claimed under section 35(2AB) of the Act, then no other deduction under any other section under the Act should be claimed,
    - ✓ An undertaking is to be submitted stating that the company maintains separate books of accounts, get the same duly audited by the Auditor every year as defined in sub-section (2) of section 288 of the Act,
    - ✓ The company should enter into an agreement with the 'Prescribed Authority' (Secretary, DSIR) for co-operation in such research and development facility and for audit of the accounts maintained for that facility,
    - ✓ The audited accounts for each year maintained separately for each approved centre shall be furnished to the Secretary, DSIR by **31st October of the succeeding year,**

- ✓ Assets acquired and products, if any emanating out of R&D work done in approved facility, shall not be disposed off without approval of the Secretary, DSIR.
- ✓ **Sales realisation arising out of the assets sold shall be offset against the R&D expenditure of the R&D Centre claimed under section 35(2AB) of the Act.**
- ✓ R&D facility should **not relate purely to** market research, sales promotion, quality control, testing, commercial production, style changes, routine data collection or activities of a like nature,
- ✓ Expenditures, **which are directly identifiable with approved R&D facility only,** shall be eligible for the weighted tax deduction. R & D utilities of a common source will also be admissible to the extent certified by a Chartered Accountant, as relatable to the R&D centre.
- ✓ Expenditure on manpower for departments other than R & D centre such as manufacturing, quality control, tool room etc. incurred on such functions as attending meetings providing advice / directions, ascertaining customer choice/response to new products under development and other liaison work shall not qualify for deduction under section 35(2AB) of the Act.
- ✓ Deduction will be allowed for capital expenditure only on plant and equipment or any other tangible item. **Capitalized expenditure of intangible nature will not be eligible for weighted deduction.**
- ✓ R&D expenditure claimed for deduction under the sub-section shall be reduced to the extent of gifts/ donations/ grants received for R & D
- ✓ Expenditure of general nature shall not be admissible. The personnel with Degree / Diploma in Science or engineering discipline and above qualification will only be regarded as R&D manpower eligible for weighted tax deduction. Manpower under the category of retainership / consultants and manpower on contract will not be admissible for weighted tax deduction.
- ✓ The approval of Secretary, DSIR shall be subject to the amendments, if any, in the Act
- ✓ Commercial activities or R & D activities to be undertaken with due approvals and to comply with laws and regulation
- ✓ Remunerations paid to the members of the board of Directors should not be included in expenditure eligible for deduction.
- ✓ Expenditure reported as CWIP will not be eligible for weighted deduction. Company to submit a list of capital equipments, with the

date of purchase/installation and cost. Further vehicles purchased for reference and testing purpose will not be admissible for weighted deduction

- ✓ The expenditure eligible should necessarily be reported in the audited financial statement prepared for the purpose of published annual report as well as for the purpose of Income Tax returns.

❖ **Policy for approval:**

- ✓ Approval to the in-house R&D centres having valid recognition by DSIR are considered from 1stApril of the yearin which application in Form 3CK is filed and is considered to be co-terminus with DSIR recognition
- ✓ **For companies not having DSIR recognized in-house R&D centre, approval is considered from the date of recognition.**
- ✓ In case of firms having signed agreement of cooperation u/s 35 (2AB) with the Prescribed Authority for one or more R&D centers approved with DSIR which implies that they have been maintaining separate accounts for R&D : From the year in which recognition is granted provided the company submits Form 3CK before end of the financial year
- ✓ In case of firms, not having DSIR recognized R&D centre, but which have applied for approval u/s 35 (2AB) of an in-house R&D center on which they had made capital investments on R&D of more than Rs. One crore, excluding expenditure on land and building, in the financial year preceding the year in which the firm applied to the prescribed authority for the approval – capital expenditure on the R&D facility for which approval has been requested (excluding capital expenditure on land and building) incurred from the commencement of said preceding year, provided the company had claimed such capital expenditure in their I.T. return for concerned assessment year and the firm/R&D centre fulfils other conditions of approval, and provided the centre was subsequently recognized by DSIR
- ✓ In case of firms, having R&D centres already recognized by DSIR and who have applied for approval of an in-house R&D centre u/s 35 (2AB) and who have made capital investment on R&D of more than Rs. one crore, excluding capital expenditure on land and buildings, on such centre in the financial year preceding the year in which the firm applied to prescribed authority for the approval – such capital expenditure incurred in the said preceding year provided the company had claimed such capital expenditure in their I.T. returns for concerned assessment year

❖ The Guidelines also provide for procedure by which approval will be granted.

❖ **Controversies and Judicial pronouncements:**

5. Scope of Assessing Officer in determining the claim of deduction under section 35(2AB) of the Act

- **Issue in dispute:**

  Whether where assesse claims deduction under section 35(2AB), pursuant to certificate issued by prescribed authority, i.e., Department of Scientific and Industrial Research (DSIR), approving such claim, Assessing Officer can deny weighted deduction under section35(2AB) in respect of scientific expenditure

- **Judgements:**

  — While addressing the said issue, the High Court of Karnataka in the case of ***Tejas Networks Ltd. v. DCIT [2015] 60 taxmann.com 309 (Karnataka) held that,*** *reading of section 35(3) would clearly indicate that where the Assessing Officer does not accept the claim of the assessee made under section 35(2AB), he has to refer the matter to the Board, which in turn, will refer the question to the prescribed authority. The decision of the prescribed authority would be final as could be seen from clause (b) of sub-section (3) of section 35. Thus, it would emerge from above analysis that neither the Assessing Officer nor the Board is competent to take any decision on any such controversy relating to report and approval granted by 'prescribed authority' as it involves expert view or opinion. The controversy arising out of certificate issued by the prescribed authority if any, has to be referred to the prescribed authority by the Board on such doubt being raised by Assessing Officer and also on his request. It is the prescribed authority alone which would be competent to take a decision with regard to correctness or otherwise of its order of approval granted in Form No. 3CL as prescribed under section 35(2AB) read with rule 7A of the rules.*

  — Similar view has been upheld by the Gujarat High Court in the case of ***DCIT (Asstt.) v. Mastek Ltd. [2012] 25 taxmann.com 133 (Guj.).***

6. Expenses on refreshment, lunch, etc. of visiting scientists whether allowable under section 35(2AB) of the Act

- **Issue in dispute:**

— Whether weighted deduction u/s. 35(2AB) of the Act can be allowed to the assessee on account of expenses incurred for lunch, refreshment and brokerage paid for property used by R & D unit employees, treating the same as expenses incurred for R & D activity covered u/s. 35(2AB) of the Act

- **Judgements:**

While addressing the said issue, the High Court of Gujarat in the case of PCIT v. Sun Pharmaceutical Industries Ltd. [2015] 60 taxmann.com 309 (Karnataka) held that,where such expenses can be factually proved to have a direct nexus with the R&D activity, claim of deduction should be allowed.

7. Whether expenses incurred outside the In-house facility are allowable as deduction u/s. 35(2AB) of the Act.

- **Issue in dispute:**

Explanation to section 35(2AB)(1) of the Act does not require that expenses included in the said section should be incurred in in-house facility. Whether, therefore, where assessee incurs various expenses outside approved laboratory facility, the same is allowable as a deduction u/s. 35(2AB) of the Act?

- **Judgements:**

While addressing the said issue, the High Court of Gujarat in the case of ***CIT v. Cadila Healthcare Ltd. [2013] 31 taxmann.com 300 (Gujarat)*** held that, for the purpose of the clause in relation to drug and pharmaceutical, the expenditure on scientific research has to include the expenditure incurred on clinical trials in obtaining approvals from any regulatory authority or in filing an application for grant of patent. The activities of obtaining approval of the authority and filing of an application for patent necessarily shall have to be outside the in-house research facility. Thus the restricted meaning suggested by the revenue would completely make the Explanation quite meaningless. For the scientific research in relation to drugs and pharmaceuticals made for its own peculiar requirements, the Legislature appears to have added such an Explanation.

Merely because the prescribed authority segregated the expenditure into two parts, namely, those incurred within the in-house facility and those were incurred outside, by itself would not be sufficient to deny the benefit to the assessee under section 35(2AB). It is not as if that the said authority was addressing the issue for deduction under section 35(2AB) in relation to the question on hand. The certificate issued was only for the purpose of listing the total expenditure under the Rules.

Chapter 10
Taxation on Buy-back of shares

Introduction:

A buyback, also known as a share repurchase, is when a company buys its own outstanding shares to reduce the number of shares available on the open market. Companies buy back shares for a number of reasons, such as to increase the value of remaining shares available by reducing the supply or to prevent other shareholders from taking a controlling stake.

Buyback of shares in common parlance may be described as a procedure followed by a Company wherein it offers to purchase shares from its shareholders. Buyback of share is an indicator that a company believes that its shares are undervalued. In addition to benefits to shareholders, buy back of shares also provides various benefits to companies like optimizing capital structure, returning excess cash to shareholders, improving earnings per share, stabilizing share prices, etc.

➢ **Provisions of the Companies Act, 2013 regarding buyback:**

- Maximum permissible **buy back is 25% of paid up capital and free reserves**
- However, **total shares to be bought back should not exceed 25% of paid up equity capital;** and
- **Debt equity ratio after the buyback < 2:1** (on consolidated basis for listed companies)
- Buy back can be done out of free reserves, securities premium account, proceeds of issue of any shares or other specified securities
- The company is not allowed make a further issue of the same kind of shares including allotment of new shares **within a period of six months** except by way of a bonus issue or in the discharge of subsisting obligations such as conversion of warrants, stock option schemes, sweat equity or conversion of preference shares or debentures into equity shares.

➢ **Taxability as per Income Tax Act, 1961 ('the Act'):**

❖ **From the perspective of the company:**

- Buyback is a way of distributing excess reserves to the shareholders, simultaneously also reducing its excess share-capital.
- Prior to introduction of section 115QA of the Act, declaration of dividend was chargeable to 'Dividend Distribution Tax', whereas, the amount

distributed as buy-back of shares was chargeable to 'Capital Gains'. Being treated as 'Capital Gains', the income tax was paid at lower rates on buy-back of shares. In order to avoid the tax, the unlisted companies started resorting to buy-back of shares instead of declaring dividends. As an anti-tax avoidance measure, the Government introduced **section 115QA of the Act vide Finance Act, 2013.**

- Prior to the amendment by Finance Act (No.2), 2019, section 115QA of the Act provided that any income distributed by **a unlisted domestic company** on buy-back of shares from a shareholder shall be taxed at the rate of **twenty percent** on such distributed income irrespective of tax payable on total income of the individual shareholder.

- Subsequently, Section 115QA of the Act was amended vide Finance Act (No.2), 2019 to provide for applicability of the said section also to **buyback offers made by listed companies after 05thJuly, 2019.** Consequently the income distributed will be taxed at the rate of twenty percent on such income.

- The company announcing the buyback is liable to pay the tax to the credit of Central Government **within fourteen days from the date of payment.**

- Further, **no credit** is available either of the payment made or tax deducted to the company as well as shareholders.

✓ **Calculation of income chargeable to tax under section 115QA of the Act:**

- Under section 115QA, tax at the rate of 20% is to be paid by the company declaring the buyback on the **'Distributed income'.**

- Distributed income is defined as **consideration paid less amount received by the company on issue of shares, if any.**

- Further, **Rule 40BB** of Income-Tax Rules, 1962 ('the Rules') provides that 'the amount received by the company on issue of shares' is determined as under:

Sr. No.	Situation by which share received by shareholder	Amount received on issue of shares	Remarks
1	Subscription	Share amount along with share premium	-

Sr. No.	Situation by which share received by shareholder	Amount received on issue of shares	Remarks
2	Before buyback, company has returned any sum out of amount received	Share amount reduced by sum returned	Sum returned under section 115-O on which additional tax has been paid will not be reduced
3	ESOPs or Sweat Equity shares issued	Fair market value as per Rule 3(8) of the Rules to the extent credited to share capital and share premium	
4	Amalgamation	Amount received by amalgamating company	
5	Demerger-Resulting Company	Amount which bears the amount received by the demerged company in respect of the original shares determined in the same proportion as the net book value of the assets transferred in a demerger bears to the net worth of the demerged company immediately before such demerger.	
6	Demerger-Demerged Company	Amount received in respect of original shares in the demerged company as reduced by the amount arrived in Sr.No.5	
7	Consideration for Acquisition of asset or settlement of liability	A/B Where, A= **Lower of** i. FMV * (Consideration on issue of shares/Total Consideration) determined by merchant banker ii. Consideration to the extent credited to share capital and premium account B=Number of shares issued as a part of consideration	

Sr. No.	Situation by which share received by shareholder	Amount received on issue of shares	Remarks
8	Shares allotted on succession or conversion	(A-B)/C Where, A=book value of assets reduced by TDS, TCS, advance tax reduced by tax claimed as refund and unamortised amount of deferred expenditure B=book value of liabilities excluding capital, reserves and surplus, provisions and contingent liabilities and provision for tax other than amount of tax paid less income-tax refund C=No. of shares issued on conversion or succession	
9	Issue of shares without consideration on basis of existing shareholding	Nil	
10	Issue of shares on conversion of preference shares or bonds or debentures, debenture-stock or deposit certificate or any other security	Amount received in respect of instrument so converted	
11	Buyback in dematerialised form	Amount for issue of shares on the basis of first-in-first-out method	
12	In any other case	Face value of shares	

❖ **From perspective of shareholders:**

- With the introduction of section 115QA of the Act, section 10(34A) of the Act was also introduced to exempt income in the hands of the shareholders arising as a result of buyback of shares of a company (listed as well as unlisted) as mentioned in section 115QA is exempt from taxation.

❖ **Controversies and Judicial pronouncements:**

8. Deduction of amount paid by companies as buyback price

- **Issue in dispute:**

  Companies paying amounts over and above the face value of shares, in a buy-back, often claim the same as a expenditure. However, the Income-tax Department has been disallowing the said claim stating the expense to be capital expenditure, not eligible for deduction.

- **Judgements:**

  — While addressing the said issue, the Bombay High Court has held in the case of ***CIT v. Brahma Bazar Hotels Ltd. [2015] 63 taxmann.com 13 (Bombay)*** that where the premium is paid by the assessee company to ensure smooth functioning of its business and to make it profitable, the premium so paid will be allowable as a revenue expenditure.

  However, one of the issues to be kept in mind is that the Bombay High Court, while distinguishing the decision of the Supreme Court in case of Brooke Bond India Ltd. v CIT (225 ITR 798), that related to expenditure incurred in connection with an increase in share capital, observed that unlike the Supreme Court's decision where the expenses were incurred voluntarily, in the case at hand, the taxpayer was forced to pay off one of the groups of shareholders by buying their shares in the interests of the company and its business and that these expenses were not incurred out of choice. Thus, it remains to be seen as to what would be the case where premium is paid voluntarily by the assessee.

  — Further, where in terms of business transfer agreement, assessee had to buy back shares of its employees kept under ESOP Trust fund, the Delhi High Court in the case of ***PCIT v. Nitrex Chemicals India Ltd. [2016] 75 taxmann.com 282 (Delhi)*** held that the amount so paid was to be allowed as deduction while computing capital gain arising from slump sale of trading business.

9. Deduction of expenses incurred by companies on buyback

- **Issue in dispute:**

  Companies incur various expenses like legal fees, etc. in a buy-back arrangement and claim the same as a expenditure. However, the Income-tax Department has been disallowing the said claim stating that the same is a capital expenditure since it necessarily relates to share capital of the company and hence is not eligible for deduction.

- **Judgements:**

  — While addressing the said issue, the Bombay High Court has held in the case of ***CIT v. M/s.Hindalco Industries Limited INCOME TAX APPEAL NO.6392 OF 2010*** that the dematerialisation of shares did not result in either a quantitative or qualitative enhancement or improvement in the respondent's assets viz. the said shares. It resulted in the respondent's complying with the SEBI regulations. It indeed facilitated the respondent's receiving dividends in respect of the investments. It did not however, affect the value of the shares to any extent whatsoever. And hence allowed the fees paid as revenue expenditure.

  The said decision was also followed in a subsequent decision of the Bombay High Court in case of ***CIT v. Aditya Birla Nuvo Ltd. [2017] 79 taxmann.com 210 (Bombay),*** wherein it allowed expenses incurred on buyback.

Similar view was upheld by the Delhi High Court in the case of ***CIT v. Selan Exploration Technology Ltd. [2010] 188 Taxman 1 (Delhi)*** wherein the High Court held that assessee had not acquired benefit or addition of an enduring nature, because after buyback benefit of addition of an enduring nature would not arise and capital employed had, in fact, gone down and, therefore, expenses were of revenue nature

Chapter 11
Angel Tax- Section 56(2)(viib)

Introduction

Angel Tax is a term basically used to refer to the income tax payable by companies in which the public are not substantially interested when they raise capital via the issue of shares and the share price of issued shares is seen in excess of the fair market value of the company. The excess realization is considered as income from other sources and therefore, taxed accordingly. The tax imposed is known as Angel Tax since it largely affects angel investors investing in startups.

Applicability

Angel tax is imposed only on investments made by a **resident** investor. It should be noted that angel tax is not applicable in case the investments are made by any non-resident or venture capital funds.

Angel tax: The issues

The imposition of angel tax depends on the fair market valuation of the company. The income tax department calculates market value based on the net assets of the company. However, estimated growth prospects of the startup and future projections based on these growth prospects are major factors in determining the fair market valuation of the startup. The methodology difference in calculation of the market value of the startup makes it liable to the angel tax at an approximate rate of 30%. Angel tax in a way wipes away a major part of the investible surplus of the startup hurting its growth prospects and the viability of the business.

Exemptions

To ease the burdens of the startup community, the government has exempted investments made by the domestic investors in companies that meet certain criteria which are as follows:

1. The paid-up capital and share premium of the startup should not exceed Rs. 10 crore after issuing shares.

2. The investor should have a minimum net worth of Rs. 2 crores and the average income in the last 3 financial years should not be less than Rs. 50 lakh.

The eligible startup can simply request angel tax exemption from the Department of Industrial Policy & Promotion (DIPP) with applicable supporting documents. The application of DIPP-recognised startups will be forwarded to CBDT (Central Board of Direct Taxes) along with the attached documents. CBDT has been mandated to accept or decline such an application within 45 days from the day of receipt.

Computation of angel tax

Angel Tax is levied at a rate of 30% plus applicable cess on net investments in excess of the fair market value.

For e.g. If a startup receives Rs.50 crore of investment by issuing 1 lakh shares at Rs. 5,000 each to a resident investor and the fair market value is Rs.2,000 per share i.e. Rs.20 crore only, then angel tax should be paid on the amount in excess of the fair market value i.e. Rs.30 crore. Therefore, Angel Tax payable in this transaction will be Rs.9 crore (30% on Rs.30 crore) plus applicable cess.

Register entity on https://www.startupindia.gov.in as start up to avail the benefit of exemption from Angel Tax

Chapter 12
Rule 37BC- Relaxation from deduction of tax at higher rate under section 206AA

Introduction:

As per section 206AA of the Income Tax Act, any person entitled to receive any sum or income or amount, on which tax is deductible under section 192 to 196D of the act, shall furnish his Permanent Account Number to the person responsible for deducting such tax (hereafter referred to as deductor), failing which tax shall be deducted at the higher of the following rates, namely: —

(i) at the rate specified in the relevant provision of this Act; or

(ii) at the rate or rates in force; or

(iii) at the rate of twenty per cent:

Rule 37BC provides some relaxation from section 206AA to non-resident person other than a company.

Extract of rule:

(1) In the case of a non-resident, not being a company, or a foreign company (hereafter referred to as 'the deductee') and not having permanent account number the provisions of section 206AA shall not apply in respect of payments in the nature of interest, royalty, fees for technical services and payments on transfer of any capital asset, if the deductee furnishes the details and the documents specified in sub-rule (2) to the deductor

(2) The deductee referred to in sub-rule (1), shall in respect of payments specified therein, furnish the following details and documents to the deductor, namely: -

(i) name, e-mail id, contact number;

(ii) address in the country or specified territory outside India of which the deductee is a resident;

(iii) a certificate of his being resident in any country or specified territory outside India from the Government of that country or specified territory if the law of that country or specified territory provides for issuance of such certificate

(iv) Tax Identification Number of the deductee in the country or specified territory of his residence and in case no such number is available, then a unique number on the basis of which the deductee is identified by the Government of that country or the specified territory of which he claims to be a resident

Analysis:

1. This rule is applicable only for Non-resident and who does not have PAN number.
2. TDS shall be continued to be deducted at the rate specified in the relevant provision of __thisAct.
3. This relaxation is given only for payment in nature of Interest, Royalty, FTS and payment __on transfer of Capital asset when Non-resident provide information as specified in sub-__rule-2.
4. The requirement of information in subrule-2 does not substitute Form-10F

Chapter 13
Employee Stock Ownership Plan ('ESOP')

Introduction:

- Employee Stock Ownership Plan or 'ESOPs' is an option given to the employees to purchase company's shares at pre-determined price at a future date. ESOP is a generic term representing a basket of incentives or investments meant for employees of a corporate entity. It is an innovative way to motivate, reward, remunerate and to retain the employees. In this way, a set of employees will be granted the ownership of the entity, and the company would be able to conserve cash which would otherwise have to be paid out as remuneration to its employees.

- According to the Securities and Exchange Board of India ('SEBI') Guidelines, 1999 on Employee stock option scheme, 'employee stock option has been defined as under:

  "employee stock option" means the option given to the whole-time Directors, Officers or employees of a company which gives such Directors, Officers or employees, the benefit or right ***to purchase or subscribe at a future date, the securities offered by the company at a predetermined price****.*

➢ **Procedure of issue/grant of ESOPs:**

a. The employer identifies the classes of employees which are eligible for ESOP and grants the ESOPs.

b. Upon expiry of a certain time period from the date of grant, **shares are vested** with the employees (vesting) when employee gets unconditional right to receive the shares.

c. Once such options are vested with the employee, **he gets right to exercise the options.**

d. Upon exercise of the option by the employee, the **company allots the shares to the employees** (allotment).

e. In India, ESOPs are governed by SEBI Guidelines 1999. Companies grant ESOPs not only to employees but also to directors of the company, linked to their performances.

➢ **Taxability as per Income Tax Act, 1961 ('the Act'):**

❖ **In hands of employees:**

The taxability of ESOPs arises in the hands of the employee at two stages.

1. On **exercise of his right to apply for the shares** by the employee, and
2. On **sale of shares** by the employee.

• **Taxability on exercise of right to apply:**

i. On exercise of right to apply for the shares, the employee is entitled to receive shares of the company at a discounted price than the Fair Market Value. This discount is in effect remuneration or bonus being paid to the employee by the company being the employer, in consideration of his services. Thus, taxability of first stage is governed by section 17 of the Act, wherein the shares received on rights exercised are taxed.

ii. Section 17(2)(vi) of the Act, provides that **value of any ESOP granted or sweat equity shares allotted or transferred, directly or indirectly, by the employer, or former employer, free of cost or at concessional rate to the assessee will be considered as perquisite.**

iii. Further the section specifies that the value of perquisite shall be calculated as per the following formula

	Fair market value of the said shares on the date of option exercised
Less:	Amount actually paid (i.e. pre-determined price)
	Value of perquisite

The mechanism for determining FMV has been prescribed under Rule 3(8) of the Income Tax Rules, 1962 (the Rules).

iv. **Calculation of fair market value for the right allotted under ESOP exercised:**

Particulars	**Valuation**	**Date**
Shares listed on a stock exchange	Average of opening and closing price	As on date of exercise

Particulars	Valuation	Date
Share is listed on more than one recognized stock exchanges	Average of opening price and closing price of the share of stock exchange **which records the highest volume of trading in the share**	As on date of exercise
No trading in the share on any recognized stock exchange as on exercise date	Closing price of the share	Date closest to the date of exercising of the option
No trading in the share on more than one recognized stock exchange as on exercise date	Closing price of the share on a recognized stock exchange, which records the highest volume of trading in such share	Date closest to the date of exercising of the option
Share in the company is not listed on a recognised stock exchange	Value of the share in the company as determined by a merchant banker	*Specified date

* Specified date means date as on exercising of option or any date earlier than the date of the exercising of the option, not being a date which is more than 180 days earlier than the date of the exercising

- **Taxability on sale of shares:**

  i. On sale of shares, the gains would be chargeable as capital gains in the hands of the employee and the same is governed by the section 45 of the Act.

  ii. The cost of acquisition of such shares is determined as per section 49(2AA) which provides that the cost of acquisition will be the **fair market value** (as per the table above) which is taken for the purpose of perquisite under section 17(2)(vi).

❖ **In hands of employers:**

  i. The employer would be required to withhold taxes on perquisite value, taxable in the hands of employees.

ii. While the tax treatment of ESOPs in the hands of the employees is settled, the availability of deduction in relation to the ESOP cost still remains a debatable issue in the absence of any specific provision under the Act. Further, the timing when the deduction for such expenditure is allowable, i.e. whether at the time of grant, vesting or exercise, and the quantum of deductions are also some of the questions to ponder upon. The Act does not contain any specific provision for taxability of ESOPs in the hands of the employers.

❖ **Controversies and Judicial pronouncements:**

10. Deduction of discount on issue of shares

- **Issue in dispute:**

  Companies issue the ESOPs at a discount. The companies claim this discount as a revenue expenditure. However, the Income-tax Department have been disallowing the said claim stating the discount to be a notional loss.

- **Judgements:**

  — In the matter of ***Biocon Ltd. Dy. CIT [2013] 35 taxmann.com 355/ [2014] 144 ITD 21 (Bang. - Trib.),***the ITAT, Bangalore held as under:

  - ESOP discount is in the nature of employees cost and hence deductible during the vesting period with respect to the market price of the shares at the time of grant of options to the employees.
  - The discount under ESOP is an ascertained liability and not a contingent liability.

  — Contrary to the above decision, the Delhi Tribunal in case of ***Ranbaxy Laboratories Ltd. [2010] 39 SOT 17 (Delhi)*** held that issue of shares at below market price results into short receipt of share premium. Accordingly, it was held that since it is not an actual loss for which no liability is incurred, the same is not allowable under the provisions of the Act.

  — While addressing the above issue, the Madras High Court in case of ***CIT v. PVP Ventres Ltd. [2012] 23 taxmann.com 286 (Mad.)*** upheld the order of the Tribunal, wherein it was held that the shares were issued to the employees only for the interest of the business to induce employees to work in the best interest of the assessee. The allotment of shares was done in strict compliance of SEBI regulations, which mandate that the difference between the market prices and the price at which the option was exercised by the employees was to be debited to the profit and loss account as an expenditure. It was not a case of contingent liability. The expenditure was an ascertained liability. Thusthe relief was granted for the expenditure arising on account of Employees Stock Option Plan.

— This case has been followed by the Delhi High Court in case ***Pr. CITv. Lemon Tree Hotels (P.) Ltd.[2019] 104 taxmann.com 26 (Delhi),*** wherein the Delhi High Court dismissed the Revenue's claim that the expenditure was merely notional, by holding that

> *"This Court is of the opinion that such an argument ignores the realities of functioning of commercial entities who would then be asked to purchase shares from market place or third party at prevailing rates instead of allotting them. Assessee companies have been claiming that ESOP since ESOP is a general expense, it is to be considered as a general provision under Section 37 of the Act. However, such deduction for discount is not claimed at one stroke but is amortized over the vesting period."*

The Revenue has filed a Special Leave Petition against the above decision of the Delhi High Court, which has been granted by the Supreme Court. The decision of the Hon'ble Apex Court, is expected to finally settle the long-standing dispute on the above issue.

➢ **Important amendment with respect to ESOPs introduced by Finance Act, 2020:**

i. Many start-ups compensate their employees by way of ESOPs considering the benefit of cash-flow available in the said option. However, since the taxability arises on exercise of options, it gives rise to cash-flow issues since the consideration is in kind.

ii. With a view to mitigate this mismatch, the Finance Act 2020 has amended section 192 (TDS on salary) by inserting sub-section 1(C) which clarifies that tax would be deducted at source on perquisites, when transferred or allotted, in nature of section 17(2)(vi) by the eligible start-upswithin fourteen days, being earlier of:

— After the expiry of forty eight months from the end of the relevant assessment year when the ESOP is taxable under section 17(2);

— from the date of the sale of such specified security or sweat equity share by the employee;

from the date of which the employee ceases to be the employee of the person.

Chapter 14
Warranty expenses

Introduction:

- ❖ A warranty, in commercial terms, is a type of guarantee that a manufacturer or similar party makes regarding the condition of its product. It also refers to the terms and situations in which repairs or exchanges will be made in the event that the product does not function as originally described or intended.

- ❖ In simple words, a warranty is similar to insurance policy in which parts of the item or service purchased can be safeguarded through repair or substitution. It might be seen as a written surety where an organization or office gives confirmation to other party of particular realities, conditions and solution. This implies that if that fact is not met by the item or service, it would permit the buyer to get a solution, much of the time, free repair or item substitution. A warranty normally has a termination date most of the time and may not be pertinent to all items and services.

- ❖ Warranty is also different from guarantee which is a promise made by the producer to the purchaser, that on the off chance that the item is of low quality, it will be supplanted, repaired or the cash kept will be refunded whereas warranty is a written confirmation that the realities determined in the item are genuine and veritable. However, in the event that they are not true then it will be supplanted or repaired.

- ❖ In other words, whereas a guarantee is a commitment made to buyers by the producers, a warranty is an assurance made to buyers by the producers.

- ❖ Warranty, when invoked, results into outflow for the seller, either in the form of expenses incurred on repair or for supplanting the items or for refunding the amount to the buyer.

➢ **Taxability as per Income Tax Act, 1961 (‘the Act’):**

  - ❖ Deduction of warranty expenses from its total income has been a point of dispute since long, with the sellers claiming the same as a deduction under section 37 of the Act while computing the profit chargeable to tax and the tax department claiming the same to be not deductible being a provision of contingent liability. The dispute has reached the upper echelons of the judicial forums in various cases. Still, the issue remains litigative, due to the peculiar facts in each case. Below, we attempt to dissect the issue with the help of various judgments, available in the public domain on the same.

- Generally, an expenditure which is contingent on the happening of a certain event is not allowable, unless it meets certain criteria. As per the Generally accepted accounting principles, a provision is made for a liability which can be measured only by using a substantial degree of estimation and which has not yet materialised.

- Warranty, being an expense, which might arise in the future, many sellers offering warranty, make a provision for warranty in their books and claim the same as an allowable deduction. However, the Income-tax Department has been disallowing the same, being a contingent liability in nature.

- Under the accrual or mercantile system of accounting, the taxpayer is entitled to make a provision for all liabilities which are foreseen in relation to transactions of the year, whether it is payable during the year or not. **The Supreme Court in Calcutta Co.Ltd. v. CIT [1959] 37 ITR 1 has pointed out that taxable income is not on gross receipts but on profits and gains of the business.The profits, as was pointed out by the House of Lords in Gresham Life Assurance Society v. Styles [1892] 3 TC 185,** should be understood in its natural and proper sense, or in a sense which no commercial man would misunderstand. It has to be real profits. **It was for this reason that the assessee was allowed deduction, in Calcutta Co. Ltd.'s case (supra) of a provision in respect of what he has undertaken by way of amenities, when it had sold a plot in a layout.** This has been followed in a number of cases.

➢ **Landmark Judicial Decision on allowability of deduction for provision of warranty:**

- The Supreme Court in the celebrated case of **Rotork Controls India (P.) Ltd. v. CIT [2009] 180 Taxman 422/314 ITR 62** has recognised the right to deduction of warranty provision in a group of cases holding that the provision is not against a contingent liability, if **the present value is ascertained properly and discounted on accrual basis. It is deductible under section 37 of the Act.**

- The Supreme Court held that the provision will depend upon the nature of business, nature of sales, nature of product manufactured and sold and the scientific method of accounting adopted by the assessee, besides the historical trend in the quantum of articles produced and sold. The Supreme Court also held that the fact that it would involve a substantial degree of estimation should make no difference to the character of the provision. In coming to the conclusion, the Supreme Court reversed the decision of the Madras High Court in the case of CIT v. Rotork Controls India Ltd. [2007]

293 ITR 311 while upholding the decisions of the Karnataka High Court in CIT v. Wipro GE Medicals Systems Ltd. (unreported) and the Delhi High Court in CIT v. Hewlett Packard India (P.) Ltd. [2008] 171 Taxman 13.

- The Supreme Court reviewed a number of decisions, inter alia, relying upon its own decision in Metal Box Co. of India Ltd. v. Their Workmen [1969] 73 ITR 53 (SC) and Bharat Earth Movers v. CIT [2000] 112 Taxman 61 (SC).
- This decision of the Supreme Court [Rotork Controls India (P.) Ltd. (supra)] is a landmark one considering the reasoning adopted in matters to be borne in mind in respect of provisions under the mercantile system of accounting.

- **Some important sections and definitions:**
  - ***Section 37*** *of the Act-"Any expenditure (not being expenditure of the nature described in sections 30 to 36 and not being in the nature of capital expenditure or personal expenses of the assessee), laid out or expended wholly and exclusively for the purposes of the business or profession shall be allowed in computing the income chargeable under the head "Profits and gains of business or profession".*
  - **Provision**– According to Indian Accounting Standard 37, "A provisionis a liabilityof uncertain timing or amount."
  - **Liability**–According to Indian Accounting Standard 37, "a liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits."
  - **Contingent liability** -According to Indian Accounting Standard 37,

    A contingent liabilityis:

    a. *a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or*

    b. *a present obligation that arises from past events but is not recognised because:*

       i. *it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; orthe amount of the obligation cannot be measured with sufficient reliability.*

Chapter 15
Equalisation levy

Introduction:

Over the last decade, Information Technology has gone through an exponential expansion phase in India and globally. This has led to an increase in the supply and procurement of digital services. Consequently, this has given rise to various new business models, where there is a heavy reliance on digital and telecommunication networks.

As a result, the new business models have come with a set of new tax challenges in terms of nexus, characterization and valuation of data and user contribution. The combination of inadequacy of physical presence based nexus rules in the existing tax treaties and the possibility of taxing such payments as royalty or fee for technical services creates a fertile ground for tax disputes.

To bring in clarity in this regard, the government introduced vide Budget 2016, the equalisation levy to give effect to one of the recommendations of the BEPS (Base Erosion and Profit Shifting) Action Plan.

Rate and applicability of Equalisation Levy

A. Charge of equalisation levy on specified services

Equalisation levy is applicable at the rate of six per cent of the amount of consideration for any specified service received or receivable by a person, being a non-resident from—

(i) a person resident in India and carrying on business or profession; or

(ii) a non-resident having a permanent establishment in India.

The equalisation levy under sub-section (1) shall not be charged, where—

a) the non-resident providing the specified service has a permanent establishment in India and the specified service is effectively connected with such permanent establishment;

b) the aggregate amount of consideration for specified service received orreceivable in a previous year by the non-resident from a person resident in India and carrying on business or profession, or from a non-resident having a permanent establishment in India, does not exceed Rs. 1,00,000; or

c) where the payment for the specified service by the person resident in India, or the permanent establishment in India is not for the purposes of carrying out business or profession.

Following services are specified services as of now:

- Online advertisement;
- Any provision for digital advertising space or facilities/ service for the purpose of online advertisement.

B. Charge of equalisation levy on e-commerce supply of services.

From the 1st day of April, 2020, an equalisation levy will be chargeable at the rate of two per centof the amount of considerationreceived or receivable by an e-commerce operator from e-commerce supply orservices made or provided or facilitated by it:

(i) to a person resident in India; or

(ii) to a non-resident in the specified circumstances as referred to in sub-section (3); or

(iii) to a person who buys such goods or services or both usinginternet protocol address located in India.

(2) The equalisation levy under sub-section (1) shall not be charged—

(i) where the e-commerce operator making or providing or facilitating e-commerce supply or services has a permanent establishment in Indiaand such e-commerce supply or services is effectively connected with such permanent establishment;

(ii) where the equalisation levy is leviable under section 165; or

(iii) sales, turnover or gross receipts, as the case may be, of the e-commerce operator from the e-commerce supply or services made or provided or facilitated as referred to in sub-section (1) is less than Rs. 2 Cr. during the previous year.

(3) For the purposes of this section, “specified circumstances” mean—

(i) sale of advertisement, which targets a customer, who is residentin India or acustomer who accesses the advertisement though internet protocol address located in India; and

(ii) sale of data, collected from a person who is resident in India orfrom a person who uses internet protocol address located in India]

Due date of payment

1. The equalisation levy on specified services should be deducted during any calendar month shall be paid by every assessee by the 7th day of the month immediately following the said calendar month.

2. Equalisation Levy on ecommerce supply of service should be collected by the e-commerce operator. The e-commerce operator is required to deposit the levy to the credit of the Indian treasury on a quarterly basis on dates as mentioned below:

Sr. No.	Date of ending of the quarter of financial.	Due date of the financial year year.
1	30th June	7th July
2	30th September	7th October
3	31st December	7th January
4	31st March	31st March

Note, equalisation levy is not part of DTAA

INTERNATIONAL TAXATION

Chapter 16
Tax Residency of company

A company is treated as a resident of India in any previous year if:

- it is an Indian company, or
- its PoEM in that year is in India (see below).

An Indian company is always resident even if it is controlled from a place located outside India or even if shareholders of the Indian company controlling more than 51% voting power are non-residents.

Place of effective management: - (POEM)

Presently, a foreign company is considered resident in India if the control and management of its affairs is situated wholly in India.

To bring to tax those companies that are incorporated outside India but controlled from India, the condition of PoEM has been introduced. PoEM is an internationally recognised concept accepted by the Organisation for Economic Co-operation and Development (OECD).

A foreign company will be regarded as a resident in India if its POEM is in India in that year. Since residency is determined for each year. POEM is also required to determine each year.

The concept **POEM** means a place where key management & commercial decision that are necessary for the conduct of the business of an entity as a whole are, in substance made.

CBDT has issued a circular laying down detailed guidelines for determination of residency of a foreign company on the basis of POEM. The concept of determination of POEM is primarily based on the fact as to whether or not the company is engaged in active business outside India (ABOI).

If a company is engaged in ABOI.

POEM of such company would be presumed to be outside India if the majority meetings of the board of directors (BOD's) of the company are held outside India. However, whether such reference to the majority meetings pertains to the majority of the meetings where key decisions are taken or a majority of overall meetings would need clarification.

<u>If a company is not engaged in ABOI.</u>

In this case, the determination of POEM would be done in two stages:

(i) Identify the person/s who actually make the key management and commercial decision for the conduct of the company's business as a whole.

(ii) Determination of place where these decisions are made.

The circular clarifies that POEM provisions shall not apply to a foreign company having turnover or gross receipt of Rs. 500 million or less in a tax year.

Meaning of active business outside India:

A Company is said to be active business outside India if its Passive Income is not more than 50% of the total income of such Company and

- *Assets in India are < 50% of the total assets*
- *Employees in India < 50% of the total employees*
- *Payroll Expenses in India < 50% of the total payroll expenses.*

Chapter 17
Provisions of Section 195

Section 195 of the Income Tax Act, 1961 lays down provisions for tax deductions for Non-Resident Indians (NRIs). This section focuses on tax rates and deductions on daily business transactions with a non-resident. Any amount generated through these business transactions is chargeable under Income Tax Act, 1961. This amount may or may not be income or profits.

The payee, under Section 195, is any non-resident with a residential status that comes under the purview of Section 6 of the Income Tax Act, 1961.

RATES OF TDS U/S 195

Particulars	RATES
Income from investments made by a NRI	20%
Income from long-term capital gains under Section 115E for a NRI	10%
Income from long-term capital gains	10%
Short-term capital gains under Section 111A	15%
Any other income from long-term capital gains	20%
Interest payable on money borrowed in foreign currency	20%
Income from royalty payable by the Government or an Indian concern	10%
Income from royalty other than that which is payable by the Government or an Indian concern	10%
Income from fees for technical services payable by the Government or an Indian concern	10%
Any other source of income	30%

Chapter 18
Article 12 & 12A of DTAA – 'Royalties' and ' Fees for Technical Services'

DTAA are primarily an agreement entered into between two countries, with the basic objective is to promote & foster economic trade & investment between the two contracting countries by avoiding double taxation.

Taxation of royalties and fees for technical services continues to an important area of these DTAA'S Primarily on two models **(THE UN MODEL & THE OECD MODEL).**

ROYALTY

Royalty is generally a consideration received by a person – a creator or an innovator for allowing his work of art or scientific invention to be used commercially. But in commercial and industrial terms, the concept of Royalty is wider. Royalty is generally a payment received by the owner of an intangible right or knowhow under license in any technology transfer.

Definition of Royalty: -

Indian domestic tax law -

- Consideration (including any lump sum consideration) for:
  - (i) the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill;
  - (ii) the transfer of all or any rights (including the granting of a license) in respect of any copyright, literary, artistic or scientific work; or
  - (iii) rendering of any services in connection with the above

OECD Model

- 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, or for information concerning industrial, commercial or scientific experience

UN Model

- 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 or for information concerning industrial, commercial or scientific experience

India-US Tax Treaty

- Payments of any kind received as a consideration for the use of, or the **right to use,** any copyright of a literary, artistic, or scientific work, or for information concerning industrial, commercial or scientific experience, including gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof.

FEES FOR TECHNICAL SERVICES (FTS)

Definition of Fees for technical services: -

Indian domestic tax law -

As per explanation 2 to Section 9(1)(vii), FTS means any consideration (includes lump sum consideration) for rendering any:

- Managerial
- Technical
- Consultancy Services
- andincludes provision of services of technical / other personnel

Excludes: Construction; Assembly; Mining; Any like project; Income chargeable as 'Salary

Basic differences between royalty and FTS can thus be summarized as below:

a) Royalty is basically for letting of IPRs or for imparting some exclusive information and knowledge. Consideration for services connected with commercial licensing of rights and knowhow are also in the nature of Royalty.

b) The consideration for the services not connected with royalty may fall in the category of Fees for Technical Services (FTS).

c) Generally, in the case of Royalty, the owner enables the user to use the technology. In FTS, the owner uses his technology to perform some service for a consideration.

d) In FTS, the supplier undertakes and guarantees result

India follows "source" rule of taxation. Royalty/FTS income is taxable in India if service is used/utilised in India. Place of rendering service not relevant.An explanation has been inserted, w.r.e.f. 1.04.1976, to provide that income of a non-resident shall be deemed to accrue or arise in India 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.

Meaning of "make available" :-

- "Included Services" define services which **"make available"** technical knowledge, experience, skill, know-how or processes or which consist of development and transfer of technical plan or technical design.
- MoU of the India USA Tax Treaty:
  - Technology will be considered "made available" when the person acquiring the service is enabled to apply the technology
  - Provision of requiring technical input by the person providing the service does not per se mean that technical knowledge, skills, etc., are made available
  - Use of a product which embodies technology shall not per se be considered to make the technology available
- If the services **do not "make available" technical knowledge,** etc., then, they are **outside the ambit of FIS Article and not taxable.**
- **Plethora of decisions** on the subject

Chapter 19
OECD commentary on Taxation of Software

OECD recognizes taxing right of the resident country, i.e, there is no taxing right for the source country.

The OECD commentary specifically deals with the issue of software, recognizing the complexity of the issue.

If transferor retains the ownership right but allows the payee to reproduce and distribute the software to the public or to modify and publicly display the program, consideration of such type would be in the nature of royalty. If such permission is only limited in extent, the payment is not considered royalty.

Any consideration which involves complete transfer of ownership, such transaction would be taxable as business profits or capital gains. The business income of the non-resident will taxable in the source country if the foreign enterprise has a **Permanent Establishment (PE).**

Sometimes the transferee obtains rights to make multiple copies of the program for operation only within the enterprise. A payment under such arrangement is to be taxed as business profits

Sometimes distributers make payment to the copyright holder to enable it to distribute copies of the program without right to reproduce the program. Consideration accruing to the owner would again be business profits.

Transactions where a software house or a computer programmer agrees to supply information and ideas of the principles behind a particular program would be taxed as royalty.

Chapter 20
Typical software transactions

1. Embedded software

- Typical facts: supply of integrated equipment comprising hardware and software where the supply of software is inextricably linked to supply of the hardware and, both, the hardware and the software, cannot function without each other
- Whether payment for software embedded in hardware and supplied along with hardware can be regarded as royalty?
- Purchase of software is akin to purchase of a copyrighted article and not purchase of any rights in the software. So not royalty! **<u>(Lucent Technologies Hindustan Ltd. v. ITO (92 ITD 366)</u>**

2. Shrink-wrapped software

- The treatment remains the same as in the case of shrink-wrapped software
- The purchaser of the computer acquires a copyrighted article and not right to use any copyright in the embedded software.Copyright remains with the owner of the software and the same is not transferred or licensed to the purchaser
- So not royalty.

3. Customized off-the-shelf software

- Off-the-shelf software customized as per the requirements of the user
- Copyright owner retains copyright in the software
- Right to copy the software generally not granted to end user
- It will be treated as FTS

4. Software Development

- Generally, all rights in the software are transferred to the user and no rights are retained by the programmer
- Where the software is customized to the requirements of the user, such software has often no value unless the supplier shares the technical

knowledge etc with the users and suitably equips them to handle the system themselves.

- Payment for customized software falls within the ambit of "fees for technical services"

Chapter 21
15CA / 15CB

What is need of 15 CA & 15 CB?

- Earlier, the person making a remittance to Non-Resident was required to furnish a certificate in specified format circulated by RBI.
- Basic purpose was to collect the taxes at a stage when the remittance is made as it may not be possible to collect the tax from the Non-Resident at a later stage.
- Thus to monitor and track the transactions in an efficient manner, it was proposed to introduce e-filling of information in the certificates.
- **Section 195 of Income tax act, 1961** mandates the deduction of Income tax from payments made to Non Resident. The person making the remittance to non – resident needs to furnish an undertaking (in form 15CA) accompanied by a Chartered Accountants Certificate in Form 15CB.
- every person liable for making a payment to non-residents shall deduct TDS from the payments made to non-residents if such sum is chargeable to Income tax then the withholding tax need to be deducted and form 15CA and 15CB are the declaration for the same.
- A person making the remittance (a payment) to a Non Resident or a Foreign Company has to submit the form 15CA. This form is submitted online. In some cases, a Certificate from Chartered Accountant in form 15CB is required after uploading the form 15CA online.
- The furnishing of information for payment to non- resident, not being a company, or to a foreign company in Form 15CA has been classified into 4 parts –

  PART A: – Where the remittance or the aggregate of such remittance does not exceed 5 lakh rupees during the F.Y. (whether taxable or not).

  PART B: – Where an order /certificate u/s 195(2)/ 195(3)/197 of Income Tax Act has been obtained from the A.O. (Whether Nil rate or Lower Rate Certificate).

  PART C: – Where the remittance or the aggregate of such remittance exceed 5 lakh rupees during the FY.

  PART D: – Where the remittance is not chargeable to tax under Domestic law.

- 15CB is the Tax Determination Certificate where the CA examines the remittance with regard to chargeability provisions under Section 5 and 9 of the Income Tax Act along with the provisions of Double Tax Avoidance Agreements.
- In form 15CB, A CA certifies details of the payment, TDS rate and TDS deduction as per Section 195 of the Income Tax Act, if any DTAA is applicable, and other details of nature and purpose of the remittance.
- Upload of Form 15CB is mandatory prior to filling Part C of Form 15CA. To prefill the details in Part C of form 15CA, the Acknowledgement Number of e-verified form 15CB should be verified.

Payment don't require 15CA/CB:-

- Individual is not required to furnish the information in Form 15CA and 15CB for remittance which requires no RBI approval.
- Rule 37BB mentions lists of payments (33 items) which does not require compliances and reporting through the submission of 15CA and 15CB.

Chapter 22
Important Judgements

- Payment for repair not per se payment for FTS – Lufthansa Cargo India Pvt. Ltd. vs. DCIT 91 ITD 133 (ITAT Del)

- Comprehensive services including inventory management, engineering coordination, repair of engines and other equipment, etc. held to be FTS. - Sahara Airlines Ltd. vs. DCIT 83 ITD 11 (ITAT Del)

- Payment for repair of hardware not FTS, in terms of Indo-US Treaty – Airport Authority of India :273 ITR 437 (AAR)

- Annual maintenance fee for system update held to be not FTS under Indo-Australian Treaty – Kotak Mahindra Primus Ltd. vs. DCIT : 105 TTJ 578 (ITAT Mum)

- **Reimbursement of expenses**

  No element of income and hence not taxable. –

  — CIT vs. Dunlop Pvt. Ltd. : 142 ITR 493 (Cal)

  — CIT vs. Industrial Engineering product Pvt. Ltd. : 202 ITR 1014 (Del)

  — Hyder Consulting Ltd. vs. CIT: 236 ITR 640 (AAR)

  — Clifford Chance v. DCIT: 82 ITD 106 (Mum) affirmed in 221 CTR 1 (Bom)

  — Mahindra & Mahindra: 313 ITR (AT) 263 (SB)(MUM)

- 'Fees for technical services' under Article 12(4)(b) of the India-Singapore tax treaty does not cover consultancy services unless these services are technical in nature

  — DCIT v Boston Consulting Group Pte Ltd (94 ITD 31) (AT – Mum)

- Concept explained in Raymond Ltd. vs. DCIT (Supra), observing as follows:

  — person receiving the technical service should be able to use it without recourse to the service provider in future

  — technical knowledge should remain with the person receiving the service after the service has come to an end

  — some sort of durability or permanency of the result of the rendering of the services is envisaged

- In the context of the digital economy, it would be relevant to take a note of the order of the Delhi Tribunal in the case of Asia Satellite Telecommunication Co. Ltd. vDCIT

INTERNAL CONTROLS

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Internal Controls: A brief overview

Standard on Internal Audit (SIA) 12, "Internal Control Evaluation" states that "Internal controls are a system consisting of specific policies and procedures designed to provide management with reasonable assurance that the goals and objectives it believes important to the entity will be met".

Internal controls assist in achieving management's objective of ensuring, to the extent practicable,

- orderly and efficient conduct of its business, including adherence to management policies
- safeguarding of assets
- prevention and detection of fraud and error
- accuracy and completeness of the accounting records
- timely preparation of reliable financial information

A plain reading of the above may implicate using the term 'controls' with 'business processes' interchangeably. However, it is very important to understand the difference between both. A process is typically an action of execution of a transaction through the established / routine set of procedures. A control differentiates itself from the process by virtue of its intention. While the process is an activity with an intention of executing a transaction, a control is that activity which is intended to prevent / detect mis-statements within the process. For example, procuring a fixed asset in a company in accordance with the management policies is the process and review by designated authorities of the quotations obtained before actual procurement is the control.

An entity's system of internal control contains manual elements and often contains automated elements. The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported. An entity's mix of manual and automated elements in internal control varies with the nature and complexity of the entity's use of information technology. For instance, circumstances which require an exercise of judgement / discretion would prefer implementation of manual control while in situations which can be defined by the management policies with finite outcomes, an automated control would prove to be more efficient.

Typically, a system of internal controls to be considered adequate should include the following five components:

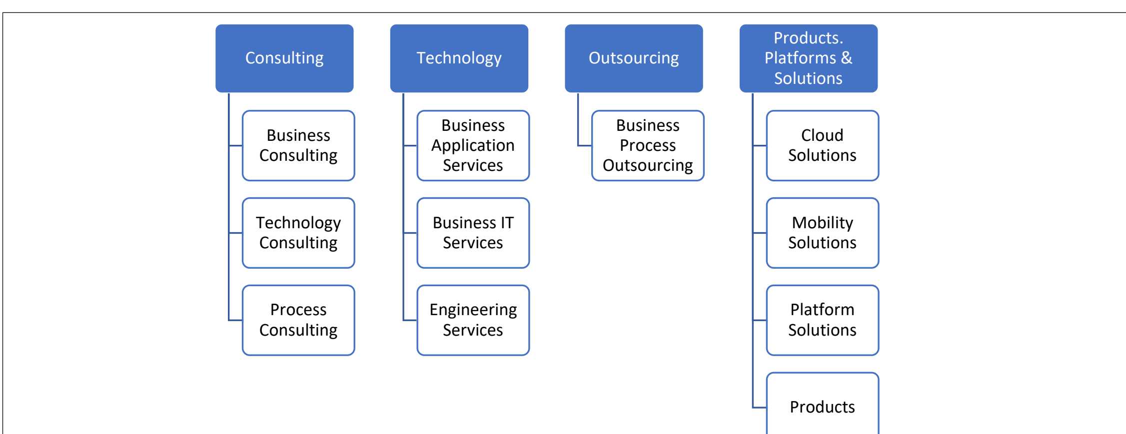
- Control Environment
- Risk Assessment
- Control Activities
- Information system and communication
- Monitoring

Understanding internal controls in perspective of IT/ITES industry

It is important for us to understand the typical functioning of the IT / ITES industry to understand the framework of internal controls. The critical business aspects of IT / ITES industry including the risks identified and associated with the industry should be understood for better implementation and assessment of internal controls.

<u>Typical Service Offerings and Revenue Models:</u>

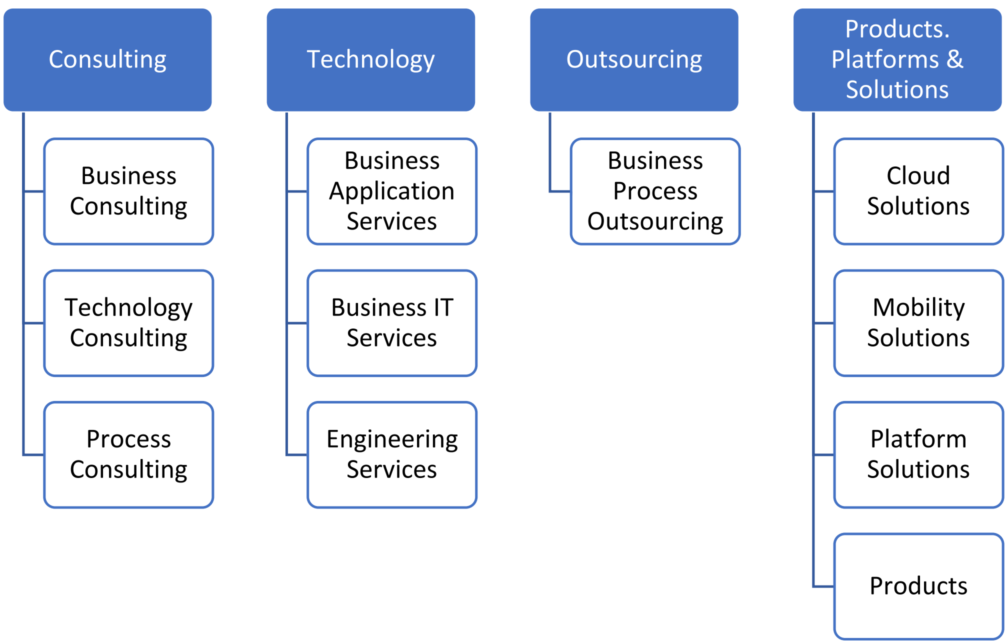
Usual service offerings by the IT / ITES industries include the below :



Contracts play a vital role in the IT industry. The Revenue model shall be based on the type of contract entered into. The type of contract varies from one-time projects with limited timeframe to long-term Master Service Agreements (MSA's) which cover a suite of services offered by the service provider. The choice of contract type is usually dependent on the strategy of the customer and their confidence in working with the service provider as a strategic partner. The contract is a compilation of number of legal requirements and commitments which will be binding on both the parties.

Owing to the dynamic nature of service offerings, it is generally observed that a lot of changes happen during the time of execution of services. Hence, unlike the fixed contractual method of billing revenues, the IT / ITES industry has adopted more flexible and dynamic billing models.

A typical list of revenue models are as below :



A significant component of the entire revenue of the IT / ITES industry comes from the services provided to the clients. Further, due to the nature of work and demands of the customer, there are occasions where situations warrant immediate change / modifications / alterations / additions to the existing scope of work as agreed upon in the original contract / agreement between the company and the customer. These situations are usually addressed by addendum agreements called as 'change orders'. A change order, just like a purchase order, is initiated by the customer and contains agreed upon terms of modification / alteration / addition to the original contract entered between the company and customer.

It is therefore necessary that appropriate internal controls are placed in the revenue measurement processes. For instance, if a company has a time and material based contract with a client, the controls associated with time booking by employees and segregation of such time booked in appropriate projects will be of paramount importance. This is because if the controls fail to identify probable lapses in the time booking or mapping processes, the company will face the risk of incorrect billing to the client which can possibly result in financial loss to the company.

Audit of Internal Contro ry Auditor's Perspective

The Companies Act, 2013 has significantly expanded the scope of internal controls to be considered by the management of companies to cover all aspects of the operations of the company. Clause (e) of Sub-section 5 of Section 134 to the Act requires the director's responsibility statement to state that the directors, in the case of a listed company, had laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively. Clause (e) of Sub-section 5 of Section 134 explains the meaning of internal financial controls as *"the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information."*

Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 requires the board report of all companies to state the details in respect of adequacy of internal financial controls with reference to the financial statements.

Globally, auditor's reporting on internal controls is together with the reporting on the financial statements and such internal controls reported upon relate to only internal controls over financial reporting. For example, in USA, Section 404 of the Sarbanes Oxley Act of 2002, prescribes that the registered public accounting firm (auditor) of the specified class of issuers (companies) shall, in addition to the attestation of the financial statements, also attest the internal controls over financial reporting.

"Internal financial controls over financial reporting" means "A process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal financial control over financial reporting includes those policies and procedures that :

(i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;

(ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and

(iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements."

To understand the focus areas specific to the IT/ITES industry, we need to understand the typical governance model under which any company in the IT/ITES industry is most likely to function.

Sr. No.	Function	People involved	Objective
1	Strategic	Steering committee comprising of the Business Unit Head / Project Manager / Executive Board	1. Project Planning 2. Performance Evaluation 3. Future plan / development 4. Contract Assessment
2	Operational	Project Manager / Delivery Heads	1. Milestone updates for projects 2. Key issues / challenges 3. Portfolio review 4. Opportunities / improvements
3	Tactical	Project Manager / Project Team	1. Individual project review 2. Individual performance assessments 3. Issues and challenges
4	Contract	Project Manager / Legal team	1. Review of contractual terms from technical and legal point of view 2. MSA review 3. Understanding performance obligations and liabilities in a contract

While the above table gives a simplified bird's eye view about the typical revenue function of a company in the IT/ITES industry, it should not be taken at the face value to assess the complexities involved in identifying the risks and assessing the operating effectiveness of the controls. For instance, it is widely observed that change orders to the main agreements are mostly verbal / agreed upon in an e-mail communication. Such change orders effect alterations to the main agreement and usually involve an additional effort and resources to be used on the project by the company. If the internal control mechanism of agreement on change orders and capturing its effect of billing is insufficient / ineffective, it might result into loss of revenue and effort for the company. Therefore, understanding the business process and the internal control environment of the company around its business cycles is of paramount importance for the statutory auditor. In an IT/ITES industry, what makes this assessment a bit more difficult is the nature of work performed.

A typical Risk Control Matrix for an IT/ITES company is as below:

Name of the Entity – **Risk Control Matrix**

Sr. No.	Financial Statement Level	Identified Risk	Assertion	Control Description
1	Revenue from Operations	For contracts in progress at period end, revenue recorded in the period is incorrect because the measure of progress towards satisfaction of performance obligation is incorrect.	Cut-Off	On completion of milestones / activities, the project manager obtains confirmation / acknowledgement from the client and creates and invoice requisition. Such requisition contains details like period for which the service is provided and the basis of revenue booked by the finance team in the relevant period.
2	Revenue from Operations	Revenue is inappropriately recorded because services are inappropriately identified or NOT identified as part of a series of distinct services.	Cut-Off	On completion of milestones / activities, the project manager obtains confirmation / acknowledgement from the client and creates and invoice requisition. Such requisition contains details like period for which the service is provided and the basis of revenue booked by the finance team in the relevant period.

Sr. No.	Financial Statement Level	Identified Risk	Assertion	Control Description
3	Revenue from Operations	Revenue is incomplete	Completeness	On completion of milestones / activities, the project manager obtains confirmation / acknowledgement from the client and creates and invoice requisition. The requisition is tracked on the basis of control summary sheet maintained by the project manager and the finance team. This sheet contains projectwise % completion as per project managers record. Finance team ensures that revenue is recognised for all such projects appropriately.
4	Revenue from Operations	Revenue is recorded at incorrect transaction amount	Accuracy	Finance executive (Mr. ABC) and Finance Manager (Mr. XYZ) review the invoice requisition raised by the project managers to confirm its accuracy with PO / SOW received from client. Invoices are raised on the basis of such review performed and revenue is recognised accordingly.
5	Revenue from Operations	Revenue is recorded in the incorrect period	Cut-Off	On completion of milestones / activities, the project manager obtains confirmation / acknowledgement from the client and creates and invoice requisition. Such requisition contains details like period for which the service is provided and the basis of revenue booked by the finance team in the relevant period.

Sr. No.	Financial Statement Level	Identified Risk	Assertion	Control Description
6	Revenue from Operations	Revenue recorded does not represent actual transactions that occurred	Occurrence	On completion of milestones / activities, the project manager obtains confirmation / acknowledgement from the client and creates and invoice requisition.
7	Operating Expenditures	Operating expenses are recorded in the incorrect accounting period.	Cut-Off	Management compares monthly financial statements, including financial metrics, to budget and prior-year amounts; significant unusual relationships are monitored, investigated, and resolved on a timely basis.
8	Operating Expenditures	Operating expenses are recorded in the incorrect general ledger account.	Classification	Management compares monthly financial statements, including financial metrics, to budget and prior-year amounts; significant unusual relationships are monitored, investigated, and resolved on a timely basis.
9	Operating Expenditures	Amounts recorded to operating expenses do not relate to goods or services received.	Occurrence	Accounts payable and operating expenses are recorded automatically by the ERP system upon matching the purchase order, completed vendor work order, or receiving document.

Sr. No.	Financial Statement Level	Identified Risk	Assertion	Control Description
10	Operating Expenditures	Costs are incorrectly classified (e.g., costs of an operating expense nature are incorrectly classified as inventory costs, costs of an inventory nature are incorrectly classified as an operating expense).	Accuracy	" Management Reviews Actual Costs Compared to Budget or Trends; Significant Variances Investigated Management periodically reviews actual inventory, cost of sales, gross profit, and operating expense amounts in comparison to budget, historical amounts, or current-year trends, and investigates and resolves any significant variances. This review is performed at a sufficient level of detail and disaggregation (e.g., by type of product line, type services)."
11	Operating Expenditures	Costs are incorrectly classified (e.g., costs of an operating expense nature are incorrectly classified as inventory costs, costs of an inventory nature are incorrectly classified as an operating expense).	Classification	" Management Reviews Actual Costs Compared to Budget or Trends; Significant Variances Investigated Management periodically reviews actual inventory, cost of sales, gross profit, and operating expense amounts in comparison to budget, historical amounts, or current-year trends, and investigates and resolves any significant variances. This review is performed at a sufficient level of detail and disaggregation (e.g., by type of product line, type services)."

Sr. No.	Financial Statement Level	Identified Risk	Assertion	Control Description
12	Employee Benefits Expenses (Stock / Share Based Compensation)	"Stock-based compensation: • Has been incorrectly recorded for stock-based awards that were not granted • Has not been recorded for stock-based awards that have been granted • Is recorded at the incorrect amounts • Is recorded in the incorrect period."	Occurrence	Management with knowledge of the entity's stock-based compensation award plans and plan activity (e.g., grants, forfeitures, expirations, modifications) reviews the schedule of stock-based compensation awards and the stock-based compensation accounts for unrecorded or inaccurately recorded transactions. Unusual activity or errors are investigated and resolved in a timely manner.
13	Employee Benefits Expenses (Stock / Share Based Compensation)	"Stock-based compensation: • Has been incorrectly recorded for stock-based awards that were not granted • Has not been recorded for stock-based awards that have been granted • Is recorded at the incorrect amounts • Is recorded in the incorrect period."	Completeness	Management with knowledge of the entity's stock-based compensation award plans and plan activity (e.g., grants, forfeitures, expirations, modifications) reviews the schedule of stock-based compensation awards and the stock-based compensation accounts for unrecorded or inaccurately recorded transactions. Unusual activity or errors are investigated and resolved in a timely manner.

Sr. No.	Financial Statement Level	Identified Risk	Assertion	Control Description
14	Employee Benefits Expenses (Stock / Share Based Compensation)	"Stock-based compensation: • Has been incorrectly recorded for stock-based awards that were not granted • Has not been recorded for stock-based awards that have been granted • Is recorded at the incorrect amounts • Is recorded in the incorrect period."	Accuracy	Management with knowledge of the entity's stock-based compensation award plans and plan activity (e.g., grants, forfeitures, expirations, modifications) reviews the schedule of stock-based compensation awards and the stock-based compensation accounts for unrecorded or inaccurately recorded transactions. Unusual activity or errors are investigated and resolved in a timely manner.
15	Employee Benefits Expenses (Stock / Share Based Compensation)	"Stock-based compensation: • Has been incorrectly recorded for stock-based awards that were not granted • Has not been recorded for stock-based awards that have been granted • Is recorded at the incorrect amounts • Is recorded in the incorrect period."	Cut-Off	Management with knowledge of the entity's stock-based compensation award plans and plan activity (e.g., grants, forfeitures, expirations, modifications) reviews the schedule of stock-based compensation awards and the stock-based compensation accounts for unrecorded or inaccurately recorded transactions. Unusual activity or errors are investigated and resolved in a timely manner.

Sr. No.	Financial Statement Level	Identified Risk	Assertion	Control Description
16	Employee Benefits Expenses (Stock / Share Based Compensation)	Stock-based compensation awards are incorrectly classified as equity awards rather than liability awards or vice versa.	Classification	Stock-based compensation awards are reviewed by finance personnel with the requisite expertise and knowledge of the applicable accounting framework and principles. The terms of the stock-based compensation award are assessed, and finance personnel document whether the award represents an equity or liability award, including reference to the appropriate accounting framework and principles. The analyses and supporting documentation are reviewed by management before the journal entry is recorded.

Sr. No.	Financial Statement Level	Identified Risk	Assertion	Control Description
17	Employee Benefits Expenses (Stock / Share Based Compensation)	Stock-based compensation continues to be recorded for share-based awards that have been forfeited, cancelled, or terminated.	Occurrence	On a periodic basis, finance personnel obtain a schedule of stock-based compensation awards that have been forfeited, cancelled, or terminated. Finance personnel input this data into the stock-based compensation award master file or stock-based compensation award ERP module. Stock-based compensation expense is calculated based on data input into the stock-based compensation award master file or stock-based compensation award ERP module, and a journal entry is prepared. Management reviews the input data, supporting documentation, the calculation of stock-based compensation expense, and the journal entry before the journal entry is recorded.
18	Employee Benefits Expenses (Stock / Share Based Compensation)	Forfeitures, cancellations, or terminations of share-based awards are incorrectly calculated.	Accuracy	A valuation analysis is performed by qualified personnel at the entity using an internally developed valuation model or is performed by a third-party service provider. The valuation methodology, significant assumptions, and underlying data used are reviewed, evaluated, and approved by management with appropriate knowledge of valuation techniques.

Sr. No.	Financial Statement Level	Identified Risk	Assertion	Control Description
19	Goodwill and other intangible assets	"Intangibles for which no future economic benefit is expected: • Are recorded • Are recorded in excess of the asset amount rather than as an operating expense."	Existence	Finance personnel maintain a listing of recorded goodwill and intangible assets. The listing is reviewed by operational management, including in-house legal counsel, as appropriate, for existence and completeness. Discrepancies are investigated and resolved on a timely basis and adjusted to operating expense.
20	Goodwill and other intangible assets	"Intangibles for which no future economic benefit is expected: • Are recorded • Are recorded in excess of the asset amount rather than as an operating expense."	Valuation and Allocation	Finance personnel maintain a listing of recorded goodwill and intangible assets. The listing is reviewed by operational management, including in-house legal counsel, as appropriate, for existence and completeness. Discrepancies are investigated and resolved on a timely basis and adjusted to operating expense.

Sr. No.	Financial Statement Level	Identified Risk	Assertion	Control Description
21	Goodwill and other intangible assets	Amortization is recorded for finite-lived intangible assets that have been disposed, fully amortized, or for which the entity does not have legal ownership.	Rights and Obligations	Finance personnel periodically reconcile intangible asset balances, and related amortization, to supporting documentation; management reviews and approves the reconciliations, including supporting documentation for account activity. Unusual activity or invalid reconciling items are investigated and resolved on a timely basis and adjusted to operating expense.
22	Goodwill and other intangible assets	Amortization is recorded for finite-lived intangible assets that have been disposed, fully amortized, or for which the entity does not have legal ownership.	Completeness	Finance personnel periodically reconcile intangible asset balances, and related amortization, to supporting documentation; management reviews and approves the reconciliations, including supporting documentation for account activity. Unusual activity or invalid reconciling items are investigated and resolved on a timely basis and adjusted to operating expense.

Sr. No.	Financial Statement Level	Identified Risk	Assertion	Control Description
23	Derivative Instruments	The terms of a recorded derivative instrument (including embedded derivatives) have been modified resulting in the derivative instrument no longer meeting the definition of a derivative.	Existence	Contracts (e.g., sales contracts, purchase contracts, leases) are reviewed by finance personnel with the requisite expertise and knowledge of the applicable accounting framework and principles. The new contracts or changes to existing contracts are assessed, and finance personnel documents whether the contracts meet the definition of a derivative including reference to the appropriate accounting framework and principle. The key terms of the derivative contract and supporting documentation are reviewed by management.

Sr. No.	Financial Statement Level	Identified Risk	Assertion	Control Description
24	Derivative Instruments	The terms of a recorded derivative instrument (including embedded derivatives) have been modified resulting in the derivative instrument no longer meeting the definition of a derivative.	Rights and Obligations	Contracts (e.g., sales contracts, purchase contracts, leases) are reviewed by finance personnel with the requisite expertise and knowledge of the applicable accounting framework and principles. The new contracts or changes to existing contracts are assessed, and finance personnel documents whether the contracts meet the definition of a derivative including reference to the appropriate accounting framework and principle. The key terms of the derivative contract and supporting documentation are reviewed by management.

Sr. No.	Financial Statement Level	Identified Risk	Assertion	Control Description
25	Derivative Instruments	Instruments exist that meet the definition of a derivative (or embedded derivative), but are not known to management and are not identified and recorded as derivatives.	Completeness	Management reviews minutes from executive, board, disclosure committee, and other operational meetings to identify new contracts or changes in existing contracts that may meet the definition of a derivative. Contracts are reviewed by finance personnel with the requisite expertise and knowledge of the applicable accounting framework and principles to assess and document whether embedded derivatives are present and are required to be accounted for separately from the host contract. This assessment, including the key terms of the contract, and the supporting documentation are reviewed and approved by management.

Sr. No.	Financial Statement Level	Identified Risk	Assertion	Control Description
26	Derivative Instruments	"The entity has applied hedge accounting: • But did not have sufficient documentation in place at the inception of the hedge to meet the requirements of the applicable accounting framework • For transactions that do not qualify for hedge accounting. "	Completeness	Derivative contracts are reviewed by finance personnel with the requisite expertise and knowledge of the applicable accounting framework and principles. The derivative contracts are assessed, and finance personnel document whether the contracts meet the definition of a derivative, and whether hedge accounting is appropriate. The key terms of the derivative contract and supporting hedge documentation are reviewed by management at the inception of the hedge.
27	Derivative Instruments	"The entity has applied hedge accounting: • But did not have sufficient documentation in place at the inception of the hedge to meet the requirements of the applicable accounting framework • For transactions that do not qualify for hedge accounting. "	Accuracy	Derivative contracts are reviewed by finance personnel with the requisite expertise and knowledge of the applicable accounting framework and principles. The derivative contracts are assessed, and finance personnel document whether the contracts meet the definition of a derivative, and whether hedge accounting is appropriate. The key terms of the derivative contract and supporting hedge documentation are reviewed by management at the inception of the hedge.

Sr. No.	Financial Statement Level	Identified Risk	Assertion	Control Description
28	Derivative Instruments	"The entity has applied hedge accounting: • But did not have sufficient documentation in place at the inception of the hedge to meet the requirements of the applicable accounting framework • For transactions that do not qualify for hedge accounting. "	Classification	Derivative contracts are reviewed by finance personnel with the requisite expertise and knowledge of the applicable accounting framework and principles. The derivative contracts are assessed, and finance personnel document whether the contracts meet the definition of a derivative, and whether hedge accounting is appropriate. The key terms of the derivative contract and supporting hedge documentation are reviewed by management at the inception of the hedge.

Audit of Internal Controls – Internal Auditor's Perspective

Internal Audit is an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system.

Risk management is frequently an area in which internal audit can contribute greatly by furnishing analyses and providing wise counsel to top management and the board of directors. Internal auditors can play an important role with management in establishing and monitoring business processes for the assessment, measurement, and reporting of risks in general and in implementing enterprise risk management initiatives.

The internal auditor should, based on his professional judgment, obtain sufficient appropriate evidence to enable him to draw reasonable conclusions there from on which to base his opinion or findings. Factors affecting the professional judgment include the activity under audit, possible errors and their materiality and the risk of occurrence of such errors. The internal auditor obtains evidence by performing one or more of the following procedures:

Inspection	• Exaination of records, documents or tangible assets • Provides reliability on effectiveness of internal controls
Observation	• Witnessing a process / procedure performed by others • For instance it can be witnessing a stock count
Inquiry and Confirmation	• Seeking information from inside / outside the entity • Inquiry can be formal or informal in nature
Reperformance	• Checking the accuracy by performing independent calculations
Analytical Review	• Studying significant ratios and trends and investigating the outliers

Let us see few model checklists of key critical areas in the IT/ITES industry which sets it apart from the other industries.

1. CONTRACTS

Contracts are the soul of revenue recognition in IT/ITES industry. There are host of varieties of contracts which are entered by the companies in this industry based on which the revenue recognition is decided.

- Review terms and conditions of contract
- Income Recognition and the Compensation Clause needs to be clearly examined
- Analyse the impact on the entity on non-compliance of terms mentioned therein
- Verify non competence agreement, if any in favour/against the company and its compliance
- Verify the termination clause, warranties or representations due on company and dispute resolution terms involved

- Verify how contract compliance is monitored and reviewed periodically
- Verify if the terms of the contract are prejudicial to the interests of the company
- Verify if the company has accepted any contracts the business objectives of which are not in the MOA & AOA of the company
- Verify that the Statement of Work ("SOW") has defined the scope of work and the deliverables
- Verify if the SOW has defined the place where the service has to be provided
- Verify if the payments to be received are up front or phased
- If the project requires any special hardware or software or specialized workforce requirements, verify as to who will provide the same i.e. the company or the client
- Verify if there are any limitations on the number of hours that can be billed per week or month
- Verify if there are any criteria for the buyer or receiver of goods to determine if the product or service is acceptable

2. TRANSACTIONS IN FOREIGN CURRENCY

As a result of globalization, a lot of foreign companies have set up their branches all over India. Hence, there will be inflow of foreign currency by way of capital, repatriation, export receivables, etc.

- Check whether the inward/ outward remittances have been duly accounted
- Ensure compliance with RBI/ FEMA compliance in relation to cross border transactions
- Review minutes of board meetings pertaining to foreign investments, if any
- Compliance with Accounting Standard / Ind – AS
- Compliance with Income tax/ GST regulations on payments made to non-residents
- Compliance with DTAA/ foreign tax reliefs on taxation of foreign income earned by resident production houses

- Tax issues on Satellite/ Optic fibre Transmission companies/ Foreign companies

3. STATUTORY COMPLIANCES

Internal auditor can identify the status of compliance with laws and regulations by inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and inspecting correspondence, if any, with the relevant licensing or regulatory authorities. A typical checklist to audit the compliance is as below:

- Obtain understanding on legal and regulatory framework applicable to the entity
- Verify compliance with the following regulations: FEMA regulations, Information Technology Act, Compliance with IPR/ copyrights/ patents, STPI and Ministry of Information Technology
- Obtain sufficient appropriate audit evidence regarding compliance with the provisions of applicable laws and regulations
- Perform specified audit procedures to help identify instances of non-compliance with other laws and regulations
- Communication appropriately to non-compliance or suspected non-compliance with laws and regulations identified during the internal audit
- If appropriate obtain written representations from management stating that all known non compliances/ suspected non-compliances have been disclosed to internal auditor
- If the company has a policy of working for 24 hours in shifts, verify if all the labour laws have been complied with
- Verify and obtain sufficient audit evidence that the company has registered with all the statutory authorities like, PF, ESI, Service Tax, Sales Tax etc (if applicable)
- Verify if any notices are issued by any of the department and the company has replied the same else has appointed any professional to do the same
- Verify that the company is adhering to all statutory compliances like, deduction and remittance of TDS, filing of monthly/quarterly returns, etc

TABLE OF CONTENTS

1. INTRODUCTION

- o In the recent past, we have seen a revolution in computing and communications and can predict that technological progress and use of information technology will transform our lives and our businesses with even greater influence.
- o Information technology gives companies the potential to expand exponentially by joining hands with various business partners globally.
- o IT and internet use has transformed the world driven by industrial revolution into a society driven by information and economy driven by knowledge.

So, main objective of this paper is the Information Technology Act and its impact on the IT Companies.

2. INFORMATION TECHNOLOGY ACT 2000

- o The Information Technology Act was enacted on 17th May 2000 primarily to provide legal recognition for electronic transactions and facilitate e-commerce. It is based on Model law on e-commerce adopted by UNCITRAL (United Nations Commission on International Trade) of United Nations organization.
- o The was amended by passing of the Information Technology (Amendment) Act 2008. The Amended act casts responsibility on body corporates to protect the sensitive personal data by creating a paradigm shift in data

protection and privacy to maintain reasonable security practices and procedures.

- o It recognizes and punishes offences by companies and individuals' action like sending offensive messages using electronic media or stealing computer resource, etc. by giving extensive power to the police and statutory authorities to penalise the offenders.

SCOPE OF THE ACT:

It extends to the whole of India and also applies to any offence that is committed outside India to any person irrespective of his nationality, if such act involves a computer, computer system or network located in India.

FURTHER REFLECTION:

As mentioned above, was brought into force to regulate the cyber world in India. The provisions of the act are robust and one of the most stringent IT laws out there.

The three key issues of electronic information impacting enterprises and us auditors are:

a) Authenticity: 'How to implement a system that ensures operations are genuine and authorized?'

b) Reliability: 'How to rely on the information which to a great extent has no physical backing?'

c) Accessibility: 'How do we gain access and authenticate the information in digital form?'

The amended act places many stringent punishments for a wide range of offences being committed in this area. To mention a few important sections:

a) Sections 66B – 66F define and impose penalties for other cybercrimes, including cyber- terrorism. They include punishment for dishonestly receiving stolen computer resource or communication device, identity theft, cheating by personification by using computer resource, violation of privacy and cyber terrorism.

- o Sections 69 through 69B grant the Central and State Governments the authority to monitor or collect traffic data, intercept or decrypt or issue order to block public access to electronic information in order to protect the sovereignty, integrity, defence of India, friendly relations with foreign states or public order. The subscribers or intermediaries or any person who fails to give the requisite assistance shall be punishable with fine, imprisonment or both.

- o These provisions ensure that the government is able to censor content in instances where fake news on social media platforms have resulted in instigating violence. This has happened in many cases. Again, terrorist cells these days use internet platforms to propagate themselves. News gives us all the details about such instances. Such information needs to be censored.

b) Section 70B creates a government agency, dubbed the "Indian Computer Emergency Response Team,". This team is established by the Central Government for collection and analysis of information, forecast, emergency, forecast, emergency measures, co- ordination, issuing guidelines and other matters.

c) Apart from the above, it also suggests severe punishments on child pornography and publishing and transmitting obscene material in electronic form. The act also includes regulations over computer related crime and electronic evidence.

CASE STUDIES:

1. Penalty and Compensation for the Damage to Computer, System and other related devices.

   a) Section 43 of the tells us that if a person without permission of the owner or in charge of the computer, computer system or network: Secures access, introduce or causes to be introduced any computer contaminant or virus, disrupts; damages; denies access or causes to do any of these acts to the authorized person, downloads; copies or extract data; destroys; deletes; alters or diminishes the value of the information, steals; conceals; destroys or alters any computer source code, provides any assistance to gain access to any computer, computer resource, system or network; shall be liable to pay penalty and compensation.

   b) In the case of MphasiS BPO Fraud:

      - o It is also India's first BPO scam in which four BPO employees working at MphasiS call centre in Pune gained the confidence of four US customers who were the customers of MphasiS's client, Citibank and obtained their Personal Identification Numbers (PIN) which these employees were not authorised to obtain.

      - o These call centre employees then opened new bank accounts using false identities at Indian banks. Within a few months, these employees, during their employment at MphasiS, transferred money from the bank accounts of Citibank customers to the new accounts they had opened at the Indian banks using the PINs and account information. The employees did not break through the firewalls or decoded encrypted software, but instead, they identified glaring loopholes in the system of MphasiS.

- o The Indian police managed to identify the fraudsters who scammed the U.S bank after one of the account holders complained about it to the Citibank and they could arrest the employees after they attempted to withdraw cash from the accounts at Indian banks. Court held that Section 43(a) of the is applicable here, and the employees were charged under this section due to the unauthorised access involved in committing transactions.

c) Again, section 66 states that if any person dishonestly or fraudulently does any act referred to in section 43, he shall be punishable with imprisonment up to three years or with fine up to five lakh rupees of both. Here, dishonestly and fraudulently refers to meaning assigned to them in the Indian Penal Code.

2. Tampering with Computer Source Documents:

a) Section 65 of the states that any person knowingly or intentionally conceals, destroys or alters any computer source code used in a computer system or network programme then such person will be punishable with imprisonment up to three years or with fine which may extend up to two lakhs rupees or both.

b) In the case of State v Mohd. Afzal And Ors. which is also known as the Parliament Act in which several terrorists attacked the Parliament House in December 2001.

- o The digital evidence was obtained, which played an essential role in the prosecution. Several storage disks and devices, a laptop was recovered from a truck at Srinagar after getting the information from the two suspects.
- o Though, the accused claimed that the devices recovered can be quickly tempered and hence, the prosecution should not rely on it. The fake identity cards and video clips of the political leaders with Parliament at the back of the video were recovered with supposedly was shot from T.V news channels.
- o It was held in this case that if the challenger is questioning the validity of the computer evidence, then there should be clear arguments against it as mere generic doubts, suspicion and theoretical doubts cannot be held as evidence.

3. Publishing of Obscene Information in Electronic Form

a) Section 67 talks about punishment for publishing or transmitting obscene material in electronic form. It says that any person publishes, transits or causes to be published in electronic form, any material which appeals to the prurient interest or if its effect is such as to tend to deprave and corrupt persons who are likely to read, see or hear the matter contained in it, shall be punished on first conviction with imprisonment up to three years and fine up to Rs. 5 lakhs and imprisonment up to five years and fine up to Rs. 10 lakhs respectively for the second conviction.

b) In the case of The State of Tamil Nadu v Suhas Katti, a known family friend of the victim who was a divorcee woman was posting obscene, defamatory messages about the victim on the Yahoo message group. A fake email account in the name of the victim was opened by the accused and mails were forwarded to the victim for information. The posting on the group resulted in annoying phone calls to the victim. The accused was interested in marrying her, but she married someone else and ended in divorce and hence, the accused started to contact her again. However, the victim's reluctance to marry the accused resulted in the accused harassing her. Under Section 67 of the , section 469 and 509 IPC, the accused was found guilty.

There are also a few other areas of concern which needs to be properly dealt are as under:

1. Spamming and Phishing are two malicious activities that could be revisited for a more sufficient specialized technical protection and stringent legislation. Though the Indian Penal Code discusses duping, it isn't adequate to check phishing.

2. Another issue on similar grounds is infringement of Intellectual property rights. The most widespread digital "abuse" that an individual makes these days is downloading motion pictures through distributed sharing systems. This is a widespread infringement of copyright laws; however, the number of culprits is so large that a successful measure cannot be taken to check it. So, to check the developing threat of digital violations, governments, through measures, frequently deny access to sites.

3. Apart from these, we have the issues relating to internet censorship, banking, insurance and the like services and the overall infrastructure, competence of the officers handling the cyber-crime cases and finally the overall education and awareness about the act.

Applicability of , 2000:

1. For companies doing business in India or with Indian entities, Section 43A of the is of particular importance. Section 43A is a new provision designed to hold companies accountable for the protection of personal data. It provides:

    - o Where a body corporate, possessing, dealing or handling any sensitive personal data is negligent in implementing and maintaining reasonable security practices and thereby causes wrongful loss or wrongful gain to any person, such body corporate shall be liable to pay damages by way of compensation for damages to the person so affected.

    - o One thing that is important to note here is that the corporate body is held liable only when a wrongful gain or loss is incurred to a person due to such neglect from the corporate body. Although the fact that the corporate has been negligent in itself does not make it a defaulting party.

    - o Also, this provision has a number of important implications for the Indian outsourcing industry and its customers in other parts of the globe. The amendment, on the other hand, takes a broader view of the IT landscape in India by recognizing that corporations and other intermediaries also bear some responsibility in ensuring data in their possession is secure.

2. Then we have section 85 which talks about the offences committed by companies. The section says that where a company commits an offence or contravenes with any of the provisions of the , then such company and every person concerned shall be held liable for such contravention unless it is proved that the persons in consideration had exercised due diligence or the offence took place without their knowledge. But if it is proved that an offence is committed with the consent or connivance of or is attributable to any neglect on the part of persons of company then such person is liable for punishment.

3. Given the fact that the nature of this sector is so dynamic, the regulation governing it also needs to be equally robust by subjecting itself to constant rev-up to stay up-beat with the IT industry. A few things that could be done to enhance the Act's impact on these companies:

    - o Let us try to understand this with an example with respect to the scope of the Act. For the Act to be applicable a company or any person needs to have at least a server present in India. So, if an entity does not have a server at the least and still operates in India, the act would not apply to it.

    - o Again, the banking and insurance sector which unfortunately is plagued by frauds. Maybe, a code of sorts could be introduced in this area combining a few of the common provisions of various acts governing this sector along with the so as to enable a more holistic and better regulation on the undesirable activities taking place. It is relevant in the given context because it is the IT companies like Infosys, TCS, etc that give the technical software and other assistance to the banking and the insurance companies.

- Apart from these, IT companies operating social media platforms are today way too powerful and influential for their own good. Just take the 4 giants in the business – Google, Amazon, Twitter and Facebook (along with Instagram and WhatsApp) who were recently grilled by the US senate on the various issues and facing regulatory actions by many governments globally.

- Social Media today has fallen prey to fake accounts, hate speech, etc. Such things need to be curbed, but it is easier said than done because it directly hits the fundamental right of the free world – "Freedom of speech and expression". The governments around the world are asking these companies to regulate the sort of content that these platforms allow to be transmitted and published. Let us dig a bit deeper and see how our tries to tackle with this problem of internet censorship.

- Article 19(1)(a) of the Constitution protects the right to free speech and expression irrespective of the medium of communication. While the Courts have interpreted this right in a broad manner, Article 19(2) permits reasonable restrictions to be placed on the right in view of public policy concerns. Purportedly in accordance with A 19(2), the contains numerous provisions that can be used to censor online content – notably in Sections 69, 69A, 69B and 79. More could be done here.

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CONCLUSION:

India's IT and ITeS sector is the most wanted and contributes highly towards the GDP growth. India is considered to be the topmost offshoring destination for IT companies across the world. Having proven its capabilities in delivering both on-shore and off-shore services to global clients, reinvented business models and technological advances now offer an entire new gamut of opportunities for top IT firms in India. The industry is expected to grow to US$ 350 billion by 2025. India spends $1.6 bn annually on training workforce in the sector. The industry is the largest employer within the private sector, employing 3.9 million people.

The IT sector constantly and rapidly goes through major overhaul including re-inventing itself through its new trend of business models and make partnerships with leading global corporates. Data protection and privacy is a major concern. Covid-19 has also been a major contributor in the overhaul. Covid-19 has resulted the Industry pivoting to New-Age Customer-Centric imperatives to revive growth. This will be achieved through:

1) Get ready for the new normal –
   a. New revenue sources from digital deals
   b. Flexible contractual terms
   c. Innovative sales models
2) Stay close to the clients with –
   a. Differentiated client services
   b. "Go-to" trusted digitalization solutions
   c. Becoming the global "skills hub"
3) Put skin in the game for strategic partnerships –
   a. Co-invest in the future growth projects
   b. Collaborate with emerging tech ecosystems

Covid-19 has also resulted in bringing necessary cost control measures and emerging profit levers like:

1) Fresh Hiring halt

2) G & A reduction due to increasing variable cost and payment terms, reducing non-essential travels and work from home policies

3) Business restructuring

4) Technology consolidation.

*Indian IT's core competencies and strengths have attracted significant investment from major countries. The computer software and hardware sector in India attracted cumulative Foreign Direct Investment (FDI) inflow worth US$ 44.91 billion between April 2000 and March 2020. The sector ranked second in FDI inflow as per the data released by Department for Promotion of Industry and Internal Trade (DPIIT).

Opportunities for Chartered Accountants in Information Technology sector:

With revolution in IT sector, the profession of a Chartered Accountant has also faced continuous challenges. A combined knowledge of finance along with Information Technology can play a major role and value in system design and development.

1) Implementation of ERP: CA's can perform various activities like requirement analysis, process mapping, user testing and acceptance, etc.

2) Block chain: The move to a financial system with a significant blockchain element offers many opportunities for the accountancy profession. With blockchain still being developed, standardised and optimised, CA's can support in research, crafting standard's and regulations to cover blockchain and also advising on the wighing of the costs and advantages of the new system.

3) Ecommerce: The growth in ecommerce has also inhibited by lack of confidence in the system. CA's can develop capability to assess whether the system and tools used in electronic commerce meets the defined criteria for data security, privacy and integrity.

4) Systems quality: Systems quality is very vital for any organisation. This as resulted in development of niche area for CA's in evaluation and analysis of information system design, management and control.

5) Cloud computing: Cloud computing provides an opportunity to the professional accountants to automate their process and deliver services to clients in more efficient and faster manner. Embracing the change in technology will also enable us to more competitive on international front.

Some of the major developments in the Indian IT and ITeS sector are as follows as on October 2020:

1) In July 2020, Infosys won a multiyear deal worth US$ 1.5 billion from investment management company, Vanguard

2) In July 2020, HCL Technologies signed a five-year deal worth US$ 600 million with telecom equipment maker Ericsson

3) In May 2020, SirionLabs, a software-as-a-service (SaaS) provider, raised US$ 44 million as part of its Series C round led by Tiger Global and Avatar Growth Capital.

4) PE (private equity) investment in the sector stood at US$ 11.8 billion across 493 deals in 2019.

5) In January 2020, Nippon Telegraph and Telephone, a Japanese tech announced its plans to invest a significant part of its US$ 7 billion global commitments for data centres business in India over the next four years.

6) As of February 2020, there were 417 approved SEZs across the country with 274 from IT & ITeS and 143 as exporting SEZs.

7) In February 2020, Tata Consultancy Services bagged a contract worth Rs 10,650 crore (US$ 1.5 billion) from pharma company Walgreens Boots Alliance.

8) UK-based tech consultancy firm, Contino, was acquired by Cognizant.

9) In May 2019, Infosys acquired 75% stake in ABN AMRO Bank's subsidiary Stater for US$ 143.08 million

10) In June 2019, Mindtree was acquired by L&T.

11) Nasscom has launched an online platform which is aimed at up-skilling over 2 million technology professionals and skilling another 2 million potential employees and students.

Some of the achievements of the IT sector during FY 2019-20:

1) About 200 Indian IT firms are present in around 80 countries.

2) Total export revenue of the industry is expected to grow 8.1% y-o-y to US$ 147 billion in FY20. IT-BPM sector accounted for the largest share in the Indian services export at 45%.

3) Total number of employees grew to 1.02 million cumulatively for four Indian IT majors (including TCS, Infosys, Wipro, HCL Tech) as on December 31, 2019.

WAY FORWARD:

1. When we think about the way ahead for this this sector and the , there are a couple of things to be considered. So, let us start with the most relevant topic of our present time – COVID-19. It has caused a boom in this industry because internet is the only bridge connecting the pandemic-hit world today. The days of post January 2020 are over and the new tech-savvy era is already here.

2. COVID-19 has made people work from home and IT companies more particularly can continue to work from home mode even after things get better. This comes with its own risks like network risk (Lack of Device Visibility), device risk (Loss of Devices), application risk (Application Viruses and Malware) and implementation risk (Weak Policy).

3. Artificial Intelligence (AI) is expected to boost India's annual growth rate by 1.3% by 2035, as per NITI Aayog. A substantial increase in AI by Indian firms can result in a 2.5% increase in India's Gross Domestic Product (GDP) in the immediate term.

4. Further, the country is providing procedural ease and single window clearance for setting up facilities. In May 2019, the Ministry of Electronics and Information Technology (MeitY) launched the MeitY Startup Hub (MSH) portal. Also, the Government has identified IT as one of the 12 champion service sectors for which an action plan is being developed. It is setting up a Rs 5,000 crore (US$ 745.82 million) fund for realising the potential of these champion service sectors.

5. The Government is also working on the Blockchain Technology and how it can be implemented in the country. While this is an amazing prospect, the will have a major role to play here. It would be prudent to accommodate all the necessary regulations required to regulate the blockchain technology into the well in advance.

6. When we look at the today, it is felt that the modernization of existing laws and enactment of new ones to certain extent is the need of the hour. Maybe it is time that we have specific laws on Social Media, Fake news, and eCommerce.

7. Often, we witness the application of two different legislations such as the and the IPC in a particular scenario. The , a later special law contained overriding provisions over IPC, a general law. Majority of the offences under the are bailable and compoundable and may also lead to amicable settlement between the parties, wherein, the offence under IPC may not be bailable and can attract higher punishment. Hence, if the complainant is willing to prosecute the offender under sections of IPC, it may deprive the offender from getting bail and from the case being settled, which the permits. Along with the IPC, the also at times collides with the Copyrights Act, 1957, the Patents Act, 1970. A

settled principle on this point will make the implementation of the smooth.

8. The reporting of cyber-crimes should be encouraged in order to devise proper mechanisms for its redressal. According to the data analysis of cybercrime, only 50 out of 500 crimes get reported. Here, I would also like to draw the readers' attention towards ***the National Cyber-Crime Reporting Portal*** launched by the Ministry of Home Affairs, Government of India. This portal facilitates the victims/ complainants to report the cybercrime complaints online and also has a special focus on cybercrimes against women and children.

9. Another area is the adjudication of the . The authorities who undertake to handle these cases need to be technically sound too. Because cyber-crimes are committed by the smartest brains out there, the authorities trying to catch them need to also be good with technology and the IT processes. This is at the core because if the officer handling the case is not competent enough the perpetrators cannot be brought to justice.

10. We spoke about the Indian and its impact on the IT companies, the areas of interplay and the like. We need to also acknowledge that in today's world and in this particular sector, there are no geographical barriers at all. So, governing this sector becomes very challenging. Very few countries like India have a robust . Due to the global nature of the Internet; it is very difficult to control content being uploaded in foreign countries and being viewed in India. A more collective approach and effort is required. Countries around the world need to come together for a common code to address the evils of the sector in a better and more holistic manner.

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