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The transfer of computer software by an Indian branch to a foreign head office is considered as export and eligible for benefit under Section 10A

Background

Recently, the Delhi High Court in the case of Virage Logic International[1] (the taxpayer) held that the transfer of computer software by the Indian branch to the foreign head office (HO) could be considered as a 'sale' to the HO which was located outside India, and therefore, the taxpayer is entitled to claim the benefit of Section 10A of the Income-tax Act, 1961 (the Act).

The High Court observed that the mere omission of a provision akin to Explanation (2) to Section 80HHC[2] of the Act by itself does not rule out the possibility of the treatment of a transfer/ transmission of software from the branch office to the HO, as an export under Section 10A of the Act. The incorporation in its entirety without any change in Section 80-IA(8) to Section 10A, is for the purpose of ensuring that inter-branch transfers involving exports are treated as such, as long as the other requirements of a sale are satisfied.

Facts of the case

- The taxpayer is engaged in the business of software development and was accorded approval by the Reserve Bank of India (RBI) under the then prevailing Foreign Exchange Regulation Act, 1973 to establish a branch office in India i.e. at Noida and New Delhi, for the development of software for export purposes.
- It received approval for setting up of 100 percent Export Oriented Unit (EOU) under the Software Technology Park (STP) Scheme of the Central Government in 1999 for the development of computer software. The software developed by was electronically transmitted to its HO, located abroad.
- In terms of the agreement between the taxpayer and its HO, the latter pays for all the direct and indirect costs for the development of the software with a markup of 15 per cent.
- The taxpayer had developed a software known as 'Softex Form', and exported it through data communication links. It received consideration and furnished the relevant clarification, which was accepted by the STPI authorities.
- The taxpayer also received remittances from the HO towards the export/ transmission of such a software. It reported a profit for the Assessment Year (AY) 2002-03 and filed a return seeking exemption under Section 10A of the Act.
- The Assessing Officer (AO) rejected the taxpayer's claim that it had sold software to its HO because they were part of the same entity. Secondly, it merely provided services to the HO, which reimbursed the costs to the taxpayer but with a nominal mark up. The AO also held that the transfer of software in the circumstances of the case did not amount to exporting it.

[1] DDIT v. Virage Logic International (ITA 1108/2007, ITA 1249/2009, ITA 173/2016) – Taxustra.com

[2] Explanation (2) to Section 80HHC provides that where goods and merchandise are transferred by a unit to a branch office, warehouse or other establishment situated outside India, and thereafter sold, such transfer shall be deemed to be export.

- Before the AO, the taxpayer contended that its Indian branch constitutes a Permanent Establishment (PE) of its foreign office, and the profits were attributable to its business carried out in India and were taxable under several provisions of the Act.

- The AO's reasoning was premised, inter alia, on the basis that Section 10A was introduced with the objective of encouraging foreign exchange accruals and earnings in India. Therefore, the taxpayer received mere remuneration (on a man-hour basis) for the development of software, and not proceeds of the software when sold by the HO. Further, the taxpayer remitted its profits back to the HO in foreign currency and on account of this the objective of introducing Section 10A was defeated.

- The AO referred to Explanation 2 to Section 80HHC, which provides that where goods and merchandise are transferred by a unit to a branch office, warehouse or other establishment situated outside India, and thereafter sold, such a transfer shall be deemed to be export. The absence of a similar provision in Section 10A was held to be an adverse circumstance, which precluded the treatment of the transfer of computer software in this case as an export.

- The Income tax Appellate Tribunal (the Tribunal) held that the legal fiction of treating a taxpayer as a separate entity vis-a-vis sale by it or transfer by it from an eligible business or to an eligible business has been recognised under Section 10A(7) of the Act.

The High Court's ruling

- The decision of the Delhi High Court in the case of Moser Baer[3] specifically dealt with the Tribunal's reasoning in the present case. In that case, it was noted that transmission of computer software from an Indian entity to its HO on the basis of an arm's length price determined for export, entitled the taxpayer to exemption under Section 10A of the Act.

- The Court is in agreement with the taxpayer's contention that the mere omission of a provision akin to Explanation (2) to Section 80HHC or the omission to make a provision of a similar kind that encompasses Explanation 2(iv) to Section 10A, by itself does not rule out the possibility of the treatment of the transfer/ transmission of software from the branch office to the HO as an export.

- A plain reading of Section 80-IA(8) shows that the transfer of any goods or service 'for the purpose of the eligible business' to 'any other business carried on by the assessee', are covered. The only condition insisted upon by the Parliament was that when the face value of such transactions was inconclusive, the AO could determine the market value: for such transactions or sales.

- The incorporation in its entirety without any change in Section 80-IA(8) to Section 10A through sub-Section (7) is for the purpose of ensuring that inter-branch transfers involving exports are treated as such as long as the other requirements for a sale are satisfied.

- In this case, the AO carried out the exercise mandated by Section 10A(7) read with Section 80-IA(8). Consequently, the particulars of the price or cost reported by the taxpayer were not binding or conclusive but rather they attained finality in the assessment proceedings, after due addition.

- The absence of a 'deemed export' provision in Section 10A similar to the one in Section 80HHC does not logically undercut the amplitude of the expression 'transfer of goods' under Section 80-IA(8) – which is now part of Section 10A.

- Accordingly, the transfer of computer software by the Indian branch to the HO can be referred to as a 'sale' to the HO out of India. Further, the taxpayer is entitled to claim the benefit of Section 10A of the Act.

Our comments

In the present case, the High Court has held that the provisions of 'deemed export' present in Section 80HHC of the Act, are absent in Section 10A of the Act, but this does not weaken the amplitude of the expression 'transfer of goods' mentioned in Section 10A of the Act. Consequently, the transfer of computer software by the Indian branch to its HO is eligible for the benefit of Section 10A of the Act.

No deduction is allowed under Section 10A of the Act to any undertaking for the assessment year beginning on 1 April 2012 and the subsequent years. However, the present case may provide relief to taxpayers with similar cases pending before appellate authorities/courts. Further, it may help the taxpayers who are claiming the benefit of Section 10AA of the Act, since the provisions of Section 10AA of the Act are *pari materia*[4] to Section 10A of the Act.

[3] CIT v. Moser Baer India Ltd. [2009] 177 Taxman 42 (Del)

4 of the same matter, on the same subject

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