

**IN THE INCOME TAX APPELLATE TRIBUNAL
'C' BENCH, BANGALORE**

**BEFORE SHRI VIJAYPAL RAO, JUDICIAL MEMBER
and
SHRI INTURI RAMA RAO, ACCOUNTANT MEMBER**

ITA Nos.1624 to 1627/Bang/2012
(Assessment years: 2006-07 & 2007-08)

M/s WiFi Networks Pvt. Ltd.
No.427, 80 Feet Circular Road,
IV Block, Koramangala,
Bangalore-560095. ... Appellant
PAN: AAACW 5293 L

Vs.

Deputy Commissioner of Income-tax (TDS),
Circle 18(1),
Bangalore. ... Respondent

Appellant by : Shri Padam Chand Khincha, CA
Respondent by : Shri Sunil Kumar Agarwala, JCIT(DR)

Date of hearing : 12/01/2016
Date of pronouncement : 24/02/2016

O R D E R

Per BENCH:

These are the appeals remanded back to the file of the Tribunal by the Hon'ble High Court of Karnataka vide order dated 14/11/2014 in ITA No.562 of 2013 and 546, 560 & 545 of 2013 by holding in paras. 5 & 6 as under:

"5. *In view of the aforesaid facts and submissions, we are of the view that the order passed by the Tribunal is not proper. It violates principles of natural*

justice. The Tribunal has a jurisdiction to decide the appeals on the ground which is not urged by both the parties. But the parties should be given an opportunity to have their say.

6. In that view of the matter, we deem it proper to set aside the order impugned herein and remand back the matter to the Tribunal and Tribunal shall consider the appeals on the ground urged by the assessee as well as the additional ground the Tribunal found relevant to decide the appeals after recording the finding on both the grounds the appeal may be disposed of on merits in accordance with law. That would meet ends of justice."

2. Briefly the facts of the case are that the assessee is a company incorporated under the provisions of the Companies Act, 1956. It is engaged in the business of software development in telecom sector. A survey operation under the provisions of sec.133A were carried out in the business premises of the assessee-company on 26/2/2010 by the DCIT(TDS), [hereinafter referred to as 'TDS Officer'] Bangalore. During the course of survey proceedings, the TDS officer had noticed that no tax deduction was made on the payment of technical fee made to one Shri Mohan Raju, who is also the managing director of the assessee-company.

3. The background leading to the payment of technical fee is as under:

Majority of the shares of the assessee-company are held by the said Shri Mohan Raju. In fact, he is the promoter of the assessee-company. One company by name Widescreen Holdings

P Ltd. [‘WHPL’] based at Bombay shown interest in the assessee-company and was interested to be associated with the assessee-company as a co-promoter and subsequently the said co-promoter acquired 51% of the shares of the assessee-company and it was stated that this acquisition of shares was done as per oral understanding between the assessee-company and Shri Mohan Raju and WHPL. The oral understanding was reduced into writing in the form of share subscription and shareholders agreement dated 12/9/2006, providing for (a) proper management and conduct of business of the assessee-company; (b) setting out the manner and exercise of control of the assessee-company by the shareholders; and (c) regulate the relationship between the parties and to provide for all other incidental matters in connection with the assessee-company and its members. The said agreement also provided for non-compete clause in terms of which the promoter and WHPL had agreed not to carry on similar business in which the assessee-company is engaged or not to compete with the assessee-company directly or indirectly or alone or in associate with others or with any other entity. This clause does not provide for any fee for this covenant. However, clause XIV of the agreement provided for right of first refusal to the assessee-company and WHPL in respect of future business initiatives of Shri Mohan Raju in specified business areas. The same clause provided that Shri Mohan Raju should offer 74% of the economic interest to the assessee-company in

the new business initiative which he may promote either as a shareholder or as a partner in the field of telecommunication, digital media and convergence other than those specified in clause 2(b) of the agreement. The said clause reads as under:

"XIV. Right of first refusal to the Company and WHPL in respect of future business initiatives of MR in specified areas:

(a) Any new business initiative of MR in the fields of telecommunication, digital media and convergence, other than those provided under Article IIb) hereinabove, shall be considered as 'specified business' for the purpose of this Article;

(b) During subsistence of this Agreement, if MR is intending to promote any 'specified business' or intends to associate himself directly or indirectly in the promotion or any 'specified business' either as a shareholder or partner, MR shall first offer 74% economic interest in such 'specified business' to the Company and if the Company for any reason is unable to offer, then the right shall shift to WHPL and if WHPL too declines to accept the offer, MR may proceed with the special business as if this agreement were never entered into.

(c) In consideration for granting the aforesaid right to participate up to a level of 74% economic interest in any future initiative of MR in 'specified business', the Company shall pay to MR a lump sum amount of Rs. 5 crores. The same shall be paid and discharged by the Company in the following manner:

On or before 31st March 2006 — Rs. 1 Crores

On or before 30th Sep 2006 — Rs. 2 Crores

On or before 31st March 2007— Rs. 2 Crores

(d) It is hereby specifically provided that in the event of breach of the above said stipulation by MR the entire consideration paid to him under this clause shall be recovered by the Company along with interest @ 12% p.a, in addition to taking punitive action against MR available to the Company under law.

Page 5 of 15

Where however the Company does not exercise the right and if WHPL accepts the offer, WHPL shall pay to the Company a sum equal to 10% of the total payment by the Company till then to MR, every time such offer is made to WHPL under this clause.

4. In consideration of granting the above said right to the assessee-company by Shri Mohan Raju, assessee-company paid a consideration of Rs.5 crores on various dates during the financial year 2005-06 and 2006-07. A sum of Rs.1 crore was paid during the financial year 2005-06 and the balance of Rs.4 crores was paid during the financial year 2006-07.

5. During the financial year 2005-06 and 2006-07, the assessee-company was show-caused by the TDS officer vide his letter dated 26/2/2010 as to why the assessee-company cannot be treated as assessee in default for non-deduction of tax on the payment of technical fee to Shri Mohan Raju. In response to show cause notice, assessee-company submitted that TDS provisions are not applicable to the payments made to said Shri Mohan Raju, as payments are made for acquisition of intellectual property rights and heavily relied on the decision of the Hon'ble Supreme Court in the case of *Tata Consultancy Services vs. State of AP* (271 ITR 401) in support of the contention that intellectual property rights are only in the nature of goods. Therefore, the provisions of TDS are not applicable. The TDS officer, rejecting the explanation filed by the assessee-company, held that the payments are in the nature of royalty within the meaning of the definition of 'royalty' in Explanation 2 to sec.9(1)(vi) of the Act.

Therefore, the TDS officer held the assessee-company in default within the meaning of section 201 of the Act and demanded tax of Rs.11,02,600/- and interest u/s 201(1A) of Rs.7,21,810/- for the financial year 2005-06, tax of Rs.44,08,000/- and interest of Rs.26,08,433/- aggregating to Rs.70,16,433/- for the financial year 2006-07.

6. Being aggrieved by this order, appeals were preferred before the Id.CIT(A). It was contended before the Id.CIT(A) that the payments in question are not in the nature of royalty. As lump sum payment was made to acquire a future right to participate up to 75% of the economic interest in any business initiative of said Shri Mohan Raju, payment was not as recurring nature. Therefore, the payment was outright acquisition of capital assets and cannot be regarded as 'royalty' within the meaning of sec.9(1)(vi) of the Act. In support of this, assessee-company relied upon *CIT vs. Ralliwolf Ltd* (143 ITR 720), *Associated Cements vs. Commissioner of Customs* (35 ITR 707), *CIT vs. Neyveli Lignite Corporation Ltd.*(243 ITR 459)(Mad.) and *CIT vs. Ahmedabad Manufacturing & Calico Printing Co.* (139 ITR 806)(Guj.). The Id.CIT(A), after considering the submissions of the assessee-company, dismissed the appeals of the assessee-company vide para.3.6 in his order dated 5/12/2012 as under:

"3.6 To summarise the facts, in the appellant's case, the amount of Rs.5 crores was made by it to Shri Mohan Raju towards the right of first refusal made due to his knowledge of process related to technology in the

Page 7 of 15

field of networking and by agreeing to give the right of first refusal in favour of the company Shri Mohan Raju has parted with his right related to the knowledge of the process. The appellant's case is also covered by clause (iv) of Explanation 2 to section 9 of the Act as by giving the right of first refusal Shri Mohan Raju has parted with his commercial and scientific knowledge, experience and skill in the field of networking in favour of the appellant-company in which it is in the business. In this regard, the appellant has relied on the decision of the Hon'ble ITAT, Bangalore Bench 'C' in the case of Cranes Software International Ltd. (in short 'CSIL') v. DCIT, Circle-1(1), Bangalore wherein in respect of payment for antivirus software the assessee was held not liable to action 201(1) of the Act. The case cited can be distinguished by the fact, that the assessee provided'simulation software products and solutions across the globe (emphasis supplied)' and was not confined to one entity unlike in the case of Shri Mohan Raju vis-a-vis the appellant- company. The facts of the appellant's case are, therefore, distinguishable from the facts in the case of CSIL cited above. In the light of the discussions made a.ove, the payment made by the appellant constitutes 'royalty' and, therefore, the appellant-company ought to have deducted the appropriate tax at source from such payment made to Shri Mohan Raju. In view of the facts discussed above, the action of the AO in raising demand u/s 201(1) and charging interest u/s 201(1A) of the Act on the appellant-company for the two assessment years in question is upheld.

7. Being aggrieved by this order of the Id.CIT(A), appeals were filed before this Tribunal. This Tribunal, after considering the rival submissions, had allowed the appeals filed by the assessee-company vide order dated 21/6/2013 by holding that the provisions of sec.194J were not applicable to the payments in question as the term 'royalty' was inserted under the provisions of sec.194J only w.e.f. 13/07/2006 and since the amounts in question were already credited on 1/2/2006 in the books of

account of the assessee-company, the provisions introduced subsequently w.e.f. 13/7/2006 cannot be applied to the credits or payments made prior to that date.

8. Against this order of this Tribunal, the revenue contested the matter before the Hon'ble High Court of Karnataka on the ground that the Tribunal had allowed the appeals of the assessee-company on the grounds which were not urged before the Tribunal without giving an opportunity of hearing to the parties to the case. The Hon'ble High Court, being satisfied with the contention of the revenue, restored this matter to the Tribunal for fresh disposal before this Tribunal again. The Hon'ble High Court made it very clear that the Tribunal shall consider the appeals on the ground urged by the assessee-company as well as the additional grounds the Tribunal found relevant to decide the appeals after recording the finding on both the counts.

9. Pursuant to the order of the Hon'ble High Court, the appeals were heard on 12/01/2016.

Learned AR of the assessee-company reiterated the same submissions. Payments were not in the nature of royalty as there is no technical process involved. He submitted that the provisions of sec.9(1)(vi) cannot be applied to the facts of the present case. Learned AR also advanced alternative plea that in any case, since the whole agreement was made on 1/2/2006, it should be construed that the amounts were due as on 1/2/2006. Since the

term 'royalty' was inserted in the provisions of sec.194J only w.e.f. 13/7/2006, obligation to deduction tax at source does not arise.

On the other hand, learned DR urged that payments are only in the nature of royalty. Therefore, provisions of sec.194J are squarely applicable to the facts of the case.

10. We heard rival submissions and perused the material on record. The issue in appeals that is to be adjudicated is whether payment made by the assessee-company to Shri Mohan Raju, who is also the promoter of the assessee-company as well as managing director of the assessee-company, is in the nature of royalty or not? To determine the nature of payment, it is essential to refer to the clauses of the agreement governing the impugned payments. Clause XIV entered into between the assessee-company and MR specifies the nature of right granted by Shri Mohan Raju to assessee-company. The clause states that during the subsistence of the agreement, Shri Mohan Raju shall offer 74% of economic interest in the new business initiatives to be promoted by him. The specified business has been defined to mean 'telecommunication, digital media and convergence. In consideration of granting of the aforesaid right to the company, it was agreed that the company shall pay to Shri Mohan Raju a lump sum consideration of Rs.5 crores which shall be discharged by the company

Page 10 of 15

- (i) on or before 31/3/2006 Rs.1 crore,
- (ii) on or before 30/9/2006 Rs.2 crores
- (iii) on or before 31/3/2007 2 crores.

In terms of the above agreement, the assessee-company paid the sum of Rs.1 crore during the financial year 2005-06 and the remaining Rs.4 crores was paid during the financial year 2006-07. The above payment was considered by the TDS Officer as royalty and therefore, held that the assessee-company to be in default for non deduction of tax at source under provisions of section 194J. Therefore, we are called upon to examine whether the impugned payments are in the nature of 'royalty'. The whole case of the TDS officer is that MR has granted the intellectual property rights in respect of software of which he is the owner and transferred certain rights for use of such software in favour of the assessee-company and therefore held that consideration was paid only for the use of intellectual copy rights in software which is nothing but a royalty. The Id.CIT(A) also upheld the action of the TDS officer by holding that by grant of right of first refusal Shri Mohan Raju had parted with his commercial and scientific knowledge and experience, skill in the field of networking in favour of the assessee-company. By holding so, TDS officer as well as the Id.CIT(A) had re-characterized the transaction ignoring the explicit terms contained in the agreement governing impugned payments. In our considered opinion, TDS provisions are only one mode of recovery of taxes. TDS provisions are not

Page 11 of 15

meant to determine the final nature of the transaction or conclusiveness of the transaction. TDS provisions are only tentative. In such circumstances, it is not open for revenue authorities to re-characterize the transaction for the purpose of holding assessee as assessee in default for non-deduction of tax at source. Clause (ba) of Explanation to section 194J specifies that the definition of term 'royalty' shall have the same meaning as assigned in Explanation 2 to clause (vi) of sub-section (1) of section 9 of the Act. The term 'royalty' is defined in Explanation 2 to section 9(1)(vi) as follows:

"Explanation 2.—For the purposes of this clause, "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—

- (i) the transfer of all or any rights (including the granting of a licence) in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property ;*
- (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 ;*
- (iii) the use of any patent, invention, model, design, secret formula or process or trade mark or similar property ;*
- (iv) the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill ;*
- (iva) the use or right to use any industrial, commercial or scientific equipment but not including the amounts referred to in section 44BB;*

Page 12 of 15

- (v) the transfer of all or any rights (including the granting of a licence) 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, but not including consideration for the sale, distribution or exhibition of cinematographic films ; or
- (vi) the rendering of any services in connection with the activities referred to in sub-clauses (i) to (iv), (iva) and (v)."

11. The Finance Act, 2012 has expanded the scope of the term 'royalty' by insertion of Explanations 4, 5 and 6 with retrospective effect from 1/6/1976. Those Explanations are as under:

"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 licence) 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 fibre or by any other similar technology, whether or not such process is secret; "

Page 13 of 15

From the above, it is clear that the definition of the term 'royalty', income of recipient chargeable under the head 'capital gains' is excluded. The consideration which falls within the meaning of the term 'royalty' is the consideration for the (i) transfer of all or any rights in respect of patent invention, model, design, secret formula or process or trade mark or similar property including granting license; (ii) imparting of any information concerning the working of, or use of, a patent, invention, model, design, secret formula or process or trade mark or similar property; (iii) use of any patent, invention, model, design, secret formula or process or trade mark or similar property; (iv) the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill; (v) use or right to use any industrial, commercial or scientific equipment but not including the amounts referred to in section 44AB ; (vi) transfer of all or any rights 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, but not including consideration for the sale, distribution or exhibition of cinematographic films; or (vii) rendering of any services in connection with the activities referred to above.

12. We have discussed in para.10 (supra) in detail the subject matter of the agreement entered by the assessee-company with MR. From the close reading of the above agreement, it is amply

clear that none of the clauses of Explanation 2 to section 9(1)(vi) is attracted to the granting of economic interest of first refusal to the assessee-company by Shri Mohan Raju in any new business initiative. The right envisaged in the agreement is only acquiring the controlling interest in the new initiative of MR. We are unable to discern from the perusal of the agreement, transfer of any rights or use of intellectual property. Therefore, considering the definition given in the Explanation 2 to sec.9(1)(vi) of the Act, the impugned consideration paid to Shri Mohan Raju cannot be treated as royalty. Hence, the question of deducting tax at source under the provisions of 194J does not arise.

13. Since we held that the consideration paid was not in the nature of royalty, the issue relating to the time of accrual of consideration is irrelevant. Hence, we do not deem it necessary to adjudicate upon this ground.

14. Be that as it may, it is worth mentioning here that in the hands of the payee i.e. MR, the impugned payments were already considered as non-compete fee by the AO but on appeal, the appellate authorities quashed the assessment on technical grounds. But the moot point to be noted here is that the amounts were already subjected to assessment in the hands of the payee. The Hon'ble Apex Court, in the case of *Hindustan Coca Cola Beverages P.Ltd. vs. CIT* (293 ITR 226), after referring to circular No.275/201/95-IT(B) dated 29/1/1997 which declares

that no demand visualized u/s 201 of the Act should be enforced after the tax deductor had satisfied the officer in-charge of TDS that tax due have been paid by the deductee, held that once taxes have already been paid by the payee, there was no need to recover the same demand from the person responsible for deducting at source. In the present case, though no taxes have been paid by the payee on the amount, it serves no purpose to enforce demand from the tax deductor as the assessment in the hands of the payee is completed, the demand, if any, can be recovered from the payee under due process of law.

15. In the result, all the appeals of the assessee-company are allowed.

Order pronounced in the open court on this 24th day of February, 2016

sd/-
(VIJAY PAL RAO)
JUDICIAL MEMBER

sd/-
(INTURI RAMA RAO)
ACCOUNTANT MEMBER

Place : Bangalore
D a t e d : 24/02/2016

srinivasulu, sps

Copy to :

- 1 Appellant
- 2 Respondent
- 3 CIT(A)-II Bangalore
- 4 CIT
- 5 DR, ITAT, Bangalore.
- 6 Guard file

By order

Assistant Registrar
Income-tax Appellate Tribunal
Bangalore