

## Supreme Court holds duplication of software is 'manufacture'

In a landmark ruling in the case of Oracle India, the Supreme Court held the process of replication of software from Master copy onto blank discs tantamount to 'manufacture'. The Apex court allowed Oracle India much awaited relief in respect of a tax holiday under section 80IA of the Income tax Act, 1961 ("Act") available for new industrial undertakings engaged in manufacture and processing of goods.

### Facts of the case

Oracle India, a wholly owned subsidiary of Oracle USA, imported master copies of the software for duplication. Oracle India paid a lump sum consideration for import of master copies and in addition, a royalty @30% on the published price of the licensed product, as permitted under the then extant policy of the Indian Government. Though, the retail price was invariably lower than the published price, royalty computation on the published price was in sync with DOT and FIPB objectives to allow higher royalties (to software companies) in an era where there were regulatory constraints on royalty out go.

For the assessment year 1995-96 and 1996-97, the Revenue denied the tax incentive under section 80IA in respect of duplication activity holding the process did not tantamount to manufacture of article or goods. The taxpayer achieved success at the Tribunal and High court level though, the department pursued an appeal before the apex court.

### Question before the SC

The only question for determination before the court in a batch of appeals for different assessment years was - whether the process by which a blank discs is transformed into software loaded disc constitutes "manufacture or processing of goods" in terms of Section 80IA(1) read with Section 80IA(12), as it stood then, of the Act?

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### **Revenue's arguments**

- The chief contention of the Revenue department before the apex Court was that the process of copying of software content from the master copies does not comprise an element of 'manufacture or processing of goods'. The department argued that since the software on the Master Media and the software duplicated on the discs are identical and no new product or good comes into existence in the process, no manufacture or processing of goods is involved in the activity of copying or duplicating; hence, the taxpayer was not entitled to deduction under Section 80IA.
- Further, when the master media is copied on the other distributable mode (blank discs, for example), it is mere clone of the software in the computer and if one compares the contents of the master media with that of the copied discs there is no change in the use, character or name of the software even after the impugned process is undertaken by the taxpayer.

### **Taxpayer's contention**

- On the contrary, the taxpayer contended that it used machinery to convert blank discs into recorded media which along with other processes become a marketable good.
- According to the taxpayer, the master media cannot be conveyed as in its original form, and in order to sub-licence, a copy thereof has to be made. It is the making of this copy that which constitutes manufacture or processing of goods in terms of Section 80IA according to the taxpayer, the blank CD in the present case constitutes raw-material in the process of manufacture of the recorded discs which is a new product distinct from the raw material use.
- The taxpayer, therefore, contended that the process of converting blank discs into recorded media resulted in manufacture of a product and it was eligible for tax incentives under section 80IA for the relevant assessment years.

### **SC ruling**

- The Court held that in interpreting the meaning of the expression "manufacture or processing of goods" for incentive provisions under the Act, the Department must study the actual process undertaken by the taxpayer. It is in the context of specific process applied by the taxpayer that the test of 'manufacture' needs to be seen whenever such issue arises for determination.
- It was held that if an operation /process renders a commodity or article fit for use for which it is otherwise not fit, the operation/ process falls within the meaning of the word "manufacture". Since in the present case, duplication of master media on blank CD renders blank discs fit to a specific use for which it was otherwise not suitable, the duplicating process undertaken by the taxpayer

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would be 'manufacture'.

- The court dismissed the Revenue's argument that the duplicating activity did not involve any manufacture activity since the software on the master media and recorded media was identical. The court relied on its earlier decisions in the case of TCS Ltd (under Sales tax law) (Tata Consultancy Services v State of Andhra Pradesh, 137 STC 620) and Gramophone Ltd's case (under Central Excise laws) (Gramophone Co of India Ltd v Collector of Customs, Calcutta, 114 ELT 770), and held that the moment copies are made from master copy for sale, recorded discs become 'goods' despite the fact that the software embedded in the two media could be identical and copyright in the programme may remain with the originator of the programme.
- Applying the aforesaid principles to the present case, the Court held that a blank disc is different and distinct from a pre-recorded CD and the process by which they become goods would certainly fall within the definition of 'manufacture'. The taxpayer was, hence, eligible to tax incentive for engaging in the manufacturing of goods or article under section 80IA.

## **BMR comments and analysis**

The apex court's decision can be hailed a landmark pronouncement insofar as the Court appears to have certainly taken a liberal interpretation of 'manufacture' in the context of incentive provisions under the Act.

The principle emanating from the decision is also consistent with the Court's views in its recent decision in Arihant Tiles case (ITO vs Arihant Tiles and Marbles (P) Ltd (2009 TIOL 127)) where the Court took a view that the process of bringing into existence a distinct article or product would qualify as 'manufacture', even though the original article may not have undergone a complete transformation.

See BMR comments on [Arihant Tiles case](#)

Moreover, the decision of the apex court is in consonance with the newly inserted definition of 'manufacture' in the Act (inserted by the Finance Act, 2009), which highlights the importance of 'processing' an article to bring into existence a distinct article and does not over-emphasize need for a complete transformation of substance under process. This should, hopefully, reduce the intense litigation surrounding the interpretation of 'manufacture or production', especially in the context of incentives provisions of the Act.

Undoubtedly, principles delivered by the court in recent decisions would be huge relief to the software industry which has been fighting battle with the Tax

administration at different levels; yet, it is suspected that interpretation of other terms of the same specie such as 'processing' or 'production' would continue to be litigated in the absence of a precise definition under the Act.

We also foresee an advantage to the industry in terms of dealing with the ongoing controversy on software income. It would be interesting to see how the favorable ruling and its principles are relied upon in the income characterization controversy

**A copy of the Supreme Court order can be accessed by clicking [here](#).**

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