Deloitte.

Tax Alert | Delivering Clarity

3 March 2021

Payment to non-residents for imported software cannot be characterised as 'royalty' as it amounts to simplicitor purchase of goods, not taxable in India, hence no TDS required

The Hon'ble Supreme Court of India (SC) has rendered its judgment that the amount paid by resident Indian end users/ distributors to non-resident computer software manufacturers/ suppliers, as consideration for the resale/use of computer software, cannot be characterised as 'royalty' (i.e use of copyright in the computer software) under Article 12 of the Tax Treaties (DTAA) as the same amounts to simplicitor purchase of goods and therefore, does not give rise to a liability to deduct any taxes at source (TDS), under section 195 of the Income-tax Act, 1961 (Act).

Background:

- The key issue before the Hon'ble Supreme Court (SC) under the subject appeals, pertains to whether the payments made by resident Indian end users/ distributors to non-resident computer software manufacturers/ suppliers, for the distribution/use of computer software, can be characterised as 'royalty' (i.e use of copyright in the computer software) under section 9(1)(vi) of the Income-tax Act, 1961 (Act) and the Indian Tax Treaties (DTAA), thereby requiring deduction of taxes at source (TDS) under section 195 of the Act?
- The subject litigation around taxability of payments for computer software has arisen on account of the divergent rulings of various courts, primarily, the judgments of the Karnataka High Court (KHC)[1],the Delhi High Court (DHC)[2] and the Authority of Advance Ruling (AAR)[3].
- The SC judgment covers `86 appeals, which can broadly be grouped into four categories of assessees namely –
  - Category 1 - Resident Indian buyers/ end users of computer software who purchase the same directly from a foreign non-resident supplier or manufacturer;
  - Category 2 - Resident Indian traders/ distributors / resellers who purchase computer software from foreign, non-resident suppliers or manufacturers for the purpose of resale to other resident Indian end-users;

---

[1]CIT v. Samsung Electronics Co. Ltd. (2012) 345 ITR 494

[2] DIT v. Ericsson A.B. (2012) 343 ITR 470, DIT v. Nokia Networks OY (2013) 358 ITR 259, DIT v. Infrasoft Ltd (2014) 264 CTR 329 and CIT v. ZTE Corporation (2017) 392 ITR 80

[3] Dassault Systems, K.K, *In Re*., (2010) 322 ITR 125 (AAR) and Geoquest Systems B.V.Gevers Deynootweg, *In Re*, (2010) 327 ITR 1 (AAR)

- Category 3 - Foreign, non-resident vendors, who, after purchasing software from other foreign, non-resident sellers, resell the same to resident Indian distributors or end users; and
- Category 4 – Foreign, non-resident suppliers who affix computer software onto hardware and then sell the same as an integrated unit/equipment to resident Indian distributors/ end users.

- The SC, by way of the said decision, has not only adjudicated on the issue of software taxability, but has also adjudicated on the interplay of the retrospective amendment brought into the definition of 'royalty' under section 9(1)(vi) by the Finance Act 2012 and on the definition as contained in various Tax Treaties (DTAA) entered into by India, with foreign jurisdictions.

Decision of the SC:

Reliance on DTAA at the stage of TDS under section 195

- The SC has upheld the principle that once a DTAA applies, the provisions of the Act can only apply to the extent that they are more beneficial to the assessee and not otherwise. Further, where any term is defined under the DTAA, the definition contained in the DTAA itself has to be looked at.
- The SC has reaffirmed the position laid down in the case of GE Technology Centre Pvt Ltd[4], that the machinery provisions of TDS under section 195 of the Act is inextricably linked with the charging provisions, as a result of which, the TDS obligation arises only when the sum is chargeable to tax under the provisions of the Act, read with the DTAA.
- Reference has also been made to CBDT Circular No 728 dated 30 October 1995, wherein it has been clarified that the tax deductor must take into consideration the effect of the DTAA provisions in respect of payment of royalties and technical fees while deducting taxes at source.
- The SC has rejected the Revenue's reliance on the decision of the SC in the case of PILCOM[5] on the basis that the same was in the context of section 194E (not section 195) which does not have any reference to payments being chargeable to tax under the Act.
- Reliance of the Revenue on Article 30 (entry into force) of the DTAA has also been rejected by the SC for the reason that the same cannot be read out of context and the same was only dealing with the 'entry into force' provisions which is as per the domestic municipal laws.

Discussion on the nature of agreements and End-User License Agreements (EULAs) under the four categories of taxpayers

- The SC, in its judgement, has referred to the following agreements/ EULAs under each of the four categories of assessees as illustrative documents:
  - Category 1 – EULA between Samsung Electronics (non-resident supplier) and the end users;

[4] GE Technology Centre Pvt Ltd Vs CIT (2010) 10 SCC 29

[5] PILCOM Vs CIT (2020 SCC Online SC 426)

- Category 2A – Re-market agreement between IBM Singapore (non-resident supplier) and IBM India (Indian distributor/ re-marketer;
- Category 2B – EULA with Indian end users of software distributed by IBM India
- Category 3 – Standard EULAs accompanying Microsoft software products sold to resident Indian end user by Microsoft Corporation (non-resident foreign vendor)
- Category 4 – Supply contract between Indian company and Swedish supplier (Ericsson Radio Systems AB)

- On an examination of the above agreements/EULAs, the SC has noted that in the case of an Indian distributor:
  - It is evident that the distributor is only granted a non-exclusive, non-transferable license to resell computer software. It is expressly stated that no copyright is transferred either to the distributor or to the ultimate end user.
  - No right has been granted to sub-license or transfer, nor is there any right to reverse engineer, modify, reproduce in any manner otherwise than permitted by the licence to the end user.
  - What is paid for by way of consideration by the distributor in India to the non-resident manufacturer or supplier, is therefore the price of a copy of the computer programme as goods (direct software sale or hardware embedded with software).
  - Importantly, the distributor does not get the right to use the product at all.
- Similarly, in the case of an end user, the SC has noted that:
  - The end user can only use the computer programme by installing it in the computer hardware and cannot reproduce the same for sale or transfer, i.e, no act contrary to the terms imposed by the EULA.
  - The licence granted *vide* the EULA is not a license in terms of section 30 of the Indian Copyright Act, 1957 (CA) but is a licence which imposes restrictions or conditions for the use of the computer software.
- Further, the SC has also rejected the argument of the Revenue that some of the EULAs term the transaction not as a sale but as one of licensing. The SC has noted that it is a settled law that in all such cases, the real nature of transaction must be looked at, by reading the agreement as a whole (i.e the agreement along with EULAs and other accompanying documents in the subject case and not EULA on a standalone basis, for determining the use of term licence).
- Accordingly, the SC has affirmed/ followed the Supreme Court judgment in the case of Sundaram Finance Limited[6] (in the context of looking at the real nature of the transaction) and the decision in

[6] Sundaram Finance Limited Vs State of Kerala ((1966) 2 SCR 828)

the case of Tata Consultancy Services[7] (in the context of a sales tax statute wherein imported computer software was categorised as 'goods'),

Taxability of 'software payments' under the DTAA

- The SC has noted that the list of appeals are concerned with DTAAs among India and 18 other countries (Singapore, UK, USA, etc) which are based on the OECD Model Tax Convention on Income and on Capital, wherein the definition of 'royalties' is substantially similar to that of the OECD Model Tax Convention and that the definition of royalty under the DTAA is exhaustive as it uses the expression 'means'.
- The term 'royalties' refers to payments of any kind received as consideration for "the use of, or the right to use, any copyright" of a literary work.
- Having noted the above, the SC has held that the transfer of all or any rights as mentioned in the CA is a *sine qua non* for the payment to qualify as 'royalty'.

Taxability under the provisions of the Act [specifically, considering the retrospective amendment brought in by Finance Act 2012 to section 9(1)(vi) of the Act]

- The definition of royalty as contained in explanation 2(v) of section 9(1)(vi) of the Act includes the transfer of all or any rights (including the granting of a license) in respect of any copyright, literary, artistic or scientific work. The comma after the word 'copyright' does not fit in because, copyright, in the said section, is spoken of as existing in a literary, artistic or scientific work (SC also noted that this was rectified in the DTC 2010).
- SC noted that the definition under the Act is wider as compared to the definition in DTAA in at least the following three aspects:
  - Consideration includes lumpsum consideration which would not amount to income of the recipient chargeable under the head 'capital gains';
  - Transfer of 'all or any rights' expressly includes the granting of licence in respect thereof; and
  - Such transfer must be 'in respect of' any copyright of any literary work.
- The SC noted that there is no difference between the provisions of Explanation 2 [to section 9(1)(vi) of the Act] and the DTAAs. However, the Revenue strongly relied on the retrospective clarificatory amendments made *vide* Finance Act 2012 (specifically Explanation 4 in the context of computer programme).
- The argument on behalf of the taxpayers that the clarificatory amendment does not alter the definition of royalty under the Act ,as the amendment applies to section 9(1)(vi)(b) and not to the definition of royalty under Explanation 2, has been rejected by the SC.

[7] Tata Consultancy Services Vs State of AP (2005 1 SCC 308)

- However, the SC also rejected Revenue's argument that Explanation 4 is merely clarifying the position of the section as it always stood (since 1 June 1976), on the basis that computer software itself was introduced in section 9(1)(vi) with effect from 1 April 1991. Therefore, quite clearly, Explanation 4 cannot apply retrospectively before the introduction of computer software in the definition, itself. Considering the same, the SC has held that the retrospective amendment to section 9(1)(vi) is not clarificatory of the position as of 1 June 1976, but, in fact, expands the definition with effect from Finance Act 2012.
- The SC has also quoted various other court rulings and stated that the person (as mentioned in section 195) cannot be expected to do an impossible act, namely, apply the expanded definition of royalty (as per the retrospective amendments) for the years (pre-2012) in question in subject appeals i.e., at a time when such explanation was not actually and factually in the statute.

Interplay with the Indian Copyright Act, 1957 (CA)

- In the context of computer software, transfer of 'all or any rights (including the granting of license) in respect of any copyright' as stated in section 9(1)(vi) of the Act, is referable to section 14 and 30 of CA.
- Assuming only the provisions of the Act apply (i.e. assuming the DTAAs do not apply), the expression 'including the granting of a licence' under section 9(1)(vi) would necessarily mean, a licence, in which, transfer is made of an interest in rights, in respect of copyright, namely, parting with an interest in any of the rights mentioned in section 14 of CA.
- The views contained in the rulings of the AAR in Dassault (supra), Geoquest (supra) and the judgements of the DHC in Ericsson (supra), Nokia Networks (supra), Infrasoft (supra) and ZTE (supra) in the context of CA have been upheld by the SC. The apex court has listed the below conclusions that can be derived from the said rulings/judgments:
  - Copyright is an exclusive right, which is negative in nature, being a right to restrict others from doing certain acts.
  - Copyright is an intangible, incorporeal right, in the nature of a privilege, which is quite independent of any material substance.
  - Ownership of copyright in a work is different from the ownership of the physical material in which the copyrighted work may happen to be embodied.
  - Illustratively, purchaser of a book or a CD/DVD becomes the owner of the physical article but does not become the owner of the copyright inherent in the work. Such copyright remains exclusively with the owner.
  - Parting with copyright entails parting with the right to do any of the acts mentioned in section 14 of CA. The transfer of the material substance does not itself serve to transfer the copyright therein.

- The transfer of the ownership of the physical substance, in which copyright subsists, gives the purchaser the right to do with it whatever he pleases, except the right to reproduce the same and issue it to the public.
- A licence from a copyright owner, conferring no proprietary interest on the licensee, does not entail parting with any copyright, and is different from a licence issued under section 30 of CA.
- Where the core of a transaction is to authorise the end user to have access to and make use of the "licensed" computer software product (over which the licensee has no exclusive rights), no copyright is parted with. It makes no difference whether the end user is enabled to use computer software that is customised to its specifications or otherwise.
- A non-exclusive, non-transferable licence, merely enabling the use of a copyrighted product, is in the nature of restrictive condition which is ancillary to such use, and cannot be construed as a licence to enjoy all or any of the enumerated rights mentioned in section 14 of CA.
- The right to reproduce and the right to use computer software are distinct and separate rights, as has been recognised in the decision of State Bank of India[8], the former amounting to parting with copyright and the latter, in the context of non-exclusive EULAs, not being so.

- Thereafter, the SC has also quoted a few rulings in relation to the doctrine of first sale/principle of exhaustion and held that the said rulings show that such doctrine is dependent upon legislation, which either recognises or refuses to recognise this doctrine.
- SC noted that in the context of section 14(d)(ii) of CA (dealing with a cinematograph film), prior to the amendment made in 2012, the distribution right to sell or give on hire or offer for sale or hire, any copy of the film, continued to vest in the copyright owner, regardless of whether such copy had been sold or given on hire on earlier occasion. This manifested the legislative intent against the application of the doctrine of first sale/principle of exhaustion.

  Post 2012, however, the balance between the copyright owner's distribution right and the right of the purchaser to further resale, was tilted in favour of the latter (the words "regardless of whether such copy has been sold or given on hire on earlier occasion" being deleted by the amendment).
- Likewise, when it comes to section 14(a)(ii) of CA, the distribution right subsists with the owner of copyright to issue copies of the work to the public, to the extent such copies are not copies already in circulation, thereby manifesting a legislative intent to apply the doctrine of first sale/principle of exhaustion (as has been found by the High Court of Delhi in Warner Bros).
- Further, the SC has also noted that, like section 14(d)(ii), section 14(b)(ii) (in the context of computer programme), has, after the 1999 Amendment, also deleted the words "regardless of whether such copy has been sold or given on hire on earlier occasions'', thereby, making it clear that the same tilt that had been made in section 14(d)(ii) of CA vide the amendment in 2012 in favour of the purchaser,

[8]SBI v. Collector of Customs, 2000 (1) SCC 727

was also to be found post the 1999 Amendment, in section 14(b)(ii) of CA, in the context of sale of copies of computer software.

- The language of section 14(b)(ii) of CA makes it clear that it is the exclusive right of the owner to sell or to give on commercial rental or offer for sale or for commercial rental, "any copy of the computer programme". Thus, a distributor who purchases computer software in material form and resells it to an end user cannot be said to be within the scope of the aforesaid provision.
- The SC has held that the object of section 14(b)(ii) of CA, in the context of a computer programme, is to interdict reproduction of the said computer programme and consequent transfer of the reproduced computer programme to subsequent acquirers/end users.
- Thus, once it is understood that the object of section 14(b)(ii) of CA is not to interdict the sale of computer software that is "licensed" to be sold by a distributor, but that it is to prevent copies of computer software once sold being reproduced and then transferred by way of sale or otherwise, it becomes clear that any sale by the author of a copy of the computer software to a distributor for onward sale to an end user, cannot possibly be hit by the said provision.
- Further, the distributor cannot use the computer software at all and has to pass on the said software, as shrink-wrapped by the owner, to the end user for a consideration. The distributor's profit margin is that of an intermediary who merely resells the same product to the end user.
- For all these reasons stated above, the SC stated that it cannot accede to the argument made by the Revenue that the distribution of copyrighted computer software would constitute the grant of an interest in copyright under section 14(b)(ii) of CA, thus necessitating the deduction of tax at source under section 195 of the Act.

Interpretation of DTAAs, OECD commentary and Revenue's own understanding

- The SC upheld the principle laid down in Azadi Bachao Andolan[9] that the DTAAs have to be interpreted liberally with a view to implement the true intention of the parties.
- The SC has noted that all the DTAAs have either the OECD Model Tax Convention or the UN Model Tax Convention as their starting point.
- The SC has also highlighted the importance and relevance of the OECD commentary in interpreting the DTAAs and the fact that the OECD commentary has been referred extensively in earlier judgements of SC as well as in several international jurisprudences.
- Quoting extensively from the OECD commentary, the SC highlights the following aspects:
  - Copying the programme onto the computer's hard drive or random access memory or making an archival copy is an essential step in utilising the programme, and therefore, should be disregarded in analysing the character of the transaction for tax purposes.

[9] Azadi Bachao Andolan (2004) 10 SCC 1

- In case of arrangements between a software copyright holder and a distribution intermediary to distribute copies of the programme without the right to reproduce that programme, distributors are paying only for the acquisition of the software copies and not to exploit any right in the software copyrights. Thus, the rights in relation to these acts of distribution should be disregarded in analysing the character of the transaction for tax purposes.

- Rejecting the reliance placed by the Revenue on India's reservations with the OECD commentary, the SC observes that India's position is not clear from the language of the reservations expressed in this context; contrasting it with categorical language used while expressing its reservations in certain other aspects.
- Further, after taking such positions qua the OECD commentary, no bilateral amendment was made by India and the other contracting states to change the definition of 'royalties' in the DTAAs. While several DTAAs (Morocco, Singapore, Mauritius) have been amended subsequent to the reservations expressed, the definition of 'royalties' has not been changed.
- Thus, the SC held that the OECD Commentary on Article 12, incorporated in the DTAAs will continue to have persuasive value as to the interpretation of the term "royalties" contained therein.
- The SC rejected the reliance of the Revenue on the High-Powered Committee Report 2003 and the E-commerce Report 2016 which had proposed Equalization Levy, stating that they are merely recommendatory reports expressing the views of the committee members, which the Government of India may accept or reject. Further, even if the position as per the reports were to be accepted, a DTAA would have to be bilaterally amended before any such recommendation can become law in force.
- SC also refers to the CBDT Circular No. 10/2002 dated 09 October 2002, which prescribed the format for the certificate to be issued by a Chartered Accountant while making foreign remittances wherein a distinction has been made between payment towards royalties and payment towards computer software which is taxable as business income.

Conclusion:

- The SC re-affirms the principle that at the stage of TDS under Sec 195, DTAA can be applied; SC ruling in PILCOM distinguished
- The SC has held that based on the definition of 'royalty' contained in Article 12 of the DTAAs, the distribution agreements/EULAs do not create any interest or right in such distributors/end users, which would amount to the use of or right to use any copyright.
- Since the provisions of the Act (section 9(1)(vi), along with Explanations 2 and 4 thereof), are not being more beneficial to the assessees, the same have no application.
- The 2012 retrospective amendment to the definition of 'royalty' in the domestic law is to be read down as only a prospective amendment (i.e, pre-2012 transactions not subject to TDS)

- Distinction between Copyrighted article and Copyright upheld – follows the Supreme Court Constitution bench judgment in the case of TCS, that classified shrink-wrap/packaged software as goods under the Constitution of India
- The amount paid by resident Indian end users/distributors to non-resident computer software manufacturers/suppliers, as consideration for the resale/use of the computer software through EULAs/distribution agreements, is not the payment of royalty for the use of copyright in the computer software, and that the same does not give rise to any income taxable in India, as a result of which the payers (in all four categories referred to in this judgement) were not liable to deduct any TDS under section 195 of the Act

Comments:

- This SC judgment is a landmark one. The SC has decided a long-standing income-tax litigation in the context of characterisation of payment towards imported computer software for use in business in favour of taxpayers. The litigation is a two-decade old issue between the Indian income-tax department and the industry (goes back to almost the year 1999) who were facing multiple litigations on the same transaction (TDS demands, demands on account of expense disallowance (for want of TDS) and a third demand in the hands of foreign vendors).
- This SC judgment is important not only because it lays to bed a two-decade old litigation, but also clarifies many vital and important aspects in relation to the interplay between the copyright law and the scope of Indian income-tax, when it comes to taxing transactions involving sale/use of copyrighted products, as opposed to transactions granting rights in the underlying copyright itself. The SC has also emphasised on the importance of OECD commentaries while interpreting DTAA.
- This SC judgment will pave way for foreign vendors of computer software to receive payments from Indian customers without TDS, thus addressing the challenges associated with getting foreign tax credit in their home countries.
- Applicability of the Equalization Levy (EQL) – With effect from April 1, 2020, an EQL @2 % was introduced on goods supplied/ services provided/ facilitated by non-residents to India through an electronic platform. A proposed amendment this year states that only those payments which are otherwise not taxable as royalty or fees for technical services, shall be subject to the EQL. Since software license fee is not taxable as royalty now, it should be examined whether the same could be subject to the 2% EQL