THE POWER OF BEING UNDERSTOOD

www.rsmindia.in

Newsflash:

Supreme Court Rules that Payment towards Software not in the nature of Royalty under the Tax Treaties

RSM

Newsflash: Supreme Court Rules that Payment towards Software not in the nature of Royalty under the Tax Treaties

6 March 2021

1.0 BACKGROUND

The Hon'ble Supreme Court this week delivered a judgement for a batch of over 86 appeals on a two-decade old controversy of taxation of payment for software. The Hon'ble Supreme Court held that the amounts paid by the resident Indian end user/ distributors to non-resident computer software manufacturers/ suppliers as consideration for the resale/ use of the computer software is not in the nature of "Royalty" for the use of copyright in computer software. The same, being business income, does not give rise to any taxable income in absence of Permanent Establishment in India and accordingly no consequential liability of withholding tax arises.

At the outset, it is highlighted that the scope of 'royalty' as per the definition in Double Taxation Avoidance Agreement ("DTAA") is narrower as compared to the definition as provided under Income-tax Act, 1961 ("the Act"). While the definition under the DTAA is a restrictive definition and would generally, *interalia* include consideration for use of or the right to use **any copyright** of a literary, artistic or scientific work, including cinematograph films or films or tapes used for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, etc.; the definition of the royalty under the Act is comparatively wider and also covers "transfer of all or any rights (including granting of a license) **in respect of any copyright**, etc.".

The scope of royalty was further expanded retrospectively with effect from 1976 vide Finance Act, 2012 by insertion of Explanation 4 to section 9(1)(vi) of the Act. Relevant extract is reproduced 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."

2.0 POINTS UNDER CONSIDERATION

2.1 Various appeals concerning the issue of taxability of software payments were made before the Supreme Court and since they were identical in terms of facts and background, they were grouped as a batch of appeals. For ease of reference and understanding, they were divided into 4 broad categories:

a) Purchase of Software for end use;
b) Shrink Wrapped Software (Resellers and Distributors);

c) Foreign Sellers; and
d) Embedded Software (Hardware including Software).

2.2 Facts of the case taken are as under:

i) Payer is a resident Indian end-user of shrink wrapped computer software imported from the United States of America ('USA');

ii) For the concerned year, Payer did not withhold tax on the said payment considering the same to be not taxable in India.

iii) On examination of the End-User Licence Agreement ["EULA"] involved in the transaction, it was found that what was sold by way of computer software includes a right or interest in copyright, which gave rise to the payment of royalty and thus is an income deemed to accrue in India under section 9(1)(vi) of the Act.

iv) The tax authorities held that the payment for the said import of software was Royalty and consequential withholding tax liability arises in the hands of the resident payer.

2.3 Issue before the Supreme Court:

Aggrieved of such unfavourable orders, the issue before the Hon'ble Supreme Court was whether the amounts paid to non-resident computer software manufacturers/suppliers (taxpayer), as consideration for the resale/use of the computer software through EULAs/distribution agreements is in the nature of royalty or not?

3.0 TAXPAYER'S CONTENTIONS

3.1 The remarketer agreement/ EULA entered into between the Indian distributors/ purchasers and the non-resident vendors does not give the Indian purchaser any right, title or interest in copyright and other intellectual property owned by the non-resident entity.

3.2 The definition of "royalties" does not extend to derivative products of the copyright, for example, a book or a music CD or software products. Thus, compensation received for the transfer of any derivate of the impugned copyright does not result in taxing the payments as royalty and withholding tax liability does not arise thereon. To corroborate its contentions, the Counsel(s) representing various Taxpayers relied on favourable judicial precedents[1].

[1] TATA Consultancy Services [2005 (1) SCC 308], Dassault Systems (2010) 322 ITR 125 (Aar), Geoquest Systems B.V In Re. [(2010) 327 ITR 1 (AAR)]

3.3 Copyright is an exclusive right: In the EULA being considered, no copyright was being given and only a limited license was provided with no right to sub-lease, lease, make copies, etc.

3.4 As per the Copyright Act, 1957 ["Copyright Act"], there was a difference between a copyright in an original work and a copyrighted article, and that this is recognised in section 14(b) of the Copyright Act, which refers to a "computer program" per se and a "copy of a computer program", as two distinct subjects. The licence to use such computer software was thus incidental to and essential to effectuate the use of the product.

3.5 In the present case, what was resold/ distributed by the Indian Resellers/ distributors was not copyright, but merely a copyrighted article, which constituted goods in the hands of the end-user, without any right to transfer the same.

3.6 Mere nomenclature, such as the use of the term "licence" in the Remarketer Agreement/ EULA, was not conclusive as to the character of the transaction.

3.7 What is granted to the distributor is only a non-exclusive, non-transferable licence to resell computer software, it being expressly stipulated that no copyright in the computer programme is transferred either to the distributor or to the ultimate end-user. Thus, no copyright per se is being transferred.

3.8 Once a DTAA applies, the provisions of the Act can only apply to the extent that they are more beneficial to the non-resident taxpayer and not otherwise.[2]

3.9 Doctrine of First Sale/ Principle of exhaustion[3]: Foreign supplier's distribution rights would not extend to the sale of copies of the work to other persons beyond the first sale i.e. no sale of copyright has happened only distribution rights regarding the copyrighted article is given.

3.10 **Liability of withholding tax under section 195**: Deductions under Section 195 of the Act can be made only after applying the more beneficial definition of royalty under the DTAA. The Indian payers in support of their contention relied on the decision of GE India[4] wherein it was upheld that deduction is necessitated only if the non-resident is liable to pay tax.

---

[2] Azadi Bachao Andolan, (2004) 10 SCC 1

[3] **Doctrine of first sale –** This doctrine limits the copyright owner's right of distribution. What it entails, is that once the copyright owner has parted with a copy of his copyrighted work by means of sale, then successive buyer would be free to re-sell the same without needing permission/s from the copyright owner. The doctrine envisions the re-selling of the copyrighted product by the person who is owner of the copy of the copyrighted product and acquired the same from the copyright owner.
Doctrine of exhaustion – Doctrine of exhaustion provides for the exhaustion of the copyright owner's right to control copies of their work after the first sale by the copyright owner or with their permission. The doctrine restricts the copyright from controlling the trade/distribution of copies of their work after they have received adequate consideration for the copy. These rights also pertain to sale and not transfer of copyright per se.

[4] GE India Technology Centre (P) Ltd. v. CIT, (2010) 10 SCC 29

4.0 TAX AUTHORITIES' CONTENTIONS

4.1 The language of explanation 2(v) of section 9(1)(vi) providing "in respect of any copyright" has to be given a wide meaning. This includes derivative products and not the transfer of copyright per se.

4.2 **Contentions with respect to Copyright**: That since adaptation of software could be made, albeit for installation and use on a particular computer, copyright is parted with by the original owner.

4.3 That only the making of copies or the adaptation of a computer programme from a legally obtained copy for non-commercial, personal use would not amount to infringement, and therefore, where such copies were made for commercial use, the converse would be true.

4.4 **Doctrine of First Sale/ Principle of exhaustion**: In regard to section 14(b)(ii) of the Copyright Act, this doctrine cannot be said to apply insofar as distributors are concerned. This doctrine would have no application inasmuch as this doctrine is not statutorily recognised in section 14(b)(ii) of the Copyright Act. This being so, since the distributors of copyrighted software "license" or sell such computer software to end-users, there would be a parting of a right or interest in copyright inasmuch such "license" or sale would then be hit by section 14(b)(ii) of the Copyright Act.

4.5 To corroborate its contentions the tax authorities relied on favourable judicial precedent[5]. Additionally rulings of Karnataka HC[6] also support the case of tax authorities.

4.6 Provisions of DTAAs are only applicable to non-resident taxpayer at the time of assessment and not open to person deducting tax under section 195 of the Act.

4.7 Being covered by explanation 4 of section 9(1)(vi) of the Act, persons liable to deduct tax under section 195 of the Act ought to have deducted tax at source on the footing that explanation 4 existed on the statute book with effect from 1976. In this regard, the tax authorities relied upon the judgment of the Supreme Court in the case of PILCOM[7] which dealt with section 194E of the Act, for the proposition that tax has to be deducted at source irrespective of whether tax is otherwise payable by the non-resident in India or not.

[5] Citrix Systems Asia Pacific Pty., In Re. [(2012) 323 ITR 1 (AAR)]
[6] Synopsis International ITA Nos. 11-15/ 2008, Samsung Electronics (2012) 345 ITR 494
[7] PILCOM, 2020 SCC Online SC 426

5.0 OBSERVATIONS OF THE HON'BLE SUPREME COURT

5.1 Royalty is defined in a manner (identical/ similar) to the definition contained in Article 12 of the OECD Model Tax Convention. This being the case, the OECD Commentary on the provisions of the OECD Model Tax Convention then becomes relevant. The OECD Commentary has been referred to and relied upon in several earlier judgments[8].

5.2 Recent DTAAs/ Protocols entered by India with countries like Morocco, Switzerland etc. contains the definition of royalty as per OECD without making much change in it.

5.3 A non-exclusive, non-transferable licence, merely enabling the use of a copyrighted product, is in the nature of restrictive conditions which are 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 the Copyright Act, or create any interest in any such rights so as to attract section 30 of the Copyright Act.

5.4 The "licence" that is granted vide the EULA is not a licence in terms of section 30 of the Copyright Act, rather it is a "licence" which imposes restrictions or conditions for the use of computer software. The EULAs do not grant any such right or interest, least of all, a right or interest to reproduce the computer software. 'License' is nothing but sale of a physical object which contains an embedded computer programme, and is therefore, a sale of goods

5.5 The storage of a computer programme per se would not be infringement of Copyright law.

5.6 The right to reproduce a computer programme and exploit the reproduction by way of sale, transfer, license etc. is at the heart of the copyright exclusive right.

5.7 Making of copies or adaptation of a computer program in order to utilize the said computer program for the purpose for which it was supplied, or to make back-up copies as a temporary protection against loss, destruction or damage so as to be able to utilise the computer programme for the purpose for which it was supplied does not constitute an act of infringement of copyright.

5.8 Observations on doctrine of First Sale/ Principle of exhaustion: After construing section 14(b)(ii) of the Copyright Act and amendments over the years, the Hon'ble Supreme Court held that the Doctrine of First Sale and Principle of Exhaustion shall apply in the facts of the present case. It further held that the EULAs and distribution agreement do not grant a license in terms of section 30 of the Copyright Act, but convey title to material object embedded with a copy of computer software.

[8] Azadi Bachao Andolan, (2004) 10 SCC 1, Formula One World Championship Ltd., (2017) 15 SCC 602, E-Funds IT Solution Inc., (2018) 13 SCC 294

5.9 Supreme Court expressly approved judgments of Delhi HC[9] and AAR[10] which were in favour of taxpayers and confirmed the law stated in these judgments.

5.10 Supreme Court noted that all cases pertained to year prior to 2012. It observed that the intent of explanation 4 of section 9(1)(vi), which was inserted in 2012, can't be retrospectively applied to prior cases as the law could not demand the impossible from the payers (i.e. as such intent was not in existence at the time of deduction of tax).

5.11 Given the definition of royalties contained in Article 12 of the DTAAs it is clear that there is no obligation on the persons mentioned in section 195 of the Act to deduct tax at source, as the distribution agreements/EULAs in the facts of these cases 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.

5.12 As has been noted in GE Technology (supra), at the heart of section 195 of the Act is the fact that deductions can only be made if the non-resident is liable to pay tax under the provisions of the Act in the first place. Section 194E deals with withholding tax, without any reference to chargeability of tax. Thus, the judgment of the Supreme Court in the case of Pilcom (supra), dealing with a completely different provision (i.e. section 194E) in a completely different setting, has no application to the facts in the present case.

6.0 CONCLUSION BY THE HON'BLE SUPREME COURT

There is no obligation to withhold taxes under section 195 on amount paid, by resident to non-resident computer software manufacturers/suppliers as consideration for sale of software under distribution agreements/ EULAs. Such 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, as contained in the definition of royalties, defined by Article 12 of DTAAs. Provisions of the Act which deal with Royalty not being more beneficial have no application. This answer shall apply to all four categories of cases enumerated in the foregoing initial paragraphs.

7.0 OTHER SIGNIFICANT ASPECTS TO BE CONSIDERED

7.1 Definition of 'Royalty' under other DTAA's

In the above case, the Supreme Court has clarified that, "*where any term is defined in a DTAA, the definition contained in the DTAA is to be looked at. It is only where there is no such definition that the definition in the Income Tax Act can then be applied*." Accordingly, the

[9] Ericsson AB (2012) 343 ITR 470, Nokia Networks OY (2013) 358 ITR 259, Infrasoft (2014) 264 CTR 329, ZTE Corporation (2017) 392 ITR 80

[10] Dassault Systems (2010) 322 ITR 125, Geoquest (2010) 327 ITR 1

definition of 'Royalty' under the India-US DTAA was to be considered since the definition under the Income Tax was much wider vis-à-vis the India-US DTAA.

Though the provisions defining the term 'Royalty' under various DTAA's may be similar, it may not be identical. The below table brings out significant differences in the said definition:

Source	Definition of 'Royalty
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…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… *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*****."**
India USA DTAA	"Royalties means…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***, including cinematograph films or work on film, tape or other means of reproduction for use in connection with radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, 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"
India UK DTAA	"Royalties means…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***, including cinematography films or work on films, tape or other means of reproduction for use in connection with radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience"
India Singapore DTAA	"Royalties" …means payments of any kind received as a consideration for the use of, or the right to use : (a) ***any copyright of a literary , artistic or scientific work***, including cinematograph film or films or tapes used for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience, including gains derived from the alienation of any such right, property or information
India – Russia	"Royalties" as used in this Article means : (a) payments of any kind received as a consideration for the use of, or the right to use, ***any copyright of a literary,***

DTAA	***artistic, or scientific work, including*** cinematography films or recordings on any means of reproduction for use in connection with radio or television broadcasting, any patent, trade mark, design or model, plan, know-how, ***computer software programme***, secret formula or process, or for information concerning industrial, commercial or scientific experience

In addition to Russia, India's DTAAs with countries such as **Turkmenistan, Romania, Morocco and Trinidad and Tobago** specifically include payments for "use of or right to use computer software" within the definition of the term "royalty". Thus, the case ratio may not hold good when the meaning of "royalty" under DTAA with other countries are differently worded and the ratio of this SC judgement needs to be carefully analysed and applied.

8.0 OUR COMMENTS

The perennial issue surrounding the taxation of payments for software has had a chequered history. The tax authorities have always stood by the stand of taxing the payments from transfer/ purchase of software, on the other hand the taxpayer contends that the payment received is for right to resell/ distribute and not for the transfer of copyright per se. Further, the corresponding issue of tax to be withheld on such payments has also been persistent. The said controversy has now become inert.

It is worth mentioning that Equalisation Levy has also been introduced via Finance Act, 2020 with a view to tax online transactions (including software sale) by non-residents. With the pronouncement of this judgement, while software payments may not attract royalty taxation, however, Equalisation Levy @ 2% may apply and be further examined by the taxpayer.

Numerous taxpayers were under litigation on this issue and Government has collected substantial taxes treating such payments as Royalty. With this favourable ruling of the Hon'ble Supreme Court, it may lead to a situation wherein there could be claim by the taxpayers for refund of such royalties paid and that the Government may be required to refund substantial amounts (along with interest) which it would have collected as Royalty in the past. It would also be interesting to see how the Government would react to this SC judgement.

For further information please contact:

RSM Astute Consulting Pvt. Ltd. |

8th Floor, Bakhtawar, 229, Nariman Point, Mumbai - 400021.

T: (91-22) 6108 5555/ 6121 4444
F: (91-22) 6108 5556/ 2287 5771

E: emails@rsmindia.in

W: www.rsmindia.in

Offices: Mumbai, New Delhi - NCR, Chennai, Kolkata, Bengaluru, Surat, Hyderabad, Ahmedabad, Pune, Gandhidham, and Jaipur.

 facebook.com/RSMinIndia

 twitter.com/RSM_India

 linkedin.com/company/rsm-india

RSM Astute Consulting Pvt. Ltd. (Including its affiliates) is a member of the RSM network and trades as RSM. RSM is the trading name used by the members of the RSM network.

Each member of the RSM network is an independent accounting and consulting firm each of which practices in its own right. The RSM network is not itself a separate legal entity of any description in any jurisdiction.

The RSM network is administered by RSM International Limited, a company registered in England and Wales (company number 4040598) whose registered office is at 50 Cannon Street, London EC4N 6JJ .

The brand and trademark RSM and other intellectual property rights used by members of the network are owned by RSM International Association, an association governed by article 60 et sec of the Civil Code of Switzerland whose seat is in Zug.

This newsflash summarizes the recent Supreme Court judgement pertaining to Taxation of Royalty in case of Software Deals. It may be noted that nothing contained in this newsflash should be regarded as our opinion and facts of each case will need to be analyzed to ascertain applicability or otherwise of the said notification and appropriate professional advice should be sought for applicability of legal provisions based on specific facts. We are not responsible for any liability arising from any statements or errors contained in this newsflash.

6 March 2021

© RSM International Association, 2021