International Tax Updates by Tirthesh Bagadia

Characterization and Taxation of Software Payment - Supreme Court rules in favor of the taxpayers

BRIEF SUMMARY

The taxation of income from the sale of computer software in cross-border transactions has been a contentious issue in India for many years, with the key question being whether such income should be characterized as royalties (triggering an Indian withholding tax) or as sales/business income (triggering no Indian tax in the absence of a permanent establishment).

In a landmark ruling[1], the Supreme Court of India ("**SC**" or "**India Apex Court**") while ruling in favour of the taxpayers has put to rest the controversy on characterization of payments made by Indian residents for use / resale of computer software. The SC held that the amounts 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 End-user Licensing Agreements ("**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.

Accordingly, the SC concluded that the person referred to in section 195 of the Income-tax Act, 1961 (**"Act"**) is not liable to withhold tax.

The SC while dealing with 103 batch appeals for the issue involved, set aside the famous Karnataka High Court ruling in the case of CIT vs. Samsung Electronics Co. Ltd - [2012] (345 ITR 494) which started the debate on the issue of characterization of software payment and their consequential taxability under the Act.

BACKGROUND

- As per the Income Tax Act, "royalty" is defined to mean consideration for the transfer of all or any rights (including the granting of a license) or use of any copyright, literary, artistic or scientific work, patent, invention, model, design, secret formula or process or trade mark or similar property.
- The comparable definition under the DTAAs defines "royalty" to mean consideration for the use of, or the right to use, any copyright of a literary, artistic or scientific work.
- Section 195 of the Act (obligates any person making a payment to a non-resident for any sum chargeable under the Act to deduct income-tax at source ("**TDS**") at the time of payment. Further, as per the provisions of section 90(2) of the Act, the taxability of a non-resident in

[1] ENGINEERING ANALYSIS CENTRE OF EXCELLENCE PRIVATE LIMITED vs. CIT & ANR (CIVIL APPEAL NOS. 8733-8734 OF 2018)

India is governed by the provisions of the Act or the tax treaty entered between India and the country of residence of the non-resident, whichever is more beneficial to such non-resident taxpayer.

- The controversy surrounding the taxation of payments for software concerns the characterization of income in the hands of non-resident taxpayers as either royalties or business profits (subject to tax in India only if the profits are attributable to the recipient's permanent establishment in India). Whereas the Revenue successfully contended in some cases that the consideration paid by resident Indian end-users / distributors to non-resident computer software manufacturers / suppliers software constituted "royalty", the taxpayers were successful in pleading the contrary position in some other cases. The decisions of these lower courts were appealed by the aggrieved parties before the SC. The SC grouped these appeals into four categories based on the business model as under:
- Category 1: Software purchased directly by an end-user from a non-resident supplier.
- Category 2: Software purchased from a non-resident supplier by an Indian distributor and resold to Indian end-users;
- Category 3: Software purchased from a non-resident supplier by a non-resident distributor and resold to Indian distributors or end-users
- Category 4: Software sold as integrated hardware unit by non-resident suppliers to Indian distributors or end-users.

PRINCIPLES LAID DOWN BY THE SUPREME COURT

Whether software payments amount to use of copyright under the Copyright Act, 1957 ("Copyright Act")?

- The SC analyzed the provisions of the Copyright Act, 1957 ("**Copyright Act**") in detail while coming to the conclusion that payment for the resale / use of the computer software through EULAs / distribution agreements, is not the payment of royalty.
- At first, the Court noted that while the term "copyright" is not expressly defined under the definitions section, section 14 of the Copyright Act makes it clear that a copyright is an exclusive right to do or authorize the doing of certain acts in respect of work (which includes literary work and hence, computer software). *Copyright is an exclusive right, which is negative in nature, being a right to restrict others from doing certain acts*. A transfer of copyright would take place only when the owner of the copyright parts with the right to do any of the acts mentioned in section 14 of the Copyright Act. *Such transfer is different from transfer of ownership of the material substance in which the copyright subsists, since there would no transfer of right to reproduce the copy or to do any*

other acts under section 14. The Court also observed that the "right to reproduce" and the "right to use" computer software are two distinct rights as the former would involve a transfer of copyright.

- *The* Court noted that the "license" that is granted vide the EULA, is *not a license in terms of section 30 of the Copyright Act, which transfers an interest in all or any of the rights* contained in sections 14(a) and 14(b) of the Copyright Act, *but is a "license" which imposes restrictions or conditions for the use of computer software*.
- *Use of the term "license" in an EULA / distribution agreement would not be conclusive of its real nature and the agreement must be looked into as a whole.* A non-exclusive, non-transferable "license" that only enables use of the copyrighted product, with imposition of restrictive conditions on use of the product, could not be construed as a license under section 30 to do the acts enumerated in section 14 of the Copyright Act.
- Further, Section 52(1)(aa) of the Copyright Act provides that making a copy of the software for utilization as well as a backup copy for temporary protection by the lawful possessor would not constitute infringement of copyright. In this regard, the Court observed that it would make no difference if the end-user used general software or software customized to its specifications.

Royalty definition under the Act v. DTAA

- The DTAA contains an exhaustive definition of the term "royalty". It includes payment made for the use or right to use any copyright in a literary work. The royalty definition under the Act is different and wider as compared to the royalty definition under the DTAA. The Act refers to consideration paid for transfer of all or any rights, including by way of a license, in respect of any copyright.
- As the license granted to distributors and end users does not create any interest or right in the software, grant of such license would not amount to the "use of or right to use" of copyright and, hence, it would not qualify as royalty under the DTAA.
- The phrase "in respect of" used in the Act means "in" or "attributable to". Thus, in order to qualify as royalty even under the Act, it is a sine qua non that there has to be transfer of all or any rights in a copyright by way of license or otherwise. In a case where there is payment for grant of license, such payment would qualify as royalty only if such license results in transfer of rights in the copyright granted to the owner of a copyright under the Copyright Act.
    - Since the license granted to the distributors and end users did not involve granting of any interest in the

rights of an owner of a copyright, payment made for such license does not qualify as royalty both under the provisions of the Act, as subsisted till 2012, as well as the DTAA.

- The Act was amended in 2012 to provide that transfer of all or any rights includes transfer of all or any rights for use of a computer software. This amendment expands the royalty definition and may not be considered as clarificatory in nature. However, such payments would not qualify as royalty for the purposes of the DTAA.

Observations in relation to interpretation of tax treaties

- The SC made some very interesting observations on interpretation of tax treaties. At the outset, the SC held that tax treaties entered by India should be interpreted liberally with a view to implement the true intention of the parties.
- The Court noted the importance of the Commentary on Article 12 of the OECD Model Tax Convention ("**OECD Model**") and held that the Commentary on OECD Model would have persuasive value with respect to the interpretation of the term "royalties". The Court held that the payers and recipients have a right to know their position and obligations under a treaty and that they could place reliance on the OECD Commentary to understand the same. Further, India's reservations to the commentary would not affect its relevance unless the reservations were incorporated into the treaties through bilateral negotiation with the respective countries. The Court noted that India had entered or amended tax treaties with different countries after expressing its reservation, yet the definition of royalty had not been changed and remained similar to the definition in the OECD Model. Hence, its reservation would not apply as it had not been incorporated in any tax treaty.

Observations in relation to withholding tax provisions

The SC noted that as per section 90(2) of the Act together with the intention of the Act, once a treaty benefit applies, the provisions of the Act would not apply unless they are more beneficial to the taxpayer. Further, it that the definition of a particular term under the ITA would be applicable only when the said term is not defined in the tax treaty. The Court also held that the TDS obligation under section 195 of the ITA is inextricably linked with the charging provisions under sections 9 and 4 of the ITA read with the tax treaty. Hence, the TDS obligation on the payer would only arise if the recipient is liable to pay income tax in India.

WAY FORWARD

- The SC also reiterated that for certainty and clarity, the DTAA provisions aligned to the OECD Model Convention may be interpreted in light of the OECD

Commentary. The SC held that India's position on the OECD Model Convention/Commentary is not decisive, particularly when such positions are not couched in explicit language, and is also not reflected in subsequent DTAAs concluded by India. Taxpayers can accordingly take positions based on the above principle by relying on OECD commentary.

- The decision of the SC constitutes the law of the land and is binding on all and will apply to all pending litigations at different levels. The payers and NRs impacted by the ruling will need to evaluate the way forward and the strategy, including alternatives to get refunds of excess taxes paid with appropriate interest.
- While the Judgement settles the issue on characterization as royalty and taxability under the provisions of Act, the taxpayers may have to examine another question regarding the applicability of the Equivalisation Levy ("EL") on such transactions.

As part of the measures to address the tax challenges posed by the increased digitalisation of the economy, in the Finance Act, 2020 the Government of India has introduced Digital Service Tax by expanding the scope of Equalisation Levy.

As per the Newly inserted provisions of Finance Act 2020, EQL shall be chargeable at the rate of 2% on consideration received or receivable by an 'e-commerce operator' from 'e-commerce supply or services' made or provided or facilitated by it to the following:

- a person resident in India; or
- a non-resident, in below mentioned specified circumstances:
  - sale of advertisement which targets customers resident in India or a customer who access the advertisement through internet address protocol located in India; and
  - sale of data, collected from a person resident in India or from a person who uses internet protocol address located in India;
  - a person who buys such goods or services or both using internet protocol address located in India.

'e-commerce operator' has been defined to mean a non-resident who owns, operates or manages digital or electronic facility or platform for online sale of goods/provision of services or both.

e-commerce supply or services means:

- online sales of goods owned by the e-commerce operator; or
- online provision of services provided by the e-commerce operator; or
- online sale of goods or provision of services or both, facilitated by the e-commerce operator; or
- any combination of the above.

EQL shall not be charged in the following cases:

- e-commerce operator has a PE in India and the e-commerce supply and services is effectively connected with such PE;
- already covered under the existing provisions relating to EQL; or
- sales, turnover or gross receipts of e-commerce operator from e- commerce supply or services is less than INR 2 crore during the previous year.

- *With SC ruling in favour of the taxpayers and characterising the software payment as not Royalty the transaction may still get covered under the newly introduced EL provisions as above. The intention of the Government to tax such transactions under the purview of EL seems very clear from clarification proposed to be inserted by the Finance Bill, 2021 ("**Bill**"). As per the clarification proposed by the Bill, if the consideration received for sale of software is not taxable as royalty under the Act, read with the relevant tax treaty, then such consideration could be taxable under the Equalization ("EL") provisions.*