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INCLUSION OF SOFTWARE PAYMENTS IN THE DEFINITION OF 'ROYALTIES'?

EXCELLENCE PRIVATE LIMITED
VS.
THE COMMISSIONER OF INCOME TAX & ANR
CIVIL APPEAL NOS. 8733-8734 OF 2018 DATED 03.03.2021

I. Important Definitions

1) In India, "software" has been defined under the Income Tax Act, 1961 and the Copyright Act, 1957.

a) **Sections 10A, 10B, and 80HHE of the ITA, dealing with export of computer software defines "computer software" to mean –**

i) any computer programme recorded on any disc, tape, perforated media, or other information storage device; or

ii) any customized electronic data or any product or service of similar nature as may be notified by the Central Board of Direct Taxes, India.

2) Section 2(ffc) of the Indian Copyright Act, 1957 defines "Computer Programme" as a set of instructions expressed in words, codes, schemes, or any other form, including a machine-readable medium, capable of causing a computer to perform a particular task or achieve a particular result. Thus, software necessarily connotes a "programme" in relation to a computer.

II. What's the issue?

1. There have been a lot of ambiguities have arisen regarding the payment made to a non-resident entity for the grant of the use of computer software by a businessman in India for internal business purposes.
2. The Income Tax Department has been treating such payments as royalty and accordingly, bringing the same to tax in India.
3. On the other hand, the assessees who make use of such computer software, have been taking a stand that the aforesaid payment is of the nature of business profits and therefore, the same would not be liable to tax in India, because of the provisions of Article 7 of the Double Taxation Avoidance Agreement (DTAA), entered into between India and several foreign countries.
4. In this connection, the assessees have been taking a stand that the scope of the definition of royalty under section 9(1)(vi) is quite wide, whereas the scope of the definition of royalty under Article 12(3) of the DTAA is restrictive.
5. In this connection, it may also be stated that the Delhi High Court has been adopting a very firm view that the amount received by the assessee under the license agreement for allowing the use of the software is not royalty, because what is transferred is neither the copyright in the software nor the use of the

copyright in the software, but what is transferred is the right to use the copyrighted material or article, which is distinct from the rights in a copyright.

6. The Madras High Court has also followed the aforesaid view adopted by the Delhi High Court.
7. However, the Karnataka High Court has adopted an erroneous view in this regard, **(in the case of Samsung Electronics Co. Ltd)**

Before we proceed to deal with the aforesaid issues in detail, it may be necessary to understand: -

a. The meanings of the terms "Royalty" and "Business profit" and the difference between the two.
b. Characterization of cross-border software payments or payments concerning the import of technical services, as either royalty or business profits or some other head, has always been a contentious issue in India. The underlying point of the question involved herein is that whether such a transaction would amount to a **"transfer of a copyright"** or **"transfer of a copyrighted article"**.

III. History of taxation

1. The applicable rate of taxation on royalty and FTS has always been a matter of debate because of the high difference in rates under the DTAAs and Income Tax Act, 1961.
2. Before 2013, as per Section 115A of the Income Tax Act, 1961, taxation on royalty and FTS was 10 percent on a gross basis.
3. However, the rate was amended by Finance Act, 2013, to 25 percent on a gross basis.
4. Again, the Government of India vide Finance Act, 2015, reverted to the previously applicable rate of 10 percent.
5. The aforesaid rates are exclusive of applicable surcharge and educational cess.
6. However, as per Section 206AA of the Income Tax Act, 1961 (applicable since 1st April 2010), there is a mandatory requirement of furnishing PAN even by a non-resident.
7. In case non-residents do not possess PAN, a higher rate of withholding tax of 20 percent against payments to non-residents would be applicable. Lastly, royalties

and fees for technical services accruing or arising to a foreign company (which has a permanent establishment in India) have been excluded from chargeability of Minimum Alternate Tax (MAT) if the tax payable on such income is less than 18.5% (exclusive of surcharge, education cess, etc.).

8. Hence given the applicable rate is 10%, there will be no MAT on such income.
9. Royalties are not compensation, but consideration for transfer or use of right in intellectual property as also for imparting information.
10. The term "royalties" has been defined as a mode of payment rather than as compensation, regardless of the form, for certain acts, contracts of services.
11. It conceptualizes royalties as any consideration that is received for the transfer of ownership, use, or enjoyment of things, or for the assignment of rights, whose amount is determined based on production, sales, operating, or other units.
12. It may also be stated here that the definition under a Treaty is more restrictive than under
13. Indian Income-Tax Act Since the term "royalties" is defined in the Convention (DTAA), it is generally independent of domestic law.
14. However, though there is a substantial similarity between Article 12 and section 9(1)(vi) of the Indian Income-Tax Act, 1961, the definition of "royalties" under the DTAA is more restrictive in scope than the definition contained in Explanation 2 to section 9(1)(vi).
15. In contrast to the wider expression used in Explanation 2, it is seen that paragraph (3) of Article 12 of the DTAA restricts it to consideration for the use of or the right to use of the enumerated items and for information concerning the industrial, commercial and scientific experience.
16. As already pointed out, the definition of the term "Royalty" under a Treaty is more restrictive than under the Indian Income-Tax Act.
17. In most of the DTAAs, the definition of the term royalty is to be found under Article 12(3) thereof, and the same is reproduced as follows:

"ARTICLE 12 – ROYALTIES 3. The term 'royalties' as used in this Article 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 cinematograph films, any patent, trademark, design, or model, plan, secret formula or process, or

for information concerning the industrial, commercial or scientific experience." *[Emphasis added]*

18. Therefore, it is always advisable for an assessee to opt for the provisions of the DTAA.
19. The reason for this approach is that the provisions of the DTAA override the provisions of the Income-Tax Act, 1961 (the Act).

IV. DTAA Vs. Act !

1. As per the **Circular No.333 [F.No.506 / 42 / 81-FTD], dated 2.4.1982**, It has been laid down, vide the aforesaid Circular of the CBDT that where a DTAA provides for a particular model of computation of income, the same should be followed, irrespective of the provisions of the Income-Tax Act.
2. **Union of India Vs. Azadi Bachao Andolan [2003] 263 ITR 706 (SC),** It was, inter alia, held in the aforesaid judgment by the Supreme Court that no provision of the DTAA can fasten a tax liability, where the liability is not imposed by the Act.
3. If a tax liability is imposed by the Act, the DTAA may be resorted to for negativing or reducing it and; in case of difference between the provisions of the Act and the DTAA, the provisions of the DTAA would prevail over the provisions of the Act.
4. It may be further stated in this context that the future amendments to the Act, not containing non-obstante clauses will not override the provisions of the DTAA. In this regard, a reference may be made to the judgment, in the case of **Sanofi Pasteur Holding SA Vs Department of Revenue and Ors [2013] 354 ITR 316 (AP): 84 DTR 185 (AP),** It was, inter-alia, held in this case that amendments to the Act, not containing non-obstante clauses, do not override the provisions of the DTAA.
5. Further, the treaty provisions are non-derogable. The retrospective amendment brought to the Act by the Finance Act, 2012 [Explanation 2 to section 2(47) and Explanations 4 and 5 to section 9] is not fortified by a non-obstante clause expressed to override tax treaties.
6. Besides, because of the judgment of the Supreme Court in the case of **Union of India Vs Azadi Bachao Andolan [2003] 263 ITR 706 (SC),** the taxability of income was to be governed by the provisions of the DTAA, as they are more beneficial to the assessee.

7. The same was the view taken by Delhi High Court in the case of **DIT Vs New Skies Satellite BV [2016] 133 DTR 185 (Del),** It was held in this case that amendment to section 9(1)(vi) by way of insertion of Explanations 4 to 6, though retrospective, did not affect Article 12 of DTAA between India and Netherlands / Thailand. Amendments to domestic law cannot be read into treaty provisions without amending the treaty itself. Tribunal was, therefore, justified in holding that the income derived by the assessees through data transmission services or from the lease of transponders was not taxable as royalty under section 9(1)(vi) as well as Article 12 of the relevant DTAA.
8. Because of the aforesaid reasons, even the future amendments brought about in the Act, will not impact the provisions of the DTAA.

V. Jurisprudence of Transaction

In this connection, the judgment of the Supreme Court in the case of **Tata Consultancy Services Vs State of Andhra Pradesh [2004] 271 ITR 401 (SC)**, is very relevant.

It was held in this case that: -

a) the test in this regard is not whether the goods are corporeal or tangible property.
b) Even incorporeal or intangible property can be "goods" when put in media for transfer or marketing.
c) The computer software packages are goods. It was also held that transfer of right to use software put in media, amounts to the sale of goods. In this regard, a reference may also be made to the judgment of Delhi High Court, in the case of **DIT Vs Infrasoft Ltd [2013] 96 DTR 113 (Del).**
d) In this case, Delhi High Court has heavily relied upon the aforesaid judgment of the Supreme Court.
e) The aforesaid judgment of the Supreme Court has been discussed in detail in paragraphs 77, 78, 79, 80, 81, 82, and 83 in 96 DTR.
f) The aforesaid paragraphs 81, 82, and part of paragraph 83, which are relevant in the present context, are reproduced as follows:

"81. The Supreme Court in TATA CONSULTANCY CASE (SUPRA) has thus laid down that Computer programs are the product of an intellectual process, but once

implanted in a medium they are widely distributed to computer owners. That a computer program may be copyrightable as the intellectual property does not alter the fact that once in the form of a floppy disc or other medium, the program is tangible, moveable, and available in the marketplace.

82. The Supreme Court has further held that a software program may consist of various commands which enable the computer to perform a designated task. The copyright in that program may remain with the originator of the program. But the moment copies are made and marketed, it becomes goods, which are susceptible to sales tax. Even intellectual property, once it is put on to a media, whether it be in the form of books or canvas (In case of painting) or computer discs or cassettes, and marketed would become "goods". There is no difference between a sale of a software program on a CD/floppy disc from a sale of music on a cassette/CD or a sale of a film on a video cassette/CD. In all such cases, the intellectual property has been incorporated on a media for purposes of transfer. The sale is not just of the media which by itself has very little value. The software and the media cannot be split up. What the buyer purchases and pays for is not the disc or the CD. As in the case of paintings or books or music or films, the buyer is purchasing the intellectual property and not the media i.e., the paper or cassette or disc or CD. The software itself, i.e., the physical copy, is not merely a right or an idea to be comprehended by the understanding.

83. It has been further held that the purchaser of computer software neither desires nor receives mere knowledge, but rather receives a certain arrangement of matter that will make his or her computer perform the desired function. This arrangement of matter, physically recorded on some tangible medium, constitutes a corporeal body. The form of the delivery of the software magnetic tape or electronic transfer via modem- is of no relevance. [Page 166] In sum, once the "information" or "knowledge" is transformed into physical existence and recorded in physical form, it is corporeal property. The physical recordation of this software is not an incorporeal right to be comprehended" [Page 167] At the end of the aforesaid paragraph 83, on page 167, it has been held that in sum, once the "information" or "knowledge" is transformed into physical existence and recorded in physical form, it is corporeal property. The physical recordation of this software is not an

incorporeal right to be comprehended In this connection, it may be emphatically stated that the aforesaid judgment of the Supreme Court, in the case of Tata Consultancy Services Vs State of Andhra Pradesh [2004] 271 ITR 401 (SC), has been followed by Delhi High Court in several judgments on the issue under consideration. The aforesaid judgment of the Supreme Court has also been followed by the Madras High Court, in the case of CIT Vs Vinzas Solutions India P.Ltd [2017] 245 Taxman 289 (Mad).

VI. **Supreme Court View on 'Taxation of payment made for foreign software'**

The Supreme Court dealt with four categories of cases:

A. *The first category deals with cases in which computer software is purchased directly by an end-user, resident in India, from a foreign, non-resident supplier or manufacture*

B. *The second category of cases deals with resident Indian companies that act as distributors or resellers, by purchasing computer software from foreign, non-resident suppliers or manufacturers and then reselling the same to resident Indian end-users.*

C. *The third category concerns cases wherein the distributor happen to be a foreign, non-resident vendor, who, after purchasing software from a foreign, non-resident seller, resells the same to resident Indian distributors or end-users*

D. *The fourth category includes cases wherein computer software is affixed onto hardware and is sold as an integrated unit/equipment by foreign, non-resident suppliers to resident Indian distributors or end-users.*

Synopsis

- Engineering Analysis Centre of Excellence Pvt. Ltd, a resident Indian end-user of shrink-wrapped computer software, directly imported from the United States of America.
- The Assessing Officer found that what was in fact transferred in the transaction between the parties was copyright which attracted the payment of royalty and thus, it was required that tax be deducted at source by the Indian importer and end-user, EAC and it was held liable to pay the amount of Rs 1,03,54,784.

- A bench rejected the argument of the Income Tax Department that, ***'the purchase of software is taxable as income arising out of India.'***
- The Court held that there is no obligation on the persons mentioned in section 195 of the Income Tax 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.
- Therefore, the consequences of Section 201 of the Income Tax Act will not fall on the resident companies for not deducting TDS from foreign software companies.
- The bench was hearing a batch of over 86 appeals which challenged the decisions of various High Courts holding that consideration paid for the purchase of foreign software amounts to 'royalty'.
- No copyright over software given, so payment for user-license agreement does not amount to royalty.
- The Court noted that the End User License Agreements (EULA) of the software do not transfer or assign the copyright over the software.
- What is granted to the distributor is only a non-exclusive, non-transferable license to resell computer software, it is expressly stipulated that no copyright in the computer program is transferred either to the distributor or to the ultimate end-user.
- **"In all these cases, 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.**
- Thus, it cannot be said that any of the EULAs that we are concerned with are referable to section 30 of the Copyright Act, since section 30 of the Copyright Act speaks of granting an interest in any of the rights mentioned in sections 14(a) and 14(b) of the Copyright Act", the judgment authored by Justice RF Nariman observed.

The judgment used the following illustration to explain the point:

A. "If an English publisher sells 2000 copies of a particular book to an Indian distributor, who then resells the same at a profit, no copyright in the aforesaid book is transferred to the Indian distributor, either by way of license or otherwise, since the Indian distributor only makes a profit on the sale of each book.

B. Importantly, there is no right in the Indian distributor to reproduce the aforesaid book and then sell copies of the same.

C. On the other hand, if an English publisher were to sell the same book to an Indian publisher, this time with the right to reproduce and make copies of the aforesaid book with the permission of the author, it can be said that copyright in the book has been transferred by way of license or otherwise, and what the Indian publisher will pay for, is the right to reproduce the book, which can then be characterized as royalty for the exclusive right to reproduce the book in the territory mentioned by the license".

Whether it is 'Sale of goods'?

The Court held that the transaction is similar to **'a sale of goods'** as held by the SC in the case **Tata Consultancy Services v. the State of A.P., 2005 (1) SCC 308.** In this regard, Court pronounced that: -

"What is "licensed" by the foreign, non-resident supplier to the distributor and resold to the resident end-user, or directly supplied to the resident end-user, is, in fact, the sale of a physical object which contains an embedded computer program, and is, therefore, a sale of goods, which, as has been correctly pointed out by the learned counsel for the assessees, is the law declared by this Court in the context of a sales tax statute in "Tata Consultancy Services v. the State of A.P., 2005 (1) SCC 308"

Double Taxation Avoidance Agreement to apply

A. The Court noted that the terms of the Double Taxation Avoidance Agreement (DTAA) with foreign companies will have application in the case. The definition of 'royalty' in DTAAs will have application.

B. Once a DTAA applies, the provisions of the Income Tax Act can only apply to the extent that they are more beneficial to the assessee and not otherwise.

C. Where any term is defined in a DTAA, the definition contained in the DTAA is to be looked at.

D. It is only where there is no such definition that the definition in the Income Tax Act can then be applied.

E. "Given the definition of royalties contained in Article 12 of the DTAAs mentioned in paragraph 41 of this judgment, it is clear that there is no obligation on the persons mentioned in section 195 of the Income Tax 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.

F. The provisions contained in the Income Tax Act (section 9(1)(vi), along with explanations 2 and 4 thereof), which deal with royalty, not being more beneficial to the assessees, have no application in the facts of these cases", the top court said in the 226-page judgment.

High Court judgment overruled

A. In 2011, the Karnataka High Court had held that payment made to foreign company amounted to 'royalty' and therefore the Indian purchaser had an obligation to deduct tax at source under Section 195 of the Income Tax Act **(Commissioner of Income Tax and another v Samsung Electronics Co Ltd).**

B. In this case, a High Court division bench of Justices VG Sabhahit and Ravi Malimath reversed the judgment of the Income Tax Appellate Tribunal which had held that amounts paid to foreign software suppliers were not 'royalty' and that the same did not give rise to any income taxable in India.

C. Following this decision, many cases were decided against Indian software companies, by holding them liable for TDS payment concerning license fee given for use of foreign software.

D. The Supreme Court has set aside the judgment of the Karnataka High Court, mentioned above, and has approved the view taken by the Delhi High Court.

Our View

- ✓ Properly characterizing revenue in a cross-border software transaction and determining the appropriate taxation on such revenue requires the ability to identify the type of transaction that produced the revenue.
- ✓ Royalty revenues generally are treated differently than income derived from sales or exchanges, so a thorough analysis is needed to determine which rights the software purchaser obtains and to what extent the title has been transferred. Income also may be generated from the provision of know-how and services related to computer programs and their development or maintenance.
- ✓ This income may be treated differently from the sale, lease, or licensing of the computer software itself. Income tax treaties also play a significant part in the treatment of cross-border transactions.
- ✓ The withholding rates on different types of income vary from one country to another, and additional complexities arise from a country's tax system itself if value-added tax (VAT) or other indirect taxes exist.
- ✓ Now, with this judgment of the apex court, a long battle comes to an end. The bench has rightly mentioned that A transaction of sale of a software programme is a sale of goods, because of the aforesaid judgment of the Supreme Court, in the case of Tata Consultancy Services.
- ✓ The judgment of the Karnataka High Court, in the case of Samsung Electronics Co.Ltd, does not represent a legal position on this issue.

QUESTIONS ?

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