

Tax Flash News

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Payment to the Malaysian group company for granting access to the SAP system software is not taxable as royalty under the Income-tax Act

Executive summary

The taxation of income from cross-border software transactions has been a contentious issue from many years, with the key question being whether such income is to be characterised as royalty or as business income. The Indian tax authorities have generally been contending that income from sale/license of software programs should be characterised as royalty. However, taxpayers have been contending that only access to standard software without transfer of any copyrights or any other rights of software does not result into royalty income.

Recently, the Bombay High Court in the case of Colgate Palmolive Marketing SDN BHD¹ (the taxpayer) dealt with the issue of taxability of the payment for providing access to the SAP system. The High Court concurred with the Tribunal's decision and held that the payment received by the Malaysian company from the Indian group company for providing the SAP system is not taxable as royalty. The payment for the SAP system does not satisfy the conditions of the royalty provisions of the Income-tax Act, 1961 (the Act). It did not satisfy the conditions of process royalty. Further, the payment was not in respect of any right, property or information, copyright, or transfer of right to use of any computer software.

Facts of the case

- The taxpayer, a Malaysian company, was engaged in the business of marketing, distribution and sale of household products, fabrics, and personal care products in Malaysia. The taxpayer entered into an agreement with an Indian group company (CPI)² for the provision of access of the SAP system.

- In terms of the agreement, the Indian entity made a payment³ for the use of the SAP system and its maintenance and upgradation without deduction of tax at source.
- The Assessing Officer (AO) held that the payments received by the taxpayer for providing the SAP system and services were taxable as 'royalty' under the Act.
- The Income-tax Appellate Tribunal (the Tribunal) held that the receipts cannot be held as royalty under the Act.

High Court's decision

The High Court agreed with the Tribunal's decision that the payment for the SAP system was not in the nature of royalty. Key observations are as follows:

Equipment royalty

- The present case pertains to Assessment Year 1999-2000 when the definition of royalty given in Explanation 2 to Section 9(1)(vi) did not include 'equipment' royalty. The amendment⁴ to include equipment royalty was introduced by the Finance Act, 2001 with effect from 1 April 2002. Therefore, the Tribunal was correct in holding that the payment for the SAP system was not taxable as a royalty.

Process royalty

- The taxpayer had not transferred any right or provided the right to use of any patent, invention, model, design, secret formula or process or trademark or similar property mentioned in Clause (i) and (iii) of Explanation 2 to Section 9(1)(vi).

¹ CIT v. Colgate Palmolive Marketing SDN BHD (ITA No. 171 of 2018) – Taxsutra.com

² Colgate Palmolive (India) Limited

³ For the Assessment Year 1999-2000

⁴ Clause (iva) of Explanation 2 to Section 9(1)(vi)

Payment made by CPI to the taxpayer was to access the SAP system hosted by the taxpayer at its facilities for the exchange of information/data. In fact, the taxpayer did not have the right to distribute the software.

- Further, the taxpayer had not imparted any information to CPI concerning the working of, or the use of, any process or any of the other things⁵ mentioned in Clause (ii) of Explanation 2 to Section 9(1)(vi).
- Explanation 6 to Section 9(1)(vi) clarifies that the expression 'process' includes transmission by satellite, cable, optic fiber or by any other similar technology, whether or not such process is secret. It includes live transmission of programs such as channel feed and not access of the SAP system of the taxpayer as done by CPI. SAP is a standard facility and was used for the input of data and generation of reports. Accordingly, Explanation 6 did not apply to the facts of this case.

Consideration in respect of right, property and information

- CPI had been granted limited access to the SAP system by establishing a communication line at its own cost for the use of data available in the SAP system. The payment made by CPI to the taxpayer was not a consideration in respect of any right, property or information as mentioned in Explanation 5 to Section 9(1)(vi) and therefore, it was not in the nature of royalty.

Copyright and other rights

- The taxpayer had merely given access to the SAP system to CPI for a certain specific purpose. By allowing such access, the taxpayer had not transferred any right or license in respect of any copyright nor was there any supply of or right to use of computer software. The taxpayer had acquired a computer software system for integrated computerised recording, summation, and generation of reports of business transactions in the supply chain. Thus, the provisions of clause (v)⁶ of Explanation 2 to Section 9(1)(vi) could not be applied to such a transaction.

- The Supreme Court in the case of Engineering Analysis Centre of Excellence Private Limited⁷ observed that to apply clause (v) to Explanation 2 to Section 9(1)(vi), it is necessary that there must be a transfer of a right in respect of copyright. The right obtained by CPI was in respect of a copyrighted article and not a copyright because rights obtained by CPI were only for its own use and not for commercial utilisation.
- For applicability of Explanation 4 to Section 9(1)(vi), there has to be a transfer of the right to use computer software. In the present case, the taxpayer had not transferred to CPI the right to use any computer software.

Business income

- The Tribunal was correct in its finding that since the taxpayer did not have a PE in India, income earned by it as business profit would not be taxable in India under Article 7 of the India-Malaysia tax treaty.

Our comments

The Bombay High Court in the instant case has dealt with the various clauses of royalty provisions under the Act while dealing with the taxability of the payment for the SAP system. Important factors analysed by the High Court are whether there was a transfer of copyright, transfer of right to use any computer software, transfer of right or provided right to use any patent, invention, model, design, secret formula or process or trademark or similar property. Taxpayers should consider these aspects while undertaking SAP system-related transactions.

⁵ Patent, invention, model, design, secret formula or process or trademark or similar property

⁶ The transfer of all or any rights (including the granting of a license) 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

⁷ Engineering Analysis Centre of Excellence Private Limited v. CIT [2021] 281 Taxman 19 (SC)

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