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TAX FLASH NEWS

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Income from providing access to computer software is not taxable as royalty

Recently, the Delhi High Court in the case EY Global Services Limited1 (the taxpayer) dealt with the issue of taxability of income from providing access to computer software by a foreign company to a member firm located in India. The High Court held that the income received by UK based entity for providing access to computer software is not taxable as 'royalty' under the provisions of the Income-tax Act, 1961 (the Act) as well as under the India-UK tax treaty (tax treaty). To tax such payments as royalty it is essential to show a transfer of copyright in the software. In the present case, the Indian entity in terms of the Service Agreement merely receives the right to use the software procured by the UK based entity from third-party vendors. These rights do not create any right to transfer the copyright in the software.

Facts of the case

Ernst & Young (EY) UK is a limited liability company engaged in providing technology and other support services and software licences to member firms of the EY network in various countries all over the world. All member firms, including EY UK, use the brand EY. The taxpayer i.e., EY UK has entered into contracts with various third-party vendors for the procurement of various software. It has also entered into a contract with EY member firms to provide support services and/or deliverables. EY India is an Indian company engaged in providing back-office support and data processing services. It has entered into an agreement with the EY UK whereby it receives 'right to benefit from the deliverables and/or Services' from EY UK. The specific services mentioned in the services schedule annexed to the Memorandum of Understanding (MOU) which was rendered by EY UK under service agreement as well as MOU executed between itself and EY India are as follows:

- Common standards and policies - Assisting in the development of common standards and policies, including accounting policies, practices, principles and procedures.

- IT Services - Promoting the adoption, maintenance and development of high quality, common information technology and communication systems by Member Firms and providing advice and assistance in connection with the systems of Member Firms, etc.

- Knowledge - Promoting and establishing global websites (both internet and intranet), establishing projects to capture and disseminate global knowledge and developing or facilitating the development of methodology and techniques which further enhance the knowledge sharing capacity of Member Firms.

Both the entities filed an application before the AAR seeking ruling on the taxability of the amounts received /receivable by EY UK in accordance with the agreement entered into with EY India.

The AAR had held that the consideration received from giving right to benefit from the computer software procured from several third-party vendors (deliverables) was in the nature of royalty under Article 13 of the tax treaty as well as Section 9(1)(vi) of the Act whereas consideration received for giving right to benefit from services was not in the nature of royalty under Article 13 of the tax treaty.

The AAR had observed that the applicant obtains license from third party vendors for all its entities under common control and creates a standard facility to be accessed and used by all entities and in lieu of that it receives consideration based on certain parameters.

[1] EY Global Services Limited v. ACIT [W.P. (C) 11957/2016 & CM 27602/2021, dated 24 November 2021] – Taxsutra.com

This is nothing but commercial exploitation of standard facility created. Therefore, the procurement of computer software from different vendors and providing the same to member firms for consideration was covered within the meaning of royalty under Article 13 of the tax treaty.

The taxpayer challenged the AAR ruling by filing a writ petition before the High Court.

High Court decision

On reference to the decision of the Supreme Court in the case of Engineering Analysis[2], the High Court observed that it is essential to show a transfer of copyright in the software for taxing the payment received by EY UK as royalty. A licence conferring no proprietary interest on the licencee does not entail parting with the copyright. Where the core of a transaction is to authorise the end-user to have access to and make use of the licenced software over which the licencee has no exclusive rights, no copyright is parted with and therefore, the payment received cannot be termed as 'royalty'.

In the present case, the EY India, in terms of the Service Agreement and the MOU, merely receives the right to use the software procured by the EY UK from third-party vendors. The consideration paid for the use of the same therefore, cannot be termed as 'royalty'. In determining the same, the rights acquired by the EY UK from the third-party software vendors were not relevant. What was relevant was the Agreement between the EY UK and the EY India. As the same does not create any right to transfer the copyright in the software, the same would not fall within the ambit of the term 'royalty' as held by the Supreme Court.

The AAR in its ruling had relied on its earlier view in the case of Citrix Systems Asia Pacific Pty Ltd.[3] which was expressly stated to be bad law in the case of Engineering Analysis Centre. Though the Supreme Court in the case of Engineering Analysis Centre was on facts considering the four categories of cases that arose in the appeals before it, it has laid down the law for general application. The law, as laid down by the Supreme Court, when applied to facts of the present case, squarely covers the same in favour of the taxpayers.

The submission made by the tax department relying on the amendment to Section 9(1)(vi) was considered and rejected by the Supreme Court in the case of Engineering Analysis Centre. Accordingly, the AAR rulings[4] were set aside and it was held that the income received by EY UK for providing access to computer software to its member firms of EY Network located in India does not amount to 'royalty' under the provisions of the Act as well as under the tax treaty.

Our comments

Software can be in various forms/model like single/multiple licence model, distribution model, shrink wrap software, customized software, software embedded in hardware etc., and taxability of the same has been a matter of debate before the Courts/Tribunal. There are many conflicting decisions on this subject where key issue is centered around interpretation of the term 'copyright' as cited in Section 9(1)(vi) and the tax treaty to constitute the same as 'royalty'.

In some of the decisions[5], the Courts have drawn a distinction between 'copyright' and 'copyrighted article'. Based on the facts of each case, they have taken a view that it was a mere transfer of a 'copyrighted article' and not rights in the 'copyright' itself, therefore it was not characterised as royalty.

In 2012, the scope of 'royalty' was expanded by insertion of Explanation 4 to Section 9(1)(vi) of the Act. The definition provides that the transfer of rights in respect of any right, property or information includes and has always included the right for use or right to use a computer software including granting of a license. Hence, the computer software was included in the definition and within the scope of the words 'right', 'property' or 'information' as provided under clauses (b) and (c) to Section 9(1)(vi) of the Act. However, the consideration paid for 'computer software' has not been specifically included under the definition of 'royalty' in various Indian tax treaties. The definition of 'royalty' is almost identically worded in majority of Indian tax treaties.

[2] Engineering Analysis Centre of Excellence Private Limited v. CIT [2021] 432 ITR 471 (SC)
[3] Citrix Systems Asia Pacific Pty Ltd., In Re., [2012] 343 ITR 1 (AAR)

[4] dated 10 August 2016
[5] Motorola Inc v. DCIT [2005] 95 ITD 269 (Delhi) (SB), Dassault Systems K.K., In re [2010] 322 ITR 125 (AAR), Tata Consultancy Services v. State of Andhra Pradesh [2004] 271 ITR 401 (SC), DDIT v. Reliance Industries Ltd [2011] 43 SOT 506 (Mum)

Subsequently, the Courts/Tribunal in some of the cases[6] have held that retrospective amendment made in the Act cannot be read into a tax treaty since the tax treaty has not been correspondingly amended in line with the new enlarged definition of 'royalty' under the Act.

The Supreme Court in the case of Engineering Analysis Centre of Excellence Private Limited[7] has 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 distribution agreements, was not in the nature of royalty for the use of copyright in the computer software, and therefore not taxable as royalty under various tax treaties.

The Delhi High court in present case relying on the decision of Engineering Analysis Centre of Excellence Private Limited held that the income received by UK entity for providing computer software access to its member firms located in India is not taxable as 'royalty'.

[6] ADIT v. Baan Global BV [2016] 71 taxmann.com 213 (Mum), ACIT v. Reliance Jio Infocomm Ltd. [2019] 111 taxmann.com 371 (Mum)
[7] Engineering Analysis Centre of Excellence Private Limited v. CIT [2021] 432 ITR 471 (SC)

KPMG in India addresses:

Ahmedabad
Commerce House V, 9th Floor,
902, Near Vodafone House, Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051.
Tel: +91 79 4040 2200

Bengaluru
Embassy Golf Links Business Park,
Pebble Beach, 'B' Block,
1st & 2nd Floor,
Off Intermediate Ring Road, Bengaluru – 560071
Tel: +91 80 6833 5000

Chandigarh
SCO 22-23 (1st Floor),
Sector 8C, Madhya Marg,
Chandigarh – 160 009.
Tel: +91 172 664 4000

Chennai
KRM Towers, Ground Floor,
1, 2 & 3 Floor, Harrington Road,
Chetpet, Chennai – 600 031.
Tel: +91 44 3914 5000

Gurugram
Building No.10, 8th Floor,
DLF Cyber City, Phase II,
Gurugram, Haryana – 122 002.
Tel: +91 124 307 4000

Hyderabad
Salarpuria Knowledge City,
6th Floor, Unit 3, Phase III,
Sy No. 83/1, Plot No 2, Serilingampally Mandal,
Ranga Reddy District,
Hyderabad – 500 081.
Tel: +91 40 6111 6000

Jaipur
Regus Radiant Centre Pvt Ltd.,
Level 6, Jaipur Centre Mall,
B2 By pass Tonk Road,
Jaipur – 302 018.
Tel: +91 141 - 7103224

Kochi
Syama Business Centre,
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682 019.
Tel: +91 484 302 5600

Kolkata
Unit No. 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata – 700 091.
Tel: +91 33 4403 4000

Mumbai
2nd Floor, Block T2 (B Wing),
Lodha Excellus, Apollo Mills Compound, N M Joshi Marg,
Mahalaxmi, Mumbai- 400011
Tel: +91 22 3989 6000

Noida
Unit No. 501, 5th Floor,
Advant Navis Business Park,
Tower-A, Plot# 7, Sector 142,
Expressway Noida,
Gautam Budh Nagar,
Noida – 201 305.
Tel: +91 0120 386 8000

Pune
9th floor, Business Plaza,
Westin Hotel Campus, 36/3-B,
Koregaon Park Annex,
Mundhwa Road, Ghorpadi,
Pune – 411 001.
Tel: +91 20 6747 7000

Vadodara
Ocean Building, 303, 3rd Floor,
Beside Center Square Mall,
Opp. Vadodara Central Mall,
Dr. Vikram Sarabhai Marg,
Vadodara – 390 023.
Tel: +91 265 619 4200

Vijayawada
Door No. 54-15-18E,
Sai Odyssey,
Gurunanak Nagar Road, NH 5,
Opp. Executive Club, Vijayawada,
Krishna District,
Andhra Pradesh – 520 008.
Tel: +91 0866 669 1000

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home.kpmg/in/socialmedia

KPMG Assurance and Consulting Services LLP, Lodha Excelus, Apollo Mills Compound, NM Joshi Marg, Mahalaxmi, Mumbai - 400 011
Phone: +91 22 3989 6000, Fax: +91 22 3983 6000