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TAX FLASH NEWS

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Payment by Indian resident end-users/distributors to non-resident computer software manufacturers/ suppliers for the resale/use of the software is not payment of royalty under various tax treaties - Supreme Court

Recently, the Supreme Court in the case of Engineering Analysis Centre of Excellence Private Limited[1] (the taxpayer) 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 Agreement (EULAs)/distribution agreements, is not payment of royalty for the use of copyright in the computer software under various relevant tax treaties. Accordingly, the same is not liable for deduction of tax at source under Section 195 of the Income-tax Act, 1961 (the Act). The Supreme Court held that on reference to the definition of 'royalty' contained in Article 12 of various relevant tax treaties, it is clear that there was no obligation on the persons mentioned in section 195 to deduct tax at source, as the 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.

Facts of the case

The taxpayer, Indian resident, imported end-user of shrink-wrapped computer software from the USA. During the AY 2001-2002 and 2002-2003, the taxpayer made payment to a non-resident vendor for the purchase of shrink-wrapped computer software without deduction tax at source. The Assessing Officer (AO) held that the taxpayer transferred copyright and hence it was taxable as royalty under the Act as well as under relevant tax treaties. Accordingly, the taxpayer was required to deduct tax under Section 195 on such payment. Since tax was not deducted at source, the taxpayer was liable to pay interest under Section 201(1A). The Commissioner of Income-tax (Appeals) [CIT(A)] dismissed the appeal of the taxpayer. However, the Tribunal held the decision in favour of the taxpayer. The Karnataka High Court held that since no withholding application was made under Section 195(2), the resident Indian importer is liable to deduct tax at source under Section 195(1).

Supreme Court decision

The Copyright Act

Though the expression 'copyright' has not been defined separately in the 'definition' section of the Copyright Act, yet, Section 14 makes it clear that 'copyright' means the 'exclusive right', subject to the provisions of the Copyright Act, to do or authorise the doing of certain acts 'in respect of a work'. Making copies or adaptation of computer programme to utilise or to make back-up copies as a temporary protection against loss, destruction or damage to utilise it, does not constitute an act of infringement of copyright. On reference to the Copyright Act provision, it indicates that the right to reproduce a computer programme and exploit the reproduction by way of sale, transfer, license etc. is at the heart of the said exclusive right. Importantly, no copyright exists in India outside the provisions of the Copyright Act or any other special law for the time being in force, vide Section 16 of the Copyright Act. In short, what is referred in the provisions of the Copyright Act, end-user shrink-wrapped computer software would not amount to reproduction so as to amount to an infringement of copyright. On analysis of EULAs, the Supreme Court held that they do not grant any right or interest, least of all, a right or interest to reproduce the computer software and the licence that is granted by EULA, is not a 'licence' that transfers an interest in all or any of the copyright rights but is a 'licence' that imposes restrictions or conditions on the use of computer software.

End user license agreement and distribution agreement

A reading of various agreements, indicates that what is granted to the distributor is only a non-exclusive, non-transferable licence to resell computer software, it

[1] Engineering Analysis Centre of Excellence Private Limited v. CIT and ANR [CIVIL APPEAL NOS. 8733-8734 OF 2018] - Taxsutra

being expressly stipulated that no copyright in the computer programme is transferred either to the distributor or to the ultimate end-user. This is further amplified by stating that apart from a right to use the computer programme by the end-user himself, there is no further right to sub-license or transfer, nor is there any right to reverse-engineer, modify, reproduce in any manner otherwise than permitted by the licence to the end-user.

What is paid by way of consideration, therefore, by the distributor in India to the foreign, non-resident manufacturer or supplier, is the price of the computer programme as goods, either in a medium which stores the software or in a medium by which software was embedded in hardware, which may be then further resold by the distributor to the end-user in India and the distributor makes profit on such resale.

When it comes to an end-user who is directly sold the computer programme, such end-user can only use it by installing it in the computer hardware owned by the end-user and cannot in any manner reproduce the same for sale or transfer, contrary to the terms imposed by the EULA.

Reference was made to the decision of State Bank of India[2]. Though this decision has been delivered under the Customs Act 1962, yet the important differentiation made between the right to reproduce and the right to use computer software has been recognized by this judgment. Whereas the former would amount to a parting of copyright by the owner thereof, the latter would not.

Definition of the tax treaty vis-à-vis the Act

The definition of 'royalty' under various tax treaties uses the expression 'means' . Secondly, the term 'royalty' refers to payments of any kind that are received as a consideration for the use of or the right to use any copyright in a literary work. However, the definition contained in Explanation 2 to Section 9(1)(vi) of the Act, is wider in at least three respects i.e. (i) It speaks of 'consideration', but also includes a lump-sum consideration which would not amount to income of the recipient chargeable under the head 'capital gains' (ii) When it speaks of the transfer of 'all or any rights', it expressly includes the granting of a licence in respect thereof; and (iii) It states that such transfer must be 'in respect of' any copyright of any literary work.

The insertion of sub-sections (v), (vi) and (vii) in Section 9(1) of the Act, by way of an amendment through the Finance Act 1976 was to introduce source-based taxation for income in the hands of a non-resident by way of interest, royalty and fees for technical services.

It was difficult to accept the tax department's argument that explanation 4 to Section 9(1)(vi) of the Act is clarificatory of the position as it always stood, since 1 June 1976, for which the tax department relied on CBDT Circular[3]. Such a circular cannot apply as it would then be explanatory of a position that existed even before Section 9(1)(vi) was actually inserted in the Act vide the Finance Act 1976. Secondly, insofar as Section 9(1)(vi) of the Act relates to computer software, explanation 3 thereof, refers to 'computer software' for the first time with effect from 1 April 1991, when it was introduced, which was then amended vide the Finance Act 2000. Therefore, clearly, Explanation 4 cannot apply to any right for the use of or the right to use computer software even before the term 'computer software' was inserted in the statute. Thus, Explanation 4 to Section 9(1)(vi) of the Act is not clarificatory of the position as of 1 June 1976, but in fact, expands that position to include what is stated therein, vide the Finance Act 2012.

Whether persons liable to deduct TDS under Section 195 of the Act can be held liable to deduct such sums at a time when Explanation 4 was factually not on the statute book, all deductions liable to be made and the assessment years in question being prior to the year 2012. It was observed that the law does not demand the impossible and when there is a disability that makes it impossible to obey the law, the alleged disobedience of the law is excused. Reference was made to the decision of Supreme Court in the case of Arjun Panditrao Khotkar[4].

It is thus clear that the 'person' mentioned in Section 195 cannot be expected to do the impossible, namely, to apply the expanded definition of 'royalty' inserted by Explanation 4 to Section 9(1)(vi) of the Act, for the assessment years in question, at a time when such explanation was not actually and factually in the statute.

AAR/High Court decisions referred by the Supreme Court

On reference to various decisions[5], the Court made the following observations :

- Copyright is an exclusive right, which is negative in nature, being a right to restrict others from doing certain acts.
- Copyright is an intangible, incorporeal right, in the nature of a privilege, which is quite independent of any material substance. Ownership of copyright in a work is different from the ownership of the physical material in which the copyrighted work may happen to be embodied.
- Parting with copyright entails parting with the right to do any of the acts mentioned in the Copyright Act. The transfer of the material substance does not, of itself, serve to transfer the copyright therein. The transfer of the ownership of the physical substance, in which copyright subsists, gives the

[2] State Bank of India v. Collector of Customs (2000) 1 SCC 727
[3] CBDT Circular No. 152 dated 27 November 1974

[4] Arjun Panditrao Khotkar v. Kailash Kushanrao Gorantyal, (2020) 7 SCC 1
[5] DIT v. Ericsson A.B. [2012] 343 ITR 470 (Del), DIT v. Nokia Networks OY, [2013] 358 ITR 259 (Del), DIT v. Infrasoft Ltd. [2014] 264 CTR 329 (Del), CIT v. ZTE Corporation [2017] 392 ITR 80 (Del)

purchaser the right to do with it whatever he pleases, except the right to reproduce the same and issue it to the public, unless such copies are already in circulation, and the other acts mentioned in the Copyright Act.

- A licence from a copyright owner, conferring no proprietary interest on the licensee, does not entail parting with any copyright, and is different from a licence issued under the Copyright Act, which is a licence which grants the licensee an interest in the rights mentioned in the Copyright Act.
- 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 in the Copyright Act.
- The right to reproduce and the right to use computer software are distinct and separate rights.

Consequently, the view contained in the determinations of the AAR in Dassault and Geoquest, and the decisions of the Delhi High Court in the case of Ericsson A.B., Nokia Networks OY, Infrasoft, ZTE, state the law correctly and these decisions have been expressly approved by the Supreme Court. The views expressed in the aforesaid decisions and determinations also accords with the OECD Commentary on which most of India's tax treaties are based.

Interpretation of tax treaty vis-a-vis OECD commentary

When the definition of 'royalty' is seen in all the tax treaties, it was found that 'royalty' is defined in a manner either identical with or 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.

In the case of New Skies Satellite BV[6] the Court observed that mere positions taken with respect to the OECD Commentary do not alter the tax treaties' provisions, unless it is actually amended by way of bilateral re-negotiation.

It is significant to note that after India took such positions qua the OECD Commentary, no bilateral amendment was made by India and the other Contracting States to change the definition of royalties contained in any of the tax treaties that we are concerned with in these appeals, in accordance with its position.

As a matter of fact, tax treaties that were amended subsequently, such as India-Morocco tax treaty, which was amended on 22 October 2019, incorporated a definition of royalties, not very different from the definition contained in the OECD Model Tax Convention. Similarly, though the India-Singapore tax treaty came into force on 8 August 1994, it has been amended several times, including on 1 September 2011 and 23 March 2017. However, the definition of 'royalties' has been retained without any changes. Likewise, the India-Mauritius tax treaty was entered into on 6 December 1983, and was amended subsequently on 10 August 2016, without making any change to the definition of 'royalty'.

Thus the OECD Commentary on Article 12 of the OECD Model Tax Convention, incorporated in the tax treaties in the instant cases, will continue to have persuasive value as to the interpretation of the term 'royalty' contained therein.

TDS

The Supreme Court in the case of GE technology[7] states that the tax deductor must take into consideration the effect of the tax treaty provisions. A deduction is to be made only if tax is payable by the non-resident taxpayer, the charging and machinery provisions contained in Sections 9 and 195 are interlinked. The decision in the case of Vodafone International Holdings B V[8] was also referred. The person liable to deduct tax is only liable to deduct tax first and foremost if the non-resident person is liable to pay tax, and second, that if so liable, is then liable to deduct tax depending on the rate mentioned in the tax treaty.

The Supreme Court's decision in the case of PILCOM[9], dealing with a completely different provision in a completely different setting, has no application to the facts of this case. That case was dealt with section 194E, for the proposition that tax has to be deducted at source irrespective of whether tax is otherwise payable by the non-resident taxpayer.

Conclusion

As per the definition of 'royalty' contained in Article 12 of various tax treaties, it was clear that there was no obligation on the persons mentioned in Section 195 to deduct tax at source, as the 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.

The provisions contained in the Section 9(1)(vi), along with explanations 2 and 4 thereof, which deal with royalty, not being more beneficial to the taxpayer, have no application in the facts of these cases. The amounts paid by resident Indian end-users/distributors to

[6] Director of Income Tax v. New Skies Satellite BV, (2016) 382 ITR 114 (Del)

[7] GE India Technology Centre (P) Ltd. v. CIT [2010] 10 SCC 29
[8] Vodafone International Holdings BV v. Union of India, (2012) 6 SCC 613
[9] PILCOM v. CIT [2020] 271 Taxman 200 (SC)

non-resident computer software manufacturers/ suppliers, as consideration for the resale/use of the computer software through 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, as a result of which the persons referred to in Section 195 were not liable to deduct any tax.

Our comments

The issue with respect to the taxability of payment for software as a royalty has been a subject matter of debate before the Courts/Tribunal. Software can be in various forms/model like single/multiple licence model, distribution model, shrink wrap software, customised software, software embedded in hardware etc., and taxability of the same has been discussed in various decisions. There have been various conflicting judgements on the subject transaction wherein 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 various decisions[10], the Courts had drawn a distinction between 'copyright' and 'copyrighted article' and had taken the view that when what is transferred is merely a 'copyrighted article' and not rights in the 'copyright' itself, then there is no question of the payment being 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.

Subsequently, the Courts/Tribunal in various cases[11] have held that retrospective amendment made in the Act cannot be read into the tax treaty since tax treaty has not been correspondingly amended in line with the new enlarged definition of 'royalty' under the Act.

The Supreme Court in the present case 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, 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 under the tax treaty. Consequently, the taxpayer was not liable to deduct any tax under Section 195 of the Act.

It is also interesting to note that the Portuguese Supreme Administrative Court[12] had held that the payments by the Portuguese company to the Belgian company for granting license for software did not amount to royalty under the Portugal-Belgium tax treaty

In 2016, the government had introduced Equalisation Levy (EL) at 6 per cent on online advertisement, digital advertising space or any other facility or service. The Finance Act, 2020 broadened the scope of the equalisation levy and introduced a 2 per cent levy on the consideration received or receivable by an e-commerce operator from an e-commerce supply or services. The Finance Bill, 2021 proposed that EL shall not apply if consideration for specified services and for e-commerce supply or services is taxable as Royalty/FTS under the Act read with a tax treaty. Therefore, taxpayers need to evaluate the impact of the Supreme Court decision vis-à-vis EL provisions.

[10] 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)

[11] ADIT v. Baan Global BV [2016] 71 taxmann.com 213 (Mum), ACIT v. Reliance Jio Infocomm Ltd. [2019] 111 taxmann.com 371 (Mum)

[12] Case No. 0621/09, dated 2 February 2011

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