Supreme Court in the case of Engineering Analysis Centre of Excellence Private Limited v. CIT[1] holds that payments made to non-resident computer software manufacturers/ suppliers for the resale/use of the software not taxable as Royalty

Under section 195 of the Act, an obligation is cast on a person making payment to a non-resident of any sum, which is **chargeable under the provisions of the Act**, to deduct tax at the rates in force at the time of payment of such sum or at the time of credit thereof to the account of the payee, whichever is earlier.

Section 5 of the Act, inter alia, specifies that the 'Total Income' of a non-resident shall include (i) Income received or deemed to be received in India, by or on behalf of the non-resident; (ii) Income accruing or arising to the non-resident in India and (iii) Income deemed to be accruing or arising to the non-resident in India.

Section 9(1)(vi) of the Act inter-alia provides that income by way of royalty payable by an Indian resident would be deemed to accrue or arise in India if the royalty is for the purpose of earning any income from any source in India. Explanation 2 to section 9(1)(vi) defines "royalty" to be a 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. In 2012, Explanation 4 was inserted in Section 9(1)(vi) to clarify that the "transfer of all or any rights" in respect of any right, property or information included and had always included the "transfer of all or any right for use or right to use a computer software". 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

The Tax Treaties entered into by India with other countries define "royalty" to mean consideration for the use of, or the right to use, any copyright of a literary, artistic or scientific work. There is no provision like Explanation 4 to section 9(1)(vi)(b) in the Tax Treaty, which artificially expands the scope of the term 'royalty' by providing that transfer of all or any rights includes transfer of all or any right for use or right to use a computer software.

The controversy surrounding the taxation of payments for computer software in international transactions has been a subject matter of extensive litigation for over two decades in India. The bone of contention between the taxpayers and the tax authorities has been in relation to characterization of income from in the hands of non-resident taxpayers as either royalties or

[1] Civil (Appeal) 8733-8734 of 2018 – Batch of 103 appeals

business profits. The tax authorities have generally taken a position that income arising from grant of software license should be characterized as "royalty", irrespective of the nature of rights acquired by the customer. The taxpayer's position, on the other hand, has been that in terms of the tax treaty, income from computer software should be characterized as royalty or business income on the basis of the nature and extent of rights granted to the customer.

There have been divergent rulings of various Indian courts on taxability of software payments:

- **In favour of Revenue:** The Karnataka High Court in the case of **CIT v. Samsung Electronics Co. Ltd: 345 ITR 494 (Kar.)** has held that software payments are taxable as "royalty" if payments made by end users of the computer program who are granted a license to make copies of the computer program for back-up or archiving purpose. Similarly, the Authority for Advance Rulings (AAR) in the case of **Citrix Systems Asia Pacific Pty. Ltd. 343 ITR 1 (AAR)** has held that payment towards software in a distribution arrangement is taxable as royalty since it is not possible to divorce software from the intellectual property of the creator of the software embedded therein and sale or licensing for use of copyrighted software amounts to the grant of a right to use a copyright.

- **In favour of taxpayer:** The Delhi High Court in the case of **DIT vs. Ericsson A.B.: 343 ITR 470 (Del.)** and the AAR in the case of **Dassault Systems K.K.: 322 ITR 125 (AAR)** ruled in favor of taxpayers by emphasizing on the distinction between acquisition of a "copyright right" and a "copyrighted" article. It was held that the license granted by the taxpayer was limited to those rights that are necessary to enable the licensee to operate the program. Hence, there is no transfer of copyright or right to use the copyright to characterize the same as royalty under the Act or the Treaty.

  Reiterating the above principle, the Delhi High Court in the case of **DIT vs. Infrasoft Ltd.: 264 CTR 329 (Del.)** on the issue as to whether the retrospective amendment in section 9(1)(vi) vide Finance Act, 2012 can be read into the tax treaty, 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 amendment made in the definition of 'royalty' under the Act.

Considering the divergent views of the Courts, the taxpayer/ Revenue moved the Supreme Court and the Court in the case of Engineering Analysis Centre of Excellence Private Limited v. CIT (supra) while setting aside the ruling of the High Court of Karnataka in case of CIT vs Samsung Electronics Co. Ltd (supra) and the AAR in case of Citrix Asia Pacific Pty. Ltd., In Re (supra), ruled in favour of the taxpayer by holding that the payment made to non-resident computer software suppliers 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.

A summary of the decision of the Supreme Court is as under:

Facts of the case:

The Supreme Court categorized the batch of appeals into following four categories of software payments:

- Category 1 – Sale of software directly to an end user by a non-resident
- Category 2 – Sale of Software by a non-resident to Indian distributors for resale to end customers in India
- Category 3 – Sale of software by a non-resident to a foreign distributor for resale to end customers in India
- Category 4 – Software bundled with hardware and sold by foreign suppliers to Indian distributors or end users

(a) Whether payment is for transfer of copyright or use of copyright:

A copyright means an exclusive right to do or to authorize to do certain acts in respect of a "work", including an exclusive right, inter alia, to reproduce the copyright in the work in any material form and exploit the same by way of sale, transfer or license etc. 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.

A computer program (software) qualifies as a "literary work" for the purposes of the Indian Copyright Act (ICA). As per Section 30 of the ICA, the owner of copyright in a "literary work" is entitled to grant any interest in his rights by way of a license in return for a royalty payment. In cases where a license is granted, an infringement of copyright under the ICA would take place only when there is any use of the rights contrary to the license so granted.

The Supreme Court analysed the meaning of the term royalty under the Act and relevant tax treaties along with various decisions of the Courts[2] and derived following conclusions:

(i) Copyright is an exclusive right, which is negative in nature, being a right to restrict others from doing certain acts.

(ii) Copyright is an intangible, incorporeal right, in the nature of a privilege. 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. For example, purchaser of a book or a

[2] DIT v. Ericsson A.B. 343 ITR 470 (Del), DIT v. Nokia Networks OY: 358 ITR 259 (Del), DIT v. Infrasoft Ltd: 264 CTR 329 (Del), CIT v. ZTE Corporation: 392 ITR 80 (Del)

CD/DVD, who becomes the owner of the physical article, but does not become the owner of the copyright inherent in the work, such copyright remaining exclusively with the owner.

(iii) The transfer of the ownership of the physical substance, in which copyright subsists, gives the 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 section 14 of the Copyright Act.

(iv) Where the core of a transaction is to authorize the end-user to have access to and make use of the "licensed" computer software product over which the licensee has no exclusive rights, no copyright is parted with and consequently, no infringement takes place, as is recognized by section 52(1)(aa) of the Copyright Act. It makes no difference whether the end-user is enabled to use computer software that is customised to its specifications or otherwise.

(v) A non-exclusive, non-transferable licence, merely enabling the use of a copyrighted product cannot be construed as a licence to enjoy all or any of the enumerated rights mentioned in section 14 of the Copyright Act [State Bank of India (SBI) v. Collector of Customs: 1 SCC 727]

Making a copy or adaptation of a computer program in order to utilize it for the purpose for which it was supplied, making back-up copies as a protection against loss, does not result in infringement of copyright under the Copyright Act. Even storage of computer program, per se, would not result in infringement. Nomenclature of the agreement does not matter and what is relevant is the real nature of the transaction having regard to the overall terms of the agreement and surrounding circumstances.

In the present appeals, the terms of some sample agreements with the distributor and end users of the software were as follows:

- Distributors were granted a nonexclusive, non-transferable license to resell computer software to end users.
- Distributors did not have a right to use the software
- The agreement specifically stated that the copyright in the software was not transferred, either to the distributor or to the ultimate end user
- End users were allowed only to use the software and they were restricted from sub-licensing, transferring, reverse engineering, modifying, or reproducing the software

The Court held that what is "licensed" by the 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. Such sale of goods does not involve transfer of a copyright in the software. Reliance in this regard was placed on the decision of the Supreme Court in the case of Tata Consultancy Services: 2005 (1) SCC 308.

(b) Meaning of royalty under the Act or the tax treaty whichever is more beneficial:

The term 'royalty' is exhaustively defined under the Tax Treaties to 'mean' payment made for the use or right to use any copyright in a literary work. Meaning of the said term under the Act is different and wider than the Tax Treaty inasmuch as transfer of all or any rights includes granting of a license, in respect of any copyright of any literary work.

Since 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 Tax Treaty.

The Court further observed that 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. 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 Act (upto 2012) as well as the Tax Treaty.

Explanation 4 to section 9(1)(vi) inserted by the Finance Act, 2012, to provide that transfer of all or any rights includes transfer of all or any rights for use of a computer software, expands the definition of royalty and may not be considered as clarificatory in nature. Moreover, since the definition of royalties under the Tax Treaty is narrower and more beneficial, the provisions of the Act would not be applicable and there would be no obligation to withhold taxes under section 195 of the Act.

Revenue had sought to rely on the decision of the Supreme Court in **PILCOM v. CIT: 271 Taxman 200 (SC)** which dealt with section 194E of Act for the proposition that tax has to be deducted at source irrespective of whether tax is otherwise payable by the non-resident assessee. The Supreme Court observed that acceptance of such contention of the Revenue would lead to absurd results since taxes would have to be withheld even where the income is not chargeable to tax in India which is not the intent of the legislature. Accordingly, the said decision has no application to the case wherein withholding tax obligations are to be determined in terms of section 195 of the Act.

(c) Retrospective amendment – Impossibility of performance of withholding tax obligations:

Explanation 4 to section 9(1)(vi) inserted by the Finance Act, 2012 (with retrospective effect from 1 June 1976) expands the definition of "royalty" under the Act. A person who made a payment prior to 2012 cannot be expected to apply the expanded definition of royalty which was not in existence at the time of making payments to determine withholding obligations under section 195 of the Act. The substantive amendment to the Act does not compel a person to do the impossible i.e., when there is a disability that makes it impossible to obey the law, the alleged disobedience of the law is excused[3].

(d) Relevance of OECD Commentaries and India's positions on the OECD Commentary:

Definition of "royalty" under the Tax Treaties is similar to the definition of royalty under the OECD Model Convention. Hence, reference may be made to the OECD Commentary which also provides that making a copy or adaptation of a computer program to enable the use of the software for which it was supplied does not constitute royalty. This also supports that the payment made by distributors and end users does not qualify as royalty.

Even though the Indian Government has expressed its reservations on the OECD commentary dealing with royalty, such reservations to the commentary would not affect its relevance unless the reservations were incorporated into the treaties through bilateral negotiation with the respective countries[4]. The Court observed that India had entered or amended tax treaties with various countries after expressing its reservation, yet the definition of royalty had not been changed and remained similar to the definition in the OECD Model Convention. Therefore, the OECD Commentary on Article 12 of the OECD Model Convention will continue to have persuasive value as to the interpretation of the term "royalties" contained in the Tax Treaties.

Conclusion:

In terms of Article 12 of the relevant Tax Treaties, the payments made by resident Indian end-users/distributors to non-resident computer software manufacturers/ suppliers, as consideration for the resale/use of the computer software through EULAs/distribution agreements, does not constitute royalty since the payment is not for the use of or the right to use copyright in the computer software. Accordingly, in terms of section 195 of the Act, the payer is not required to withhold tax at source at the time of making payments to the non-resident supplier.

Our comments:

The controversy surrounding the taxation of payments for computer software in international transactions has been a subject matter of extensive litigation for over two decades in India. Ruling of the Supreme Court in a batch of appeals involving cases of IBM India, Samsung Electronics, GE India, Hewlett Packard India, Mphasis of the world, is a welcome respite. In its succinct and well-reasoned decision the SC has settled the vexed issue of characterization of payments to non-resident vendors for import of software licenses for use or resale in India, holding as business profits as opposed to royalty and hence in absence of a PE not taxable, as per the source rule in India - a view which is also aligned to the international understanding.

[3] Arjun Panditrao Khotkar v. Kailash Kushanrao Gorantyal, (2020) 7 SCC 1
[4] New Skies Satellite BV vs. DIT: 382 ITR 114 (Del.)

The Court also laid down that definition of royalty under section 9(1)(vi) of the Act, which was expanded vide Finance Act, 2012 (with retrospective effect from 01.04.1976) is not clarificatory in nature and withholding tax liability cannot be fastened on the payer pursuant to a substantive legislative change (with retrospective effect) which did not subsist at time of payment by the payer.

Supreme Court also emphasizing on the importance of OECD commentary in interpreting the Treaties observed that the reservations expressed by the Indian Government may not affect the application of the tax treaties unless the reservations are incorporated therein. This requirement of bilateral negotiation and incorporation of changes will safeguard the assessee from any unilateral amendment made by the Indian Government.

To take the benefit of the aforesaid decision of the Supreme Court, the taxpayers (who have paid taxes on software by treating the same as royalty), in whose cases litigation is pending before the appellate authorities, may move an application for admission of additional ground and seek necessary relief from the said authorities. In cases where no litigation is pending then the taxpayer may consider moving refund application before the assessing officer. However, it may be noted, if the income, ie. consideration received for sale of software, is not taxable as royalty under the Act read with the relevant tax treaty, the same may be subject to Equalisation Levy.

The ratio decidendi of the aforesaid decision may also apply to payments made for subscription of database or for satellite bandwidth charges and assist taxpayers in ongoing disputes.

For any further clarification, please write to:

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