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Direct Tax Alert

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Supreme Court decides on the issue of taxation of payment for purchase of software from foreign companies in favour of taxpayers

Amounts paid by resident Indian end-users/distributors to non-resident computer software manufacturers/suppliers, as consideration for the resale/use of the software, held as not "royalty" under the Tax Treaties. Supreme Court has held that software payments do not give rise to any income taxable in India and accordingly there is no liability to withhold taxes on such payments.

The Supreme Court[1] of India has finally put to rest the litigation surrounding the taxation of payments for purchase of software in terms of the characterisation of income in the hands of non-resident taxpayers and consequential withholding tax obligation by the resident deductors. The decision which was awaited eagerly and expected to have significant impact has been pronounced by the Supreme Court of India after hearing a batch of appeals. The core of the litigation was whether software providers were paid for a copyrighted article or for the use or right to use a copyright and accordingly therefore whether the payment should be characterised as 'royalty' or not.

The Karnataka High Court in a batch of appeals reported as *CIT v. Samsung Electronics Co. Ltd*[2] *[320 ITR 209]* had held in favour of the Revenue that the payment for 'software' amounted to 'royalty' and hence constituted taxable income deemed to accrue in India under section 9(1)(vi) of the Income-tax Act, 1961 ('the Act') requiring

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

[2] [2012] 345 ITR 494 (Kar)

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deduction of tax. This was subsequently relied on by the High Court in other cases and many of those were challenged before the Supreme Court.

A series of judgements in the High Court of Delhi including *Infrasoft Ltd*[3], *Ericsson A. B*[4] had held such payments to not be in the nature of royalty, contrary to the decision of the Karnataka High Court. Revenue was in appeal against the said orders before the Supreme Court.

The Supreme Court had categorized the batch of appeals into 4 categories, and in all 4 categories held in taxpayers' favour:

- Purchase of software by resident end user;
- Purchase of software by resident distributor/ reseller;
- Purchase of software from a non-resident distributor/ reseller; and
- Purchase of software embedded in hardware sold as integrated unit by resident end user/ distributer/ reseller.

Ruling of the Supreme Court

The Supreme Court has held that the distribution agreements/ End User Licensing Agreement ('EULA') in these cases did not create any interest or right for such distributors/end-users, **which would amount to the use of or right to use any copyright**.

Transfer of Copyright vis-à-vis right in/ use of copyright

The Supreme Court analysed the definition of 'royalty' under the Double Taxation Avoidance Agreement ('DTAA') and the Act along with the various precedents from different fora and agreed with the following conclusions of the various Courts:

- Copyright is an exclusive right which includes right to restrict others from doing certain acts.
- 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.
- A copyright can said to be transferred if the right to do any of the acts mentioned in section 14 of the Copyright Act is also transferred.
- 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 payment for the same cannot be regarded as royalty.
- A non-exclusive, non-transferable license, merely enabling the use of a copyrighted product cannot be construed as a license to enjoy all or any of the enumerated rights.
- The right to reproduce and the right to use computer software are distinct and separate rights.

While observing the above, the Supreme Court makes it clear that the ownership of copyright in a work is different from the ownership of the physical material in which the copyrighted work may happen to be embedded.

The Revenue further argued that sale of computer software could constitute grant of interest in a copyright by virtue of Section 14(b)(ii) of the Copyright Act. However, the Supreme Court held that the EULAs and the distribution agreements conveys title to the material object embedded with a copy of the computer software to the distributors/end-users and did not accede to the argument of the Revenue.

[3] [2014] 264 CTR 329 (High Court, Delhi)

[4] [2012] 343 ITR 470 (Del)

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The Supreme Court has held that the "licence" that is granted *vide* the EULA, is not a licence 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 "licence" which imposes restrictions or conditions for the use of computer software.

Applicability of DTAA provisions which are beneficial to the taxpayer

The Supreme Court has held that the said payments do not fall within the ambit of the definition of "royalty" under the DTAA. The Supreme Court has also held that where the definition of royalties contained in the DTAAs are beneficial, *vis-à-vis* the provisions of the Act (section 9(1)(vi), along with Explanations 2 and 4 thereof), **the provisions of the Act would not have an application** and there would be no obligation to withhold taxes under section 195 of the Act.

Further, it has been upheld that deduction at source is only to be made if the non-resident is liable to pay tax under the charging provision contained in section 9 read with section 4 of the Act, read with the DTAA.

Revenue had sought to rely on the decision of the Supreme Court in *PILCOM v. CIT, West Bengal-VII*[5], 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 has held that the decision is on a completely different provision in a completely different setting and has no application to the facts of this case.

Impact of retrospective amendment to section 9

In connection to expansion of the definition of "royalty" by insertion of Explanation 4 with retrospective effect, it has been held that "person" mentioned in section 195 of the Act 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, at a time when such Explanation was not actually and factually in the statute.

Sale of goods

The Supreme Court has held 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 programme, and is therefore, a sale of goods. This is basis law declared by the Supreme Court in *Tata Consultancy Services v. State of A.P.*[6], which has been correctly pointed out by the learned counsel for the assessees.

The Supreme Court also concluded that the Revenue has in the past itself appreciated the difference between the payment of royalty and the payments towards computer software in the form of goods. While drawing this conclusion, the Supreme Court relied on particulars required to be furnished in NOC in Annexure B as per Circular No. 10/ 2002 dated October 9, 2002.

Interpretation of DTAAs and reliance on OECD Commentary

- The Supreme Court observed that the OECD commentary on royalty payments under Article 12, is instructive, which states that rights in relation to copy of a software which is

[5] [2020] 271 Taxman 200 (SC)

[6] [2004] 271 ITR 401 (SC)

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just to enable the effective operation of the program by the user, should be disregarded in analysing the character of the transaction for tax purposes. The commentary further states that the rights acquired by a distributor to distribute the software (except the right to reproduce the software), should be disregarded in analysing the character of the transaction for tax purposes.

- Even though the Government of India has expressed its reservations on the OECD commentary dealing with royalty, or taken positions, the Supreme Court has held that OECD Commentary on Article 12 of the OECD Model Tax Convention, incorporated in the DTAAs, will continue to have persuasive value as to the interpretation of the term “royalties” contained therein.

Dhruva Comments

With this decision, the Supreme Court has put to rest a long pending issue, which is a welcome relief. The payment for purchase of computer software from countries with which India has a DTAA as covered in the decision, stands settled.

The observation on the non-applicability of decision of *PILCOM* assuages the apprehensions of the various taxpayers in relation to payments covered under section 195 of the Act.

Taxpayers would need to keep an eye out and evaluate the interplay of this development with the provisions of Equalisation Levy. In the Union Budget 2021, it was proposed that transactions which are taxable as “Royalty” or “Fees for technical services” under the Act read with DTAA will not be subjected to Equalisation levy.

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Follow us on:

ADDRESSES

Mumbai
One World Center, 11th floor,
Tower 2B, 841, Senapati Bapat Marg,
Elphinstone Road (West),
Mumbai 400013
Tel: +91 22 6108 1000 / 1900

Ahmedabad
B3, 3rd Floor, Safal Profitaire,
Near Auda Garden,
Prahladnagar, Corporate Road,
Ahmedabad 380015
Tel: +91-79-6134 3434

Bengaluru
Prestige Terraces, 2nd Floor
Union Street, Infantry Road,
Bengaluru 560001
Tel: +91-80-4660 2500

Delhi / NCR
101 & 102, 1st Floor, Tower 4B
DLF Corporate Park
M G Road, Gurgaon
Haryana 122002
Tel: +91-124-668 7000

Pune
305, Pride Gateway, Near D-Mart, Baner,
Pune 411 045
Tel: +91-20-6730 1000

Kolkata
4th Floor, Unit No 403, Camac Square,
24 Camac Street, Kolkata
West Bengal 700016
Tel: +91-33-66371000

Singapore
Dhruva Advisors (Singapore) Pte. Ltd.
20 Collyer Quay, #11-05
Singapore 049319
Tel: +65 9105 3645

Dubai
WTS Dhruva Consultants
U-Bora Tower 2, 11th Floor, Office 1101
Business Bay P.O. Box 127165
Dubai, UAE
Tel: + 971 56 900 5849

KEY CONTACTS

Dinesh Kanabar
Chief Executive Officer
dinesh.kanabar@dhruvaadvisors.com

Mehul Bheda (Mumbai/Ahmedabad)
mehul.bheda@dhruvaadvisors.com

Ajay Rotti (Bengaluru)
ajay.rotti@dhruvaadvisors.com

Vaibhav Gupta (Delhi/NCR)
vaibhav.gupta@dhruvaadvisors.com

K. Venkatachalam (Pune)
k.venkatachalam@dhruvaadvisors.com

Aditya Hans (Kolkata)
aditya.hans@dhruvaadvisors.com

Mahip Gupta (Singapore)
mahip.gupta@dhruvaadvisors.com

Nimish Goel (Dubai)
nimish.goel@dhruvaadvisors.com

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