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Supreme Court provides clarity on payments for software to non-residents

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Summary

The issue of taxation on software payments has been a subject matter of extensive debate and litigation for over two decades in India. The major dispute has been whether payments made for the acquisition of off-the-shelf software is for copyright or copyrighted article and accordingly will it be subject to tax as royalty. Giving finality to this issue, the Supreme Court (SC) in a batch of appeals, involving around 80 taxpayers, pronounced its judgment earlier this week.

It held that the amount 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 licence agreement (EULA)/distribution agreements, cannot be classified as 'royalty' payment made for the use of copyright in the computer software. Hence, it does not give rise to any income taxable in India and accordingly, no tax is required to be withheld at source (TDS) at the time of making such payments.

The SC also held that the above ruling would apply to the following categories of transactions:

1. Cases in which computer software is purchased directly by an end-user who is resident in India, from a foreign non-resident supplier/manufacturer.
2. Cases where resident Indian companies act as distributors or resellers, by purchasing computer software from foreign non-resident suppliers/manufacturers and then resell the same to resident Indian end-users.
3. Cases wherein the distributor happens to be a foreign non-resident vendor, who after purchasing software from a foreign non-resident seller, resells the same to resident Indian distributors or end-users
4. Cases wherein computer software is affixed onto hardware and is sold as an integrated unit/equipment by foreign non-resident suppliers to resident Indian distributors or end-users.

Key observations of the SC

On the Act

- The SC went through the structure of the Income-tax Act, 1961 (the Act) and reiterated[1] that once a tax treaty applies, the provisions of the Act can only apply to the extent that they are more beneficial to the taxpayer and not otherwise. It also observed that only when a particular term is not defined in the tax treaty, the definition in the Act can be applied.
- As regards responsibility to withhold tax at source, the SC reiterated that TDS liability does not arise when the recipient is not liable to pay income tax in India, i.e. when there is no income chargeable to tax in India.
- The SC rejected the revenue's reliance on the decision of PILCOM[2] stating that the said decision was dealing with a completely different provision[3] in a completely different setting and has no application to the facts of this case.

On the Copyright Act, 1957 (Copyright Act)

- The SC went through relevant provisions of the Copyright Act and noted that a computer programme is classifiable as a literary work. As regards meaning of the term copyright, the SC noted that although the term has not been defined but the same appears to mean exclusive right in respect of work to do or authorise the doing of certain acts.
- The SC noted that right to copyright includes the right to reproduce the work in any material form, issue copies of the work to the public, perform the work in public, or make translations or adaptations of the work. It then held that the right to reproduce a computer programme and exploit the reproduction by way of sale, transfer, licence, etc. is at the heart of the said exclusive right.
- It further held that the making of copies or adaptation of a computer programme in order to utilise the said computer programme for the purpose for which it was supplied, or to make up back-up copies as a temporary protection against loss, destruction or damage so as to be able to utilise the computer programme for the purpose for which it was supplied, does not constitute an act of infringement of copyright.

On the EULA/distributor agreements

- The SC observed that what is granted to the distributor is only a **non-exclusive, non-**

[1] Placing reliance on Union of India v. Azadi Bachao Andolan, (2004) 10 SCC 1

[2] PILCOM v. CIT, West Bengal-VII (2020) 425 ITR 312 (SC)
[3] Section 194E of the Act

transferable licence to resell computer software. Further, 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.

- Accordingly, it observed that the consideration represents the price of the computer programme as 'goods', which may be then further resold by the distributor to the end-user in India, the distributor making a profit on such resale. **The SC noted that the distributor does not get the right to use the product at all.**
- The SC observed that the license granted vide the EULA is not 'license' as per the terms of the Copyright Act[4] but is a license which imposes restrictions or conditions for the use of computer software.
- It highlighted that in all these cases, the EULA do not grant any right or interest, least of all, a right or interest to reproduce the computer software.[5] The end user can only use it by installing it in its computer hardware.
- Accordingly, it concluded 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[6].

Definition of the term royalty in the Act vis-à-vis the tax treaty

- The SC noted the difference in the definition of the term royalty in tax treaties vis-à-vis the Act. It observed that the definition in the Act is wider in following aspects:
  - it includes lump sum consideration not chargeable under capital gains
  - 'all or any rights' expressly includes transfer of license, and
  - includes that term transfer must be 'in respect of' of any copyright of any literary work.
- It noted that the transfer of 'all or any rights in respect of' under the Act correspond to provisions[7] of the Copyright Act and is more expansive than tax treaties provision which reads - 'use of, or the right to use' any copyright.

[4] Section 30 of the Copyright Act

[5] It also relies on the SC ruling in State Bank of India v. Collector of Customs to distinguish between the reproduction of software and the use of software and holds that the former would amount to parting of copyright by the owner and the latter would not.

[6] Tata Consultancy Services v. State of A.P., 2005 (1) SCC 308

[7] sections 14(a), 14(b) and 30 of the Copyright Act

- As regards retrospective amendment in the Act[8], the SC disregarded the tax department's argument that it is clarificatory in nature and is applicable from 1976, as the term 'computer software' itself was entered into the statute in the year 1991. Even under the Copyright Act, the SC noted that the term 'computer software' was added in 1994.

- As regards application of TDS provisions on the basis of expanded definition of the term 'royalty', the SC relied[9] upon two latin maxims - *lex non cogit ad impossibili*a, i.e., the law does not demand the impossible and *impotentia excusat legem* i.e., when there is a disability that makes it impossible to obey the law, the alleged disobedience of the law is excused. It therefore held that a tax deductor could not be expected to apply the expanded definition to the years in question, at a time when such explanation was not actually and factually in the statute.

On various high court (HC) rulings and Authority for Advance Rulings (AAR)

- The SC on exhaustive analysis of past rulings on the subject matter upheld the order of Dassault (AAR)[10] and Geoquest (AAR)[11] and the judgments of Delhi HC in Ericsson A.B.[12], Nokia Networks OY[13], Infrasoft[14], ZTE[15]. It also observed that these judgments also accord with the OECD Commentary on which most of India's tax treaties are based.

- It summarised the law laid down by Delhi HC as follows:
  - 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 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.
  - 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[16].

[8] Insertion of Explanation 4 to section 9(1)(vi)
[9] Arjun Panditrao Khotkar v. Kailash Kushanrao Gorantyal (2020) 7 SCC 1; CIT v. NGC Networks (India) Pvt. Ltd., ITA No. 397/2015 and CIT v. Western Coalfields Ltd., ITA No. 93/2008
[10] Dassault Systems, K.K., In Re., (2010) 322 ITR 125 (AAR)
[11] Geoquest Systems B.V. Gevers Deynootweg, In Re., (2010) 327 ITR 1 (AAR)
[12] DIT v. Ericsson A.B., (2012) 343 ITR 470
[13] DIT v. Nokia Networks OY, (2013) 358 ITR 259
[14] DIT v. Infrasoft Ltd., (2014) 264 CTR 329
[15] CIT v. ZTE Corporation, (2017) 392 ITR 80
[16] under section 30 of 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 mentioned in the Copyright Act, or create any interest in any such rights[17].
- The right to reproduce and the right to use computer software are distinct and separate rights.

- Further, the SC rejected approach followed by respective courts in following cases -
  - Ruling given by AAR in the case of Citrix Systems[18]
  - Decision of the Karnataka HC in Samsung Electronics[19] as being defective since no distinction was made between computer software that was sold/licensed on a CD/other physical medium and the parting of copyright in respect of any of the rights or interest in any of the rights mentioned in the Copyright Act[20].
  - Karnataka HC ruling in the case of Synopsis International[21].

Interpretation of tax treaties, OECD Commentary and Tax department's understanding

- The SC noted that tax treaties should be interpreted liberally with a view to implement true intention of the parties. It noted that all the tax treaties which were applicable in the cases before it have as their starting point, either the OECD Model Tax Convention or the United Nations Model Double Taxation Convention, insofar as the taxation of royalty for parting with copyright is concerned.
- It also noted that OECD Commentary has been referred to in various earlier judgments. Accordingly, it held that the OECD Commentary on Article 12, will continue to have persuasive value as regards the interpretation of the term "royalties" contained in such tax treaties.
- The SC also observed the reservation given by India when it comes to taxation of royalties and observed that the same is not clear as to what exactly the nature of these positions are.
- It referred to the Delhi HC ruling in the case of Director of Income Tax v. New Skies Satellite BV[22], wherein the HC observed that

[17] so as to attract section 30 of the Copyright Act
[18] Citrix Systems Asia Pacific Ptyl. Ltd., In Re., (2012) 343 ITR 1 (AAR)
[19] CIT v. Samsung Electronics Co. Ltd., (2012) 345 ITR 494
[20] in sections 14(a) and 14(b)
[21] CIT v. Synopsis International Old Ltd., ITA Nos. 11-15/2008
[22] (2016) 382 ITR 114

mere positions taken with respect to the OECD Commentary do not alter the tax treaty 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 to change the definition of royalties contained in any of the tax treaties that were part of the batch of appeals under consideration, in accordance with its position.

- As regards the High-Powered Committee Report, 2003 and the E-Commerce Report 2016, the SC observed that such reports are recommendatory reports, expressing the views of the Committee members which the government may accept or reject.
- It also referred to the CBDT Circular[23] whereby the CBDT had itself made a distinction between remittances for royalties and remittances for supply of articles or computer software in the proforma of the certificate to be issued as per the circular. It opined that the government itself has appreciated the difference between the payment of royalty and the supply/use of computer software in the form of goods.

Our comments

This is a landmark ruling that has finally settled the contentious issue of the characterisation of software payments in favour of the taxpayers. It provides relief to taxpayers who have been litigating this issue in various tax and judicial forums for almost two decades now.

In this process, the SC has also clarified many important aspects relating to the copyright, persuasive value of OECD commentary and reiterated the supremacy of tax treaties over domestic law.

Going forward, while these payments would be out of the income tax net, taxpayers would need to evaluate the applicability of equalisation levy provisions in these cases.

[23] CBDT Circular No. 10/2002 dated Oct 9, 2002

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