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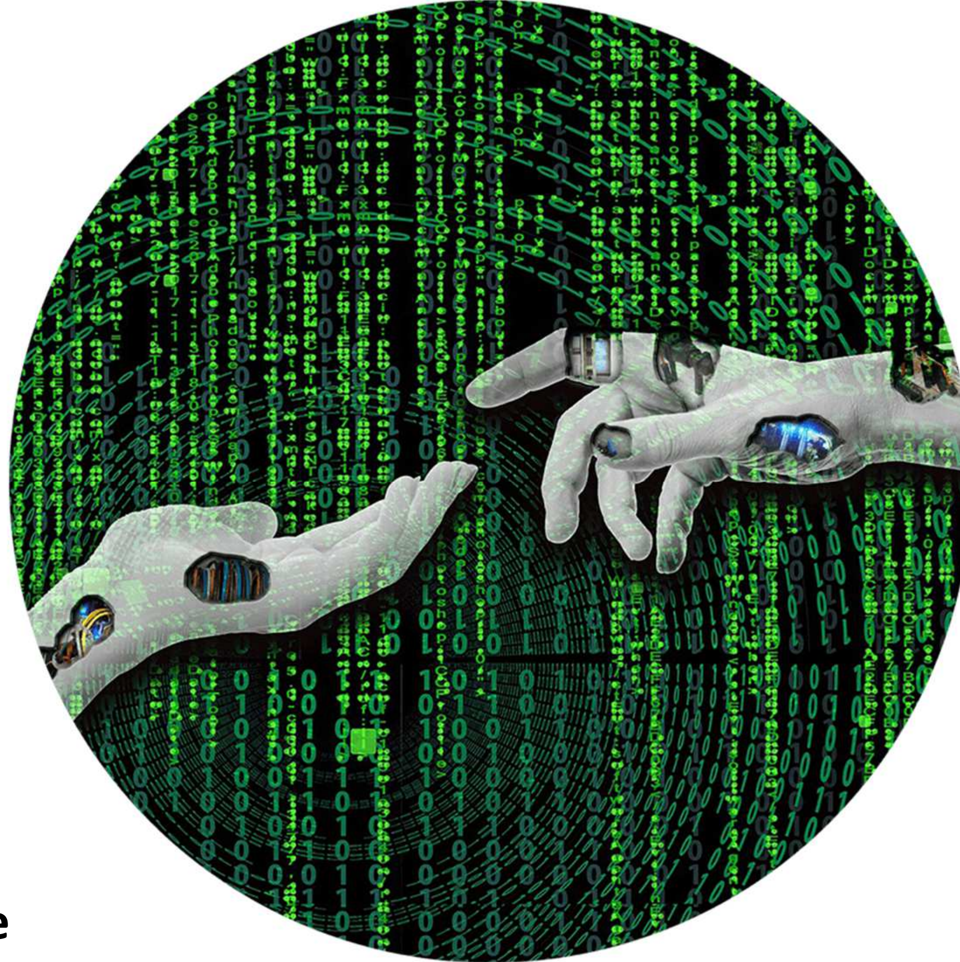


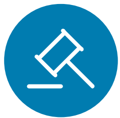
Compare and contrast software copyright treatment in Australia and India

The Dbriefs Corporate Income Tax series

Neil Pereira / Sharath Rao / Rachel Sciascia

5 October 2021

Agenda



- **Introduction**
- **Australian context**
  - New ruling TR 2021/D4
  - Old ruling TR 93/12
  - Examples in new ruling
  - Copyright
    - ATO's view
    - Copyright Act
  - Implications for clients
- **Indian context – Supreme Court case**
  - Categories covered by the SC judgement
  - Interplay with Indian Copyright Act
  - Position under the DTAA and OECD
  - New Equalisation levy on digital goods
  - Implications for clients
- **Questions and answers**

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Polling question 1

Which of the following jurisdiction do you see tax authorities taking an expansive view of transactions that would be captured by royalties and consequently subject to withholding tax?

- Malaysia
- Japan
- China
- Indonesia
- Singapore
- Don’t know/not applicable

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Australian context

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Australian context

New draft Taxation Ruling TR 2021/D4 and withdrawn Taxation Ruling TR 93/12

- **New Ruling versus old Ruling**
  - Addresses changes arising from technological change:
    - At the time the old ruling (TR 93/12) was released, software was typically contained on physical data
    - New draft ruling addresses modern methods of distribution of software, e.g., cloud software and software-as-a-service

- **New Ruling – retrospective and prospective**
  - Still in draft but once it is finalised, it is proposed to apply both before and after its issue date **TBC pursuant to submissions**

- **Old Ruling – withdrawn from 1 July**
  - Still applies prior to 1 July 2021 to the extent that it has been relied upon

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Australian context

Income Tax Assessment Act 1936

- **"royalty** or **royalties"** includes any amount paid or credited, however described or computed, and whether the payment or credit is periodical or not, to the extent to which it is paid or credited, as the case may be, as consideration for:

  a) **The use of, or the right to use**, any copyright, patent, design or model, plan, secret formula or process, trade mark, or other like property or right;

  b) The use of, or the right to use, any industrial, commercial or scientific equipment;

  c) **The supply of** scientific, technical, industrial or commercial knowledge or **information**;

  d) The supply of any assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of, any such property or right as is mentioned in paragraph (a), any such equipment as is mentioned in paragraph (b) or any such knowledge or information as is mentioned in paragraph (c);…

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Australian context

ATO's view of Royalty per old Ruling

- **A payment is considered to be a royalty for purposes of the Income Tax Assessment Act 1936 where the payment is:**

  a) Consideration for the granting of a licence to **reproduce or modify** the computer program in a manner that would, without such licence, constitute an **infringement of copyright** (paragraph (a) of the definition of royalty). Examples include payments for the right to manufacture copies of a program from a master-copy for distribution, and payments for the right to modify or adapt a program

  b) Consideration for the **supply of know-how** (paragraph (c) of the definition of royalty). Payments for **the supply of the source code** or algorithms of a program are, prima facie, considered to come within this paragraph

- **Exceptions:**
  - Payments for the granting of a licence which allows only **simple use** of the software, i.e., allows the end-user to run the software on a single computer or a computer network but does not otherwise permit any use of the copyright in the program;
  - All ownership rights for the copyright are transferred (i.e., **sale** of copyright);
  - Sale of goods where the copyright is **integrated** into the hardware or stored on physical carrying medium without being separately priced, and the end user has simple use rights;
  - **Services** ancillary to the simple use of software

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Australian context

ATO's view of Royalty per old Ruling

- **Right to use copyright**
  - Rights of copyright owner - without a licence, the use of these rights would constitute an **infringement of copyright**
  - Hence it would follow that payments solely for the right to import and/or distribute software, *without any licence to use the copyright*, are not royalties. Such payments are not for the right to do any act comprised in the copyright, notwithstanding that the importation without the copyright owner's permission would constitute an infringement of copyright.
  - Where the licence to use the copyright is acquired by the end-user from a distributor or retailer, the distributor or retailer is considered to be acting as agent for the copyright owner. In such cases, payments made by the distributor or retailer in respect of software which has been licenced through his agency will include an amount in the nature of royalty for the right to use copyright
  - Right to enter a commercial arrangement is a right of a Copyright. Note exceptions to the Copyright Act and in particular Division 47B – Reproduction for normal use…*
- **Right to use software – limited to shrink wrap cases**
  - Payments for any licence for simple use of computer software (i.e., where the end-user acquires only the right to run the program, whether on a single computer only or on the licensee's computer network, and does not acquire any rights to use the copyright in the program) are not royalties for purposes of income tax law - *neither copyright in the program nor property in the tangible carrying media is transferred to the end-user; the software and all copies made of it remain the property of the software manufacturer or developer*

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Australian context

ATO's view of Royalty per new Ruling

- **An amount is Royalty under s 6(1) where it is paid or credited as:**
  - Consideration for the **grant of a right** to do something in relation to software that is the **exclusive right of the owner of copyright** in software. These include:
    - Right to reproduce, modify, or adapt the software; and
    - A right to grant a sub-licence for the use of software (whether distributed via physical media, digital download or cloud-based technology)
  - Consideration for the **supply of know-how** in relation to software;
  - Consideration for assistance furnished as a means of enabling the application or enjoyment of the software where the assistance is subsidiary and ancillary to the right to use the copyright in the software or to the supply of know-how in relation to the software
- **Exceptions:**
  - Licensee or end-user has **simple use rights** – rights to use the software for the purpose it was designed for but does not permit any use in the underlying copyright;
  - Distributor **does not obtain any rights** in relation to the software that is the exclusive right of the copyright owner;
  - All ownership rights for the copyright are transferred (i.e., **sale** of copyright);
  - Sale of goods where the copyright is **integrated** into the hardware or stored on physical carrying medium without being separately priced, and the end user has simple use rights;
  - **Services** ancillary to the simple use of software

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Australian context

Comparison of the Rulings

- **Paragraph 29 of old Ruling TR 93/12**
  - **29. Payments for a licence for simple use only of computer software are not royalties, irrespective of whether the software is acquired by a distributor for sub-licencing to end-users** (e.g., where packaged software is acquired by the distributor under licence and is sub-licenced to the end-user) **or by end-users directly**
  - However note para 21 referred to above …where the **licence to use the copyright** is acquired by the end-user from the distributor…as agent
- **Paragraph 75-76 of new Ruling TR 2021/D4**
  - 75. **A payment by a software distributor for the right to sub-licence the use of software is a royalty**. This is the case whether the software is distributed by way of physical carrying media, digital download or cloud-based technology such as software-as-a-service. **It is also the case whether the payment by the distributor is for the right to grant licences for the simple use of the software** or to grant licences which confer more extensive rights, for example, the right to modify or adapt the software (see examples 4 and 5 of this Ruling)
  - 76. Such a payment is considered to be a royalty because it is for the **right to do something in relation to software that is the exclusive right of the copyright owner**. That is, it is a payment by the distributor for the right to use the copyright in the software or to authorise another person (the end-user) **to use the copyright in the software**
  - Comments on **Trading stock and the treatment of proceeds from the sale of software** now guidance on ATO website

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Australian context

Examples in the new Ruling

Royalty	Not a royalty
1. Licence to reproduce software	3. Licence for the simple use of software
2. Licence to modify software including access to source code	**6. Software distribution agreement not conferring copyright**
4. Software distribution agreement conferring the right to enter into end user licence agreements (EULA) – distributor <> customer	8. Services ancillary to the simple use of the software
5. Software distribution agreement conferring the right to enter into cloud services agreements	
7. Services ancillary to the modification of software	

- Further examples to be provided following submissions in the in the final ruling

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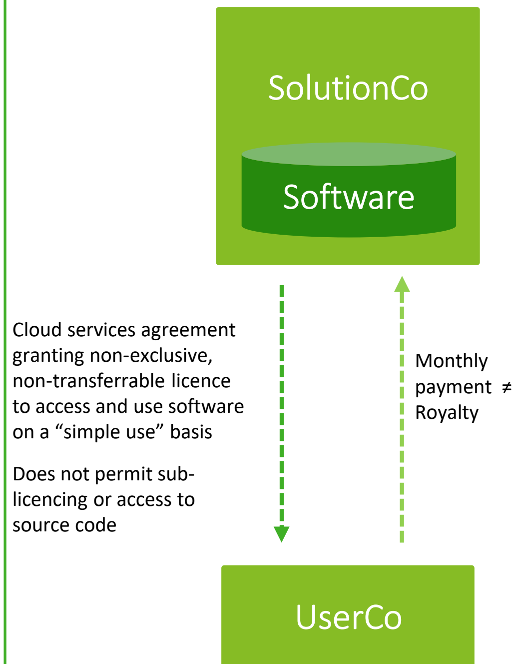
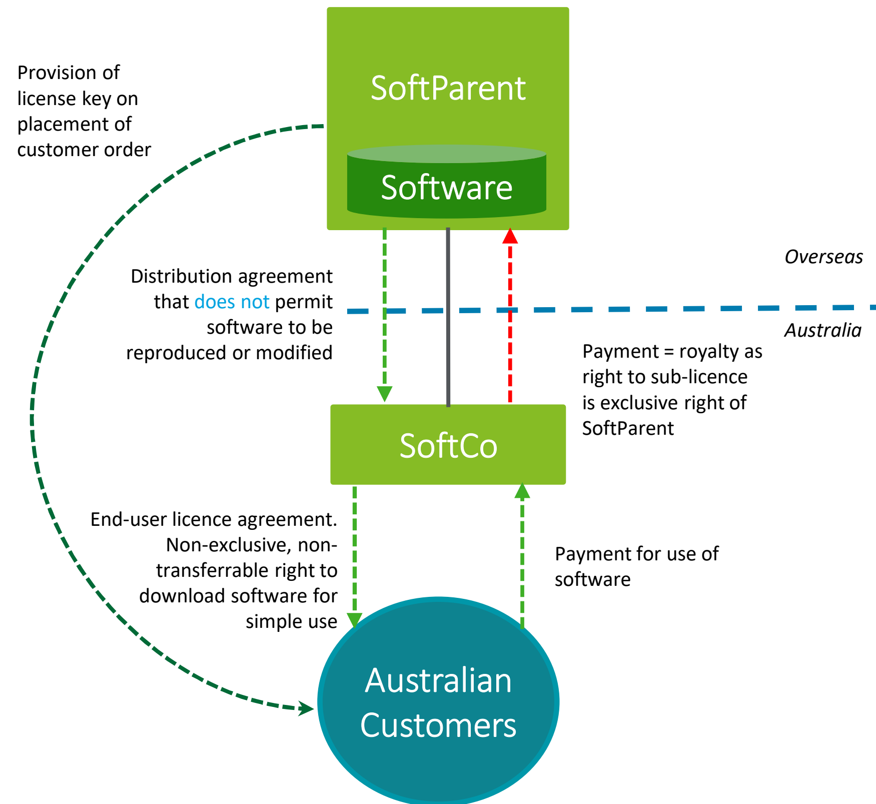
Australian context

Examples in the new Ruling – examples 3 – 5

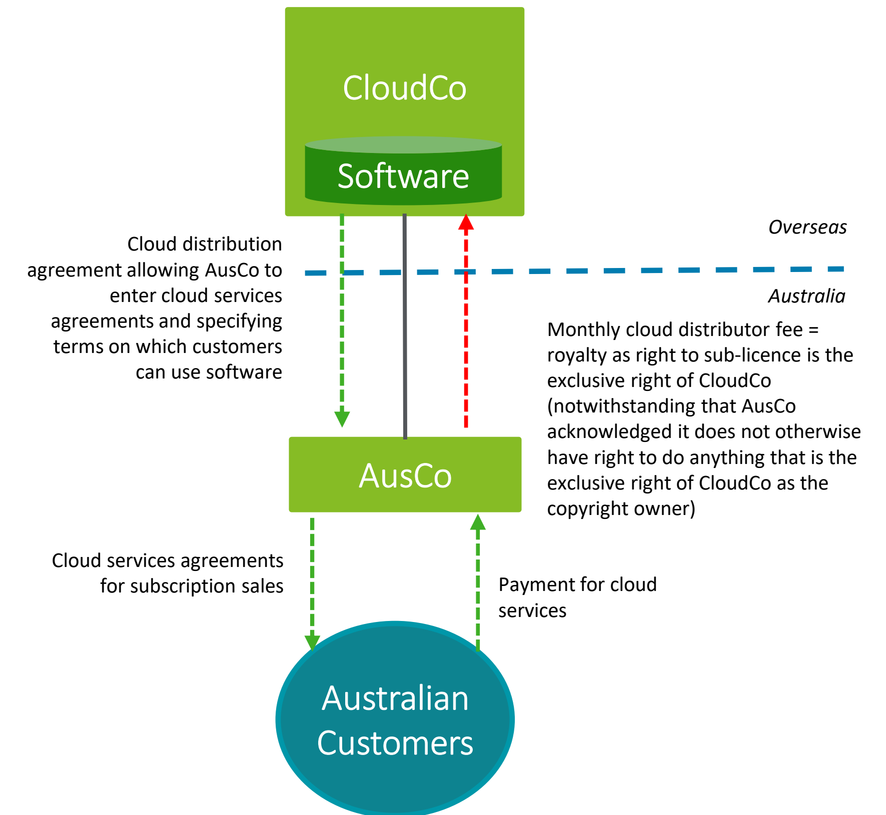
Example 3 – licence for the simple use of software



Example 4 – software distribution agreement conferring the right to enter into end-user licence agreements



Example 5 – software distribution agreement conferring the right to enter into cloud service agreements



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Australian context

ATO’s view of copyright and Australian Copyright law

- **Copyright Act 1968 (Cth) cf. ATO explanation**
  - Rights based approach and SaaS ≠ Copyright Act
  - ATOs extrapolation of right to communicate
    - The Copyright Act defines communicate as “means make available online **or** electronically transmit (whether over a path, or a combination of paths, provided by a material substance or otherwise) a work or other subject-matter….
  - Ruling explanation
- 61. …first…sending or receiving a work (including software) by way of electronic transmission. An electronic transmission may occur via a combination of paths. For example, a communication over the internet may involve transmission over copper wire and optic fibre cables. Software acquired under licence is communicated for the purposes of subsection 31(1) of the Copyright Act when it is downloaded onto a computer or device
- 62. ...second.. involves the making of a copyright work available online irrespective of whether it is electronically transmitted. This does not require that there be an actual communication of the work in the ordinary meaning of that word. A communication may occur in the relevant sense when software is made accessible to or is used by an end-user via cloud-based technology such as software-as-a-service, that is, without being downloaded on the end-user's computer or device. Depending on the circumstances of the particular case the communication may be taken to have been made by any number of people including the end-user and the software distributor. The extension of copyright to the making of works available online seeks to address the challenges of copyright in the digital age by improving copyright protection in an online environment

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Australian context

Implications for clients

- Interaction with **tax treaties** – treaty view should prevail ATO will provide further guidance based on submissions in final ruling expected early 2022
  - Foreign jurisdiction's tax authority may have a different view of what constitutes a royalty
  - Potential withholding tax leakage
- Implications for **Multinational Anti-Avoidance Law (MAAL)**
- **Financial statement** implications for uncertain positions
- Review **distribution agreements / end-user licence agreements**
  - What rights* are granted to the distributor?
  - Does the distributor grant any licences to the end-user?
  - Does the distributor govern the use of the software by end-user?
  - Consider legal advice – contract law, copyright law
- Implications for **transfer pricing**
  - **Bifurcation** of charges between services v royalties, where embedded
  - Draft Ruling notes that the ATO **will not** apply the new Ruling where it conflicts with terms of settlement from prior dispute. Expected that this should also extend to existing APAs (particularly where withholding tax has been reviewed / considered as a collateral issue and the ATO signed-off on the non-royalty nature of the distribution right payments)
- *Residual issues – are there still existing in present day agreements rights to the source code even of these rights are not in practice utilized by distributor

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Polling question 2

How do you see tax authorities considering the OECD views around software copyright treatment and royalty taxation issues?

- High alignment to OECD
- Medium alignment
- Neutral low alignment
- Divergent
- Don’t know/not applicable

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Indian context

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Indian context

SC case – Engineering Analysis Centre of Excellence Pvt Ltd versus The Commissioner of Income Tax

Background

- Computer software was brought within the ambit of "royalty" definition in 1991 (Copyright Act, 1957 recognized computer software in 1994)
- Litigation on characterization of payments for purchase of shrink-wrapped software/off the shelf software started in late 1990s (Indian Revenue view – "royalty" versus taxpayer's view – goods)
- The matter reached the Indian Supreme Court (SC) for the first time in 2010 when the SC held that payer need not approach tax authority for every payment and can make a determination on his own and directed the case back to the Karnataka High Court (KHC) to decide on merits
- SC has now decided on the divergent rulings of various courts, primarily, the judgments of the KHC- against taxpayer, the Delhi High Court (DHC) – in favor of taxpayer and the mixed Rulings of Authority of Advance (AAR)

Facts of the appeals covered

- The Supreme Court (SC) judgement covers 86 appeals, broadly grouped into four categories

Category 1	Indian end users of computer software who purchase the same directly from a foreign non-resident supplier or manufacturer
Category 2	Indian distributors / resellers who purchase computer software from non-resident suppliers /manufacturers for the purpose of resale to other resident Indian end-users
Category 3	Non-resident vendors, who, after purchasing software from other foreign, non-resident sellers, resell the same to resident Indian distributors or end users
Category 4	Non-resident suppliers who affix computer software onto hardware and then sell the same as an integrated unit/equipment to resident Indian distributors/ end users

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Indian context

SC case – Engineering Analysis Centre of Excellence Pvt Ltd versus The Commissioner of Income Tax

- **Interplay with Indian Copyright Act (CA)**
  - **Rights granted to the end-user in End User License Agreement (EULA)**
    - 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 section 30 of CA
    - A non-exclusive, non-transferable licence, merely enabling the use of a copyrighted product, is in the nature of restrictive condition which is ancillary to such use, and cannot be construed as a licence to enjoy all or any of the enumerated rights mentioned in section 14 of CA
    - The right to reproduce and the right to use computer software are distinct and separate rights, the former amounting to parting with copyright and the latter, in the context of non-exclusive EULAs, not being so
  - **Right of Distributors to resell [Section 14b(ii) of CA clarified]**
    - It is the exclusive right of the owner to sell or to give on commercial rental or offer for sale or for commercial rental, “any copy of the computer program”
    - Objective is to interdict reproduction of the said computer program and consequent transfer of the reproduced computer program to subsequent acquirers/end users
    - A distributor who purchases computer software in material form and resells it to an end user cannot be said to be within the scope of this provision

- **Nature of agreements and End-User License Agreements (EULAs) under the four categories of companies**
  - Regardless of the terminology of “licensing” mentioned in some of the EULAs, it is settled law that the real nature of transaction must be looked at, by reading the agreement as a whole. Accordingly, the transaction would be in the nature of sale and not licensing
  - **In case of an Indian Distributor**
    - Only granted a non-exclusive and non transferrable license to resell computer software
    - Does not have the right to sub-license or reverse engineer/modify nor does the distributor have the right to use the product at all
    - Consideration paid by the distributor to the non-resident manufacturer is in effect the price of a copy of the computer program as “goods”
  - **In case of an End User**
    - Can only use the computer program by installing it in the computer hardware and cannot reproduce the same for sale or transfer
    - License granted vide the EULA is not a license in terms of section 30 of the CA but is a license which imposes restrictions or conditions for the use of the computer software

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Indian context

SC case – Engineering Analysis Centre of Excellence Pvt Ltd versus The Commissioner of Income Tax

- **Taxability of "software payments" under the DTAA (Double Tax Treaty)**
  - Held that transfer of all or any rights in underlying copyright is a *sine qua non* for the payment to qualify as royalty
    - Definition of "royalty" in DTAAs is rooted from the OECD Model Tax Convention wherein it refers to payments of any kind received as consideration for "the use of, or the right to use, any copyright" of a literary work

- **Interpretation of DTAAs and OECD commentary**
  - Held that the DTAAs have to be interpreted liberally with a view to implement the true intention of the parties
  - Distributing copies of the program without the right to reproduce that program amounts to only paying for the acquisition of the software copies and not to exploit any right in the software copyrights
  - Held that the OECD Commentary on Article 12, incorporated in the DTAAs will continue to have persuasive value as to the interpretation of the term "royalties" contained therein

- **Taxability under the provisions of the Indian domestic tax law in light of the 2012 clarificatory**
  - Noted that there is no difference in the definition as given in the provisions of Explanation 2 to section 9(1)(vi) of the Act and the DTAAs
  - Held that clarificatory Explanation to section 9(1)(vi) is not clarificatory of the position as of 1 June 1976, but, in fact, expands the definition with effect from Finance Act 2012
  - Held that beneficial provision of the DTAA to apply

- **Key takeaways:**
  - The SC has held that based on the definition of "royalty" contained in Article 12 of the DTAAs, 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 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 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 payers (in all four categories referred to in this judgement) were not liable for any withholding tax

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Indian context

Other developments – Equalisation Levy

- **Equalisation Levy (EL)**
  - India introduced EL in 2016
  - From 1 April 2020, scope expanded to include EL of 2 percent on consideration received or receivable, by an "e-commerce operator" from "e-commerce supply or services" to "specified payer" – Interim measure until there is global consensus on taxing cross-border income on digitalized services/products
  - **E-commerce operator** means a non-resident who owns, operates or manages digital or electronic facility or platform for online sale of goods or online provision of services or both
  - **E-commerce supply or services** means online sales of goods, online provision of services, or facilitation by e-commerce operator for either of the above (or any combination of the above)
  - "**Specified payers**" – a person resident in India; or a NR in "specified circumstances"; or a person who buys such goods or services or both using internet protocol address located in India
  - "Online sale of goods" and "online provision of services" to include one or more of the following online activities:- Acceptance of offer for sale; Placement of purchase order; Acceptance of purchase order; Payment of consideration; Supply of goods or provision of services, partly or wholly
  - EL to be paid by non-resident (NR) e-commerce operator
  - Vide Finance Act 2021, an explanation has been inserted to provide that consideration received for e-commerce supply or services shall not include consideration received which is taxable as royalty or fees for technical services under the Act and the applicable tax treaty

- **Given the SC ruling that software payments are not "royalty", the software sales (all formats – download, cloud, etc.) may potentially come under EQL ambit**

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Indian context

Implications for clients

- Review of EULA/distribution agreements (including inter-company agreements) to evaluate the no-WHT position
- Communications to be sent to Indian distributors/customers to not do WHT
- In case of insistence from distributors to withhold taxes, explore options of obtaining an advance order from tax authorities for nil WHT
- Filing of India tax Return to claim refund of taxes withheld, if any
- Examine the applicability of Equalisation Levy

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Question and answers

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