Deloitte.

Indian Supreme Court judgment on characterisation of software payments

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Background

Issues dealt by Hon'ble SC

- 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 (Department view -'royalty' vs taxpayer's view – goods)
- The matter reached the Apex Court for the first time in 2010 when the Apex Court held that payer need not approach tax authority for every payment and can make a determination on his own and remanded the case back to 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 favour 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

Was this litigation faced by your company?

(Select one of the options flashing on the right panel to respond)

- Yes
- No, since we withheld taxes
- No such transactions

SC judgment

Reliance of DTAA at the stage of TDS under section 195

Reaffirmed that the TDS obligation arises only when the sum is chargeable to tax under the provisions of the Act, read with the DTAA; relying on:

- Principle of **GE Technology Centre Pvt Ltd**
- **CBDT Circular No 728** dated 30 October 1995

Nature of agreements and End-User License Agreements (EULAs) under the four categories of Assessees

- Held that 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. Noting the below facts:
- **In case of an Indian Distributor**
  - The distributor is only granted a non-exclusive and non transferrable license to resell computer software where no copyright is transferred to the distributor
  - The distributor 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
  - The consideration paid by the distributor to the non-resident manufacturer is in effect the price of a copy of the computer programme as goods
- **In case of an End User**
  - The end user can only use the computer programme by installing it in the computer hardware and cannot reproduce the same for sale or transfer
  - The license granted vide the EULA is not a license in terms of section 30 of the Indian Copyright Act, 1957 (CA) but is a license which imposes restrictions or conditions for the use of the computer software

Taxability of 'software payments' under the DTAA

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

Did your overseas group company face foreign tax credit issues in getting credit for the TDS/WHT in India?

(Select one of the options flashing on the right panel to respond)

- Yes
- No
- Don’t know/Not applicable

SC judgment

Taxability under the provisions of the Act in light of the 2012 clarificatory Explanation to section 9(1)(vi) of the Act

- 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

Interplay with Indian Copyright Act (CA)

SC noted the below:

- 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.
- The language of section 14(b)(ii) of CA makes it clear that 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 programme". Thus, 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 the aforesaid provision.
- The object of section 14(b)(ii) of CA is to interdict reproduction of the said computer programme and consequent transfer of the reproduced computer programme to subsequent acquirers/end users. Therefore, any sale by the author of a copy of the computer software to a distributor for onward sale to an end user, cannot possibly be hit by the said provision.
- The distributor cannot use the computer software at all and has to pass on the said software, as shrink-wrapped by the owner, to the end user for a consideration. The distributor's profit margin is that of an intermediary who merely resells the same product to the end user.

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 programme without the right to reproduce that programme are paying only 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.

Did the withholding tax increase your cost of business? Did it impact your price negotiations with vendor?

(Select one of the options flashing on the right panel to respond)

- Yes, vendor contracts were net of tax
- No, tax cost was borne by the foreign vendors
- Don’t know/Not applicable

Key takeaways

- The SC re-affirms the principle that at the stage of TDS under Sec 195, DTAA can be applied; SC ruling in **PILCOM vs CIT** distinguished since same was in the context of section 194E (not section 195) which does not have any reference to payments being chargeable to tax under the Act

- 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 2012 clarificatory Explanation to the definition of 'royalty' in the domestic law is to be read down as only a prospective amendment (i.e., pre-2012 transactions not subject to TDS)

- Distinction between Copyrighted article and Copyright upheld

- 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 to deduct any TDS under section 195 of the Act

Thank you!

Kindly spare a minute to help us with your feedback for today’s session…

For any queries, please feel free to write to us at intax@deloitte.com

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