Tax Hotline

February 10, 2021

SOFTWARE BATCH APPEALS - COURTROOM PROCEEDINGS (DAY 1: FEBRUARY 9, 2021)

The controversy surrounding the taxation of payments for software concerns the characterisation of income in the hands of non-resident taxpayers as either royalties or business profits. The Supreme Court of India is currently hearing a batch of 103 appeals[1] which raise this issue. The crux of the issue seems to pivot around whether software providers are remunerated for a copyrighted article or for the use or right to use a copyright. The former would be characterised as business profits, which would not be taxable in India unless they were attributable to the recipient's permanent establishment in India, whilst the latter would be subject to withholding taxes.

The outcome of this case will have a significant impact on digital businesses, especially against the backdrop of the tax challenges posed by digitalisation of the economy.

The 103 appeals have been divided in four broad categories on the basis of their business models:

Category 1: Shrink wrapped software (resellers and distributors);

Category 2: Purchase of software for end use;

Category 3: Embedded software (hardware/equipment bought along with the software inside); and

Category 4: Foreign Sellers.

On 9 February 2021, Senior Advocates Arvind Datar and Percy Pardiwala presented their arguments regarding Category 1 business models, i.e. the sale of shrink wrap software through Indian resellers or distributors. Reading from the judgement of the Karnataka High Court in *Samsung*, Datar outlined the Revenue's contention concerning Section 14(b)(ii) of the Copyright Act. This provision states that a Copyright means, amongst other things, the right "to sell or give on commercial rental or offer for sale or for commercial rental any copy of the computer program". The Revenue, Datar submitted, had construed the arrangement between the non-resident owners of the computer programs and the Indian resellers and distributors, as the transfer of the right to "commercial rental of the software programs". This, according to them, was tantamount to the transfer of the copyright itself. Datar argued, however, that such copyright would vest only in the original author of the software, and not with a distributor or reseller.

THE SUBSTANCE OF THESE PROPOSITIONS IS SUMMARISED BELOW:

1. Construct of the ITA

Section 195 of the Income Tax Act 1961 ("**ITA**") obliges the payer of income to withhold taxes at specified rates on payments to a non-resident that are chargeable to tax in India.[2] Further, as per the provisions of section 90(2) of the ITA, the taxability of a non-resident in India is governed by the provisions of the ITA or the tax treaty entered between India and the country of residence of the non-resident, whichever is more beneficial to such non-resident taxpayer. It was his contention that even though the consideration may qualify as Royalties under the ITA, the applicable tax treaty would restrict the charge. Therefore, the withholding obligations under section 195 would no longer be applicable.

2. What is the 'consideration paid for'?

Datar relied on the Supreme Court decision in *Tata Consultancy Services*[3] to argue that sale of shrink wrap software constituted a sale of goods. This proposition was relied on by courts in several cases[4] to conclude that income from sale of shrink wrap software does not amount to royalty, but to business income from the sale of goods, as there is no transfer of right to *use* the copyright.

The court questioned him whether the resale or distributorship agreements could be construed to characterise the payments as consideration for two components: first, the right to use the copyright, and secondly, the cost of the product. Examining Explanation 2 to Section 9(1)(vi) of the ITA, Datar noted that the term "royalty" was defined as "consideration paid for" certain intellectual property, and that the "consideration" could not be dissected between the product and copyright. Datar buttressed this proposition by relying on the Supreme Court's judgement in *BSNL*.[5] In that case, it was held that the purpose of consideration in a transaction ought to be determined according to its dominant purpose and principles of contract law.

He elaborated his argument by drawing an analogy between the sale of shrink wrap software and the sale of a book. Whilst purchasing a book, he explained, the buyer pays for the book and not for the right to use the copyright on the literary work contained in the book. Similarly, the purchaser of shrink wrap software did not obtain the copyright to the software. Much like the purchaser of a book may not reproduce or alter the literary work inside the book, i.e., the use of the copyright in the book, the purchaser of shrink wrap software acquired not the rights to use the copyright, but only the product, i.e., the copyrighted article.

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Datar also argued that if what was purchased were not a product or goods, the transaction would not have been subject to sales tax, but rather the service tax, which was not the case.

3. Reliance on TCS judgement – justified?

The Karnataka High Court in *Samsung Electronics* noted that the Supreme Court's judgement in *Tata Consultancy Services* dealt with whether the sale of canned software amounted to sale of goods under the Andhra Pradesh General Sales Tax Act, and not whether the payment was made for the import of software or for the supply of software by the non-resident companies was royalty. Therefore, that court had discounted the taxpayer's reliance on the Supreme Court's precedent. Datar rejected this argument as inconsistent insofar as it would require the same consideration to be subject to customs duty and sales tax, to also be subject to income tax, but only upon being recharacterized as royalty.

4. Interplay of the provisions of Copyright Act and ITA

Datar discussed the provisions of the Copyright Act in some detail. He drew the court's attention to the meaning of "copyright" under Section 14. He argued that all rights in Section 14 are conferred on the owner of the copyright, and they do not vest in the distributor.

He highlighted Section 63B of the Copyright Act to distinguish a "computer program" from a "copy of computer program", and specifically stated that Section 14(b)(ii) talks about a 'copy' of the computer programme.

He further argued that the term 'license' used in Section 9(1)(vi) of the ITA should mean a license granted by the owner under Section 30, read with Section 14, of the Copyright Act. Further, he distinguished an assignment of copyright under Section 18 from a license of copyright under Section 30 to state that where a distributor or a reseller does not have any rights conferred under Section 14, the question of transfer of such rights by way of a license would not arise. Additionally, in the context of Section 30, he pointed out that licensing contracts for software specifically state that there is no transfer of interest in the copyright through such a license.

He further highlighted Section 52(aa) of the Copyright Act. This provision grants a statutory right to the lawful possessor of the 'copy of such computer programme' (i.e. purchaser of copyrighted article) to: (i) utilise the computer programme for the purpose for which it was supplied and (ii) to make back-up copies purely as a temporary protection against loss, destruction or damage in order only to utilise the computer programme for the purpose for which it was supplied. This was quite different from the grant to use or the right to use the copyright underlying the copyrighted product itself, and the consideration for the latter could not be characterised as a royalty.

5. Addressing Samsung Electronics

The Karnataka High Court had held in *Samsung Electronics*[6] that the right to make a copy of the software and storing the same in the hard disk of the designated computer and taking backup copy was tantamount to a copyright under Section 14(1) of the Copyright Act. Therefore, it was concluded that a payment for the grant of such a license qualified as a royalty.

In this respect, Datar argued that it was impractical to contend that the distributors possessed the copyright to the software as that remained the intellectual property of the non-resident company. He reiterated that distributors were responsible for selling merely copyrighted articles, but not the copyright. He suggested that a perusal of the software licensing agreements would establish whether distributors are allowed to commercially exploit the software, which should facilitate the characterisation of the income.

Datar concluded his argument by outlining the following essential propositions:

1. No single right in the copyright itself is 'transferred' or 'licensed' in the sale of shrink wrap software;
2. The sale of shrink wrap is essentially a sale of goods, which could not be recharacterized as a transfer of a copyright;
3. Commentaries on the OECD and UN Model Tax Conventions, which form the basis of Indian tax treaties, state categorically that consideration for the sale of a copyrighted article did not qualify as royalty;
4. The relevant transactions should be treated at par with their treatment for the purposes of other taxes such as customs duties and sales tax, and the income should be characterised in harmony with how the State of which the taxpayer is a resident characterises it.

Senior Advocate Percy Pardiwala, who was due to continue arguments on the following day outlined the essence of his submissions. He argued that the definition of "royalties" under Article 12 of tax treaties (specifically Article 12(3) of Singapore tax treaty) was narrower than of the term "royalty" under Section 9 of the ITA. He stated that the consideration for the "use or right to use any copyright" under the tax treaty is more restricted than, consideration for the "transfer of all or any rights in respect of" under Section 9(1)(vi) ITA. He further submitted that Section 90(2) of the ITA would require that the definition under the treaty, being more beneficial to the taxpayer, prevail over the definition contained in Section 9 of the ITA. He cited a number of Supreme Court judgements to support this position. The court requested to submit a detailed compilation of the OECD and UN Model commentaries along with the relevant tax treaties. The hearing will continue tomorrow, when Pardiwala will put forth his detailed submissions on the provisions of tax treaties.

We will attempt to bring to you accurate updates and analyses on these hearings as they unfold in the courtroom.

– Ipsita Agarwalla, Arijit Ghosh & Dhruv Sanghavi
You can direct your queries or comments to the authors

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[1] Some of the significant High Court decisions being appealed include *Samsung Electronics* (Karntaka HC) 345 ITR 494, *Infrasoft* (Delhi HC) 220 Taxman 273 (Del), and *Ericsson AB* (Delhi HC) (2012) 343 ITR 370. From these, only the Karnataka HC in *Samsung* had decided in favor of the Revenue.

[2] This view has been upheld in multiple judicial precedents in India, including by the SC in following cases:
a. GE India Technology Centre (P) Ltd vs CIT [2010] 327 ITR 456 (SC)
b. Vodafone International Holdings BV vs UOI and Anr [2012] (341 ITR 1) (SC)

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[3] 271 ITR 401

[4] ADIT, (International Taxation), 2(1) v. Solid Works Corporation [2010] 42 SOT 13 (Mumbai); DDIT V. TII Team Telecom International Ltd. [2010] 40 SOT 38 (Mumbai); ACIT v. Sonata Information Tech. Ltd. (ITA No 4446 (Mumbai) of 2011); M/s Velankani Mauritius Ltd. & Anr. v. DDIT (ITA.985 & 986/B/09); M/s Capgemini Business Services (India) Ltd. Vs. ACIT (ITA No. 7779/M/2011)

[5] Writ Petition (civil) 183 of 2003

[6] (2011) (245 CTR 481)

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