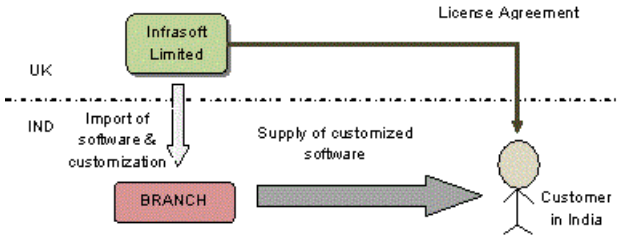
Tax Hotline

January 19, 2009

ENIGMA OF SOFTWARE TAXATION: ROYALTY OR BUSINESS INCOME?

The assessee (**"Assessee / Taxpayer"**) is part of an international group which is held by Infrasoft Corporation, USA and is the leader in civil engineering work. The Assessee being a marketing and development company, operated mainly through a branch office in India, which is engaged in import of software and providing it to the customers in India after customization based on specific parameters under a license agreement, however, with specific limitations on the right to its use, copying, sale, sub-license etc..

The assessing officer (**"AO"**) held that the receipts of the Assessee from such software was in the nature of royalty income and were, therefore, liable to be taxed in India in accordance with Article 13 of Double Taxation Avoidance Agreement between India and UK (**"DTAA"**) and Section 44 D read with Section 115A of the Income Tax Act, 1961 (**"ITA"**). Against this order of the AO, the Assessee appealed to the CIT(A). However, CIT(A) also held that the income earned by the Assessee from software license was in the nature of royalty both under the DTAA and the ITA.



ARGUMENTS

The primary argument of the Assessee was that the software licensee was entitled to only a copy of the software and the not the right to exploit the copyright therein. The Assessee further relied on inter alia *Motorola Inc. v. DCIT*[1] and *Samsung Electronics Co. Ltd. V. ITO*[2], wherein the Income Tax Appellate Tribunal (the **"Tribunal"**) in Delhi and Bangalore, had distinguished between a right to use a copyright and the right to use a copyrighted article and had held that the receipts from the transfer of software, which was actually a copyrighted article, with limited rights did not amount to royalty as the customers did not get rights in the copyright in the software, but only got access and limited rights to a copy of the software. Thus, the receipts from the transaction in question were not in the nature of royalty but were, in essence, business income.

The Department argued that in transactions such as this, the licensee was granted the rights to exploit the intellectual property in the software and thus, the receipts from such transactions were royalty income in the hands of the Assessee. The Department distinguished the above judgments on the ground of the facts involved therein and in fact relied on judgments from other countries. The Department also dismissed the OECD recommendations, on the ground that the OECD recommendations were non-binding in nature and that each country had adopted separate principles for the taxation of such income. The Department further contended that each country is required to implement its own observation, in accordance with the principle in tax treaty law or good faith in international agreement. India is not a member of OECD and has already expressed its reservation against OECD recommendations.

RULING AND ANALYSIS

The Tribunal placed strong reliance on the rulings in the case of *Motorola Inc.* and *Samsung Electronics*, observing that the facts in these cases were similar to the facts in the case at hand. Consistent with the decisions in these cases, the Tribunal allowed the appeal of the Assessee and held that the receipts from the transaction in question were business income and not royalty income, under the provisions of the ITA, as the licensee did not get any rights in the intellectual property of such software. It also observed that the CIT(A) ignored the decisions of the Tribunal wherein similar payments have been held to be business profits, which were binding on the CIT(A).

Taxation of software in India has always been a point of controversy. The judiciary has in the past taken conflicting stands in this regard. The Advance Ruling Authority (**"AAR"**) had recently in the case of *Airports Authority of India v. DCIT*[3] held that a transaction involving supply of software on a non-exclusive and non-transferable basis did not amount to sale but was in essence a license. The AAR[4] observed that the Airport Authority was granted the right to use the copyright in the software and therefore, the receipts from such transaction would amount to royalty. On the other hand, as discussed above, the Bangalore and the Delhi Tribunals have in *Motorola Inc.* and *Samsung Electronics* (cited above) relied on the OECD commentaries and have discussed in great detail, the concepts of copyright in the Indian context and the treatment of such transactions in developed nations such as USA. The

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Tribunals is these cases have distinguished between the concept of sale of software with limited rights and the license of software thread bare. While royalty payments would be taxed at the rate of 20% (on a gross basis), the business profits of branch would be taxable at the rate of 42% (on a net basis) in India.

Considering the fact that the software industry is one fastest growing sectors in the Indian economy, the controversy with respect to taxation of software needs to be put to an end and the present decision seems to part of the consistent and more popular view taken by the Indian courts and by OECD in its recommendatory report.

- Neha Sinha & Mansi Seth

You can direct your queries or comments to the authors

[1] (2005) 179 Taxman 79

[2] (2005) 276 ITR (AT) 1 Bangalore

[3] (2008) 304 ITR 216 (AAR)

[4] Decisions of the AAR are binding only on the taxpayer and the tax authorities. Nevertheless such decisions have a persuasive value.

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