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INTERNATIONAL JOURNAL OF LAW MANAGEMENT & HUMANITIES

[ISSN 2581-5369]

Volume 4 | Issue 2

2021

Demystifying the Software Taxation in India

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ABSTRACT

With the extensive and rapid growth of the Information Technology, the dependency on the softwares, imported/purchased from a non-resident, foreign supplier or manufacturer, too has increased a lot. However, the increasing use of the software driven computers has shown a far reaching implication on the tax regime of India. The major debate was about, whether the income earned from the payment made towards the import/purchase of the software by a resident in India from a non-resident supplier, was deemed to be earned from the transfer of copyrighted right or the copyrighted article and whether the importers/purchasers of software were required to withhold tax, in form of 'Tax Deducted at Source', on the aforesaid payments. The dispute of taxation of softwares had taken a toll on the software purchasers/importers and it is after a couple of decades that the Apex Court ruled that the payments made towards the purchase of the softwares do not fall under the 'Royalty' and are to be treated as purchase of products and therefore a tax liability does not arise in India.

I. INTRODUCTION

The past decade has seen a paradigm shift of the conventional business models, which comprised of the brick and mortar model, to the completely digitalised business market. Digitalisation has resulted into making the cross border trade easier and faster and is the major step towards a global economy. However, the sudden rise of the digitalised economy pays its attributes to the 'Information Technology' (IT) which has developed at a galloping pace in the last couple of decades and one can link the progression to the software driven computers.

However, massive shift of the business environment has wide impact on the societal and economical factors of a country and the tax laws are no different. For the past two decades the dispute of taxability has haunted the Software Importers/Purchasers in India, the major concern being whether the income earned through the payment made towards the import/purchase of the software by a resident in India from a non-resident supplier, was deemed to be earned from the transfer of copyrighted right or the copyrighted article and whether the importers/purchasers of software were required to withhold tax, in form of 'Tax Deducted at

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Source' (herein "TDS")[2], on payments made towards the purchase of the said software? It is pertinent to note that the Intellectual Property Rights (herein "IPR") are considered to be an invaluable wealth and the developments of softwares is one such precedent. The entire dispute on the Software Taxation orbited around the mere interpretation of the definition of 'Royalty', as defined under the Income Tax Act, 1961 (herein "the Act"). It is after about two decades that the Supreme Court of India decided upon the aforesaid issue of Software Taxation, in an appeal[3], and passed a judgement in the favour of the Software Importers/Purchasers by holding that the payments made towards the purchase of the softwares do not fall under the 'Royalty' and are to be treated as purchase of products.

The present article would shed light upon the erstwhile practice of the Revenue Department in taxing the softwares and will demystify the judgement of the Supreme Court.

II. SITUATION PRIOR TO THE RULING

Prior to the judgement of the Apex Court in '*Engineering Analysis*', there have been various stands taken by different courts and tribunals on whether the importers/purchasers are liable to withhold tax in form of TDS as necessitated under Section 195 of the Act. However, one first needs to understand the issue in debate. The dispute, as mentioned above, was about whether the software, which was imported or purchased, was to be treated as copyrighted right or copyrighted article? In case of copyrighted right, the end user or the recipient of the software is legally entitled to reproduce the said software, however in case of copyrighted article the end user can only use the software for his/her personal use and is restricted from exploiting the software any further. Therefore, the use of a copyrighted right would attract royalty on the income earned whereas the latter would be termed as an income from business and profession. It is pertinent to note that, the taxmen were of the view that the import/purchase of software, through the End User Licence Agreement (herein "EULA"), was that of copyrighted article, as there was not a transfer of the copyright per se, and that was to be viewed as purchase of products where withholding of tax on making payment was not required. The Revenue Department, on the other hand, was of the view that the import of software was that of a copyrighted right and the licensing fee for the software was for the right to reproduce for commercial use and hence, it necessitates the withholding of taxes on payments made towards the purchase/import of such softwares.

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[2] As provided under Section 195 of the Act

[3] Engineering Analysis Centre Of Excellence Private Limited vs. Commissioner of Income Tax (CIT), LL 2021 SC 124.

(A) Legal Position of payments made towards purchase/import of Softwares

'Royalty' as consideration, as defined under the Act, reads as "transfer of all or any rights (including the granting of a license) in respect of any copyright[4]" Speaking of the Intellectual Property, a copyright is an established position of law under the 'literary works', as given under the Section 13(a) of the Copyright Act, 1957 and it also includes softwares.

(B) Contrary Views

Over the past two decades, various tribunals and High Courts have given different views on this particular issue. It all started with the decision of the Authority of Advance Ruling (herein 'AAR') in the matter of '*Dassault Systems K.K'*[5], where the tribunal was of the view that the software which is imported, was transferred to the end consumer as a copyrighted article and does not transfer the right to use the copyright. The court had held that "Mere transfer of a computer software, de hors of any copyright associated with it, would not tantamount to it being covered within the ambit of royalty under Explanation 2 to section 9(1)(vi) of the Act.". Therefore, it was held that the import of software does not amount to royalty and thereby in lieu of the same the tribunal came to a conclusion that payment made towards the purchase of the software would not require withholding of taxes.

Again in 2011, a similar question of law in connection to the taxes on the import of software arose before the High Court of Delhi, in the case of '*Director of Income Tax v. Ericsson A.B*', where the High Court upheld the view given by the AAR in the case of *Dassault Systems K.K* and held that import of software did not amount to royalty as given under the Act.

(C) Amendment of Section 9 (1) (iv) of the Income Tax Act, 1961

However, the major disputes started arising when a retrospective amendment was brought in the Section 9 (1) (iv) of the Act and an Explanation 4 clause was added to the aforementioned provision. Prior to the amendment, the said provision talked about 'transfer of all or any rights' which was later amended to include 'transfer of all or any right for use or right to use a computer software (including granting of license)'. The above stated rulings were the major reason behind the amendment which then went on to include situations where a right to use the copyrighted article was also transferred to the end user.

Therefore, one can conclude stating that the intent of the legislature behind the aforementioned amendment was to include the payment made towards the purchase of the software under the

[4] Section 9 (1) (vi) of the Income Tax Act, 1961.
[5] [2010] 322 ITR 125 (AAR) .

ambit of TDS thereby making the importers liable to withhold tax on the said payments.

Post this amendment, the High Courts started taking a different view. The High Court of Karnataka in the ruling of, '*CIT v. Samsung Electronics Co. Ltd*[6]', held that the licensing of the software empowers the consumer to exploit the software commercially and this indicates that towards the fact that the transfer of the copyright has been given to the end customer, had it not been the case, the said act of exploiting the software commercially or copying would amount to infringement. This points towards the fact that a clear case of 'royalty' was being made out. Therefore, the High Court arrived at a decision that the importer of software was liable to withhold taxes on payments made towards the purchase of the softwares as it amounted to royalty.

However, there were cases like 'Director of Income Tax v. Nokia Networks'[7], 'CIT v. ZTE Corporation'[8], where the High Court of Delhi had held its ground and adopted the view given in the case of Dassault Systems. The Court held that the amendment which was introduced in 2012 could not be read with the Double Taxation Avoidance Agreements (herein 'DTAA') and that the provisions of the DTAAs would prevail over the Domestic Statute, to an extent that is more beneficial to the Assessee/tax payer[9]. The court had showed its disagreement with the judgment of the High Court of Karnataka passed in the case of *'Samsung Electronics'*

It is pertinent to note that, the Appeal, in the Supreme Court of India, was filed against the ruling of the High Court of Karnataka in *'Samsung Electronics'.*

III. APPEAL IN THE SUPREME COURT OF INDIA

It is almost after a decade that the dispute revolving around the taxation of software has come to an end. The Apex Court has left no question unanswered in the said Appeal and has decided upon the issues of

- Situation where the software is purchased by the end-user/consumer from a non-resident supplier/manufacturer.
- Situation where, a non-resident and foreign distributor purchases the software from a non-resident and foreign supplier/manufacturer and then sells/resells the same software to residents in India (end users).

[6] (2012) 345 ITR 494.
[7] (2013) 358 ITR 259.
[8] (2017) 392 ITR 80.
[9] Section 90(2) of the Income Tax Act, 1961.

- Situation where, a company incorporated in India or an India agent purchases the software from a non-resident and foreign supplier/manufacturer and then sells/resells the same software to residents in India (end users).
- Situation where, the software is appended to the computer hardware and is sold by a non-resident and foreign supplier/manufacturer, as an integrated unit, to to residents in India (end users).

This is indicative of the fact that the Court has left no stones unturned and has provided a logical and a legal reasoning behind the said ruling. The reasoning provided by the Apex Court is as follows:-

(A) Definition

The transaction of purchasing/importing the software from a non-resident supplier/manufacturer is governed by the DTAA that India has entered into with that particular country, from which the software is being purchased or imported. Article 12 of the DTAAs set out a few definition and it also defines the term 'Royalty' which includes any kind of payment/s which is/are received as a consideration for use of or right to use the copyrighted article. However, the definition of 'Royalty' as given under the Act makes the payment, made towards the purchase of the software, liable to tax in India, by the way of withholding taxes at the time of making payments. The Apex Court held that the provisions of the domestic law only come into action only when there are no relevant provisions in the DTAA and therefore the definition of 'Royalty', as given under the DTAAs would be applicable in the present case. Also, the Section 90 (2) of the Act comes into action in the present scenario, as the provisions of the Income Tax Act can only apply to the extent that they are more beneficial to the assessee and not otherwise.

(B) Retrospective Amendment

The Apex Court held that, the amendment brought, in the Section 9 (1) (iv) of the Act by adding an Explanation 4 clause, was bad in law and the mere intention of the said amendment was to include the transaction of purchasing softwares under the ambit of domestic taxation. It observed that the law cannot demand the impossible[10] (*lex non cogit ad impossibilia*) and in holding so, the court relied upon the ruling of the High Court of Bombay in the case of '*CIT v. Western Coalfields Ltd*'[11]. By doing so, the Court relied upon the 'Doctrine of Impossibility'.

[10] Paragraph 85, '*Engineering Analysis v. CIT*'
[11] ITA No. 93/2008

Hence, the amendment demanded the impossible as even a bare perusal of the amendment suggested that it was brought in to deal with cases of use or purchasing of software from the non-resident supplier.

(C) International Treaty Provisions

While coming to its conclusion, the Apex Court placed reliance on the commentaries of 'Organisation for Economic Cooperative Development' (herein 'OECD'). It held that the said commentary is instructive on the matters of 'Royalty' as set out in Article 12. It also made a reference to the 'Vienna Convention of Law of Treaties' (herein 'VCLT'). Although, India is not a party to the VCLT, yet the interpretation of the treaties set out in the Article 31 provide India with a direction that it requires to interpret the treaties with respect to the domestic legislations. The Court therefore, made recourse to the liberal interpretations of treaty, and the followed the principle which was set out in the case of '*Union of India v. Azadi Bachao Andolan*'[12] (that is of the liberal interpretations of international treaties).

The Apex Court also placed emphasis upon the 'Principle of Exhaustion' which restricts the copyright holders control over the copyrighted articles after they are sold. It is practically impossible to control/regulate the sale of the Intellectual Property (herein 'IP') permanently and hence the exclusive rights of the IP can be enjoyed till the first sell of the said product. This 'Principle of Exhaustion' is also known as the 'Doctrine of First Sell'. The aforementioned principle/doctrine has been statutorily accepted[13].

IV. Conclusion

In this respect, the Apex Court has assured that the interests of the non-residents would be of significance. The judgment passed by the Apex Court in '*Engineering Analysis'* is a commendable holding that India is willing to stand by the general practice of the International Law. It also puts in place the conflicting views of the different courts and confirms the view taken by the AAR in '*Dassault Systems K.K'* and overrules the findings of the High Court of Karnataka in *'Samsung Electronics'*. It is with this judgement that India has reached to a conclusion that, amount paid by the importer or the end user as consideration for buying/importing the software do not fall within the ambit of Section 195 of the Act and hence there arises no need to withhold taxes on such payments.

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[12] (2004) 10 SCC 1
[13] Warner Bros Entertainment Inc v. Santosh V.G, 2009 SCC Del 835.

 [ISSN 2581-5369]