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# Taxation of Computer Software: An Analysis

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**ABSTRACT**

*The Concept of royalty is generally a periodical payment to be paid by the user of the assets. It is made in exchange for the proper use of another party's property. The royalty payments received are considered to be income. i.e. this payment is likely to incur taxes. Currently, India has seen a lot of cross border transactions which results in the payments of royalties to foreign nationals or foreign companies. The increased globalisation and growth of information technology also increased the import of software technology services and other intellectual property. The government's focus on socio-economic development coupled with all-around development of various sectors also increased. Therefore the country is faced with more challenges to import the necessary intellectual property, and it has resulted in increased outflow of payments in the form of royalties. With the growing technologies, taxing computer software under royalties is an unending controversy. There are no specific provisions under the Income-tax Act,1961 that specifically deal with income taxability that arises from software-related transactions. The taxability of income related to software that arises in an international transaction is ruled by general taxation principles, concepts and provisions of the Act. It is a never-ending issue on whether software related payments that a resident makes to a foreign recipient is in the nature of "Royalties" or "Business Income".*

***Keywords:*** *Tax Implications of Computer Software, Classification of Income issues, Royalties or Business Income.*

## I. INTRODUCTION

In this paper, the discussion is about the tax implications in royalties on computer software and the characterisation of income. It's an unresolving controversy on whether software related payments made by a resident to a far off recipient is within the nature of **"Royalties or Fees for Technical Services"** or **"Business Income".** If the payer takes a stand that the payment constitutes a "Business Income" within the hands of the recipient and within the absence of a Permanent Establishment of such recipient in India, no tax is to be withheld, it often ends in prolonged litigation. With the expansion of data technology, business process outsourcing and the bio-informatics industry, there are increasing instances of Indian companies that acquires

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software from foreign companies. Counting on the parties' requirements, the software could also be exclusively developed for the Indian company and, therefore, a foreign company, which might transfer all rights in reference to such software to the Indian company. Taxation of the payments that have been made by the Indian company to a foreign company for software would depend upon the character of the transaction.

In general terms, a computer software, or simply to mention software, maybe a collection of computer programs and therefore the related data which provides instruction and telling a computer what to try to and the way to try to it. The surge in transactions undoubtedly picked the interest of the tax authorities over the past few years. The determination of taxation of payments for such transactions and, therefore, the appropriate revenue characterisation is difficult. The income characterisation issue of software payments challenges the unique nature of rights connected with software. It is further compounded by factors like the multiplicity of delivery models and evolving practices within the Information Technology domain, which led to extensive litigation with the Revenue authorities. The difficulty primarily is on characterising the software transactions as either royalty income or business profits. However, the Supreme Court has put an end to an over two-decade-old software royalty tax dispute after the ruling that crosses border payments made for the sale of software to a non-resident aren't taxed as royalty[2].

## II. Taxation of Computer Software

The controversy on the taxability of cross-border software payments fundamentally relates to the characterisation of the income, which is in the hands of the non-resident payee. The controversy revolves around the issue that "whether the payment received by a non-resident for giving license of the computer software, popularly called 'sale of software', is actually chargeable to tax as 'royalty', or it is considered only a 'sale'. The Revenue entertains such sales to be royalty on the ground that during the course of the sale of computer software, the computer program which embedded in it is also licensed and as against the claim of the taxpayers who treat the transaction as a transfer of 'copyrighted article' and not a transfer of the right in the copyright or license of the software. The taxability of software-related transactions depends upon the nature and extent of rights that are granted or transferred under the specific arrangement with respect to the use and exploitation of the program.

[2] Engineering Analysis Centre of Excellence Private Ltd vs. Commissioner of Income tax & anr

**(A) Under Income tax act**

Certain payments are excluded from taxability under the act. The royalty which is payable in respect of computer software, if that consideration made by a resident for transfer of rights, relates to software supplied by the non-resident manufacturer along with computer or system based equipment under any scheme approved under the policy on computer software export, Software development and training 1986 of the government of India. On purchase of software from a resident, the tax deduction at source shall be deducted at 10 per cent. When purchased from a non-resident, then TDS shall be deducted at the rates being in force[3]. The Finance Act 2012 has inserted Explanation-4 to section 9(1)(vi) with retrospective effect from 1st June 1976[4]. By inserting this explanation to the particular section, the controversy revolving on the taxability of software payments by characterising it as royalty has sought to be put at sleep. The implication would be whether, by inserting and expanding the scope of the definition "royalty" by way of retrospective amendment, can payment for software be brought to tax.Further, it was observed in a case that computer software was recognised as a separate item in the second proviso and in the explanation of the section. Even the 2012 amendment does not specifically include computer software in the term 'literary work' under royalty definition, and by this, it would be beyond the scope of the restrictive beneficial definition under the treaty. Although computer software is included under the copyright act, the consideration which is paid for literary work and not for copyright in the literary work, the payment made would not constitute royalty under the treaty[5].

In a case, the assessee imported 'shrinkwrapped' or 'off-the-shelf' software from the suppliers in foreign countries for business use and made the payment without deducting tax at source. Under section-9(1)(vi) of the Act as well as Article 12 of the DTAA, the payments made in any kind of consideration for the use of, or the right to use, any copyright of a literary, artistic or scientific work" is deemed to be 'royalty'. The amount paid to the supplier to supply the particular software is not the price of the CD alone nor the software alone, or the price of the licence granted. It is actually the combination of all. The respective agreement entered is clear that what is transferred is a right to use the copyright for internal business. Therefore it is held that the payments made in respect of the computer program would constitute 'royalty' under the applicable DTAA and also falls within the ambit of 'royalty' under the definition in the

[3] Under section-195; rate 25% as provided in section-115A or if any relevant DTAA provides lower rate than that rate, then it shall apply instead of 25%

[4] Explanation 4- It is hereby clarified that the transfer of all or any rights in respect of any right, property or information includes and has always included transfer of all or any right for use or right to use a computer software (including granting of a license) irrespective of the medium through which such right is transferred.

[5] Capegemini Business Services (India) Limited (46 CCH 253) (Mum ITAT)

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Act. Thus, TDS is required to be deducted[6]. The Authority for Advance Ruling held that the license fees paid for 'Licensed Program' are taxable as 'royalty' under the Act and the respective DTAA[7]. Thus the provisions of withholding tax are applicable to the applicant[8].

The payments for any information concerning technical, industrial, commercial or scienfic knowledge, experience or skill would amount to royalty under the act[9]. The Authority of Advance Ruling in a case interpreted the clause that it does not contemplate merely imparting information on these matters and held payments for access to the database which contains publicly available financial data does not amount to royalty under Income tax act, as because the information does not relate to underlying experience or skill which contributed to the end-product[10]. The similar view has been taken later by the tribunal[11]. Therefore it is evident that only when an information is a result of experience, skill and expert knowledge of payee and there is imparting or making available of knowledge, experience, or skill can be said such information covered under section-9. Further the Bombay High Court had an occasion to observe that the information must be imparted, which means the industrial or commercial experience must be given, bestowed, communicated or granted from assignor to assignee for consideration[12].

**(B) Under Model Convention**

The taxability was envisaged by OECD in three situations. In the first case, Payments made where less than full rights in the software are transferred i.e. a partial transfer of rights, here the consideration is likely to represent a royalty only in limited circumstances. One scenario, the transferor is the author of the software and alienates part of his right in favour of a third party to enable the latter to develop or exploit the software itself commercially. While, the other is acquisition of the software for personal or business use of the purchaser and will be business income or independent personal services. Secondly, Payments made for alienation of Complete Rights attached to the software, i.e. Payments that has been made for transfer of a full ownership cannot result in royalty. Thirdly, Software payments made under mixed contracts. For instance, the sale of computer hardware with embedded software with concessions of the right to use software with provision for services, whereas in that case consideration be split on

[6] CIT vs. Samsung Electronics Co. Ltd.,64 DTR (Kar.) 178
[7] Millennium IT Software Ltd., 338 ITR 391
[8] Section-195 of Income tax act
[9] Clause (iv) of Explanation-2 to Section-9(1)(vi)
[10] Factset Research Systems Inc.,[2009] 317 ITR 169 (AAR)
[11] Mc Kinsey Knowledge Centre India (P.) Ltd vs. ITO [2018] 92 taxmann.com 226 (ITAT Delhi); ITO (Int. Tax.) vs. Cadila Healthcare Ltd. [2017] 77 taxmann.com 309/162 ITD 575 (ITAT-Ahmedabad)
[12] Diamond Services International P. Ltd vs. Union of India [2008] 304 ITR 201 (Bom)

 

the basis of information mentioned in the contract and the appropriate tax treatment being applicable to each part[13].

The character of payments received in transactions that involves transfer of computer software depends on the nature of the rights the transferee acquires under the specific arrangement regarding the use and exploitation of the program. Generally, the rights in computer programs are a form of intellectual property. The term "computer software" is used to describe both the program in which the intellectual property rights i.e. copyright subsist and therefore the medium on which its embodied. Most of the OECD member countries recognises a distinction between the copyright in the program and software that incorporates a copy of the copyrighted program. Also, transfer of rights with respect to software occur in many different ways that ranges from the alienation of the entire rights in the copyright in a program to the sale of a product which is subject to restrictions on the utilisation. The consideration paid can take various forms. These factors make it difficult to determine where the line between software payments that might be deemed royalties and other types of payments should be drawn[14]. It's worth noting that in cases when a software payment is correctly regarded as a royalty, applying the copyright provisions to software payments may be challenging, because another clause demands that software be classified as a literary, artistic, or scientific production.[15]

It is important to note that protection afforded regarding computer programs under copyright law may differ from country to country. The copyright rights purchased are restricted to allowing the user to use the application. The transferred rights in these cases are specific to the nature of computer programs which allows the user to copy the program. In some countries the act of copying the program onto the hard drive without a license, would constitute a breach of copyright. However, the copyright laws of the many countries automatically grant this right to the owner of software which includes a computer program. Copying the software onto the computer's hard drive or random access memory, or making an archival copy, is considered a necessary step in using the programme, regardless of whether this right is allowed by law or under a licence agreement with the copyright holder. As a result, when determining the tax character of a transaction, rights associated with these acts of copying should be ignored[16].

The reproduction of computer programs resulted in distribution arrangements in which the transferee obtains rights to make multiple copies of the program for operation only within its

[13] OECD in its 1992 Model Convention envisaged these three situations for the first time.
[14] Commentary on Article-12, Para-12.2
[15] Commentary on Article-12, Para-13.1
[16] Payments in these type of transactions would be dealt as commercial income in accordance with Article-7; Commentary on Article-12, Para-14

own business. Those arrangements mentioned as "site licenses", "enterprise licenses", or "network licenses". It permits the making of multiple copies of the program and the rights are generally limited for the purpose of enabling the operation of the program on the licensee's computers or network[17]. The reproduction for any other purpose is not permitted.

The consideration paid for the transfer of the full ownership of the rights in the copyright, the payment that made cannot represent a royalty and so the provisions are not applicable. Difficulties arise where there is a transfer of rights involving, exclusive right of use of the copyright during a specific period, additional consideration related to usage and consideration in the form of a considerable payment[18]. Each instance will be determined by the facts of the case, but in general, if the payment is in exchange for the transfer of rights that comprise a distinct and specific property, the payment is valid[19], then such payments are likely to be business profits under Article-7 or a capital gain under Article-13 rather than royalties. The growing and development of electronic commerce has multiplied the number of transactions. The key question to be addressed in determining whether payments originating from these transactions constitute royalties is the identification of that for which the payment is primarily made.

Further, the consideration is essentially for something other than for the use of, or right to use the rights in the copyright[20], and the use is limited to such rights that required to enable downloading, storage and operation on the customer's computer, network or other storage, performance or display device, This use of copyright shouldn't affect the analysis of the character of the payment made for purposes of applying the definition of "royalties". The transactions that permit the customer to electronically download digital products like software, images, sounds or text[21], for customer's own use or enjoyment[22]. The payment is mainly for the purchase of data transmitted as a digital signal, and so does not qualify as royalties, but rather as company income or capital gains. India's position on OECD regarding the interpretations provided in the OECD Model Convention is of the view that some of the payments referred therein may constitute royalties. The amount that received by a non-resident company, for granting license to use its copyrighted software for licensee's own business

[17] The 2000 OECD Model Convention brought further refinements on *rights to make multiple copies*.
[18] Commentary on Article-12, Para-15
[19] *Distinct & Specific property*, which is more likely in case of geographically limited than time limited rights, Para-16
[20] The rights such as to aquire or any other types of contractual rights, data or services, Para-17.2
[21] The 2008 Model Convention to OECD Model expanded the scope of software payments by including transactions concerning digital products.
[22] The customer may be an enterprise also, Commentary on Article-12, Para-17.3

purpose alone, cannot be tax as 'Royalty' under Article 12(3) of India-US DTAA. In absence of any amendment here, then no need to examine effect of subsequent amendment to Section 9(1)(vi) of the Act.

The assessee paid a subscription fee to a globally famous specialist organisation that collects and publishes business data on software technology. In accordance with the agreement that entered, Wipro was to receive access to database comprising commercial knowledge. The authority sought to tax these under royalties saying that, this information comes under commercial experience in royalty head under IT act. The tribunal ruled that experience mentioned should be one's own experience in the realm of Industrial, commercial, scientific and not compilation of somebody else experience. Since, the facts were not the compilation of Gartner's experience and it did not warrant copyright protection also the assessee's claims were upheld that payments made to non-residents is considered to be royalty[23].

**(C) Know-how**

The information should be technical know-how, for this is to amount to know, It must be the result that goes beyond pure technical progress and are gained by payee through their own activities, skills and innovations. Such information be more than mere knowledge which the payer can obtain or deduce by himself and should be provided by the payee. Since the payments made for the standard operating procedure that is developed by the payee with his skill and know-how and the same were available to the payer to use in rendering of services to its clients, therefore those payments considered as royalty[24]. However the payments only for mere data that could have been obtained by payers by their own means and those payments are not treated as royalty because there was no imparting of any technical skill, experience or know-how by the payee[25].

In the know-how contract, one among the parties agrees to impart to the opposite party, in order to use them for his own account, his special knowledge which remain unrevealed to the public[26]. Examples of payments, which should therefore not be considered to be received as consideration for the clause of know-how but, rather, for the clause of services include payments for pure technical assistance, payments for a list of potential customers, when such a list is developed specifically for the payer out of generally available information, payments for advice provided electronically, for electronic communications with technicians or for

[23] Wipro Limited vs. ITO 278ITR(AT) 57 (Bang)
[24] Oncology Services India Pvt. Vs. ADIT, [2017] 82 taxmann.com 42 (Ahmedabad-Trib)
[25] P P.T. McKinsey Indonesia vs. Dy. DIT [2013] 29 taxmann.com 100 (Mum-Trib)
[26] Para-11.1, Commentary on Article-12

accessing, through computer networks, a trouble-shooting database like a database that gives users of software with nonconfidential information in response to frequently asked questions or common problems that arise frequently[27].

**(D) Copyright vs. Copyrighted article:**

The question of determining whether transfer of a copyright right or only of a copyrighted article understood by taking into account all the facts and circumstances of the case, and also by determining the benefits and burden of ownership that has been transferred[28]. The notion that "copyright" and "copyrighted article" are interchangeable in the context of income taxation was presented in the case, The assessee, on the other hand, is relying on **other case**[29]**,** contended that while one cannot have a copyright without a copyrighted article, but one can certainly have a copyrighted article without a copyright. The Hon’ble Special Bench specifically noted the *contention of learned counsel that if a person owns a copyrighted article, he automatically has a right over the copyright also. The software supplied was a copyrighted article and not a copyright right, and therefore the payment received by the assessee in respect of the software can’t be considered as royalty either under the Income-tax Act or the DTAA.* Thus, the Special Bench expressly rejected the argument that copyright and copyrighted article are one and the same and accepted the view that, there is a distinction between “copyright” and “copyrighted article”; and a payment to be “royalty. Untill the Microsoft decision, this view was considerably accepted.

The ***Gracemac*** was a common judgment in three connected appeals, of three different assessees[30]. The case was taken as the lead matter by the Tribunal. *Microsoft Corporation in its return filed for assessment year 1996-97 offered its income from licensing of software to Original Equipment Manufacturers to tax, but did not offer to tax its income which is from sale of Microsoft software products to Indian Distributors. however, the payments received from Indian Distributors also got taxed as ‘royalty’ under section 9(1)(vi) of Income Tax Act, 1961 and Indo-US DTAA. Thus against this order, the appeal has been made*[31]*. Similarly, In case of MRSC, the payments that received from Indian distributors on sale of Microsoft software products were not offered to tax as royalty. It was assessed the entire payments in their hands taxed as royalty income on the ground that payments received towards licensing of Microsoft*

[27] Para-11.4, Commentary on Article-12
[28] ADIT vs. Bartronics India Ltd. [2014] 62 SOT 141 (Hyderabad ITAT)
[29] Lucent Technologies vs. ITO 82 TTJ 163
[30] Gracemac vs. ADIT, ITA Nos. 1331-1336/Del/2008
[31] Microsoft Corporation vs. ADIT, ITA Nos. 1392/Del/2005

*software products which amounts to grant of right in Intellectual property Rights*[32].

The issue altogether in these cases was whether supply of off-the-shelf software by non-resident companies to Indian distributors is taxable within the hands of the non-resident companies as "royalty" under the Act and Article-12 of the India-US DTAA. Basically, the payments made by the distributors to the non-resident companies was in issue. The assessing officer took the view that the payment made by the Indian end-user was in the nature of royalty. As the source of the royalty was the Indian end-user and the assessing officer held that the sums would be taxable in India. The Tribunal pointed out that *the taxation of payments made by end users for computer programme in the form of 'shrink wrapped' software through a distribution channel is involved.* It then moved to the assessee's claims that "copyright" and "copyrighted article" are two different things.

In Indian law, the term "copyrighted article" has no definition. The Special Bench decision, had relied on American decisions and on OECD commentary to introduce this distinction. Whereas the Tribunal purported to rely on the Supreme Court judgment[33], for the proposition that OECD commentary would not be a guide for interpreting provisions of the Income Tax Act. The decision of the Supreme Court in this case cannot be seen as an absolute bar against the said practice. Indeed, the OECD commentary has been cited by the Supreme Court[34]. It was observed *it is clear that the end users have not purchased copy of software products on electronic media as contended by the assessee but a licence to use such software products.* As a result, the Tribunal dismissed the distinction between "copyright" and "copyrighted article," concluding that end-user payments were in the nature of royalties. Again the contrary view was taken and it was held that since the end user is given the right to use the copyright, this should be characterized as royalty[35].

There have been divergent views of various Indian courts relating to taxability of software payments. The Karnataka High Court ruled in favour of the revenue, holding that payments paid by end users of a computer programme who are granted a licence to make copies of the computer programme for backup or archiving purposes are taxed as "royalty."[36]. Similarly, the Authority for Advance Rulings also in favour of revenue, held that payment that made towards software in a distribution arrangement is taxable as royalty since it is impossible to separate software from the intellectual property of the creator of the software embedded therein. Thus

32 Microsoft Regional Sales Corporation vs. ADIT, ITA Nos. 1393-1395/Del/2005
33 CIT vs. P.V.Kulandagan Chettiar (2004) 137 Taxmann 460 (SC)
34 Azadi Bachao Andolan vs. Union of India 263 ITR 706
35 Mumbai Tribunal in ADIT vs. TII Team Telecom International
36 CIT vs. Samsung Electronics Co. Ltd 345 ITR 494 (Kar.)

sale or licensing for use of copyrighted software amounts to the grant of a right to use a copyright[37]. However, the Delhi High ruled in favor of taxpayers by emphasizing on the distinction between acquisition of a "copyright right" and a "copyrighted" article. It was held that the license which is granted by the taxpayer was limited to those necessary rights in order to enable the licensee to operate the program. Therefore, there is no such transfer of copyright or right to use the copyright to characterize the same as royalty under the act or the appropriate treaty[38].

## III. Permanent establishment

By the growing digitalization, sometimes the old concepts of taxation may no longer exists in certain cases. For instance, the concept of permanent establishment has been an issue because it requires some kind of permanency located in the country which allows to tax a non-resident on that basis. However, countries also trying to find a way or means to tax people, who are not physically present in the country, but having transactions with the country.

In the cases of *Motorola, Ericsson and Nokia* the tribunal ruled in the light of three different sets of facts, One such issue, the tribunal dealt with, is whether the activities of the non-residents result into a business connection or Permanent Establishment i.e.,'PE' in India, merely because the non-residents had wholly owned subsidiary in India. Wherein the case of Motorola, The special bench held that, by the facts, it was however established the activities carried on by the employees were preparatory and auxiliary in character and because, as per the relevant DTAA between India and USA, there was a specific exclusion from the constitution of a PE by the carrying on of such activities, therefore no PE of Motorola was constituted in India.

In the case of Ericsson, it was held that it did not have a PE in India on account of there being no 'fixed place of business'. Furthermore, there was no 'Agency PE' as an Ericsson subsidiary, and it had no ability to sign contracts on Ericsson's behalf. Also, as the profits with regard to the installation had already been taxed in the hands of the Indian subsidiary, therefore the same could not be taxed once again in the hands of supplier[39]. In Nokia case, the Special Bench held that its liaison office would not constitute its permanent establishment in India because it was not carrying on any commercial activities. In fact, to mention, it was specifically barred by the Reserve Bank of India from doing so. The case of its subsidiary, as the facts led to a perception of the subsidiary being a projection of the activities of Nokia in India. To constitute PE in India,

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[37] Citric Systems Asia Pacific Pty. Ltd. 343 ITR 1 (AAR)
[38] DIT vs. Ericsson A.B. 343 ITR 470 (Del.); Dassault Systems K.K. 322 ITR 125 (AAR)
[39] Ericsson case

the reasonable inference can be drawn that the subsidiary was a virtual projection of the supplier in India[40].

The observation of the tribunal that, No income is deemed to accrue or arise in India to a non-resident from the sale of hardware and software if that sale is actually effected outside India to an Indian purchaser eventhough the non-resident supplier made it along with other group companies, who has entered into contract for supply and installation of equipment in India. In such cases, as the sale of the equipment is effected outside India, the title and the risk passes to the Indian purchaser outside India and thus, there is no business connection with respect to domestic tax law between the non-resident supplier and the Indian purchaser.

## IV. CHARACTERISATION ISSUE -ROYALTY OR BUSINESS INCOME

The classification of software payments is an international tax issue that affects both cloud computing software providers and purchasers. It is addressed to be important as it affects how software receipts are taxed and under which head it is to be taxed, also whether withholding of taxes applied or not are all in question. The key difference that arises is whether payment constitutes royalty i.e. sale of copyright or business income i.e. sale of copyrighted article. Under OECD model convention, the royalty definition captures wide range of payments and no specific mention made to software, much less cloud computing payments. It has backed a right-based system, in which royalties are paid for the use or right to use copyrights, whereas payments for copyrighted products, such as pre packaged software or off the shell software are considered as business income. Royalties are subject to flat rate of withholding tax in source country and rate varies from country to country.

The Income where characterized as business income, is get taxed in the source country only if the foreign entity maintains permanent establishment in that country. Suppose if it does not maintain permanent establishment in that country, then it is possible that business receipts will not get taxed in the source country. There are advantages to have income characterized as business income as because the software purchaser is not liable to withhold tax, when their payment represents business income rather than royalties.

### (A) Business profits or payments for right to use or use of, a copyright

The most important characterisation issues that arises from e-commerce was the distinction between business profits and treaty definition of "royalties" that deals with payments for the use of, or the right to use, a copyright. The royalties applies to “payments for” any of the various

[40] Nokia Networks OY (2005) 95-ITD-269 (SB)

items listed in that definition. Most importantly the question to be addressed is the identification of the consideration for the payment. In the case of transactions which permit the customer to electronically download digital products, the payment that made to acquire such data transmitted in the form of a digital signal for the own use or enjoyment of the acquirer and it constitutes the essential consideration for the payment for use of a copyright by the customer under the relevant law and contractual arrangements. This is merely an incidental part of method of capturing and storing the digital signal. Whereas this incidental part is not considered to be important for classification purposes because it does not attracts the essential consideration for the payment i.e., to acquire data transmitted in the form of a digital signal, which is the determining factor for the purposes of assessing royalties under the treaty..

**(B) Business profits and payments for Know-how**

The e-commerce transactions that leads to know-how payments are relatively rare, In some transactions, it is necessary to differentiate whether the consideration for a payment is that the provision of services or the provision of know-how i.e. information concerning industrial, commercial or scientific experience. The provision of information will be viewed as the provision of information about a computer programme, only if the information is relating to computer programming techniques.

## V. Ruling on software payments

The debatable issue on the taxation of software payments regarding the characterization of income in the hands of non-resident taxpayers as either ‘royalties’ i.e. triggering an Indian withholding tax or ‘business profits’ i.e. triggering no Indian tax in the absence of permanent establishment. The tax authorities taken a position that income arising from grant of software license should be characterized as "royalty", irrespective of the nature of rights which acquired by the customer. While, the taxpayer's position, on the other hand, in terms of the tax treaty, that income from computer software should be characterized as royalty or business income on the basis of the nature and extent of rights which is granted to the customer[41]. The Supreme Court has ruled that payments for software cannot be considered royalties[42]. However the two decade controversy was settled. The verdict was important to provide tax certainty to the stakeholders and also provides a conclusive tax treatment.

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[41] Ipsita Agarwalla & Meyappan Nagappan; *Impact and Analysis of the Supreme Court decision on characterization and taxation of software payments;* Published on March-8, 2021; Available at Impact of Supreme Court Decision on Software Payments Taxation (natlawreview.com), Last accessed on May-20, 2021

[42] *Supra.n.2,* Civil (Appeal) 8733-8734 of 2018 –Batch of 103 appeals

**(A) Observation**

Considering the arguments, contentions and issues, the Supreme Court ruled in favour of the tax payer. It was held that there is no obligation to withhold tax at source while making remittance for purchase of software on the premise that the nature of software does not qualify as 'royalty' as being taxable in India.

**(B) On the Act**

The Supreme Court observed that on the basis of section-90(2), once a tax treaty applies, the provisions of the act would not apply unless they were more beneficial to the taxpayer[43]. Moreover, the definition of a particular term under the act would be applicable only when the said term is not defined in the tax treaty. Also the TDS obligation under section-195 is inextricably connected with the charging provisions under sections-9 and 4 read with the tax treaty. Thus, the TDS obligation on the payer would arise only if the recipient is liable to pay tax in India.

The Supreme Court also differentiated the present dispute from its ruling in PILCOM, it was held that treaty provisions have no relevance in examining the payer's obligations under section-194E. Whereas the previous case dealt with tax deduction at source on any sum that chargeable under the act. To find the chargeability, the payer have to consider the relevant treaty provisions. Therefore it was said that the PILCOM does not have any application to the facts of the relevant case.

The court re-stated old principles of taxation under the act and their interplay with tax treaties. The way, the court differentiated this case with the above said ruling should provide certainty to taxpayers that the reasoning would not be used arbitrarily against the taxpayers. Also, it is unclear as to why the tax treaty provisions, being more beneficial would not apply in the context of withholding under section-194E and similar sections. It was recognised that denying the payer the ability to analyse the impact of the tax treaty would have two repercussions. At first, the payer may make an excess payment and the refund of which available to the recipient at the stage of its assessment. Secondly, the treaties impose a limit on the tax rate that the recipient could be charged with in the contracting state i.e. India. However, the payer have to deduct tax at the rate under the act in which may be higher than the limit under the treaty. Thus, the tax deducted would be a larger sum than the tax that is finally payable by the recipient[44]. Thereby,

[43] The Court relied on ruling in Union of India vs. Azadi Bachao Andolan, (2004) 10 SCC 1

[44] Neeraj jain, Partner Vaish Associates Advocates & Anshul Sanchar; *Engineering analysis centre of excellence private limited(SC)-Software taxation,* on 24th March, 2021; Available at Engineering Analysis Centre Of Excellence Private Limited (SC) – Software Taxation - Tax - India (mondaq.com), Last accessed on 22nd

it was held that a person making a payment to a non-resident would be liable to deduct tax only if he is liable to pay under section-195, and accordingly, the person would be liable to deduct tax at the given rate in the treaty.

**(C) On the Copyright Act**

The Supreme Court examined the provisions of the Copyright Act, and comes to the conclusion that payment for the resale or use of the computer software through end user licensing agreement or through distribution agreements, is not actually the payment of royalty. The Court makes it clear that a copyright is an exclusive right to do or authorize the doing of certain acts in respect of work that includes literary work and hence, computer software. The transfer of copyright would take place only when the owner of the copyright parts with the right to do any of the acts which mentioned in section-14 of the Copyright Act. Such transfer is different, since there would no transfer of right to reproduce the copy or to do any other acts under this section. It also observed that the "right to reproduce" and therefore the "right to use" computer software are two separate rights, because the former attracts transfer of copyright[45], and held that no copyright would exist in India outside the Copyright act provisions. Further held that the making of copies or adaptation of a computer programme in order to utilise it for the purpose for which it was supplied, or to make up any back-up copies as a temporary protection against loss, destruction or damage so as to utilise it, does not constitute an act of infringement of copyright.

The Supreme Court dismissed the argument[46], by stating that the doctrine has been statutorily recognized in the Act and is applicable to the case of the distributor or reseller. Also noted the decision by the European Court of Justice, wherein it was concluded that the transfer of a copy of a computer programme, accompanied by the conclusion of an agreement constituted a first sale of a copy of a program[47]. The Court held that the distribution right subsists with the owner of copyright to issue copies of the work to the public, to the extent such copies are not copies already in circulation, thereby manifesting a legislative intent to apply this doctrine. Thus, the Court held that the Copyright Act only prohibited reproduction and subsequent sale of a copy of the licensed copy, and not the resale of the copy.

The Supreme Court set aside the ruling of AAR, by stating that the license for the use of a product under an end user licensing agreement cannot be construed as the license under section-

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[45] State Bank of India vs. Collector of Customs (2000) 1 SCC 727

[46] Delhi HC in case of John Wiley & sons Inc., vs. Prabhat Chander Kumar Jain, IA No.11331/2008 in CS (OS) No.1960/2008 reported in 2010 SCC Online Del 2000

[47] Used Soft Gmbh vs. Oracle International Corpn (Case C-128/11)

30 of the Copyright Act, as it only imposes restrictive conditions upon the end-user and does not part with any interest relatable to any rights mentioned in sections-14(a) and 14(b). Also set aside the ruling of Karnataka High Court, and held the ruling does not state the law clearly[48]. The other ruling of AAR was upheld, wherein it has correctly distinguished between the ownership of copyright in a work from the ownership of the physical material in which the copyrighted work may happen to be embedded. The Court gave its blessing to decision of AAR[49].

**(D) Sale of goods vs. Copyrighted article**

The observations in *Tata Consultancy Services*[50], makes it clear that the law doesn't make any distinction between tangible property and intangible property. Therefore software has the properties like its utility, capable of being bought and sold, capable of transmitted, transferred, delivered, stored and possessed should be treated as goods regardless of the medium it is stored on. The Court does not resolve this inconsistency wholly. It treats the consideration to be for sale of goods as some places and to be for license or right to use copyrighted article at other places. The Court technically addressed software on a CD format or in tangible format. However, in a digital license, no title is given in reference to the software or the copy of the software or any tangible good and thus arguably it shouldn't be categorized as a sale.

**(E) Doctrine of Impossibility**

The Supreme Court reiterated that withholding liability does not generally arise when the recipient is not susceptible to pay tax in India, i.e. say, when there is no income that is chargeable to tax in India. Also affirmed that taxpayer cannot be penalized due to retrospective amendments and therefore the law does not demand the impossible. Liability to withholding tax cannot considered to be fastened upon the taxpayer by virtue of retrospective amendments within the Act. The contention got negated that treaty benefits shouldn't be evaluated at withholding stage[51].

**(F) Tax treaties**

The Court noted the importance of the Commentary on Article-12 of the OECD Model Tax Convention and held that it might have persuasive value with reference to the interpretation of

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[48] CIT vs. Synopsis International Old Ltd., ITA Nos.11-15/2008

[49] Geoquest systems B.V. Geveres Deynootweg; DIT vs. Ericsson; DIT vs. Nokia Networks; DIT vs. Infrasoft; CIT vs. ZTE Corpn

[50] Tata consultancy services vs. State of Andhra Pradesh, 5th Nov 2004

[51] Vikas vasal; *Finality on taxation of software payments to non residents*; Published on 18th March 2021; Available at Finally...finality on taxation of software payments to non-residents (livemint.com); Last accessed on 24th May, 2021

the term "royalties". It had been held that the payers and recipients, they need a right to know their position and obligations under a treaty and place reliance on the Commentary to understand it. Further, India's reservations to the commentary would not affect its relevance unless incorporated through bilateral negotiation with the respective countries. Also noted that India entered or amended tax treaties with different countries after expressing its reservation, yet the royalty definition had not been changed, and it is almost like the definition within the OECD Model. Therefore, its reservation would not apply because it had not been incorporated in any tax treaty. Importantly, the observations of the Supreme Court have reinstated the sanctity of the OECD Commentary.

## VI. Impact

The judgment settled almost the two-decade controversy and is probably going to impact various technology companies and distributors or resellers. The taxpayers should first revisit their positions for royalties which paid in the past and apply for refunds, wherever possible and applicable. Also, they're posed with another question regarding the applicability of the equalisation levy on the transactions made. The Court has relied on cases under Customs law, Copyright Act etc., so as to characterise the transaction. So, Indian entities with foreign investment that engaged in e-commerce with reference to 'sale of goods' can also re-check their compliance with those rules. As an example to mention, if an entity is dealing only with licensing or providing the right to use with regard to software in wholly digital format, then it is unlikely to face any problems. Moreover, simply to say, currently, the long-existing controversy has come to an end.

## VII. Conclusion

The recent judgment delivered by Supreme Court on March 2021, gave a conclusion in characterizing software payments. It was ruled out that payments by an Indian entity to a non-resident for the purchase of off-the-shelf software does not regarded as royalty under the relevant tax treaties, and accordingly, there is no withholding tax obligation on the Indian payer. Royalty under the Income-tax act is wide enough to include consideration for license of computer software without any transfer of underlying IP. However, under the internationally accepted principles, the definition is narrower.

## VIII. Suggestions

The proposal has been made in 2020 for the change to the definition of royalties, article-12. The proposal is to include computer software in the definition of royalties. My point of view is that, the proposal to amend definition of royalty to include "software payment" is a welcome move, because traditional taxation rules at times do not actually provide comprehensive guidance on taxation of payments with respect to use of computer software. Computer programmes or other software have become a vital tool in the conduct of most organisations, due to improvements in communication and information technology. It is not possible to think of any business without using computer software, and every company has to incur expenditure on computer software.

The suggestions on Direct tax submitted for pre-budget memorandum 2021-22 is that payments for a copyrighted article like shrinkwrapped software as also payments made by distributors of software be specifically excluded from the definition of "royalty". It is made for minimising litigations, and I agree with this opinion in order to reduce the existing controversies. However, currently, this ruling has put to rest a long-drawn controversy. But to think, the technology sector has contributed a lot to socio-economic transformations across the globe. There are emerging technologies too, such as artificial intelligence, Internet of things (IoT). In this era of relentless evolution, reconsideration of the tax rules is necessary.

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