

## Tax Update: Payment for use of computer software is not royalty

### Engineering Analysis Centre of Excellence Private Limited v. CIT (Civil Appeal Nos. 8733-8734 of 2018)

#### FACTS OF THE CASE

- The taxpayer is a resident Indian end-user of shrink-wrapped computer software. The taxpayer directly imported shrink-wrapped software from USA.
- The Tax Officer (TO) after applying Section 9(1)(vi) of the Income-tax Act, 1961 (IT Act) and Article 12(3) of the Double Taxation Avoidance Agreement between India and US (India-US DTAA) held that payment for the said transaction was for transfer of copyright and characterized the payment in the nature of royalty. Accordingly, the taxpayer was held liable to withhold tax under Section 195 of the IT Act.
- The Commissioner of Income-tax (Appeals) (CIT(A)) dismissed the appeal of the Taxpayer. However, the Income-tax Appellate Tribunal (ITAT) ruled in favour of the taxpayer. The TO approached the Karnataka High Court, against the said order of the ITAT.
- The Karnataka High Court upon examining the End-User License Agreement (EULA) remarked that what was sold by way of computer software included a right or interest in copyright. This would thus give rise to the payment of royalty and would be an income deemed to accrue in India under Section 9(1)(vi) of the IT Act and would require withholding of tax.
- Against the order of the Karnataka High Court, the said matter was preferred before the Hon'ble Supreme Court of India. Various appeals have been filed against the order of the Karnataka High Court (by the assessee), Delhi High Court (by the TO) and Authority for Advance Ruling (AAR) (by the assessee).

#### JUDGEMENT

As the current matter involved cases filed by various taxpayers and TO, the Hon'ble Supreme Court grouped the matter into four categories as under:

Cases in which computer software is purchased directly by a resident end-user from a non-resident supplier/manufacturer	Cases in which the resident Indian company acts as a distributor or reseller of computer software from non-resident supplier/manufacturer and then resells the same to resident Indian end-user	Cases in which the non-resident distributor after purchasing software from a non-resident seller, resells the same to resident Indian distributor or end-user; and	Cases in which computer software is affixed onto hardware and is sold as an integrated unit/equipment by non-resident supplier to resident Indian distributor or end-user.
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The Court while pronouncing its decision has discussed various aspects pertaining to the matter, which have been briefly outlined below:

#### Interpretation of 'Copyright' as per the Indian Copyright Act, 1957 (ICA)

- The Court examined the provisions of the ICA and remarked that no copyright exists in India outside the provisions of the ICA.
- The Court noted that though the expression 'copyright' has not been defined separately in the definitions section of the ICA, Section 14 makes it clear that copyright means the exclusive right, subject to the provisions of the ICA, to do or authorize the doing of certain acts in respect of a work. Further, the Court observed that when an author in relation

to a literary work- which includes a computer program- creates such work, the author has the exclusive right to do or authorize the doing of several acts in respect of such work.

- The Court observed that in the case of a computer program, Section 14(b) specifically sets out how the exclusive right that is with the owner of the copyright may be parted with i.e. if there is any parting with the right to reproduce the work in any material form; the right to issue copies of the work to the public(not being copies already in circulation); the right to perform the work in public or communicate it to the public; the right to make any cinematograph film or sound recording in respect of the work; the right to make any translation of the work; the right to make any adaptation of the work; or the right to do any of the specified acts in relation to a translation or an adaptation.
- Further, it was noted that infringement of copyright takes place when a person ‘makes for sale or hire or sells or lets for hire’ or ‘offers for sale or hire’ or ‘distributes so as to affect prejudicially the owner of the copyright’. **Importantly, the making of copies or adaptation of a computer program in order to utilize the said computer program for the purpose for which it was supplied, or to make back-up copies as a temporary protection against loss, destruction or damage, does not constitute an act of infringement of copyright.**

#### Analysis of the EULA

- The Court reproduced certain sample clauses of the EULA with respect to each category listed above and held as under:
  - A reading of the aforesaid distribution agreement would show that what is granted to the distributor is only a non-exclusive, non-transferable license to resell computer software. It is expressly stipulated that no copyright in the computer program is transferred either to the distributor or to the ultimate end-user.
  - This is further amplified by stating that apart from a right to use the computer program by the end-user himself, there is no further right to sub-license or transfer. Additionally, there is no right to reverse-engineer, modify, reproduce in any manner other than that permitted by the license to the end-user.
  - The consideration paid therefore, by the distributor in India to the foreign, non-resident manufacturer or supplier, is the price of the computer program as goods, either in a medium which stores the software or in a medium by which software is embedded in hardware. This may be then further resold by the distributor to the end-user in India, with the distributor making a profit on such resale. It is important to note that the distributor does not get the right to use the product at all.
  - In all these cases, the ‘license’ that is granted vide the EULA, is not a license in terms of Section 30 of the ICA, which transfers an interest in all or any of the rights contained in Sections 14(a) and 14(b) of the ICA. It is in fact a ‘license’ which imposes restrictions or conditions for the use of computer software.
  - A simple illustration to explain the aforesaid position is given in the following paragraph. If an English publisher sells 2000 copies of a particular book to an Indian distributor, who then resells the same at a profit, then no copyright in the aforesaid book is transferred to the Indian distributor - either by way of license or otherwise. The Indian distributor only makes a profit on the sale of each book. Importantly, there is no right granted to the Indian distributor to reproduce the aforesaid book and then sell copies of the same. On the other hand, if an English publisher were to sell the same book to an Indian publisher, this time with the right to reproduce and make copies of the aforesaid book with the permission of the author, it can be said that copyright in the book has been transferred by way of a license or otherwise, and what the Indian publisher will pay for, is the right to reproduce the book. This can then be characterized as royalty for the exclusive right to reproduce the book in the territory mentioned by the license.
  - There can be no doubt as to the real nature of the transactions. What is “licensed” by the foreign, non-resident supplier to the distributor and resold to the resident end-user, or directly supplied to the resident end-user, is in fact the sale of a physical object which contains an embedded computer program, and is therefore, sale of goods.

#### Applicability of the DTAA

- The Court rejected the argument of the TO that Section 195 of the IT Act deals with deduction made prior to assessment to tax, not being in the nature of tax and a stage prior to declaring a person as ‘assessee in default’. Therefore, the DTAA’s provisions in these cases would not apply at all
- Referring to the ruling on the case of **GE India Technology Centre (P) Ltd. v. CIT, (2010) 10 SCC 29**, the Court remarked that what is made clear is the fact that the person spoken of in Section 195(1) of the IT Act is liable to make the necessary deductions only if the non-resident is liable to pay tax under the IT Act and not otherwise. In saying so, the

Court held that the charging and machinery provisions contained in Sections 9 and Section 195 of the IT Act are interlinked.

- The Court cited Article 12(2) of the India-Singapore DTAA and held that if the TO's submission is correct, then the DTAA would not apply and royalty would be liable to be taxed in India at the rate mentioned in the IT Act. This royalty can be much higher than the DTAA rate. As a result of this, the deduction made under Section 195 of the IT Act by the person responsible would have to be a proportion of a much higher sum than the tax that is ultimately payable by the non-resident assessee. This equally absurd result cannot be countenanced given the fact that the person liable to deduct tax is only liable to deduct tax first and foremost if the non-resident person is liable to pay tax, and second, if he is liable, then the tax would be deducted depending on the rate mentioned in the DTAA.

#### Definition of Royalty under the IT Act vis-à-vis DTAA

- The Court noted that the DTAA contains an exhaustive definition of the term 'royalty'. It includes payment made for the use or right to use any copyright in a literary work. The royalty definition under IT Act is different and wider as compared to royalty definition under DTAA. IT Act refers to consideration paid for transfer of all or any rights including by way of a license in respect of any copyright.
- The Court remarked that the phrase 'in respect of' used in the IT Act means 'in' or 'attributable to'. Thus, in order to qualify as royalty even under IT Act, it is *sine qua non* that there has to be transfer of all or any rights in a copyright by way of license or otherwise. In case where there is a payment for grant of license, such payment would qualify as royalty only if such license results in transfer of rights in the copyright granted to the owner of a copyright under the ICA.
- In view of the above, the Court held that since the license granted to distributors and end users do not create any interest or right in software, grant of such license would not amount to 'use of or right to use' copyright and hence it would not qualify as royalty under the DTAA.
- The Court also noted that the IT Act was amended in 2012 to provide that transfer of all or any rights includes transfer of all or any rights for use of a computer software. This amendment expands the royalty definition and may not be considered as clarificatory in nature. However, such payments would not qualify as royalty for the purposes of DTAA.
- On the argument of the TO that on account of the expanded definition of royalty under Section 9(1)(vi), the persons responsible ought to have deducted taxes under Section 195, the Court answered this contention by applying two latin maxims namely, "*lex non cogit ad impossibilia*", i.e., the law does not demand the impossible and "*impotentia excusat legem*", i.e., when there is a disability that makes it impossible to obey the law, the alleged disobedience of the law is excused. Thus, the Court applying the doctrine of impossibility observed that the "person" mentioned in Section 195 of the IT Act cannot be expected to do the impossible, namely, to apply the expanded definition of "royalty" inserted by Explanation 4 to Section 9(1)(vi) of the IT Act, for the assessment years in question, at a time when such explanation was not actually and factually in the statute.

#### Rulings of The AAR and the judgments of High Courts

- The Court derived the following conclusions on a reading of the judgments of the AAR and High Court in the said matter:
  - Copyright is an exclusive right which is negative in nature being a right to restrict others from doing certain acts;
  - Copyright is an intangible, incorporeal right, in the nature of a privilege, which is quite independent of any material substance. Ownership of copyright in a work is different from the ownership of the physical material in which the copyrighted work may happen to be embodied. An obvious example is the purchaser of a book or a CD/DVD, who becomes the owner of the physical article, but does not become the owner of the copyright inherent in the work, such copyright remaining exclusively with the owner;
  - Parting with copyright entails parting with the right to do any of the acts mentioned in the ICA. The transfer of the material substance does not, of itself serve to transfer the copyright therein. The transfer of the ownership of the physical substance in which copyright subsists, gives the purchaser the right to do with it whatever he pleases except the right to reproduce the same and issue it to the public unless such copies are already in circulation and the other acts mentioned in the ICA;
  - A license from a copyright owner conferring no proprietary interest on the licensee does not entail parting with any copyright and is different from a license issued under the ICA, which is a license which grants the licensee an interest in the rights. Where the core of a transaction is to authorize the end-user to have access to and make use of the 'licensed' computer software product over which the licensee has no exclusive rights, no copyright is

parted with and consequently no infringement takes place. It makes no difference whether the end-user is enabled to use computer software that is customized to its specifications or otherwise;

- A non-exclusive, non-transferable license merely enabling the use of a copyrighted product is in the nature of restrictive conditions which are ancillary to such use and cannot be construed as a license to enjoy all or any of the enumerated rights or create any interest in any such rights;
- The right to reproduce and the right to use computer software are distinct and separate rights as has been recognized in ***SBI v. Collector of Customs, 2000 (1) SCC 727***, the former amounting to parting with copyright and the latter in the context of non-exclusive EULAs, not being so.
- In view of the above, the Court upheld the view contained in the determinations of the AAR in the case of ***Dassault Systems, K.K., In Re., (2010) 322 ITR 125*** and ***Geoquest Systems B.V. Gevers Deynootweg, In Re., (2010) 327 ITR 1*** and the judgments of the High Court of Delhi in ***DIT v. Ericsson A.B., (2012) 343 ITR 470***, ***DIT v. Nokia Networks OY, (2013) 358 ITR 259***, ***DIT v. Infrasoftware Ltd., (2014) 264 CTR 329*** and ***CIT v. ZTE Corporation, (2017) 392 ITR 80*** as correct in law.

#### Doctrine of first sale/principle of exhaustion

- The Court noted that as per the doctrine of first sale, once a copyrighted article is sold by the owner of the copyright, then the owner exhausts all rights to control that particular article/copy although the copyright continues to vest with the owner.
- The Court observed that the ICA prevents a person other than an owner from reproducing the software and transferring them to a subsequent user which suggests that the ICA intends to apply the doctrine of first sale/principle of exhaustion.
- The TO contended that the ICA was amended in 1994 & 1999 and it no longer recognizes the principle of exhaustion. Accordingly, when distributors sell computer software or copyrighted software license to end-users, there would be parting of a right or interest in copyright itself as per the ICA. Further, the TO placed reliance on the decision of Court of Appeals of the US in the case of ***Timothy S Vernor v Autodesk Inc (621 F. 3d 1102 (9th Cir. 2010))*** to contend that doctrine of first sale cannot be invoked by distributor/licensee who are not the owner of copyright.
- The Court held that it is incorrect to suggest that distribution of software by the distributor constitutes grant of an interest in the copyright or infringement of the copyrights.

#### Interpretation of DTAA, OECD Commentary and the TO's own understanding

- The Court while quoting its decision in the case of ***Union of India vs. Azadi Bachao Andolan ((2004) 10 SCC 1)*** held that the DTAA that have been entered into by India with other Contracting States have to be interpreted liberally with a view to implement the true intention of the parties.
- The Court found that the definition of 'royalties' seen in all the concerned DTAA is either identical with or similar to the definition contained in Article 12 of the OECD Model Tax Convention and accordingly, highlighted the importance of the OECD commentary for Article 12 of the OECD Model Tax Convention.
- The Court observed that after India took its positions to 'reserving its right' to tax royalties *qua* the OECD Commentary, no bilateral amendment was made by India and the other Contracting States to change the definition of royalties contained in any of the concerned DTAA. Further, the Court highlighted that DTAA that were amended subsequently, such as the India-Morocco DTAA also incorporated a definition of royalties, not very different from the definition contained in the OECD Model Tax Convention.
- The Court even took note of the India-Singapore and India-Mauritius DTAA which has been amended several times, however, the definition of 'royalties' has been retained without any changes.
- In view of the above, the Court concluded that the OECD Commentary on Article 12 of the OECD Model Tax Convention, incorporated in the DTAA will continue to have persuasive value as to the interpretation of the term 'royalties' contained therein.
- The Court rejected the TO's reliance placed on the E-commerce Report, 2016 that the proposed Equalisation Levy on specified digital services would require an express inclusion in tax treaties in order to be feasible. The Court points out that these reports do not carry the matter much further as they are recommendatory reports expressing the views of the committee members, which the Government of India may accept or reject.

- The Court also referred to the CBDT Circular No. 10/2002 dated October 9, 2002 whereby the CBDT after referring to Section 195 had itself made a distinction between remittances for royalties and remittances for supply of articles or computer software in the proforma of the certificate to be issued as per the Circular. Accordingly, the Court opined that it is one more circumstance to show that the revenue has itself appreciated the difference between the payment of royalty and the supply of computer software in the form of goods, which is then treated as business income of the taxpayer, taxable in India only if it has a Permanent Establishment in India.

### Conclusion

- Given the definition of royalties contained in Article 12 of the DTAA, the Supreme Court concluded that it is clear that there is no obligation under Section 195 of the IT Act to deduct tax as the EULAs do not create any interest or right in the distributors/end-users, which would amount to the use of or right to use any copyright.
- The Court ruled in favour of the taxpayer for all four categories of cases enlisted above and held that:

*“Our answer to the question posed before us, is that the amounts 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 persons referred to in section 195 of the Income Tax Act were not liable to deduct any TDS under section 195 of the Income Tax Act.”*

### ELP Comments

The taxation of payment for grant of copyright vis-à-vis copyrighted article/product has been a contentious issue over the years with various higher appellate authorities taking divergent views.

The income-tax authorities have generally taken a position that income from grant of software program/license should be characterized as ‘royalty’ in accordance with the expanded definition of royalty under Explanation 2 to Section 9(1)(vi) of the IT Act, whereas the taxpayers contention has been that what has been transferred is only a copyrighted article/product and not copyright and further. The expanded definition prescribed under the IT Act, therefore, ought not to override the provisions of the DTAA in the absence of any amendments therein.

This ruling has finally put an end to the said controversy and ruled that payments by resident end-users or distributors (residents/NR) of shrink-wrapped software is not royalty under the DTAA.

The above decision would certainly give clarity to the software industry with respect to withholding tax on payment for grant of license to use software. It would be interesting to see, how this ruling may help those deductors/taxpayers who have conservatively deducted/paid taxes on payments pertaining to grant of license to use software.

The ruling also discussed the doctrine of impossibility, wherein the law does not demand the impossible and thus, a person cannot be obligated to perform an action, which was not present in the statute book, when the transaction took place. Thus, on the basis of a retrospective law, the income-tax authorities cannot obligate a person to withhold taxes under Section 195 of the IT Act for a transaction which was done in the past.

This has been a welcome ruling, which has put to rest a long-drawn controversy.

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