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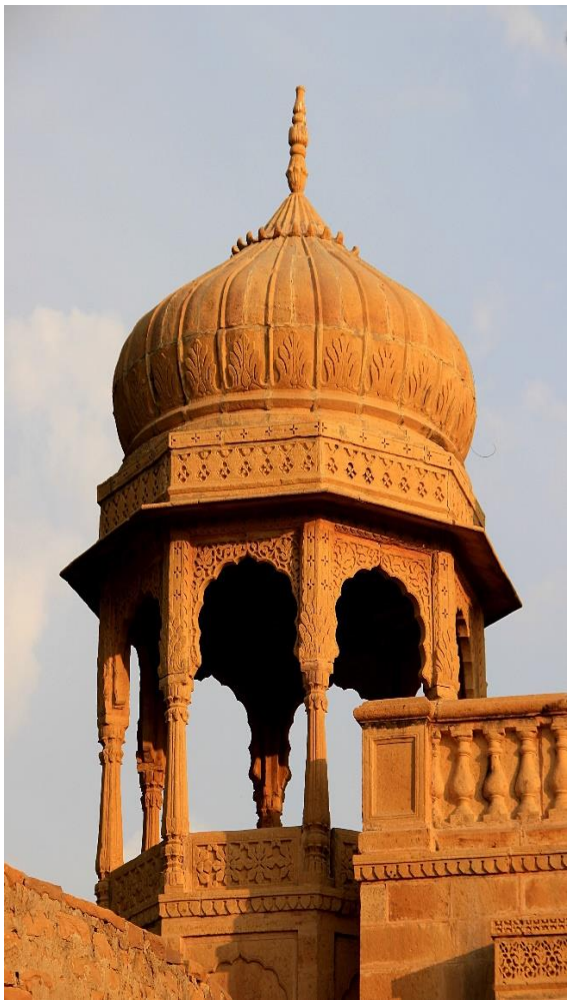

Supreme Court holds that payment for right to use software is not taxable as 'Royalty'

The Supreme Court of India, on 2nd March, 2021, pronounced a landmark judgment in a batch of cases comprising over 100 appeals on the much debated issue of taxation of payments for the purchase of software.

The appeals which were filed both by the assessee as well as revenue against the various judgments of the High Courts, were on the issue whether payment for software under different situations are to be taxed as 'royalty' or not.

The assessees relied on various decisions of the High Court of Delhi in which the issue was decided in favour of the assessees. Whereas the tax department relied on decisions of the Karnataka High Court as well as on Advance Ruling under which it was held that purchase of software included a right or interest in copyright and as such, was liable to tax as Royalty under section 9(1)(vi) of the Income-tax Act and the provisions of the tax treaties.

The Supreme Court for determination of the issues posed to it, grouped the appeals into four categories as under:

- Cases in which computer software is purchased directly by an end-user in India from a non-resident supplier;
- Cases of purchase of computer software by resident distributors or resellers from non-resident suppliers for reselling the same to Indian end-users;
- Cases of purchase of computer software by non-resident distributors or resellers from non-resident suppliers for reselling the same to Indian end-users;
- Cases wherein computer software is affixed onto hardware and is sold as an integrated unit/equipment by non-resident suppliers to Indian distributors or end-users.

Arguments of the assessees

The assessees, which supplied software to the distributors for further resale of the software or sold directly to the end users, raised the following major contentions:

i. The shrink-wrapped computer software imported by a non-exclusive distributor for resale constitutes 'goods', which is not covered by the definition of 'royalty'.

ii. The definition of royalty does not extend to derivative products of the copyright. For example, a book or a CD or software product.

iii. Retrospective amendment to section 9(1)(vi) of the Income-tax Act brought in by Finance Act, 2012, which added Explanation 4 to the provision and extended its ambit with effect from 1st June 1976, could not be applied to the DTAA in question.

iv. As per Copyright Act, 1957, there is a difference between a copyright in an original work and a copyrighted article.

v. Merely making copies of computer software in order to utilize the product to the extent permitted by End User License Agreement (EULA) would not constitute an infringement of copyright under section 52 of the Copyright Act.

vi. Since no distribution rights by the original owner extended beyond the first sale or the copyrighted goods (Doctrine of first sale/ exhaustion), it can be said that only the goods and not the copyright in the goods had passed on to the importer.

Arguments of the tax department

In response to the aforesaid contentions raised on behalf of the assessees before the Supreme Court, the revenue urged the following main arguments in support of its contention of taxability of the impugned

receipts as 'Royalty' in India.

1. Explanation 4 as inserted by Finance Act, 2012 to extend the scope of royalty is clarificatory in nature and is applicable since 1st June, 1976.

2. The provisions of DTAA are applicable only to the assessee and not the deductor who is required to withhold tax under section 195 of the Income-tax Act.

3. The expression 'in respect of' used in the definition of royalty under Explanation 2(v) should be given wide meaning and as such, any right in relation to copyright will be covered in the definition of royalty.

4. As per the decision of the Supreme Court in PILCOM v. CIT SCC Online SC 426, the tax has to be deducted irrespective of whether tax is otherwise payable by non-resident assessee or not.

5. As per Copyright Act, since adaption of software could be made, albeit for installation and use on a particular computer, copyright is parted with by the original owner and as such, the same shall fall in the ambit of royalty.

6. The department further relied on reports of the High Power Committee on 'Electronic Commerce and Taxation' and Committee on 'Taxation of e-commerce' to urge the position of the Government of India with regard to the taxes on royalty.

7. The revenue further pointed out that the Indian government had expressed its reservation on the OECD commentary dealing with the parting of copyright and royalty.

8. Referring to doctrine of first sale / principle of exhaustion, it was submitted that this doctrine cannot be said to apply in so far as distributors are concerned and as such even distribution by reseller would amount to use of copyright, taxable as royalty.

Decision of the Supreme Court

The Supreme Court after hearing the arguments of the assessees as well as the tax department, held as under:

Provisions of Copyright Act

After examining the provision of the Copyright Act, the Supreme Court held that:

1. A literary work includes a computer programme. In respect of computer programme, section 14(a) of the Copyright Act specifies how the exclusive right that is with the owner of the copyright may be parted with. Section 14(b) of the Copyright Act defines the copyright as "to sell or give on hire or offer for sale or hire any copy of the computer programme".

2. In order to fall in the definition of 'royalty' under the Income-tax Act, there must be transfer by way of licence or otherwise, of all or any of the rights mentioned in section 14(b) read with section 14(a) of the Copyright Act.

3. Making of copies or adaptation of the computer programme in order to utilize the said computer programme 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.

4. The sale or commercial rental spoken of in section 14(b)(ii) of the Copyright Act is of "any copy of a computer programme", making it clear that the section would only apply to the making of copies of the computer programme and then selling them, i.e., reproduction of the same for sale or commercial rental. Thus, a distributor who purchases computer software in material form and resells it to an end-user cannot be said to be within the scope of the aforesaid provision and thus would not constitute royalty.

After examining various EULAs pertaining to the impugned issue, the Supreme Court noted that making of copies of a computer programme is allowed by the supplier only for the purpose of back up. The title, copyright and IPR remains with the supplier and there is a complete restriction on reproduction of the software.

It further noted that the license granted to the distributor is non-exclusive, non-transferable, and only to resell computer software.

Based on the analysis of the above, the Supreme Court held that what is paid by consideration to the Non-Resident supplier is the price of a computer programme as goods, either in a medium which stores the software or in a medium by which software is embedded in hardware. The distributor does not get the right to use the product at all. Hence in all these cases, the license i.e. granted vide EULA is not a license in terms of section 30 of Copyright Act.

Scope of royalty under the Income-tax Act after its amendment by Finance Act, 2012 vis-à-vis DTAA

With respect to the definition of royalty under the Income-tax Act after its amendment by the Finance Act, 2012, the Supreme Court held as under:

- The Supreme Court held that it is difficult to accept that Explanation 4 is clarificatory of the position with regard to taxation of royalty as it always stood on 1st June, 1976.

- Similarly, it cannot be accepted that the Explanation 6 to section 9(1)(vi) of the Income-tax Act will apply with effect from 1st June, 1976 when the technology relating to transmission by a satellite, optic fibre or other similar technology, was only regulated by the Parliament for the first time through the Cable Television Networks (Regulation) Act, 1995, much after 1976.

With respect to the argument of the tax department that definition of royalty under the Income Tax Act shall apply to the cases under consideration, the Supreme Court held that as per the Explanation 4 to section 90 and under Article 3(2) of the DTAA, the definition of term 'royalty' shall have the meaning assigned to it by the DTAA. As such, the expression 'royalty' when occurring in section 9 has to be construed with reference to Article 12 of the DTAA.

Obligation of the deductor to withhold tax

The machinery provision contained in section 195 of the Income-tax Act is inextricably linked with the charging provision contained in Section 9 read with section 4 of the Income-tax Act. The deduction of TDS is only to be made if the Non-Resident is liable to pay tax under charging provision under the Income-tax Act read with DTAA.

As regards reliance placed by the tax department on the decision of Supreme Court in the case of PILCOM case (supra) to urge that the deductors were under obligation to withhold tax, the Supreme Court held that such decision was on the issue of withholding tax u/s 194E which deals with TDS without any reference to chargeability of tax under the Income-tax Act, whereas in section 195, deduction of tax can be made only if the Non-Resident is liable to pay tax in India. The Supreme Court thus relying on its earlier decision in GE Technology Centre P. Ltd v. CIT (2010) 10 SCC 29 held that the decision in PILCOM case has no application to the facts of this case.

With respect to the argument of the tax department that there was a liability to withhold tax on the payment made to the Non-Resident supplier with retrospective effect, the Supreme Court quoted two legal maxims: *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. The Supreme Court thus held that the

"person" mentioned in section 195 of the Income Tax 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 Income-tax Act for the purpose of deduction of tax, for the assessment years prior to the year when such Explanation was introduced, i.e. at a time when such explanation was not actually and factually in the statute.

Principles of taxation of software emerging from High Court decisions

The Supreme Court quoted with approval the various Rulings of the Delhi High Courts as under:

i. Copyright is an exclusive right, which is negative in nature, being a right to restrict others from doing certain acts.

ii. 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.

iii. Parting with copyright entails parting with the right to do any of the acts mentioned in section 14 of the Copyright Act. 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 section 14 of the Copyright Act.

iv. A licence from a copyright owner, conferring no proprietary interest on the licensee, does not entail parting with any copyright, and is different from a licence issued under section 30 of the Copyright Act, which is a licence which grants the licensee an interest in the rights mentioned in section 14(a) and 14(b) of the Copyright Act. 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, as is recognized by section 52(1)(aa) of the Copyright Act. It makes no difference whether the end-user is enabled to use computer software that is customised to its specifications or otherwise.

v. A non-exclusive, non-transferable licence, 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 licence to enjoy all or any of the enumerated rights mentioned in section 14 of the Copyright Act, or create any interest in any such rights so as to attract section 30 of the Copyright Act.

vi. 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.

Relevance of OECD Commentary and report of various committees appointed by the Government of India

The Supreme Court held that for the purpose of analyzing the definition of royalty in all the DTAA relevant to the present appeals, which are either identical or similar to Article 12 of OECD Model Tax Convention, the OECD commentary may be relied upon, as per which where a distributor makes payments to acquire and distribute software copies (without the right to reproduce the software), the rights in relation to those acts of distribution should be disregarded in analyzing the character of the transaction for tax purposes.

The Supreme Court held that the committee reports relied upon by the tax department do not carry the matter much further as they are recommendatory, expressing the views of the Committee Members, which the Government of India may accept or reject. Even if the position put forth in such reports were to be accepted, the DTAA would have to be bilaterally amended before any such recommendation becomes law in force for the purpose of the Income-tax Act.

Conclusion

The Supreme Court also noted that a distinction has been made by Revenue between the payment of royalty and supply of computer software in the proforma of certificate to be issued in Annexure B of the erstwhile remittance certificate, in the case of remittance of royalty.

Based on the aforesaid, the Supreme Court concluded that in all the category of appeals, there is no obligation on the deductor to withhold tax as the distribution agreement/ EULAs in the facts of these cases do not create any interest or right in such distributors/ end users, which would amount to the use of or right to use any copyright.

This landmark decision resolves a highly disputed issue on the subject of software taxability and lays down principles for interpretation of DTAA which will be very useful in many matters.

Extension of date of filing declaration and making payment under Vivad se Vishwas Scheme

The Government had introduced Vivad se Vishwas (VsV) Scheme for settlement of tax disputes under the Income-tax Act. Under VsV Scheme, taxpayers can make payment of their disputed tax on the additions/ disallowances under appeal before Appellate forum, subject to which consequential interest and penalty will be waived off and immunity from prosecution would also be granted.

The time period for filing of declaration by the taxpayer as well as payment under the same was extended from time to time taking into consideration COVID-19 pandemic. The Government had previously allowed filing of declaration till 28 February 2021 and payment of taxes till 31st March 2021.

It has now been decided by the Government, vide Notification No. 9/2021 dated 26 February 2021, to further extend the date of filing the declaration till 31st March 2021 and also allowing an additional month of making payment under such scheme from 31st March 2021 to 30th April 2021.

Extension of last date of completion of assessment or reassessment by tax authorities

In a separate Notification 10/2021 dated 27th February 2021, the Government has extended the time limit for completing assessment and reassessment proceedings as under:

a) The due dates (after extension by Notification No. 93/2020) of assessments or reassessments falling due on 31st March 2021- Due date extended from 31st March 2021 to 30th April 2021.

b) In respect of assessments and reassessments for which the original statutory due date for completion was 31st March 2021. For instance, regular assessment for AY 2019-20- Due date extended from 31st March 2021 to 30th September 2021.

Rule prescribed for computing perquisite value of accretion on employer contribution to certain funds

The Finance Act, 2020 introduced section 17(2)(vii) providing that where any amount is contributed by employer towards Provident Fund, Superannuation fund or NPS in aggregate exceeding Rs. 7.50 lakh, the amount in excess of Rs. 7.50 lakh shall be considered as perquisite.

Further, the annual accretion in the form of interest, dividend or any similar amount on such excess amount was also to be considered as perquisite in terms of section 17(2)(via). Such annual accretion was to be computed in the manner to be prescribed.

The CBDT, by Notification No 11/ 2021 dated 5th March 2021, has now provided the following formula to compute the annual accretion, which will be considered as taxable perquisite in the hands of the employee:

TP= (PC/2)*R + (PC1+ TP1)*R

Where,

TP= Taxable perquisite under section 17(2)(viia) for the relevant financial year;

TP1 = Aggregate of taxable perquisite under section 17(2)(viia) since AY 2020-21 (excluding the relevant financial year);

PC= Amount or aggregate of amounts of principal contribution made by the employer in excess of Rs. 7.5 lakh to the specified fund or scheme during the relevant financial year;

PC1 = Amount or aggregate of amounts of principal contribution made by the employer in excess of Rs. 7.5 lakh to the specified fund or scheme since AY 2020-21 (excluding the relevant financial year);

R= I/ Favg;

I=Amount or aggregate of amounts of income accrued during the relevant financial year in the specified fund or scheme account;

Favg = (Aggregate of opening balance of the specified fund or scheme + Aggregate of closing balance of the specified fund or scheme)/2.

In our view, the above formula considers taxable annual accretion based on average rate of return on all the aforesaid funds and same basis will also apply to the opening balance of the fund representing such excess contribution and annual accretion thereto.

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