Debate on Characterisation of Payment for Purchase of Software

There have been various standardised software for day-to-day business needs, which were developed outside India by foreign companies and then sold in India either to direct customers or to wholesale vendors. The trend of import of software has resulted in a debate as to whether payment on account of import of software is in the nature of royalty income or merely a sale of goods, for the non-residents. Taxability of the non-resident supplying such software will depend on the nature of payment made on account of purchase of software. The nature of payment for use of software will decide whether the amount received by the non-resident will be in the nature of royalty or business income. In this article, the author analyses the debate on characterisation of payment for purchase of software.

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In this era of globalisation, transactions between two international states are very common, and technology has played an important role in boosting the international trade. Nowadays technology has become an integral part of every business and every person has to update himself with recent technological developments to compete in this technology driven era. This basic fact has resulted in purchase of software from abroad, either being standard one or designed for specific business needs. There have been various standardised software for day-to-day business needs, which were developed outside India by foreign companies and then sold in India either to direct customers or to wholesale vendors, who import these software as per the market demand. These software were generally imported in the form of diskettes, CD, Pen Drive, etc.

The import of software has resulted in a debate as to whether payment on account of import of software is in the nature of royalty income or merely a sale of goods, for the non-residents. Taxability of the non-resident supplying such software will depend on the nature of payment made on account of purchase of software. The nature of payment for use of software will decide whether the amount received by the non-resident will be in the nature of royalty or business income.

The tax implication in India, for the payment of software under both the circumstances, i.e. royalty as well as business income, is highlighted hereunder:

Taxability as Royalty

Under the Act: Non-residents receive payments for software outside India and it may not accrue or arise in India. However, under Section 9(1)(vi) of the Act, royalty paid by Indian resident to a non-resident is deemed to accrue or arise in India, unless it is payable in respect of right, property or information used or services utilised for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India. Similarly, royalty paid by a non-resident to another non-resident is also deemed to accrue or arise in India where it is payable in respect of right, property or information used or services utilised for the purposes of a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India.

Under the Double Tax Avoidance Agreement (DTAA): Royalty paid by a person resident in India is considered as arising in India and is regarded as taxable in India.

Under the Act, Profits received in India, accruing or arising in India or deemed to accrue or arise in India are taxable in India. Generally non-residents receive payments for software outside India and it may not also accrue or arise in India. Also, under Section 9(1)(i) of the Act, income deemed to accrue or arise in India, in the case of a business, is only so much part of the income as is reasonably attributable to the operations carried out in India. Generally, no activities are as such carried out in India and hence no profits are deemed to accrue or arise in India.

Taxability as Business Income

Under the Act: Profits received in India, accruing or arising in India or deemed to accrue or arise in India are taxable in India. Generally non-residents receive payments for software outside India and it may not also accrue or arise in India. Also, under Section 9(1)(i) of the Act, income deemed to accrue or arise in India, in the case of a business, is only so much part of the income as is reasonably attributable to the operations carried out in India. Generally, no activities are as such carried out in India and hence no profits are deemed to accrue or arise in India.

Under the DTAA: Business profits are not taxable in India unless they are attributable to a Permanent Establishment (PE) in India. Hence, where non-residents deriving income from software do not have any PE in India, profits earned from sale of computer software are not taxable in India under DTAA.

One has to analyse the nature of transaction in the following manner to decide whether a particular transaction is in the nature of royalty income or business income.

Legal Analysis

▸ ***Royalty Income***

Royalty has been defined under Explanation 2 to Section 9(1)(vi) of the Act as under:

"……., "royalty" means consideration (including any lump sum consideration but excluding any consideration …….. chargeable under the head "Capital gains") for—

(i) ……..
……..
……..

(v) the transfer of all or any right (including granting of a licence) in respect of any copyright, literary, artistic, or scientific work……..."

(Emphasis supplied)

Further, the definition of the term 'royalty' in different DTAA's is almost similar. General definition of royalty as per DTAA is as under:

"The term "royalties" as used in this Article means:

(a) payment of any kind received as a consideration for the use of, or the right to use, any copyright or a literary, artistic, or scientific work,……"

(Emphasis supplied)

The above definition of royalty in essence put emphasis on the right to use of any copyright. In the Indian context, the law that regulates copyrights and provides protection thereto is the Indian Copyright Act, 1957 (IC Act). Section 14 of the IC Act defines 'copyright' as follows:

"For the purposes of this Act, "copyright" means the exclusive right subject to the provisions of this Act, to do or authorise the doing of any of the following acts in respect of a work or any substantial part thereof, namely:-

(a) ……

(i) to reproduce the work in any

material form including the storing of it in any medium by electronic means;

(ii) *to issue copies of the work to the public not being copies already in circulation;*

(iii) *to perform the work in public, or communicate it to the public;*

(iv) *to make any cinematograph film or sound recording in respect of the work;*

(v) *to make any translation of the work;*

(vi) *to make any adaptation of the work;*

(vii) *to do, in relation to a translation or an adaptation of the work, any of the acts specified in relation to the work in sub-clauses (i) to (vi);*

(b) in the case of a computer programme,-

(i) *to do any of the acts specified in clause (a);*

(ii) *to sell or give on commercial rental or offer for sale or for commercial rental any copy of the computer programme;"*

(Emphasis supplied)

The above definition highlights the acts which fall under the definition of copyright. From the above definition it is clear that there should be reproduction, issue of copies or selling or giving on commercial rental of the computer software. Further, the term 'to sell or give/offer for sale or for commercial rental' seeks to include within its purview those transactions in which the purchaser makes copies of the software and distributes/sells the same. Moreover, computer programmes are protected under the IC Act. They are treated as literary works. Under the IC Act, in addition to all the rights applicable to a literary work, owner of the copyright in a software enjoys the rights to sell or give on hire or offer for sale or hire, regardless of whether such a copy has been sold or given on hire on earlier occasion. No other person shall make one or more copies of computer programme in storing in the computer memory without the permission of the copyright owner.

From the above analysis of law, it is clear that amount received against use of software shall be taxable as royalty only when the user of the software is using the copyright in the software and not otherwise.

▸ *Business Income*

Sale of computer software will be taxable as Business income, if treated as sale of goods. In this regard it is important to refer to the definition of sale relating to goods under the Sale of Goods Act, 1930. Section 4(1) of the Sale of Goods Act defines "sale and agreement to sale" as under:

"A contract of sale of goods is a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price."

The above definition makes it clear that there should be "a contract for sale" along with "transfer of the property in goods". The settled position under the Sale of Goods Act with respect to "contract for sale" and "transfer of property" is as follows:

i) Sale is an agreement between parties:
- under mutual ascent;
- supported by money consideration; and
- resulting in transfer of title from buyer to seller.

ii) Property means general property in goods and not merely a special property.

The above settled position when applied in the case of sale of computer software, the following position immerges:

The amount received against use of software shall be taxable as royalty only when the user of the software is using the copyright in the software and not otherwise. Income Sale of computer software will be taxable as Business income, if treated as sale of goods.

i) Sale of software involves sale of diskette/CD along with license to use the software. However, in the present case the importance of license is negligible since the software is sold by the seller to the buyer with the restrictions that the buyer cannot reproduce, to issue copies or to sell or give on commercial rental the software and the software can only be used for its day-to-day business operations.

Importance of license agreement is primarily governed by the value derived by software product from intellectual effort put into it along with ease of reproduction of software. However, the buyer of the software do not derive any value from intellectual effort since the buyer gets the software in a finished form as an end user, for a price. Moreover, the seller does not give any right to the buyer to make copies or reproduce the computer software.

ii) Sale of computer software is in essence the transfer of property in the nature of computer software, despite presence of various restrictions (viz. restriction on reproduction, restriction on making copies and restriction on sale or giving on commercial rental). Property in the nature of computer software is transferred since on purchase of software, the buyer has specific right on such software, i.e. right to use the software for

specified purposes other than purposes of restrictive nature.

The above analysis of royalty income and business income highlights the basic understanding as to when a particular payment for purchase of software is treated as royalty income or business income in the hands of the non-resident. The nature of payment is very much facts-specific and depends on the nature of transaction between the non-resident seller and the resident buyer.

Depending on the nature and facts of transactions, different types of business models for purchase of computer software are discussed below:

1. ***Delivery of single copy of software:*** Under this model, foreign company owns the copyright in the computer software. Software programme is loaded on disks and placed in boxes covered with shrink wrap license. Software is sold to the buyer either on tangible medium or through the Internet, i.e. the software will be downloaded and activated once the activation key is being registered on the website of the seller. Buyer is simply permitted to operate the software and not to exploit the copyright in the software by way of reproduction, making copies and sale or giving on commercial rental.
2. ***Distribution Model:*** Under this model, foreign company enters into an agreement with independent distributors for distribution of software. Distributor purchases specific number of copies of software programme from the foreign company, based on the market demand. Distributors supply the software to customers directly or through independent distribution channels. Under this arrangement foreign company puts restriction on the distributors that distributors are not permitted to duplicate the software for public distribution.
3. ***Multiple User Licenses Model:*** Under this model, foreign company transfers a single disk containing the software programme to an Indian company. The Indian company is granted the right to load software on agreed number of workstations, for a onetime fee per user. Additional fee is required to be paid by Indian company for any additional user. The Indian company gets the right to install the software for its internal use and not to exploit the copyright in the software, commercially.
4. ***Original Equipment Manufacturer Model:*** Under this model, foreign company transfers a single disk containing the software to an Original Equipment Manufacturer (OEM), i.e. manufacturer of desktops, laptops, etc., along with non-exclusive license to (i) make unlimited copies of software; (ii) pre-install such copies on the hard drive of the computer system manufactured; and (iii) distribute pre-installed software along with the computer system. OEM pays royalty to foreign company based on the number of copies of software loaded onto computer system manufactured.
5. ***Software Bundled with Hardware:*** Under this model, computer software pre-installed in computer hardware is sold together as a single product. Supplier of the equipment may enter into a separate agreement for its private labeled product, with the equipment buyer. The supplier of the equipment becomes one point contact for the buyer, both for hardware and software. The buyer receives the right to use the software programme but cannot modify or resell the software. (This arrangement is typical to transfer of telecom equipment embedded with software).

Taxability in the hands of non-resident, under all the aforesaid models is to be analysed in the light of the following important court rulings on the subject matter.

The taxability of sale of software in the hands of non-resident depends on the use of software by the buyer. If the buyer uses the software for its internal business purpose and does not exploit the copyright in the software, it will amount to business income of the non-resident treating the sale of software as mere sale of goods. However, if the buyer exploits the copyright in software, i.e. makes copies of the software, income on such account in the hands of non-resident would be in the nature of royalty.

Important Judicial Developments

▸ ***Motorola Inc vs. DCIT (2005) 95 ITD 269 (Del)(SB)***

Motorola Inc. executed contracts with Indian telecom operators for supply of advanced network equipment (GSM systems) for use in fixed as well as mobile telecommunication networks. Motorola had wholly owned subsidiaries in India. The important contractual arrangement were that (i) Equipment supply contracts were executed between Motorola and telecom operators; (ii) Installation contracts were executed between Indian subsidiary and telecom operators; and (iii) Marketing/Business promotion agreement between appellant and Indian subsidiary. Further, software was inseparable and integral part of

hardware, without which hardware could not function. Moreover, Indian telecom operators could not onward sell the software independently without sale of the hardware. On the basis of aforesaid facts, the special bench of the Honourable Tribunal held that license granted is for the perpetual use of software and the software could not be sold independently, except with the sale of hardware. Software is an integral part of telecom equipment and without which the hardware could not function. The honourable Tribunal further held that *payment for software licensing can be held as royalty only if payment is for a copyright right, and not copyrighted article.* Payment in the present case is for copyrighted article and not copyright right since (i) under Copyright Act, 1957, 'copyright' is an exclusive right granted to the holder; whereas, the appellant have merely transferred a non-exclusive restricted license to use the software; (ii) the telecom operators have only been granted limited user rights in the software, i.e. use only for their business operations and not for commercial exploitation; and (iii) no rights as mentioned in clause (a)/(b) of Section 14 of the Copyright Act, 1957, i.e. right to reproduce or make copies, to make translation or adaptation, were acquired by the telecom operators. On the basis of the above, the honourable Tribunal held that as payment of hardware and software were at lump sum payment, no separate consideration should be attributable by the revenue authorities towards software as 'royalty' and in the absence of PE, software payments are not taxable in India.

▸ ***Lucent Technologies Hindustan Ltd. vs. ITO (2005) 92 ITD 366 (Bang)***

The assessee (i.e. Lucent Technologies) is engaged in the manufacture and sale of electronic switching systems required for the telecommunication industry and a substantial part of its sale are to the Department of Telecommunications (DOT). Initially DOT places a purchase order for supply of digital local telephone exchange equipment on the assessee. The price of the equipment to be supplied is a lump sum price; and the equipment to be supplied consists of various modules as well as the software that runs the equipment. On the basis of the order from DOT, assessee places an order on Lucent USA, for supply of parts and components of switching system. From the perusal of the purchase order it was clear that the application software has also to be supplied along with the equipment. In other words, the acquisition of software was inextricably linked to the acquisition of hardware and one cannot function without the other. It was impractical to have such value addition without the help of other. The assessee has not acquired any rights in the software. The software that is so supplied by Lucent USA is customer-specific and cannot be even re-used or duplicated in any other exchange when identical orders are placed by the DOT. The assessee has not acquired rights in the copyright program so that it can be exploited commercially. *What the assessee has purchased is a copyrighted article and not copyright of the rights.* Therefore, department was not justified in bifurcating the transactions as one of supply of hardware and the other of software, and in treating the payment for software as a part of royalty.

Delhi Tribunal in the case of Microsoft Corporation and Gracemac Corporation vs. ADIT (2010) 47 DTR 65 (Del)(ITAT), did not accept the distinction between "copyright right" and "copyrighted article", on the basis that such distinction is not apparent from the plain language of the definition of royalty under the Act or the DTAA between India and US. Further, the ITAT declined to import the expression "copyrighted article" from OECD commentary or US regulations for the purpose of interpretation of the term "royalty" and held that for the purpose of the Act, a copyrighted article cannot be treated as a product.

▸ ***Samsung Electronics Company Ltd. vs. ITO (2005) 94 ITD 91 (Bang)***

The assessee imported software products from USA, France and Sweden. Agreement between the parties shows that what the assessee had acquired is only a copy of the

copyrighted articles, i.e. software, whereas the copyright remains with the owner, i.e. foreign parties. The incorporeal right to software, i.e., copyright, remained with the owner and the same was not transferred to the assessee. The primary condition for bringing within the definition of 'royalty' in DTAA is that the payment of any kind received as consideration for the use of right to use any copyright of a literary, artistic or scientific work, etc. Right to use a copyright is totally different from right to use the programme embedded in a cassette or CD or it may be a software. The assessee had acquired a readymade, off the shelf computer programme for being used in its business. No right was granted to the assessee to utilise the copyright of the computer programme. The assessee had merely purchased a copy of the copyrighted article, namely, a computer programme which is called 'software'. Therefore, the remittance made by the assessee was not 'royalty' as defined in the relevant DTAA and the same was not taxable in India. The honourable Tribunal applied the decision of apex court in the case of *Tata Consultancy Services vs. State of Andhra Pradesh (2004) 271 ITR 401 (SC)*.

Under 'Pure distribution model', the distributors are not permitted to make copies or duplicate the software. Distributor is allowed to sale only such number of software as are imported from the foreign company. In this model also the sale will be of copyrighted article, hence not taxable as royalty but will be taxable as business income, subject to the fact that the foreign company has a PE in India.

▸ ***Sonata Software Ltd. vs. ITO (2006) 6 SOT 700 (Bang)***

The assessee has imported software packages for the purpose of distributing it to ultimate users. The imports had been made from certain non-residents of USA, UK, Singapore, Taiwan and Hong Kong. The imports were made in terms of agreement, of most cases, entered into with these non-residents. The honourable Tribunal relying on the judgment of Samsung Electronics (supra) held that where the software imported, which is a shrink wrapped software or off the shelf software; same amounts to purchase of goods and not payment of royalties. *The payment is for use of copyrights article and not for acquiring any copyright.* The payment partake the character of purchase and sale of goods. In the absence of Permanent Establishment in India, it is concluded that no income is deemed to accrue or arise in India.

▸ The understanding of the honourable Tribunal in the aforesaid judgements have been affirmed by the decisions of Authority for Advance Ruling in the following cases:

- *FactSet Research Systems Inc. (2009) 317 ITR 139 (AAR)*
- *Dassault Systems K.K. (2010) 322 ITR 125 (AAR)*
- *GeoQuest Systems BV (2010) 327 ITR 1 (AAR)*

▸ However, the honourable Delhi Tribunal in the case of *Microsoft Corporation and Gracemac Corporation vs. ADIT (2010) 47 DTR 65 (Del)(ITAT)*, did not accept the distinction between "copyright right" and "copyrighted article", on the basis that such distinction is not apparent from the plain language of the definition of royalty under the Act or the DTAA between India and US. Further, the honourable ITAT declined to import the expression "copyrighted article" from OECD commentary or US regulations for the purpose of interpretation of the term "royalty" and held that for the purpose of the Act, a copyrighted article cannot be treated as a product. Moreover, the honourable ITAT analysed the definition of 'copyright' under the IC Act and held that reference to IC Act has to be made for the limited purpose of finding out the meaning of the word 'copyright', only because the said term is not defined in the Act or DTAA. The expression 'exclusive right' used in the IC Act refers to the right of the author/creator and not the nature of right given by him to some party to reproduce the copyrighted work or sell the computer programme, etc. Even a non-exclusive right given by the owner to a person to do one or more acts has a copyright in respect of the property. Even grant of one such right in respect of a copyright or work would amount to transfer or use of the copyright. Accordingly, the honourable ITAT held that a right granted to use the computer software will be royalty.

▸ It is important to note that in the following rulings, which were delivered after the Delhi ITAT ruling of Microsoft Corporation (supra), the honourable Mumbai ITAT decided the issue of purchase of software applying the concept of "copyright" and "copyrighted article, relying on the judgment of Motorola (supra) and Samsung (supra):

- *DDIT -vs.- Reliance Industries Ltd. (2010-TII-154-ITAT-MUM-INTL)*
- *ADIT -vs.- M/s Tata Communications Ltd. (2010-TII-157-ITAT-MUM-INTL)*
- *M/s Daimler Chrysler AG -vs.- DIT (2010-TII-203-ITAT-MUM-INTL)*

The honourable Mumbai ITAT based on the terms and conditions of the agreement held that

the assessee has purchased a copyrighted article and not the copyright itself. There is no transfer of any part of copyright. The honourable ITAT observed that so far as the merit of the issue is concerned, there is unanimous view of various benches of the tribunal that payment for use of copyright article cannot be brought to tax as royalty.

Final Analysis

From the above legal and judicial analysis [subject to the ruling of honourable Delhi ITAT in the case of Microsoft (supra)] one may conclude that the taxability of sale of software in the hands of non-resident depends on the use of software by the buyer. If the buyer uses the software for its internal business purpose and does not exploit the copyright in the software, it will amount to business income of the non-resident treating the sale of software as mere sale of goods. However, if the buyer exploits the copyright in software, i.e. makes copies of the software, income on such account in the hands of non-resident would be in the nature of royalty. On the basis of this analysis, the taxability of various business models will be as follows:

1. *Delivery of single copy of standardised software on tangible media or through the Internet:* Under this model the buyer is only permitted to operate the software and not to exploit the copyright in the software. This will tantamount to sale of copyrighted article, hence amount received by the non-resident would not be taxable as royalty but will be taxable as business income. However, if the seller does not have a PE in India, the whole of the amount received would not be taxable in India. Means of delivery (i.e. through tangible media or through Internet) of the software would be immaterial.
2. *Pure distribution model:* Under this model, the distributors are not permitted to make copies or duplicate the software. Distributer is allowed to sale only such number of software as are imported from the foreign company. In this model also the sale will be of copyrighted article, hence not taxable as royalty but will be taxable as business income, subject to the fact that the foreign company has a PE in India.
3. *Multiple User License:* Under this model the Indian resident is licensed only to use the software for a fee and is not granted the right to exploit the copyright of the software. In this model also the fee received by the non-resident will be in the nature of business income for sale of copyrighted article and not royalty, since right is granted to copy the program only for use in business of the user and for each copy of software, the user is required to pay fee to the non-resident. However, if the seller does not have a PE in India, the fee received will be exempt from tax in India.
4. *Original Equipment Manufacturer (right to make copies):* Under this model, the equipment manufacturer makes unlimited number of copies of the software under the non-exclusive license. Payment to the non-resident is made on the basis of number of copies installed in the equipment. In this model, the Indian equipment manufacturer exploits the copyright in the software for its manufacturing business. The amount received by the non-resident from the OEM will be in the nature of royalty since the non-resident provides license for copyright right and not business income.
5. *Software bundled with Hardware:* Under this model, the software and hardware is inseparable and hardware cannot be used without the software. Further, the seller charges a composite price for the single product which consists of software and hardware. Moreover, the buyer cannot modify or resell the software embedded in the hardware. The amount received by the seller is for the sale of copyrighted article and not royalty; since right to make copies for commercial exploitation is not granted to the buyer.

Taxability of non-resident in India on account of income from sale of software depends on the use of software by the buyer in India. If the Indian buyer uses the software for its own business purpose as copyrighted article, income from such transaction will be taxable as business income in the hands of non-resident, subject to the fact that the non-resident has a PE in India.

Conclusion

Taxability of non-resident in India on account of income from sale of software depends on the use of software by the buyer in India. If the Indian buyer uses the software for its own business purpose as copyrighted article, income from such transaction will be taxable as business income in the hands of non-resident, subject to the fact that the non-resident has a PE in India. However, if the Indian buyer uses the software as copyright right, i.e. exploits the copyright in the software, income from such transaction is taxable as royalty in the hands of non-resident. ■