Taxability of Software Payments under the Act – The Controversy Continues

Taxability of software payments is one of the most debated topics in the field of international taxation. The controversy basically relates to whether payment for use of computer software can be termed as royalty as per provisions of Section 9(1)(vi) of the Income-tax Act, 1961 ('the Act') or under provisions of relevant double tax avoidance agreement ('DTAA'). There have been series of judgements analysing this issue and more or less the issue was settled with majority rulings holding that payment for use of computer software would not be covered under definition of royalty under various DTAAs. However, the said position was revisited in the judgement of Delhi Income-tax Appellate Tribunal ('ITAT') in the case of *M/s Gracemac Corporation*[1] , wherein Delhi ITAT held that payment for use of computer software is taxable as royalty both under the Act as well as DTAAs. The above ruling of Delhi ITAT as well as position of taxability of computer software under various DTAAs has been analysed in depth in the article published in the March edition of the Chartered Accountant Journal. However, as against series of judgements analysing taxability of software payments under DTAAs, there are few judgments analysing taxability of software payments under the Act. Further, as the definition of royalty under the Act is wider as compared to royalty definition under provisions of the DTAAs, judgements analysing the provisions of DTAAs may not be applicable while determining taxability under the Act. Hence, in the instant article, we have examined taxability for software payments under provisions of the Act.

Types of Software Payments

Before analysing whether payment for use of computer software would be taxable under the Act it would be imperative to determine type of software payments. Generally, software payments can be categorised under any of the following categories:

(i) Use of 'Off-the-shelf' software or 'shrink wrapped' software

Computer software which are ready to use and are not customised for any single person are termed as 'off-the-shelf' software or 'shrink wrapped' software. Common example of these types of software is Microsoft Office, Microsoft Windows, Accounting software like Tally etc.

Normally, before using any off the shelf software, a licence agreement is required to be signed electronically by the user. This licence agreement contains restrictions in terms of its use and grants its user only a non-exclusive right to use the software only for the purpose specified in the licence agreement. Further, the

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[1] *134 TTJ 257*

source code for these software is kept by the companies and hence, the user cannot modify the software for its own use.

(ii) Use of Customised software

Customised software is software which is developed based on specific requirement of its user. Accordingly, they can be used only by the user for which it is produced and not by any other user. An example of customised software would be specific accounting software which is produced and modified based on requirements given by the user.

Here, the distinction needs to be drawn between software made for a specific industry vis-à-vis, software made for a specific user. For example, a software like AutoCAD may be used only by the architectural industry or engineering industry only but is not made for any one specific user. Hence, such computer software would still qualify as off-the-shelf software and not fall in the category of customised software.

However, if AutoCad is developed specific for a user, it may fall under the category of customised software.

In determining whether or not a payment is for the use of copyright, it is important to distinguish between a payment for the right to use the copyright in a program and the right to use the program itself. A payment for the right to use the program itself only allows the licensee to operate or run the program on a computer. On the other hand, a payment for the right to use the copyright in a program allows the licensee to modify, adapt or copy, or otherwise do what would ordinarily be the exclusive right of the copyright owner.

(iii) Granting of rights (excluding right to use) pertaining to Off-the-shelf or customised software

Sometimes, software companies also grant rights permitting to modify the software or use the software for commercial exploitation to its users. These rights, which are normally proprietary rights of developer of computer software are granted to the user for certain additional consideration.

Thus, once we have examined nature of software payments, we would now proceed to determine its taxability under the Act.

Definition of Royalty under the Act

Under the Indian tax laws, royalty is deemed to accrue or arise in India if payable by a resident. Furthermore, royalty payable by a non-resident is also deemed to accrue or arise in India if it is utilised for the purpose of a business in India or for earning income from a source in India.

The term 'royalty' has been defined in Explanation 2 to Section 9(1)(vi) of the Act as follows:

> *"royalty means consideration (including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head "Capital gains") for—*
> *(i) the transfer of all or any rights (including the granting of a license) in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property;*
> *(ii) the imparting of any information concerning the working of, or the use of, a patent, invention, model, design, secret formula or process or trade mark or similar property;*
> *(iii) the use of any patent, invention, model, design, secret formula or process or trade mark or similar property;*
> *(iv) the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill;*
> *(iva) the use or right to use any industrial, commercial or scientific equipment but not including the amounts referred to in Section 44BB;*
> *(v) the transfer of all or any rights (including the granting of a license) in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films ; or*
> *(vi) the rendering of any services in connection with the activities referred to in sub-clauses (i) to (iv), (iva) and (v)."*

Thus, the phrase 'royalty' has been widely defined under the Act and hence, based on the above definition, one would need to analyse whether software payments would fall under any of the above clauses of royalty definition i.e. (i) to (vi).

I. Payment for Use of 'Off the Shelf' Computer Software

Applicability of clause (v) of royalty definition

- On an analysis of above clauses of royalty definition, it can be observed that clause (v) of the

Royalty definition specifically covers consideration for transfer of all or any rights (including the granting of a license) in respect of any 'copyright'. The term 'copyright' has not been defined under the Act. Accordingly, one could take its meaning from the provisions of Copyright Act, 1957 ('Copyright Act').

The Authority of Advance Rulings ('AAR') in the case of *FactSet Research Systems Inc*[2], and *Dassault Systems KK*[3] has also held that as the expression 'copyright' has not been defined in the Income Tax, it must be understood in accordance with the law governing the copyright in India i.e. Copyright Act, 1957.

Under the provisions of Copyright Act, a computer programme is considered as literary work and hence, covered under the provisions of Copyright Act.

Applicability of clauses (iv) and (iva) of royalty definition

- In case of purchase of packaged software, it can be said that the purchaser or licensee obtains nothing more than a set of coded computer instructions, without the underlying source code. Hence, it cannot be said that knowledge or information about the program in the relevant sense of know-how has been transferred.
- Thus, as payments made for using a software cannot be considered as imparting of any technical, industrial, commercial or scientific knowledge, experience or skill or granting any use or right to use any industrial, commercial or scientific equipment, clause (iv) and (iva) of the royalty definition would not be applicable to software payments.

Applicability of clauses (i), (ii) and (iii) of the royalty definition

Whether covered by expression 'use of process' under clauses (i), (ii) and (iii)

- As regards clauses (i), (ii) and (iii), use of computer software also cannot be considered to be as use of any patent, invention, model, design, secret formula or trademark. However, it may need to be evaluated if computer software can be considered to be a "process" so as to be covered by clauses (i), (ii) and (iii) of the royalty definition.

  In this regards, Delhi ITAT in the case of Gracemac (supra) held that computer programme is a process when it executes instructions lying in it in passive state. Therefore, any consideration made for the use of process would amount to royalty under provisions of the Act.

  However, recently Mumbai ITAT in the case of *TII Team Telecom International Pvt. Ltd*[4] has after analysing the provisions of Copyright Act and relying on the judgement of Delhi High Court in the case of *Asia Satellite Telecommunications*[5] held that although software contains written instructions or codes, payment for computer software cannot be construed as payment for using the process encoded in the software. The Mumbai ITAT specifically held when someone pays for the software, he actually pays for a product which gives certain results, and not the process of execution of instructions embedded therein.

  Similar view was also taken by AAR in the case of *Dassault Systems* wherein it held that by making use of or having access to the computer programs embedded in the software, it cannot be said that the customer is using the process that has gone into the end product or that he acquired any rights in relation to the process as such.

  Thus, although there are divergent judicial precedents on this issue, it could be fairly argued that payment for computer software cannot be considered to be payment for use of "process" so as to be covered under clauses (i), (ii) and (iii) of the royalty definition.

Whether covered by the expression 'similar property' under clauses (i), (ii) and (iii)

- As against clause (v) which specifically covers payment in relation to 'copyright, remaining clauses, i.e. clauses (i) to (iii) covers payment in relation to other similar property like patent, invention, trademark etc. Hence, as clause (v) specifically covers copyright,

While arguments exist in favour of non-taxability under the Act, it needs to be appreciated that the judicial precedence on taxability under the Act is limited as majority of the favourable rulings dealt with the interpretation of tax treaties.

[2] *317 ITR 169*
[3] *322 ITR 125*
[4] *ITA No. 3939/Mum/2010*
[5] *332 ITR 340*

which includes computer software, one can argue that the said clause being more specific in nature would be applicable over other general clauses.

- Similar view was also held by Special Bench of Delhi ITAT in the case of *Motorola Inc, Ericsson Radio Systems AB and Nokia Corporation*[6] which observed that the main issue in relating to software payments is to examine whether the payment is for a copyright or use of a copyrighted article. Hence, even Delhi ITAT held that clause (v) is the relevant clause while analysing taxability of software payments.

Thus, based on the above analysis, it should be possible to argue that the operative clause should be (v) to Explanation 2 to Section 9(1)(vi) and the payment would be taxable under the Act, if it is for a copyright as per the said clause.

Accordingly, meaning of the term 'copyright' as per the provisions of the Copyright Act is analysed below:

Copyright Act, 1957

As per Section 14 of the Copyright Act, 'copyright' means the exclusive right to do or authorise the doing, of certain acts, which in the case of a literary work, includes the following:

a) In the case of a literary, dramatic or musical work not being a computer programme:-

(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 the 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 translation or an adoption 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 (as amended by Copyright (Amendment) Act, 1999)

Provided that such commercial rental does not apply in respect of computer programmes where the programme itself is not the essential object of the rental

c) …

d) …

Explanation: For the purposes of this section, a copy which has been sold once shall be deemed to be a copy already in circulation.'

Thus, based on the above definition, key points in relation to computer software for being covered under the Copyright definition are summarised below:

i) Presence of an exclusive right to undertake acts listed in clause (a) and (b)

Hence, as per above provisions of the Copyright Act, the copyright clearly vests in a person who has an exclusive right to do all or any of the above mentioned acts to the exclusion of others. Such a person may either exercise these exclusive rights himself or alternatively authorise others to exercise a particular right (such as the right to reproduce) or a combination of the abovementioned rights. However, presence of exclusive right is absolutely essential to be covered in the definition of copyright.

In the following rulings it has been held that presence of an exclusive right is essential to cover within the ambit of 'copyright'.

- *Fact Set Research Systems Inc (supra)*

9.1 The learned Departmental Representative has argued relying on Section 14a(i) and (vi) of the Copyright Act that the rights specified therein are granted to the customers and therefore there is a transfer of rights in respect of the copyright. We find no substance in this contention. The expression 'exclusive right' in the opening part of Section 14 is very important and it qualifies all the components of clause(a). The applicant is not conferred with the exclusive right to reproduce the work (including the storing of it in electronic medium), as contemplated by sub clause (i) of Section 14(a). The exclusive right remains with the applicant being the owner of the copyright and by permitting the customer to store and use the data in the computer for its internal business purpose, nothing is done to confer the exclusive right to the customer. Such access is provided to any person who subscribes, subject to limitations.

- *Delhi SB in case of Motorola (supra)*

Secondly, under the definition of "copyright" in Section 14 of the Copyright Act, the emphasis is that it is an exclusive right granted to the holder thereof. This condition is not satisfied in the case of JTM

[6] *96 TTJ 1*

because the license granted to it by the assessee is expressly stated in clause 20.1 as a "non exclusive restricted license".

Thus, if the right and license granted is not exclusive, based on the above judicial precedents, it would not tantamount to 'copyright' within the meaning of Section 14 of the Copyright Act, 1957.

ii) Right to reproduce software is not a right granted under the Copyright Act

One of the prescribed rights in a copyright as per Section 14 of the Copyright Act is the right to reproduce software including storage of the same by electronic means. However, Section 52(1)(aa) of the Copyright Act provides that making copies of lawfully procured software program in order to utilise the software for the purpose for which it was supplied/or making backup copies to protect the lawfully acquired software program does not tantamount to infringement of copyright.

Accordingly, based on a combined reading of Sections 14 and 52(1)(aa) of the Copyright Act, it could be said that the 'right to use' a software is not one of the rights which are vested with the owner of the copyright under the provisions of Section 14 of the Copyright Act. Therefore, making copies of the software for a purpose for which it was procured does not result in a right in the copyright.

iii) Right to sell or give on commercial rental any copy of the computer programme

Section 14(b)(ii) refers to the right to sell or give on commercial rental any copy of the computer programme. In this regards, reference is invited to the Delhi SB ruling of Motorola (supra) wherein it was held that the right noted in Section 14(b)(ii) is only available to the owner of a computer program.

Normally, the above right is not available to a user of a computer software and hence, the said granting the user right cannot be construed as giving right to give computer programme on commercial rental.

Use of Copyright vis-à-vis use of Copyrighted Article

In determining whether or not a payment is for the use of copyright, it is important to distinguish between a payment for the right to use the copyright in a program and the right to use the program itself. A payment for the right to use the program itself only allows the licensee to operate or run the program on a computer. On the other hand, a payment for the right to use the copyright in a program allows the licensee to modify, adapt or copy, or otherwise do what would ordinarily be the exclusive right of the copyright owner.

In this regards, Supreme Court in the case of *Tata Consultancy Services v. State of Andhra Pradesh*[7] while determining the issue of "goods" under Sales Tax Act held that programmed software when put on a media like a CD are "goods" under Andhra Pradesh Sales Tax Act as well as under Article 366(12) of the Constitution of India. Thus, sale of programmed software loaded on a CD would be chargeable as sales tax.

The Supreme Court even held that a software program may consist of various commands which enable the computer to perform the designated task and the copyright in that program may retain with the originator of the program. However, the moment copies are made and marketed, they become goods which are susceptible to sales tax.

It was further held that even intellectual property once it is put on the media whether it is in the form of books or canvas or computer discs or cassette and marketed would become goods.

Thus, based on the above ruling, as sale of software is chargeable to sales tax, it can be contended that sale of software is sale of a copyrighted article and not sale of copyright.

Therefore, for the purpose of categorising income from a transaction as amounting to 'royalty' what is to be seen is whether the transferee has the exclusive right of commercial exploitation of the intellectual property contained therein.

Thus, based on the above, it could be contended that in case payment is made for use of standard off-the-shelf software wherein no exclusive rights are granted to the user as well as any no right in the computer software is granted to the user to undertake any activities as mentioned in Section 14 read with Section 52 of the Copyright Act, the payment for use of software would be said to be sale of copyrighted article and not copyright so as to be covered under clause (v) of royalty definition under the Act.

In case payment is made for use of standard off-the-shelf software wherein no exclusive rights are granted to the user as well as any no right in the computer software is granted to the user to undertake any activities as mentioned in Section 14 read with Section 52 of the Copyright Act, the payment for use of software would be said to be sale of copyrighted article and not copyright so as to be covered under clause (v) of royalty definition under the Act.

[7] *271 ITR 401*

Judicial Precedents under the Act

Favourable judicial precedents under the Act

In below mentioned judicial precedents, Indian Courts have distinguished between a 'Copyright' and a 'Copyrighted Article' and have held that payments for purchasing software which does not grant any right to use a copyright but merely grants a right to use a copyrighted article does not amount to royalty within the definition of the Act and hence, should not be subject to withholding tax.

- In the case of *Dassault Systems K.K (supra)*, AAR has held that a non-exclusive and non-transferable licence enabling the use of a copyrighted product cannot be construed as to enjoy any or all of the rights ingrained in a copyright. Accordingly, parting of intellectual property rights inherent and attached to the software product in favour of the licencee/customer is required so as to be covered under the royalty definition under the Act. Hence, merely authorising or enabling a customer to have the benefit of data or instructions contained in the computer software without any further right to deal with them independently would not amount to transfer of rights in relation to copyright or conferment of the right of using the copyright. The AAR accordingly, held that the payments received by the ABC from various Value Added Resellers on account of supplies of software products to the end customers does not result in income in the nature of royalty. Specific observations of AAR are reproduced below:

  17.1. Passing on a right to use and facilitating the use of a product for which the owner has a copyright is not the same thing as transferring or assigning rights in relation to the copyright. The enjoyment of some or all the rights which the copyright owner has, is necessary to trigger the royalty definition. Viewed from this angle, a non-exclusive and non-transferable licence enabling the use of a copyrighted product cannot be construed as an authority to enjoy any or all of the enumerated rights ingrained in a copyright. Where the purpose of the licence or the transaction is only to establish access to the copyrighted product for internal business purpose, it would not be legally correct to state that the copyright itself has been transferred to any extent. It does not make any difference even if the computer programme passed on to the user is a highly specialised one. The parting of intellectual property rights inherent in and attached to the software product in favour of the licencee/customer is what is contemplated by the definition clause in the Act as well as the Treaty. As observed earlier, those rights are incorporated in Section 14. Merely authorising or enabling a customer to have the benefit of data or instructions contained therein without any further right to deal with them independently does not, in our view, amount to transfer of rights in relation to copyright or conferment of the right of using the copyright.

  ….Different considerations will arise if the grant is non-exclusive that too confined to the user purely for in-house or internal purpose. The transfer of rights in or over copyright or the conferment of the right of use of copyright implies that the transferee/licencee should acquire rights - either in entirety or partially co-extensive with the owner/transferor who divests himself of the rights he possesses pro tanto. That is what, in our view, follows from the language employed in the definition of 'royalty' read with the provisions of Copyright Act, viz., Section 14 and other complementary provisions.

- In the ruling of the Special Bench of Delhi ITAT in the case of *Motorola Inc, Ericsson Radio Systems AB and Nokia Corporation (supra)*, payments were made for transfer of a non-exclusive restricted license in software (not being shrink-wrap software). The Special Bench distinguished between payments for a 'copyrighted article' and for a 'copyright right' held that payment for purchase of software cannot be taxable as royalty. The Special Bench reached its conclusion based on following observations:
  - Merely because the terminology of the Agreement is a 'license', it cannot be said that the payment should be categorised as royalty.
  - Under the Copyright Act, 1957, 'copyright' is an exclusive right granted to the holder thereof; whereas in this case, a non-exclusive license to use the software has been given.
  - The holder of a copyright can commercially exploit the same by making multiple copies of the software; whereas in the present case, restricted right to use the software for the assesse's own purpose and maintenance has been given.
  - To constitute a copyright right, the assessee should have had one or more of the rights mentioned in clause (a)/ (b) of Section 14 of the

Copyright Act, 1957 (such as reproduce or make copies of the work); whereas it was clear that the assessee has not been given any of the rights mentioned in the section and therefore the assessee has not acquired any copyright but only a copyrighted article.

- Further, the Delhi ITAT in the case of *Infrasoft Ltd.*[8] following the above decision held that if the licensees do not have any of such rights as mentioned in clauses (a) & (b) of Section 14, it would mean that they do not have any right in the copyright and in such a case, the payment made to them could not be characterised as royalty either under the Income-tax Act or under the DTAA. Relevant observations of Mumbai ITAT are as follows:

  "The sum and substance of the relevant clauses material in this context of the agreement entered into by the assessee with the licensee in the present case thus were similar to that of the agreement analysed and relied upon by the Special Bench in the case of Motorola Inc. (supra) to come to the conclusion that the payment made for transfer of right to use the software was not for any copyright in the software but only for the software as such as a copyrighted article and the same, therefore, could not be considered as royalty within the meaning of explanation (2) below Section 9(1) of the Income-tax Act or Article 13.3 of the relevant DTAA.:

- The above decision has been followed by the Mumbai ITAT in the case of *Tata Communications Ltd.*[9] and *Alcatel USA International Marketing Inc.*[10] wherein the ITAT held that payment for use of copyrighted article cannot be brought to tax as royalty.
- Further the *Bangalore ITAT* in the cases of *Sonata Software Limited*[11] held as follows:

  "This Tribunal in the case of Samsung Electronics Co. Ltd. v. ITO [IT Appeal Nos. 264 to 266 (Bang.) of 2002, dated 18-2-2005] has recently 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 copy rights article and not for acquiring any copy right. This view has been arrived at after considering various decisions on the subject as well as the decision of the Supreme Court in Tata Consultancy Services 'case (249 ITR 99). We accordingly hold that the payments for import of software do not amount to payment of royalty chargeable under Section 9(1)(vi) of the Act. The payments partakes the character of purchase and sale of goods. Actually, the payee has no permanent establishment in India. Hence, it can be concluded that no income is deemed to accrue or arise in India. Accordingly, the provision of Section 195 is not applicable to such payment."

- Further, the Bangalore ITAT in the case of *Velankani Mauritius Ltd. and Bydesign Solutions*[12] Inc. after placing reliance on the judgement of Motorola Inc (supra) and Sonata Software (supra) also held that sale of off-the-shelf shrink-wrapped software amounted to the sale of copyrighted articles and hence, cannot be treated as income from royalty under the Act. The specific observations of Bangalore ITAT are as follows:

  "15. Therefore, in the facts and circumstances of the case, and in the light of the above binding decisions, we find that the sale of software cannot be treated as income from royalty either under the IT Act or under the terms of DTAA."

The operative clause for determining the taxability under the head royalty would be clause (v) to Explanation 2 to Section 9(1)(vi) and would be taxable in India if the same constitutes a payment for transfer of all or any rights in respect of a copyright. Whether the payment constitutes for a copyright would need to be determined as per Section 14 of the Copyright Act, 1957.

- In the case of *GeoQuest Systems B. V.*[13], the AAR placing reliance on the decision in the case of *Dassault Systems K.K (supra)* and *Fact Research Systems Inc. (supra)* has held that the transfer of rights envisaged by sub-clause (v) of Explanation 2 to Section 9(1)(vi) of the Act should be in respect of copyright. Mere transfer of computer software de-hors any copyright associated with it does not fall within the ambit of the said sub-clause.
- In the recent ruling of Delhi High Court in the case of *M/s Dynamic Vertical Software India Pvt. Ltd*[14], the High Court has held that payment made to

[8] *125 TTJ 53*
[9] *138 TTJ 257*
[10] *2009-TIOL-733-ITAT-MUM*
[11] *6 SOT 700*
[12] *132 TTJ 124*
[13] *327 ITR 1*
[14] *332 ITR 222*

Microsoft towards purchase of software for distributing in India is not taxable as royalty. The specific observations of Delhi High Court are as under:

"What is found, as a matter of fact, is that the assessee has been purchasing the software from Microsoft and sold it further in Indian market. By no stretch of imagination it would be termed as "royalty".

Adverse Judicial Precedents

While arguments exist in favour of non-taxability under the Act, it needs to be appreciated that the judicial precedence on taxability under the Act is limited as majority of the favourable rulings dealt with the interpretation of tax treaties.

Delhi ITAT in the case of Gracemac Corpn. (supra), held that consideration received from licensing of computer software would be in the nature of royalty under the provisions of the Indian Tax Laws and did not accept the above principles of distinction between "use of copyright" and "use of copyrighted article". The ITAT held that the consideration from license of shrink wrapped software is in the nature of royalty as defined in the Act.

Applicability of phrase 'including the granting of licence' as mentioned in clause (v) of the royalty definition

Further, we would like to point out that the clause (v) also includes the phrase 'including the granting of a license' in respect of the copyright. Accordingly, the issue for consideration is whether mere grant of a non-exclusive license would also be covered within the ambit of royalty as construed under clause (v) of the Act.

- **Favourable Judicial Precedents Mere grant of a license would be covered within the ambit of royalty**

Reference is invited to the recent ruling of the Bangalore tribunal in the case of *ING Vysa Bank Ltd.*[15] dated 5th August, 2011 wherein it has been held that license to use off the shelf software would be taxable as royalty under the Act and tax treaty.

- **Adverse Judicial Precedents– Mere non-exclusive license not covered within the ambit of royalty**

The AAR in the case of Dassault (supra) while analysing the phrase "including the granting of licence" as mentioned in clause (v) of the royalty definition held that the said phrase has to be read in conjunction with preceding words i.e. "transfer of rights in respect of copyright". Hence, a mere non-exclusive licence to use a computer software would not be covered under the definition of royalty. The specific observations of AAR are also reproduced below:

17.2. We may refer to one more aspect here. In the definition of royalty under the Act, the phrase "including the granting of a licence" is found. That does not mean that even a non-exclusive licence permitting user for in-house purpose would be covered by that expression. Any and every licence is not what is contemplated. It should take colour from the preceding expression "transfer of rights in respect of copyright". Apparently, grant of 'licence' has been referred to in the definition to dispel the possible controversy a licence - whatever be its nature, can be characterised as transfer.

The above ratio was also followed by the Mumbai Tribunal in the case of *Kansai Nerolac Paints Ltd.*[16] and *Daimler Chryslar AG.*[17]

II. Payment for Use of 'Customised' Computer Software

In case of customised computer software, as the software is made for a specific user, an exclusive licence is granted by the developer to the user. Further, additional rights relating to the computer software are also granted by the developer to the user.

In such a scenario, as explained above, it may be covered under the definition of copyright as per Copyright Act and consequently, payment in relation to use of customised computer software may be covered as royalty under clause (v) of the royalty definition under the Act.

III. Payments for Granting of Rights (Excluding Right to Use) Pertaining to Off-the-Shelf or Customised Software

In situations, where software companies grant additional rights pertaining to the software to the user like the right to modify the software, use the software for commercial exploitation etc. which are normally available with the copyright holder, for some additional consideration, as explained above, the same may be covered under the phrase "transfer of all or any rights (including the granting of a licence) in respect of a copyright" as per clause (v) of the royalty definition.

Hence, in such cases, software payments may be covered under royalty definition under the Act.

Applicability of Provisions of Section 115(1A) of the Act

- It is also worthwhile to examine

[15] *ITA No. 160 (Bang)/2010*
[16] *134 TTJ 342*
[17] *ITA No.3817/Mum/2008*

Section 115A(1A) of the Act which states as under:

(1A) Where the royalty referred to in clause (b) of sub-section (1) is in consideration for the transfer of all or any rights (including the granting of a licence) in respect of copyright in any book to an Indian concern or in respect of any computer software to a person resident in India, the provisions of sub-section (1) shall apply in relation to such royalty as if the words the agreement is approved by the Central Government or where it relates to a matter] included in the industrial policy, for the time being in force, of the Government of India, the agreement is in accordance with that policy] occurring in the said clause had been omitted

The issue for consideration is whether as per Section 115A(1A) of the Act, it is not necessary that the copyright therein should be specifically transferred as consideration in respect of any computer software is stated to be taxable under Section 115A. In this regards, reference is invited to the rulings of the AAR in the case of GeoQuest Systems BV (supra) and Dassault Systems KK (supra) wherein it was held that Section 115A(1A) cannot be interpreted dehors of clause (v) to Explanation 2 to Section 9(1)(vi).

In the recent ruling of Delhi High Court in the case of *M/s Dynamic Vertical Software India Pvt. Ltd* [18], the High Court has held that payment made to Microsoft towards purchase of software for distributing in India is not taxable as royalty.

In the case of GeoQuest Systems BV (supra), it was held as under:

11. Then, coming to Section 115A, it prescribes the rate of tax applicable to a foreign company on the income by way of 'royalty' or 'fees for technical services'. Sub-section 1A to the extent relevant reads as under:-

"where the royalty is in consideration for the transfer of all or any rights (including the granting of a licence) in respect of copyright in any book to an Indian concern or in respect of any computer software to a person resident in India....."

This provision, prima facie, cannot be interpreted to mean that the transfer of any rights could only be in respect of the computer software without reference to copyright. It is reasonable to interpret the word 'copyright' to qualify not only the 'book' but also the 'computer software'. If the transfer of computer software, per se was contemplated to fall within the definition of 'royalty', it should have been stated so in the definition clause contained in Explanation 2 to Section 9(1)(vi). Clause (v) as noticed earlier speaks of "transfer of all or any rights' in respect of any copy right". Thus, whether copyright has been transferred or not is the line of inquiry which should precede the application of clause (v).

Conclusion

Given the analysis above, it may be possible to summarise the issue as under:

- The operative clause for determining the taxability under the head royalty would be clause (v) to Explanation 2 to Section 9(1)(vi) and would be taxable in India if the same constitutes a payment for transfer of all or any rights in respect of a copyright. Whether the payment constitutes for a copyright would need to be determined as per Section 14 of the Copyright Act, 1957.
- Section 14 of the Copyright Act, 1957 refers to grant of an exclusive right. Accordingly, if no exclusive right is granted under the agreement, it may be possible to argue that the same would not be covered as royalty.
- If payment is for the use of 'off-the-shelf' software, based on the current law and limited judicial precedents on the issue under the Act, it could be highly litigative to contend that the payment for use of computer software is not taxable as royalty under the Act.
- If payment is for the use of customised software, it is possible that licence may be exclusive in nature and hence, may be covered under clause (v) of royalty definition under the Act.
- If payments are made for transfer of all or any right (as covered by the Copyright Act) pertaining to computer software, the same may be covered under clause (v) of the royalty definition under the Act.

It is also important to take note of evolving nature of the issue and rulings from the High Court are also expected in the near future (e.g. Karnataka HC in the case of GE Technology/ Samsung, after the case was remanded by the SC for consideration on merits, Delhi HC in the case of Nokia, Ericsson, Motorola).

Hence, till the time, the issue gets settled at the highest level, litigation over taxability of software payments is likely to continue. ■

[18] *332 ITR 222*