Taxability of Technology Related Payments – The Controversy Continues

In the article published in the October 2011 issue of this journal, we had discussed the taxability of software related payments under the Income-tax Act, 1961 ('Act') – the most debated topic in the field of international taxation. This article is meant to extend the said discussion in relation to technology related payments to a next level in the light of the recent developments/decisions rendered by various Indian courts. Characterisation of software/technology related payments have been a contentious issue in India in the recent times with varied judgements from the Indian Courts. These decisions have placed the computer technology industry in dilemma with regards to the very basic question – Characterisation and Taxability of the revenues these industries derive from its ordinary business transactions. Read on…

(Contributed by the Committee on International Taxation of the ICAI. Comments can be sent to citax@icai.org)

The decisions in Indian courts with respect to characterisation of software/technology related payments principally have focused their discussions on treating the revenues earned from technology related payments as 'royalty' or 'sales' income. There have been several rulings (including the recent decision of the Delhi High Court in case of *Director of Income Tax Vs. Ericsson Radio System AB* which have appreciated the distinction between the copyright Vs. copyrighted article and held that technology related payments (such as payment for software) are

not taxable as royalty. On the other hand, a recent unfavorable ruling of the Karnataka High Court in the case of *CIT Vs. Samsung Electronics Co Ltd* failed to appreciate the distinction between copyright Vs. copyrighted article and held that payments made for shrink-wrapped software was taxable as royalty. These rulings would increase the uncertainty on characterisation of payments for computer program as well as other payments involving other technology/ electronic commerce transactions.

The purpose of this article is to discuss following three important rulings rendered recently in the context of TDS on software related payments:

- *CIT Vs. Samsung Electronics Co Ltd* (Karnataka High Court)
- *Director of Income Tax Vs. Ericsson Radio System AB* (Delhi High Court)
- *CIT Vs. M/S Wipro Ltd* (Karnataka High Court)

Basic Issue in Relation to Software Related Payments

The characterisation of software related payments as 'royalty' or 'sales' income can have obvious consequences. Income characterised as 'royalty' would generally attract withholding tax, whereas any income characterised as 'sales' income or 'business' profits generally would not be subject to tax in the absence of a Permanent Establishment ('PE').

The Taxpayers had generally taken a view that where an end user does not obtain rights that enable commercial exploitation of the intellectual property in the computer software, the transaction should be classified as generating 'business profits'.

While the Tax Authority is of the view that such payments should be classified as 'royalty', regardless of the nature and extent of rights granted to the end user or the purpose for which the end user uses the software.

Under Section 9(1)(vi) of the Act & Article 12 of the DTAA, "payments of any kind in consideration for the use of, or the right to use, any copyright of a literary, artistic or scientific work" is deemed to be "royalty". It is well settled that in the absence of any definition of 'copyright' in the Act or DTAA with the respective Countries, reference is to be made to the respective law regarding definition of Copyright, namely Copyright Act, 1957, in India, wherein it is clearly stated that "literary work" includes computer programmes, tables and compilations including computer [databases].

The Taxpayer's position is largely based on the OECD Commentary and is supported by a number of decisions of the Income Tax Appellate Tribunal and decision of Delhi High Court in case of Ericsson Radio System AB. The OECD Commentary and the Delhi High Court had recognised the distinction between a right in the copyright and a copyrighted article. However, the Karnataka High Court in case of Samsung Electronics had taken a divergent view.

Definition of Royalty under Income-tax Act, 1961 and Double Taxation Avoidance Agreements ('DTAA')

Under the Act, 'Royalty' is defined to inter alia mean consideration for the transfer of all or any rights (including the granting of a license) or use of any copyright, literary, artistic or scientific work, patent, invention, model, design, secret formula or process or trade mark or similar property.

The comparable definition under the DTAAs defines 'royalty' to inter-alia mean consideration for the use of, or the right to use, any copyright of a literary, artistic or scientific work.

CIT Vs. Samsung Electronics Co. Ltd. (Karnataka High Court)

Facts:

- The assessee was engaged in the development and export of computer program. The assessee imported "shrink-wrapped"/"off-the-shelf" software from suppliers in foreign countries for use in its business and made payment for the same without deducting tax at source under Section 195.
- The Assessing Officer and Commissioner of Income tax (Appeals) held that the payments were assessable to tax as "royalty" under Section 9(1)(vi)/Article 12 and that the assessee was liable to pay the tax under Section 201. On appeal, the Tribunal relied on the judgement of the Supreme Court in case of *Tata Consultancy Services Vs. State of AP* (2004) 271 ITR 401 (SC) and held that the assessee had acquired a "copyrighted article" but not the "copyright" itself and so the amount paid was not assessable as "royalty". Thus, as the essential criteria ('use' or 'right to use' any copyright of a literary, artistic or scientific work, etc.) for payments to fall within the ambit of 'royalty' were not met, the consideration towards purchase of program was held not to be in the nature of royalty. Accordingly, in the absence of PE in India, the payment is not taxable in India and no taxes are required to be withheld on the same.
- Aggrieved, the Tax Authority appealed before the High Court. The High Court, without considering

the issue on characterisation, held that every payment to a non-resident is subject to withholding tax provisions under the Act in the absence of a nil/ lower withholding tax order from the Tax Authority.

- Aggrieved, the assessee appealed before the Supreme Court. The Supreme Court, reversing the order of High Court, held that withholding tax provisions would apply only when the payments are chargeable to tax in India. On the issue of taxability of payments made for computer programs, Supreme Court remanded the matter to High Court to decide whether the payment constitutes 'royalty' and hence taxable in India.

Ruling of the High Court:

- Under Section 9(1)(vi) of the Act & Article 12 of the DTAA, "payments of any kind in consideration for the use of, or the right to use, any copyright of a literary, artistic or scientific work" is deemed to be "royalty".
- It is well settled that in the absence of any definition of 'copyright' in the Act or DTAA with the respective Countries, reference is to be made to the respective law regarding definition of Copyright, namely Copyright Act, 1957, in India, wherein it is clearly stated that "literary work" includes computer programmes, tables and compilations including computer [databases].
- On reading the contents of the respective agreement entered with the non-resident, it is clear that under the agreement, what is transferred is only a licence to use the copyright belonging to the non-resident subject to the terms and conditions of the agreement and the non-resident supplier continues to be the owner of the copyright and

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all other intellectual property rights. What is transferred is a right to use the copyright for internal business by making copies and back up copies of the program.

- Under the Copyright Act, 1957, a software programme constitutes a "copyright". A right to make a copy of the software and use it for internal business by making copy of the same and storing it on the hard disk amounts to a use of the copyright under Section 14 (1) of the Copyright Act because in the absence of such a license, there would have been an infringement of the copyright. Accordingly, the argument that there is no transfer of any part of the copyright and the transaction involves only a sale of a copyrighted article is not acceptable.
- The amount paid to the supplier for supply of the "shrink-wrapped" software is not the price of the CD alone nor software alone nor the price of license granted. It is a combination of all. In substance unless a license was granted permitting the end user to copy and download the software, the CD would not be helpful to the end user.
- There is a difference between a purchase of a book or a music CD because while these can be used once they are purchased, software stored in a dumb CD requires a license to enable the user to download it upon his hard disk, in the absence of which there would be an infringement of the owner's copyright. Therefore, there is no similarity between the transaction of a computer program and books.
- The decision of the Supreme Court in case of *TCS Vs. State of AP* (271 ITR 404) distinguished as being in the context of sales-tax.
- Thus, the payments made in respect of computer program would constitute 'royalty' under the applicable DTAA and would also fall within the ambit of 'royalty' under the broader definition in the Act. Thus, the assessee would be required to deduct tax on the payment made in respect of computer programs.

Director of Income Tax Vs. Ericsson Radio System AB (Delhi High Court)

Facts:

- The assessee, a Swedish company, entered into contracts with ten cellular operators for the supply of hardware equipment and software. The installation and testing were done in India by assessee's group entities.
- The contracts were signed in India. The supply of the equipment was on CIF basis and the assessee took responsibility thereof till the goods reached India. The equipment was not to be accepted by the customer till the acceptance test was completed (in India). The assessee claimed that the income arising from the said activity was not chargeable to tax in India.
- The Assessing Officer and Commissioner of Income tax (Appeals) held that the assessee had a "business connection" in India under Section 9(1)(i) & a "permanent establishment" under Article 5 of the DTAA. It was also held that the income from supply of software was assessable as "royalty" under Section 9(1)(vi) & Article 13. On appeal, the matter was referred to Special Bench of the Tribunal. The Tribunal held that as the equipment had been transferred by the assessee offshore, the profits therefrom were not chargeable to tax. It also held that the profits from the supply of software were not assessable to tax as "royalty" either under the Act or DTAA with Sweden.
- Aggrieved by the order of Special Bench, the Tax Authority filed an appeal before the High Court.

Ruling of the High Court

- The profits from the supply of equipment were not chargeable to tax in India because the property and risk in goods passed to the buyer outside India. The assessee had not performed installation service in India. Though the supply of equipment was subject to the "acceptance test" performed in India, this was not material because the contract made it clear that the "acceptance test" was not a material event for passing of the title and risk in the equipment supplied. If the system did not conform to the specifications, the only consequence was that the assessee had to cure the defect. Consequently, the assessee did not have a "business connection" in India.
- The argument that the software component of the supply should be assessed as "royalty" is not acceptable because the software was an integral part of the GSM mobile telephone system and was used by the cellular operator for providing cellular services to its customers.

In case of *Director of Income Tax Vs. Ericsson Radio System AB*, the Delhi High Court ruled that the payment received by the assessee was towards the title of the equipment of which software was an inseparable part incapable of independent use and it was a contract for supply of goods. Therefore, no part of the payment could be classified as payment towards royalty.

Three important decisions rendered in the context of software/use of technology related payments give rise to several open ended questions before the tax payers, one of which is that whether the payment made in relation to shrink wrapped/off the shelf software would constitute payment for a copyright, would need to be determined as per Section 14 of the Copyright Act, 1957?

- Software was embedded in the equipment and could not be independently used. It merely facilitated the functioning of the equipment and was an integral part thereof. The Tax Authority accepts that it could not be used independently. The fact that in the supply contract, the lump sum price was bifurcated is not material. The same was only because differential customs duty was payable.
- To qualify as royalty, it is necessary to establish that there is transfer of all or any rights (including the granting of any license) in respect of copy right of a literary, artistic or scientific work. Section 2 (o) of the Copyright Act makes it clear that a computer programme is to be regarded as a "literary work". Thus, in order to treat the consideration paid by the cellular operator as royalty, it is to be established that the cellular operator, by making such payment, obtains all or any of the copyright rights of such literary work.
  In the presence case, this has not been established. It is not even the case of the Revenue that any right contemplated under Section 14 of the Copyright Act, 1957 stood vested in this cellular operator as a consequence of Article 20 of the Supply Contract.
- A distinction has to be made between the acquisition of a “copyright right” and a “copyrighted article”. The submissions made by the assessee on the basis of the OECD commentary are correct.
- Even assuming the payment made by the cellular operator is regarded as a payment by way of royalty as defined in Explanation 2 below Section 9 (1) (vi), nevertheless, it can never be regarded as royalty within the meaning of the said term in Article 13, para 3 of the DTAA. This is so because the definition in the DTAA is narrower than the definition in the Act. Article 13(3) brings within the ambit of the definition of royalty a payment made for the use of or the right to use a copyright of a literary work. Therefore, what is contemplated is a payment that is dependent upon user of the

copyright and not a lump sum payment as is the position in the present case.

- The payment received by the assessee was towards the title of the equipment of which software was an inseparable part incapable of independent use and it was a contract for supply of goods. Therefore, no part of the payment could be classified as payment towards royalty.

CIT Vs. M/s Wipro Ltd. (Karnataka High Court) (203 Taxman 621)

Facts:

- Assessee made certain payments to a non-resident 'Gartner Group' USA/Ireland in order to access an online database. The assessee was of the view that no tax was deductible under Section 195 of the Act on the ground that the payment was akin to making a subscription for a journal or magazine of a foreign publisher and though the journal contained information concerning commercial, industrial or technical knowledge, payee made no attempt to impart same to payer and thus, payment fell outside scope of clause (ii) of Explanation 2 to Section 9(1)(vi) as well as article 12 of Indo-US DTAA.
- Assessing Officer and Commissioner of Income tax (Appeals) held that payments made to 'Gartner Group' was 'royalty' within the meaning of Explanation 2 to Section 9(1)(vi) and in alternative 'fees for technical services'(Included services) both of which were liable for tax in India in terms of Section 195, read with Section 9(1)(vi) and (vii) and relevant provisions of DTAA. On further appeal by the assessee, the tribunal allowed the appeals holding that payment made to M/s. Gartner did not constitute royalty as the same was in the nature of subscription made to the journal or magazine and no part of the copyright or copyright was transferred to the assessee and, therefore, the income was not chargeable to tax in India. Further, the tribunal held that there was no obligation on the part of the assessee to deduct tax under Section 195(1) of the Act and accordingly, set aside the orders and deleted both the tax liability under Section 201(1) of the Act and the interest levied under Section 201(1A) of the Act.
- On appeal, the HC allowed the Revenue's appeal. Being aggrieved, the assessee moved the apex court which set aside the order passed by the division Bench by analysing the provisions of Section 195 of the Act and remitted the matter to the High Court for answering the substantial question of law framed by it.

Ruling of the High Court

- It is clear from the material on record that the issue is identical to that raised in case of Samsung Electronics (supra) wherein it was held that payment made for acquisition of shrink wrapped software or off-the-shelf software would amount to transfer of right to use the copyright so held by the non-resident.
- Mere fact that in the instant case, the issue do not pertain to shrink wrapped software or off-the-shelf software and access to database maintained by M/s. Gartner is granted online, would not make any difference in the reasoning assigned by us to hold that such right to access would amount to transfer of right to use the copyright held by M/s. Gartner and the payment made to M/s. Gartner in that behalf is for the licence to use the said database maintained by M/s. Gartner and such payment is to be treated as 'royalty';
- Therefore, we answer the substantial question of law in the negative in favour of the revenue and against the respondent.

Conclusion

Thus, an analysis of the above discussed three important decisions rendered in the context of software/use of technology related payments give

The ruling of the Karnataka High Court in case of Samsung (wherein it has been held that payment for purchase of a copy of a computer program for internal business use by an end user as well as for resale to end users is taxable as royalty) would have significant tax implications on the industries dealing in computer software/other technology. The Delhi HC in case of Ericsson Radio System A.B. New Delhi having upheld the decision of the Special Bench on this issue, could help the Taxpayers to reinforce its position on this contentious issue.

rise to following open ended questions before the tax payers:

- Whether the payment made in relation to shrink wrapped/off the shelf software would constitute payment for a copyright, would need to be determined as per Section 14 of the Copyright Act, 1957?
- Where there is any distinction between a copyright Vs. copyrighted article in light of the decision of the Karnataka High Court in case of Samsung Electronics?
- Whether in case of bundled contract i.e. software supplied along with hardware, any bifurcation can be made between the payments made for software and hardware?
- Whether every payment made by the Taxpayer for use of computer program would constitute 'royalty' under the Act and relevant DTAA?

Way Forward

The ruling of the Karnataka High Court in case of Samsung (wherein it has been held that payment for purchase of a copy of a computer program for internal business use by an end user as well as for resale to end users is taxable as royalty) would have significant tax implications on the industries dealing in computer software/other technology. The Delhi HC in case of Ericsson Radio System A.B. New Delhi having upheld the decision of the Special Bench on this issue, could help the Taxpayers to reinforce its position on this contentious issue.

Thus, there are significant inconsistencies in judicial thinking on the issue of characterisation of technology related payments – whether royalty or sales income – and accordingly, the Taxpayers are facing ambiguity with regards to the position to be adopted for withholding tax purposes while making such payments.

It is important for the taxpayers to review their cross-border transactions in detail to assess the withholding tax risk as the incorrect position with regard to the same could result in severe financial consequences by way of interest, penalty and disallowance of expenditure. ■