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Executive summary

This Tax Alert summarizes a ruling of the Supreme Court (SC), dated 2 March 2021, on a group of appeals, with the lead case of Engineering Analysis Centre Of Excellence Pvt. Ltd., on the issue of whether payments in different cross-border software transactions, i.e., payments made by end users or distributors (resident as well as non-resident) of software and payments made in respect of software embedded in the hardware, qualify as “royalty” under the Income Tax Act (ITA), as well as various Double Taxation Avoidance Agreements (DTAAs).

The SC referred to the terms of the agreements entered into with various parties for the use of software and noted that distributors were granted a non-exclusive and non-transferable license to resell the software. Furthermore, end users were granted a limited right to use the software without any right to sub-license, transfer, reverse engineer, modify or reproduce the software. In this light, the SC examined various provisions of the Copyright Act, 1957 in force in India (ICA) and held that a limited right to use the software, make copies of the software for the purpose for which it was granted and without grant of rights of the copyright owner (such as reproduction, issuing copies, commercial exploitation), does not qualify as grant of a copyright under the ICA.

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1 [TS-106-SC-2021]
The SC noted that the definition of royalty under the ITA, prior to amendment in 2012, as well as the DTAA under consideration [which are similar/identical to the OECD\textsuperscript{2} Model Convention (MC)], necessarily requires grant of a copyright in software to the licensee for the payment to qualify as royalty. Since the payment made by end users and distributors did not involve payment for grant of any right specified under the ICA, payments made by the distributors and end users do not qualify as royalty under the DTAA, as well as the pre-amended provisions of the ITA. Such payments qualify as business income not taxable in India under the DTAA.

In addition, the SC held that the machinery provisions of withholding under the ITA in respect of payment made to non-resident (NR) taxpayers is triggered only in respect of payments chargeable to tax in India after considering the provisions of the ITA as well as the DTAA. In case where a payment is not chargeable to tax in India under the DTAA, then no withholding is required on such payments. In doing so, the SC distinguished its earlier decision in the case of PILCOM\textsuperscript{3} on the grounds that in that ruling, the SC was concerned with payments to NR sportspersons and the withholding provisions in respect of such persons were governed by different provisions of the ITA which were not linked to the chargeability of income.

**Background**

- Under the ITA, “royalty” is defined to 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 DTAA defines “royalty” to mean consideration for the use of, or the right to use, any copyright of a literary, artistic or scientific work.

- The ITA imposes an obligation on any person responsible for paying (payer) to an NR payee any interest or any sum taxable under the provisions of the ITA, to withhold tax at the time of credit of such income to the account of the NR payee or at the time of payment, whichever is earlier (withholding provision). Furthermore, the scope of the withholding provision in respect of certain specified payments differs and does not link to the condition of chargeability.

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\textsuperscript{2} Organisation for Economic Co-operation and Development

\textsuperscript{3} [TS-219-SC-2020]; Refer our Tax Alert, “SC rules on the obligation to withhold taxes on guarantee fees paid to various non-resident sports associations” dated 1 May 2020

\textsuperscript{4} Refer our Tax Alert, “Karnataka HC ruling characterizes payment for purchase of shrink-wrapped computer program as royalty” dated 30 November 2011

\textsuperscript{5} [(2012) 343 ITR 1 (AAR-Delhi)]
On the other hand, the Delhi HC, in various cases, and the AAR ruled in favor of taxpayers by emphasizing on the distinction between acquisition of a “copyright right” and a “copyrighted” article. It was held that the license granted by the taxpayer was limited to those rights that are necessary to enable the licensee to operate the program. Hence, there is no transfer of copyright or right to use the copyright to characterize the same as royalty under the IIA or the DTAA. It is a case of mere transfer of a copyrighted article and income therefrom should be characterized as business income, not taxable in the absence of a taxable presence (permanent establishment) of an NR income recipient in India.

Considering the divergent views of judicial authorities spanning over two decades, the cases travelled to the SC. The SC has rendered its decision in a batch of 103 appeals.

Facts considered by the SC

The SC adjudicated on the appeal in the following four categories of software payments:

- **Category 1** – Sale of software directly to an end user by an NR
- **Category 2** – Sale of software by an NR to Indian distributors for resale to end customers in India
- **Category 3** – Sale of software by an NR to a foreign distributor for resale to end customers in India
- **Category 4** – Software bundled with hardware and sold by foreign suppliers to Indian distributors or end users

SC’s ruling

The SC gave a common ruling for all the four categories of software payments, as below:

**Whether software payments amount to use of copyright under the ICA**

- Meaning of “copyright” in the definition of royalty should be understood as per the ICA, and not otherwise.
- **Relevant provisions of the ICA:**
  - A copyright means an exclusive right to do or to authorize to do certain acts in respect of a “work”, including an exclusive right, *inter alia*, to reproduce the copyright in the work in any material form and exploit the same by way of sale, transfer or license etc.
  - A computer program (software) qualifies as a “literary work” for the purposes of the ICA. As per Section 30 of the ICA, the owner of copyright in a “literary work” is entitled to grant any interest in his rights by way of a license in return for a royalty payment.
  - In cases where a license is granted, an infringement of copyright under the ICA would take place only when there is any use of the rights contrary to the license so granted.
  - Copyright is an exclusive right, which is negative in nature, being a right to restrict others from doing certain acts. Copyright is an intangible, incorporeal right, in the nature of a privilege, which is quite independent of any material substance. Ownership of copyright in a work is different from the ownership of the physical material in which the copyrighted work may happen to be embodied.
  - Terms of some sample agreements with the distributor and end users of the software are indicated as follows:
    - Distributors were granted a non-exclusive, non-transferable license to resell computer software to end users.

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6 Refer our Tax Alerts, “Delhi HC ruling on 'business connection' and tax treatment of payments for software bundled with hardware” dated 28 December 2011, “Delhi HC rules that distinction between copyrighted article and copyright right still relevant under DTAA despite retrospective amendment to domestic tax law definition of ‘royalty’” dated 14 September 2012 and “Delhi High Court reiterates distinction between copyright right and copyrighted article in respect of software transactions” dated 27 November 2013
7 Refer our Tax Alert, “AAR rules on taxability of software payments” dated 2 February 2010; AAR ruling In Re., [(2010) 327 ITR 1 (AAR)]
Distributors did not have a right to use the software.

The agreement specifically stated that the copyright in the software was not transferred, either to the distributor or to the ultimate end user.

End users were allowed only to use the software and they were restricted from sublicensing, transferring, reverse engineering, modifying, or reproducing the software.

The past judicial decisions rendered by the AAR\(^8\) and the Delhi HC\(^9\) held as follows:

- Parting with copyright entails parting with the right to do any of the specified acts conferred under the ICA (such as reproduction, issue of copies, commercial exploitation etc).
- A non-exclusive, non-transferable license merely enabling the use of a copyrighted product, which is subject to restrictive conditions, cannot be construed as a license to enjoy all or any of rights of the copyright owner, or to create any interest in any such rights. Such license granted does not qualify as license of the nature specified in Section 30 of the ICA (supra).
- The use of the software is different from the right to reproduce granted under the ICA. Reliance in this regard was placed on the decision of SC in the case of State Bank of India (SBI) v. Collector of Customs\(^10\), which held that mere use of a software, subject to restrictions, does not result in parting of a copyright in the software.

In case of license, the end user only gets a right to use computer software and not any of the rights conferred on the owner of a copyright under the ICA. There is a difference between the ownership of a physical item in which the software is embedded and ownership of the copyright. For e.g., in a case where a publisher sells books to an Indian distributor who then resells the same at a profit, it would not involve transfer of any right to the Indian distributor. On the other hand, if the publisher sells the book to an Indian publisher, with the right to reproduce and make copies of the book, it would result in grant of copyrights to the Indian publisher and payment made by the Indian publisher would qualify as royalty. The adverse rulings of the Karnataka HC and the AAR (supra) were distinguished to this extent.

Making a copy or adaptation of a computer program in order to utilize it for the purpose for which it was supplied, making back-up copies as a protection against loss, does not result in infringement of copyright under the ICA. Even storage of computer program, per se, would not result in infringement.

The nomenclature of the agreement does not matter. What is relevant to be considered is the real nature of the transaction, having regard to the overall terms of the agreement and surrounding circumstances.

What is “licensed” by the foreign, NR supplier to the distributor and resold to the resident end user or directly supplied to the resident end user is, in fact, the sale of a physical object which contains an embedded computer program. This is sale of goods, which does not involve transfer of a copyright in the software. Reliance in this regard was placed on the decision of SC in the case of Tata Consultancy Services\(^11\).

**Doctrine of first sale or principle of exhaustion**

- As per the doctrine of first sale, once a copyrighted article is sold by the owner of the copyright, then the owner exhausts all rights to control that particular article/copy, although the copyright continues to vest with the owner.

- The ICA provides an exclusive right to the owner of a copyright to sell or rent a copy of software to the extent such copies are not copies already in circulation. Thus, it prevents a person other than an owner from reproducing the software and transferring them to a subsequent user. This suggests that the ICA intends to apply the doctrine of first sale/principle of exhaustion.

- The tax authority argued that the ICA was amended in 1994 and 1999 and it no longer recognizes the principle of exhaustion under DTAA and DTAT.

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\(^8\) Refer our Tax Alert, “AAR rules on taxability of software payments” dated 2 February 2010; AAR ruling In Re., [(2010) 327 ITR 1 (AAR)]

\(^9\) Refer our Tax Alerts, “Delhi HC ruling on ‘business connection’ and tax treatment of payments for software bundled with hardware” dated 28 December 2011, “ Delhi HC rules that distinction between copyrighted article and copyright right still relevant under DTAA despite retrospective amendment to domestic tax law definition of ‘royalty’” dated 14 September 2012 “ and “Delhi High Court reiterates distinction between copyright right and copyrighted article in respect of software transactions” dated 27 November 2013

\(^10\) [(2000) 1 SCC 727]

\(^11\) [2005 (1) SCC 308]
of exhaustion. Accordingly, when distributors sell computer software or copyrighted software license to end users, there would be parting of a right or interest in the copyright itself, as per the ICA. Furthermore, reliance was placed on the decision of the US Court of Appeals in the case of Timothy S. Vernor v. Autodesk Inc.\textsuperscript{12}, to contend that the doctrine of first sale cannot be invoked by the distributor/licensee who are not the owner of copyright.

The intent of the ICA is not to prevent a distributor from selling the software which is licenced to be sold by the distributor, but to prevent reproduction of copies of software already sold and sale thereof. A distributor cannot use the software at all and it merely resells the product to end users. Thus, it is incorrect to suggest that distribution of software by the distributor constitutes grant of an interest in the copyright or infringement of the copyrights.

Royalty definition under the ITA v. DTAA

The DTAA contains an exhaustive definition of the term “royalty”. It includes payment made for the \textit{use or right to use any copyright} in a literary work. The royalty definition under the ITA is different and wider as compared to the royalty definition under the DTAA. The ITA refers to consideration paid for \textit{transfer of all or any rights, including by way of a license, in respect of any copyright}.

As the license granted to distributors and end users does not create any interest or right in the software, grant of such license would not amount to the “\textit{use of or right to use}” of copyright and, hence, it would not qualify as royalty under the DTAA.

The phrase “in respect of” used in the ITA means “in” or “attributable to”. Thus, in order to qualify as royalty even under the ITA, it is a \textit{sine qua non} that there has to be transfer of all or any rights in a copyright by way of license or otherwise. In a case where there is payment for grant of license, such payment would qualify as royalty only if such license results in transfer of rights in the copyright granted to the owner of a copyright under the ICA.

Since the license granted to the distributors and end users did not involve granting of any interest in the rights of an owner of a copyright, payment made for such license does not qualify as royalty both under the ITA provisions, as subsisted till 2012, as well as the DTAA.

The ITA was amended in 2012 to provide that transfer of all or any rights includes transfer of all or any rights for use of a computer software. This amendment expands the royalty definition and may not be considered as clarificatory in nature. However, such payments would not qualify as royalty for the purposes of the DTAA.

Relevance of OECD Commentaries and India’s positions on the OECD Commentary

Definition of “royalty” under all the relevant DTAA\textsuperscript{13} under consideration is identical or similar to the definition of royalty under the OECD MC. Hence, the OECD Commentary on the same becomes relevant.

The OECD Commentary supports that making a copy or adaptation of a computer program to enable the use of the software for which it was supplied does not constitute royalty. This also supports that the payment made by distributors and end users does not qualify as royalty.

Although India has stated its position on the above OECD Commentary that, in some cases, such use may also qualify as royalty, the positions are vague and do not alter the DTAA’s provisions, unless it is actually amended by way of bilateral renegotiation. Reliance in this regard was placed on the Delhi HC decision in the case of New Skies Satellite BV\textsuperscript{14}.

Also, India has not amended the DTAA\textsuperscript{s} under consideration post expressing the positions on the OECD MC/Commentary to modify the definition therein. Moreover, even the DTAA\textsuperscript{s} signed post expressing the positions on the OECD MC/Commentary contain a similar definition as contained in DTAA\textsuperscript{s} signed prior to expressing India’s positions on the OECD MC/Commentary. Hence, the guidance provided by the OECD would continue to have persuasive value for interpretation of the DTAA.

For clarity and certainty, the DTAA provisions that are aligned to the OECD MC may be interpreted in light of the OECD Commentary.

\textsuperscript{12} [621 F. 3d 1102 (9th Cir. 2010)]
\textsuperscript{13} DTAA\textsuperscript{s} applicable to taxpayers before the SC - India’s DTAA\textsuperscript{s} with Australia, Canada, China, Cyprus, Finland, France, Germany, Hongkong, Ireland, Italy, Japan, Korea, Netherlands, Singapore, Sweden, Taipei, US, UK
\textsuperscript{14} [(2016) 382 ITR 114]
Retrospective amendment and obligation to withhold taxes

► The definition of “royalty” under the ITA was amended in 2012 by way of insertion of Explanation 4 (with retrospective effect from 1 June 1976), purportedly to clarify that the transfer of all or any rights in respect of any right, property or information includes right for use/to use a computer software (including the granting of a license), regardless of the medium through which such right is transferred (Explanation 4).

► Explanation 4 expands the royalty definition. A person who made a payment prior to 2012 cannot be expected to apply the expanded definition of royalty which was not in existence at the time of making payments to determine withholding obligations under Section 195. The substantive amendment to the ITA does not compel a person to do the impossible (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).

Whether treaty benefits, if any, can be considered while determining withholding obligation under Section 195

► Section 195 of the ITA confers a withholding obligation on the person paying any sum to an NR, which is chargeable to tax under the ITA. Thus, the machinery provisions of Section 195 are interlinked with the charging provisions of the ITA.

► Total income of an NR chargeable to tax in India includes income which accrues, arises or is deemed to accrue or arise in India. This, however, is subject to the provisions of a DTAA. In a case where an item of income is not chargeable to tax as per the DTAA, then such income would not be chargeable to tax even under the ITA.

► A person referred to in Section 195 is required to withhold tax only if the amount is chargeable to tax under the ITA as well as the DTAA. This is upheld by the SC in the case of GE India Technology Centre (P) Ltd.\(^\text{15}\)

► The tax authority’s argument basis the date of entry into force article under the India-US DTAA was rejected on the ground that the distinction between withholding taxes and other taxes is made in the DTAA only to indicate different date of applicability of DTAA provisions and that does not affect the chargeability of income under the DTAA and, consequently, under the ITA.

\(^\text{15}\) (2010) 10 SCC 29
The taxation of payment for use of computer software programs has been a contentious issue in India since many years. This SC decision on software royalty taxation was much awaited to settle the controversy and to provide certainty on the issue. The tax authorities have generally taken a position that income arising from transactions involving grant of software program/license should be characterized as “royalty”, irrespective of the nature of rights acquired by the end user or a distributor or purchaser of the products embedding the software. The taxpayer’s position, on the other hand, generally has been that characterization as royalty or business profits, especially under the applicable DTAA, should be based on the nature and extent of rights granted to the end user/distributor.

In its landmark ruling, the SC has now put this controversy to rest and ruled that payments by resident Indian end users or distributors (residents/NRs) of shrink-wrapped software, is not royalty under the DTAs containing the royalty definition on the lines of the OECD MC.

Taking note of the provisions of the ICA, the SC concluded that the payer who gets non-exclusive, non-transferable and restricted right to a copy of the software, makes payment for the copyrighted article and not for use of the “copyright” of the owner. Similarly, where the end user does not obtain any rights in the copyright under the license agreement, making a copy of the software for the purposes of internal use and as permitted by the license does not involve grant of a right in the copyright. The SC concurred with the view that payment made by end users and distributors is akin to payment for sale of goods and not for grant of license in copyright under the ICA.

This SC decision is likely to apply to a wide range of software transactions, regardless of the mode of delivery of the software. This ruling provides useful guidance for analyzing the evolving licensing and delivery models in the software industry.

The SC reiterated that the nomenclature or label given to a transaction are not decisive and true effect of the agreement is required to be considered, having regard to the overall terms of the agreement viewed considering the surrounding circumstances.

The SC also concluded that the scope of domestic laws, which was expanded by amendments vide Finance Act, 2012 to the royalty definition under the ITA, is not clarificatory and a payer cannot be fastened with an obligation to withhold taxes having regard to subsequent substantive legislative changes which did not subsist as at the date of payment.

The SC also reiterated that for certainty and clarity, the DTAA provisions aligned to the OECD MC may be interpreted in light of the OECD Commentary. The SC held that India’s position on the OECD MC/Commentary is not decisive, particularly when such positions are not couched in explicit language, and is also not reflected in subsequent DTAs concluded by India.

The decision of the SC constitutes the law of the land and is binding on all and will apply to all pending litigations at different levels. The payers and NRs impacted by the ruling will need to evaluate the way forward and the strategy, including alternatives to get refunds of excess taxes paid with appropriate interest.

This SC ruling highlights the significance of DTAA entitlement. It may be recollected that DTAA entitlement is subject to diverse conditions, such as payee being beneficial owner, holding a Tax Residency Certificate (TRC), as also complying with applicable anti-avoidance provisions including those introduced pursuant to the multilateral instrument.

For the period after 1 April 2020, an NR will also need to evaluate the impact of E-Commerce Supply or Services Equalisation Levy (ESS EL) and its interplay with chargeability of royalty payment.