Supreme Court Decision on Software Payments

Open issues and possible views.

Study Group, The Chamber of Tax Consultants

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Speaker: Vishnu Bagri

email: vishnu@sduca.com

Supreme Court, did finally, adjudicate…

ENGINEERING ANALYSIS CENTRE OF EXCELLENCE PRIVATE LIMITED Vs. THE COMMISSIONER OF INCOME TAX
2021 SCC Online SC 159

Question of Law

Whether payment made by the resident user / distributors to the non resident supplier or manufacturer of the software can be categorized as "royalty" under section 9(1)(vi) of the Income tax Act and is liable for deduction of TDS under section 195 of the Act.

Held

The Hon'ble Supreme Court of India (SC) held that the **amount paid** by resident Indian end users / distributors to non-resident computer software manufacturers / suppliers, as consideration for the resale / use of computer software, **cannot be** characterised as 'royalty' (i.e. use of **copyright in** the computer software) **under Article 12** of the Tax Treaties (DTAA) and therefore, does not give rise to a liability to deduct any TDS under section 195 of the Act.

We will discuss:

- What are the key learnings / principles emerging from the SC decision?
- Does this cover post 2012 payments?
- Does this cover domestic software transactions?
- How do the principles impact the new gen business models?

1. DTAA should be considered to understand chargeability.

Applicability of DTAA

Applicability of DTAA - *Quoting from Azadi Bachao Andolan*

"……If it was not the intention of the legislature to make a departure from the general principle of chargeability to tax under Section 4 and the general principle of ascertainment of total income under Section 5 of the Act, then there was no purpose in making those sections subject to the provisions of the Act. The very object of grafting the said two sections with the said clause is to enable the Central Government to issue a notification under Section 90 towards implementation of the terms of DTACs which would automatically override the provisions of the Income Tax Act in the matter of ascertainment of chargeability to income tax and ascertainment of total income, to the extent of inconsistency with the terms of DTAC."

2. TDS u/s 195 is subject to test of chargeability

Reliance on DTAA at the stage of TDS u/s 195

- The machinery provision contained in section 195 is inextricably linked with the charging provision contained in section 9 read with section 4.
- It is only when the non-resident is liable to pay income tax in India on income deemed to arise in India and no deduction of TDS is made under section 195(1), or such person has, after applying section 195(2), not deducted such proportion of tax as is required, that the consequences of a failure to deduct and pay, reflected in section 201 will apply.

Differentiating "PILCOM" 2020,SCC Online SC 426

- Section 194E belongs to a set of various provisions which deal with TDS, without any reference to chargeability of tax under the Act by the concerned nonresident assessee.
- This section is similar to sections 193 and 194 of the Act by which deductions have to be made without any reference to the chargeability of a sum *received by a non-resident assessee* under the Act.
- On the other hand, as has been noted in GE Technology (supra), at the heart of section 195 of the Act is the fact that deductions can only be made if the nonresident assessee is liable to pay tax under the provisions of the Act in the first place.

Anomaly in SC's observation as Section 193 and 194 deals with residents;

However, reliance can be placed for "test of chargeability" u/s 195.

3. Definition of royalty under the treaty is “exhaustive”

4. “in respect of” must be read as equivalent to “attributable”

Definition under DTAA

- The SC has noted that the list of appeals are concerned with DTAAs among India and 18 other countries (Singapore, UK, USA, etc.) which are based on the OECD Model Tax Convention on Income and on Capital, wherein the definition of 'royalties' is substantially similar to that of the OECD Model Tax Convention and that the definition of royalty under the DTAA is exhaustive as it uses the expression 'means'.

- The term 'royalties' refers to payments of any kind received as consideration for "the use of, or the right to use, any copyright" of a literary work.

Definition under the Act

- The definition in Explanation 2 to section 9(i)(vi) is much wider in 3 aspects:
  - It speaks of "consideration", but also includes a lump- sum consideration which would not amount to income of the recipient chargeable under the head "capital gains";
  - When it speaks of the transfer of "all or any rights", it expressly includes the granting of a license in respect thereof; and
  - It states that such transfer must be "in respect of" any copyright of any literary work.
- Even where such transfer is "in respect of" copyright, the transfer of all or any rights in relation to copyright is a 'sine qua no' under explanation 2 to section 9(1)(vi) of the Act.
- SC held that there would be no difference "in this position" between the definition of "royalties" in the DTAAs and the definition of "royalty" in explanation 2(v) of section 9(1)(vi) of the Act

5. Meaning of ‘copyright’ must be understood as per the Copyright Act 1957 and not otherwise.

6. Licenses to be understood as per Section 30 of the Copyright Act

Meaning of copyright under the Copyright Act, 1957

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) 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 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);

Meaning of copyright under the Copyright Act, 1957

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, ~~*regardless of whether such copy has been sold or given on hire on earlier occasions**~~

**The italicized words have been deleted w.e.f 15.01.2000 – relevant to understand the relevance of doctrine of first sale (para120)*

Observations in relation to the Copyright Act

- The SC delves into licensing via EULA and held that such license is not a license as per the provisions of the Copyright Act as the license imposes restrictions / conditions on the use of software.
- The EULAs do not grant any **right or interest in the software**. Even the right to reproduce the software is not granted and is expressly prohibited. The SC draws comparison to selling of books via a distributor vs selling of books to a publisher for reproduction.
- SC concluded as follows on copyright:
  - Copyright is an exclusive right – restricts others from doing certain acts;
  - It is an intangible, incorporeal right independent of material substance

Observations in relation to the Copyright Act

- Ownership of copyright is different from ownership of the material in which the copyright is embedded;
- Parting with copyright means parting as per section 14 of the Copyright Act;
- A license, which does not confer any proprietary interest to the licensee is different from section 30 of the Copyright Act (which grants interest in / transfers the rights);
- Core of the transaction – authorisation to use licensed software with no exclusive rights in the software is not an infringement, even in case of customised software or otherwise;
- Right to reproduce the software is different from right to use the software – SBI vs Collector of Customs [(2000) 1 SCC 727]. Country wide license is different from reproduction of software.

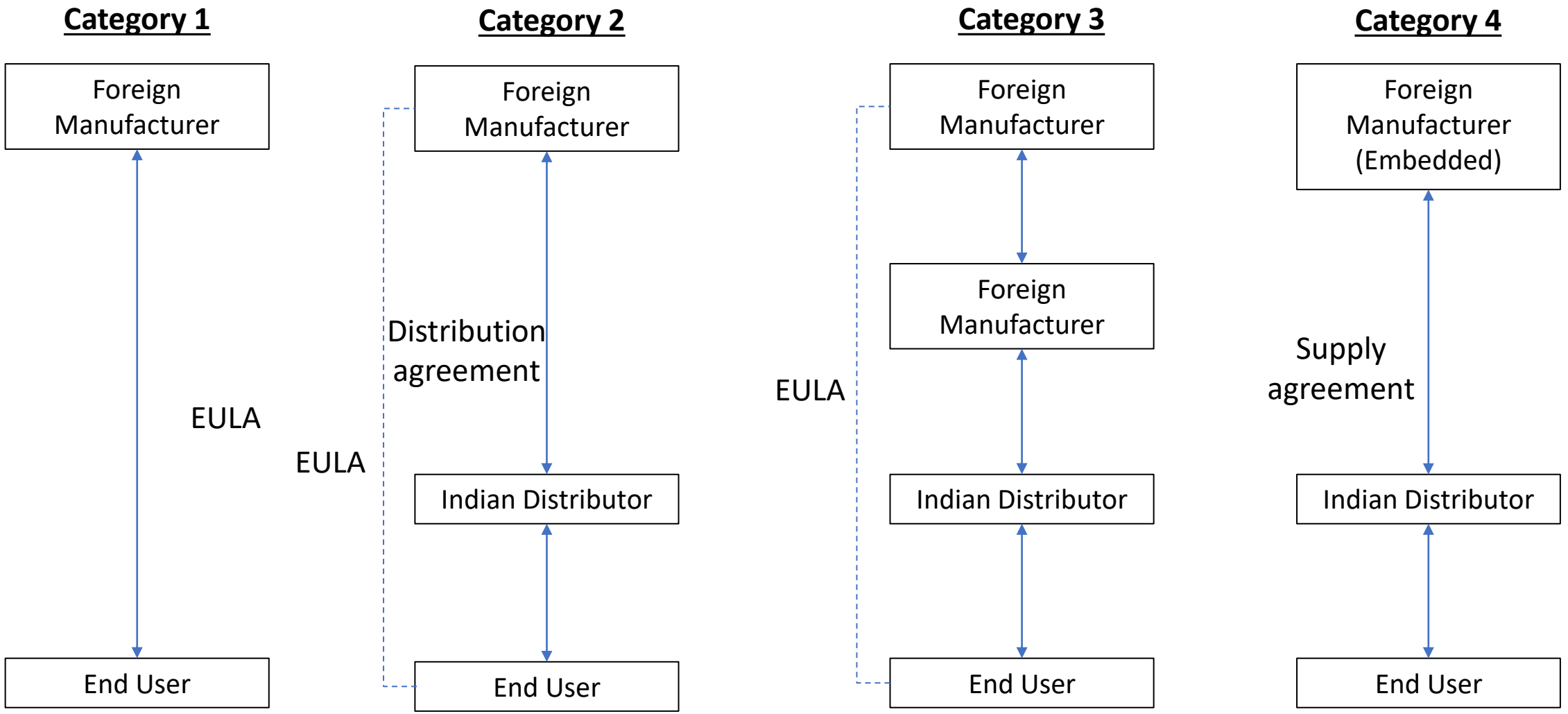
Observations in relation to the Copyright Act

Doctrine of first sale / Principle of exhaustion

- Distribution right in relation to a particular article is exhausted by the first sale of that article in the Community by the right holder or with his consent.
- The first sale of a copy of a computer program by the rightholder or with his consent exhausts the distribution right with the exception of the right to control further rental of the program or a copy thereof.
- It amounts to a transfer of the right of ownership of the copy in question and thus a sale for the purposes of the exhaustion of the distribution right.
- Where a seller makes a program available in intangible form (e.g., by downloading from a website, or download under a licence for an unlimited period in return for a licence fee), the intention is to make the copy usable by the customer, permanently, in return for payment of a fee designed to enable the copyright owner to obtain a remuneration corresponding to the economic value of the copy of the work. (referred in para 121 of SC's decision)

7. The real nature of the transaction must be looked at upon reading the agreement as a whole.

Discusses 4 categories of transactions



Understanding different agreements

End-user standpoint

- End-user who is directly sold the computer programme, can only use it by installing it in the computer hardware owned by the end-user and cannot in any manner reproduce the same for sale or transfer, contrary to the terms imposed
- The licence granted vide the EULA is not a license in terms of section 30 of the Indian Copyright Act but is a licence which imposes restrictions or conditions for the use of the computer software.
- The SC has also rejected the argument of the Revenue that some of the EULAs term the transaction not as a sale but as one of licensing. The SC has noted that it is a settled law that in all such cases, the real nature of transaction must be looked at, by reading the agreement as a whole (i.e the agreement along with EULAs and other accompanying documents in the subject case and not EULA on a standalone basis, for determining the use of term licence).

Understanding different agreements

Distributor standpoint

- What is granted to the distributor is only a non-exclusive, non-transferable license to resell computer software, no copyright in the computer programme is transferred either to the distributor or to the ultimate end-user
- Apart from right to use the computer program there is no right to sub-license or reproduce or transfer or reverse –engineer or modify the program.
- What is paid for the program is the price of the goods either in a medium which stores the software or in a medium by which software is embedded in hardware which may be then further resold by the distributor to the end-user in India, the distributor making a profit on such resale.
- Importantly, the distributor does not get the right to use the product at all.

Understanding different agreements

With respect to the category 4 agreements where the software is embedded in hardware and provided by non-resident vendor to a resident user

- What is “licensed” by the foreign, non- resident 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 programme, and is therefore, a sale of goods, which, as has been correctly pointed out by the learned counsel for the assessees, is the law declared by this court in case of TATA consultancy

8. Retrospective amendments not enforceable for TDS obligations, since law cannot expect the “person” to do the impossible.

TDS obligations for transactions before 2012

Pre 2012

SC also held that the “person” mentioned in section 195 **cannot be expected to do the impossible**, namely, to apply the expanded definition of “royalty” inserted by explanation 4 to section 9(1)(vi), for the assessment years in question, at a time when such explanation was not actually and factually in the statute and deduct tax from that very period.

Is the position settled?

Applicability of Explanation 4 to Sec 9(1)(vi)

In case of treaty likely position is shrink wrapped software payments not royalty.

In case of Act Position not free from litigation.

- It is a clarification amendment and should not expand the meaning. However, SC in passing mentions that it does not agree with the statement - *Explanation 4 will not expand the scope of Explanation 2*.
- Explanation 4 states – "…..transfer of all or any rights **in respect of** any right, property or information includes and has always included transfer of all or any **right for use or right to use** a computer software (including granting of a licence) irrespective of the medium through which **such right** is transferred.
- View
  - → Such right should be read as copyright.
  - → Right for using a copyright vs. right for using an article.
  - → Right to use a copyright vs. right to use an article.

Can software payments be construed as towards a patent, invention or process?

Reliance can be placed on
- the SC decision to state "not royalty"
- DTAA where applicable

Position not free from litigation.

Role of Explanation 5

View

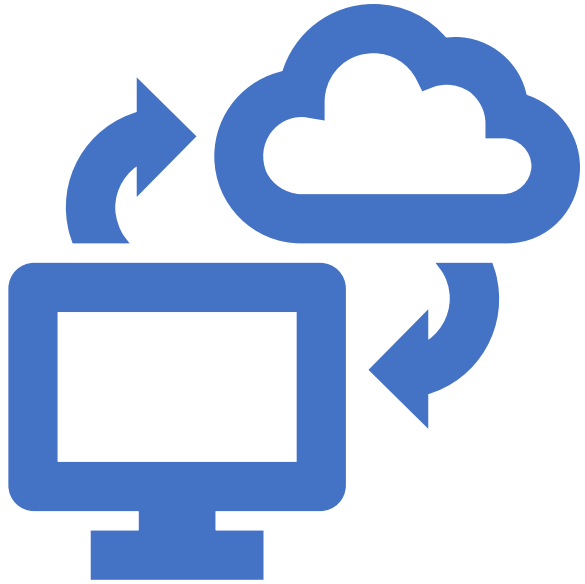
- In case of shrink-wrapped software; consideration paid by customers are is towards the 'promised outcome' of the feature / functionality. It is, in my view, not 'in respect of' the patent; invention or process.
- If 'in respect of' is given a wide meaning then even the purchase of a tangible product could be construed as a royalty. E.g. any mobile phone (manufacturing process; software; brand)
- Interpretation should provide a harmonious result between a transaction involving digital (intangible) or tangible – SC did conclude the medium cannot determine the characterisation.

Broad meanings to “in respect of” + “right” can result in ‘absurd’ outcomes.

E.g. purchase of Playstation 5 requires TDS?.

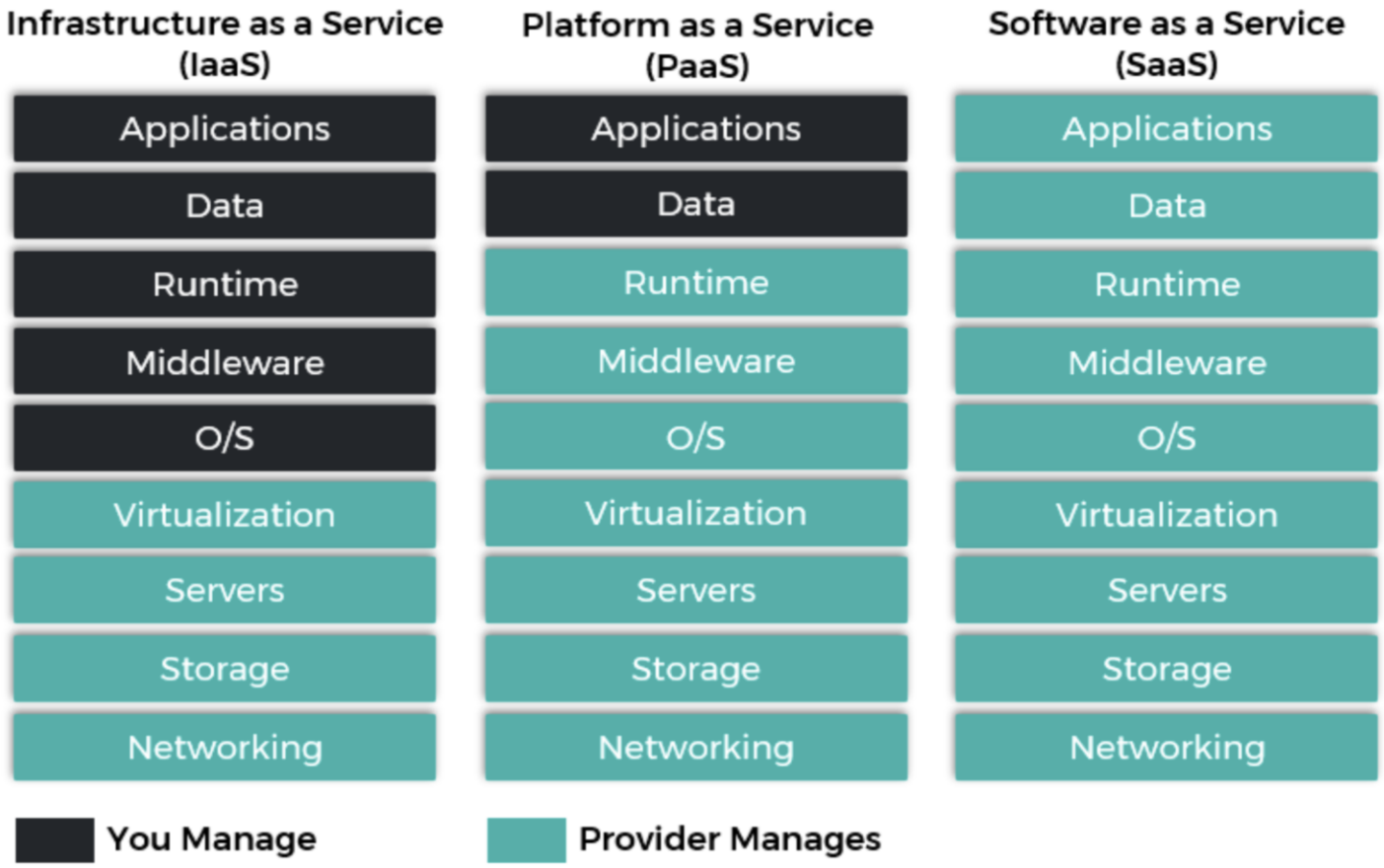
How does the decision impact the new gen models?

- Software as a service (SAAS)
- Platform as a service (PAAS)
- Infrastructure as a service (IAAS)



Cloud technologies

Difference is extent of stack managed inhouse vs outsource



Hosting solutions such as Azure, AWS, etc.

Computing technologies such as Elastic; Apache Stratos

Utility tools such as Dropbox, O365, etc.

EULA across different providers - SaaS

3.1. Access to Cloud Products. Subject to these Terms and during the applicable Subscription Term, you may access and use the Cloud Products for your own business purposes or personal use, as applicable, all in accordance with these Terms, the applicable Order and the Documentation. This includes the right, as part of your authorized use of the Cloud Products, to download and use the client software associated with the Cloud Products. The rights granted to you in this Section 3.1 are non-exclusive, non-sublicensable and non-transferable.

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Common Features

- **Access** – only ‘authorized use’ including right to download and use only.
- **License** – non-exclusive, non-sublicensable and non-transferable.
- **Restrictive Terms** – no reproduction or modification of any kind

EULA across different providers – SaaS and PaaS

8.3 Service Offerings License. We or our licensors own all right, title, and interest in and to the Service Offerings, and all related technology and intellectual property rights. Subject to the terms of this Agreement, we grant you a limited, revocable, non-exclusive, non-sublicensable, non-transferrable license to do the following: (a) access and use the Services solely in accordance with this Agreement; and (b) copy and use the AWS Content solely in connection with your permitted use of the Services. Except as provided in this Section 8.3, you obtain no rights under this Agreement from us, our affiliates or our licensors to the Service Offerings, including any related intellectual property rights. Some AWS Content and Third-Party Content may be provided to you under a separate license, such as the Apache License, Version 2.0, or other open source license. In the event of a conflict between this Agreement and any separate license, the separate license will prevail with respect to the AWS Content or Third-Party Content that is the subject of such separate license.

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Common Features

- **Access** – 'permitted use of services' only
- **License** – non-exclusive, non-sublicensable and non-transferable.
- **Restrictive Terms** – no reproduction or modification of any kind

View: Fee paid is not royalty

- Software primarily resides on the cloud and is accessed by the user for stated purpose e.g., project management; integration with its own product.
- Download of ‘apps’ does result in obtaining a license to use. However, it is not ‘license’ as defined in the Copyright Act.
- The SaaS provider still retains full ownership of the software. The restrictions placed such as – “non-exclusive, non-transferable” along with clauses indicate customers cannot modify, delete the source codes. Thus, it is use of copyrighted articles as opposed to acquiring copyright.

View: Fee paid is not royalty

- PAAS provides the right to use the computing technologies i.e., software but does not allow right to reproduce.
- IAAS do not give a right to use the equipment but merely benefit from the hosting services / computing technologies.
- Case specific review
  - Mischief play of Explanation 4; 5 & 6 read with Explanation 2.
  - Applicability of Equalisation Levy

Database Subscription – Whether Royalty?

- SC decision does not explicitly cover payments for database subscriptions;
- Karnataka High Court had earlier ruled in the case of Wipro Technologies [(2013) 355 ITR 284) that such payments are in the nature of royalty. This decision also relied on the Samsung decision;
- Now that Samsung decision has been struck down, can it be said that database subscription payments are not royalty?
- Application of principles laid out by SC to determine what constitutes use of copyrighted material vs use of copyright itself.
- View: Mere access of database does not give the user a “right” in the database.

194J – Impact on domestic software transactions

- Section 194J – definition of royalty under explanation (ba) – **as defined under explanation 2 to section 9(1)(vi)**.
  - Fundamental issue – should Explanation 4 be considered while interpreting Explanation 2?
- Prior to SC decision, where TDS has already been withheld on software, TDS at the second stage of transfer of such software (without modifications) was not required to be undertaken (Notification 21/ 2012);
- View: Post SC decision, the payments by resident distributors to non-resident suppliers does not fall under the purview of royalty and hence no TDS obligations arise; The Notification cannot indirectly impose an obligation which fails at the threshold of 194J itself.

Equalization Levy 2.0

- EL 2.0 introduced by the Finance Act 2020 seeks to tax e-commerce transactions. Key aspects:
  - Consideration received / receivable by an non-resident e-commerce operator;
  - For e-commerce supply of services including provision / facilitation of goods or services;
  - Certain specified persons – residents in India, non-residents in specified cases (sale of ads targeting Indian customers / access through Indian IP address and sale of data) and persons buying goods / services using Indian IP address

Equalization Levy 2.0

- Where consideration is taxable as royalty / FTS, then EL 2.0 is not applicable;
- Software transactions likely to be covered under EL 2.0 post the SC decision;
- Key considerations:
  - Obligation is on the non-resident to make EL 2.0 tax remittances – ongoing dialogue between USTR and India on 'unfair' imposition.
  - In cases of dispute on nature of payments by tax officers, how can Indian vendors safeguard against non-compliance with TDS?
  - Indian vendors to obtain TRCs, declarations from non-residents to substantiate its position.

Review of tax triggers
(countries with whom DTAA exist)

Royalty / FTS as per DTAA → Gross basis taxation @ 10%

- If not royalty / FTS, then check for PE in India

PE in India → Net basis taxation @ 40%

- If no PE in India, check for EL 1.0 or 2.0 applicability

EL 1.0 → EL 1.0 @ 6%

- If EL 1.0 is not applicable, check for EL 2.0

EL 2.0 → EL 2.0 @ 2%

- If EL 2.0 is not applicable, then such payment is not taxable in India

Review of tax triggers
(countries with whom DTAA does not exist)

Royalty / FTS → Gross basis taxation @ 10%

- If not royalty / FTS, then check for PE in India

PE in India → Business connection incl SEP → Net basis tax @ 40%

- If no PE in India, check for EL 1.0 or 2.0 applicability

EL 1.0 → EL 1.0 @ 6%

- If EL 1.0 is not applicable, check for EL 2.0

EL 2.0 → EL 2.0 @ 2%

- If EL 2.0 is not applicable, check for SEP

Business connection incl SEP → Net basis taxation @ 40%

- If no business connection then such payment is not taxable in India

The SC did adjudicate finally

…but yet no finality!

Working with the SC decision.

Legislative developments – should we hope or fear ?

Understanding the business

Appreciating the transaction

Relevance of Agreements

Actual conduct / substance vs. terminologies used

Application of the 'law'

Positions & interpretations

Referring to 'allied' laws

Global references gathering relevance

OECD commentary

Judicial decisions in other jurisdictions

Applying the decision

Commercial negotiations should factor the tax litigation risks on 'not royalty' position for digital transactions.

Thank you

vishnu@sduca.com

The views expressed and the information provided in this presentation are of general nature and is not intended to address the circumstances of any particular individual or entity. Appropriate professional advise should be sought prior to relying on the same for decision making.

UN Model discussion on inclusion of software in the definition of royalty

The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, ***computer software*** *or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.*

- UN Committee of Experts have decided against adopting this amendment and instead, in the commentary, include a minority view wherein use of software constitutes use of copyright and thus royalty payments.
- This is also in light of Article 12B for addressing income from automated digital services which excludes incomes already taxed as royalty.