Taxability of payment to non-residents for purchase or licensing of software as "Royalty" - Supreme Court Ruling

1. Background

Whether payment to non-residents for purchase or licensing of software is taxable in India as 'royalty' has been one of the most prominent controversies in the arena of international taxation for close to couple of decades now. In this context, one would recollect the retrospective amendment made to the domestic income tax law in the year 2012 to enable taxation of the right to use a computer software (including granting of a license) as 'royalty'.

However, the taxation of non-residents are not solely governed by the provisions of the domestic tax laws but the agreements entered into between the Government of India and other countries (commonly known as "tax-treaties") also have to be looked at. To be exact, the non-residents have the choice to adopt the provisions of the domestic tax laws or the tax treaties, whichever is beneficial, subject to certain conditions to determine their eligibility for invoking the tax treaties.

While the amendment was made in the domestic tax laws to tax the payments for software as royalty, there was no such provision in most tax-treaties entered into by India. The non-residents were rightfully free to choose such beneficial provisions of the tax-treaties and consider the income from sale or licensing of software as not taxable in India. However, the same was challenged by the revenue authorities on certain grounds and the matter became litigious. Authority of Advance Ruling (AAR) and the Honourable High Courts across the country came up with divergent ruling and the issue was taken to the Honourable Supreme Court, which has settled the matter in favour of the assessee on 2 March 2021 in the case of **Engineering Analysis Centre of Excellence Private Limited Vs. CIT (Civil Appeal Nos. 8733-8734 of 2018)**.

The key-matters discussed in the said judgement have been summarized in this article.

2. Key highlights of the judgement

2.1 Issues covered

The Honourable Supreme Court has pronounced its ruling in various appeal on the subject matter which specifically covered the below issues:

- Purchase of software by resident end-user from non-resident supplier or manufacturer
- Purchase of software by resident distributors or re-sellers from non-resident supplier or manufacturer
- Purchase of software by resident distributors or re-sellers from non-resident distributors or re-sellers
- Purchase of integrated unit of hardware/ equipment and software by resident distributors/ end-users from non-resident

2.2 Key facts noted by the Honourable Supreme Court

- **In respect of distribution agreements:** The distribution agreement grants non-exclusive, non-transferable license to resell the computer software. It was expressly stipulated that no copyright in the computer program is either transferred to the distributor or the ultimate end-user. There is neither a right to sub-license or transfer nor a right to reverse-engineer, modify, reproduce in any manner.

  The distributor is allowed only to resell the product and make a profit out of the same. In fact, the distributor does not get the right to use the product at all.

- **In respect of end-user license agreements (EULA):** The same does not transfer an interest in all or any of the rights of the owner of the copyright as enumerated in the Copyrights Act, 1957, but imposes restrictions or conditions for the use of computer software. The end user can only use the computer programme by installing it on a computer hardware and reproduction of the same is expressly prohibited.

2.3 Principles upheld by the Honourable Supreme Court in relation to "royalty"

- Copyright is an exclusive right, which is negative in nature, being a right to restrict others from doing certain acts. It is an intangible, incorporeal right, in the nature of privilege, which is quite independent of any material substance.

- The ownership of the copyright in a work is different from the ownership of the physical material in which the copyrighted work may happen to be embedded.

- The differentiation of the right to reproduce the computer software which amounts to parting of copyright by the owner, as against the right to use the computer software would not amount to parting of copyright by the owner has been re-emphasized.

- Parting with copyright entails parting with any of the right to do any of the acts mentioned in Section 14 of the Copyright Act. The transfer of the material substance does not by itself serve to transfer the copyright therein. The transfer of the ownership of a physical substance, in which the copyright subsists, gives purchaser the right to do with it whatever he pleases, **except the right to reproduce the same and issue it to the public, unless such copies are already in circulation, and other acts mentioned in Section 14 of the Copyright Act.**

- A license from a copyright owner, conferring no proprietary interest on the licensee, does not entail parting with any copyright, and is different from a license issued under section 30 of the Copyright Act, which is a license which grants the licensee an interest in the rights mentioned in section 14(a) and 14(b) of the Copyright Act. Where the core of a transaction is to authorize the end-user to have access to and make use of the "licensed" computer software product over which the licensee has no exclusive rights, no copyright is parted with and consequently, no infringement takes place, as is recognized by section 52(1)(aa) of the Copyright Act. It makes no difference whether the end-user is enabled to use computer software that is customized to its specifications or otherwise.

- A non-exclusive, non-transferable license, merely enabling the use of a copyrighted product, is in the nature of restrictive conditions which are ancillary to such use and cannot be construed as a license to enjoy all or any of the enumerated rights mentioned in section 14 of the Copyright Act, or create any interest in any such rights so as to attract section 30 of the Copyright Act.

- The Court upheld the principle that the true effect of the transaction may be determined from the terms of the agreement and in the light of circumstances, beyond form, unless prohibited by the statute. The court noted that the real nature of the transaction of licensing under distribution agreement or the EULA is a sale of physical object which contains an embedded computer program and is therefore amounts to sale of goods.

- The definition of "royalty" in Article 12 of India – Singapore tax treaty (considered for instance) uses the expression "means" and hence is an exhaustive definition. Further, the definition is much narrower as compared to the definition under the domestic tax law.

- Based on the above, it is held that the sale or licensing of software through distribution agreement, or EULA or sale of media containing software do not entail transfer of any of the rights of the owner of a copyright and hence do not fall within the purview of "royalty" and the taxing provisions for royalty cannot be extended to the same.

2.4 Other matters dealt by the Honourable Supreme Court

- The definition as per tax-treaty shall be considered for the purpose of interpretation of the tax-treaty and the definition as per domestic tax laws may be applied only when the said term is not defined in the treaty.

- The Honourable court re-iterated the fact that the provisions of tax treaty shall prevail over the provisions of the domestic tax laws provided the former is more beneficial than the latter. The court has also drawn reference to the CBDT Circular No. 333 dated 2-4-1982 which clarified the same.

- An additional principle, which already settled many controversies in the past, was once again visited by the Honourable Supreme court and it was consistently held that **"the language in the tax treaties have to be interpreted liberally along with the true intention of the parties to the said treaty"**. This view of the court was in line with the judgement pronounced by the same court in the case of **Azadi Bachao Andolan** (2004) (10 SCC 1).

- It has been reaffirmed that the machinery provisions of TDS under section 195 of the Act is inextricably linked to the charging provisions, as a result of which the TDS obligation arises only when the sum is chargeable to tax under the provisions of the Act, read with the DTAA.

- The provisions of Section 194E on withholding tax on payment to non-resident sportsmen or sports association which does not have a reference to **"amounts chargeable to tax"** has been clearly distinguished from the provisions of Section 195. The ruling of Honourable Supreme Court in the case of PILCOM in the context of Section 194E has been held as **"not having any application to the instant case"**.

- It has been re-iterated that the retrospective amendments made to the domestic tax laws in the year 2012 cannot be expected to be considered by the deductors for the period(s) prior to such amendments based on the principles that the law does not demand the impossible and where there is a disability that makes it impossible to obey the law, the alleged disobedience of the law is excused.

- The court underlined the importance of OCED Commentary in interpretation of matters relating to tax treaties.

3. Concluding Thoughts

- The Honourable Supreme Court has ended the long drawn legal battle with a welcome judgement for the taxpayers. It is also noted that the judgement deals with many important aspects in detail.

- In cases where the withholding tax obligations were not met, many of them were held to be 'assessee in default' and heavy tax demands were raised on them. Further, in some cases, the Indian deductors would have borne the tax liability by grossing up the tax on payments made towards software. In such scenarios, this judgement can help the assessee in reversing the demand and also enable refund of the taxes already paid. However, it is to be noted that refund for TDS can be claimed only upon satisfaction of prescribed conditions and within the specified timelines.

- We would like to add a word of caution that the conditions for invoking tax treaties must be met and the necessary documents (like Tax Residency Certificate, Form 10F etc.) should be received, before relying on the provisions of the tax treaty. Further, the implications of certain aspects like Preamble, Principal Purpose Test, etc., brought in by Multi-lateral instrument (MLI) would also need to be evaluated carefully, wherever applicable, before taking the position of non-taxability under the tax treaties based on this Supreme Court Ruling.

- The applicability of equalization levy on the sale/ licensing of software by non-resident in India must also be evaluated and taken cognizance of.

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