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Payment to non-resident software manufacturers / suppliers for sale of software under end user license agreements / distribution agreements does not qualify as 'royalties' under DTAA and not liable for withholding taxes under section 195

The Apex Court of India, has, in the matter of ***Engineering Analysis Centre of Excellence Private Limited and Others v. The Commissioner of Income Tax and Anr***[1], ruled in favor of the taxpayers on the highly contested issue of whether consideration for the sale of software under end user license agreements ("EULAs") or distribution agreements may be considered as 'royalties' under the Double Taxation Avoidance Agreements executed by India with various countries[2].

The various appeals before the Apex Court were grouped into the following four categories:

i. Computer software is purchased directly by Indian resident end-users from foreign non-resident suppliers / manufacturers.

ii. Computer software is purchased by resident Indian companies from foreign non-resident suppliers / manufacturers whereby such Indian companies act as distributors or resellers of the software to resident Indian end users.

iii. Resale of computer software to resident Indian distributors / end-users by foreign non-resident distributors after purchasing the same from other foreign non-resident suppliers / manufacturers.

iv. Computer software affixed onto hardware for sale as an integrated unit / equipment by foreign non-resident suppliers to resident Indian distributors / end users.

The Apex Court, in a well-reasoned judgement, ruled that considering the definition of "royalty" contained in Article 12 of the DTAAs considered, there is no obligation to

[1] Civil Appeal Nos. 8733 – 8734 of 2018 and Others

[2] Australia, Canada, China, Cyprus, Republic of Finland, France, Germany, Hong Kong, Ireland, Italy, Japan, Republic of Korea, Netherlands, Singapore, Kingdom of Sweden, Taiwan, USA, UK

deduct tax under section 195 of the Income-tax Act, 1961 ("the Act") in the facts of these cases since the distribution agreements / EULAs in these cases do not create any interest or right in such distributors / end-users, which would amount to the use of or right to use any copyright. The provisions of section 9(1)(vi) (including Explanations 2 and 4 thereof) of the Act, which deal with royalty, not being more beneficial to the assessees, have no application in the facts of these cases.

The important observations made by the Apex Court in arriving at its opinion are summarized below.

1. Provisions of DTAA override the Act

- The scope of total income of a non-resident provided under section 5(2) of the Act is subject to other provisions of the Act (including section 90). Accordingly, once a Double Taxation Avoidance Agreement ("DTAA") applies, the provisions of the Act can only apply to the extent that they are more beneficial to the assessee and not otherwise.
- Considering the Explanation 4 to section 90 of the Act and Article 3(2) of DTAA, where any term is defined in a DTAA, the definition contained in the DTAA is to be looked at. Accordingly, the definition of the term "royalty", when occurring in section 9 of the Act, has to be construed with reference to Article 12 of DTAA.
- The Apex Court relied upon its decision in the case of ***Union of India v. Azadi Bachao Andolan***[3] in this regard.

2. Requirement of withholding tax under section 195 in absence of chargeability to tax in India

- Tax is required to be deducted under section 195 only if the non-resident is liable to pay tax under the charging provision contained in section 9 read with section 4 of the Act, read with the DTAA.
- The Apex Court relied on its decisions in the case of ***GE India Technology Centre (P) Ltd. V. CIT***[4] and ***Vodafone International Holdings BV v. Union of India***[5] in this regard.
- The decision of the Apex Court in the case of ***PILCOM v. CIT***[6], wherein it was held that the obligation to deduct tax under section 194E of the Act is not affected by the DTAA and availability of benefit under DTAA cannot by itself absolve the liability to deduct tax under section 194E of the Act, has no application to the facts in the instant cases since section 194E of the Act does not contain any reference to chargeability to tax of the concerned non-resident payee under the Act.

3. Meaning of copyright and license

Some of the relevant provisions of the Copyright Act, 1957 ("CR Act") and the observations of the Apex Court regarding the same are as under:

- Copyright means an ***exclusive right***, subject to the provisions of the Copyright Act, 1957 ("CR Act"), to do or authorise the doing of certain acts "in respect of a work". Accordingly, copyright is a negative right in nature, being a right to restrict others from doing certain acts.
- In case of a computer programme, two sets of acts as outlined below constitute copyright:
  - Right to reproduce the work in any material form, to issue copies of the work to the public (not being copies already in circulation), to perform the work in public or communicate it to the public, to make any cinematograph film or sound recording in respect of the work, to make any translation of the work, to make any adaptation of the work, or to do any of the specified acts in relation to a translation or an adaptation.[7]

[3] (2004) 10 SCC 1
[4] (2010) 10 SCC 29
[5] (2012) 6 SCC 613
[6] 2020 SCC Online SC 426
[7] Section 14(a) read with section 14(b) of the Copyright Act, 1957

- Selling or giving on commercial rental or offering for sale or for commercial rental any copy of the computer programme.[8]

- Parting with copyright entails parting with the right to do any of the acts mentioned in section 14 of the CR Act. Thus, the right to reproduce a computer programme and exploit the reproduction by way of sale, transfer, license etc. is at the heart of the said exclusive right.
- A license as referred to in section 30 of the CR Act, is a licence which grants the licensee an interest in the rights mentioned in section 14(a) and 14(b) of the Copyright Act, 1957.
- The making of copies or adaptation of a computer programme in order to utilise the said computer programme for the purpose for which it was supplied, or to make up back-up copies as a temporary protection against loss, destruction or damage, does not constitute an act of infringement of copyright under section 52(1)(aa) of the Copyright Act, 1957.

The Apex Court analyzed the distribution agreements / EULAs in light of the above provisions of the CR Act and observed as under:

- What is granted to the distributor under the distribution agreements is only a non-exclusive, non-transferable licence to resell computer software, it being expressly stipulated that no copyright in the computer programme is transferred either to the distributor or to the ultimate end user.
- Under these agreements, there is no further right to sub-license or transfer, nor is there any right to reverse-engineer, modify, reproduce in any manner otherwise than permitted by the licence to the end-user. Therefore, the distributor essentially pays as consideration the price of the computer programme as goods which may be then further resold 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.
- Even when it comes to an end user who is directly sold the computer programme, such end user 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 by the EULA.
- Further, the "licence" that is granted in the instant cases vide the EULA, is not a licence in terms of section 30 of the Copyright Act, which transfers an interest in all or any of the rights contained in sections 14(a) and 14(b) of the CR Act, but is a "licence" which imposes restrictions or conditions for the use of computer software.
- In response to the argument that in some of the EULAs, it was clearly stated that what was licensed to the distributor/end-user by the non-resident, foreign supplier would not amount to a sale, thereby making it clear that what was transferred was not goods, the Apex Court noted that in all such cases, the real nature of the transaction must be looked at upon reading the agreement as a whole and there was no doubt that the license in the instant cases constituted a sale of goods . The Apex Court relied on its decision in the case of ***Tata Consultancy Services v. State of A.P.***[9]

Additionally, the Court, reiterated the following principles pronounced in earlier favorable rulings of lower courts on this issue:

- 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. The transfer of the material substance does not, of itself, serve to transfer the copyright therein.

[8] Section 14(b) of the Copyright Act, 1957

[9] 2005 (1) SCC 308

- The right to reproduce is different from the right to use computer software. Whereas the former would amount to a parting of copyright by the owner thereof, the latter would not. The Court relied upon its decision in the case of ***State Bank of India v. Collector of Customs***[10] in this regard.
- 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 customised to its specifications or otherwise.

4. Scope of royalty as defined in DTAA and the Act

The Court referred to the definition of 'royalty' in India – Singapore DTAA for the purpose of analysis and noted as under:

- The definition of "royalties" in Article 12(3) of the India-Singapore DTAA is exhaustive.
- The definition contained in Explanation 2 to section 9(1)(vi) of the Act is wider in at least three respects vis-à-vis the definition in DTAA:
  - It includes a lump-sum consideration which would not amount to income of the recipient chargeable under the head "capital gains".
  - It expressly includes the granting of a licence in respect of "all or any rights".
  - It states that the transfer of "all or any rights' must be "in respect of" any copyright of any literary work.
- The expression "in respect of copyright" referred to Explanation 2(v) to section 9(1)(vi) of the Act is equivalent to "in" or "attributable to" and is more expansive than the DTAA provision, which refers to "use of, or the right to use" any copyright.
- To constitute 'royalty', there must be transfer by way of licence or otherwise, of all or any of the rights mentioned in section 14(b) read with section 14(a) of the Copyright Act.
- Even the expression "including the granting of a licence" in clause (v) of *explanation* 2 to section 9(1)(vi) of the Income Tax Act, would necessarily mean a licence in which transfer is made of an interest in rights "in respect of" copyright, namely, that there is a parting with an interest in any of the rights mentioned in section 14(b) read with section 14(a) of the Copyright Act.

5. Clarificatory nature of Explanation 4 to section 9(1)(vi) of the Act

The Court held that Explanation 4 to section 9(1)(vi) of the Act is not clarificatory of the position as of 1.6.1976, but in fact, expands the scope vide the Finance Act 2012 for the following reasons:

- CBDT Circular No. 152 dated 27.11.1974 relied upon by the Additional Solicitor General cannot apply as it would then be explanatory of a position that existed even before section 9(1)(vi) was actually inserted in the Income Tax Act vide the Finance Act 1976.
- Explanation 3 to section 9(1)(vi) of the Act refers to "computer software" for the first time with effect from 1.4.1991 and accordingly, Explanation 4 cannot apply to any right for the use of or the right to use computer software with effect from 1.6.1976 even before the term "computer software" was inserted in the statute.
- Similarly, the term "computer software" was introduced for the first time in the definition of a literary work and defined under section 2(ffc) of the CR Act only in 1994 (vide Act 38 of 1994).

[10] (2000) 1 SCC 727

- The Court also noted that it is equally ludicrous for the aforesaid amendment which also inserted Explanation 6 to section 9(1)(vi) of the Act to apply with effect from 1.6.1976, when technology relating to transmission by a satellite, optic fibre or other similar technology, was only regulated by the Parliament for the first time through the Cable Television Networks (Regulation) Act, 1995.

- Notification No. 21/2012 dated 13.06.2012[11] would also not assist in asserting the clarificatory nature of Explanation 4 since such notification was issued on 13.6.2012 after the insertion of Explanation 4 vide the Finance Act 2012.

6. Liability to deduct tax under section 195 in cases prior to the amendment in 2012 when Explanation 4 was factually not on the statute book

- The Court considered the below two latin maxims:
  - *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.
- Considering the above, it was held that the person mentioned in section 195 of the Act cannot be expected to do the impossible, namely, to apply the expanded definition of "royalty" inserted by *explanation* 4 to section 9(1)(vi) of the Act, for the assessment years in question, at a time when such *explanation* was not actually and factually in the statute.

7. Observations on the earlier rulings of the AAR and High Courts on this issue

- The Court considered and set aside the negative ruling of the AAR in the case of ***Citrix Systems Asia Pacific Ptyl Ltd.***[12] and observed as under:
  - The conclusion of the AAR that when computer software is licensed for use under an EULA, what is also licensed is the right to use the copyright embedded therein, is wholly incorrect since an end-user only receives a right to use the software and nothing more and the owner continues to retain the rights under section 14(b) of Copyright Act in case of a non-exclusive licence.
  - Ownership of copyright in a work is different from the ownership of the physical material in which the copyrighted work may happen to be embedded.
  - Any ruling on the more expansive language contained in the Explanations to section 9(1)(vi) of the Income Tax Act would have to be ignored if it is wider and less beneficial to the assessee than the definition contained in the DTAA.
  - Further, the expression "copyright" has to be understood in the context of the CR Act considering that domestic laws which apply in the Contracting States must be applied unless there is any repugnancy to the terms of the DTAA.
- Further, the Court observed that the reasoning in the negative decision in the case of ***CIT v. Samsung Electronics Co. Ltd.***[13] suffered from the same fundamental defect that the ruling in Citrix Systems (supra) suffered from.
- The Court also set aside the reasoning of the High Court of Karnataka in ***CIT v. Synopsis International Ltd.***[14] for the following reasons:

[11] The Notification provides that a transferee is exempt from deducting tax under section 194J when TDS has already been deducted under section 195 on the payment made in the previous transfer of the same software which the transferee acquires without any modification.

[12] In Re (2012) 343 ITR 1 (AAR)

[13] (2012) 345 ITR 494

[14] ITA Nos. 11-15/2008

- The Karnataka High Court had observed that in case of transfer of a copyrighted article, though a right in copyright was not transferred, however a right in respect of copyright contained in the copyrighted article was transferred and any other interpretation would result in the said provision becoming otiose. In this regard, the Apex Court held that the expression "in respect of", when used in a taxation statute, is only synonymous with the words "on" or "attributable to" and such meaning accords with the meaning to be given to the expression "in respect of" contained in *explanation* 2(v) to section 9(1)(vi) of the Income Tax Act.
- Section 16 of the CR Act has been completely missed and the expression "copyright" has to be understood only as is stated in section 14 of the Copyright Act and not otherwise.
- The High Court was wholly incorrect in stating that the storage of a computer programme *per se* would constitute infringement of copyright since such position would directly be contrary to the terms of section 52(1)(aa) of the Copyright Act.
- The High Court is not correct in referring to section 9(1)(vi) of the Income Tax Act and then applying it to interpret the provisions under the India – Ireland DTAA. Article 12 of the aforesaid DTAA defining "royalties" would alone be relevant to determine taxability under the DTAA, as it is more beneficial to the assessee as compared to section 9(1)(vi) of the Income Tax Act, as construed by the High Court.
- The finding that when a copyrighted article is sold, the end-user gets the right to use the intellectual property rights embodied in the copyright which would therefore amount to transfer of an exclusive right of the copyright owner in the work, is also wholly incorrect.

▪ Further, the Apex Court upheld the view contained in the determinations of the AAR in ***Dassault Systems K.K.***[15] and **Geoquest Systems B.V.**[16] and of the High Court of Delhi in ***DIT v. Ericsson A.B.***[17]***, DIT v. Nokia Networks OY***[18]***, DIT v. Infrasoft Ltd.***[19]***, CIT v. ZTE Corporation***[20].

8. Interpretation of DTAAs and reliance on OECD Commentary

- The DTAAs that have been entered into by India with other Contracting States have to be interpreted liberally with a view to implement the true intention of the parties.
- "Royalties" in all the relevant DTAAs in the instant case is defined in a manner either identical with or similar to the definition contained in Article 12 of the OECD Model Tax Convention. The OECD Commentary on the provisions of the OECD Model Tax Convention then becomes relevant.
- The positions taken by India on the OECD Model Commentary regarding taxation of software use the language "reserves the right to" and "is of the view that some of the payments referred to may constitute royalties". It is not at all clear as to what exactly the nature of these positions is. This may be contrasted with the categorical language used by India in its positions taken with respect to other aspects where the language used is "India does not agree to".
- The Apex Court relied on the decision in ***DIT v. New Skies Satellite BV***[21] wherein it was held that mere positions taken with respect to the OECD Commentary do not alter the DTAA's provisions,

[15] In Re (2010) 322 ITR 125 (AAR)
[16] In Re. (2010) 327 ITR 1 (AAR)
[17] (2012) 343 ITR 470
[18] (2013) 358 ITR 259
[19] (2014) 264 CTR 329
[20] (2017) 392 ITR 80
[21] (2016) 382 ITR 114

unless it is actually amended by way of bilateral re-negotiation.

- Even after India took such positions *qua* the OECD Commentary, no bilateral amendment was made by India and the other Contracting States to change the definition of royalties contained in any of the DTAAs relevant in these appeals, in accordance with its position.
- Even DTAAs that were amended subsequently, such as India – Morocco DTAA, India – Singapore DTAA, India – Mauritius DTAA, were amended without making any change to the definition of "royalties".
- Accordingly, the OECD Commentary on Article 12 of the OECD Model Tax Convention, incorporated in the relevant DTAAs in the instant cases, will continue to have persuasive value as to the interpretation of the term "royalties" contained therein.

9. Others

- *Principle of exhaustion* - A distributor who purchases computer software in material form and resells it to an end-user cannot be said to be within the scope of section 14(b)(ii) of the CR Act (relating to meaning of copyright in case of computer software), which provides that it is the exclusive right of the owner to sell or to give on commercial rental or offer for sale or commercial rental any copy of the computer programme. Accordingly, the object of section 14(b)(ii) of the CR Act is not to prevent the sale of computer software that is licensed to be sold by a distributor, but it is to prevent copies of computer software once sold from being reproduced and then transferred by way of sale or otherwise. Sale by the author of a computer software to a distributor for onward sale to an end-user cannot be covered under section 14(b)(ii) of the CR Act.
- The High-Power Committee Report 2003 and the E-Commerce Report 2016 are recommendatory reports expressing the views of the committee members, which the Government of India may accept or reject. When it comes to DTAA provisions, even if the position put forth in the aforementioned reports were to be accepted, a DTAA would have to be bilaterally amended before any such recommendation can become law in force for the purposes of the Income Tax Act.
- Vide Circular No. 10/2002 dated 09.10.2002, the Revenue, has itself made a distinction in the proforma of the certificate to be issued in Annexure B to the aforesaid Circular, between remittances for royalties (Row No. 5) and remittances for supply of articles or computer software (Row No. 7).

Aurtus Comments

The decision of the Apex Court will go a long way in laying to rest the controversy regarding the taxation of payments made to non-residents for end use / distribution of software in treaty scenarios. Additionally, the principles laid down by the Court regarding royalty payments will also provide as useful guidance in determination of the tax treatment of royalty payments of a different nature.

The observations of the Court with respect to retrospective applicability of the amendments made to section 9(1)(vi) by the Finance Act, 2012 would provide relief to taxpayers in non-treaty cross border royalty transactions prior to 2012 and serve as a landmark in interpreting the impact of retrospective amendments going forward.

Further, the distinction drawn between the provisions of section 195 and section 194E as interpreted in the case of PILCOM (supra) was much needed and would help in preserving the settled position of there being no obligation to deduct tax under section 195 in absence of chargeability to tax in India.

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