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WHETHER THE PAYMENT MADE BY INDIAN RESIDENTS FOR PURCHASE OF COMPUTER SOFTWARE FROM FOREIGN SUPPLIERS/MANUFACTURERS CAN BE TERMED AS 'ROYALTY'?

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INTRODUCTION

The Supreme Court of India (Supreme Court), vide a common judgment dated 02 March 2021, in a batch of tax appeals, in the lead case of *Engineering Analysis Centre of Excellence Pvt Ltd v The Commissioner of Income Tax & Another* held that the amount paid by resident Indians to non-resident manufacturers/ suppliers of computer software in terms of distribution agreement or End-User Licence Agreement (EULA) does not amount to royalty and that such payment does not give rise to any income taxable in India and therefore, there is no liability on the resident Indian companies to deduct tax at source on purchase of software under section 195 of the Income Tax Act 1961 (Act). Khaitan & Co represented one of the Appellants, i.e., Concentrix Services India Private Limited (the Appellant), before the Supreme Court in one of the connected appeals.

FACTUAL BACKGROUND

The Supreme Court considered two sets of appeals, one arising from the High Court of Karnataka and the second arising from the judgments passed by the High Court of Delhi. The Supreme Court also set to rest the contradictory rulings by Authority for Advance Rulings (AAR) on the issue.

The Appellant is a resident Indian reseller of shrink-wrapped computer software, directly imported from a non-resident company. The Appellant did not deduct tax in respect of the payments made to the non-resident company as the transactions constituted sale of goods. However, the case of the Revenue was that the transaction between the parties was a copyright for the right to use the software which attracted the payment of royalty and thus, assessed that tax be deducted at source under Section 195 of the Act.

When the matter was carried to the High Court of Karnataka by various assesses, the High Court upheld the appeal relying on its judgment in *CIT v Samsung Electronics Co. Ltd. & Others [(2011) 245 CTR (Kar) 481]*, which held that what was sold by way of computer software included a right or interest in Copyright, which thus gave rise to the payment of royalty and would be deemed to be income of the resident in India under section 9(1)(vi) of the Act, requiring the deduction of tax at source.

Being aggrieved, the Appellant, along with other assessees, filed civil appeals before the Supreme Court. The various appeals were divided into four categories:

- Computer software purchased directly by a resident end-user from a foreign non-resident supplier/manufacturer.

- Indian companies acting as distributors or resellers of non-resident suppliers and then reselling it to Indian end-users.

- Non-resident Foreign vendor who purchases software from a non-resident seller and resells to Indian distributors or end-users.

- Software affixed onto hardware and sold as an integrated unit by non-resident suppliers to resident Indian distributors or end-users.

The Appellant fell under the second category.

ISSUE

The issue before the Supreme Court was whether the payments made by an Indian resident payer for purchase of software from foreign software suppliers were in the nature of 'royalty' as defined in explanation 2 to Section 9(1)(vi) of the Act and Double Taxation Avoidance Agreement (DTAA) and consequently whether the payer was required to deduct tax at source on such payment under Section 195 of the Act.

ARGUMENTS BY THE APPELLANTS

- The purchase by the resident Indian distributor of the computer software for onward sale, is a transaction of sale of goods. Even the end user only received a limited license to use the product by itself.

- The definition of "royalties" under the DTAA did not extend to derivative products of the Copyright. It is settled law that taxability of income would be governed by the provisions of the DTAA, as they are more beneficial to the assessee. Further, the OECD Model Tax Convention on Income and Capital (OECD Commentary), the United Nations Model and the United States Internal Revenue Code, etc., do not treat sale of a copyrighted article as royalty.

- Amendment made to Section 9(1)(vi) in 2012 could not be applied retrospectively to assessment years prior to 2012.

- As per Section 14(b)(ii) of the Copyright Act, the foreign supplier's distribution right would not extend to the sale of copies of the work to other persons beyond the first sale.

ARGUMENTS BY THE RESPONDENTS

- Explanation 2(v) to Section 9(1)(vi) of the Act merely clarifies the law from 1976 when Section 9 (1)(vi) of the Act was first brought into force.

- DTAAs would not apply to "persons" in Section 195 of the Act who are not assessees.

- As per judgment passed in *PILCOM v CIT, [2020 SCC OnLine SC 426]* (PILCOM), in terms of Section 194E of the Act, tax has to be deducted at source irrespective of whether tax is otherwise payable by the non-resident assessee.

- In some cases, since the software adaptation could be made, albeit, for installation and use on a particular computer, Copyright is parted with by the original owner.

- Under Section 52(1)(a) of the Copyright Act, making copies or adaptation of a computer programme from a legally obtained copy for non-commercial, personal use would not amount to infringement; therefore, the converse would amount to infringement.

- The doctrine of first sale/principle of exhaustion will not apply to distributors.

- The judgment of *Tata Consultancy Services v State of AP [2005 (1) SCC 308]*(Tata Consulting) wherein, for purpose of sales tax law, it was held that software recorded on compact discs are goods, cannot be applicable to the Act.

JUDGMENT

The Supreme Court, in a detailed judgment, held that:

- Upon application of the DTAA, provisions of the Act can only be applied to the extent they are more beneficial to the assessee.

- Tax Deduction at Source under Section 195 of the Act can only be made if a non-resident is liable to pay tax under the charging provision in Section 9 read with Section 4 of the Act and the DTAA. The judgment of PILCOM would not be applicable to the present case.

- As per amended Sections 14(b)(ii) and 52(1)(aa), 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 make back-up copies does not constitute infringement of Copyright and does not amount to parting with copyright.

- The EULAs have to be read as a whole to ascertain the true nature of a transaction. What is licensed is sale of a physical object which contains an embedded computer programme and is, therefore, sale of goods as per *Tata Consulting*.

- Explanation 4 to Section 9(1)(vi) of the Act cannot have retrospective application.

Hence, in all the four categories, the Supreme Court held in favour of the assessees.

COMMENT

The Supreme Court judgment has settled and resolved conflicting views taken by the High Court of Karnataka and Delhi and the AARs, 20 years after when the controversy

first arose. The judgment is a welcome move which will have a far-reaching positive impact on software companies doing business in India.

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