Tax Alert

Taxability of shrink-wrap software - Supreme Court rules in favor of the taxpayer

The long-standing tax controversy surrounding 'off-the-shelf software' or 'shrink-wrapped software' or 'standard software' has finally come to rest with the Hon'ble Supreme Court's verdict on 2 March 2021. The deep-rooted controversy has led to numerous litigations that have been pending for years in the judicial system. The verdict was important not just to provide a conclusive tax treatment but also to provide tax certainty to the stakeholders.

The appellants' involved in the petition were broadly classified into the following four categories:

1. An Indian resident purchasing computer software directly from a foreign/non-resident supplier or manufacturer;
2. Resident Indian companies acting as distributors or resellers by purchasing computer software from foreign/ non-resident suppliers or manufacturers and then reselling the same to resident Indian end-users;
3. The distributor, a non-resident vendor, who, after purchasing software from another non-resident seller, resells the same to resident Indian distributors or end-users;
4. Computer software is affixed onto hardware and is sold as an integrated unit/equipment by foreign/non-resident suppliers to resident Indian distributors or end-users.

We have captured below the key arguments of both the parties and the verdict of the Hon'ble Supreme Court.

Contentions of the Appellants

- The amount paid for a shrink-wrapped software cannot be considered as the consideration for all or any rights in the copyright of the software. The money is paid for the product and not for the rights of the product. Reference was made to the OECD commentary.
- The distinction was clarified between an operating system and the application software. The operating software is generally embedded in the product (e.g., Windows operating system is embedded in the laptop) whereas, the application software needs to be purchased upon payment of VAT. It cannot entail royalty payments because it has not transferred any rights w.r.t copyrights. The test to determine the difference between copyright and copyrighted article is that if the buyer can do what the author can do, it is a transfer of copyright; however, if the buyer cannot do what the author can do, then the copyright is not actually transferred.
- It was submitted that the definition of royalty in the tax treaty is narrower than the definition in the Act. The tax treaty defines royalty as payments of any kind received as a consideration "for the use of, or the right to use, (so transfer of right is not covered) any copyright of a literary, artistic or scientific work", whereas Sec. 9(i)(vi) Explanation 2(v) defines royalty as consideration (including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head capital gains) for the transfer of all or any rights in respect of any copyright, literary, artistic or scientific work. It was emphasized that the words "in respect of" found in the Act are absent in the definition of royalty under the tax treaty, and the words, "transfer of all or any rights" are not present in the tax treaty. Thus, copyright, even if assigned, is not taxable as royalty under the tax treaty.
- Section 14 of the Copyrights Act, 1957 was referred to understand the definition of copyright. A copyright is an exclusive right to do or authorize the doing of certain acts "in respect of a work." Section 52(1)(aa) of the same Act lists certain actions not to be considered as an infringement of copyright. The Section includes the act of copying the program onto the computer's hard drive or random access memory or making an archival copy when it is an essential step in utilizing the program. It was contended that, in fact, a license is not required to give someone a right to copy as that is an inherent right, provided by the law, with someone who purchases the software to run it on the computer. Thus, rights in relation to these acts of copying, where they do no more than enabling the effective operation of the program by the user, should be disregarded in analyzing the character of the transaction for tax purposes.
- It was further argued that the doctrine of first sale/principle of exhaustion was cemented in Section 14(b)(ii) of the Copyright Act, which makes it clear that the supplier's distribution right would not extend to the sale of copies of the work to other persons beyond the first sale, but it would only be a resale. As a distributor, the taxpayer only resells the shrink-wrapped software. On a textual interpretation, the right to sell does not include the right to resell. Thus, by reselling, the distributor doesn't use the author's copyright.
- Reference was made to Circular No. 10/2002 dated 9 October 2002 by the Central Board of Direct Taxes (CBDT) in which "remittance for royalties" and "remittance for the supply of articles or "computer software" were addressed as separate and distinct payments, the former attracting the "royalty" provision under Article 12 of the Tax Treaty, and the latter being taxable as business profits under Article 7 of the Tax Treaty, provided that the foreign, non-resident supplier or manufacturer had a permanent establishment (PE) in India.

Revenue's Contention

- The software alleged to be "off the shelf software" or "standard software" are in substance enterprise-specific software and are customized, whereby certain rights are passed on to the buyers. The case in discussion deals with software solutions for specific industries which are packaged and sold through a distributor.
- The explanation 2(v) to Section 9(1)(vi) of the Income Tax Act applies to the payments made to a non-resident by way of royalty for the use of or the right to use any copyright. For this, reliance was placed on the language of explanation 2(v) and stressed that the words "in respect of" have to be given a wide meaning. Reliance was placed upon the CBDT Circular No. 152 dated 27 November 1974 together with the statement of the Finance Minister made before the Lok Sabha on 7 September 1990 and CBDT Notification No. 21/2012 dated 13 June 2012,to submit that explanation 4 to Section 9(1)(vi) of the Income Tax Act is a clarificatory amendment of the position in law right from 1 June 1976 when Section 9(1)(vi) of the Income Tax Act was first brought into force.
- It was argued that the provisions for TDS are distinct and exist apart from the provisions for assessment under the Act. The tax treaty covers the taxpayer, not the deductor under Section 195. A "payer" under Section 195 and a "taxpayer" under Section 2(7) of the Income Tax Act are distinct. Thus, it is clear that the tax treaty would not apply to the persons mentioned in Section 195 of the Act who are not a deductor and not a taxpayer. Thus, when a payment is to be made, we look at Section 195, the deductor cannot be in the position to decide what's more beneficial to the assessee. Reliance was placed upon a recent Supreme Court judgment in the case of PILCOM[1].
- It was argued that according to a commonly accepted definition, a 'sale' is an agreement by which a person, in return for payment, transfers to another person his rights of ownership in an item of tangible or intangible property belonging to him. Referring to various End User License Agreements (EULAs) and other agreements on record, the learned Additional Solicitor General was of the opinion that the software is not sold but licensed, and the title remains with the author.
- It was further argued that the OECD commentary relied upon by the appellants is based on the views obtained from the member countries of OECD, without taking into account the views of countries outside OECD, including India. The Indian Government had expressed its reservations on the OECD commentary, especially on the part dealing with the parting of copyright and royalty. Therefore, the reliance placed on OECD will not help, and the domestic law will prevail. In case it is held that the tax treaty provisions are to be applied in one or more cases, in that case also the royalty definition will include the position which we are dealing with in all these cases (all 4 categories of assessee's involved) because the software has been licensed and not sold and if it has been used by Indian entity for a particular object, these cannot be treated as off-the-shelf.
- With respect to the Copyright Act, the learned Additional Solicitor General relied upon Sections 2(a)(v), 19(3), 30A, 52(1)(ad), 58 and 65A of the Copyright Act to buttress the submission that in some of the cases before us, since the adaptation of software could be made, albeit for installation and use on a particular computer, copyright is parted with by the original owner. He added that section 51(b) of the Copyright Act makes it clear that when any person makes for sale or hire, or sells or lets for hire, or distributes, either for the purpose of trade or to such an extent as to affect prejudicially, the owner of the copyright, or imports into India, any infringing copies of the work, such importation into India without a license would amount to infringement of copyright. He relied strongly upon the AAR's ruling in Citrix Systems Asia Pacific Ptyl. Ltd[2].
- Citing numerous judgments, he was of the opinion that the doctrine of first sale/principle of exhaustion under Section 14(b)(ii) of the Copyright Act cannot be said to be applicable as far as distributors are concerned.

1. PILCOM v. CIT, West BengalVII, 2020 SCC Online SC 426
2. (2012) 343 ITR 1 (AAR)

Ruling

After considering the arguments of both the parties, the Supreme court ruling in favor of the taxpayer made the following observation:

- The machinery provision contained in Section 195 of the Income Tax Act (withholding tax provisions on payment to a non-resident) is inextricably linked with the charging provision contained in Section 9, read with Section 4 of the Act. Such withholding tax provisions can only be made if the non-resident is liable to pay tax under the charging provision of Section 9, read with Section 4 of the Income Tax Act. The CBDT Circular No. 728 dated 30 October 1995 clarifies that the tax deductor must take into consideration the effect of the tax treaty provisions. Reference was made to the judgment in GE Technology[3].
- Once a tax treaty applies, the provisions of the Act can only apply to the extent that they are more beneficial to the taxpayer and not otherwise. Further, by explanation 4 to Section 90 of the Act, it has been clarified by the Parliament that where any term is defined in a 'tax treaty,' the definition contained in the tax treaty is to be looked at. Only in a case, where there is no such definition present, the definition in the Act can then be applied.
- The PILCOM judgment was distinguished on the basis that Section 194E of the Act belongs to a set of various provisions which deal with TDS,i.e., Sections 193 and 194. No reference to the charge ability of tax under the Income Tax Act is made under these Sections, unlike in Section 195.
- With respect to the interpretation of the treaty and OECD commentary, the SC observed that India's position on OECD uses the language "reserves the right to" and "is of the view that some of the payments referred to may constitute royalties." Basis the same, the nature of these positions and their exact interpretations are not very clear.
- It was noted that India made a reservation and 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 within any of the tax treaties that we are concerned with in these appeals. As a matter of fact, tax treaties that were amended subsequently, such as the Convention between the Republic of India and the Kingdom of Morocco, incorporated a definition of royalties not very different from the definition contained in the OECD Model Tax Convention. Similarly, though the India-Singapore DTAA came into force on 8 August 1994, it has been amended several times. However, the definition of "royalties" has been retained without any changes. It is thus clear that the OECD commentary on Article 12 of the OECD Model Tax Convention, incorporated in the tax treaty in the cases before us, will continue to have persuasive value as to the interpretation of the term "royalties" contained therein.
- Coming to whether the payment for shrink wrap or off the shelf software be considered as royalty, the SC, after analyzing various judicial precedents and definition of royalty provided in Article 12 has held that as distribution agreement/EULAs 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 income from the sale of software would not be taxable in India as royalty is covered under the tax treaty.

3. GE India Technology Centre (P) Ltd. v. CIT, (2010) 10 SCC 29

Our Comments

Usage of standard software for business purposes is very common in today's day and age with all businesses going digital. The verdict of the Apex Court has come as a huge relief to the taxpayers. The ruling covers many aspects of software taxability and has put an end to numerous pending litigation in the judicial systems. Apart from the taxability of software, this ruling also provides certain principles that could be crucial in other matters as well.

- Even where India has provided any reservation for a certain aspect of the OECD commentary, in the absence of any modification in the bilateral treaty, the commentary would continue to hold persuasive value if the Treaty Article is based on the OECD model;
- In a case where amendment is made with a retrospective effect, the taxpayers cannot be asked to do impossible, i.e., to apply a provision of a statute when it was not actually and factually on the statute book. Thus, the person mentioned in Section 195 of the Income Tax Act cannot be expected to apply the expanded definition of "royalty" inserted by explanation 4 to Section 9(1)(vi) of the Act, for the assessment years when such explanation was not actually and factually in the statute.

Impact on Software payments – Going forward

Also, it would be important to note that amendments proposed in Budget 2021, include the clarification on payment of Equalisation Levy (EL). The clarification mentions that if the payment is liable for royalty/FTS, it would not be liable for payment of EL. However, given the controversy on software taxation and no enabling provision for claiming refund under EL provisions, this decision would help taxpayers in taking appropriate tax positions. However, it needs to be seen whether tax authorities at a lower level respects this decision or they would find some innovative ways to continue the litigation.

Overall with this decision, it can be said that the battle on software taxation is won. The only recourse available with the tax authorities is to distinguish the facts of each case in order to continue the litigation or file a special review petition against the said order. A special review petition can be filed only in a case where there is a discovery of new and important evidence or there is an error apparent from records or any other sufficient reason. While the scenario seems unlikely, it is certain that the taxpayers must now be ready to pay EL.

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