SC: Cross-border payments for software use not royalty, withholding tax provisions not applicable

A three-judge bench ruling of the Supreme Court settled the 20 year old dispute on taxability of cross-border applicability of tax on software usage. In the 226-page ruling, the Apex Court held that distribution agreements did not create any interest or right in end-users, which would amount to use of or right to use any copyright. In comparison with Section 9(1)(vi) of the Income Tax Act, Article 12 of the Double Taxation Avoidance Agreement being more beneficial to the assessees, there was no obligation to deduct tax under section 195. Amounts paid by resident Indian end-users or distributors to non-resident computer software suppliers, as consideration for resale or use of computer software through EULAs/distribution agreements, is not payment of royalty for use of copyright in the computer software, and that the same does not give rise to any income taxable in India.

Gist of the main observations of the Apex Court:

- The machinery provision contained in section 195 is inextricably linked with the charging provision contained in section 9 read with section 4, as a result of which, a person resident in India, responsible for paying a sum of money, chargeable under the provisions of the Act, to a non-resident, shall at the time of credit of such amount to the account of the payee in any mode, deduct tax at source at the rate in force which, under section 2(37A)(iii), is the rate in force prescribed by the DTAA.
- Thus, 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, follow, by virtue of which the resident-payee is deemed an "assessee in default", and thus, is made liable to pay tax, interest and penalty thereon.
- Referring to definition of the expression "copyright" under the Copyright Act, the Apex Court observed that section 14 of that Act makes it clear that "copyright" means the "exclusive right", to do or authorise the doing of certain acts in respect of a work. In essence, such right is referred to as copyright, and includes the right to reproduce the work in any material form, issue copies of the work to the public, perform the

work in public, or make translations or adaptations of the work. This is made even clearer by the definition of an "infringing copy" contained in section 2(m) of the Copyright Act, which in relation to a computer programme, i.e., a literary work, means reproduction of the said work.

- Referring to articles of the Double Taxation Avoidance Agreements with foreign countries, the Apex Court held that by virtue of Article 12(3) of the DTAA, royalties are payments of any kind received as consideration for "the use of, or the right to use, any copyright" of a literary work, which includes a computer programme or software.
- Further, analysing the distribution agreement entered for software use, the Apex Court observed that what is granted to the distributor 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.
- Differentiating the definition of "royalty" under the DTAA and the Act, the Court held that Article 12 of the DTAA defined the term stating that such definition is exhaustive – it uses the expression "means" - consideration for the use of or the right to use any copyright in a literary work, whereas under the Act, explanation 2 to section 9(1)(vi), is wider in at least three respects:
  - 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 licence in respect thereof; and
  - It states that such transfer must be "in respect of" any copyright of any literary work.
- Section 9(1)(vi) was brought into force prospectively. The definition of royalty contained in explanation 2(v) of section 9(1)(vi) of the Income Tax Act includes the transfer of all or any rights (including the granting of a licence) "in respect of any copyright, literary, artistic or scientific work"… The comma after the word "copyright" does not fit as copyright is obviously spoken of as existing in a literary, artistic or scientific work. As a matter of fact, this drafting error was rectified in the Draft Taxes Code 2010, under Chapter XIX in Part H thereof.
- OECD Commentary on Article 12 of the OECD Model Tax Convention, incorporated in the DTAAs, will continue to have persuasive value as to the interpretation of the term "royalties" contained therein.
- The effect of section 90(2), read with explanation 4 thereof, is to treat the DTAA provisions as the law that must be followed by Indian courts, notwithstanding what may be contained in the Income Tax Act to the contrary, unless more beneficial to the assessee.

The Apex Court held that withholding tax provisions under section 195 did not apply to such agreements.

Source: Supreme Court in Engineering Analysis Centre of Excellence Private Limited in Commissioner of Income-tax, Civil Appeal Nos. 8733-8734 of 2018 dated March 2, 2021

***

CONTACT DETAILS:

Head Office
75/7 Rajpur Road, Dehradun
T +91.135.2743283, 2747084, 2742026
F +91.135.2740186
E info@vkalra.com
W www.vkalra.com

Branch Office
80/28 Malviya Nagar, New Delhi
E info@vkalra.com
W www.vkalra.com

For any further assistance contact our team at
kmt@vkalra.com