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Supreme Court Set To Resolve A 20-Year Old Software Tax Dispute

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Where Did It All Start?

Bengaluru. Back in 2005, the income tax department sent notices to several taxpayers for payments made on import of software. The earliest cases involved Lucent Technologies Hindustan Ltd., Samsung Electronics Company Ltd., and Sonata Software Ltd.

What Were The Notices About?

Taxability of cross-border software payments. Specifically, whether the payment received by a non-resident for giving licence of the computer software is taxable as royalty or sale receipt.

Broadly, the tax department has characterised this income as royalty. It has argued that when a software is sold, the embedded program is licensed to the end user. The Indian entity is granted the rights to exploit the intellectual property or copyright in the software and so, the payment for such purchases amounts to royalty income in the hands of the seller. Hence, tax must be deducted at source by Indian companies on payments to the foreign sellers.

What’s The Taxpayers’ Argument?

Companies have argued these transactions are in the nature of a sale and not a license. No copyright or part of any copyright is licensed to the taxpayer. The non-resident owner continues to have the proprietary rights in the software and the use of the software by the Indian company is limited to making backup copy and redistribution. So, payment received for sale of computer software is business income. And in the absence of a business presence or permanent establishment of the seller in India, such business income is outside the ambit of taxation.

For instance, in its petition before the apex court, Sonata Information Technology Ltd. has explained the issue at heart:

- When a book or audio cassette or DVD is sold, it can straightaway be used by the customer.
- In contrast, a software package purchased by a customer cannot be used by him without first being copied on to the hard disk of his computer/laptop.
- As the software copyright is held by the foreign supplier, he gives a limited licence or permission directly to the Indian purchaser to copy the software on one designated computer only and also make one back-up copy for emergencies.
- The customer is prohibited from making any other copies of the software. This limited licence or permission is given to the customer only in order to enable him to use the software purchased by him.
- This licence or permission is granted only to the customer and not to the Indian company which imported that software.
- On the contrary, under the distributor agreements, the Indian company is prohibited from making any copy or even opening the software package.

What's Been The Judiciary's View So Far?

Several judges across Income Tax Appellate Tribunals, the Authority for Advance Ruling and high courts have ruled on this issue. But the two most important, and conflicting, rulings have come from the Karnataka and Delhi High Courts.

In the 2009 Samsung Electronics' case, the Karnataka High Court ruled in favour of the tax department. The high court noted that the case involves transfer of copyright. It said if the end user doesn't get the permission to copy and download the software, the CD is of no use. If such a license is not granted by the foreign seller, the actions of the end user will amount to violation of copyright. And so, payments made in respect of computer program would constitute royalty.

But in Ericsson Radio System's case, the Delhi High Court took a contrary view. It made a distinction between payment for a "copyrighted article" vs "copyright right". For a payment to qualify as "royalty", it must be established that the Indian company has obtained all or any of the copyright rights, the court said.

Enter, Retrospective Amendment

Taxability of software payments became of the most litigious issue before courts. So, a retrospective amendment was introduced in Finance Act, 2012, clarifying the scope of royalty income. It stated that payment for a right to use computer software is taxable as a royalty, regardless of the medium through which the software is transferred.

At the time, experts had opined that the clarification had expanded the scope of tax on royalty income.

Companies argued against the applicability of the amendments citing existence of beneficial treaty provisions. Various tax tribunals ruled in favour of companies saying the retrospective amendment in the definition of royalty may not be sufficient to cover cases unless the definition of royalty under various double taxation avoidance agreements is changed.

What’s Happening At The Supreme Court?

The 107 appeals before the apex court have been divided in four broad categories on the basis of their business models

- Indian traders/distributors/resellers of shrink-wrapped software i.e. over the counter software which isn’t customisable.
- Purchase of software for end use by Indian buyers.
- Embedded software in hardware or equipment
- Foreign software vendors who sell to Indian distributors/end users.

The prevailing consensus is that consideration for the sale of shrink-wrapped software does not qualify as royalties, Dhruv Sanghavi, co-head of international tax at Nishith Desai Associates, told BloombergQuint.

Deviating from this consensus can lead to double taxation since the state/country in which the taxpayers are resident disagree with India's characterisation of the income, Sanghavi explained. This would lead to non-availability of tax credit in the home country of the foreign sellers.

The resulting double taxation could possibly be relieved through mutual agreement between the tax authorities of the two states. However, such procedure is unlikely to be effective because Indian tax authorities would be bound, and therefore unable to deviate from the outcome at the Supreme Court, leaving no room for dialogue.

Dhruv Sanghavi, co-head of International Tax, Nishith Desai Associates

If the tax department’s stand is upheld, the potential outcome of such double taxation is costs being passed on to Indian consumers, or non-residents simply not doing business in India, Sanghavi added.

The apex court is likely to conclude the hearings in the case this week.