rate is applied to construction work only when the service provider is registered in Belgium as a construction contractor.

Knubben Dak en Leidekkersbedrijf BV (C-13/10), *Doc 2010-5440*, *2010 WTD 49-22*, also raises a question of the freedom to provide services. It concerns the same VAT provision as *Belpolis,* but asks whether the registration requirement is discriminatory when any contractor from any EU member country may register. Foreign providers are able to register. De Broe nonetheless foresaw a loss for the government.

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NEWS ANALYSIS

Delhi Tax Tribunal Reignites Software Debate

by Neha Sinha and Rajesh Simhan

The characterization of payments made for shrink-wrapped software has been a controversial issue in India, resulting in a large number of litigations. On the one hand, the revenue authorities argue that software companies license their software to the end-users and do not merely provide a copy thereof. Thus, payments made by the end-users are in the nature of royalty payments, liable to tax in India under the provisions of the Income Tax Act, 1961; subject to the beneficial provisions of tax treaties. On the other hand, software companies contend that end-users only receive a copy of the software — that is, a ''copyrighted article,'' as opposed to a right to the copyright of the software. Consequently, payments made for the software are in the nature of business income and are not liable to tax in India in the absence of a permanent establishment in India.

The Indian judicial authorities have delivered divergent judgments on this subject. While in a number of cases, they have recognized the distinction between a copyright and a copyrighted article, they have in some decisions rejected the concept of a copyrighted article and held that end-users are licensed software products. Thus, the debate surrounding this issue remains unsettled.

The controversy has resurfaced yet again with the decision delivered by the Delhi bench of the Income Tax Appellate Tribunal in the *Microsoft* case.[1] In this case, the Delhi tribunal, while adjudicating on a similar issue, held that the end-users were licensed Microsoft software and not merely provided a copy of it; thus, the payments made were in the nature of royalty payments subject to tax in India. The decision has also dealt with several other issues, including the relevance of the OECD commentary and the principle of treaty override.

This article discusses the *Microsoft* holding and its implications for software companies.

Facts of the Case

Microsoft Corp. entered into an agreement with Gracemac Corp., a wholly owned subsidiary, granting an exclusive no-royalty license to manufacture and distribute Microsoft software products. Microsoft also

[1] *Gracemac Corporation v. ADIT*, *Microsoft Corporation v. ADIT*, and *Microsoft Regional Sales Corporation v. ADIT* (I.T. Appeal Nos. 1331, 1332, 1333, 1334, 1335, and 1336 (Del) of 2008).

granted Gracemac an exclusive right to appoint a third party that would have the right to authorize end-users to reproduce Microsoft software, albeit only for internal use. The rights and licenses were granted to Gracemac in lieu of issuance of shares of Gracemac to Microsoft Corp. The agreement further stipulated that Microsoft Corp was the sole owner of all master copies of the software provided, including related documentation and packaging, and that Gracemac could not make any copies of the masters except as permitted and must return them forthwith upon termination of the agreement.

To facilitate manufacturing, Gracemac entered into a license agreement with Microsoft Operations Pte Ltd. (MO) in Singapore. Under the agreement, MO was granted:

- nonexclusive license to manufacture/reproduce Microsoft software in Singapore;
- nonexclusive license to distribute Microsoft software; and
- nonexclusive right to license or sub-license the right to reproduce Microsoft software to some end-users (large-account customers) for their internal use.

In consideration, MO was required to pay Gracemac royalties for each copy of Microsoft software distributed, calculated as a percentage of the net selling price received from the distributors.

For the purpose of distribution of Microsoft software, MO also entered into a nonexclusive distribution agreement with Microsoft Regional Sales Corp. (MRSC). Operationally, MO sold Microsoft software to MSRC in Singapore, which entered into distribution agreements with distributors in various countries, including India, for distribution of the software.

In the process of distribution, MRSC delivered copies of Microsoft software to the Indian distributors' former warehouse in Singapore, which sold it to resellers in India, which in turn sold it to the end-users. The end-users signed the end-user license agreement (EULA) with Microsoft Corp., owner of all intellectual property in Microsoft software, which laid down the conditions for use of Microsoft software products.

Issue

The primary question here was the characterization of the payments made for Microsoft software — specifically, whether the payment made for Microsoft software to Microsoft Corp. and other group companies Gracemac and MRSC (hereinafter referred to as the appellants) was taxable in the hands of those companies as royalties under the ITA and article 12 of the India-U.S. treaty.

Primary Arguments

Revenue

The revenue authorities' principal argument was that the end-users were licensed to use Microsoft software. Thus, payments made by end-users were in the nature of royalties and were taxable in India under the provisions of the ITA and the India-U.S. treaty.

The revenue authorities contended that in order to use the Microsoft software, end-users were required to copy the software on the computer hardware. Also, under the VPP model,[2] the end-users were permitted to make as many copies of the software as permitted under the terms of the license. The revenue authorities referenced section 14 of the Copyright Act, 1957, which provides that a copyright, inter alia, includes the right to reproduce the work in any material form, including the storing of it in any medium and/or the right to sell or give on commercial rental a copy of the computer program.

Further, the revenue authorities pointed out that the end-users could access Microsoft software and run it on their computer systems only after entering the activation code, which was made available to the end-users in accordance with execution of the EULA. They also relied heavily on the terms of the EULA to contend that the use of Microsoft software by the end-users amounts to license. The EULA provided that the Microsoft software was being ''licensed and not sold.'' Also, the EULA placed a number of restrictions and limitations on use of the Microsoft software by the end-users, such as the grant of the activation code and the requirement to destroy all copies of the software in specified circumstances.

Hence, the revenue authorities argued that the transaction under question could not be characterized as sale, because in a sale, the buyer becomes the absolute owner of property sold and requires no further authorization to use the property, which was not the case for Microsoft software. Thus, the transaction in question was, in essence, a license and not an outright sale of the media containing Microsoft software, the authorities said.

Appellants

The principal contention of the appellants was that the end-users were merely sold a copy of Microsoft software and were not granted rights regarding intellectual property contained therein. To emphasize the difference between copyright and copyrighted article, the appellants relied on the Supreme Court of India's decision in *Tata Consultancy Services v. State of Andhra Pradesh*,[3] in which the Court held that shrink-wrapped software was in the nature of goods and was susceptible to sales tax. (For prior coverage, see *Doc 2004-21586* or *2004 WTD 217-2*.) The Court had observed

[2]The Volume Purchased Products (VPP) model is used for large customers such as corporate houses, where they are given a set of media containing the Microsoft software and are permitted to make as many copies for internal use as prescribed in the license.

[3](2004) 192 CTR 257 (Supreme Court of India).

that when copies of a software program are made and marketed, the copyright to the computer program may remain with the originator of the program and the copies become goods. The appellants also relied on the OECD commentary and the Bangalore bench of the Income Tax Appellate Tribunal's decision in *Sonata Information Technology Limited v. Addl. CIT*,[4] in which the tribunal recognized the distinction between a copyright and a copyrighted article.

Regarding the case against Gracemac, the appellants argued that Gracemac granted MO the license to manufacture and distribute Microsoft software and that it received royalties from MO. Consequently, because the royalty payment was between nonresidents outside India, those amounts were not liable to tax in India.

Decision

The Delhi tribunal held that payments made for Microsoft software were in the nature of royalties and were thus liable to tax in India in accordance with the provisions of the ITA and the India-U.S. treaty.

The tribunal rejected the argument that there was a difference between a copyright and a copyrighted article. The Delhi tribunal observed that the term ''copyrighted article'' does not appear in the ITA or the India-U.S. treaty and was borrowed from U.S. regulations. The Delhi tribunal refused to rely on the U.S. regulations and the OECD commentary to recognize the concept of copyrighted work, stating that the term ''royalty'' was succinctly defined under the ITA and article 12(3) of the India-U.S. treaty. The tribunal also said that in the absence of any ambiguity under domestic law, there was no need to rely on external aids of interpretation.

Further, the Delhi tribunal referred to the terms and conditions of the EULA to determine the nature of the transaction and observed that the appellants' contention that Microsoft software was sold as a product was incorrect because the use of the software by the end-users was conditional upon compliance with directions issued by Microsoft Corp. The tribunal observed that in the case of sale of a product, the buyer is the absolute owner of the product, unlike in the current case in which the end-users were required to accept the terms of the EULA before getting the activation code; were restricted from making copies of the software, except in specified circumstances; and could be asked to destroy all copies of Microsoft software in possession if the EULA terms were violated. Further, the EULA stated that ''the product is licensed and not sold.'' The Delhi tribunal concluded that the end-users did not merely purchase a copy of Microsoft software as the appellants contended, but were granted a license to use Microsoft software products. Consequently, the payment by the end-users was for grant of license to use the intellectual property rights in those products, and the payment amounted to royalties as defined under the ITA.

The tribunal also referred to the suits filed by the appellants alleging infringement of copyright when consumers were using unlicensed or pirated software and observed that the appellants could not alternate their stand, claiming that Microsoft software provided to the end-users is a copyrighted article for tax purposes while also claiming infringement of copyright for use of unlicensed/pirated Microsoft software products. It further held that the Delhi High Court's grant of injunctions under the Copyright Act proved beyond doubt that Microsoft software was licensed to the end-users.

Also, the tribunal held that royalty payments made by MO to Gracemac could be subject to tax in India because the payments were calculated based on the number of copies sold in India, and thus the royalty payments should be treated as arising and accruing to MO in India, according to the Explanation to section 9 of the ITA.[5]

The Delhi tribunal also stated that domestic law will override the provisions of a tax treaty in the case of an irreconcilable conflict. The tribunal further said that a domestic law amendment that conflicts with tax treaties would have the effect of overriding the treaty provisions.

Analysis and Impact

The Delhi tribunal decision is cause for concern not only for software companies, but also for the legal community because of its observations on critical aspects of international tax principles. The Delhi tribunal's remarks on the authority and applicability of OECD commentary and the possibility of a unilateral treaty override are against the fundamental principles of international tax jurisprudence and previous practice of Indian judicial authorities. The stand taken by the tribunal is especially surprising given the heavy reliance that the Supreme Court and the high courts have placed on the OECD commentary and on foreign judgments in interpreting treaty provisions.[6]

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[4](2006) 6 SOT 700 (Bangalore tribunal).

[5]As per the Explanation to section 9 of the ITA, any royalty income of a nonresident will be deemed to accrue or arise in India irrespective of whether the nonresident has a residence or a place of business or a business connection in India.

[6]Some of the significant decisions in which Indian judicial authorities (including the Supreme Court) have placed reliance on OECD commentary and foreign judgments are: *Union of India v. Azadi Bachao Andolan* [(2003) 263 ITR 707 (Supreme Court)]; *Commissioner of Income Tax, A. P. I. v. Visakhapatnam Port Trust* [144 ITR 146 (Andhra Pradesh High Court)]; *Graphite India Limited v. Deputy Commissioner* [(2003) 86 ITD 384 (Calcutta High Court)]; and *Daimler Chrysler India v. DCIT* [ITA No. 968/PN/03 (Pune Tribunal)].

In this decision, the Delhi tribunal failed to ascertain the real nature and substance of the transaction and equated the right to use a product that was developed using an intellectual property to a right to the intellectual property itself. As a result, the Delhi tribunal rejected the argument that a copyright is different from a copyrighted article and held that a copyrighted article is an article comprising a given copyright. Consequently, in the tribunal's view, when an end-user obtains a CD containing software, he is in essence being granted a license to use the software.

Also, the Delhi tribunal did not consider that the restrictions placed on end-users' use of MS software — as well as the limitations on making copies and so on — are measures taken by Microsoft Corp. to prevent end-users from making copies for commercial exploitation and infringing Microsoft Corp.'s exclusive right to commercially exploit its copyright. This is similar to the buyer of a book being prohibited from selling photocopies or the buyer of a DVD being prohibited from screening the movie publicly. The buyer is, however, permitted to make copies for his own reading or to watch the movie with friends and family. The Delhi tribunal has mistakenly perceived these restrictions as those appearing in licensing models, whereby the licensor places restrictions on the licensee, as opposed to a sale in which the buyer has absolute rights to the property bought. In fact, the appellants' position is reinforced by the fact that the end-users are permitted only to make copies for internal use and not for commercial exploitation. Interestingly, in a number of recent decisions delivered by the Mumbai Tribunal[7] and the Bangalore Tribunal,[8] the judicial authorities have recognized the distinction between a copyright and a copyrighted article.[9]

Another important aspect of this holding is that the Delhi tribunal completely disregarded the appellants' contention that in the absence of MSRC/MO having a PE in India, the royalty payable to Gracemac could not be deemed to arise in India in accordance with article 12(7) of the India-U.S. treaty while holding that there is no conflict whatsoever between the provisions of the ITA and those of the treaty. The Mumbai bench of the Income Tax Appellate Tribunal recently held precisely to the contrary in *SET Satellite Singapore Pte Ltd. v. ADIT*,[10] a case concerning payment of royalties between two nonresidents under the India-Singapore tax treaty, which is worded similarly to the India-U.S. tax treaty. (For the decision, see *Doc 2010-16211* or *2010 WTD 140-14*; for related coverage, see *Doc 2010-14253* or *2010 WTD 123-2*.)

Also, the tribunal's observations regarding the concept of treaty override go against the grain of the provisions of the ITA as well as the well-enshrined law in India that the ITA's provisions would only apply to an assessee if they are more beneficial than the applicable tax treaty. This is especially important in light of the discussions surrounding the proposed Direct Taxes Code (DTC), which is sought to be introduced in India in April 2011. The matter is relevant to discussions of treaty override issues that have been incorporated into the draft DTC, albeit in limited form.

This decision has reignited the debate surrounding the characterization of payments made for shrink-wrapped software, and it has left software companies — especially Microsoft Corp. — in a lurch. The divergent views of the lower judiciary on this subject are causing confusion and are adversely affecting businesses and profit margins. Taxpayer certainty is one of the essentials of an effective and efficient tax regime. The varied stances taken by judicial authorities on factually similar cases will lead to loss of investor confidence. More specifically, it will lead to a loss of confidence by the international business community, which is engaged with Indian businesses. It is thus essential that clarity on this matter emerge. Hopefully, this matter will ultimately be decided by the Supreme Court so that the legal position can be settled with finality.

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[7]*Kansai Nerolac Paints v. ADIT* [MANU/IU/0269/2010], *Doc 2010-17279*, *2010 WTD 149-13*, and *Solid Works Corporation v. ADIT* [2010 TII 130 ITAT MUM INTL]. (For prior coverage of *Kansai Nerolac Paints*, see *Doc 2010-17732* or *2010 WTD 154-5*.)

[8]*Velankani Mauritius v. DDIT* [MANU/IL/0027/2010].

[9]The distinction has also been accepted by the Indian judicial authorities in a plethora of decisions, including *Motorola Inc. v. DCIT* [(2005) 95 ITD 269], *Sonata Information Technology Limited v. Addl. CIT* [(2006) 6 SOT 700], and *Lucent Technologies International Inc. v. DCIT* [120 TTJ 929].

[10]ITA No. 7349/Mum/2004.