Tax Hotline

February 12, 2021

SOFTWARE BATCH APPEALS - COURTROOM PROCEEDINGS (DAY 2: FEBRUARY 10, 2021)

Arguments on behalf of taxpayers in the Software batch of appeals before the Supreme Court continued for the second consecutive day on February 10, 2021.

Representing IBM, Percy Pardiwala, senior advocate, commenced the day's arguments by submitting that a limited, non-exclusive, and non-transferable license was provided to customers where the licensee could only make one copy in his hard disk and another copy as a backup.

Referring to *Ericson AB*[1], he stated that the matter pertained to an integrated supply of telecom equipment with software being an integral part of it, and there being no independent existence. To demonstrate that only the right to use copyrighted material, and not the copyright, was allowed, he referred to specific clauses of the licensing agreement between the non-resident owner of the copyright and the resident distributer of the copyrighted products, which stated that in case the equipment is transferred, the transferee or successor will still have to obtain a fresh license from the supplier in order to use the software embedded in the equipment. Quoting the Delhi High Court in *Infrasoft*[2], Pardiwala observed that most licensing agreements clarify specifically that no interest in the copyright is transferred.

1. **Interaction Between Explanation 4 and Explanation 2**
   According to the relevant part of the definition contained in Explanation 2(v) to Section 9(1)(vi) of the ITA, a "royalty" means a consideration for the transfer of all or any rights (including the granting of a license) in respect of any copyright. In 2012, Explanation 4 was inserted in Section 9(1)(vi), purportedly, to clarify that the "transfer of all or any rights" in respect of any right, property or information included and had always included the "transfer of all or any right for use or right to use a computer software". In relation to the question of whether this amendment affected the interpretation of the definition of "royalty", Pardiwala contended that it did not. This, according to him, was because unlike some other clarifications (e.g., Explanations 5 and 6), Explanation 4 did not refer back to the definition of "royalty" in Explanation 2. According to him, Explanation 4 was applicable only to clause (b) of section 9(1)(vi), which used the exact terminology as in Explanation 4, but provided for an exception to when a payment could be considered to be "royalty". Therefore, he submitted, that the retrospective amendment in Explanation 4 did not affect the interpretation of the term "royalty".

1. **Role of domestic law in the interpretation of tax treaties**
   Thereafter, he invited attention to Article 12(3) of the India-US tax treaty which defines the term "royalties". He argued that even if Explanation 4 were considered to influence the definition of the term "royalty" under the Act, it wouldn't impact the definition of "royalties" under the treaty. He drew the court's attention to Article 3(2) of the treaty, according to which only undefined terms adopted their domestic law meanings for treaty purposes. However, since the term "royalties" had been defined under the treaty, the treaty would override domestic law as per Section 90(2) of the Act. He cited The *Seimens AG*[3] and the *Nokia*[4] judgements as precedents in this context.

1. **CBDT Circular No. 10 of 2002**
   It used to be the practice of the Reserve Bank of India of allowing remittances to non-residents of India only after obtaining a "No Objection Certificate" from the Income Tax Department. This practice was discontinued through a communication in CBDT Circular No. 10 of 2002. This circular contained a form which had to be populated with details of the remittances by persons making the transfers. Interestingly, as Pardiwala pointed out, this form had itself characterised income from the sale of software as business income, and not royalty. This, he argued, was tantamount to a concession by the Revenue that there was indeed a distinction between the sale of a copyrighted article and the assignment of a copyright.

S. Ganesh, senior advocate, presented his arguments on behalf of *Sonata Information*, which was a distributor of packaged software. His arguments are summarised below:

1. **Statutory right to make copies of software programme**
   Ganesh argued that in case of sale of books or audio discs buyers could enjoy the goods directly, and did not require a license, hence the transaction of sale is concluded. However, a software package could not be put to any meaningful use unless a seller allowed buyers to copy the software on a hard disk, or to create a backup. Acknowledging this principle, the legislature introduced section 52(1)(aa) of the Copyright Act 1957 giving the buyers of computer programs the right to make a copy if:

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a. It is done to utilize the computer program for the purpose for which it was supplied, or

b. It is done to make backup copies for emergencies.

The right to make a copy in order to use the software, he argued, was quite different from assigning a "copyright".

1. **Analogy of the Indian Easements Act**
   Referring to Section 52 of the Indian Easements Act 1882, which defines the term "license" (albeit in the context of immovable property), Ganesh paraphrased it as the grant of a permission to a person to do something which would otherwise be unlawful. In the instant case, however, buyers were "given" the limited right to copy the software on their hard disks and to create backup copies for their own use. Such a "license" did not vest any new right in the buyers, he submitted, as they were already possessed of such rights through statute - Section 52(1)(aa) of the Copyright Act. The essence of his proposition was that consideration for shrink wrap software could not be characterised as payment for rights which were never transferred by the sellers to the purchasers. Therefore, the consideration could not be characterised as "royalty", as it was not for the transfer of a "copyright". In this respect Ganesh relied on the advance ruling in *Dassault Systems*.[5]

1. **Applicability of withholding obligations on distributors**
   Insofar as distributors were concerned, Ganesh submitted that they did not have so much as the right to open the package in which the software was supplied to the buyer under their licensing agreements. Therefore, distributors did not possess even the limited rights that the final buyers of the shrink wrap software did. Therefore, he argued, payments from distributors of such software could not be characterised as royalty. If at all a license were granted, he submitted, it was to the buyers, and not the distributors. Therefore, no royalty payments could be perceived as flowing from the distributors to the sellers. Royalty payments, if any, could only be perceived as having being made by the final buyers to the distributors. These payments, however, were made by residents of India to other residents of India. Since Section 195 of the ITA applied only to payments made to non-residents, Ganesh submitted, the obligation of withholding taxes under that provision did not arise.

1. **Onerous interpretation of withholding obligations**
   It was submitted that distributors operated on a small profit margins. Ganesh argued that the application of Section 195 to distributors would result in serious consequences for them in that they would be declared "assessees in default" and would be disallowed the deduction of the purchase amounts in the computation of their own profits, which might lead them to financial ruin. Therefore, he submitted, that if the court two interpretations to be possible, the one favouring taxpayers should be adopted.

1. **Role of OECD Commentary**
   With respect to India's tax treaties, Ganesh submitted that they were modelled after the OECD Model Tax Convention. Therefore, according to him, the OECD commentary should be relied on whilst interpreting the relevant treaty provisions. He suggested that the court ought to rely on the commentary which states that payment for use of a copyrighted article did not qualify as royalties, whilst construing the nature of the transactions under review.

Prateesh Kapur, senior advocate, representing Sunray Computer, a reseller of shrink wrap software addressed whether the sale of a computer programme could qualify as a "copyright", as defined in Section 14(b) of the Copyright Act. Before examining that provision, he drew the court's attention to Explanation 4 to section 90 of the ITA, which, similar to Article 3(2) of the OECD Model, provides that undefined terms have the meaning they have under the domestic law of the state applying a tax treaty. Given that the term "royalties" was defined, however, he argued that meaning of the 'royalty' should be confined to the definition under Article 13(3) of the applicable treaty, and that it should be interpreted in light of the OECD Commentary.

With respect to the interpretation of the term "copyright" under the Copyright Act, he made the following submissions:

1. **Contextual Interpretation**
   Kapur argued that under the Copyright Act, the "sale of copies" of software should be understood as infringement only when the article is reproduced and sold, as it is only the owner of the copyright who has right to reproduce it. Citing *TCS vs. State of Andhra Pradesh*,[6] he observed that once software was produced on a material medium, it constituted goods. A copyright, on the other hand, he submitted, was a right in itself and not a right attached to goods.

1. **Textual Interpretation**
   He noted that section 14(b) of the Copyright Act was amended to incorporate what is known as the 'exhaustion doctrine'. This doctrine implies that once a copyrighted article is sold by the owner of the copyright, she exhausts all rights to control that particular article, although the copyright continues to vest with her. In the instant case, a resident reseller selling a product did not sell any rights associated with the product which remained with the non-resident seller of the software. By reselling a copyrighted product, he submitted, a reseller does not in any way impinge upon any of the rights of the owner of the copyright, and therefore, the consideration paid by the reseller is not for any part of the bundle of rights that a copyright is. Therefore, the consideration could not be characterised as a royalty.

1. **Constitutional definition of "goods"**

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Kapur noted that Article 366(12) of the Constitution of India had defined the term “goods” broadly enough to include a copyrighted article. Further, relying on *TCS*, he argued that a simple sale of shrink wrap software could only be characterised as a sale of “goods” as defined in the Constitution. Therefore, he submitted, Parliament could not recharacterize income from the sale of “goods”, i.e., business income, as royalty.

Representing *Sasken Communication* – an end user of shrink wrap software – Ajay Vohra, senior advocate, began his submissions by outlining the admitted facts that his client was granted a non-exclusive and non-transferable license to use shrink wrap software. He elaborated that the license was provided without any right to modify, reverse-engineer or decompile the software. Following is the essence of his arguments.

1. **Enlargement of definition of Royalty does not affect tax treaties**
   Vohra explained that whilst Explanation 4 inserted by the 2012 amendment to the ITA did enlarge the definition of “royalty” for the purposes of the ITA, this did not expand meaning of “royalties” under Article 13 of the India-UK tax treaty. Relying on *Azadi Bachao Andolan,*[7] he argued that principles of statutory interpretation could not be followed rigidly whilst interpreting a tax treaty. Further, he contended that a unilateral amendment to domestic law could not translate to the amendment of a tax treaty, and that a treaty would need to be amended bilaterally to expand the definition of “royalties” therein. Invoking Article 26 of Vienna Convention, he buttressed his argument that a treaty should be followed in good faith, and that clarificatory and declaratory amendments to domestic law could not be read into treaties.

1. **Applicability of section 195**
   In the final limb of his submissions, Vohra argued that the obligation to withhold taxes could not be viewed in vacuum, and that it could not be applied to every payment made to a non-resident. The payment ought to take the form of income chargeable to tax in India, before the withholding obligation could arise. Citing the Bombay High Court in *DIT v. Mahindra,*[8] he argued that no obligation to withhold taxes could be attached to the payer of income, if the non-resident recipient were not taxable in India in respect of that income, or if limitation period for the assessment of recipient’s income had lapsed. Such a payer could not be held liable to the consequences of failure to withhold under Section 201 of the ITA.

Interestingly, all submissions made were in respect of Category 1 transactions. Whilst no oral arguments were made in respect of the other categories outlined by Datar on February 9, 2021, Justice Nariman did request counsel to submit sample contracts under each of the categories.

In the next edition of our reportage of this case, we shall summarise arguments of the Additional Solicitor General of India, who commenced his submissions on February 11, 2021 and will continue on February 16, 2021.

– Arijit Ghosh & Dhruv Sanghavi
You can direct your queries or comments to the authors

[1] (2012) 343 ITR 470 ; 2011 SCC Online Del 5600
[2] [2014] 264 CTR (Del) 329; [2013] 39 taxmann.com 88 (del)
[3] [2009] 310 ITR 320 (Bom)
[4] [2013] 358 ITR 259 (Del); [2012] 25 taxmann.com 225 (Delhi)
[5] [2010] 322 ITR 125 (AAR)
[6] (2005) 1 SCC 308.
[7] (2004) 10 SCC 1.
[8] (2014) 365 ITR 560 ; 2014 SCC OnLine Bom 693.