

“Import of Software is subject to withholding of tax – Conflict between Judgments”

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Recent Judgment of Delhi ITAT in the case of Microsoft Corporation has pushed software industry as well as other business industry in the confusion.

Hon'ble Delhi ITAT held that in case of import of software tax has to be withheld as this will be equal to royalty as defined u/s 9(1)(vi) of the Income Tax Act, 1961 (“the Act”).

In the order, which may raise multiple litigations, the Tribunal also held that provisions of DTAA will not always override the provisions of Income Tax Act. This observation of Tribunal gives a doubt on the authenticity of provisions of section 90(2) of the Act which gives a relief to the assessee by way of giving an option to apply the provisions of the Act or DTAA whichever is more beneficiary to the assessee.

Whereas recent Judgment of ITAT Mumbai in the case of TATA Communication Ltd., (ITA No.1473/Mum/2009) where the Hon'ble Tribunal held that the payment received by the US entity for sale of “shrink wrapped software” is not in the nature of royalty taxable within the provisions of Income-tax Act, 1961 (the Act) or under India-USA tax treaty (tax treaty). Accordingly, the taxpayer was not liable to withhold any tax while making payments to US entity under Section 195 of the Act.

The claim of the TATA Communication Ltd was that “Off the Shelf software” purchased by the assessee did not have tax implication in India inasmuch as the assessee has not purchased any copyrights in the software but only a copyright product. A reference was made to several decisions of this Tribunal, in support of the proposition that the buyer of the software was liable to pay royalty only when the copyright was transferred to it, including in the cases of Lucent Technologies Hindustan Ltd v ITO, 92 ITD 366, Samsung Electronics Co. Ltd. V ITO, (94 ITD 91) and Motorola Inc v. DCIT, (95 ITD SB 269). It was also submitted that since USA based company from which, software was purchased, did not have Permanent Establish in India, the question of income could have arisen only in the event of the payment for purchase of software being treated as royalty, but given the facts of the case and given the fact that purchase is made only of the copyright software and not copyright per se, the amount has not been treated as royalty in the hands of the US based company.

the Hon'ble Mumbai Tribunal held that the copyright article is distinct from copyright per se and payment for copyright article, therefore, cannot be

treated as payment of copyright, which could be brought to tax. While payment for use of copyright is indeed covered by the definition of 'royalty', the payment for use of copyright article would not be covered by the definition of 'royalty'.

This is a welcome decision by Mumbai Tribunal especially in the view of the decision of Delhi Tribunal which is totally a reverse decision.

Abstract of the Microsoft case is given below:

Till 31.12.1998, Microsoft Corporation directly entered into agreements with Indian distributors for sale of Microsoft products being "off the shelf" / "shrink wrapped" software, on principal to principal basis. The Indian Distributors, in turn, sold these Microsoft products to re-sellers/consumers. The business model was changed w.e.f. 1.1.1999. Microsoft Corp granted an exclusive license to its 100% subsidiary Gracemac Corp, USA, to manufacture and distribute in the territory the MS retail software products. Gracemac in turn, entered into a license agreement with Microsoft Operations Pte Ltd, Singapore ("MO"), under which it granted the latter a license to manufacture and distribute (reproduce) Microsoft software in Singapore in consideration of a royalty ranging from 30% to 40% of the selling price (in India). MO in turn entered into a distribution agreement with Microsoft Regional Sales Corporation, USA ("MRSC"), appointing the latter as distributor for selling the Microsoft software which were manufactured by MO. MRSC, in turn, entered into agreements with various distributors in various countries including India. The distributors distributed copies of software in their respective countries. MO sold the software copies to MRSC in Singapore. The Microsoft software copies are delivered by MRSC to the Indian Distributors "ex-warehouse" in Singapore. The distributor sold the products to re-sellers in India who, in turn, sold them to end users. Microsoft Corp entered into agreements with end users to use the software products licenced to them as per terms of agreement.

In the case of Microsoft Corp (till the change), the assessee accepted that income from licensing software to OEMs was "royalty" though it argued that income from licensing software to distributors was "sale of a copyrighted article" and not assessable in India for want of a PE. In the case of Gracemac (after the change), it was argued that as the royalty was received from a Singapore company (MO), the source of the royalty (though based on sales in India) was not in India and consequently not assessable in India. In the case of MRSC, it was argued that revenue was derived from sales of software to independent distributors and not from licensing and the revenue was not assessable to tax in India for want of a PE. The AO & CIT (A) took the view that the revenue received by all three parties was assessable as "royalty" under s. 9(1)(vi) as well as Article 12 of the India-USA DTAA. On appeal to the Tribunal, HELD:

(i) The income received for supply of software is assessable as “royalty” under s. 9(1)(vi) as a copyright subsists in a computer programme and it is also a literary as also a scientific work. A computer programme is also a patent, invention or process. As end-users have made payment for transfer of rights (including the granting of a license) in respect of copyright, patent, invention, process, literary or scientific work, the payment would be in the nature of royalty. Under the Explanation to s. 9 (1) inserted by Finance Act 2010 w.r.e.f 1.6.1976, income u/s 9(1)(vi) is deemed to accrue or arise in India even if the non-resident does not have a place of business in India;

(ii) As regards Article 12(3) of the India-USA DTAA, the definition of the term “royalty” is identical that in section 9(1)(vi) and there is no conflict. Under both, royalties are deemed to arise in the State in which the payer is situated;

(iii) Assuming there was a conflict between the Act and the DTAA, the proposition that the DTAA will prevail over the Act is not infallible. Later domestic tax legislation can over-ride treaty provisions if there is an irreconcilable conflict (Gramophone Company of India AIR 1984 SC 667 followed). As the India-USA DTAA was entered on 20.12.1990, the subsequent retrospective amendment to section 9 which provides that royalties will be deemed to accrue or arise in India even if the non-resident has no place of business in India will apply irrespective of any contrary provision in the India-USA DTAA;

(iv) Though the OECD Commentary provides that software supply profits are not assessable as “royalty”, the same merely contains the views of the authors and cannot be equated with the court decisions or law. Further, several Countries have expressed reservations in following the OECD commentary and there is also a cleavage of opinion in the OECD on whether a copyrighted article has copyright in it;

(v) The judgement of the Supreme Court in Tata Consultancy Services vs. State of AP (271 ITR 401) where a distinction was drawn between a “copyright” and a “copyrighted article” is not applicable as the Court was concerned with the provisions of the sales-tax act and was not concerned with the issue whether the transfer of a copyrighted software can give rise to “royalty”. Similarly, in Motorola 95 ITD 269 (SB) the Special Bench was concerned with a case where the software licensed to the cellular operator was a part of the hardware and had no independent use;

(vi) As the assessee has itself filed suits in Indian courts alleging copyright-infringement when pirated / unlicensed software is used, it cannot “blow hot & cold” in the same breath on the same issue;

(vii) Accordingly, the payments received by Microsoft Corporation from end users through distributors in respect of sale of computer software is taxable as royalty u/s 9(1)(vi);

(viii) As regards Gracemac, the argument that since EULA has been signed between end users and Microsoft Corp, no license was granted by Gracemac and consequently royalty payments are not chargeable to tax in the hands of Gracemac is not acceptable because the agreements are a “camouflage”. As end users have made payments for grant of license in respect of copyright in computer programmes, the consideration is taxable as “royalty” in the hands of Gracemac;

(ix) However, as regards MRSC, the income ought to have been assessed as business income u/s 9(1)(i) as it had a “business connection” with distributors in India and not as “royalty” as the royalty for grant of rights has already been assessed in the hands of Gracemac and there will be double taxation.

(x) The assessee (though non-resident) is liable to pay interest u/s 234A to 234C in view of Anjum Ghaswala (252 ITR 1) where the levy of interest was held mandatory in nature.

Decisions like this and decision of Karnataka High Court in case of Samson Electric Co. (185 Taxman 313) gives a shock and surprise to professionals and business community when it breaks the set trends of the practice and settled law which gives rise to the confusion and decreases the confidence level of assessee and professionals.