Tax Hotline

February 17, 2021

SOFTWARE BATCH APPEALS - COURTROOM PROCEEDINGS (DAY 3: FEBRUARY 11, 2021)

Arguments on behalf of the taxpayers in the Software batch of appeals before the Supreme Court of India continued for the third consecutive day on 11 February 2020.

Representing GE India, Sachit Jolly, Advocate, commenced the days arguments by making reference to the global licensing agreement between Ansys Inc (the non-resident owner of a copyright) and GE Global (purchaser of the copyrighted software). By virtue of being an affiliate of GE Global, GE India (the end-user, resident of India) was permitted to use the software. This was the first set of submissions with respect to Category 2 transactions (i.e., purchase of software for end use).

To demonstrate that no copyright was transferred through the agreement, he referred to its terms, which specified explicitly that the license was non-transferable, non-exclusive, and that there was no transfer of intellectual property in the software. The license restricted the end user from sub-licensing, reverse engineering, decompiling or modifying the software. Even with respect to the software product itself, the agreement noted that consent of the owner was required for the licensee to allow any third parties to use the software product, which could be conferred or withdrawn at any point, on the sole discretion of the owner of the copyright.

1. License under the Agreement not a Copyright

Jolly addressed whether licensing of the software to the end user could qualify as a "copyright" as defined in Section 14 of the Copyright Act 1957. He submitted that Section 14 enumerates the right to carry out a number of actions, and that the exclusive right to do them would mean a copyright. Referring to the terms of the global licensing agreement, he argued that that license did not constitute a copyright, as it did not grant GE India the right to sell, or give or offer on commercial rental, any copies of the computer programme. Consequently, Jolly argued, the end user did not possess the copyright underlying the software.

2. Addressing the Karnataka High Court judgment in *Samsung*

Jolly noted that the Karnataka High Court had recognised in the case of *Samsung*[1] that the licensing agreement under perusal had granted a non-transferable license, with no rights to modify or decompile the software. Nonetheless, the High Court went on to observe that the transfer was a license to 'use the copyright', which the bench deemed to constitute as a transfer of a part of the copyright itself. Assailing that conclusion, Jolly contended the agreement granted merely a license to "use the copyrighted material" and not to "use the copyright", which the High Court has conflated.

3. Retrospectivity of withholding obligations

In context of withholding obligations upon purchasers of software making payments to overseas owners of such software, Jolly argued that retrospective amendments could not change withholding obligations which existed at the time of payment. He argued that it was impossible to comply with withholding tax obligations retrospectively as payments would be executed before the passage of such law. He drew support from the Bombay High Court's decision in *Western Coalfields* and *NGC Networks*, which held that such assessees could not be held in default for non-compliance.

"Royalty" has been defined in Explanation 2 to Section 9(1)(vi) of the ITA to mean consideration for the transfer of all or any rights (including the granting of a license) in respect of a copyright. Jolly argued that the definition of "royalty" was broadened in 2012 by the insertion of Explanation 4[2] thereof, which could not be interpreted so as to impose retrospectively a withholding obligation upon a payment made prior to the amendment.

4. Wider implications of the extant case:

Jolly drew the Court's attention to the wider implications their findings from the current set of appeals, will have. He submitted that the implications of what constitutes 'royalty' would extend to and impact several other forms of transactions and agreements. Specifically, in the context of withholding obligations, he suggested that though the present appeals concerned only payments made to non-residents, the interpretation of the term "royalty" would affect the withholding obligations with respect to payments to residents under Section 194J as well.

Balbir Singh, Additional Solicitor General of India appeared for the Revenue. His central argument was that withholding tax obligations under Section 195 arose with respect to all payments which were chargeable to tax under the provisions of the ITA, and the impact of tax treaties should not be considered at that stage. The impact of tax treaties, according to him, ought to be reckoned only in the course of assessment, i.e., when one files ones tax returns.

Singh elaborated the following propositions.

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Analysing SEBI's Consultation Paper

1. Withholding obligations are distinct from a taxpayer's final tax liability

Singh framed the issue before the court was whether a resident purchaser or distributor of shrink wrap software was liable to withhold taxes from payments made to the owner of the copyright, and not whether the non-resident recipient of income was liable to tax thereon. That issue, according to him, should be determined only in light of the provisions of the ITA. Referring to Section 190 of the ITA, he stated that any tax which is deductible at source as per provisions of the ITA, is payable regardless of the result of he recipient's assessment, which may occur at a later time. With respect to Section 195 of the ITA, this obligation arose on the payer at the time of making the payment.

2. Inapplicability of treaty provisions whilst withholding

According to Section 90(2) of the ITA, the provisions of the ITA are applicable to taxpayers only insofar as they are more beneficial than the provisions of tax treaties. According to Singh, the determination of whether the ITA or the applicable tax treaty was more beneficial could only be made by the taxpayer and not the payer of income. Therefore, it was imperative for the payer to withhold taxes from payments which were chargeable to tax under the ITA, without regard to tax treaty provisions.

3. Options for low or no deduction; and the availability of safeguards:

Singh stated that the taxpayer has a number of options under the ITA to reduce withholding obligations at the stage of deduction, and rid themselves of any confusion with respect to such obligation. Referring to Section 195(2), he argued that, a payer may make an application under the ITA if one felt that the entire sum to be paid is not chargeable to tax. Based on determination by the tax authorities, the payer may then deduct tax proportional to only what is chargeable. Further, under Section 197, a taxpayer obtain a certificate for low or no deduction of tax at source from the income tax authorities. This he contended, allowed adequate opportunity for accurate determination.

Citing *Transmission Corp. of AP*,[3] Singh noted that the deduction under Section 195 was tentative, as it was subject to final assessment of "income". This, according to him, provided safeguards against taxpayers' rights from being adversely affected. Therefore, he argued, payers ought to withhold taxes under the provisions of the ITA, which were only tentative, and subject to final assessment.

4. Applicability of withholding obligation under Section 194J (between residents), in the reseller model:

Singh argued that in the distributor model where the resident entity procures the software from the non-resident supplier, in order to resell to purchasers, Section 194J (which imposes a withholding obligation on royalty payment made to a resident) would apply to the transaction between the purchaser and the resident reseller. In this context, he noted that the CBDT had previously granted exemption from this obligation, provided that tax is withheld in the transaction between the resident distributor and the non-resident supplier. [Therefore, without an obligation to withhold on the final purchaser; the obligations falls on the reseller to withhold while making paying consideration to the supplier. The exemption granted to the final purchaser is contingent on the reseller withholding tax, as without it, both legs of the transaction would escape any withholding liability. **Inapplicability of tax treaties**:

Referring to Article 30 thereof, Singh submitted that the India-US tax treaty was not applicable to withholding taxes payable in India. The Article deals with the time scale for 'entry into force' of the treaty provisions, and the specific taxes in each country which would be affected. Whilst the paragraph for addressing US taxes mentioned "taxes withheld at source" specifically, the paragraph concerning India however referred only to treaty applicability "in respect of income". Therefore, he argued that the India-US tax treaty did not apply at the stage of withholding taxes insofar as Indian withholding taxes were concerned. He relied on the judgement of the Calcutta High Court in *PILCOM*,[4] in which it was held withholding tax obligations on payers were not affected by tax treaties, even though the recipient may claim treaty benefits subsequently.

5. Licensing agreements contradict the Sale of Goods Act:

Specifically in the context of Category 2 (i.e., end users) transactions, Singh submitted that the end user was never granted the final right of ownership in the software. Therefore, the transaction could not be characterised as a sale of goods. He noted that such agreements were open-ended in nature, as opposed to a conclusion of sale. Elaborating this argument, he stated if newer versions of the software were subsequently released, the purchaser could update them, either as a matter of right, or at cost, through renewal or reinstatement clauses in the agreement. This, he submitted, implied that they were not one-time, off-the-shelf purchases, and could not qualify as sales of goods. Rebutting Sachit Jolly's argument, he noted that the agreement in question permitted modification of the source code, and as such would be covered by elements of copyrights mentioned in Section 14 of the Copyright Act.

In the context distributors, Singh argued that the licensing agreements under perusal, denoted a commercial arrangement where he noted that audits of the potential users had to be undertaken by the distributor to gauge their infrastructure and objectives, and to decide compatibility of their software. This he contended was entirely dissimilar to an agreement for the sale of goods. He further pointed out that such agreements allowed for the software to be recalled by the supplier at any time, and that the software generally has trackers to monitor their use by the purchaser. To this end, he argued that Section 65B of the Copyright Act which provides that tinkering of software's rights management information would also constitute infringement, would apply. Such open-ended agreements with liberties and prohibitions, he contended, indicated a transfer of copyright.

6. Contrary AAR decisions on whether copyright has been transferred:

Finally, Singh assailed the taxpayers' reliance on the advance ruling in *Dassault Systems* (which held a clear distinction between a transfer of a copyrighted product and a transfer in the underlying copyright). He relied on a subsequent advance ruling in *Citrix Systems*,[5] which held that a mere license that is limited in right, user, and duration (like the ones in the extant case) would also constitute a license that confers an "interest in the copyright" under Section 30 of the Copyright Act. That ruling differed from *Dassault Systems* despite acknowledging it, and held that whenever software is licensed for use, the copyright embedded within it is taken as well, as it cannot be divorced from the software.

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

[1] Samsung citation

[2] Explanation 4 was inserted in Section 9(1)(vi) in 2012 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".

[3] (1999) 7 SCC 266

[4] (2011) 335 ITR 147.

[5] 2012 SCC OnLine AAR-IT 4