

Tax Hotline

November 11, 2003

PAYMENT FOR IMPORT OF SOFTWARE IS NOT 'ROYALTY', RULES BANGALORE ITAT

The recent ruling of the Bangalore bench of the Income Tax Appellate Tribunal ("ITAT") would have a positive impact on the taxation of software, which has been in the eye of controversy in recent years on account of the stance taken by the Indian tax authorities in this regard. The ITAT has held that payments for import of software do not constitute royalty, if there is no transfer of copyright rights in the software. These payments would be business income of the foreign entity and thus be liable to tax in India only if the foreign entity has a permanent establishment or business connection in India. It may be pertinent to note that the special task force set up to examine the issues of taxation of software has submitted its recommendations to the Central Board of Direct Taxes and it is expected that a circular may be issued shortly in this regard.

FACTS

Lucent Technologies Hindustan Ltd. ("Lucent-India") is engaged in the business of manufacture and supply of electronic switching systems required in the telecommunication industry. The switching system manufactured and supplied by Lucent-India is based on customer specifications. Each switch has to be configured according to such specifications and software has to then be integrated with the switch. For this purpose, Lucent-India imports software as well as parts and components of the switching system i.e. hardware. Lucent-India integrates the software into hardware and sells the switch. In the fiscal year under consideration, Lucent-India imported certain software from Lucent Technologies Inc., US ("Lucent-US") and hardware from Lucent-Taiwan. At the time of making payments made to Lucent-US for the software purchases, Lucent-India did not withhold tax at source. The Income Tax Officer ("ITO") took the view that the payments to Lucent-US constituted payments towards royalty and thus Lucent-India ought to have withheld tax at source. He initiated tax recovery proceedings against Lucent-India in this regard.

The ITO held that the highly sophisticated and complex telecom software imported could be regarded as patent or invention or scientific work or secret formula or process and accordingly the payments made for the acquisition of the same would be royalty as defined in Explanation to section 9(1)(vi) of the Indian Income Tax Act, 1961. The view taken by the ITO was upheld in appeal by the Commissioner of Income Tax (Appeals). Lucent-India then filed an appeal before the ITAT.

RULING

Taking into consideration the rival contentions, the ITAT appreciated the fact that Lucent-India acquired no rights in the copyright program of the telecom software imported by it. Lucent-India had paid for purchase of the copyrighted article as opposed to copyright of the rights contained in the software. The ITAT also took into consideration the US IRS treasury regulations on "Classification of Certain Transactions Involving Computer Programs" wherein it is stated that a transaction involving transfer of a computer program is treated as a transfer of a copyrighted article if the buyer does not acquire any right to make copies, distribute or make a derivative program therefrom. Further as per Article 12 of the India-USA tax treaty, such payments would not constitute royalty as payment is not for use of a copyright, patent, etc. The ITAT held that the acquisition of software was inextricably linked to the acquisition of the hardware and one cannot function without the other. The ITAT further held that the transaction of purchase of hardware and software cannot be bifurcated so as to make the payments towards software subject to Indian taxes. The import of software is customer specific and it is a clear case of business transaction of purchase of equipment alongwith software to make the hardware functional. Lucent-India thus would not be under an obligation to withhold tax at source at the time of making payments to Lucent-US.

Source: *Lucent Technologies Hindustan Ltd. V. ITO, ITA No. 114 & 115 (Bang)/2002 dated October 31, 2003*

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