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TAX FLASH NEWS

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Income from sale of software does not amount to royalty under India-Netherlands tax treaty

Background

Recently, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Baan Global B V[1] (the taxpayer) held that income from sale of software does not amount to royalty within the meaning of Article 12(4)[2] of India-Netherlands tax treaty (tax treaty) since the taxpayer has not allowed the end user to use the process by using the software.

The Tribunal observed that the retrospective amendment[3] made in the Income-tax Act, 1961 (the Act) cannot be read into the tax treaty since the tax treaty has not been correspondingly amended in line with the new enlarged definition of 'royalty' under the Act.

Facts of the case

- The taxpayer is a Netherlands based entity engaged in the business of development and sale of computer software and provides other services in relation to its software product. The taxpayer entered into a 'Distribution Agreement' with an Indian subsidiary company for the supply of its software to Indian customer on which it receives a fix percentage sum as per the agreement.
- Indian subsidiary is an independent distributor of computer software which sells under the brand name of 'INFOR' and is sold as 'off the shelf' software in the market used by the customers in various businesses, like in connection with financial accounting, inventory management, HR management, etc.
- The customer in India places an order with Indian subsidiary which in turn passes on the order to the taxpayer for the purchase of the software. The taxpayer has the exclusive right to accept or reject the order. However, once the order is accepted by the taxpayer, the CD containing the software is sent to India and in turn Indian subsidiary distributes the CD to the customer in India.
- The taxpayer also delivers the license-key for the software directly to the customer and the customers pay the consideration for the sale of software to Indian subsidiary, which in turn after retaining the distributor's margin remits the balance amount to the taxpayer. The taxpayer also carries out through Indian subsidiary 'other general services' related to software.
- During the year, the taxpayer had received payment as sales consideration for the computer software products supplied by it to its Indian subsidiary and payment on account of 'other general services' (OGS fees) from the said Indian subsidiary.
- The taxpayer claimed that since it does not have a Permanent Establishment (PE) in India, only the payment received as 'OGS fee' was offered for tax in India as 'Fees for Technical Services' (FTS). However, income from the sale of software products was treated as business profit. Hence, this amount was not shown chargeable to tax in India in the absence of any PE in India.
- The Assessing Officer (AO) held that the payment received by the taxpayer for the sale of software is royalty under the Act as well as under the tax treaty and accordingly, liable to be taxed at 15 per cent under Article 12 of the tax treaty.

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[1] ADIT v. Baan Global B V (ITA No. 7048/Mum/2010) – Taxsutra.com

[2] The term 'royalties' means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

[3] Explanation 4 to Section 9(1)(vi) of the Income-tax Act, 1961 w.r.e.f 1 June 1976

- The Commissioner of Income-tax (Appeals) [CIT(A)] held that the payment was received by the taxpayer from the sale of a copyrighted article and therefore, it does not amount to 'royalty' under Article 12(4) of the tax treaty.

Tribunal's ruling

- In order to tax the payment in question as 'royalty', it is *sine qua non* that the said payment must fall within the ambit and scope Article 12(4) of the tax treaty. The main emphasis on the payment constituting 'royalty' are for consideration for the 'use of' or the 'right to use' any copyright. The key phrases 'for the use' or 'the right to use any copyright of'; 'any patent; 'or process', 'or for information,'; 'or scientific experience', etc., are an important parameter for treating a transaction in the nature of 'royalty'. If the payment doesn't fit within these parameters, then it doesn't fall within terms of 'royalty' under Article 12(4) of the tax treaty.
- The computer software does not fall under most of the term used in the Article barring 'use of process' or 'use of or right to use of copyrights'. In the present case, the sale of software cannot be held to be covered under the word 'use of process', because the taxpayer has not allowed the end user to use the process by using the software, as the customer does not have any access to the source code.
- The customer is available to use software product as such and not the process embedded in it. Several processes may be involved in making computer software but what the customer uses is the software product as such and not the process, which is involved in it.
- The definition of copyright though has not been explained or defined in the tax treaty, however, the various Courts have consistently opined that the definition of *'copyright'* as given in the 'Copyright Act, 1957' has to be taken into account for understanding the concept. The definition of 'copyright' in Section 14 is an exhaustive definition, and it refers to a bundle of rights. In order to fall within the realm and ambit of the right to use copyright in the computer software programme, the rights must be given, and if the said rights are not given then, there is no copyright in the computer programme or software.
- As noted by CIT(A), under the terms of the agreement between the taxpayer and India subsidiary, the agreement specifically forbids them from decompiling, reverse engineering or disassembling the software. The agreement also provides that the end user shall use the software only for the operation and shall not sublicense or modify the software. None of the conditions mentioned in Section 14 of the Copyright Act are applicable.
- If the conclusion of CIT(A) are based on these facts, he has righty concluded that the consideration received by the taxpayer is for pure sale of 'shrink wrapped software' off the shelf and hence, cannot be considered as a 'royalty' within the meaning of Article 12(4) of the tax treaty, as the same is consideration for sale of copyrighted product and not to use of any copyright.
- The retrospective amendment brought into the Act with effect from 1 June 1976 cannot be read into the tax treaty, because the tax treaty has not been correspondingly amended in line with the new enlarged definition of 'royalty'.
- The alteration in the provisions of the Act cannot be *per se* read into the tax treaty unless there is a corresponding negotiation between the two sovereign nations to amend the specific provision of 'royalty' in the same line. The limitation clause cannot be read into the tax treaty for applying the provisions of domestic law like in Article 7 in some of the treaties, where domestic laws are made applicable.
- The amendment carried out in the domestic law with retrospective effect will not automatically alter the provisions of a tax treaty. In relation to the applicability of Article 3(2) of the tax treaty, the Tribunal observed that it could apply to terms which are not defined in the tax treaty. If a particular term has been specifically defined in the treaty, then any reference to the domestic law or any amendment carried out in the definition of such term under such law will have no bearing on the definition of such term in the context of the tax treaty, unless tax treaty is also correspondingly amended by the parties.
- One contracting state which is a party to a tax treaty cannot unilaterally alter its provision and enlarge the scope of any term from the prism of its domestic law. If there is no amendment in the treaty and if any amendment is carried out under the domestic law then same cannot be read into the treaty. In the present case, the 'royalty' has been specifically defined in the tax treaty and amendment to the definition of such term under the Act would not have any bearing on the definition of such term in the context of a tax treaty.
- A tax treaty which has entered between the two sovereign nations, then one country cannot unilaterally alter its provision. Thus, the amended and enlarged definition under the Act should not be read into the tax treaty.

- The Delhi High Court in a series of decisions[4] have specifically disagreed with the ratio and conclusion of the Karnataka High Court[5]. The Delhi High Court concluded that when taxpayer supplies the software which is incorporated on CD, it has applied only a tangible property and payment made for acquiring such a property cannot be regarded as payment by way of royalty.
- Relying on the proposition laid down by the Delhi High Court, the Tribunal held that the payment received by the taxpayer does not amount to 'royalty' within the meaning of Article 12(4) of the tax treaty and accordingly, the same is not taxable in India. Since the taxpayer does not have PE in India, same cannot be taxed as business income under Article 7 of the tax treaty.

Our comments

The issue with respect to the characterisation of payment for computer software has been debated before the Courts/Tribunals. In the present case, the Mumbai Tribunal affirmed the decision of the Delhi High Court[6]. The Delhi High Court had observed that when taxpayer supplies the software which is incorporated on CD, it has applied only a tangible property and payment made for acquiring such a property cannot be regarded as payment by way of royalty. The Mumbai Tribunal observed that if a particular term has not been defined in the tax treaty but the same has been defined in the domestic law, then the definition given in the domestic law will be considered for analysing the transaction under the treaty. However, if a particular term has been specifically defined in the tax treaty, then any reference to the domestic law or any amendment carried out in the definition of such term under such law will have no bearing on the definition of such term in the context of the convention, unless tax treaty is also correspondingly amended by the parties.

The Delhi High Court in the case of New Skies Satellite BV[7] while expressing a similar view observed that unless the relevant tax treaty is amended jointly by both parties to incorporate income from data transmission services as royalty, the benefit under the tax treaty cannot be taken away. In relation to the applicability of Article 3(2) of the relevant tax treaty, the High Court observed that it could apply only to terms not defined in the tax treaty.

This decision may help taxpayers who are facing challenges with respect to the characterisation of income from computer software under a beneficial tax treaty scenario.

In line with the recent trend of clarifying various issues with a view to provide clarity and certainty, it would be apt if the government issues an appropriate clarification with respect to the characterisation of computer software transactions vis-à-vis beneficial tax treaty.

[4] DIT v. Infrasoft [2013] 39 taxmann.com 88 (Del), Pr.CIT v. M. Tech India Pvt Ltd [ITA 890/2015 (Del)], Alcatel Lucent, Canada [2015] 372 ITR 476 (Del)

[5] CIT v. Synopsis [2013] 212 Taxman 454 (Del), CIT v. Samsung Electronics Co Ltd. [2012] 345 ITR 494 (Del)

[6] Pr.CIT v. M. Tech India Pvt Ltd [ITA 890/2015 (Del)], Alcatel Lucent, Canada [2015] 372 ITR 476 (Del), DIT v. Ericsson A.B. [2012] 343 ITR 470 (Del), DIT v. Nokia Networks [2012] 358 ITR 259 (Del)

[7] DIT v. New Skies Satellite BV [2016] 382 ITR 114 (Del)

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