SUPREME COURT JUDGEMENT ON TAXABILITY OF SOFTWARE PAYMENTS OUTSIDE INDIA

Executive summary

On 2 March 2021, the Indian Supreme Court in the case of Engineering Analysis Centre of Excellence Private Limited ruled in favor of non-Indian taxpayers with computer software sales to Indian customers. The Court ruled that software sales should not be characterized as "royalties" under applicable tax treaty law, consequently not triggering Indian withholding tax in the absence of a permanent establishment (subject to the entity's tax treaty eligibility).

Background

The taxation of income from the sale of computer software in cross-border transactions has been a contentious issue in India for many years, with the key question being whether such income should be characterized as royalties (triggering an Indian withholding tax) or as business income (triggering no Indian tax in the absence of a permanent establishment).

While the Indian domestic tax laws provide a very broad definition of royalties (covering payments for the transfer of all or any rights for the use of or right to use computer software), various tax treaties limit the definition of royalties to payments for the use of, or the right to use, any copyright of a literary, artistic or scientific work.

Indian tax authorities have generally taken the position that income arising from transactions involving the sale of software programs or licenses should be characterized as royalties, irrespective of the nature of rights acquired by the end-user or the reseller. However, taxpayers have often taken the position that the characterization under the applicable tax treaty should be based on the nature and extent of rights granted to the end-user.

Divergent views of the Indian judicial authorities over the course of two decades have resulted in the progression of the issue to the Supreme Court.

Supreme Court Ruling

The Supreme Court ruling covered the following categories of software payments:

- Sales of software directly to an end-user by a nonresident
- Sales of software by a nonresident to Indian distributors for resale to customers in India
- Sales of software by a nonresident to a foreign distributor for resale to customers in India
- Software bundled with hardware and sold by foreign suppliers to Indian distributors or end-users

The following considerations were provided in the Supreme Court's decision.

- An end user who obtains a non-exclusive, non-transferable and restricted right to a copy of the software makes a payment for the copyrighted software and not for use of the "copyright" of the owner. Similarly, where the end user does not obtain any rights in the copyright under the license agreement, making a copy of the software for internal use (as permitted by the license) does not involve the grant of a right in the

copyright. The Supreme Court concurred with the view that a payment made by end users and distributors is akin to a payment for the sale of goods and not for the grant of a license in copyright under the Indian Copyright Act 1957 (ICA).

- The designation given to a transaction is not a decisive factor, and the true effect of the agreement needs to be considered, taking into account the overall terms of the agreement and the relevant circumstances.

- Prior to the expansion of the royalty definition under the domestic tax law in 2012 to specifically include software payments, an amount could only be treated as a royalty if there was a transfer of all or any rights in a copyright by way of license or other similar arrangement. If there was a payment for the grant of a license, such payment would constitute a royalty only if such license results in the transfer of the rights in the copyright under the ICA. As the licenses granted to the distributors and the end-users did not involve the grant of any rights in the copyright, the payments made for such licenses cannot be considered as royalties under both the domestic tax law (prior to 2012), and the tax treaties.

- The 2012 expansion of the scope of the royalty definition in the domestic tax laws, which was intended to have retrospective application, could not oblige withholding agents to apply withholding on a retrospective basis.

- If the tax treaty provisions are aligned with the Organisation for Economic Co-operation and Development Model Convention (OECD MC), such provisions may be interpreted using the OECD MC Commentary. The OECD Commentary supports the position that a payment to make a copy or adaptation of a computer program to enable the use of the software for which it was supplied does not constitute a royalty. This also supports the position that the payment made by distributors and end users should not constitute a royalty.

- The Supreme Court reiterated their earlier ruling which confirms that a withholding agent is only required to withhold tax if the amount is chargeable to tax under both the domestic tax law and the tax treaty. The Supreme Court confirmed that the determination of the income of a nonresident chargeable to tax in India is subject to the provisions of the relevant tax treaty. If an item of income is not chargeable to tax under the tax treaty, then such income could not be chargeable to tax under the domestic tax law.

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