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EY Tax Alert

Karnataka HC ruling characterizes payment for purchase of shrink-wrapped computer program as royalty



Executive summary

This Tax Alert summarizes a recent ruling of the Karnataka High Court (HC)^[1] on the issue of whether payment for purchase of shrink-wrapped computer program would be in the nature of 'royalty', under the provisions of the Indian Tax Laws (ITL) and the applicable Double Taxation Avoidance Agreements (DTAAs). This decision was rendered in a batch of appeals, with the lead case being Samsung Electronics Co Ltd. (Taxpayers). As the end-users of the computer program were granted a license to make copies of the computer program for back-up or archival purpose, the HC was of the view the end users were granted a copyright under the Indian Copyright Act 1957 (ICA), in the absence of which, making such a copy would have been an infringement of the ICA. Accordingly, the HC held that the payment was for right to use a copyright and would be characterized as royalty under the ITL as well as under the DTAAs.

Background and facts

- ▶ Under the ITL, 'royalty' is defined to mean consideration for the transfer of all or any rights (including the granting of a license) or use of any copyright, literary, artistic or scientific work, patent, invention, model, design, secret formula or process or trade mark or similar property. The comparable definition under the applicable DTAAs

defines 'royalty' to mean consideration for the use of, or the right to use, any copyright of a literary, artistic or scientific work. If a payment is in the nature of 'royalty' the same would be subject to withholding tax under the ITL.

- ▶ One of the Taxpayers in the case was engaged in the development and export of computer program. The Taxpayer imported 'shrink-wrapped' (or off-the-shelf) computer program from non-resident suppliers in USA, France and Sweden, for use in its business.
- ▶ Certain other Taxpayers in the case were engaged in the distribution of 'shrink-wrapped' computer programs. These Taxpayers used to import copies of the computer programs for subsequent sale to customers in India.
- ▶ No tax was withheld in respect of such payments on the ground that the same cannot be treated as royalty either under the ITL or under the applicable DTAAs. However, the Tax Authority held such payments to be in the nature of royalty and subject to deduction of tax at source under the ITL.
- ▶ The Bangalore Income Tax Appellate Tribunal (ITAT), in the case of Samsung Electronics Co. Ltd.^[2], as well as in a number of other cases, had held that payments made for purchase of computer program would not be in the nature of royalty where the end user is granted rights that no more than enable effective use of the

computer program. The ITAT had held that the end users had acquired a readymade off-the-shelf computer program (copyrighted article), without any right in the copyright. Thus, as the essential criteria ('use' or 'right to use' any copyright of a literary, artistic or scientific work etc.) for payments to fall within the ambit of 'royalty' were not met, the consideration towards purchase of program was held not to be in the nature of royalty. Therefore, the payment was held not taxable in India in the absence of a business presence or permanent establishment (PE) of the foreign vendors, in India.

- ▶ Consequently, no taxes were required to be withheld under the ITL. This principle was largely followed in a number of subsequent decisions of various ITATs. Aggrieved, the Tax Authority appealed before the HC. Without considering the issue on characterization, the HC had held that, unless the payer obtains a 'nil' or 'lower' withholding tax order from the Tax Authority, any payment to a non-resident is subject to the withholding provisions under the ITL^[3].
- ▶ Aggrieved, the program taxpayers appealed before the Supreme Court (SC). The SC, while reversing the aforesaid order of the HC, held that the withholding provisions under the ITL would apply only if those remittances are 'chargeable to tax' in India and not in each and every case of a payment to a non-resident. However, on the issue of taxability of the program payments, the SC

^[1] [TS-696-HC-2011 (Kar)]

^[2] [94 ITD 91]

^[3] Kindly refer Ernst & Young Tax Alert 'Karnataka High Court rules on withholding tax obligation for non-resident payments' dated 19 November 2009 for detailed comments

remanded the matter to the Karnataka HC to first decide the issue of whether the payment constitutes royalty and, hence, taxable in India^[4].

Issue for consideration

Whether the payments made by the Taxpayers to non-residents for purchase of computer program is chargeable to tax in India, under the royalty or business income provisions in the ITL and/or applicable DTAA's.

Tax Authority's contentions

- ▶ The payments are made in view of the 'use' of the computer program and would fall within the definition of royalty under the ITL as well as the other applicable DTAA's.
- ▶ The Taxpayers are granted the license to 'use' the copyrighted work in which the copyright vests with the non-resident. As per the agreements, the copyright is to prepare a copy for the effective use of the program by unloading program in the computer hard disk and also to take copy for back-up. Thus, a right is conferred by way of license or permission, which would not have been available otherwise. Since the Taxpayers are using the

copyrighted work and information pertaining to scientific formula, it could be only royalty and not sale, as no copyright or any part of the copyright is sold to the Taxpayers.

Taxpayer's contentions

- ▶ The payments made are for the purchase of a copy of a copyrighted article and not the copyright in the computer program. Hence, such payments cannot be classified as royalty either under the ITL or under the DTAA. Since the non-resident suppliers have no PE in India, the payments are not taxable under business income.
- ▶ Reliance may be placed on the SC ruling in the case of TCS^[5] rendered in the context of the Sales Tax Laws, since the court therein had considered an identical transaction of transfer of incorporeal right in the program. In such a transaction it was held that, the copyright remains with the originator of program, and what is sold is a copy of the copyrighted program. What is then acquired is only the ownership of that particular copy, not the intellectual property in the copyright. Thus, it would be a 'sale' and would not be characterized as royalty under the ITL or the applicable DTAA.
- ▶ The other Taxpayers, who are distributors, place back-to-back orders of the customers with the non-resident program suppliers. The Taxpayers

neither make any payment nor do they acquire any right to use the copyrighted article. Neither do they open or read the terms of sale of the packaged program. The payments are made by the customers, and thus, the Taxpayers are not liable to tax in respect of such payments.

- ▶ The term 'use' as contained in the ITL definition of royalty cannot be interpreted to mean copying of any portion of program into a machine and then processing of the machine instructions. 'Use' in the statute cannot be taken out or divorced from the context of the question under consideration and thus, the transaction pertaining to the program payments, cannot be termed as 'royalty'.
- ▶ Since under the Easement Act, the formal permission given to the purchaser/end user by the copyright owner is not a license, the provisions of the ICA are not attracted. The ICA provisions would apply only if the Taxpayers have been given a right to sell or offer to sale a computer program. Further, the transaction was not covered by any license or assignment under the ICA and, thus, it cannot be construed as license. Though the term 'license' has been used in the agreement, it connotes sale of the shrink-wrapped product.
- ▶ The OECD Commentary on the Model Convention treats the permission to make a copy, as merely incidental to the sale of the program package and as essential to effectuating the sale as not constituting a use of the copyright. Further, the payments made for purchase of the shrink-wrapped program is akin to purchasing a book from the shop and cannot be characterized as royalty. In view of the OECD Commentary, the

[4] Kindly refer Ernst & Young Tax Alert 'Supreme Court rules no withholding when there is no income chargeable to tax' dated 13 September 2010 for detailed comments.

[5] Tata Consultancy Services v. State of Andhra Pradesh [(2004) 271 ITR 404]

program payments are not in the nature of royalty and, as such, not taxable in India to warrant a tax withholding on the payments.

HC's ruling

- ▶ The term 'copyright' has not been defined in the ITL or DTAA's and, hence, a reference may be made to the ICA, as per which 'computer programs' are considered to be literary works and, accordingly, entitled to copyright protection. The right to copyright would constitute an exclusive right of the copyright holder and any violation of the said right would amount to infringement under the statute.
- ▶ As per the provisions of the respective agreements entered into by the Taxpayers with the non-residents, what is transferred is only a license to use the copyright belonging to the non-resident, subject to certain conditions, and the non-resident supplier continues to be the owner of the copyright and all other intellectual property right. What is transferred here, is a the right to use a copy of the program for the internal business, by making copies and back-up copies of the program. In the absence of this license, such acts would have constituted an infringement.
- ▶ Therefore, the right to make a copy of the program and use it for internal business by making copies and back-ups would itself amount to copyright work under the provisions of the ICA. Thus, the contentions that there is no transfer of any part/whole of the copyright and that the

transaction only involves sale of the copy of the copyrighted program, cannot be accepted.

- ▶ The contention that there is no transfer of copyright or any part thereof, cannot be accepted, since copyright is a negative right and it is an umbrella of many rights. The license is granted for authorizing the use of the copyright in respect of the shrink-wrapped program, and the same amounts to transfer of right to use the copyright, as per the terms of the agreements.
- ▶ The contention that since the program is not customized, the same is to be treated as sale of goods, cannot be accepted. The TCS decision (*supra*) relied upon in this regard, may be distinguished. The question in that ruling was not on whether the payments for the program imports were royalty, but, was on whether canned program sold by the taxpayers amounted to sale of goods under the Andhra Pradesh General Sales Tax Act. Further, the issue of transfer of right to use the goods as per the expanded definition of 'sale' did not come up for consideration. In the present case, the issue is on the tax characterization of program payments under the ITL and the applicable DTAA. It is well settled that the intent of the Legislature in imposing Sales Tax and Income Tax are entirely different.
- ▶ The amount paid to the non-resident suppliers was neither for the price of the computer program CDs or program nor for the price of license granted. But, it is a combination of all aspects granted under the license.

- ▶ In substance, unless the license is granted permitting the end-user to copy and download the program, the 'dumb CD' containing the program would not be helpful, as it is operative only if it is downloaded to the hardware of the designated computer as per the terms of the agreements. Herein lies the difference between the computer program and copyright in respect of books or pre-recorded music program, as these articles can be used once they are purchased. Therefore, there is no similarity between the transaction of program and books. The Legislature, in its wisdom, has treated the literary work like books and other articles separately from computer program articles, within the meaning of copyright, under the ICA.
- ▶ Therefore, the program payments would constitute 'royalty' under the applicable DTAA, and would also fall within the ambit of 'royalty' under the broader definition in the ITL. Thus, the Taxpayers would be required to deduct tax on the payments made and would be.

Comments

The computer software industry in India has labored with uncertainty on the most fundamental tax issue i.e., the character of the revenue a computer software company derives from its ordinary business transactions. The discussion, principally, has focused on characterizing transactions as generating either 'royalty' or 'sales' income. The characterization as 'royalty' or 'sales' income can have obvious consequences. Income characterized as 'royalty' would

generally attract withholding tax, whereas any income characterized as 'sales' income or 'business profits' generally would not be subject to tax in the absence of a PE. While there have been several rulings which have appreciated the distinction between the delivery of the copyrighted article to the end-user and the granting of rights to commercially exploit the intellectual property while dealing with characterization of shrink- wrapped computer program, the present ruling does not seem to consider this distinction as relevant for the purpose of determining the characterization issue.

This ruling of the Karnataka HC, in which the payment for purchase of a copy of a computer program for internal business use by an end user as well as for resale to end users is taxable as royalty, is likely to have a significant impact on cross-border taxation of computer program transactions. While the outcome of other rulings on this issue are awaited, the absence of consistency in judicial thinking on the issue of appropriate characterization of technology related payments is likely to result in ambiguity for companies making such payments on the position to be adopted for withholding tax purposes, in view of the onerous consequences associated with withholding tax default by way of interest, penalty and disallowance of expenditure.

It is important for taxpayers to review their cross-border transactions in detail to assess the withholding tax risk.

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