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EY Tax Alert

Karnataka HC ruling on taxability of payments for accessing database and for purchase of computer program bundled with sale of hardware



Executive summary

This Tax Alert summarizes three recent rulings of the Karnataka High Court (HC) on characterization and taxability of payments for certain forms of technology transactions under the provisions of the Indian Tax Laws (ITL) and the applicable Double Taxation Avoidance Agreements (DTAAs). Two of the rulings^[1], in the case of Wipro Ltd. (Wipro) and Infosys Technologies Ltd., (Infosys), relate to taxability of payments made to non-resident vendors which provide online access to a database containing repository of high-value information/data. The third ruling^[2] in the case of Lucent Technologies (Lucent) relates to taxability of payment for purchase of a copy of a computer program that was supplied as a bundled contract, along with hardware on which the computer program was to be installed. The HC ruled that the above payments are in the nature of royalty under the provisions of the ITL and the applicable DTAAs and, therefore, taxable in India. In the case relating to payments for online access to a database, the HC relied on its earlier decision in the case of Samsung Electronics^[3] and held that a payment made for obtaining a license to access a database is consideration for the right to use a copyright, taxable as royalty in India. In the case of payment under a bundled contract, the HC held that the purchase of computer program was a separate and distinct transaction from the purchase of hardware. As the specific exemption contained in the ITL for purchase of

^[1] ITA No. 2805/2005 in the case of Wipro Ltd. and ITA No. 613/2005 in the case of Infosys Technologies Ltd.

^[2] ITA No. 168/2005 in the case of Lucent Technologies

^[3] [2011-TII-43-HC-KAR-INTL]

an integrated system is not applicable, the payment for purchase of a computer program is taxable as royalty.

Access to online database

Facts of the case

- ▶ Wipro, an Indian company, made certain payments to a US resident in order to access an online database. Wipro was of the view that such payments do not amount to 'royalty' and, accordingly, no tax was withheld in India.
- ▶ The Tax Authority treated such payments to be royalty (alternatively, fees for technical services), liable to tax in India under the ITL as well as the India-US DTAA (US DTAA). This action of Tax Authority was upheld by the First Appellate Authority on an appeal to it. On further appeal to the Bangalore Income Tax Appellate Tribunal (ITAT), the ITAT ruled in favor of Wipro by holding that the payments was in the nature of subscription made to a journal or a magazine and no part of the copyright was transferred. Aggrieved by the above order of the ITAT, the Tax Authority preferred an appeal before the HC.
- ▶ Before the HC, the Tax Authority contended that:
 - ▶ The payment made to the non-resident is by way of royalty as what was granted to Wipro was a license to have access to the database maintained by the non-resident, which is a scientific/technical service.

- ▶ There was transfer of copyright to the extent of having access to the database, which, in the absence of a license would have been an infringement of copyright. This could not be considered to be akin to a subscription made to a journal or a magazine.

- ▶ Before the HC, Wipro contended that:
 - ▶ No part of copyright is transferred for granting access to the database.
 - ▶ Payments were akin to making a subscription for a journal or magazine of a foreign publisher and though the journal contained information concerning commercial, industrial or technical knowledge, there was no attempt to impart any knowledge to Wipro. The payments amount to income from business to the non-resident.
 - ▶ The payments were not contingent on productivity, use or disposition of the information concerning industrial, commercial or scientific experience, in order to be construed as royalty under the US DTAA.
 - ▶ The payments were for the purpose of a business carried on outside India or for the purpose of making or earning any income from any source outside India and, hence, not taxable in India under the provisions of the ITL.

Ruling of the HC

- ▶ The issue was identical to that raised in the case of Samsung Electronics (*supra*) wherein it was held that the payments made for acquisition of shrink wrapped software or off-the-shelf software would amount to transfer of right to use the copyright so held by the non-resident.

- ▶ The mere fact that the present case pertains to access to online database, and not shrink wrapped software, would not make any difference. Applying the decision in the case of Samsung Electronics (*supra*), the right to access database would amount to transfer of the right to use the copyright held by the non-resident.
- ▶ Payment made by Wipro was for the license to use the database maintained by the non-resident, taxable as 'royalty' in India.

The HC also applied this decision of Wipro in the case of similar payments made by Infosys.

Purchase of copy of computer program under a bundled contract (Lucent)

Background and facts of the case

- ▶ Lucent, an Indian company, had obtained orders from the Department of Telecommunications (DoT), Government of India (GoI), for the manufacture and supply of telecommunication equipments. To execute the above orders, Lucent imported computer program from the US and hardware from Taiwan and the same were integrated in India.
- ▶ Under the ITL, an exemption is granted for royalty paid under an integrated contract in respect of purchase of computer software from a non-resident manufacturer along with computer equipment, under a specified scheme approved by the GoI (Exemption).
- ▶ The Tax Authority took a view that the contracts for the acquisition of software were separate from the contract with the DoT and the same may not be integrated to give the benefit of the Exemption under the ITL. Independently, the payment for acquisition of software was taxable as royalty under the ITL and the US DTAA.
- ▶ The First Appellate Authority upheld the order of the Tax Authority. On an appeal to the Bangalore

ITAT, it observed that the purchases of software and hardware were two different transactions though the acquisition of software without the hardware does not serve any purpose. The ITAT held that payments for software cannot be termed as 'royalty' as Lucent had not acquired any rights in the copyright program and, hence, it could not be exploited commercially.

- ▶ Aggrieved, the Tax Authority preferred an appeal to the HC.

Ruling of the HC

- ▶ The ITAT committed an error by only considering the contract between Lucent and DoT and not giving any importance to the contracts of purchase of software/hardware. The finding recorded by the ITAT is erroneous that the payment made for supply of software was an integrated import and, hence, covered under the Exemption of the ITL.
- ▶ In view of the Exemption, it is clear that Legislature was aware of the import of software, both independently and under an integrated system. The Exemption under the ITL was not applicable in the present case as Lucent had not obtained the required approval.
- ▶ Payments made for purchase of software by Lucent are taxable as royalty under the ITL.

Comments

Characterization of software payments has been a contentious issue in India in the recent times with varied judgments from the Indian Courts. 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, a recent unfavorable ruling of the HC in the case of Samsung electronics (*supra*) held that payments made for shrink-wrapped software was taxable as royalty ^[4]. Also in the case of Lucent, while the HC has ruled that the payment for computer program should be examined as a separate transaction for determining its characterization, the ruling does not throw much light on the reasons as to why, under the facts, the payment was treated as generating royalty. These rulings would increase the uncertainty on characterization of payments for computer program as well as other payments involving other technology/electronic commerce transactions.

^[4] Please refer to Ernst & Young tax alert dated 30 November 2011 on 'Karnataka HC ruling characterizes payment for purchase of shrink-wrapped computer program as royalty'.

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