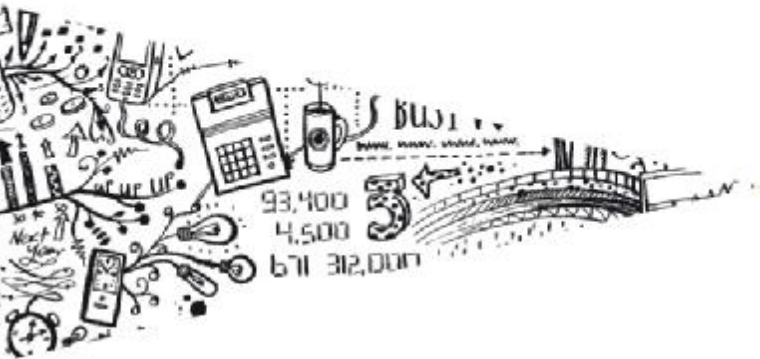


19 October 2011

EY Tax Alert

Media reports on decision of the Karnataka High Court on characterization of computer software



Executive summary

It has recently been reported in the media that the Karnataka High Court (HC) has pronounced a ruling on the issue of appropriate characterization of computer software in cross-border transactions. While a copy of the decision is awaited, the media reports suggest that the HC has reversed the decision of the Income Tax Appellate Tribunal (ITAT) and has held that such payments would constitute royalty under the Indian Tax Laws (ITL), as well as the relevant Double Taxation Avoidance Agreements (DTAAs) and, consequently, appropriate taxes are required to be withheld. A detailed Tax Alert would follow once a copy of the decision is available.

Background

- ▶ The Bangalore ITAT, in the case of Samsung Electronics Co. Ltd.^[1], as well as in a number of other cases, had held that payments made for purchase of computer software 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 software. 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 software 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 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 (NR) is subject to the withholding provisions under the ITL^[2].
- ▶ Aggrieved, many software companies appealed before the Supreme Court (SC). The SC, while reversing the aforesaid order of the HC, had 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 an NR. However, on the issue of taxability of the software payments, the SC remanded the matter to the HC to first decide the issue of whether the payment constitutes royalty and, hence, taxable in India^[3].

[2] Kindly refer EY Tax Alert 'Karnataka High Court rules on withholding tax obligation for non-resident payments' dated 19 November 2009 for detailed comments.

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

Recent decision of the HC

- ▶ It has been reported in The Hindu, dated 16 October 2011, that the HC has recently pronounced an order on the above issue. The reports also suggest that the HC has reversed the ITAT's order and has held that such payments would fall within the ambit of 'royalty', both under the ITL and DTAAs. As per the media reports, according to the HC, what had been transferred through a copy of the computer software is only a license to use the copyright belonging to the NR companies, which were subject to various terms and conditions. This ultimately authorizes the end users to make use of the copyright in the software. This, therefore, would amount to transfer of part of the copyright and transfer of right to use the copyright.
- ▶ Furthermore, it is reported that the HC has observed that the right to make a copy of the software and use it for internal business, store it in the hard disk of the designated computers and take a back-up would itself amount to copyright under the Indian Copyright Act. Accordingly, payments to NR companies for supply of shrink-wrapped software amount to royalty, both under the ITL and the relevant DTAAs.
- ▶ It may be noted that a copy of the HC decision is awaited. A detailed Tax Alert would be circulated once the decision copy is available.

[1] [94 ITD 91]

Comments

The issue of whether consideration received for use of computer software should be characterized as royalty or as business profit has been a contentious issue in recent times. Recently, the Authority for Advance Rulings (AAR), in the case of Millennium IT Software Ltd.^[4], had deviated from the principles arising from previous rulings of the AAR and also earlier ITAT rulings and had held that the consideration for software payments is in the nature of royalty. However, there have been several rulings of ITAT and the AAR which have appreciated that the distinction needs to be made between a copyright right and a copyrighted article for the purpose of characterization of computer software transactions. This recent HC decision is likely to have a significant impact on cross-border taxation of computer software transactions.

^[4] Kindly refer EY tax alert 'Ruling by Authority for Advance Rulings on characterization of computer software' dated 7 October 2011 for detailed comments.

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