Legal Issues in 'IP Taxation'

Issue: Whether Expenditure incurred for procuring Software from a Non-Resident is Taxable as Royalty?

Relevant Provisions

- **Section 5(2) of the Income Tax, 1961**
  - *"Subject to the provisions of this Act, the total income of any previous year of a person who is a non-resident includes all income from whatever source derived which—*
    a) *is received or is deemed to be received in India in such year by or on behalf of such person ; or*
    b) *accrues or arises or is deemed to accrue or arise to him in India during such year."*

- **Section 195(1) of the Income Tax, 1961**
  - ***"Any person responsible for paying to a non-resident**, not being a company, or to a foreign company, any interest…or any other sum **chargeable under the provisions of this Act** (not being income chargeable under the head "Salaries") **shall, at the time of credit of such income to the account of the payee** or at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier, **deduct income-tax thereon at the rates in force**:…"* [Emphasis supplied]

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Relevant Provisions (Contd.)

- **Section 195(2) of the Income Tax, 1961**
  - *"Where the person responsible for paying any such sum chargeable under this Act (other than salary) to a non-resident considers that the whole of such sum would not be income chargeable in the case of the recipient, he may make an application [in such form and manner to the Assessing Officer, to determine in such manner, as may be prescribed, the appropriate proportion of such sum so chargeable, and upon such determination, tax shall be deducted under sub-section (1) only on that proportion of the sum which is so chargeable…"*

- **Double Tax Avoidance Agreement -**
  - A tax treaty signed between two or more countries to help taxpayers avoid paying double taxes on the same income. A DTAA becomes applicable in cases where an individual is a resident of one nation but earns income in another.

Relevant Provisions (Contd.)

- **Section 9(1)(vi) of the Income Tax, 1961**
  - *"income by way of royalty payable by—*

(a) the Government; or

(b) a person who is a resident, except where the royalty is payable in respect of any right, property or information used or services utilised for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India; or

(c) a person who is a non-resident, where the royalty is payable in respect of any right, property or information used or services utilised for the purposes of a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India:"

Relevant Provisions (Contd.)

❖ **Section 9(1)(vi) of the Income Tax, 1961**

- *"Explanation 2.— For the purposes of this clause, "royalty" means consideration (including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head "Capital gains") for— (i) the transfer of all or any rights (including the granting of a licence) in respect of a* ***patent, invention, model, design, secret formula or process or trade mark or similar property****;"* [Emphasis supplied]

- *"Explanation 4.—For the removal of doubts, it is hereby clarified that the transfer of all or any rights in respect of any right, property or information includes and has always* ***included transfer of all or any right for use or right to use a computer software*** *(including granting of a licence) irrespective of the medium through which such right is transferred."* [Introduced by the amendment in Section 9(1)(vi) vide Finance Act, 2012] [Emphasis supplied]

Relevant Case Laws

- ***CIT v. Samsung Electronics Co. Ltd.*, 345 ITR 494 (Kar.)**
  - The Karnataka High Court held that software payments are taxable as "royalty" if payments are made by end users of the computer program, who are granted a license to make copies of the computer program for back-up or archiving purpose. As per the court, a right to make a copy of the software and use it for internal business by making a copy of the same and storing it on the hard disk amounts to a use of the copyright u/s14 of the Copyright Act, 1957 because in the absence of a license, there would have been an infringement of the copyright.

- A similar view was taken in the Advance Rulings in the case of **Citrix Systems Asia Pacific Pty. Ltd., 343 ITR 1 (AAR)**, wherein the Authority of Advance Ruling was of the opinion that payment towards software in a distribution arrangement is taxable as royalty since it is not possible to separate software from the intellectual property of the creator of the software embedded therein. Any sale or licensing for use of copyrighted software amounts to the grant of a right to use a copyright

Relevant Case Laws (Contd.)

- ***DIT vs. Ericsson A.B.*, 343 ITR 470 (Del.)**
  - The Delhi High Court after pointing out the distinction between acquisition of a "copyright right" and a "copyrighted" article, held that the license granted by the taxpayer was limited to those rights that are necessary to enable the licensee to operate the program. Hence, there is no transfer of copyright or right to use the copyright to characterize the same as royalty under the Act or the Treaty.

- **Section 90 (2) of the Income Tax, 1961**
  - "*Where the Central Government has entered into an agreement with the Government of any country outside India or specified territory outside India, as the case may be, under sub-section (1) for granting relief of tax, or as the case may be, avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to that assessee*."

Relevant Case Laws (Contd.)

- ***Engineering Analysis Centre of Excellence Private Limited v. CIT*, Civil Appeal Nos. 8733-8734 of 2018**

  The Supreme Court categorized the batch of appeals into following four categories of software payments:

  - **Category 1** – Sale of software directly to an end user by a non-resident
  - **Category 2** – Sale of Software by a non-resident to Indian distributors for resale to end customers in India
  - **Category 3** – Sale of software by a non-resident to a foreign distributor for resale to end customers in India
  - **Category 4** – Software bundled with hardware and sold by foreign suppliers to Indian distributors or end users

Relevant Case Laws (Contd.)

- ***Engineering Analysis Centre of Excellence Private Limited v. CIT*, CIVIL APPEAL NOS. 8733-8734 OF 2018**
  - *"...it is clear that there is no obligation on the persons mentioned in section 195 of the Income Tax Act to deduct tax at source, as the distribution agreements/EULAs in the facts of these cases do not create any interest or right in such distributors/end-users, which would amount to the use of or right to use any copyright. The provisions contained in the Income Tax Act (section 9(1)(vi), along with explanations 2 and 4 thereof), which deal with royalty, not being more beneficial to the assessees, have no application in the facts of these cases."*
  - *"...the amounts paid by resident Indian end-users/distributors to non-resident computer software manufacturers/suppliers, as consideration for the resale/use of the computer software through EULAs/distribution agreements, is not the payment of royalty for the use of copyright in the computer software, and that the same does not give rise to any income taxable in India, as a result of which the persons referred to in section 195 of the Income Tax Act were not liable to deduct any TDS under section 195 of the Income Tax Act..."*

THANK YOU!

Questions?

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