Mumbai Tribunal rules that supply of off-the-shelf software not taxable as royalty

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In brief

In a recent ruling, the Mumbai Income Tax Appellate Tribunal (Tribunal) has held the amount received by the Dutch company from supply of 'off-the-shelf' software to an Indian customer to be business income and not 'royalty'.

In detail

The ruling deals with a batch of appeals with similar facts, discharged by a consolidated order.

Facts

- The taxpayer[1], a non-resident company registered in Netherlands, engaged in the business of development and sale of computer software and provision of other services in relation to its software product, supplied 'off-the-shelf' software in CDs along with license keys to Indian customers under a 'Distribution Agreement' with its Indian subsidiary (Indian company).
- Payment for the software was made by customers to Indian company which, after retaining its margin, remitted the balance to the taxpayer. It also received fees for "other general services" (OGS).
- In the absence of a permanent establishment (PE) in India in terms of Indo-Dutch DTAA (the treaty), income from sale of software products was not offered to tax in India, whereas fees for OGS was submitted to tax as 'fees for technical services' (this aspect was not disputed).

Tax Officer's allegations

- The Tax Officer [TO] alleged that the payment for sale of software was in the nature of 'royalty', both under the Act and the Treaty, and hence taxable @ 15%.

First Appellate Authority's decision

- Disposing off the TO's appeal, the Commissioner of Income Tax (Appeals) (CIT(A)) held the impugned payment received by the taxpayer to be from sale of *copyrighted product* and not from any right in the copyright.
- On a careful examination of the facts (not referred to by the TO), the definition of 'copyright' under section 14 of the Copyright Act, and the ratio laid down in various judicial precedents quoted by the taxpayer, the CIT(A) concurred with taxpayer's argument that Indian customers received limited right to access the copyrighted software, without any right to exploit the copyright in the software, and therefore payments under consideration were not in the nature of 'royalty'.

Issues before the Tribunal

- Whether the consideration received on sale of computer software product is to be characterized as 'Business income' or 'Royalty income'.

TO's contentions

- Relying on Karnataka High Court rulings[2] on similar

[1] TS-351-ITAT-2016 (Mum)

[2] CIT *v.* Samsung Electronics Co. Limited [2012] 345 ITR 494

CIT *v.* Synopsis International Old Limited [2013] 212 Taxman 454

facts, the TO alleged the software sale proceeds to be in the nature of royalty both, under the treaty and the Act.

- The TO further opined that Explanation 4 to Section 9(1)(vi) of the Act[3], enlarged the scope of the term, 'royalty' and that also needed to be read into the treaty by virtue of Article 3(2).

Taxpayer's contentions

- The taxpayer, claiming taxability under the treaty, contended that under the present terms of the agreement, it was a mere sale of "off-the-shelf" software and no right to use any copyright/ license was conferred upon the Indian customers/ Indian company.

- The taxpayer supported its contentions with various precedents including those of the Delhi HC, wherein the rulings quoted by the TO were clearly distinguished.

Tribunal's ruling

After extensive discussion of all case law and arguments canvassed by both parties, the Tribunal held as under:

- Sale of off-the-shelf software entailed transfer of a copyrighted article without any transfer of right to use copyright in the software.

- Such sale could not be covered under 'use of process' in the absence of any access to the source code granted to end-user. Even the source code (computer programs written in higher level programming languages and readable by humans), did not entail use of a process, as these were for modifying component systems for own internal computing operations.

- Upholding the CIT(A)'s order and relying on various favourable judgments quoted by the taxpayer, the Tribunal held that a non-exclusive, non-transferable license (without any right to sublease or sublicense), with no covenant granting any copyright or right to use, could not be reckoned as royalty within the scope of Article 12(4) of the Treaty. Further, in the absence of a PE in India, such payment could not be taxed as business income under Article 7 of the treaty.

- Further, the Tribunal emphasised that the retrospective amendment brought into the Act could not be read into the Treaty, unless there was a corresponding amendment in the Treaty. Also, in view of the specific definition of the term, 'royalty' under the treaty, there was no requirement to refer the definition of such term under the Act by virtue of Article 3(2).

The takeaways

- The ruling provides further insight into the view that the judiciary has been adopting on characterisation of income from supply of "off-the-shelf" software as business income. It further clarifies that limited use of 'source code' for internal business operations without any commercial exploitation, falls outside the purview of 'royalty'.

- It reiterates the principle laid down by several judgments, that an amendment to the Act cannot automatically be read into the treaty, and will not alter the specific definition/ scope of the treaty.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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[3] Introduced by Finance Act, 2012, with retrospective effect from 01.06.1976

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