DMD ADVOCATES

Case Highlights

Engineering Analysis Centre of Excellence Private Limited v. CIT & anr., CA Nos. 8733-8734 of 2018

I. Facts/Background in Brief

a. The assessee, an Indian resident company, was the end-user of shrink-wrapped computer software which was imported from the United States of America (**USA**). At the time of remittance, the assessee did not deduct any tax at source under the provisions of the Income Tax Act, 1961 (‘**Act’**) on the premise that the transaction was one of sale of copyrighted article and not transfer of any right to use copyright.

b. However, according to the Revenue, the payment made by the assessee was towards transfer of ‘copyright’ in the software and hence, was covered within the definition of the term ‘Royalty’ as defined under Section 9(1)(vi) of the Act as well as under Article 12 of the Double Taxation Avoidance Agreement (**DTAA**), thereby requiring the assessee to deduct tax at source under Section 195 of the Act. To reinforce its case, the Revenue, at a later stage, also relied upon the retrospective amendment made to Section 9(1)(vi) of the Act vide Finance Act 2012.

II. Issues Before the Court

a. The Hon’ble Supreme Court divided the entire batch of appeals[1] into 4 different categories viz; direct sale from foreign supplier to the end-user; distribution by resident reseller to end-user; distribution by non-resident resellers to end-user; and sale of hardware with embedded software.

b. Broadly, the Court then examined the following common question for all categories of taxpayers:

> *Whether the amounts paid for software constituted “royalty” under the Act/DTAA and consequently, whether the payers were required to withhold tax at source under section 195 of the Act in respect of such payments?*

III. Findings of the Court

a. ***Section 195- Tax withholding only if ‘income’ chargeable to tax in India***

[1]The appeals before the Supreme Court were filed both by the assessee(s) as well as by the Revenue, due to conflicting judgments by the Delhi High Court and the Karnataka High Court and various benches of the Authority for Advance Rulings (**AAR**)

The Hon’ble Supreme Court reiterated the principle[2] that obligation to deduct tax at source under Section 195 of the Act arises only when the subject payment is “chargeable to tax” in India in the hands of the non-resident recipient. While holding so, the Court negated the reliance placed by the Revenue on the earlier ruling of the Supreme Court in the case of PILCOM[3] which dealt with the obligation of deduction of tax at source under Section 194E of the Act – which section is completely different from Section 195.

b. ***The Amounts Paid by the Assessee did not amount to ‘Royalty’***

i. The Court reaffirmed the principle that beyond the rights mentioned in Section 14 of the Copyright Act, 1957, the copyright holder does not enjoy any further rights. Secondly, unless the payer of consideration acquires any of the rights mentioned in Section 14 of the Copyright Act, 1957, the consideration for mere use of computer software does not tantamount to royalty. Use of the term “license” under EULA is not the same as license as understood under Copyright Act, 1957. Further, merely because the purchaser has the right to copy the computer software on his/its hardware, does not mean that the payer has a right to make copies of the software. Consequently, the consideration paid for acquisition of a computer software simplictor is not royalty either under the Act or the applicable DTAA.

ii. Thus, the Court held that the amounts paid by the assessee as consideration for software did not amount to royalty under the provisions of the DTAA.

iii. **Application of the Doctrine of Right of First Sale/Principle of Exhaustion:** The Revenue also argued that the right to distribute software in India amounted to a transfer of copyright, thereby attracting the provisions of tax deduction at source under Section 195 of the Act, in lieu of payment of royalty. The Court rejected the said contention holding that under section 14(b) of the Copyright Act, in order to constitute transfer of copyright, the right to reproduce and sell must be transferred. The mere right to re-sell copies of computer software already sold by the owner of the copyright would not amount to transfer of copyright, as it entails only the distribution of copies of software already in distribution.

iv. **Retrospective Application of Amended Section 9(1)(vi):** The Court also addressed the vexed issue of applicability of retrospective amendment made to Section 9(1)(vi) of the Act vide Finance Act, 2012. In this regard, the Court rejected the reliance of the Revenue on CBDT Circular No.152 of 27.11.1974 on the ground that Section 9(1)(vi) was inserted vide Finance Act 1976, which could not have been explained by a Circular issued in 1974. The Court also rejected the argument of the Revenue that the aforesaid amendment was clarificatory on the ground that *explanation* 3 to Section 9(1)(vi), referred to “computer software” for the first time with effect from 01.04.1991, when it was introduced, which was then amended vide the Finance Act 2000. Quite clearly, *explanation* 4, therefore, could not be applicable to any right for the use of

[2] GE India Technology Centre (P) Ltd. v. CIT: (2010) 327 ITR 456 (SC)
[3] PILCOM v. CIT: (2020) 425 ITR 312 (SC)

or the right to use computer software even before the term “computer software” was inserted in the statute. Likewise, even *qua* Section 2(o) of the Copyright Act, the term “computer software” was introduced for the first time in the definition of a literary work, and defined under Section 2(ffc) only in 1994 (vide Act 38 of 1994).

v. Having held that the amendment is not clarificatory, the Court held that the payer/deductor cannot be expected to do the impossible, namely, to apply the expanded definition of “royalty” inserted by *explanation* 4 to Section 9(1)(vi) of the Income Tax Act, for the assessment years in question, at a time when such *explanation* was not actually and factually in the statute.

c. ***Applicability of the DTAA***

i. The Revenue had also contended that Section 195 of the Act requires any “payer” to deduct tax at source and at the time of deduction, the payer cannot examine the applicability of DTAA in the hands of the recipient/non-resident assessee.

ii. The Court, while rejecting the aforesaid argument of the Revenue, referred to its earlier decision in GE India Technology(supra) wherein it was held that a “payer” under Section 195 is liable to deduct tax only if consideration paid/payable to the non-resident assessee is chargeable to tax in India in the hands of the non-resident assessee. In determining whether the consideration is chargeable to tax in India or not, the payer can look at the appliable DTAA. This position is fortified by CBDT Circular[4] wherein it has been stated that the deductor has to consider the provisions of the DTAA while deducting tax at source.

iii. Notwithstanding the above, the Court also stated that for the contention of the Revenue to succeed, the “payer” would have to pay tax at a higher rate prescribed under the Act, rather than the DTAA, with no procedure for refund which is available only to the assessee, thereby resulting in a grave loss to the “payer”. Therefore, this contention of the Revenue could not succeed.

d. ***Rulings of the Karnataka High Court vis-à-vis Delhi High Court***

i. The Supreme Court overruled the view of the Karnataka High Court as it incorrectly interpreted Section 9(1)(vi) and failed to consider the implications of Section 14 and Section 52 of the Copyright Act, 1957 altogether to essentially state that whenever a copyrighted article is sold, the end-user gets the right to exercise the intellectual property rights, amounting to a transfer of copyright and that “royalty” included consideration apart from that paid for the rights associated with a copyright.

ii. The view of the Delhi High Court was quoted in approval by the Supreme Court. Further, the Supreme Court also stated that the view of of the Delhi High Court was also in consonance with OECD’s interpretation of the DTAA.

[4] No.728 of 30.10.1995

e. ***Application of OECD Commentaries in the Indian Scenario***

i. The Revenue contended that the OECD Commentaries will not apply in the instant case since India has expressed its dissent/reservations. However, the Court rejected this contention, stating that such unilateral dissent/reservation by India does not change the actual provisions of the DTAAs which are based on the OECD Model. The Court held that for this contention of the Revenue to succeed, amendments should have been made to the relevant DTAAs through bilateral negotiations, without which, the interpretation of the OECD will hold good.

IV. CONCLUSION

a. The Supreme Court held that the amounts paid in consideration for software to non-residents, did not amount to payment of royalty under both, the Act as well as the DTAAs, during the relevant period, as the EULAs in question 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. As a corollary, consideration for use of computer software did not constitute royalty chargeable to tax in India on which tax was deductible under Section 195 of the Act.

Our taxation partner, Sachit Jolly, successfully argued on behalf of Engineering Analysis (lead case) and GE India Technology Centre in the above batch of matters, especially on the aspect of impossibility of performance, i.e., obligation to withhold tax cannot be fastened on a payer, when the provision requiring such withholding tax was not on the statute book at the time of remittance.

***