



**COCHIN CHAPTER  
OF  
THE INSTITUTE OF COST AND WORKS ACCOUNTANTS OF INDIA**

# NEWS LETTER

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OCTOBER – DECEMBER 2011

INSIDE

- ❖ **Chairman's Communique**
- ❖ **Professional Development Programme**
  - **XBRL**
  - **Preparation of Business Plans**
  - **Improving Personal Productivity**
- ❖ **Seminar For Plus Two Teachers**
- ❖ **Past Chairmen's Gettogether**
- ❖ **Taxability of Software Payments – A brief note**  
By *Sherry Samuel Oommen and Ajith R,*  
Tax professionals working with the tax practice of KPMG in India
- ❖ **Certificate Course in IFRS**
- ❖ **All India CMA Students' Fest – DRAGATHI '12**

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Dear Professional Colleagues,

***Wish you all a very Happy New Year 2012.***

2011 was an eventful year for our Institute and the Chapter. The new Cost Accounting (Record) Rules and Cost Accounting (Report) Rules published by Ministry of Corporate Affairs has opened up new opportunity for the Cost and Management Accountants in service and also in practice.



Let me note down some of the major highlights of chapter activities during 2011

- Completed renovation activities in chapter and added two more class rooms
- Two new satellite centers added this year. Classes is going on in full swing in SD college, Alappuzha
- No of students admission in chapter has increased
- Past Chairmen's meeting was conducted in Chapter
- An interactive session on "Latest Developments in Cost Audit and Cost Accounting Record Rules" was conducted on 17th July 2011 at IMA hall

The **New Year** ahead of us is full of challenges and very promising too. Your committee will be working more actively towards Professional Development activities of students and members.

Based on the feedback from the members to publish members' directory, the committee has decided to come up with a Members address book with photograph in the month of March 2012. To achieve this target your Chapter is observing February as a **Membership Month**. Our chapter staff will be contacting you in this regard. I request you to kindly extend maximum support to them, so that the mission is accomplished with maximum efficiency. May I also request you to direct them to your friend who has not taken membership/renewed membership so far.

**Students Study Circle forum** in our chapter has been conducting "Study Circle Meeting" every Saturday morning. The practise followed is that, each week two students will be presenting papers on any of the recent topics. This programme is open for members also. Every week we are inviting one of our members as moderator and they are sharing their valuable practical experience with the students.

As in earlier years, we are conducting **Chief Financial Officer (CFO) meet** for the Final students on 5th of Feb 2012 for the benefit of our student fraternity. We look forward to invite successful top CFO's from the industry to interact with the Final students of our Chapter.

**IFRS Certificate course** has been announced in Cochin and the proposed dates will be from 22nd to 27th Feb 2012. Detailed brochure has been already circulated to members. I request all the members to make use of the programme.

Our chapter is conducting **Pragathi 2012 "Cost Arena" on 18th Feb 2012**. Last year Pragathi witnessed around 650 students participation from south India and Goa. This year we are planning to conduct it as a National programme. All the work has been started and we expect around 1200 students to participate in the programme. I request all the members to extend maximum support to our students by way of advertisement and sponsorship for the successful conduct of Pragathi 2012.

Various agencies/companies are contacting our chapter for **placement** of our students. We have a good data base of qualified and semi-qualified students. Members can make use of this database for placement to your prestigious organisation.

During the month of January chapter is arranging two more **Professional Development programme** 1) Joint Programme with ICSI, Kochi chapter on "**Capital market - Myths and realities**" on 19th Jan 2012 and 2) **Financial Modelling using MS Excel** on 28th Jan 2012.

February is the month of **Union Budget** and the Chapter will be conducting Pre-budget and Post-budget meeting for the benefit of our members.

Once again wish you all a great New Year 2012 for you and your family.

## All India CMA Students' Fest – PRAGATHI '12

The members and managing committee of Cochin Chapter is happy to invite you to the All India CMA Students' Fest on 18<sup>th</sup> February 2012 at Gokulam Convention centre, Kaloor, Ernakulam.



We will be grateful if you could spare your valuable time to be present and encourage our students.

We also expect your support in terms of sponsorship/ advertisement to the magazine.



# PROFESSIONAL DEVELOPMENT PROGRAMME

## eXtensible Business Reporting Language (XBRL)

Chapter in association with Kochi Chapter of ICSI & CCGRT, Mumbai conducted a seminar on eXtensible Business Reporting Language (XBRL) on 24<sup>th</sup> October 2011 at Gokulam Convention Centre, Ernakulam.

The function was presided over by Shri. CS Sivakumar P., Chairman, ICSI who welcomed the gathering. Pooja Patel, from IRIS Consultancy, Mumbai was the speaker. Shri. Ramdas S., Chairman, Cochin Chapter felicitated and Shri. K.M. Babu, Chairman PD Committee, Cochin Chapter express vote of thanks.



A large number of professionals from both the profession attended the programme.

## Preparation of Business Plans

Chapter conducted an evening programme jointly with ICSI on “**Preparation of Business Plan**” on 15<sup>th</sup> November 2011 at Silver Jubilee Hall of ICWAI. Shri. Jose Joseph Mekkalth Chartered Accountant was the speaker



## Improving Personal Productivity



Monthly professional development programme conducted at Silver jubilee hall on 22<sup>nd</sup> December 2011. The topic was “**Improving Personal Productivity**” and the speaker was Manoj T.N., Management Trainer.

## SEMINAR FOR PLUS TWO TEACHERS

Chapter conducted a seminar for Plus two teachers in Kerala regarding the Cost and Management policies and teaching skills on 4<sup>th</sup> November 2011 at Hotel Park Central, Kaloor. Under the presidentialship of Shri. K.M. Babu, PD Committee Chairman, Shri. Rajendran Puthiyedath, Chief Editor, Mathrubhumi inaugurated the seminar. Shri. Suresh S., President, Higher Secondary Commerce Teachers Forum welcomed the gathering. Shri. Sivaraman K.M., Principal, Govt. Higher Secondary School, Aluva & District coordinator, commerce forum felicitated and Shri. Varughese Nainan, Director expressed vote of thanks.



After the inauguration Shri. A.S. Durga Prasad, CCM, ICWAI and Smt. Jubilee Navaprabha, Prof. SD College, Alappuzha handled the sessions.

## PAST CHAIRMEN'S GETOGETHER

The Management Committee conducted a getogether of Chapter Chairmen on 6<sup>th</sup> November 2011 at Silver Jubilee Hall of Cochin Chapter.



# ACADEMIC

## MODULAR TRAINING

The modular training for Final students conducted during Oct 31 to Nov 6 at Chapter premises.

## BUSINESS COMMUNICATION SEMINAR

Business Communication Seminar for the Intermediate students are conducted as per the following

Date	Venue
12-11-2011	Kaloor
13-11-2011	Nirmala College
19-11-2011	Kaloor
20-11-2011	Kaloor
22-11-2011	Calicut
23-11-2011	Tirur

## FINAL ASSESSMENT EXAMINATION

Final Assessment examination for Foundation students conducted from 5-12-2011 to 8-12-2011.

## Taxability of Software Payments – A brief note

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### 1. Background

Taxability of software payments is currently one of the most debated topics in the field of international taxation. The controversy basically relates to whether the payment for the use of computer software can be termed as royalty for the provisions of Section 9(1)(vi) of the Income Tax Act 1961 ('the Act') and under the provisions of relevant double tax avoidance agreement ('DTAA'). There have been a series of judgments analyzing this issue and more or less the issue was settled with majority rulings holding that payment for use of computer software would not be covered under the definition of royalty under various DTAA's. However as against series of judgments analyzing taxability of software payments under DTAA's, there are a few judgments analyzing the taxability of software payments under the Act. Further, as the definition of royalty under the Act is wider as compared to royalty provisions under provisions of the DTAA's, judgments analyzing the provisions of DTAA's may not be applicable while determining taxability under the Act. The purpose of this article is to throw light on some of the recent trends with respect to the taxability of payments in respect of off-the-shelf/ shrink wrapped software.

The Chennai Bench of Income-tax Appellate Tribunal in the case of *DCIT v Abaqus Engineering Private Limited [2011-TII-143-ITAT-MAD-INTL]* held that the payment made for supply of software is not „royalty“ since it is a „copyrighted article and not copyright in the software. The said principles were also reiterated by the Mumbai Tribunal in the case of *ADIT v TII Team Telecom International Private Limited [2011] 47 SOT 76 (Mum)*. Thus, in wake of a brewing controversy, we have provided our brief comments on the said issue:

### 2. Analysis

#### 2.1. Types of Software Payments:-

The term “software” has been defined under the Income Tax Act, 1961 (“ITA”) and under the Copyright Act, 1957. Sections 10A, 10B and 80HHE of the ITA, dealing with export of computer software define “computer software” to mean:

- a) any computer programme recorded on any disc, tape, perforated media or other information storage device; or
- b) any customised electronic data or any product or service of similar nature.

Section 2(ffc) of the Indian Copyright Act defines “computer programme” as a set of instructions expressed in words, codes, schemes or any other form, including a machine readable medium, capable of causing computer to perform a particular task or achieve a particular result. Thus software necessarily connotes “programme” in relation to a computer.

Before analyzing the taxability of payment for use of computer software it would be imperative to determine the type of software payments. Generally software payments can be categorized under any of the following categories.

## Use of 'Off-the shelf' software or 'shrink wrapped' software

Computer software which are ready to use and are not customised for any single person are termed as the off-the-shelf software or „shrink wrapped „software. Common examples of this software are Microsoft Office, Microsoft Windows, accounting software like Tally etc. Normally, before using any off-the-shelf software a licence agreement is required to be signed electronically by the user. This licence agreement contains restrictions in terms of its use and grants its user only a non-exclusive right to use the software.

### i. Use of Customised Software

Customised software is software which is developed based on specific requirement of its user. Accordingly they can be used only by the user for which it is produced and not by any other user. An example of customised software would be specific accounting software which is produced and modified based on requirements given by the user. Here, the distinction needs to be drawn between software made for specific industry vis-à-vis software made for a specific user.

### ii. Granting of rights (excluding right to use) pertaining to off-the-shelf or customised software

Sometimes, software companies also grant rights permitting to modify the software or use the software for commercial exploitation to its users. These rights, which are normally proprietary rights of a developer of computer software, are granted to the user for certain additional consideration.

Thus, once we have examined the nature of software payments, we would now determine its taxability under the Act.

## 2.2. Definition of Royalty under the Act

Under the Indian Tax laws, royalty is deemed to accrue or arise in India if payable by a resident. Furthermore, royalty payable by a non-resident is also deemed to accrue or arise in India if it is utilized for the purpose of a business in India or for earning income from a source in India.

The term 'royalty' has been defined in Explanation 2 to section 9 (1) (vi) of the Act as follows:

***"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;
- (ii) The imparting of any information concerning the working of or the use of, a patent, invention, model, design, secret formula or process or trade mark or similar property;
- (iii) The use of any patent, invention, model, design, secret formula or process or trade mark or similar property;
- (iv) The imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill;
- (v) The transfer of **all or any rights** (including the granting of a licence) **in respect of any copyright**, literary, artistic or scientific work including films or video tapes for

use in connection with television or tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films; or

- (vi) The rendering of any services in connection with the activities referred to in sub-clauses(i) to (v);

Under clause (v) of the explanation, for payment to be properly characterized as “royalty” it must be for the transfer of “all or any rights” in respect “any copyright”.

### 2.3. Definition of Copyright under the Copyright Act

As per section 14 of the Copyright Act, 1957 “copyright” means the exclusive right subject to the provisions of the Act, to do or authorize the doing of any of the following acts in respect of any work or ant substantial part thereof, namely:

- a) In case of a literary, dramatic or musical work, not being a computer programme;
  - (i) To reproduce the work in any material from including the storing of it in any medium by electronic means;
  - (ii) To issue copies of the work to the public not being copies already in circulation;
  - (iii) To perform the work in public, or communicate it to the public;
  - (iv) To make any cinematograph film or sound recording in respect of the work;
  - (v) To make any translation of the work;
  - (vi) To make any adaptation of the work;
  - (vii) To do, in relation to a translation or an adaptation of the work, any of the acts specified in relation to the work in sub-class (i) to (vi).
- b) In the case of a computer programme,
  - (i) To do any of the acts specified in the clause (a);
  - (ii) To sell or give on commercial rental or offer for sale or of commercial rental any copy of the computer programme.

### 2.4. Definition of Royalty under the OECD Model Convention

Article 12- Royalties of the OECD MC defines the term “royalties” as follows:

*“The term “royalties” as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.”*

### 2.5. Judicial Precedents

One of the major issues on tax treatment of cross-border software transactions has been whether payments for software, where the seller retains all copyright, trademark and other proprietary rights in the software, should be characterized as ‘royalty’ or ‘business’ income. Section 9 of the Income-tax Act, 1961 defines royalty and fees for technical services as having deemed source in India. Such income is taxed under section 115A of the Act at a flat rate of 10 per cent on gross amount of receipt subject to reduced (prescribed) rate under appropriate DTAA. In case of business income, the same is subject to tax in India only if there is sufficient business connection in India. If there happens to be in existence a comprehensive DTAA and there is a PE, the business income would be subject to tax.

The following favorable judicial precedents substantiate the above view:

- The Special Bench of the Delhi Tribunal in the case of **Motorola Inc. v. DCIT (2005) 95 ITD 269 (SB)** wherein it has been held that the software supplied was a copy

righted article and not a copyright right, and the payment received by the assessee in respect of the software cannot be considered as royalty either under the Act or under the Indo-US DTAA. Further, the Tribunal also stipulated the four rights which if acquired by the transferee would constitute him the owner of the copyright, viz:

- (i) The right to make copies of the computer programme for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease, or lending.
- (ii) The right to prepare derivative computer programmes based upon the copyrighted computer programme
- (iii) The right to make a public performance of the computer programme.
- (iv) The right to publicly display the computer programme.

Only if ALL of the above rights have been transferred could the license fees paid be considered as royalty.

- The Mumbai Tribunal in the case of **ADIT v. Solid Works Corporation [2010-TII-130- ITAT-MUM-INTL]** made the following observations:
  - The distributor is not authorised to enter into any contract directly or indirectly on behalf of the taxpayer. Also, the distributor cannot tamper with or remove from the original packaging and all the product shall be distributed by the distributor as it is.
  - The end user license agreement (EULA) provides facility to ultimate consumer to install software on his computer and use it personally without allowing any right to the consumer of disassemble, reverse engineer, decompile the software.
  - Customer was also not entitled to sell, license, sub-license, transfer, assign, lease or rent the software. Therefore it is clear that end user and distributor did not have any right over the copyright of the software.
  - The definition of royalty as per the tax treaty requires that there should be a transfer of copyright. Sale of software by the taxpayer to the distributor or end user does not involve any transfer of copyright either in part or in whole. Accordingly, consideration paid by the distributor cannot be said to be a payment for right to use copyright or transfer of use of copyright.
- The Delhi Tribunal in the case of **Lucent Technologies Hindustan Ltd v. ITO [2009] 28 SOT 98 (Del)** held the following:
  - ✚ The agreement provided for the turnkey functioning of the project of GSM Network for which the Lucent Technologies International Inc and Lucent Technologies India Limited (LTIL) were responsible.
  - ✚ The installation, commissioning, testing and bringing up to operational status of the hardware and the software supplied by the assessee was undertaken by the Indian subsidiary, LTIL. For this purpose, the assessee had made available personnel in the form of employees of the affiliates of the assessee to LTIL for remuneration.
  - ✚ LTIL had also assumed the responsibilities of the warrantee in regard to the hardware supplied by the assessee, as also the responsibility to replace the same within the period specified in the support contract between Escotel Mobile

Communications Limited (EMCL) and LTIL. This clearly showed that the subsidiary LTIL was also acting on behalf of the assessee.

- ✚ In the present case, undisputedly the employees of the affiliates of the Assessee had been employed through LTIL for the services of installation, commissioning, testing and bringing up to operation of the hardware and the software sold by the assessee to EMCL through its contract in regard to the GSM project to be completed on a turnkey basis.
- ✚ The material clauses of the license agreement entered into by the assessee with the Indian operators were similar to that of the agreement analyzed and relied upon by the Special Bench in the case of Motorola Inc. (supra)

## 2.6. International perspective – A few aspects

- The US IRS regulations also seek to draw a distinction between transfer of copyright rights and transfer of copyrighted articles based on the type of rights transferred to the transferee. Briefly stated, if the transferee acquires a copy of a computer programme but does not acquire any of the rights identified in certain sections (of the U.S. Regulations), the regulation classified the transaction as the Transfer of a copyrighted article. Paragraph 3 of the Explanatory Note says that if a transfer of a computer programme results in the transferee acquiring any one or more of the listed rights, it is a transfer of a copyright right. The actual regulations bring out the distinction very clearly between the copyright right and a copyrighted article. They also specify the four rights which, if acquired by the transferee, constitute him the owner of a copyright right. They are as follows:
  - ⊃ The right to make copies of the computer programme for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease, or lending;
  - ⊃ The right to prepare derivative computer programmes based upon the copyrighted computer programme;
  - ⊃ The right to make a public performance of the computer programme;
  - ⊃ The right to publicly display the computer programme
- The OECD in its model commentaries also lend support to the argument that payments for a copyrighted article would fall outside the realm of “royalties”. The Technical Advisory Group set up by the OECD to examine the characterization of various types of electronic commerce payments have also held the view that transactions where the essential consideration is the granting of the right to use a copyright in a software, the payments will give rise to royalty.
- The views of the Australian Tax Office (“ATO”) are not much different from that of the OECD. In Taxation Ruling 93/12 the ATO states that payments for the transfer of rights in computer software are royalties. These rights include the right to do any of the acts comprised in the copyright, such as modification, adaptation or reproduction. On the other hand, payments for rights in the tangible article (or program copy), or for rights to use the program, are not royalties. The ruling recognizes that amounts attributable to the right to load a program onto the user’s computer would strictly be a royalty, but accepts that the amount, if quantifiable, is likely to be minimal.
- Recently, the **Federal Court of Australia** in the case of **International Business Machines Corp** held that software license income is assessable as “royalty” inter-alia on

the factual position that the payments were effected for acquisition of stated IP rights rather than mere distributorship rights. Thus, there can be no doubt that the nature of rights acquired would define the related tax treatment.

- Revenue Canada's Advisory Committee does not make any specific recommendations on the characterization of digital transactions. In general, though, the Advisory Committee is sympathetic to the prevailing view that goods that were previously sold in physical form should be treated in the same manner for income tax purposes independent of the form of delivery. Hence, electronic delivery of software or services should not make any difference in characterizing the transaction
- "Charl P. du TOIT" in the Commentary titled "Beneficial ownership of royalties in Bilateral Tax Treaties" has opined that articles such as Books and Records are copyrighted articles and if they are sold, the user does not obtain the right to use any significant rights in the underlying copyright itself, which is what should determine the characterization of the revenue as sale proceeds rather than royalties. He has further opined that consideration relating to sale of software can amount to royalty only in limited circumstances.

## 2.7. Adverse Judicial Precedents

While arguments in favour of non-taxability under the Act, it needs to be appreciated that the judicial precedence on taxability under the Act is limited as majority of favorable rulings dealt with the interpretation of tax treaties.

- Delhi Tribunal in the controversial case of **Microsoft Corporation v ADIT [010-TII-141- ITAT-DEL-INTL]** wherein it was held that income from supply of copyrighted software is taxable as royalty under the domestic tax law of India as well as under the India-US Tax Treaty. It would be pertinent to note that issue in the said case pertained to whether income from licensing of software to original equipment manufacturers (OEMs) would partake the nature of "royalty".
- This view has also been recently upheld by the Bangalore Tribunal in the recent case of **ING Vysya Bank Ltd v DDIT I.T.A. No.160 (Bang.)/2010**. However, it would be pertinent to note that the said decisions are against the favorable decisions pronounced by the same Tribunals on similar facts, particularly the decision of the Special Bench of the Bangalore Tribunal in the case of Motorola (supra). In our view, the co-ordinate bench of the Bangalore Tribunal ought to have considered the said special bench ruling and was bound to follow the same while delivering the Microsoft ruling (supra).
- A similar view was recently adopted by the Authority of Advance Ruling ("AAR") in the case of **Millennium IT Software Limited (AAR No 835 of 2009 dated 28 September 2011)**. In the said ruling, the AAR held that payment received under the Software License and Maintenance Agreement was the right to use copyright in the software and would be taxable as "royalty" under the Act and the India-Sri Lanka DTAA.

It would be pertinent to note that the Mumbai Tribunal in the recent case of **ADIT v TII Team Telecom International Pvt. Ltd. (ITA No. 3939/Mum/2010)** has specifically disapproved the logic followed by the Delhi Tribunal in the case of Microsoft (supra) and has upheld the distinction between a copyright and a copyrighted article. The Mumbai ITAT inter-alia distinguished the ruling in the case of Microsoft taking cognizance of the word "of" between the phrases "copyright" and "literary" under the India-Israel DTAA. After analyzing the provisions of the Copyright Act it was held that although software

contains written instructions or codes, payment for computer software cannot be construed as payment for using the process encoded in the software. Typically in case of an off-the-shelf purchase the payment would be for the article, and not for the exploitation of the copyright as such.

## 2.8. Recent Case law (favourable)

Recently, the Chennai Bench of Income-tax Appellate Tribunal in the case of **DCIT v ABAQUS Engineering Private Limited [2011-TII-143-ITAT-MAD-INTL]** held that the payment made for supply of software is not 'royalty' since it is a 'copyrighted article and not copyright in the software.

### Facts of the case

- The taxpayer is a distributor of software developed by its parent company i.e. ABAQUS Inc. It entered into a Regional Support Agreement (RSA) with ABAQUS Inc for distribution of software products in India.
- The Assessing officer (AO) examined the RSA and observed that:
  - The taxpayer was appointed as a distributor by the ABAQUS Inc for the sale of software products in India.
  - The software products were general products developed by ABAQUS Inc, a licensed copy of which could be sold to the end-users.
  - The end user got only a license to use the software product for a particular period.
- The AO there after sought directions from the Additional commissioner of Income-tax (ACIT) about the applicability of the definition of royalty under section 9 (1) (vi) of the Act.
- The ACIT has referred to the RSA and concluded that:
  - ❖ The taxpayer was given the right to use ABAQUS trademarks in its business for marketing.
  - ❖ The taxpayer was given the right to reproduce affix or have affixed copyright.
  - ❖ ABAQUS Inc had also allowed the taxpayer to generate license keys for delivery to customers.
  - ❖ The taxpayer was allowed to customise and modify the programs for its business.

### Tribunals ruling

- The Tribunal concurred the view of the CIT (A), since the CIT (A) has followed the Delhi Tribunal Special Bench decision in the case of Motorola Inc. Further, following the TII Telecom International, the Mumbai Tribunal held that the payment received for supply of software was not treated as 'royalty'.
- The expression patent, trademark, design or model, plan secret formula or process, etc are used together in the treaty. However, when two or more words which are inclined to equivalent meaning they are deemed to be used in their similar sense. Accordingly, payment made for the software cannot be regarded as „royalty“ since it was not made for a process.
- Under standard terms and conditions for the sale of software, the buyer of software is not even allowed to tinker with the process on the basis of which such software runs or even work around the technical limitations of the software.

- Accordingly, the tribunal held that the taxpayer had sold „copyrighted software“ and not copyright in the software. Therefore the payment of supply of software could not be treated as royalty.

On a related subject, it is quite interesting to note that the **Mumbai ITAT** in the case of **M/s Novell Inc (ITA No 4368/Mum/2010)** also held upheld the distinction between transfer of a copyright and the transfer of copyrighted product. It held that **“where the creator of an intellectual property allows another to exploit it commercially by taking copies and selling it, but retaining the dominion over such property with him, the same is a case of transfer of copyright. If however, the creator himself exploits his work by converting it into end products ready for use and transfers the right to use such end products to another but not the further right to copy the same, it would be a case of transfer of a copyrighted product. The consideration in the former case would be royalty, but that in the latter would be business profit.”**

## 2.9. Recent Case law (adverse)

Recently the Karnataka High Court in the case of **CIT v Samsung Electronics Co Ltd and others [ITA No 2808/2500 and others]** had held the payment for off-the-shelf/ shrink wrapped software amounts to royalty within the meaning of Article 12 of the India US tax-treaty and relevant Article of the tax treaty with other countries in which the relevant non resident tax payer is located (the tax treaty) and section 9(1) (vi) of the Income tax Act, 1961.

### Facts of the case

- A batch of appeals (Supra) was taken up by the high court; however for the purpose of clarity, the facts of the Samsung Electronics Co Ltd (taxpayer) were adopted in order to appreciate the question of the law raised.
- The taxpayer, a domestic Company, imported software products from USA, France and Sweden during the financial years 1998-1999, 1999-2000 and 2000-2001.
- The assessing officer (AO) issued a show cause notice requiring the taxpayer to explain as to why tax was not deducted at source on such payments. The taxpayer contented that the software imported was shrink wrap product and the same was not customized. Hence, the payment did not constitute royalty under section 9(1) (vi) of the Act and also under the tax treaty and hence the payer did not have a liability to withhold taxes at source.
- The AO passed a detailed order and held that there was an obligation to deduct tax under the section 195(1) of the Act since the payments for the purchase of software amounted to ‘royalty’ taxable in the hands of the non-resident recipient. The taxpayer, aggrieved by the order, preferred an appeal before the commissioner of income-tax Appeal CIT (A) who confirmed the order of AO.
- Being aggrieved by the CIT (A)’s order, the taxpayer preferred an appeal before the Income tax Appellate Tribunal (the Tribunal). The tribunal ruled in favor of the taxpayer by holding that the payment for purchase of shrink wrap software did not amount to ‘royalty’.
- The tax department, aggrieved by the Tribunals order, preferred an appeal before the High Court. The High Court set aside the order of the Tribunal holding that any payment made to the non-resident company would be liable to tax deduction unless certificate is obtained by making an application under the section 195(2) of the Act.

- The taxpayer, aggrieved by the High Court, preferred an appeal to the Supreme Court. The Supreme Court set aside the order of the high court and remanded the matter back to the high court deciding the case on merits. The Supreme Court also framed the substantial question of law to be answered by the High Court.

### High Court's ruling

- The definition of „royalty“ is restrictive in the tax treaties whereas, the definition of ‘royalty’ under the Act is broader in its content. Therefore, the definition of the definition in the „royalty“ in the tax treaties is more beneficial to the tax payer and hence we have to find out as to whether the payment made by the taxpayer would amount to royalty under the tax treaties.
- As per the agreement, what is transferred is only a licence to use the copyright belonging to the non-resident subjected to the terms and conditions of the agreement laid down as under:
  - ❖ The taxpayer shall protect confidential information and shall not remove any copyright, confidentiality or other proprietary rights provided by the non-resident;
  - ❖ The taxpayer shall not reverse engineer, decompile, or otherwise attempt to derive or modify the source code of the software;
  - ❖ The taxpayer shall not modify or copy any part of the Software or Documentation.
  - ❖ Further, it may not use sub distributors for further distribution of software documentation without the prior consent of the non-resident suppliers;
  - ❖ The taxpayer shall not be an owner of any copies of, or any interest in, the software but rather, is licensed pursuant to the agreement to use and distribute such copies

The non-resident suppliers continued to be the owner of the copy right and all other intellectual property rights.

- Copyright is a negative right. It is an umbrella of many rights and license is granted for making use of the copyright in respect of the shrink wrapped software/ off-the-shelf software under the respective agreement, which authorizes the end user. Hence the same would amount to transfer of part of the copyright and the transfer of right to use the copyright for internal business as per the terms and conditions of the agreement. Hence, it cannot be accepted the transfer of off-the-shelf software/ shrink wrapped software does not amount to transfer of copyright or any part thereof.
- The right to make a copy of the software and to use it for internal business by making copy of the same and storing the same in the hard disk of the designated computer and taking back up copy itself amount to copy right work under Section 14(1) of the Copyright Act. The said activity should have constituted infringement, but for the license granted;
- It is clear from provisions of the Copyright act the right of the copyright work would also constitute the exclusive right of the copyright holder and any violation of the said right would amount to infringement under the section 51 of the Act. Therefore, the contention of the taxpayer that there is no transfer of any part of copyright or copyright under the impugned agreements or licenses cannot be accepted.
- From the above, it can be concluded that the payment would constitute royalty within the meaning of tax treaty. Once it is established the payment would constitute

payments towards royalty, there is obligation to deduct tax at source under section 195 of the Act.

Interestingly, post the ruling of the Karnataka High Court in the case of Samsung Electronics (supra), the **Delhi High Court** in the case of **Ericsson AB (ITA 504, 507, 508, 511, 397 of 2007)**, held a contrary view. The High Court was required to examine the tax implications emanating from offshore supply of equipment comprising of hardware and software. In this connection, the High Court held the following key principles, which in our view, is in line with the OECD principles on characterization of software supply:

- Profits from offshore supply of equipment comprising of hardware and software are not taxable in India;
- Revenues from software license are not taxable as royalty income as there is no transfer of any rights in respect of copyright of the software. The High Court upheld the distinction between the acquisition of a “copyright right” and a “copyrighted article”.
- Software supply is an integral part of the equipment. Accordingly, it is not permissible for the Revenue to assess sale of hardware and the sale of software under different Articles, and the payments made by Indian customers for acquiring such equipment cannot be taxed as royalty.

### 3. Conclusion

The ruling of the Delhi High Court in the case of Ericsson (supra) is indeed a welcome decision. However, considering the contrary rulings of the Karnataka High Court in the case of Samsung Electronics and Lucent Technologies, it is quite likely that the Revenue authorities may file an appeal against this decision before the Supreme Court and the focus would now shift to the Supreme Court.

Needless to state, considering the current trend of negative rulings, it could be highly litigative to contend that the payment for use of computer software is not taxable as royalty under the Act or the related DTAA. Thus, it becomes imperative to review the actual factual matrix and the related tax implications.



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