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Delhi Tax Appellate Tribunal Rules on the Mircosoft Software Saga:

Computer Licensing Payments Taxed as Royalty Income

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A recent ruling of the Delhi Income Tax Appellate Tribunal (ITAT) in the case of Microsoft Corporation and its affiliates (taxpayers) addressed the issue of whether the consideration received from licensing of computer software was taxable as a royalty under the provisions of the Indian Income tax Act, 1961 (the Act) and the India-US tax treaty (the tax treaty). The ITAT held that the consideration was royalty arising in India and therefore, the taxpayers were liable to tax in India.

Background

Microsoft Corporation, USA ("MS Corp") granted Gracemac Corporation, USA ("Gracemac"), it's wholly owned subsidiary, an exclusive right to manufacture and distribute Microsoft products ("MS products"). Gracemac further granted a non-exclusive license to Microsoft Operations Pte Ltd Singapore ("MO") to manufacture and distribute MS products. MO paid Gracemac royalty on each MS product sold.

MO entered into a distribution agreement with Microsoft Regional Service Corporation, Singapore ("MRSC") for distribution of MS products in Asia, including India. The MS products were sold to the end-users through resellers in India. The intellectual property rights in MS products vested with MS Corp and the end-users signed an End-User License Agreement ("EULA") with MS Corp, which laid down the terms of use of the MS product.

The Indian tax authorities, disregarded the Singapore entities, and considered that the transactions involved in the distribution channel had been planned to bring down the amount of taxable royalty. Therefore, the tax authorities held that G Corp was taxable on the entire payments made by end user in respect of grant of license to copy the software program.

The Indian tax authorities, disregarded the Singapore entities, and considered that the transactions involved in the distribution channel had been planned to bring down the amount of taxable royalty.

Statutory Provisions

Under the Income tax Act, 1961 ("the Act"),

1. royalty is deemed to accrue or arise in India if it is payable by a resident; and

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2. any 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.
3. The term "royalty" under the Act is defned, to mean consideration for the transfer of all or any rights (including the granting of a licence) or use of any copyright, literary, artistic or scientifc work, patent, invention, model, design, secret formula or process or trade mark or similar property.
4. Tax treaties also defne the term "royalty" and are taxed based on source rules. Royalty would generally arise in the state where the payer is a resident. However, if the royalty does not arise in either of the contracting States, it would be deemed to arise where the intangible property is utilized.

Taxation of software in India is a controversial issue and very uncertain. This ruling deviates from the principles emerging from past rulings.

Issue Before the ITAT

The issue before the ITAT was:

1. whether the right to use (including the granting of licence), in respect of computer programs pertains to royalty; and
2. whether the payments made to G Corp arises in India.

The taxpayers had relied on the US Regulations and the OECD commentaries to challenge that there is dissimilarity between 'copyright' and 'copyrighted article' and that the consideration received by MS Corp/Gracemac from Indian distributors was towards sale of a product, i.e. a 'copyrighted article', and not grant of any copyright in the software.

ITAT Findings

The ITAT held as follows:

Copyrighted article is neither defned in the Act nor in the tax treaty. Copyrighted article is one in which copyright subsists. The expression 'copyrighted article' fnds its origin in the US regulations and then found its way into the OECD commentary. The OECD commentary can, at best, be considered as the views of its authors. Also, India has expressed reservation on this aspect. Therefore, the OECD commentary or the US regulations would not be a safe or acceptable guide or aid for interpretation of the Act or the tax treaty provisions. Copies made from master copies of MS software cannot be used by end users without obtaining an activation code, which is given on signing of the agreement known as EULA with MS Corp. Therefore, it cannot be said that the consideration received was in respect of MS software recorded on CD.

A licence is an authorization of an act which, without such authorization, would be an infringement. The various terms and conditions in the EULA provide that the software is licensed and not sold. The end user is not simply using the CD but the program contained in the CD, which is protected by copyright and the right to copy the program has to be exercised before it can be put to use. Therefore, the payments made by the end users are for the license granted in the copyright in the product and will amount to royalty under the Act and the tax treaty.

Even if one were to consider that there is a difference between the defnition of royalty in the Act and the tax treaties and that the defnition in the latter is narrower, the binding nature of a tax treaty is not without exceptions. The later domestic tax legislation may override tax treaty provisions whenever there is an irreconcilable confict.

Sovereign power of the Parliament extends not only to the making but also the breaking of a treaty. Unilateral cancellation of a tax treaty through an amendment to the internal law, subsequent to conclusion of the tax treaty, is a recognized sovereign power. If, after the treaty has come into force, an Act of Parliament is passed which contains a contrary provision, the scope and effect of the legislation cannot be curtailed by the reference to the treaty.

The Act was amended retrospectively to provide that royalty will be deemed to accrue or arise in India irrespective of the fact whether the nonresident has a residence or a place of business or business connection in India or the nonresident has rendered services in India. Therefore, by way of this amendment in the Act, income by way of royalty will be deemed

to accrue or arise irrespective of the contrary provision in the Tax Treaty.

The contention of Tax Authority that the Singapore entities are legal façade cannot be accepted as they were incorporated under the respective jurisdictions and have been issued residency certificates from the respective jurisdictions. Payments received by MS Corp from end users through distributors, in respect of sale of MS software, are taxable as royalty. The agreements entered into between the group companies have been drafted in such a way so as to give an impression that G Corp has no connection with the granting of licence. But, when the real intention is gathered from the in depth reading of the agreements, payments made in respect of copyright in MS software are taxable as royalty in the hands of G Corp. The payments received by G Corp are for use of right in India and, therefore, arise in India. Accordingly, G Corp is taxable in India on the payments received from MO. However, MRSC cannot be taxed again on the same income, by way of royalty, for exploitation of the same rights which had been taxed in the hands of G Corp, as it would result in double taxation. Therefore, the addition in the hands of MRSC is deleted.

This ruling disagrees with other judicial precedents by affirming that the OECD commentary is not an aid to interpret provisions relating to tax treaties or the Act, and that a later provision in domestic tax law would override the tax treaty provisions.

Majmudar & Co.'s Views

Subsequent to this decision we have the following views:

Taxation of software in India is a controversial issue and very uncertain. This ruling deviates from the principles emerging from past rulings.

The Mumbai ITAT stated that the definition of 'royalty' under the tax treaties is more restrictive than what is provided in the Act and that it is incorrect to hold that computer software on a media continues to be an intellectual property right.

This ruling disagrees with other judicial precedents by affirming that the OECD commentary is not an aid to interpret provisions relating to tax treaties or the Act, and that a later provision in domestic tax law would override the tax treaty provisions.

Separately, the Mumbai ITAT in a recent ruling adjudicated on a similar issue and after considering the various clauses of the license agreement, the IC Act, and other decisions, including that of the Special Bench of the Delhi ITAT in the case of Motorola Inc. held that the payment was for the purchase of a copyrighted article and not the copyright itself. Further, the Mumbai ITAT stated that the definition of 'royalty' under the tax treaties is more restrictive than what is provided in the Act and that it is incorrect to hold that computer software on a media continues to be an intellectual property right. Therefore, the payment made for the purchase of software cannot be termed as 'royalty'. ❑

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