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Software Taxation Case - The Rule of Law Prevails

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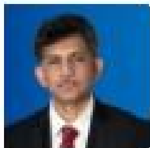
The Hon'ble Supreme Court has put the controversial issue of tax on payments made for buying software to rest by deciding it in favour of the assessees. It is important to note that the Supreme Court has jettisoned the argument that treaty benefits do not entail at the time of discharging the withholding obligation and reaffirmed the law laid down in *Azadi Bachao Andolan* and *GE Technology*. The Supreme Court followed the Constitution Bench's judgment in *Tata Consultancy Services* to categorically hold that the transaction between non-resident seller and Indian distributor is that of sale of goods.

The incisive judgment authored by Justice R. F. Nariman underscores the significance of OECD Commentary on Model Tax Convention and respects its persuasive value for the interpretation of the expressions used in the DTAA. The judgment affirms the law laid down by the High Court of Delhi in several judgments and upholds the rationale of AAR ruling in *Dassault Systems* which was diametrically opposite to what was held by the High Court of Karnataka in *Samsung*.

To make this moment more thought provoking, we bring to you the first reactions of major tax experts to understand what the judgment envisages and how it impacts the taxability of transactions in today's world.



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The Hon'ble Supreme Court, in a landmark ruling delivered on 2nd March, 2021, put an end to all controversies in the matter relating to taxability of cross-border payments to non-resident enterprises for license to use computer software simpliciter, namely in absence of granting any rights with respect to the copyright associated with such software, by holding that such payments do not constitute "royalty" under international tax treaties signed by India with various countries; and that they are in the nature of normal business profits, which absent attributable to permanent establishments of such non-resident enterprises in India, are not taxable in India.

While deciding the case, the Hon'ble Supreme Court negated all attempts of the Indian Revenue made particularly over the last decade, to impose income tax on such payments with a soft rap on the knuckles of the Indian Revenue; or to put in differently, through a strong chastise directed towards the Indian Revenue. A brief reflection is made on some of the observations of the Hon'ble Supreme Court, as follows :

The Hon'ble Supreme Court analysed the relevant provisions of the international tax treaties signed by India, which came up for consideration in the batch of appeals before the Hon'ble Apex Court, to hold that the definition of "royalty", interalia in the context of dealing with payments relating to computer software, was similar to that contained in the OECD Model Convention (MC), which had to be understood and interpreted according to the commentary of the OECD MC.

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The Hon'ble Supreme Court accepted the commentary to the OECD MC in this regard to hold that in order to constitute "royalty" under international tax treaties, there needs to be licensing of rights to use the copyright associated with computer software; and that per se grant of license to use a computer software, namely without granting any rights to exploit the copyright relating to the software, merely constitute sale or license of a copyrighted product, which is significantly different from granting rights to exploit the software; and such license to per se use the software simpliciter could not be held to constitute "royalty" under international tax treaties.

The Hon'ble Supreme Court went on to apply the above principles both in the context of an end-user of computer software and a distributor of computer software, who has been granted license by the licensor to merely distribute the computer software, being a copyrighted product; and not any rights to exploit the copyright associated with the software.

While the Indian Revenue had been making attempts to bring such payments under the taxation net since several years, the intensity or ferocity of such attempts had gained monstrous proportions in the last decade, through the following actions on its part :

1. As an observer nation to the OECD, the Indian Revenue had expressed its reservations with respect to the commentary to the OECD MC interalia on royalty relating to computer software, as discussed above; and

2. The Indian Revenue had made certain amendments to the definition of "royalty" under the domestic tax laws of India vide the Finance Act, 2012 with retrospective effect from 1st April, 1976, so as to bring cross border payments made to non-resident enterprises for use of computer software simpliciter, namely even without granting of exploitation rights with respect to copyright associated with the same, within the definition of "royalty"; and had extended a chivalrous arguement to the effect that such retrospective clarification in the matter of royalty albeit under the domestic tax laws of India, would aid in explaining the connotation of "royalty" even under international tax treaties signed by India, obviously in a manner favourable to the Indian Revenue.

As discussed above, the Hon'ble Supreme Court nullified and thwarted both the arguements of the Indian Revenue, by holding that expression of reservations by the Indian Revenue with respect to commentaries to the OECD MC has no relevance whatsoever, where the relevant provisions of the international tax treaties signed by India are similar to those of the OECD MC, unless the Indian Revenue is able to bilaterally renegotiate and amend its international tax treaty signed with any particular country, on the lines of such reservations. The Hon'ble Supreme Court further held that the Indian Revenue could not unilaterally modify its bilateral tax treaties entered into with various sovereign nations through amendments made in its domestic tax laws.

The aforesaid ruling of the Hon'ble Supreme Court would go a long way in restoring the confidence of foreign investors in the taxation system and judiciary of the country. Further, the dictum of the Hon'ble Supreme Court in the above case is also likely to favourably impact the other line of cases on "royalty" pending before the Hon'ble Supreme Court, namely in the matter of cross-border payments for connectivity charges for the use of cable lines, satellites, transponders, etc., which though as per the commentary to the OECD MC, do not constitute "royalty" under the OECD MC, the relevant provisions thereof being similar to the international tax treaties signed by India with various countries, however, the Indian Revenue has been trying to tax the same on similar action points, as referred to in paragraphs (1) and (2) above, namely by expressing reservations to the relevant provisions of the commentary to the OECD MC; and introducing retrospective amendments to the definition of "royalty" under the domestic tax laws of India, with the extended arguement that such unilateral amendment made under the domestic tax laws of India needs to be applied as an aid to interpret international tax treaties in its favour.