taxnotes® international

Volume 101, Number 13 ■ March 29, 2021

India's Ruling on Software Sales And Its Implications for the Equalization Levy

by Anshu Khanna

Reprinted from *Tax Notes International*, March 29, 2021, p. 1669

India's Ruling on Software Sales and Its Implications For the Equalization Levy

by Anshu Khanna

Anshu Khanna

Anshu Khanna is a partner with Nangia Andersen LLP in San Francisco.

In this article, the author dissects the Indian Supreme Court's recent decision in *Engineering Analysis Center of Excellence*, which held that payments for off-the-shelf software are not royalties and thus are not subject to withholding. She then considers the implications of the ruling for India's equalization levy.

On March 2 the Indian Supreme Court issued a decision in a 20-year-old software royalty dispute that brought cheer to the global tech community.[1] The taxation of software-related payments to nonresidents has been the subject of extensive debate and litigation in India for over two decades. The underlying question in this debate was whether payments made to acquire off-the-shelf software qualified as payments for copyright or copyrighted articles and, accordingly, whether the income is a royalty, which would trigger withholding in India, or business income, which triggers no Indian tax in the absence of a permanent establishment. In *Engineering Analysis Center of Excellence*, the Supreme Court, addressing a batch of more than 100 appeals, finally gave its answer: Software sales should not be characterized as royalties under applicable tax treaties. Therefore, subject to the entity's tax treaty eligibility, the sales are not taxable and not subject to withholding in India.

Undoubtedly, the ruling is cause for celebration in the United States, home to the biggest tech giants. The U.S. tech community is also debating and protesting another levy, the digital services tax (also known as the equalization levy), which India introduced in April 2020. It is important to know what this Supreme Court decision means for multinational companies and to consider whether it has any connection to or repercussions for the equalization levy. After all, in the world of taxation, any joy comes with caveats.

The Background to the Case

Facts

The characterization of cross-border software payments or payments related to imported technical services as royalties, fees for technical services (or included services), business profits, or something else has always been a contentious issue in India. Differing stances advanced by taxpayers and Indian revenue authorities led to litigation at various levels and eventually appeals to the Supreme Court.

In its ruling, the Supreme Court considered a sampling of facts from the various appeals that led to its conclusions of law. The Court grouped the appeals into four categories:

- sales of software directly to an Indian end-user from a nonresident supplier or manufacturer;

[1] *Engineering Analysis Centre of Excellence Pvt. Ltd. v. CIT*, Civil Appeal No. 8733 and 8734 of 2018.

- sales of software by nonresident suppliers or manufacturers that are intended for resale to Indian end-users;
- sales of software by nonresidents to a foreign nonresident seller or distributor for resale to Indian end-users; and
- sales of integrated equipment — that is, software that is attached to hardware and sold as a unit — by foreign suppliers to Indian distributors or end-users.

Taxpayers' Arguments

Taxpayers have persistently contended that these transactions constitute the sale of software products and do not include the licensing of any copyright interests. The nonresident owner retains proprietary rights to the software, and the Indian company's use of the software is limited to making backup copies and redistributing it.

Accordingly, the taxpayers argued that payment received for the sale of computer software is business income and would not be subject to tax in India based on article 7 of the double tax agreements entered into between India and several foreign countries. Hence, the income is outside the ambit of Indian taxation.

Indian Tax Authorities' Position

Indian tax authorities have generally taken the position that income arising from transactions involving the sale of software programs or licenses should be characterized as royalties regardless of the nature of rights acquired by the end-user or the reseller.

Lower Court Rulings

Indian high courts were divided on this issue.

The Delhi High Court took the view that funds received under the license agreements that allowed the use of the software did not constitute royalties.[2] It contended that the transaction did not involve the transfer of the copyright nor the right to use the copyright in the software, but instead involved the right to use the copyrighted article itself, which is distinct from the rights included in copyright. The Madras High Court followed the Delhi High Court, but the Karnataka High Court adopted a contrary view.[3]

These divergent views from the various high courts led the issue to progress to the Supreme Court. The Supreme Court set aside the Karnataka High Court's decision and the ruling of the Authority of Advance Rulings in *Citrix Systems*,[4] which favored the Indian tax authorities, and it dismissed the Indian tax authorities' appeals against decisions of the Delhi High Court favoring taxpayers.

The Supreme Court's Ruling

The recent judgment from the apex court brings a long battle to an end. It also cements some key messages — namely, that the proper tax treatment of a sale of a software program is as a sale of goods, and hence does not involve a royalty; and the supremacy of tax treaties, including the OECD's commentaries.

The Nature of the Transactions

The Supreme Court ruled that the amounts that Indian resident distributors and end-users pay to nonresident computer software manufacturers and suppliers for the right to resell or use computer software through distribution agreements and end-user license agreements cannot be classified as royalty payments for the use of copyright in the computer software. Hence, the income is not taxable in India and no tax is required to be withheld at source at the time the payments are made.

Importance of Characterization

Properly characterizing revenue in a cross-border software transaction and determining its appropriate taxation requires identifying the nature of the transaction that generated the revenue. Royalty revenues are generally treated differently than income derived from sales or exchanges, and therefore a thorough analysis is necessary to determine which rights a software

[2] Significant Delhi High Court decisions include *CIT v. ZTE Corporation*, (2017) 392 ITR 80; *Director of Income Tax v. Infrasoft Ltd.*, [2014] 264 CTR 329; *Director of Income Tax v. Nokia Networks OY*, [2013] 358 ITR 259; and *Director of Income Tax v. Ericsson A.B.*, [2012] 343 ITR 470.

[3] *CIT v. Samsung Electronics Co. Ltd.*, [2012] 345 ITR 494 (Kar.).

[4] *Citrix Systems Asia Pacific Pty. Ltd.* (Authority for Advanced Rulings), [2012] 343 ITR 1.

purchaser obtains and to what extent the title has been transferred. Income may also be generated from the provision of know-how and services related to computer programs, including their development and maintenance. This income from provision of services may be treated differently than income from the sale, lease, or licensing of the computer software itself.

Holdings on Characterization

The Supreme Court undertook an in-depth analysis of key provisions in the Copyright Act, 1957, and concluded that a payment made by an end-user or distributor is akin to a payment for the sale of goods rather than a payment for the grant of a license in copyright. An end-user that obtains a nonexclusive, nontransferable, and restricted right to a copy of the software makes a payment for the copyrighted software itself and not a payment for use of the copyright that belongs to the owner.

The Court found that end-user license agreements for software do not transfer or assign the copyright of the software. Likewise, a distributor is only granted a nonexclusive, nontransferable license to resell computer software. Often, these agreements expressly stipulate that no copyright of the computer program is transferred to either the distributor or the ultimate end-user. The agreements do not convey any right to sublicense, transfer, modify, or reproduce the software in any manner other than that permitted by the licenser. Also, if the end-user does not obtain any rights to the copyright under the license agreement, then making a copy of the software for internal use (as permitted by the license) does not involve the grant of a right to the copyright. Payments made by end-users and distributors are akin to payments for the sale of goods and cannot be construed as a license to enjoy all (or any) of the enumerated rights in section 14 of the Copyright Act or create any interest in such rights so as to attract section 30 of the Copyright Act. Hence, they do not amount to royalties.

Further, the Supreme Court concluded that the designation that the parties give to a transaction is not a decisive factor in determining the nature of that transaction. Instead, the true impact of the agreement must be considered taking into account the terms of the agreement and the relevant circumstances.

Importance of Tax Treaties

Treaties and Commentary

The Supreme Court also emphasized the relevance and importance of tax treaties and the OECD commentary. At the outset, the Court held that India's tax treaties should be interpreted liberally with a view toward implementing the true intention of the parties. The ruling highlights the significance of an entitlement to tax treaty benefits, in part because the same conclusions may trigger Indian withholding tax under the domestic tax law. Tax treaty benefits are subject to broad conditions, which include that the selling entity is also the beneficial owner; the holding of a tax residency certificate; and compliance with applicable antiavoidance provisions, including those introduced under the OECD multilateral instrument.

The Supreme Court also underscored the sanctity of the OECD commentary. The ruling notes the importance of the commentary on article 12 of the OECD model tax convention and its persuasive value regarding the definition of royalties. Payers and recipients have a right to know their positions and obligations under a treaty, and the Court confirmed that they can rely on the commentary to understand those rules. India's reservations to the commentary would not affect its relevance unless those reservations were incorporated into a DTA through bilateral negotiation with the respective countries.

Income tax treaties also play a significant role in the treatment of cross-border transactions. Withholding rates on different types of income vary from one country to another. Additional complexities arise from a country's tax system itself, especially if VAT, goods and services tax, or other indirect taxes apply.

Interaction With Domestic Law

The ruling confirms that the determination of a nonresident's income that is chargeable to tax in India is subject to the provisions of domestic law and the relevant tax treaty. If a treaty provides that an item of income is not chargeable to tax, then it cannot be taxed under the domestic tax law. Combining this conclusion with the rulings

regarding characterization, the Court held that withholding agents should not withhold tax on payments made to nonresident software providers.

The Court also addressed the retrospective application of amendments to domestic tax laws. While the 2012 expansion of the scope of the royalty definition in the domestic tax laws was intended to have retrospective application, it could not oblige taxpayers to apply withholding on a retrospective basis. Notably, the definition of royalty in India's domestic laws is quite wide and more expansive than the provision in India's DTAs. The Supreme Court remarked that, in accordance with section 90(2) of the Income Tax Act, the more expansive definition must be ignored if it is wider and less beneficial to taxpayers than the definition under tax treaties.

The Ruling and the Equalization Levy

In April 2020 India introduced its enlarged version of digital taxes, which some call the equalization levy 2.0, bringing nonresident e-commerce operators engaged in the online supply of goods or the provision of services into its purview. It is charged at rate of 2 percent if the gross consideration received by the nonresident e-commerce operator from residents (or nonresidents under specified circumstances) exceeds INR 20 million (approximately $273,000). It covers both business-to-business and business-to-consumer transactions. The compliance burden is on the nonresident e-commerce operator. This, plus the fact that the levy is not creditable as a foreign tax credit, means it is an additional cost to them.

The Budget 2021 proposals clarified some important aspects of the equalization levy, particularly:

- payments in the nature of royalties or fees for technical services (taxable under domestic laws read with the relevant tax treaty) shall not be subject to the equalization levy;
- online sales of goods or services will be subject to the equalization levy regardless of whether the e-commerce operator owns the goods or provides or facilitates the services; and
- online sales of goods or services include one or more of the following activities occurring online:
  - acceptance of an offer for sale;
  - placing of a purchase order;
  - acceptance of the purchase order;
  - payment of consideration; or
  - supply of goods or provision of services, partly or wholly.

Note that if a payment is not construed as taxable as a royalty or fee for technical services under tax treaties, then it may still fall within the purview of this digital tax levy.

These proposals confirm the government's intention to widen the scope of the levy.

The way the proposals are worded, it may include:

- payment gateways or aggregators that may assist in online settlement of consideration for offline transactions;
- transactions that are executed online;
- transactions initiated or concluded through email, even if delivery happens physically; or
- transactions that involve an online purchase order without any online payment of consideration or conclusion of sale.

It could subject intercompany transactions — such as technical support services, cloud storage, the use of enterprise resource planning tools, or the placement of orders — to the levy.

Because of how the equalization levy provisions are worded, there are some interpretational issues that lead to practical challenges in its implementation. Considering the ramifications and increased focus on the equalization levy, it is imperative that foreign companies evaluate and explore their options to assess whether they are subject to the levy. It is also advisable to have intragroup transactions evaluated or ring-fenced because the amendments are proposed to apply retrospectively with effect from fiscal 2020-2021. Companies should recognize that the levy depends on the real nature of the underlying transactions and prepare their tax positions accordingly.

India's interest in the equalization levy is evident from the above — and it is only going to

increase going forward. In view of the Supreme Court decision, many believe that the tax authorities' focus will shift even more toward the equalization levy to make up for lost revenue, and it may eventually cover all digital transactions with nonresidents, with or without royalties.

The Supreme Court judgement settles the debate regarding the characterization of software sales as royalties when the nonresident seller or software provider is eligible to claim benefits under a tax treaty. However, in light of new equalization levy provisions, nonresidents will also need to evaluate the impact of the equalization levy and its interplay with the ruling, particularly given Budget 2021's proposed expansion of the levy's scope. The equalization levy targets all online sales of goods and services, and it may cover software payments that are not taxable as royalties. It applies if software is contracted for or supplied using an online platform. Therefore, payments for cross-border software sales may have escaped being treated as royalties only to be captured by the widening net of the equalization levy. Foreign software sellers without an Indian PE may have to pay the 2 percent equalization levy on transactions if one or more of the relevant activities is conducted online. It will not affect refunds for years when the equalization levy was not in force. However, global companies need to analyze its impact on transactions that occurred after April 2020.

Recommendations for Global Tech Companies

The Supreme Court's decision is now the law of the land: It is binding on all Indian tax authorities and subordinate courts in India and will apply to all pending litigation and audits. Taxpayers with disputes pending in India that involve similar issues should review their litigation strategy and consider whether they may be entitled to refunds. The principles laid down by the Supreme Court regarding the interpretation of tax treaties and the sanctity of the OECD's commentary will bolster some taxpayers' positions and strengthen their cases.

Taxpayers should revisit their positions regarding royalties paid in the past. They may be able to seek refunds of taxes withheld based on royalty characterization. For transactions from 2020 onwards, nonresidents should evaluate their transactions based on the equalization levy and consider ring-fencing to limit their exposure.

The Supreme Court decision may also affect Indian e-commerce companies that are the subjects of foreign direct investment. Typically, e-commerce in services is not an issue under the foreign direct investment rules if an entity is acting only as a marketplace for selling third-party products or services, including facilitating the sale of software. However, if an Indian entity sells its software products in India through its online platform, the rules may apply because India does not permit foreign direct investment in its inventory-based model of e-commerce.

The Supreme Court's ruling is a happy ending to this a long-pending litigation. It may help nurture the global business community's faith that the Indian judiciary will ensure that those entitled to a genuine benefit under the law will not be denied that right. Tax deficits are a reality for many countries, especially in the midst of the pandemic. The equalization levy is an opportunity for the Indian authorities to rake in some lost tax revenues. Hopefully, the digital tax levy is viewed objectively by the authorities and not just seen as a revenue-gathering mechanism. Global companies must analyze the impact of their transactions with India and consider the potential applicability of the equalization levy and other taxes. ■