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Tax free Import of Software into India

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Taxation of software in India has always been a point of controversy.

The issue relating to characterisation of payments for software license has been a long standing unresolved one. The problems facing the software industry have also been compounded by the ruling of the Karnataka High Court in the case of CIT v/s. Samsung Electronics Co. Ltd 1, which led to creation of lot of panic and ambiguity pertaining to the withholding obligations on import of software.

The Authority for Advance Ruling ("AAR") has, in its recent ruling in the case of Dassault Systems K.K. ("Applicant"), now provided some succor to the software industry. In a very well reasoned and detailed ruling, the AAR held that payments received from import of software products cannot be characterised as "royalties" but should be characterised as "business profits". Therefore, in the absence of a Permanent Establishment ("PE") of the non-resident supplier in India, such payments would not be taxable in India.

Facts

The Applicant is a company incorporated under the laws of Japan and is engaged in the business of providing standardised software products but of a highly specialised nature. The Applicant's products are marketed through a distribution channel comprising of independent third party Value Added Resellers ("VAR") who are in the business of selling software to end users. For this purpose the Applicant enters into a General VAR Agreement ("GVA") to authorise a VAR to act as a reseller of products developed by the Applicant. The GVA stipulates that the Applicant shall retain all rights, title and interest in the software products including patent, copyright and trade secret rights.

Under the GVA, the VAR receives an order from the end-user and simultaneously places an order with the Applicant. The Applicant sells the software products to the VAR for a consideration based on the standard list price and the VAR in turn sells the products to the end-users at a price independently determined by it. The end-user is required to enter into a tri-partite end-user license agreement with the VAR and the Applicant.

Decision

There were primarily two issues faced by the AAR, first being whether the income derived from the sale of software products to VAR would fall within the ambit of "royalty" as defined under Article 12 of the India Japan Tax Treaty ("DTAA"). The second being whether VAR can be considered to be dependent agents of the Applicant thereby giving rise to an agency PE in India by virtue of Article 5 (7) of the DTAA.

Royalty Income

The term ‘royalties’ has been defined both under the provisions of Income Tax Act, 1961 (“ITA”) and under the provisions of Article 12 (3) of the DTAA, the taxpayer having an option of choosing the one more beneficial to him. Keeping in mind the lack of “material difference” between the 2 definitions, the AAR sought to arrive at a conclusion pertaining to both these definition. The AAR observed that both the definitions mandate either the use of or right to use or transfer of “copyright of literary or scientific work”. Therefore in order for a particular income to be characterised as royalty the AAR held that the Applicant must have a right to use the “copyright” contained in the software.

The term “copyright” has not been defined under the provisions of the ITA. Keeping this in mind the AAR quoted with acceptance the legal principle established in the case of FactSet Research Systems Inc. wherein it was held that in the absence of definition in the ITA, the definition in the law governing the subject-matter must be adopted. On the basis of this legal principle, the AAR observed that the term copyright should have the same meaning as understood under the Copyright Act, 1957 (“CR Act”). Section 14 of the CR Act defines the term copyright and enlists the various rights attached to such a copyright. Thus only in the event of the taxpayer enjoying some or all the rights which the copyright owner has by virtue of the aforementioned provision the income derived there from would be characterised as royalty.

In the present case, a non-exclusive and non-transferable license enabling the use of a copyrighted product was furnished by the Applicant. The AAR held that such a license cannot be construed to give the End- User the authority to enjoy any or all of the enumerated rights ingrained in a copyright. In this regard the AAR stressed on the difference between the “the use of copyrighted article” and the “use of copyright” in the article. Further it was held that where the purpose of the license or the transaction was only to establish access to the copyrighted product for “internal business purpose”, it would be legally incorrect to state that the copyright has been transferred. Therefore in spite of such a computer programme being a highly specialized one, the AAR held that the income derived there from cannot be construed to be in the nature of royalty.

Agency PE

The AAR held that VAR cannot be considered a PE of the Applicant in India, as the transaction between VAR and the Applicant are on a principal to principal basis. Further the VAR dealings were not confined to merely conducting business with the Applicant or its group concerns and consisted of various other dealings with different types of software. Hence, the AAR held that the Applicant had an independent status and therefore did not have a PE in India.

Due to the absence of a PE in India and the import of software not amounting to royalty income, as discussed above, the AAR held that the income of the Applicant should not be taxable in India.

Analysis

Taxation of software in India has always been a point of controversy. The decision of the AAR in Dassault Systems K.K. is in line with the jurisprudence developed over a series of cases like Motorola Inc. v/s. DCIT, Hewlett-Packard (India) (P.) Ltd and Sonata Software Ltd.where in the courts have differentiated a sale of a copyrighted article from a transfer of the underlying copyright.

The AAR in the past has taken a conflicting stand in the case of Airports Authority of India wherein it was held that a transaction involving supply of software on a non-exclusive and non-transferable basis amounted to a right to use the copyright in the software and therefore, the receipts from such transaction would amount to royalty. However, this decision of the AAR provides a much required clarity on taxation of software in India.

At the same time, It may also be interesting to analyze the effect of the Karnataka High Court's decision in the Samsung Electronics case on this ruling. The Karnataka High Court had held that where a payment made to a non resident bears a semblance to the character of income, in such case, the payor has an obligation to withhold tax under section 195 of the ITA. In light of the Samsung Electronics case it remains to be seen whether the Applicant would still be required to withhold taxes on the payments received by it from resident payers, though the same is not chargeable to tax in India.