

Tax Hotline

February 19, 2021

SOFTWARE BATCH APPEALS - COURTROOM PROCEEDINGS (DAY 5: FEBRUARY 17, 2021)

Arguments on behalf of the taxpayers against the submissions on behalf of the Revenue in the Software batch of appeals before the Supreme Court continued on 17 February 2020.

Percy Pardiwala, continuing his rebuttal from yesterday, made the following arguments

1. Reservations to the OECD Convention are irrelevant to the question

Balbir Singh, appearing for the Revenue, had argued that India had expressed reservations to the interpretation of "royalties" in the Commentary to the OECD Model Tax Convention. In rebuttal, Pardiwala directed the attention of the Court to the India-Singapore tax treaty, which was amended in 2017. He explained that this amendment did not modify the definition of royalties in the treaty, despite India having expressed its reservation much before 2017. Thus, he contended that India had the opportunity to negotiate an amendment to the definition of "royalties", but chose not to do so.

Singh had also cited an Australian tax ruling to argue that a country's reservations to the OECD Commentary should be used in the interpretation of its tax treaties. Pardiwala countered this by highlighting that the ruling was not a judicial pronouncement, but was merely a view of the Australian tax commissioner. Further, the ruling only stated that reservations would be of considerable relevance to explain variations in a treaty from the OECD Model. Pardiwala argued that since the treaties in question had not varied from the OECD model, the reservations would be irrelevant.

2. Indian Position on the OECD Commentary is not binding

Pardiwala noted that the 1997 Committee Report on Taxation of E-commerce, cited by Singh to set out the "Indian position" on the OECD Commentary, was an opinion, which can be viewed as an executive recommendation at best. Since the Government had not categorically accepted these recommendations, they would not be binding on the government or the assessee. Further, Pardiwala referred to the 2016 Committee Report to point out that the Report chose to propose an equalization levy, since the other option of withholding taxes on digital transactions would have required subsequent amendments to a large number of treaties. The Committee noted that without such amendments to the treaties, any unilateral amendments to the Income Tax Act ("ITA") would be ineffective. On this basis, Pardiwala argued that even if Explanation 4 (introduced through Finance Act, 2012) brought purchase of software within the definition of royalty, it would have no impact on the tax treaties.

Pardiwala also argued that the Supreme Court's finding in *GMExports*¹ (regarding the overriding effect of domestic law over international law, in cases of conflicting interpretation between treaty provisions and domestic statutes), cannot be relied upon to submit that Section 9 of the ITA would prevail over Article 12 of the tax treaty for the interpretation of "royalties". Pardiwala noted that while *GMExports* had dealt with the General Agreement on Tariffs and Trade, the present case deals with a tax treaty that had been incorporated into domestic law through section 90 of the ITA. This incorporation into domestic law, he said, was upheld by the Supreme Court in *Azadi Bachao Andolan*.² Applying the Court's findings on interpretation of treaties in *GMExports* to the present case, Pardiwala further submitted that the OECD Commentary should be relied upon.

3. The distinction between a copyright and a copyrighted article

Pardiwala argued that the claim regarding the non-existence of the concept of copyrighted articles (as opposed to a copyright) is contrary to the Supreme Court's decision in *TCS*.³ The Court there held that once copies of a software programme are made and marketed, the software becomes "goods". He contended that this finding indicated the Court's acceptance of the concept of copyrighted articles. He further submitted that it was inconsequential whether the consideration was paid for sale, or for the copyrighted article, as in both cases the consideration would fail to constitute royalty.

He also relied on the judgment in *Infrasoft*,⁴ where the Delhi High Court had found that the license under the purchase agreement was only limited to a right to use the copyrighted material, and did not transfer any rights to use the copyright. He argued that although the agreement was described as a "license", the rights differed from a license as under Section 30 of the Copyright Act which grants an interest in the copyright itself. Hence, he submitted, consideration for the same would not qualify as royalty.

Singh had previously directed the Court's attention to the advance ruling in *Citrix System*⁵ which held that consideration for software purchase would constitute royalty. In response, Pardiwala noted that the ruling did not take into account the distinction between a copyright and a copyrighted article. As such, he stated that the ruling in *Dassault Systems*⁶ was preferable and should be applied since it took into consideration this distinction, and held that software purchase would not constitute royalty.

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4. Classification of “Enterprise Software” is irrelevant to the question of royalty

Pardiwala noted that in determining payment classification as royalty, it is irrelevant whether a software is a general end-user software or an “enterprise software” for business purposes. Only the nature of rights pursuant to the agreement between the parties would be relevant in deciding whether the consideration would constitute royalty. He also rebutted Singh’s argument that the batch-appeals only involved enterprise software and not general end-user software. He stated that Sonata, for example, was distributing Microsoft’s software such as the Windows Operating System, and IBM was distributing shrink-wrapped software, neither of which could be considered enterprise software.

5. Explanation 4 is not declaratory of the existing position

Singh had cited a circular from 1974 which used the term “transfer of all or any right for use of, or right to use a copyright” in the context of withholding taxes under Section 195. He compared this to Explanation 4 of Section 9(1) (vi) of the ITA, and emphasized that it used the same terms in the context of computer software while defining of royalty. On this basis, he had submitted that the Explanation, introduced in 2012, only declared the position of which had existed since 1974.

In response, Pardiwala pointed out that Section 9(1)(vi) of ITA itself was introduced in 1976. Hence, the 1974 circular had no scope in the interpretation of this section. Further, he contended that the question of software as it is understood today did not exist at the time of the circular. He noted that the circular only referred to a copyright in literary work; and that the term “computer software” was included in “literary work” under section 2(o) of the Copyright Act much later, in 1994. Thus, he argued that the circular does not deal with the position of law that Explanation 4 addresses, and that the explanation does not reflect the existing position of law.

Arvind Datar, representing the petitioners, reiterated his submissions from Day 1. Further, he noted:

1. The Agreement was for a Conditional Sale of Goods

Datar submitted that the terms laid down in the end-user agreement would not constitute a license under the Copyright Act, but were conditions for the sale of goods under the Sale of Goods Act. He referred to Section 12(2) of the Sale of Goods Act which provides that the breach of a condition of sale gives rise to a right to repudiate the contract. He pointed toward the end-user agreement which stated that if the buyer did not accept the terms therein, the software packet would be returned for a full refund. Applying Section 12(2) to this clause, he stated that the terms of the “license agreement” would constitute conditions on the sale of goods, as the contract is repudiated through a return and refund in cases where the users failed to agree to such conditions.

- Arijit Ghosh & Dhruv Sanghavi

(*We would like to acknowledge input from Pranav Mihir Kandada for the preparation of these notes.)

¹ (2016) 1 SCC 91.
² (2004) 10 SCC 1.
³ (2005) 1 SCC 308.
⁴ (2014) 264 CTR 329.
⁵ 2012 SCC OnLine AAR-IT 4.
⁶ 2010 SCC OnLine AAR-IT 2.

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