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CASE ANALYSIS: ENGINEERING ANALYSIS CENTRE OF EXCELLENCE PRIVATE LIMITED v. THE COMMISSIONER OF INCOME TAX & ANOTHER

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ABSTRACT

The case Engineering Analysis Centre of Excellence Private Limited v. The Commissioner of Income Tax & Another is a land mark judgement which has resolved a two decades of conflict between the income tax authorities and the tax payers. It is about the payment of consideration by Indian companies or end users to utilize computer software purchased from foreign sources and whether or not it is taxable as 'Royalty' and has also resolved the confusion created by conflicting rulings of various adjudicating bodies. This case combines concepts from taxation and intellectual property rights. The case analysis begins with an introduction to the conflict regarding the taxation of payments for the purchase of computer software in international transactions, which is followed by a list of provisions involved along with the facts, background, bench, and issues of the case. This is followed by the contentions presented by the Appellants and Respondents. This is further followed by the judgement and critical analysis of the judgement. Finally, the case analysis concludes with a short note on the grounds of revision of the judgement.

INTRODUCTION

One of the major points of discord between taxpayers and tax authorities for over two decades in India has been the controversy embracing the taxation of payments for the purchase of computer software in international transactions. This has become the focus of extensive litigation. The crux of the contention is related to the characterization of income held in the hands of non-resident taxpayers as either business profits or royalties.

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The tax authorities have taken the stance that income arising from grant of software license should be characterized as "royalty," without considering the nature of rights gained by the customer. On the other hand, taxpayers have taken the stance that income from computer software should be categorized as royalty or business income on the essence of the nature and extent of rights granted to the customer by the terms of the treaty.

India has entered into tax treaties with other countries that define "royalty" as a consideration for the use or the right to use the copyright of a literary, artistic, or scientific work.[1] The tax treaties lack a provision like Explanation 4 of Section 9(1)(vi)(b)[2], which has expanded the scope of the term 'royalty' by providing that grant of all or any rights includes transfer of all or any right for use or right to use a computer software.[3]

The present case *of the Engineering* ***Analysis Centre of Excellence Private Limited v. Commissioner of Income Tax***[4] **is about the payment of consideration by Indian companies or end users to utilise computer software purchased from foreign sources and whether or not it is taxable as royalty. This case also deals with the question of whether TDS can be deducted for software purchased from foreign software suppliers.**
This case is interesting because it resolves a major point of discord between taxpayers and tax authorities. It also resolves the confusion created by the conflicting rulings of the Hon'ble High Courts of Karnataka and Delhi, as well as the Authority for Advance Rulings (AAR)**. Further, the case states that taxpayers need not do the impossible to meet the statutory requirements created by amendment, which is to be applied retrospectively.**

TAXATION STATUTORY PROVISIONS INVOLVED IN THE CURRENT CASE

- Sections 9(1) and (vi) of the Income Tax Act, 1961.[5]
- Section 195 of the Income Tax Act, 1961.[6]
- Section 201 of the Income Tax Act, 1961.[7]

[1] Article 12(3) of the Double Taxation Avoidance Agreement between India and USA.
[2] Section 9(1)(vi)(b) Explanation 4, The Income Tax Act, 1961, No. 43, Acts of Parliament, 1961 (India).
[3] The Income Tax Act, 1961, No. 43, Acts of Parliament, 1961 (India).
[4] (2021) SCC OnLine SC 159.
[5] Supra, note 3 at 2.
[6] Ibid.
[7] Ibid.

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FACTS OF THE CASE

In the instant case, the appellant is an Indian resident involved in the resale of software packaged in shrink-wrapped material imported from a non-resident company. Because the transaction constituted sale of goods, the appellant had not deducted tax with respect to the considerations given.

In contrast, the Department of Revenue claimed that the transaction that happened between the parties is a copyright for the right to use the software, which will result in royalty payments and as a consequence assessed that under Section 195 of the Act[8] which states that the tax should be deducted at source.

The Hon'ble Supreme Court heard two sets of appeals, one originating from the High Court of Karnataka and the other from the High Court of Delhi judgements. The High Court of Karnataka decreed in favor of the Revenue, whereas the High Court of Delhi decreed in favor of the Assesses.

When the matter was presented to the High Court of Karnataka, the appeal was upheld, citing its verdict in the *CIT v. Samsung Electronics Co, Ltd.. & Others*[9], which ruled that what was sold as computer software includes a right or interest in copyright, consequently resulting in the payment of royalty and deemed to be an income of the resident as required by Section 9 (1) (vi) of the Act, which requires the deduction of tax at source.

Civil appeals were filed with the Supreme Court by the appellant accompanied by other assesses who were also aggrieved by the decision of the Court.

The Hon'ble Supreme Court divided the appeals into four types of software payments:

1. An end user, who is an Indian resident, purchases computer software directly from a foreign non-resident supplier or manufacturer.
2. Resident Indian companies resell computer software purchased from a foreign non-resident supplier or manufacturer.
3. A foreign, non-resident vendor acts as a distributor to purchase computer software from a foreign, non-resident seller, and resells it to resident Indian distributors or end users.

[8] Ibid.
[9] (2011) 245 CTR (Kar) 481.

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4. Foreign, non-resident suppliers sell integrated units/equipment consisting of computer software entangled with hardware to resident Indian distributors or end users.

The appellant EAC fall under the second category.

BACKGROUND OF THE CASE

In one set of appeals, the Assessing Officer decreed in favor of the Revenue Department. The Commissioner of Income Tax dismissed the appeal. The Revenue Department also succeeded in the Authority for Advanced Rulings (AAR) on the present issue. The Income Tax Appellate Tribunal then decreed in favor of the appellants, and the tribunal applied its own order passes in the case of Samsung Electronics Co., Ltd. v. Income Tax Officer[10].

The Revenue Department appealed to the High Court of Karnataka. The High Court of Karnataka ruled in favor of the Revenue Department. Thus, the assesses have appealed to the Hon'ble Supreme Court of India. The other set of appeals which was judged by the High Court of Delhi decreed in favour of the assesses in case of **DIT vs. Ericsson A. B[11].** The aggrieved Revenue Department has appealed to the Hon'ble Supreme Court. The Supreme Court also set to rest the contradictory rulings by Authority for Advance Rulings (AAR) in the case of the **Citrix Systems Asia Pacific Pty. Ltd.[12]** on the issue.

The Hon'ble Supreme Court of India clubbed all the appeals together.

BENCH: Hon'ble Justices Rohinton Fali Nariman, B.R. Gavai, Hrishikesh Roy.

ISSUES INVOLVED IN THE CURRENT CASE

There were two major issues before the Hon'ble Supreme Court:

1. Whether the amount made by the resident Indian buyer for the purchase of computer software from the foreign software suppliers are in nature of 'Royalty' as defined under explanation 2 to Section 9(1)(vi) of the Act and Double Taxation Avoidance Agreement (DTAA)?
2. Is the requirement that the payer should deduct tax at the source on such a payment, as provided under Section 195 of the Act, applicable?

[10] ITA Nos. 264-266/Bang/2002.
[11] **343 ITR 470 (Del.)**.
[12] **343 ITR 1 (AAR).**

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CONTENTIONS OF APPELLANTS

The resale of computer software purchased from a foreign supplier or manufacturer by a resident Indian distributor is merely the sale of goods. The imperative point to be kept in mind is that even the end user is only granted a limited licence for self-utilization of the computer software.

The derivative products of the Copyright are not included in the definition of "Royalties" as provided under the Doubt Taxation Avoidance Agreement. It is a well-settled fact that the provisions of the DTAA regulate the taxability of income because they are inclined toward the assessment. Likewise, the OECD Model Tax Convention on Income and Capital, the UN Model, and the United States Internal Revenue Code, among other things, are of similar opinion to the DATT in not considering the sale of copyrighted material to be royalty.

It has been argued by the learned Senior Advocate Shri Preetesh Kapur that it is clear that only the goods have been passed on to the importer and not the copyright in the goods has been passed on. This is clarified by the language of Section 14(b)(ii) of the Copyright Act, 1957[13] by the statutory application of the doctrine of first sale/principle of exhaustion.

It is humbly submitted by Shri Arvind Datar, learned Senior Advocate appearing on behalf of one of the assesse that the retrospective amendment which added explanation 4 to Section 9 (1)(vi) of the Income Tax Act,1961[14] done by virtue of Finance Act, 2021 which expanded its ambit with effect from 01.06.1976, will not be applicable to the DTAA, as the expanded definition of royalty did not exist at that time of application to an assessment year. He further cited the case of *Union of India v. Azadi Bachao Andolan*,[15] and argued that the DTAA would prevail over the domestic law as it is more advantageous to the deductor tax to an extent under Section 195 of the Income Tax, Act. He humbly concluded by stating that there is no need for any tax deduction to be done by the Indian imported under 195(1) of the Income Tax Act.[16]

CONTENTIONS OF RESPONDENTS

The Additional Solicitor general appearing on behalf of the Revenue argued that the DTAAs

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[13] The Copyright Act, 1957, No. 14, Acts of Parliament, 1957 (India).
[14] The Income Tax Act, 1961, No. 43, Acts of Parliament, 1961 (India).
[15] (2004) 10 SCC 1.
[16] The Income Tax Act, 1961, No. 43, Acts of Parliament, 1961 (India).

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is not applicable to the persons mentioned in Section 195 of the Income Tax Act[17] if they are not in fact assesses because of the fact that when provisions of DTAAs read along with Section 90 of the Income Tax is applicable only to persons who could be described as assessees.

Further, he relied on *AP Transco*[18] case which provides a clear-cut distinction that a payer under Section 195 of the act and an assessee under Section 2(7) of the Income Tax, Act[19] are different.

He also relied heavily on a recent judgement of the Supreme Court of India, given in the case of *PILCOM v. The Commissioner of Income Tax*[20] (PILCOM), which laid down that tax has to be deducted at source irrespective of whether tax is otherwise payable by the non-resident assessee. He also stated that tax concessions are not available in relation to payments with respect to software imported separately or independently of computer hardware, which was clarified by CBDT Circular No. 588 dated 02.01.1991.

The Additional Solicitor General humbly argued that copyright is parted from the original owner since adaptation of software is possible, admittedly for installation and use on a particular computer. He further relied upon Section 52(1) (ad) of the Copyright Act,1957[21], that making copies or adaptation of computer programmer from a legally obtained copy for non-commercial, personal use does not amount to infringement and as a consequence per contra would amount to infringement if copies or adaptation are made for commercial use.

He also argued that the doctrine of first sale/principle of exhaustion has no application as it is not statutorily recognised in Section 14(b)(ii) of the Copyright Act,1957[22], There is parting of a right or interest in copyright by the distributors of copyright software license or sell such computer software to end-users and as a consequence would be hit by Section 14(b)(ii) of the Copyright Act.

The principle laid down in the judgement of *Tata Consultancy Services v. State of Andhra*

[17] The Income Tax Act, 1961, No. 43, Acts of Parliament, 1961 (India).
[18] Transmission Corpn. of A.P. Ltd. v. CIT, (1999) 7 SCC 266.
[19] The Income Tax Act, 1961, No. 43, Acts of Parliament, 1961 (India).
[20] (2020) SCC OnLine SC 426.
[21] The Copyright Act, 1957, No. 14, Acts of Parliament, 1957 (India).
[22] The Copyright Act, 1957, No. 14, Acts of Parliament, 1957 (India).

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Pradesh[23] which states that software recorded on compact discs are goods. This principle was laid down in the context of sales law tax and is therefore not applicable to the Act.

JUDGEMENT:

After hearing the arguments for both sides, the Hon'ble Supreme Court of India ruled that software firms that purchase computer software from foreign software suppliers/manufacturers have now been exempted from deducting the TDS. As a consequence of this ruling, the cost of purchasing computer software by Indian firms/end-users will be lower because foreign suppliers/manufacturers may choose to lower the price due to the tax relief provided by the judgment. This effect will be of great benefit to Indian suppliers/end-users.

The Hon'ble Supreme Court further clarified while citing the definition of royalties provided in Article 12 of the Double Taxation Avoidance Agreements that persons mentioned under Section 195 of the Income Tax Act have no obligation to deduct tax at source because the distribution agreement/EULAs in these cases do not create any interest or rights in such distributors/end-users, which would amount to the use of or the right to use any copyright.

The Court also stated that the expanded definition of royalty under Section 9(1)(vi) of the Act, which was done through the Finance Act, 2012, is not clarificatory in nature, and withholding cannot be bound on the payer due to a substantive legislative change that did not subsist at the time of payment by the payer. The amendment done through the Finance Act, 2012, had a retrospective effect from 01.04.1976. Thus, the Act's Explanations 4–9(1)(vi) cannot be applied retrospectively.

The application of provisions contained in the Double Taxation Avoidance Agreements can only be done to the degree that they are more beneficial to the assessee.

Furthermore, the Hon'ble Supreme Court has also laid down that adapting a computer program or generating copies to use it for the purpose it was purchased for and delivered, or even making backup copies, will not constitute an infringement of copyright and do not amount to parting with copyright, according to modified Sections 14(b)(ii) and 52(1) (aa). It has also been laid

[23] (2005) (1) SCC 308

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down that EULAs must be read as a whole to determine the true nature of the transaction.

The Court also stated that, if a non-resident is in a compelled to pay tax under Section 9 read with Section 4 of the Act and along with the Double Taxation Avoidance Agreements, then only a tax deduction at source can be allowed under Section 195 of the Act.

Consequently, the judgement of the Supreme Court of India in the case of *PILCOM v. Commissioner of Income Tax*[24], which laid down that tax has to be deducted at source irrespective of whether tax is otherwise payable by the non-resident assessee, is not applicable.

After stating the above findings, the Supreme Court ruled in favor of the assessees in all four categories provided and upheld the ruling of the High Court of Delhi. The Court has determined that the amounts remunerated by the resident end-users/distributors to non-resident computer software suppliers/manufacturers are not royalty payments for the use of copyright in the software.

Therefore, they do not result in any income taxable in India, thereby excluding the people referred to in Section 195 of the Income Tax Act,1961.

CRITICAL ANALYSIS OF THE JUDGEMENT

a) Payment: For the transfer or use of copyright:

A copyright provides an exclusive right to do or to authorize to do certain acts in respect of a "work." It also includes an exclusive right to reproduce the work in any material form and exploit it by way of sale, transfer, license, etc. Furthermore, the production of copies or adaptation of computer programs to utilize or to make up back-up copies as a temporary protection against loss, destruction, or damage in order to utilize it does not amount to an act of infringement of copyright. Even the storage of the same would not be considered an infringement of copyright.

For the purposes of the Indian Copyright Act,1957 a computer program, that is, computer software, qualifies as a literary work. The owner of the copyright is allowed to grant any interest in his rights by granting a license in return for a royalty payment. When such a license is granted, only the use of the rights contrary to the license granted would amount to the

[24] (2020) SCC OnLine SC 426.

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infringement of copyright under the ICA.

After analyzing the meaning of the term royalty under the Act and relevant tax treaties along with various decisions of the Court, the Hon'ble derived the following conclusions:

- Copyright is an exclusive right that gives the right to restrict others from performing certain acts. This is also negative in nature. Copyright is an intangible and incorporeal right in the nature of a privilege. The ownership of physical materials is quite different from the ownership of copyright in a work.
- The transfer of ownership of the physical thing in which the copyright exists provides the purchaser the right to do with it whatever may please them. However, the only exception is that they do not receive the right to reproduce and issue the same to the public, unless such copies are already in circulation and other acts are provided in Section 14 of the Copyright Act, 1957.
- Copyright is not parted when the core of the transaction is to provide the end-user access to and make use of the "licensed" computer software product over which the licensee has no exclusive rights; consequently, no infringement takes place, as endorsed by Section 52 of the Copyright Act, 1957.
- When the license granted is non-exclusive and non-transferable, it cannot be construed as a licence to enjoy all or any of the enumerated rights mentioned in Section 14 of the Copyright Act, as it merely enables the use of a copyrighted product.

Clauses of the agreement states do not matter, and only the real nature of the transaction with regard to the overall terms of the agreement and the surrounding circumstances is relevant.
In the present case, the meanings of some of the terms of the sample agreement with the distributor and end users of the software are as follows:

- A non-exclusive, non-transferable license to resell computer software to end users was granted to the distributors.
- Distributors were not granted the right to use software.
- The non-transference of copyright to the distributor or to the ultimate end user is specifically stated in the agreement.
- Distributors and end users were restricted from sub-licensing, transferring, reverse engineering, modifying, or reproducing software. Only the use of a computer program was granted to end users.

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The sale of a physical object that contains an embedded computer program is "licensed" by the non-resident supplier to the distributor and resold to the resident end user or directly supplied to the resident end user. Such sale of goods does not involve the transfer of copyright to the software. This relied on the Supreme Court's judgment in the case of Tata Consultancy Services.[25]

b) Meaning of royalty: More beneficial

The definition of the term royalty is exhaustively provided under Tax Treaties which mean payment made for the use or right to use any copyright in a literary work, but the meaning of the aforementioned term under the Act is different which is also wider than the Tax Treaty inasmuch as transfer of all or any rights includes granting of a license, in respect of any copyright of any literary work

A grant of license does not qualify as royalty under the tax treaty when such a license granted to distributors and end users does not create any interest or right in the software; thus, grant of such license would not amount to the "use of or right to use" of copyright.

The phrase "in respect of" used in the Act means "in" or "attributable to", which was observed by the Hon'ble Supreme Court. It is an essential prerequisite that there must be transfer of all or any rights in a copyright by way of license or otherwise, in order to qualify as royalty even under the Act.

In view of this fact, when the license granted to the distributors and end users does not involve granting of any interest in the rights of an owner of a copyright, payment made for such license will not qualify as royalty either under the Act (up to 2012) or the Tax Treaty.

The expanded definition of royalty under Section 9(1)(vi) of the Act, which was done through the Finance Act, 2012, is not clarificatory in nature, and withholding cannot be bound on the payer due to a substantive legislative change that did not subsist at the time of payment by the payer. The provisions of the Act would not be applicable because the definitions of royalties under the tax treaty are narrower and more beneficial. Thus, there is no obligation to withhold taxes under Section 195 of the Act.

[25] (2005) (1) SCC 308.

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The revenue strived to rely on the decision of the Supreme Court in case of PILCOM[26] which dealt with Section 194E of Act for the proposition that tax has to be deducted at source irrespective of whether tax is otherwise payable by the non-resident assessee.

The Hon'ble Supreme Court observed that the end results would be absurd if it accepted the contention since it would be necessary to withhold taxes even where income is not chargeable to tax in India, which is not the intention of the legislature. As a consequence, the said decision has no applicability to this case wherein withholding tac obligations are to be determined in terms of Section 195 of the Income Tax Act.

c) Impossibility of withholding tax obligations.

The definition of "royalty" under the Act has been expanded by the insertion of Explanation 4 into Section 9(1)(vi) accomplished by the Finance Act, 2012 (with retrospective effect from June 1, 1976). The alleged disobedience of the law is excused when there is a disability that makes it impossible to obey it.[27]

A person who has made payments prior to 2012 cannot be logically expected to apply the expanded definition of royalty, which was not in existence at the time of making payments to determine withholding obligations under Section 195 of the Act. Thus, the substantive amendment to the Act does not compel a person to do something impossible.

d) India's Position on the OECD Commentary and Relevance of OECD Commentaries

When the reservations expressed by the Indian Government on the OECD commentary dealing with royalty, unless the reservations were incorporated into the treaties through bilateral negotiations with the respective countries, such reservations would not affect its relevance.

The definition of "royalty" provided in the Tax Treaties and OECD Model Convention are similar. Ergo, importance may be given to the OECD Commentary as well because making a copy or adaptation of a computer program to enable the use of the software for which it was

[26] PILCOM v. Commissioner of Income Tax, (2020) SCC OnLine SC 426.
[27] Arjun Panditrao Khotkar v. Kailash Kushanrao Gorantyal, (2020) 7 SCC.

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supplied is not considered royalty. This also supports that the payment made by distributors and end users does not qualify as a royalty. The aforementioned decree may also be applied to payments made for the subscription of databases or for satellite bandwidth charges and furthermore assist taxpayers in ongoing disputes.

REVERSING THE JUDGEMENT

The judgement in the present case could be overruled by the Supreme Court of India if it upholds the substantive legislative change done by amending the Income Tax Act, by passing the Finance Act, 2012, and giving effect to its retrospective part. The present judgement can be overruled by the Supreme Court of India if it applies its own judgement provided in the case of the PILCOM v. Commissioner of Income Tax.[28] (PILCOM), and declare that tax has to be deducted at the source, irrespective of whether tax is otherwise payable by the non-resident assessee.

[28] (2020) SCC OnLine SC 426.