Delhi ITAT’s decision in Microsoft case could create fresh confusion and controversies – Nov 10, 2010

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IN a very recent decision having manifold ramifications, the Delhi Income Tax Appellate Tribunal has held that payments effected by a resident to a non-resident for import of shrink-wrapped software is taxable as royalty income, in the hands of the non-resident, as reported in Microsoft Corporation and others v. ADIT reported in 2010-TII-141-ITAT-DEL-INTL.

Facts of the case

The appellants are the US-based Microsoft Corporation (MS Corp) and its subsidiaries, the Gracemac Corporation (Gracemac) and the Microsoft Regional Sales Corporation (MRSC). Upto 31 December 1998, MS Corp had directly entered into agreements with various Indian Distributors for sale of Microsoft products being “off the shelf” / “shrink-wrapped” software, on principal to principal basis. The Indian distributors, in turn, sold these Microsoft products to resellers/consumers.

The above business model was changed w.e.f. 1 January 1999 and MS Corp entered into an agreement with its subsidiary, Gracemac to grant it an exclusive license, in exchange of all shares, to manufacture in the retail territory the Microsoft (MS) retail software products and an exclusive right to license any third party in the retail territory to grant directly to customers the right to reproduce the software portion of MS retail products for internal use. All master copies provided by MS Corp would at all times remained its sole property. Gracemac in turn, entered into a license agreement with Microsoft Operations Pvt. Ltd. (MO), Singapore, under which MO, was granted non-exclusive license to manufacture (reproduce) Microsoft software in Singapore; non exclusive license to distribute the software products so manufactured to retailers or to MS Corp or to subsidiaries of MS Corp and non-exclusive right to license or sub-license the right to reproduce Microsoft software to certain end users (large account customers) for their internal use. In consideration, MO paid royalty to Gracemac for each MS retail software copy.

MO entered into a non-exclusive distribution and inter-company services agreement (distribution agreement) with MRSC for appointing MRSC as a distributor for selling the copies of Microsoft software, which were reproduced / manufactured by MO. MO sold all the software copies to MRSC in Singapore. MRSC, in turn, entered into agreements with various distributors in various countries including India. The distributors had a right to distribute the copies of software in their respective countries. The distributor sold the products to the re-sellers in India who, in turn, sold them to the end users. MS Corp entered into End Users License agreement (EULA) with end users to use the software products licensed to them as per terms of agreement.

The royalty amount paid by MO to Gracemac ranges from 35% to 40% of net selling price received by MRSC from the distributors for the Indian Territory.

In case of Gracemac, the Assessing officer (AO) had taxed the payments made by MO Singapore to Gracemac @ 35%/40% of net sales consideration received by MRSC from Indian distributors in India on the ground that the source of Gracemac's royalty income was out of the licensing of Microsoft software products in India. The AO also held that the royalty was taxable under Article 12(7) (b) of the India -USA Double Taxation Avoidance Agreement (DTAA) as the payment to Gracemac was based on the number of users of intellectual property rights in India.

In the case of MS Corp (till the change in its business model), the assessee accepted that income from licensing software to OEMs was "royalty" though it argued that income from licensing software to distributors was "sale of a copyrighted article" and not assessable in India in the absence of a permanent establishment (PE). In the case of MRSC, the payments received from Indian distributors on sale of Microsoft software products were not offered to tax as "royalty" on the basis that the income was not taxable in India as per DTAA. The AO assessed the entire payments in the hands of MRSC as royalty income on the ground that payments have been received towards licensing of Microsoft software products, which amounted to grant of right in Intellectual property Rights (IPRs).

The Commissioner of Income Tax (Appeals) [CIT(A)] upheld the stand taken by the AO. He enhanced the assessment of Gracemac by bringing the entire consideration received by MRSC from Indian distributors on the ground that MRSC and MO were mere legal façades.

Observations and decision of the Tribunal

++ When a Sovereign State recognizes the legal existence of an entity by issuing a tax residency certificate it is obligatory for any other Sovereign State including India to recognize the same and it is not open to Revenue to declare these entities as façade without any basis, and this finding of CIT(A) has to be reversed.

++ The Tribunal held that it is a golden rule of interpretation that the language of the statute should be read as it is. The intention of the Legislature is primarily to be gathered from the language used, which means that the attention should be paid to what has been said as also to what has not been said. On a plain reading of the definition of 'royalty' as appearing in clause (v) of Explanation 2 of section 9(1)(vi) of the Income Tax Act, 1961 (Act), one will find that the legislature has used coma (,) after word "copyright". It is settled law that use of punctuation marks cannot be said as redundant. The use of punctuation mark coma (,) after word "copyright" indicates that legislative intent is to treat word "copyright" independent of words "literary, artistic or scientific work". Further the definition of term 'royalty' appearing in clause (v) of Explanation 2 is inclusive. Deletion of punctuation and addition of word "of" would limit the scope of royalty only to copyright work relating to literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting.

++ Unless the nature of the payment is determined as per provisions of section 9(1) (vi) of the Act, the provisions section 115A (1A) for the purposes of levy of income tax cannot be pressed into operation. To this extent, it is agreeable that unless nature of the payment is decided, provisions of section 115A (1A) cannot be applied.

++ The term "copyrighted article" is nowhere used even under the Act or India -US DTAA. The expression 'copyrighted article' finds its origin in US regulations and then found its way in the OECD commentary. And in absence of ambiguity in definition of royalty in section 9(1)(vi) of the Act or Article 12(3) of India-US DTAA there is no need for importing the expression "Copyrighted Article" from OECD Commentary or US regulations for the purposes of interpretation of the term "royalty".

++ Assuming there was a conflict between the Act and the DTAA, the proposition that the DTAA will prevail over the Act is not infallible. Later domestic tax legislation can over-ride treaty provisions, if there is an irreconcilable conflict (Gramophone Company of India AIR 1984 SC 667 followed). As the India-USA DTAA was entered on 20 December 1990, the subsequent retrospective amendment to section 9, which provides that royalties will be deemed to accrue or arise in India even if the non-resident has no place of business in India will apply irrespective of any contrary provision in the India-USA DTAA.

++ That a computer programme contains the programme code and depending on the operating system , a process may be made up of multiple threads of execution that execute instructions concurrently. It is clear that computer programme is a process when it executes instructions lying in it in passive state. Therefore, any consideration made for the use of process would amount to royalty

++ Computer programme has been considered as a literary work in order to protect the interests of the author under the Copyright Act; it would be incorrect and illogical to interpret the income tax provisions relating to royalties based on the Copyright Act. It will not be appropriate to restrict the scope of definition of term royalty under Income tax law only on the ground that since computer programme has been provided protection under Copyright Act, the provisions of other IPR laws will not be applicable.

++ Section 2(m) of the Patent Act defines a patent to mean a patent for any invention granted under the Act. Clause (iii) of Explanation 2 of section 9(1) (vi) of the Act defines royalty as consideration for the use of any patent, invention, model, design, secret formula or process or trade mark or similar property. Therefore, the payments made by the end users as a consideration for the use or the right to use of such patents will be in nature of royalty. In section 9(1) (vi) of the Act a patent and an invention are two different items. Section 2(m) of the Patent Act, 1970 defines a patent to mean a patent for any invention granted under the Act. Hence, Microsoft computer programmes are inventions and the payment made for the use or the right to use the same would amount to royalty.

++ In appellant’s own case the Delhi High Court granted injunction for infringement of their copyrights. The appellant had enforced their rights under Copyright Act stating that the use of unlicensed/pirated copy of software products involved infringement of copyrights. Thus, the appellant is blowing hot and cold in the same breath by terming software programme as an article for sake of tax payments on one hand and on the other hand terming it as license when it comes to infringement.

Major Implications

++ This decision will have manifold ramifications for importers of packaged software, which are normally done through the licensing route. Till now, the overall view has been that, the import of software licenses is to be treated as ‘business income’ in the hands of the software supplier and consequently, there is no need for deduction of tax at source, under Section 195 of the Income tax Act, in the absence of a permanent establishment of the software supplier. Some of the decisions that have followed this reasoningare, that of the Bangalore Tribunal inVelankani Mauritius Ltd vs. Dy Director of Income Tax (2010-TII-64-ITAT-BANG-INTL) the Mumbai Tribunal in Kansai Nerolac Paints vs. ADIT (ITAT Mumbai) and that of the ARA in Dassault Systems reported in (2010-TIOL-02-ARA-IT) ,wherein, it has been categorically held, interalia, that income from software supply is not “royalty” but is to be treated as “business profits” and consequently, is not taxable in the absence of a permanent establishment.

++ If it is held that payments for import of shrink wrapped software is ‘royalty’, even software procurement transactions outside India could get taxed under the Indian Income tax Act. Can it then be said that the Indian Income tax Act will get an extra territorial nexus?

++ Moreover, the decision does not distinguish between supply of shrink wrapped software packages through the electronic medium and the physical medium. The broad view, till now, has been that, shrink wrapped software packages imported in the physical medium, through the customs stations, are to be treated as ‘goods’. At least, this is the view that is applicable from the point of view of levy of CVD on these imports. Can a different view be taken that, these are services, for purposes of levy of income tax, despite that, these are 'goods' for indirect tax purposes?

++ The decision cannot be made applicable outside of Delhi, as many other Tribunals have taken a different stand. For instance, the, Software importers operating in Karnataka, which perhaps accounts for the bulk of software imports into India, can continue to depend on the jurisdictional Bangalore Tribunal's decision in Velankani Mauritius Ltd v. Deputy Director of Income tax (2010-TII-64-ITAT-BANG-INTL) referred to above, in which it has been held that income from shrink wrapped software cannot be considered as 'royalty' but as 'business profits'.

++ There is little doubt that this decision would create fresh controversies and the Revenue might want to take advantage of this decision, however controversial it might be. Clarity would elude the packaged software industry, till we have a decision from a High Court. But till then, it is confusion and controversies, all around

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