Sum paid to NR to acquire software for in-house use without permission of commercial exploitation is royalty

Summary – The Chennai ITAT in a recent case of F.L. Smidth Ltd., (the Assessee) held that w here assessee remits certain sum to its Danish concern for acquiring a software license without any permission of commercial exploitation thereof, remittance attracts royalty under section 9(1)(vi).

Facts

- The assessee was a 'company' engaged in the business of consulting engineers and architects.
- The assessee had remitted a certain sum in lieu of '2003 Microsoft licensing for 270 sets of MS Office, Windows and Cals'. The assessee remitted this payment without deducting any TDS. The Assessing Officer proposed to treat assessee as the 'assessee in default' under section 201(1).
- The assessee submitted that it had acquired a readymade, non-customized 'shrink wrap software' available in the market only for in-house use without any right to copy, refurnish, sale or display thereof. Thus, the assessee stated that its remittance made did not in any way comprise an income component being incurred towards acquiring and sharing of the software licence.
- However, the Assessing Officer treated the remittee entity as distributor/agent of Microsoft and observed that since both entities were non-residents, TDS had to be deducted even in an instance of forwarding of payments. He treated these payments as 'royalty' under section 9(1)(vi) explanation 2 (i) & (v) as per expressions 'the transfer of all or any rights (including the granting of a license)' used therein. The Assessing Officer also opined that licence in this case was regarding '2003 Microsoft licensing for 270 sets of MS Office, Windows and Cals.' He categorized the assessee's transaction to be including a licenced software and payment thereof as the one for obtaining user licence. He refused OECD Model Convention's applicability by holding that India was not a signatory thereof.
- On appeal, the Commissioner (Appeals) accepted the contentions of the assessee and held that remittance made by the assessee for purchase of software did not partake income in India attracting the provisions of explanation (2) to section 9(1)(vi) and, thus, it was not obligatory on the assessee to deduct tax thereon.
- On further appeal by the revenue:

Issue to be decided

- Whether the assessee's act of acquiring '2003 Microsoft licensing for 270 sets of MS Office, Windows and Cals' amounts to payment of 'royalty' or not?

Held

- At this stage, it is appropriate to refer to the relevant provisions dealing with the concept of 'royalty' in the Act. Section 9 applies in case of a non-resident recipient whose income accrued or arising in India is deemed as taxable unless otherwise provided. Section 9(1)(vi) deals with 'royalty' sums. The assessee, being a resident entity comes within the ambit of section 9(1)(vi)(b). A resident paying 'royalty' is excluded from operation of this deeming fiction of income only in case the said sum is payable in respect of any right, property or information used or services utilized for the purpose of business or profession carried on by such a person outside India or for the purpose of making or earning any income from any source outside India. The assessee carries its business in India. Therefore, it is out of the purview of this 'exclusion' clause.

- Thereafter come the first and second proviso and explanation 1. They are not attracted in the present case. Only *Explanation* 2 (clauses (i) to (vi)) defines 'royalty', *Explanation* 3 [inserted by the Finance Act, 2001 with effect from 1-4-2002] elaborates a 'computer software', *explanation* 4 [inserted by the Finance Act, 2012 with effect from 1-6-2006] clarifies 'transfer', *explanations* 5 & 6 clear the air about 'royalty' *vis-à-vis* controlling possession of the right, its direct or indirect use and location thereof. Lastly, *explanation* 6 removes doubts about the expression 'process' used in this specific 'royalty' related provision.
- Article 1 of the Indo-Denmark DTAA dated 25-9-1987 clarifies that royalties and fee for technical services arising in a Contracting state and paid to the resident of the other Contracting state may be taxed in that other state. Article 2 defines the rate of tax on a 'royalty' paid to be at the rate of 20 per cent of the gross amount. Article 3 defines a 'royalty' as payment of any kind received as a consideration for the use of, or the right to use ……. Article 4 pertains to 'fee for technical services'. The same is irrelevant herein. Article 5 excludes operation of articles 1 & 2 if the beneficial owner of the royalties or fee for technical services being a resident of a Contracting state, carries on business in the other Contracting state in which the royalties or fee for technical services arise, through a permanent establishment……. This article further clarifies that in the latter instance, articles 7 and 15 would govern the situation. In view thereof, it emanates that the recipient/beneficial owner in the present case is Microsoft, USA. The remittee is only placing indent for all its group concerns for appropriate internal arrangement and convenience. Therefore, article 5 of this DTAA does not help the assessee as operation of articles 1 & 2 is only excluded when the beneficiary of the royalty is resident of the other Contracting state. Thus, the DTAA clauses support the revenue *qua* taxability of the 'royalty' element in India.
- In order to get a clarity on the issue, various case laws submitted by the parties were analysed and it was held that the assessee has paid a 'royalty' sum to its Denish group concern in lieu of acquiring software licence for '2003 Microsoft licensing for 270 sets of MS Office, Windows & Cals'. Undisputedly, the granting of licence is already included as a right in explanation 2 clause (i) and (v). These clauses form part of the 'royalty' provision since its coming into being. This licence would also enable the assessee to make use of the 'shrink wrap software' availed. In these circumstances, the following two case laws would squarely apply in the instant case.

  (i) *CIT (IT)* v. *Samsung Electronics Co. Ltd*. [2012] 345 ITR 494/203 Taxman 477/16 taxmann.com 141 (Kar.) wherein it was held that when licence is granted to make use of the software by making copy of the same and to store it in the hard disk of the designated

computer and to take back-up copy of the software, it is clear that what is transferred is right to use the software, an exclusive right, which the owner of the copyright, *ie*., the respondent-supplier owns and what is transferred is only right to use copy of the software for the internal business as per the terms and conditions of the agreement. Thus, but for the licence agreement, infringement of user terms would violate the copyright law.

(ii) Further in *CIT* v. *Synopsis International Old Ltd*. [2012] 28 taxmann.com 162/212 Taxman 454 (Kar.) their lordships explained in a very wider sense the outcome of granting of a licence and held that in modern day technology world the same grants an authority to a particular thing. It enables a person to do something lawfully what is not otherwise authorized and lawful to do so. It was observed that a licence is no more than the right to do the thing actually licenced to be done. Per their lordships, a licence transfers interest to a limited extent. They have held that in software technology, a licence is one of the right of a copyright which entails payment of 'royalty'. It has been categorically held that for attaining or obtaining a licence, an exclusive right is not required.

- Thus, taking into consideration the nature of software technology availed, invoice raised specifically quoting only licence and right of usage embedded therein. The issue was decided in the revenue's favour.
- Further the Commissioner (Appeals) view that this transaction pertained to sale of 'goods' does not refer neither to any statutory provision nor evidence on record. Admittedly, the present case involves only a licence pertaining to 'shrink wrap software'. There is no material to prove any 'goods' element in the '2003 Microsoft licensing for 270 sets of MS Office, Windows and Cals'.
- The Commissioner (Appeals) next finding that the assessee has merely followed a cost sharing formula is also immaterial. The cost sharing formula or any other method is only an internal arrangement. In determining 'royalty' payment, we have to refer to facts of the case *vis-à-vis* the statutory provision. Since the said conditions therein are satisfied, it was held that this formula in itself cannot defeat applicability of the TDS provision. Further, whatsoever may be the medium or mode of acquiring the licenced right, the fact remains that the assessee has acquired a licence to use the Microsoft Office software. Its claim that it is merely a copy of the copyrighted article does not make any difference. Therefore, the assessee ought to have deducted TDS for acquiring '2003 Microsoft licensing for 270 sets of MS office, Windows and Cals' in question. Thus, the assessing authority has rightly raised demand under section 201(1) and interest under section 201(1A).
- Furthermore, the revenue's additional ground that since the assessee had made payment to a non-resident, it ought to have followed the procedure laid down in section 195 does not deserve acceptance. As per case law of *GE India Technology Centre (P.) Ltd*. [2010] 327 ITR 456/193 Taxman 234/7 taxmann.com 18 (SC), section 195 come into pay only when the sum paid to the non-resident contains wholly or partly sum chargeable under the provisions of the Act. Their lordships have held in very clear terms that in absence of this element, there is no question of any tax deduction at source. Accordingly, this additional ground is rejected.