Effect of amendment to the Act can't be given to DTAA unless corresponding amendment is also made to DTAA

Summary – The Mumbai ITAT in a recent case of Galatea Ltd., (the Assessee) held that Consideration received by assessee for sale of software claimed to have been supplied as part of machine to end user is not royalty under article 12 of DTAA between India and Israel

Amendment made in section 9(1)(vi) by way of insertion of an Explanation by Finance Act, 2012, for extending scope of term 'Royalty', shall not be read into provisions of article 12.3 of Indo-Israel tax treaty as amendment made in provisions of Act cannot be automatically read into articles of treaty unless corresponding amendment is made in treaty also

Where assessee sold to its customers machines and operating software, however, there was no transfer of copyright or any rights therein nor was there any situation giving rise to any type of infringement of copyright by customers of assessee, sales consideration received by assessee would not constitute 'Royalty' within meaning of article 12(3) of DTAA between India and Israel

Facts

- The assessee was a company incorporated under the laws of Israel and was tax resident of Israel for the purpose of Indo-Israel DTAA. It was 100 per cent subsidiary of a company in Israel. It had no business connection in India, nor did it have any P.E. in India.
- During the year under consideration, the assessee-company sold to its customers machines and operating software. In the invoice issued by the assessee-company, the consideration was mentioned separately for the machine and operating software. Some of the customers deducted tax at source at the rate of 10 per cent from the payments made by them towards operating software and application software, treating the same as 'Royalty' under article 12(3) of the Israel tax treaty. However, the assessee was of the view that the aforesaid payments made by the customers did not constitute 'Royalty', under the Israel tax treaty and the tax was wrongly withheld by the customers, accordingly, it filed its return of income for the impugned assessment year at *nil* and claimed refund of the tax withheld/deducted by its customers.
- The Assessing Officer treated the same as taxable in the hands of the assessee in India.
- The DRP upheld the action of the Assessing Officer without giving any relief to assessee.
- On appeal to Tribunal:

Held

- The whole dispute arose merely because value of software was separately mentioned. But, there was no separate transaction of sale of software and, therefore, it was predominantly transaction of sale of machine and, therefore, it could not have been brought within the definition of 'Royalty' as envisaged in section 9(1)*(vi)* and, therefore, in the absence of there being any P.E. of the assessee in India, the income arising from sale of machine could not have been taxed in its hands in India.

- The undisputed facts are that none of the customers have purchased only machine or only software. There was no customer who purchased only software. The machine sold by the assessee could not be made operational or functional in the absence of operating software along with the application software. The software supplied by the assessee to end user was for integration with the machine supplied by the assessee and that this software had no other independent use as such, except to enable such machine to function. The End User License Agreement (EULA) entered into by the assessee with the customers wherein there are various clauses which indicate that the software supplied by the assessee was meant only and exclusively for the purpose of making the said machine functional. Clause 2.1 of the agreement provides that customer is granted non-exclusive, non-transferable limited license to use the software and related know-how on the machine for the sole purpose of scanning the internal/external feature of rough diamond and creating a three dimensional image of these features of rough diamond. Clause 2.2 of the agreement puts certain restrictions upon the customers for any other use of the software in any other machine. This clause restrains the customer from duplicating the software or making any copies, modifications, isolating the software and making it available as a standalone data base or product, removing any product identification, copyright or other proprietary notice from the software or decompiling, disassembling, reverse engineering, or making any other attempt to reconstruct or discover the source code, *etc.* This clause clearly lays down that customer shall not reproduce the software or any of the documentation provided in connection with the software or related know-how. It is further noted that clause 6.2 of the said agreement lays down that the assessee is and shall remain sole and exclusive owner of the right, title and interest in the software and related know. This software cannot be used by the customer except for the operation of the machine. It is further noted that the machine was equipped with requisite security controls and hardware locks to stop any type of misuse of software.
- From the aforesaid facts and features of the transactions, it could be concluded that the customer was not interested in the hardware alone or in the software alone. He was interested in the system as a whole and functioning of the machine. Operating software enable the machine to run and the application of software made functioning of the machine possible. It is an undisputed fact that the software which was loaded onto the hardware did not have any independent existence as such. The software supplied was ostensibly and undisputedly an integral part of the hardware. Now, since the hardware and software constituted one integrated system, part of the payment thereof cannot be earmarked towards sale of hardware and the other part towards 'Royalty' for use of software as such. Thus, the dominant character and essence of the transaction was sale of machine by the assessee. The software, independently, had no value for the customer. He was concerned with as only the functioning of the machine and benefits of use provided by machine.

- The only argument given by the revenue to counter the submissions of the assessee was that in this case, payment was made separately for the software at the time of sale of machine as well as subsequently and that software was provided by e-mail and, therefore, separate treatment should be given to the software. However, this argument of the revenue would not be sustainable under the law. The dominant and fundamental character of the transaction shall not be altered because of these two features only. The break-up of invoice value of hardware and software may be as a result of some other legal requirement or as a matter of convenience or an agreement between buyer and seller. It has been submitted that separate values were given for the purpose of proper assessment of custom duty to be levied at the time of imports of the machines. Further, software has been supplied separately by e-mail for various security reasons and to enable the customer to have the benefits of updated technologies. Similarly, separate payments have been made at the time of sale and subsequently by customer as a matter of terms between both the parties keeping in view various factors such as financial and administrative convenience and commercial expediency. The dominant and essential character of the transaction was sale of machine by the assessee and purchase of the same by the customer, and it shall remain the same with or without these two features.
- From various judgments, it is clearly evident that Courts have held that where software is supplied predominantly as part of an equipment and if the software loses its identity and the equipment takes over the main objects of the transaction then it has to be treated as transaction of sale and purchase of machine and not as transaction for sale and purchase of software. It has already been established on the basis of facts that the transaction involved in this case was that of sale of diamond scanning machine. The customer had no interest in the software except to the extent of effective functioning of the machine. Thus, it has to be treated as transaction of sale of machine in the hands of the assessee and the amount bifurcated for software cannot be treated differently as consideration in the nature of 'Royalty' as envisaged under section 9(1)*(vi)* and since the assessee has no P.E. in India, as per admitted facts on record, the amount of profit arising on receipt of sale consideration of machine would not be liable to be taxed in its hands in India.
- It has also been examined that in case there is some conflict between the provisions as contained in articles of tax-treaty and provisions of the Act then whatever course is beneficial to the assessee in terms of determination of its tax liability, the same should be allowed to be followed by the assessee as per well accepted position of law. It has been further submitted that if the amendment has been made in the provisions of the Act, the same shall not be automatically and by implication imported into the articles of the treaty unless of course a corresponding amendment is made in the tax treaty as well. It was thus submitted that amendment made in section 9(1)*(vi)* by way of insertion of an *Explanation* by Finance Act, 2012, for extending the scope of the term 'Royalty', shall not be read into the provisions of article 12.3 of the Indo-Israel tax treaty incorporated in the treaty for explaining meaning of the term 'Royalty'.

- In terms of section 90(2), provisions of the Act or the treaty, whichever is more beneficial shall apply to the assessee. Further, amendment to the Act cannot be automatically read into the treaty unless the treaty is also amended.
- Thus, the provisions of Indo-Israel treaty would be preferred over the provisions of the Act, since there is no amendment in the treaty and the department is seeking to put more tax liability upon the assessee taking help of amendment made in section 9(1)*(vi)*.
- The provisions of article 12 of India Israel tax treaty defines the term 'Royalty'. Article 12(3) has revised this term 'Royalty' to mean payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph film, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.
- Thus, the status of the provisions in the treaty is kept same as was in the pre-amended law as contained in the provisions of the Act. According to these provisions of the treaty, as has been explained in various judgments, transfer of copyright is different from transfer of copyrighted article. Thus, in view of the above facts, even if payment for software is taxed separately from hardware, on a standalone basis, even then the same would not fall within the scope of article 12(3) since there was merely transfer of a copyrighted article, and not the copyright or any rights contained therein. This position is substantially clarified once we go through various clauses of agreement entered into by the assessee with the customers called as End User License Agreement. The effect of the various clauses of these agreements has already been discussed and explained in earlier part of the order.
- It is further noted that the aforesaid position, as contained in the pre-amended law or as contained in article 12(3) of the Act tax treaty has been discussed at length by various Courts of the Country.
- From the various judgments, it can be safely concluded that if the assessee cannot be fastened with the tax liability taking shelter of provisions of tax treaty, then the same cannot be imposed by applying the provisions of the Act by disregarding and overriding the provisions of the treaty.
- Further, for the purpose of appreciating scope and meaning of article 12(3) of Indo-Israel DTAA in the context of impugned transactions done by the assessee, the provisions of Copyright Act, 1957, in India have also been analysed to examine whether there was any transfer of copyright or rights therein, in the given facts of this case, by the assessee to its customers in India.
- In this regard, section 14 of the Copyright Act, 1957 explains and defines the meaning of term copyright. From the perusal of definition of section 14 it is evident that none of the clauses is attracted when assessee has sold the machine along with its requisite software to operate and use the machine. The assessee has not given any right, whatsoever, to its customers to resell any copy of the software supplied along with machine, as has been discussed. The other arguments made on behalf of the revenue is that the customers were supplied the software through e-mail and other electronic medium and they had also made copies of the software programme for the purpose of loading the machine and creating back-up files. It is noted that even this apprehension of the

revenue has been taken care of by the Copyright Act. Section 51 lists out those situations 'when copyright is infringed or deemed to be infringed. Further, section 52, carves out exception to section 51 and lists out certain acts not to be considered as infringement of copyright. It is clear that if customer makes requisite copies to enable it to use the software for exclusively its own purposes or makes back-up copies purely as a temporary protection against loss, in order only to utilize the computer programme for the purpose for which it was supplied, then section 52 clearly states that it shall not amount to infringement of the copyright. Thus, in the facts of this case, neither there was any transfer of copyright or any rights therein nor there was any situation giving rise to any type of infringement of copyright by the customers of the assessee. Thus, account of sales consideration received by the assessee on account of sale of machine along with operating software would not constitute 'Royalty' within the meaning of article 12(3) of the Indo-Israel DTAA.

- Apart from that, the Supreme Court has observed time and again in some of its judgments that where two views are available, then the view favourable to the assessee should be followed, in the interest of justice and harmony.
- Although, the stand of the revenue has been that there were two views available on this issue but in the facts of the case, the latest views coming from Delhi High Court and other Courts are leaning more towards the views in favour of the assessee on the issue and, therefore, under such circumstances and in the interest of justice and fairness more recent judgments have been followed.
- It is clarified and reiterated that the effect of subsequent amendment to section 9(1)*(vi)* has not been examined and also whether the amount received for use of software would be 'Royalty' in terms thereof for the reason that the assessee is covered by tax treaty the provisions of which are more beneficial and also for the reason that in this case transaction under consideration was predominantly and essentially of the character of sale and purchase of machine and not that of software.
- Thus, it is held that the amount received by the assessee was not liable to tax as 'Royalty' and therefore addition made by the Assessing Officer is directed to be deleted.