*IN THE HIGH COURT OF DELHI AT NEW DELHI

% Judgment reserved on : 3rd July, 2013
Judgment pronounced on:22nd November, 2013

+ **ITA 1034/2009**

DIRECTOR OF INCOME TAX ..... Appellant

Through Mr. Sanjeev Sabharwal, Advocate.

versus

INFRASOFT LTD. ..... Respondent

Through Mr. Ajay Vohra with Mr. Somnath Shukla, Advocates.

CORAM:
HON'BLE MR. JUSTICE SANJIV KHANNA
HON'BLE MR. JUSTICE SANJEEV SACHDEVA

SANJEEV SACHDEVA, J.

1. This is an appeal under Section 260A of the Income Tax Act, 1961 (hereinafter referred to as the "Act") filed by the Revenue impugning order dated 19.12.2008 passed by the Income Tax Appellate Tribunal (hereinafter referred to as "ITAT")

2. Vide order dated 20.10.2009, the following

substantial questions of law were framed:

> "1) Whether the learned ITAT erred in holding that nature of receipts amounting to Rs. 2,74,00,630/- was business income and not royalty income wherein the meaning of Section 9(1)(vi) read (SIC) with Article 12 of Indo-US-DTAA?
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> 2) Whether supply of software on license is royalty/included services within the meaning of Section 9(1)(vi) / Article of Income Tax Act / Indo-USA-DTAA?"

3. On 03.07.2013, the counsel for the respondent Assessee submitted that he was not relying upon Section 9(1)(vi) of the Income Tax Act and in view of the statement made by the counsel, we on 03.07.2013 held that Explanation 4 to Section 9(1)(vi) of the Income Tax Act, 1961 need not be examined and applied. Reference was also made to the judgment of the Supreme Court in ***UNION OF INDIA VS. AZADI BACHAO ANDOLAN (2003) 263 ITR 706***. In view of what

transpired on 03.07.2013, with respect to the examination and applicability of Section 4 to Section 9(1)(vi), the second issue framed on 20.10.2009, does not arise for consideration and is thus not dealt with in the present judgment. The substantial Question of law framed on 20.10.2009 was recast as under:

> "Whether the Income Tax Appellate Tribunal was right in holding that the consideration received by the respondent Assessee on grant of licences for use of software is not royalty within the meaning of Article 12(3) to the Double Taxation Avoidance Agreement between India and the United States of America?"

4. The respondent/Assessee is an international software marketing and development company of an international group. The holding company is based in US being Infrasoft Corporation.

5. The Assessee M/s Infrasoft Ltd. is primarily into the

business of developing and manufacturing civil engineering software. One such software, which is subject matter of the present controversy, is called MX. The said MX software is used for civil engineering work and for design of highways, railways, airports, ports, mines, etc. The said software is used by private consultants.

6. In view of the market position, the Board of the Assessee Infrasoft Limited opened a branch office in India. The branch in India imports the package in the form of floppy disks or CDs depending on the requirements of their customers. The system is delivered to a client/customer. The delivery of the system entails installation of the system on the computers of the customers and training of the customers for operation of the system. The branch office further undertakes the responsibility of updation and operational training apart from providing support for solving any software issues. The respondent

Assessee develops customized software to be used by the customers for designing highways, railways, airports, ports, mines, etc. The software so customized is then licensed to an Indian customer and the branch office of the Assessee in India perform services involving interface to peripheral installation and training etc.

7. On 28.11.2003, the respondent Assessee vide its return of income, declared a loss of Rs.21,75,246/-. The same was assessed under Section 143(3) of the Act on 31.01.2006. The assessment order was framed by the Assessing Officer (hereinafter referred to as the "AO") whereby the Assessing Officer taxed the receipts on sale of licensing the software as "royalty" as per Article 13 *(Sic Article 12)* of Indo-US Double Taxation Avoidance Agreement. Under Section 44D read with Section 115A of the Income Tax Act, the Assessing Officer brought the aggregate amount of Rs.2,85,76,278/-, received by the Assessee during the

year under consideration to tax at 20%.

8. The AO issued a show cause notice to the Assessee company requiring them to show cause as to why the receipts shown by the Assessee company from sale/licensing of software, having referred to the nature of service rendered by the Assessee company, should not be taxed as royalty as per Article 13 *(Sic Article 12)* of DTAA and Section 44D read with Section 115A of the Act.

9. In reply to the said show cause notice, the Assessee company relying on the judgment of the Supreme Court in the case of ***TATA CONSULTANCY SERVICES VS. STATE OF ANDHRA PRADESH (2004) 271 ITR 401 (SC) (BCAJ) (2005) 1 SCC 308*** stated that the moment copies of software programmes were made and marketed, the same become goods which were chargeable to sales tax. The Assessee company further contended that when the software were goods

as held by the Supreme Court in the said case, the Assessee company would be entitle to deduction of purchase cost of software as well as other expenses incurred and the net profit alone could be taxed as business profit as per Article 7 of DTAA between USA and India. The Assessee company further objected to the show cause notice contending alternatively that even if the receipts were to be treated as royalties or even for technical services, the same having arisen through a permanent establishment in India, it was chargeable to tax as business profit as per the said Article 7 of DTAA. The Assessee further contended before the AO that Section 44D inserted by Finance Act, 2003 w.e.f 01.04.2004, making all the expenditure incurred for earning royalty or fee for technical services allowable, was liable to be given retrospective application to the case of the Assessee for the Assessment Year 2003-04 as that was the legislative intent behind insertion of the said provision.

10. The AO rejected the contention of the Assessee company. With respect to the decision of the Supreme Court in ***TATA Consultancy Services (supra),*** the AO distinguished the said judgment holding that the same had been rendered in the context of the Sales Tax Act and was applicable in terms of the definition of "goods" as given in the Sales Tax Act and was in the context of deciding whether the software recorded on the computer disk was covered within the said definition of goods or not. In the context of the facts of the case as per the AO, the said judgment was not applicable.

11. With regard to the definition of royalty as given in Section 9 (1) (vi) of the Act as well as Article 12 of the DTAA, the AO came to the conclusion that the amount received by the Assessee company from sales/licensing of the software was royalty in terms of the said definition. The reasoning of the AO to arrive at this conclusion is as under:-

"(i) The software is licensed not sold. The copyright of the software remains with the Assessee however it allows the use of copyright to the person making payment to it. As per the Indian Copyright Act 1957 as amended in 1994 software are entitled to copyright protection. The Assessee possesses Copyright in the software, which it can enforce in India if any violation of such right is notices by it. Further the Indian Copyright Act recognizes 'copyright' as doing or authorizing the doing of any of the following acts in respect of a work or any substantial part thereof namely, - in case of a computer programme to sell or give on commercial rental or offer for sale or for commercial rental any copy of the computer program. It is therefore clear that the Assessee has authorized to use of the copyright of the customer in India.

(ii) The software owned by the Assessee is patented software. Consideration for allowing the use of the patented article falls within the definition or royalty payment. Even if it is

considered that the software owned has not been patent, there is no denial of the fact that it is essentially an invention. The development of such software requires highly technical manpower, with highly sophisticated infrastructure and huge investments. Similarly, the software can also be considered as a scientific work. Therefore, the software can also be said to be information developed out of scientific experience.

(iii) The payment is also qualified for the use of secret formula or process. The software developed by Infrasoft when installed in a computer responds to every instruction in a specific way. It recognizes the command and as per its programming yields the desired result and reflects the same on the output devices. This argument is further strengthen from the fact that cost of the medium viz. computer discs, floppy etc., on which the program is written is negligible as compared to the overall price of software. Had it not been a secret programming, anybody could have written

these types of programs and sold it at a very low price as compared to the price of the original software.

(iv) The software developed by infrasoft is customizing software which are used for specific purposes like design of highways, railways, airport, port, mines etc. This software are purchased by private consultant or end users and they further exploits for commercial purposes. This clearly falls under definition of 'royalty'."

12. In view of the above reasoning, the AO treated the entire amount received by the Assessee Company for transfer of software as well as other incidental services towards installation of software, imparting of training etc. in the nature of royalty. He further held that since the royalty income had accrued/arisen to the Assessee Company through its PE in the form of branch office in India, the same was chargeable to tax in India as per Article 13 (vi) *(Sic Article 12 (vi))*of the

DTAA. He held that though the royalty income was liable to be taxed as business profit under Article 7 of DTAA, the expenses incurred for earning the said income were to be allowed as per domestic law and as per him, since Section 44D was applicable to the Assessment Year 2003-04 specifically prohibited any allowance for such expenditure, the entire amount received by the Assessee as royalty was thus chargeable to tax @ 20% of the gross receipts as per the provisions of Section 44D read with Section 115A of the Act. The AO thus brought the aggregate amount of Rs.2,85,76,278/- received by the Assessee during the year under consideration to tax @ 20%. The AO thus framed the assessment under Section 143(3) vide his order dated 31.01.2006.

13. Aggrieved by the order of the AO, the Assessee filed an appeal before the Commissioner of Income Tax (Appeals) (hereinafter referred to as the 'CIT (A)'). The

main grounds raised by the Assessee company against the said order were as under:-

(i) The programme software was goods in terms of the judgment in the case of ***TATA CONSULTANCY SERVICES (SUPRA);***

(ii) The payment received by the Assessee company was payment for copyrighted article and not copyrighted right and thus could not be assessed as royalty under Article 13 *(Sic Article 12)* of DTAA;

(iii) The provision of DTAA override the provision of Income Tax;

(iv) The right to use a copyright was totally different from the right to use a programme embedded in a software;

(v) There was no transfer of right in a copyrighted article;

(vi) The Assessee company carried on business in India through a permanent establishment and thus Article 13(vi) of the

Indo-UK Convention was not applicable but in fact Article 7 was applicable;

(vii) Section 115A could not be applied as the receipts were not royalty and since the receipts were not taxable as royalty and fee for technical services, the same could not be subjected to tax under Section 44D read with Section 115A.

14. The CIT(A) vide the order dated 10.01.2008, rejected the submissions of the Assessee company. The CIT(A) in his order noted that the Assessee company was engaged in licensing of MX software which is an engineering friendly tool for designing all types of road projects to Indian customers. He noted the clarification on behalf of the Assessee company that the standard MX software needed to be customized depending on the country-wise, project-wise and customer specific requirements and that the software was supplied by the Assessee company to customers in India only after such customization to include Indian standard of road

construction and project specific requirements of the Indian customers. On the issue of the Assessee company having PE in India in the form of a branch office, the CIT(A) noted that there was no dispute that the branch office of the Assessee company had been opened in terms of the approval granted by the Reserve Bank of India and constituted a PE in India.

15. The CIT(A) examined a sample representative agreement between the Assessee company and one of its Indian customers for software licensing and maintenance to ascertain the exact nature and character of income received by the Assessee company in India on account of supply of software, annual maintenance charges and training fee amounting to Rs.2,74,00,630/-, Rs.9,25,648/- and Rs.2,50,000/- respectively. After referring to the relevant terms and conditions of the said agreement, the CIT(A) came to the conclusion that the Assessee company had transferred certain rights to the Indian

customers to use software at certain locations for fixed licence fee. The CIT(A) noted that the amounts received by the Assessee company were in lieu of the following services rendered by it:

> "(a) that appellant had transferred certain right in respect of copyright of software to Indian customers.
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> (b) that appellant had charged 'Licence Fee' for supply of software as evident from terms and conditions of 'Licence fee' agreement. It is pertinent to mention here that no where under the agreement words 'sale consideration' were used.
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> (c) that appellant had granted licence to Indian customer to use the software in lieu of the payment.
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> (d) that appellant had also received payment in lieu of software maintenance service which included provisions of updates and user support services to customers.

(e) that appellant had also received payment in lieu of training services rendered to Indian customers."

16. The CIT(A) held that what was taxed as royalty was the amount received as consideration for the use or right to use and not outright purchase of the right to use an asset. He held that the royalty was a consideration including a lump sum consideration for transfer of all or any right (including the granting of a licence) in respect of a copyright, patent, trademark, design and modal or secret formula etc. According to the CIT(A), there are two types of transfers, one is transfer of "right in the property" and transfer of "right in respect of property". He held that these two transfers were distinct and had different legal effects. In one, right for purchase while in other, no purchase is involved. He relied on the decision of the Calcutta High Court in the case of ***CIT VS. DAVY ASHMORE INDIA LTD. (1991) 190 ITR 626***, wherein it was held that

where a transferee retains the property rights in a design, secret formula etc. and allows the use of such rights, the consideration received for such user was in the nature of royalty and where there is an outright sale or purchase, the consideration is for transfer of such design, secret formula etc. and could not be treated as royalty. The CIT(A) finally held that the amount received by the Assessee Company from its Indian customers under software licence agreement was in the nature of royalty and same was chargeable to tax in India as per Explanation 2 to Section 9(1)(vi). The CIT(A) rejected the plea of the Assessee company wherein the Assessee company had relied on the revised OECD commentary to contend that only transfer that enabled a transferee to commercially exploit a software copyright gave rise to royalty income and as only limited right to use the software had been transferred, the amount received for such limited use was not royalty income. The CIT(A)

rejected the contention of the Assessee company holding that OECD had given a very conservative interpretation of the word "used" and the same was not applicable in the facts of the case of the Assessee company. The CIT(A) noted that the said revised OECD commentary on software payment had not been accepted even by some of the OECD member countries and was not applicable in India since India was not even a member of OECD and specially when the Indian High Powered Committee had expressed its reservation in characterization of the software payment in the said country. With regard to the reliance of the Assessee company on the judgment of the Supreme Court in the case of ***TATA CONSULTANCY SERVICES (SUPRA),*** the CIT(A) held that though the transfer of right to use a good was not sale in its traditional sense but the same was held to be sale on the expanded definition given in the relevant Sales Tax Act, wherein such transfer was treated as deemed

sale. He held that different statutes or different phraseologies treat the same transaction differently and thus it was not permissible to import the meaning assigned in one statute into the different statues.

17. The CIT(A) rejected the contention of the Assessee company and held the receipts to be royalty income and concluded as under:-

> "4.8.1 As per provisions of section 9(1)(vi) the royalty income should satisfy twin conditions that there has to be consideration, and this consideration should be for transfer of all or any right (including the granting of the licence) in respect of the copyright, patent, invention, design, secret formula or process, scientific work. In this case the payment under software license agreement has fulfilled both the conditions and the income from software license was taxable in India as royalty.
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> 4.8.2 As per provision of section 9 the payment made for import of software are

royalty payment and the only exception provided is in the form of second proviso to section 9(1)(vi) of the Act which excludes such royalty income from purview of section 9(1)(vi) only when the computer software is supplied by a non-resident manufacturer along with computer or computer based equipment under any scheme approved under the policy of computer software export, software development and training 1986 of the Government of India. However, this exception is not applicable to the facts of this case where appellant had granted software licence to various Indian customers.

4.8.3 The characterization taxability of income from import of software has been made amply clear in the Income Tax Act through section 115A of the Act which specifically refers to cases where royalties are paid to non—resident for the transfer of all or any right (including the granting of the license) in respect of any computer software to a person resident in India.

4.8.4 A copy of software supplied by the appellant did not amount to a sale but it is a licence to use the software. This is because software is an intellectual property right (IPR) which can be licensed to one use and can be given further to any number of user. In other words the IPR in software still remain intact with the supplier. Thus effectively the consideration paid is only for license use. It is pertinent to mention here that the Finance Act, 2004 has inserted Category No.55B to include intellectual property services" to mean.

"(a) transferring whether permanent or otherwise or

(b) permitting use or enjoyment of any intellectual property right"

for levy of service tax. This amendment has been noticed by the CESTAT in Araco Corporation v. CCE [2005] (180) ELT 91 (Tri-Bang).

4.8.5 By the expedient of "deeming

fiction" or inclusive definition" Parliament and State Legislatures are competent to give a specific definition to a particular transaction. Such definition is confined to the specific statute only. Such definition cannot be imported into a different statue which defines the same transaction differently. The necessary corollary is that "sales treatment: of computer software under sales tax law, does not, per se, influence income-tax treatment of software transactions, as income-tax law defines this transaction differently.

4.8.6 OECD recommendations remain mere recommendations unless they are incorporated into domestic law and/or DTAAs. The distinction between "copyright right" and "program copy" recommended by the OECD has been dissented from even by several member of the OECD. Indian laws and India's DTAA recognize only two types of transactions in respect of computer software sale and licence (letting). No further dissection of licensing (on the lines of the OECD

> commentary) is permitted under the Indian Copyright Act, Income-tax Act and Indian DTAAs. Therefore, notwithstanding attractive phraseology and nomenclature, any computer software licence fees, where the vendor retains ownership and grants user rights only to the licensee are, without an iota of doubt, taxable as royalties having an Indian source."

18. On the basis of the findings/observations recorded by him, the CIT(A) held the income earned by the Assessee company from software licence is in the nature of royalty both under the domestic law and the DTAA and thus upheld the order of the AO holding the Income from software licence chargeable to tax in India as royalty under Section 9(1)(vi) of the Income Tax Act, 1961 read with Article 13 *(Sic Article 12)* of the DTAA.

19. Aggrieved by the order of the AO as confirmed by the CIT(A), the Assessee Company filed an appeal before the Income Tax Appellate Tribunal (ITAT for Short).

The ITAT noted that the amount received by the Assessee company had been treated as royalty income by the AO and the CIT(A) on the basis of Explanation 2 to Section 9(1)(vi) of the Act holding that there was transfer of some rights (including the granting of a licence) in respect of the copyright. The ITAT noted the stand of the Assessee company that there was no transfer of any right in respect of copyright by the Assessee and it was a case of mere transfer of a copyrighted article. The ITAT noted that if the payment received by the Assessee Company was for a copyright then it would classify as royalty both under the Income Tax Act, 1961 and under the DTAA. However, if the payment was for a copyrighted article then it would represent the purchase price of an article and could not be considered as royalty either under the Act or under the DTAA. The Tribunal noted the decision of a Special Bench of ITAT in the case of ***MOTOROLA INC., ERICSON RADIO SYSTEM AB** AND **NOKIA***

NETWORKS OY VS. DEPUTY CIT (2005) 147 TAXMAN 39 (DEL.). The Tribunal noted that the Special Bench of ITAT referring to the definition of "copyright", as given in Section 14 of the Copyright Act, 1957, had noted that the right mentioned in sub-clause (ii) of clause (b) of Section 14 was available only to a computer programme and if the licensees did not have any of such rights, as mentioned in clauses (a) and (b) of Section 14, it would mean that they did not have any right in the copyright and in such cases, the payments made to them could not be characterized as royalty under the Act for DTAA. The ITAT noted that the Special Bench of the Tribunal in the case of ***MOTOROLA INC. (SUPRA)***, had held that since the licensees were not allowed to exploit the computer software commercially, they had acquired under licence agreement, only the copy righted software which by itself was an article and not any copyright therein. The ITAT relying on the judgment in the case

of ***MOTOROLA INC. (SUPRA),*** noted that in the case of the Assessee company, the licensee to whom the Assessee company had sold/licensed to the software was allowed to make only one copy of the software and associated support information for backup purposes with a condition that such copyright shall include Infrasoft copyright and all copies of the software shall be exclusive properties of Infrasoft. Licensees was allowed to use the software only for its own business as specifically identified and was not permitted to loan/rent/sale/sub-licence or transfer the copy of software to any third party without the consent of Infrasoft. The licensee had been prohibited from copying, de-compiling, de-assembling, or reverse engineering the software without the written consent of Infrasoft. The ITAT further noted that the licence agreement between the Assessee Company and its customers stipulated that all copyrights and intellectual property rights in the software and copies made by the

licensee were owned by Infrasoft and only Infrasoft had the power to grant licence rights for use of the software. The ITAT further noted that the licence agreement stipulated that upon termination of the agreement for any reason, the licencee shall return the software including supporting information and licence authorization device to Infrasoft.

20. The ITAT further noted that the CIT(A) had distinguished the judgment in the case of ***MOTOROLA INC.(SUPRA)*** on the basis that the Assessee had purchased an integrated electronic switches system consisting of both hardware as well as software whereas in the present case, there was a licence of only the software without there being any sale of integrated hardware. The ITAT further noted that the CIT(A) had not dealt with the aspect of the rights granted to the licensees as had been specifically noted in the case of ***MOTOROLA INC. (SUPRA).***

21. The ITAT further noted the decision of the ITAT Bangalore Bench in the case of ***SAMSUNG ELECTRONIC COMPANIES LTD. VS. INCOME TAX OFFICER (2005) 276 ITR PAGE 1 (BANGALORE),*** wherein the Tribunal came to the conclusion that the incorporeal right to the software i.e. copyright had remained with the owner and the same was not transferred to the Assessee. The Tribunal in the case of ***SAMSUNG ELECTRONICS (SUPRA)*** had held that the right to use of a copyright is totally different from the right to use a programme embedded in a cassette or a CD which may be a software and the payment made for the same could not be said to be received as consideration for the use of or right to use of any copyright to bring it within the definition of royalty as given in the DTAA. It was held that what the Assessee had acquired was only a copy of the copyrighted articles whereas the copyright remained with the owner and the Assessee had acquired a computer programme for being used in its

business and no right was granted to the Assessee to utilize the copyright of a computer programme and thus it was held that the payment for the same was not in the nature of royalty.

22. The ITAT noted that the CIT(A) had distinguished the case of ***SAMSUNG ELECTRONICS (SUPRA)*** on the basis that the software licenced by the Assessee in the case of ***SAMSUNG ELECTRONICS (SUPRA)*** was off the shelf software whereas the software in the case of the Assessee Company required to be customized to meet the needs of an Indian customer. The ITAT held that the customization of the concerned software or the professional services rendered by the Assessee company for such customization had not resulted in any material change in the terms and conditions of the licence agreement or in the relationship between the Assessee as an owner of the software and a licensee to whom the right to use the said software was given by the Assessee company. The ITAT noted that the

software provided by the Assessee Company was basically a standard software and the customization so done to the limited extent as per the specific requirements of the customers did not bring about any change in the nature of the software or the licence granted to the customers.

23. The ITAT further held that the case of the Assessee Company was clearly covered by the decisions of the Tribunal in the case of ***MOTOROLA INC. (SUPRA)*** AND ***SAMSUNG ELECTRONICS (SUPRA).*** Following the said decisions, the ITAT held that the amount received by the Assessee under the licence agreement for allowing the use of the software was not royalty either under the Income Tax Act or under the DTAA. The ITAT set aside the order of the CIT(A) and restored the matter to the file of the AO with a direction to reframe the assessment in terms of the said decision.

24. Aggrieved by the decision of the ITAT dated 19.12.2008, the Revenue has filed the present appeal.

25. Learned counsel for the appellant/revenue has submitted that the Assessee Company had received amounts under the software licence agreement and the said amounts were in the nature of royalty and were chargeable to tax in terms of Section 9(1)(vi) of the Act. He further contended that the right to use of software under the software licence agreement resulted in earning of royalty income and was thus chargeable to tax in the hands of the Assessee company as royalty income under Article 12 of the relevant DTAA. He further contended that in the present case, there was no sale of the software but it was mere licence to use the software and as such, the receipt from such a sale was receipt towards royalty. Learned counsel for the appellant/Revenue further contended that royalty was defined in Explanation 2 to Section 9(i)(vi) to include consideration for transfer of

either one or more intellectual property rights mentioned therein and as such, there was no scope for an argument that computer software was not fully covered within the meaning of royalty. He further contended that computer software was one of the intellectual property referred to in the Explanation 2 and transfer of rights therein by the licensor would give right to royalty income.

26. Learned Counsel for the Revenue relied upon the decision of the Andhra Pradesh High Court in the case of **COMMISSIONER OF INCOME TAX VS SAMSUNG ELECTRONICS CO. LTD (2012) 345 ITR 494 (KARN)** to contend that right to make a copy of the software and storing the same in the hard disk of the designated computer and taking backup copy would amount to copyright work under section 14(1) of the Copyright Act and the payment made for the grant of the licence for the said purpose would constitute royalty.

27. Contradicting the stand of the appellant/Revenue, learned counsel appearing for the Assessee company/respondent submitted that what was transferred was neither the copyright in the software nor the use of the copyright in the software, but what was transferred was the right to use the copyrighted material which was clearly distinct from the rights in a copyright. Learned counsel contended that no doubt, if right to use the copyright had been transferred, the same would give rise to royalty. But where right that is transferred is not a right to use the copyright but is only limited to the right to use the copyrighted material, the same would not give rise to any royalty income and would be business income.

28. We have examined the rival contentions of the parties and are of the view that there is no infirmity in the impugned order and what has been transferred is not copyright or the right to use copyright but a limited

right to use the copyrighted material and does not give rise to any royalty income.

29. In the present day global economy it is not unusual for an individual or a business entity to operate commercially in more than one countries. When an individual or business entity which is resident in one country makes a taxable gain in another country the said individual or entity may be obliged by the domestic laws to pay tax on the income locally as well as in the country in which the income was so earned. The result of such a situation is that an individual or entity may become liable to double taxation, one in the resident country and the other in the country in which the income so arises. In this situation both the countries may make the said individual or entity liable to tax with the result that the individual/entity may end up paying tax in both the countries. To avoid such an inequitable situation many nations enter into bilateral double taxation agreements with each other.

30. The bilateral double taxation agreements generally lay down two situations, in the first situation the individual may be required to pay tax in the country of residence and is exempted in the country in which the income arises. In the other situation the country where the income arises deducts tax at source and the taxpayer receives compensation in the form of a foreign tax credit in the country of residence which would entitle the taxpayer to a credit in the country of residence to the extent the income that has been taxed in the country where the income has so arisen. To be able to avail the benefit of foreign tax credit the Assessee has to declare himself (in the country where income has arisen) to be a non-resident.

31. India has comprehensive double taxation avoidance agreements with various countries. The double taxation avoidance agreement that India has entered into with various countries stipulate agreed rate of tax

and jurisdiction on specified types of income arising in a country to tax resident of another country.

32. To resolve the controversy, we would need to examine some of the relevant provisions of the Income Tax Act and the Indo US Double Taxation Avoidance Agreement.

33. Section 90 of the Act, 1961 lays down as under:

> "90. (1) The Central Government may enter into an agreement with the Government of any country outside India or specified territory outside India,—
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> (a) for the granting of relief in respect of—
>
> (i) income on which have been paid both income-tax under this Act and income-tax in that country or specified territory, as the case may be, or
>
> (ii) income-tax chargeable under this Act and under the corresponding law in force in that country or specified territory, as

the case may be, to promote mutual economic relations, trade and investment, or

(b) for the avoidance of double taxation of income under this Act and under the corresponding law in force in that country or specified territory, as the case may be, or

(c) for exchange of information for the prevention of evasion or avoidance of income-tax chargeable under this Act or under the corresponding law in force in that country or specified territory, as the case may be, or investigation of cases of such evasion or avoidance, or

(d) for recovery of income-tax under this Act and under the corresponding law in force in that country or specified territory, as the case may be, and may, by notification in the Official Gazette, make such provisions as may be necessary for implementing the agreement.

(2) Where the Central Government has entered into an agreement with the Government of any country outside India or specified territory outside India, as the case may be, under sub-section (1) for granting relief of tax, or as the case may be, avoidance of double taxation, then, in relation to the Assessee to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to that Assessee.

(3) Any term used but not defined in this Act or in the agreement referred to in sub-section (1) shall, unless the context otherwise requires, and is not inconsistent with the provisions of this Act or the agreement, have the same meaning as assigned to it in the notification issued by the Central Government in the Official Gazette in this behalf.

Explanation 1.—For the removal of doubts, it is hereby declared that the charge of tax in respect of a foreign company at a rate higher than the rate at which a domestic company is chargeable, shall not be regarded as

less favourable charge or levy of tax in respect of such foreign company.

Explanation 2.—For the purposes of this section, "specified territory" means any area outside India which may be notified as such by the Central Government.]

34. Section 90 of the Act gives relief to the taxpayer who have paid the tax to a country with which India has signed the double taxation avoidance agreement. Section 90 confers the power on the Central government to enter into any agreement with the government of another country for granting relief to an Assessee who has paid income tax under this Act and also income tax in that other country and also in respect of income tax which is chargeable under this Act and under the corresponding law of that country. This has been done with a view to promote mutual economic relations, trade and investment and for avoidance of double taxation of income under this Act

as well as the act of the said contracting country. Section 90 (2) lays down that where the Central Government has entered into an agreement with the government of any other country for granting relief of tax or for avoidance of double taxation, then the provisions of this Act shall apply to the Assessee only to the extent that they are more beneficial to the said Assessee. In case the provisions of this Act are more onerous and burdensome then the provisions of this Act would not apply and the Assessee would be governed squarely by the provisions of the double taxation avoidance agreement.

35. Section 91 of the Act lays down as under:

> "91(1) If any person who is resident in India in any previous year proves that, in respect of his income which accrued or arose during that previous year outside India (and which is not deemed to accrue or arise in India), he has paid in any country with which there is no agreement under section 90 for the relief or

avoidance of double taxation, income-tax, by deduction or otherwise, under the law in force in that country, he shall be entitled to the deduction from the Indian income-tax payable by him of a sum calculated on such doubly taxed income at the Indian rate of tax or the rate of tax of the said country, whichever is the lower, or at the Indian rate of tax if both the rates are equal.

(2) If any person who is resident in India in any previous year proves that in respect of his income which accrued or arose to him during that previous year in Pakistan he has paid in that country, by deduction or otherwise, tax payable to the Government under any law for the time being in force in that country relating to taxation of agricultural income, he shall be entitled to a deduction from the Indian income-tax payable by him—

(a) of the amount of the tax paid in Pakistan under any law aforesaid on such income which is liable to tax under this Act also; or

(b) of a sum calculated on that income at the Indian rate of tax;

whichever is less.

(3) If any non-resident person is assessed on his share in the income of a registered firm assessed as resident in India in any previous year and such share includes any income accruing or arising outside India during that previous year (and which is not deemed to accrue or arise in India) in a country with which there is no agreement under section 90 for the relief or avoidance of double taxation and he proves that he has paid income-tax by deduction or otherwise under the law in force in that country in respect of the income so included he shall be entitled to a deduction from the Indian income-tax payable by him of a sum calculated on such doubly taxed income so included at the Indian rate of tax or the rate of tax of the said country, whichever is the lower, or at the Indian rate of tax if both the rates are equal.

Explanation.—In this section,—

(i) the expression “Indian income-tax” means income-tax 73[***] charged in accordance with the provisions of this Act;

(ii) the expression “Indian rate of tax” means the rate determined by dividing the amount of Indian income-tax after deduction of any relief due under the provisions of this Act but before deduction of any relief due under this 74[Chapter], by the total income;

(iii) the expression “rate of tax of the said country” means income-tax and super-tax actually paid in the said country in accordance with the corresponding laws in force in the said country after deduction of all relief due, but before deduction of any relief due in the said country in respect of double taxation, divided by the whole amount of the income as assessed in the said country;

(iv) the expression “income-tax” in relation to any country includes any excess profits tax or

business profits tax charged on the profits by the Government of any part of that country or a local authority in that country.

36. Section 91 of the Act provides relief to the taxpayers who have paid taxes to a country with which India has not signed a double taxation avoidance agreement. This actually gives relief to Assessee in both situations, one where there is a double taxation avoidance agreement with a corresponding country under section 90 and second in cases where there is no double taxation avoidance agreement under section 91. Under the provisions of section 91 a person who has paid tax in any country with which there is no agreement under section 90, would be entitled to deduction from the Indian income tax payable by him of a sum calculated on such doubly taxed income at a lower of the two rates of tax that is Indian rate of tax or the rate of tax of the said country whichever is lower

and in case both the rates are equal then at the Indian rate of tax.

37. In the case of ***DIT v. Rio Tinto Technical Services (2012) 340 ITR 507 (Del)*** the Delhi High Court has held as under:

> Section 90(2) mandates that where the Central Government has entered into a Double Taxation Avoidance Agreement under sub-section (1) for granting relief of tax or, as the case may be, avoidance of double taxation, then in relation to the assessee to whom the agreement applies, the provisions of the Act apply to the extent they are more beneficial to the assessee. In other words, where an article in a Double Taxation Avoidance Agreement and a provision of the Act apply to the assessee, then the article of the Double Taxation Avoidance Agreement or the provision the Act will apply depending upon which one of the two is more beneficial/advantageous to the assessee. The first requirement, therefore, is to see whether the provisions of the Act apply to

a particular transaction undertaken/ income earned by an assessee, which is taxable in India under the Act. In case the transaction/income is not taxable under the Act, the income earned would not be taxed. In case the said transaction or income of an assessee is taxable under the Act, then the provisions of the Double Taxation Avoidance Agreement, if applicable, may be resorted to if they are more beneficial and advantageous to the assessee, i.e., if they negate or reduce the tax liability. In ***AZADI BACHAO ANDOLAN (SUPRA)*** after referring to the said section it has been held (pages 722 and 724) :

> "The provisions of sections 4 and 5 of the Act are expressly made 'subject to the provisions of this Act', which would include section 90 of the Act. As to what would happen in the event of a conflict between the provision of the Income-tax Act and a notification issued under section 90, is no longer res integra . . .

A survey of the aforesaid cases makes it clear that the judicial consensus in India has been that section 90 is specifically intended to enable and empower the Central Government to issue a notification for implementation of the terms of a Double Taxation Avoidance Agreement. When that happens, the provisions of such an agreement, with respect to cases to which they apply, would operate even if inconsistent with the provisions of the Income-tax Act. We approve of the reasoning in the decisions which we have noticed. If it was not the intention of the Legislature to make a departure from the general principle of chargeability to tax under section 4 and the general principle of ascertainment of total income under section 5 of the Act, then there was no purpose in making those sections 'subject to the provisions' of the Act. The very object of grafting the said two sections with the said clause is to enable the Central Government to

> issue a notification under section 90 towards implementation of the terms of DTAs which would automatically override the provisions of the Income-tax Act in the matter of ascertainment of chargeability to income-tax and ascertainment of total income, to the extent of inconsistency with the terms of DTAC."

38. The Supreme Court of India in the case of ***AZADI BACHAO ANDOLAN (SUPRA)*** has laid down that in case of conflict the provisions of the Double Taxation Avoidance Agreement would prevail over the statutory provisions of the Act in case the same are more beneficial to the Assessee and while discussing the judgments of various High Courts has held as under:

> 22. The Andhra Pradesh High Court in CIT v. Visakhapatnam Port Trust [(1983) 144 ITR 146 (AP)] held that provisions of Sections 4 and 5 of the Income Tax Act are expressly made "subject to the provisions of the Act"

which means that they are subject to the provisions of Section 90. By necessary implication, they are subject to the terms of the Double Taxation Avoidance Agreement, if any, entered into by the Government of India. Therefore, the total income specified in Sections 4 and 5 chargeable to income tax is also subject to the provisions of the agreement to the contrary, if any.

23. In CIT v. Davy Ashmore India Ltd. [(1991) 190 ITR 626 (Cal)] while dealing with the correctness of Circular No. 333 dated 2-4-1982, it was held that the conclusion is inescapable that in case of inconsistency between the terms of the Agreement and the taxation statute, the Agreement alone would prevail. The Calcutta High Court expressly approved the correctness of CBDT Circular No. 333 dated 2-4-1982 on the question as to what the assessing officers would have to do when they found that the provision of the double taxation was not in conformity with the Income Tax Act,

1961. The said circular provided as follows (quoted at ITR p. 632):

> "The correct legal position is that where a specific provision is made in the Double Taxation Avoidance Agreement, that provision will prevail over the general provisions contained in the Income Tax Act, 1961. In fact the Double Taxation Avoidance Agreements which have been entered into by the Central Government under Section 90 of the Income Tax Act, 1961, also provide that the laws in force in either country will continue to govern the assessment and taxation of income in the respective country except where provisions to the contrary have been made in the Agreement.

Thus, where a Double Taxation Avoidance Agreement provided for a particular mode of computation of income, the same should be followed, irrespective of the provisions in the Income Tax Act. Where there is no specific provision in the Agreement, it is the basic law

i.e. the Income Tax Act, that will govern the taxation of income.

24. The Calcutta High Court held that the circular reflected the correct legal position inasmuch as the convention or agreement is arrived at by the two contracting States "in deviation from the general principles of taxation applicable to the contracting States". Otherwise, the Double Taxation Avoidance Agreement will have no meaning at all. [See also in this connection Leonhardt Andra Und Partner, GmbH v. CIT, (2001) 249 ITR 418 (Cal)]

25. In CIT v. R.M. Muthaiah [(1993) 202 ITR 508 (Kant)] the Karnataka High Court was concerned with DTAT between the Government of India and the Government of Malaysia. The High Court held that under the terms of the Agreement, if there was a recognition of the power of taxation with the Malaysian Government, by implication it takes away the corresponding power of the Indian Government. The Agreement was thus held to operate as a bar on the power of the Indian

Government to tax and that the bar would operate on Sections 4 and 5 of the Income Tax Act, 1961, and take away the power of the Indian Government to levy tax on the income in respect of certain categories as referred to in certain articles of the Agreement. The High Court summed up the situation by observing (ITR at pp. 512-513):

> "The effect of an 'agreement' entered into by virtue of Section 90 of the Act would be: (i) if no tax liability is imposed under this Act, the question of resorting to the agreement would not arise. No provision of the agreement can possibly fasten a tax liability where the liability is not imposed by this Act; (ii) if a tax liability is imposed by this Act, the agreement may be resorted to for negativing or reducing it; (iii) in case of difference between the provisions of the Act and of the agreement, the provisions of the agreement prevail over the provisions of this Act and can be

enforced by the Appellate Authorities and the court.

28. A survey of the aforesaid cases makes it clear that the judicial consensus in India has been that section 90 is specifically intended to enable and empower the Central Government to issue a notification for implementation of the terms of a Double Taxation Avoidance Agreement. When that happens, the provisions of such an agreement, with respect to cases to which they apply, would operate even if inconsistent with the provisions of the Income-tax Act. We approve of the reasoning in the decisions which we have noticed. If it was not the intention of the Legislature to make a departure from the general principle of chargeability to tax under section 4 and the general principle of ascertainment of total income under section 5 of the Act, then there was no purpose in making those sections 'subject to the provisions' of the Act. The very object of grafting the said two sections with the said clause is to enable the Central

> Government to issue a notification under section 90 towards implementation of the terms of DTAs which would automatically override the provisions of the Income-tax Act in the matter of ascertainment of chargeability to income-tax and ascertainment of total income, to the extent of inconsistency with the terms of DTAC.

39. In the case of ***AZADI BACHAO ANDOLAN (SUPRA)*** the Supreme Court of India has thus specifically laid down that provisions of Sections 4 and 5 of the Income Tax Act are subject to the provisions of Section 90 thus they are subject to the terms of the Double Taxation Avoidance Agreement, if any, entered into by the Government of India. Therefore, the total income specified in Sections 4 and 5 chargeable to income tax is also subject to the provisions of the agreement to the contrary, if any. It has thus held that the conclusion is inescapable that in case of inconsistency between the terms of the Agreement and the taxation statute,

the Agreement alone would prevail, when the agreement is more beneficial. Where a provision is made in the Double Taxation Avoidance Agreement, that provision will prevail over the general provisions contained in the Act.

40. Thus, where a Double Taxation Avoidance Agreement provides is more advantageous to an assessee, irrespective of the provisions in the Act, the agreement prevails. Where there is no provision in the Agreement, it is the basic law i.e. the Income Tax Act, that will govern the taxation of income.

41. The Supreme Court of India has approved the reasoning of the ***KARNATAKA HIGH COURT IN CIT V. R.M. MUTHAIAH (SUPRA)*** that the effect of an 'agreement' entered into by virtue of Section 90 of the Act would be: (i) if no tax liability is imposed under this Act, the question of resorting to the agreement would not arise. No provision of the agreement can possibly fasten a

tax liability where the liability is not imposed by this Act; (ii) if a tax liability is imposed by this Act, the agreement may be resorted to for negativing or reducing it; (iii) subject to above, in case of difference between the provisions of the Act and of the agreement, the provisions of the agreement prevail over the provisions of this Act and can be enforced by the Appellate Authorities and the court.

42. The Supreme Court of India has thus held that the judicial consensus in India has been that section 90 is specifically intended to enable and empower the Central Government to issue a notification for implementation of the terms of a Double Taxation Avoidance Agreement. When that happens, the provisions of such an agreement, with respect to cases to which they apply, would operate even if inconsistent with the provisions of the Act, to advantage of an assessee. A notification under section 90 towards implementation of the terms of DTAs which

would automatically override the provisions of the Act in the matter of ascertainment of chargeability to income-tax and ascertainment of total income, rate of tax etc. to the extent of inconsistency with the terms of DTAA.

43. The Supreme Court while dealing with the concept of liability to taxation in international transactions in ***AZADI BACHAO ANDOLAN (SUPRA)*** further laid down as under:

> What is "liable to taxation"?
>
> Fiscal residence
>
> 62. The concept of "fiscal residence" of a company assumes importance in the application and interpretation of the Double Taxation Avoidance Treaties.
>
> 63. In Cahiers De Droit Fiscal International [Jean-Maio Rivier: Cahiers De Droit Fiscal International, Vol. LXXIIa at pp. 47-76.] it is said that under the OECD and UNO Model Conventions, "fiscal residence" is a place where a person, amongst others a

corporation, is subjected to unlimited fiscal liability and subjected to taxation for the worldwide profit of the resident company. At paragraph 2.2 it is pointed out:

> "The UNO Model Convention takes these two different concepts into account. It has not embodied the second sentence of Article 4, paragraph (1) of the OECD Model Convention, which provides that the term 'resident' does not include any person who is liable to tax in that State in respect only of income from sources in that State. In fact, if one adhered to a strict interpretation of this text, there would be no resident in the meaning of the Convention in those States that apply the principle of territoriality."

Again in paragraph 3.5 it is said:

> "The existence of a company from a company law standpoint is usually determined under the law of the State of incorporation or of the country where

> the real seat is located. On the other hand, the tax status of a corporation is determined under the law of each of the countries where it carries on business, be it as resident or non-resident."

64. In paragraph 4.1 it is observed that the principle of universality of taxation i.e. the principle of worldwide taxation, has been adopted by a majority of States. One has to consider the worldwide income of a company to determine its taxable profit. In this system it is crucial to define the fiscal residence of a company very accurately. The State of residence is the one entitled to levy tax on the corporation's worldwide profit. The company is subject to unlimited fiscal liability in that State. In the case of a company, however, several factors enter the picture and render the decision difficult. First, the company is necessarily incorporated and usually registered under the tax law of a State that grants it corporate status. A corporation has administrative activities, directors and

managers who reside, meet and take decisions in one or several places. It has activities and carries on business. Finally, it has shareholders who control it. Hence, it is opined:

> "When all these elements coexist in the same country, no complications arise. As soon as they are dissociated and 'scattered' in different States, each country may want to subject the company to taxation on the basis of an element to which it gives preference; incorporation procedure, management functions, running of the business, shareholders' controlling power. Depending on the criterion adopted, fiscal residence will abide in one or the other country.
>
> All the European countries concerned, except France, levy tax on the worldwide profit at the place of residence of the company considered.

South Korea, India and Japan in Asia, Australia and New Zealand in Oceania follow this principle."

91. In our view, the contention of the respondents proceeds on the fallacious premise that liability to taxation is the same as payment of tax. Liability to taxation is a legal situation; payment of tax is a fiscal fact. For the purpose of application of Article 4 of DTAC, what is relevant is the legal situation, namely, liability to taxation, and not the fiscal fact of actual payment of tax. If this were not so, DTAC would not have used the words "liable to taxation", but would have used some appropriate words like "pays tax". On the language of DTAC, it is not possible to accept the contention of the respondents that offshore companies incorporated and registered under MOBA are not "liable to taxation" under the Mauritian Income Tax Act; nor is it possible to accept the contention that such companies would not be "resident" in

Mauritius within the meaning of Article 3 read with Article 4 of DTAC.

93. In A Manual on the OECD Model Tax Convention on Income and on Capital, at para 4B.05, while commenting on Article 4 of the OECD Double Tax Convention, Philip Baker points out that the phrase "liable to tax" used in the first sentence of Article 4.1 of the Model Convention has raised a number of issues, and observes:

> "It seems clear that a person does not have to be actually paying tax to be 'liable to tax' — otherwise a person who had deductible losses or allowances, which reduced his tax bill to zero would find himself unable to enjoy the benefits of the Convention. It also seems clear that a person who would otherwise be subject to comprehensive taxing but who enjoys a specific exemption from tax is nevertheless liable to tax, if the exemption were repealed, or the person no longer qualified for the exemption,

> the person would be liable to comprehensive taxation."

98. In John N. Gladden v. Her Majesty the Queen [85 DTC 5188 at p. 5190] the principle of liberal interpretation of tax treaties was reiterated by the Federal Court, which observed:

> "Contrary to an ordinary taxing statute a tax treaty or convention must be given a liberal interpretation with a view to implementing the true intentions of the parties. A literal or legalistic interpretation must be avoided when the basic object of the treaty might be defeated or frustrated insofar as the particular item under consideration is concerned."

100. Interpreting the article of the Treaty Against Avoidance of Double Taxation, the Federal Court said (at p. 5):

> "The non-resident can benefit from the exemption regardless of whether or not

he is taxable on that capital gain in his own country. If Canada or the US were to abolish capital gains completely, while the other country did not, a resident of the country which had abolished capital gains would still be exempt from capital gains in the other country."

103. According to Klaus Vogel:

"Double Taxation Convention establishes an independent mechanism to avoid double taxation through restriction of tax claims in areas where overlapping tax claims are expected, or at least theoretically possible. In other words, the contracting States mutually bind themselves not to levy taxes or to tax only to a limited extent in cases when the treaty reserves taxation for the other contracting States either entirely or in part. Contracting States are said to 'waive' tax claims or more illustratively, to divide 'tax sources', the 'taxable objects', amongst themselves."

Double Taxation Avoidance Treaties were in vogue even from the time of the League of Nations. The experts appointed in the early 1920s by the League of Nations describe this method of classification of items and their assignments to the contracting States. While the English lawyers called it "classification and assignment rules", the German jurists called it "the distributive rule" (Verteilungsnorm). To the extent that an exemption is agreed to, its effect is in principle independent of both whether the other contracting State imposes a tax in the situation to which the exemption applies, and of whether that State actually levies the tax. Commenting particularly on the German Double Taxation Convention with the United States, Vogel comments: "Thus, it is said that the treaty prevents not only 'current', but also merely 'potential' double taxation." Further, according to Vogel,

> "only in exceptional cases, and only when expressly agreed to by the parties, is exemption in one contracting State

> dependent upon whether the income or capital is taxable in the other contracting State, or upon whether it is actually taxed there". [See in this connection Klaus Vogel: Double Taxation Convention, pp. 26-29 (3rd Edn.).]

44. The Supreme Court of India in the ***AZADI BACHAO ANDOLAN (SUPRA)*** has thus laid down that the concept of "fiscal residence" of a company assumes importance in the application and interpretation of the DTAA's. The Supreme Court referred to the Commentary of Jean-Maio Rivier "Cahiers De Droit Fiscal International" that under the OECD and UNO Model Conventions, "fiscal residence" is a place where a person, amongst others a corporation, is subjected to unlimited fiscal liability and subjected to taxation for the worldwide profit of the resident company. The existence of a company from a company law standpoint is usually determined under the law of the State of incorporation or of the country where the real

seat is located. On the other hand, the tax status of a corporation is determined under the law of each of the countries where it carries on business, be it as resident or non-resident.

45. The Supreme Court held that the principle of universality of taxation i.e. the principle of worldwide taxation, has been adopted by a majority of States. One has to consider the worldwide income of a company to determine its taxable profit. In this system it is crucial to define the fiscal residence of a company very accurately. The State of residence is the one entitled to levy tax on the corporation's worldwide profit. The company is subject to unlimited fiscal liability in that State. In the case of a company, however, several factors enter the picture and render the decision difficult. First, the company is necessarily incorporated and usually registered under the tax law of a State that grants it corporate status. A corporation has administrative activities, directors and managers

who reside, meet and take decisions in one or several places. It has activities and carries on business. Finally, it has shareholders who control it. When all these elements coexist in the same country, no complications arise. As soon as they are dissociated and 'scattered' in different States, each country may want to subject the company to taxation on the basis of an element to which it gives preference; incorporation procedure, management functions, running of the business, shareholders' controlling power. Depending on the criterion adopted, fiscal residence will abide in one or the other country.

46. The Supreme Court held that liability to taxation is a legal situation; payment of tax is a fiscal fact. For the purpose of application of Article 4 of DTAA, what is relevant is the legal situation, namely, liability to taxation, and not the fiscal fact of actual payment of tax. The Supreme Court quoted with approval the commentary of Philip Baker on Article 4 of the OECD

Double Tax Convention that a person does not have to be actually paying tax to be 'liable to tax'

47. The Supreme Court further referred to the Judgment of the Federal Court in John N. Gladden v. Her Majesty the Queen (supra) that Contrary to an ordinary taxing statute a tax treaty or convention must be given a liberal interpretation with a view to implementing the true intentions of the parties. A literal or legalistic interpretation must be avoided when the basic object of the treaty might be defeated or frustrated insofar as the particular item under consideration is concerned. The non-resident can benefit from the exemption regardless of whether or not he is taxable on that capital gain in his own country. If Canada or the US were to abolish capital gains completely, while the other country did not, a resident of the country which had abolished capital gains would still be exempt from capital gains in the other country.

48. The Supreme Court further referred to the commentary of Klaus Vogel that Double Taxation Convention establishes an independent mechanism to avoid double taxation through restriction of tax claims in areas where overlapping tax claims are expected, or at least theoretically possible. In other words, the contracting States mutually bind themselves not to levy taxes or to tax only to a limited extent in cases when the treaty reserves taxation for the other contracting States either entirely or in part. Contracting States are said to 'waive' tax claims or more illustratively, to divide 'tax sources', the 'taxable objects', amongst themselves.

49. In the present case the respondent Assessee is the resident of USA with which India has signed a double taxation avoidance agreement. In terms of the Law as laid down by the Supreme Court of India in ***AZADI BACHAO ANDOLAN (SUPRA)*** the Assessee has the right to be governed by the provisions of the Income Tax Act

or the DTAA whichever is more beneficial. The provisions of such an agreement, with respect to cases to which they apply, would operate even if inconsistent with the provisions of the Act and in case of inconsistency between the terms of the Agreement and the taxation statute, the Agreement alone would prevail. In the present case there is an Agreement for avoidance of double taxation between India and USA and the Assessee is covered by the same. The chargeability to tax of the income of the Assessee would have to be thus governed by the provisions of the DTAA i.e. India - US Double Taxation Avoidance Agreement. In case the income of the Assessee is chargeable under the DTAA then the provisions of the Agreement would prevail over the provisions of the Act, even if they are inconsistent with the DTAA.

50. To further resolve the controversy we need to examine the provisions of the Indo US DTAA. We notice that the Authorities below and the Tribunal have referred to

Article 13 of the Indo – UK DTAA whereas in the Memo of appeal the Revenue has relied upon Article 12 of the Indo – US DTAA and both the counsels relied upon and referred to the Indo – US DTAA at the time of hearing of the present Appeal. The Provisions of Articles 7 and 13 of the Indo – UK DTAA and Articles 7 and 12 of the Indo – US DTAA for the purposes of the present case are pari-materia so we are referring to the same. Article 7 of the Indo – US DTAA stipulates as under:

> "1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise "carries on business" as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment; (b) sales in the other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment;

or (c) other business activities carried on in the other State of the same or similar kind as those effected through that permanent establishment.

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall "in each Contracting State" be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing "wholly" at arm's length with the enterprise of which it is a permanent establishment and other enterprises controlling, controlled by or subject to the same common control as that enterprise. In any case where the correct amount of profits attributable to a permanent establishment is incapable of determination or the determination thereof presents exceptional difficulties, the profits attributable to the permanent establishment may be estimated on a reasonable basis. The estimate

adopted shall, however, be such that the result shall be in accordance with the principles contained in this article.

3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment, including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole (or the part thereof which includes the permanent establishment), whether incurred in the State in which the permanent establishment is situated or elsewhere, in accordance with the provisions of and subject to the limitations of the taxation laws of that State. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return

for the use of patents, know-how or other rights, or by way of commission or other charges for specific services performed or for management, or, except in the case of banking enterprises, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than toward reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents, know-how or other rights, or by way of commission or other charges for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices.

4. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

5. For the purposes of this Convention, the profits to be attributed to the permanent establishment as provided in paragraph 1(a) of this article shall include only the profits derived from the assets and activities of the permanent establishment and shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

6. Where profits include items of income which are dealt with separately in other articles of the convention, then the provisions of those articles shall not be affected by the provisions of this article.

7. For the purposes of the Convention, the term " business profits " means income derived from any trade or business including income from the furnishing of services other than included services as defined in article 12 (royalties and fees for included services) and including income from the rental of tangible personal property other than property described in paragraph 3(b) of article 12 (royalties and fees for included services).

(Emphasis Supplied)

51. What Article 7 of the Double Taxation Avoidance Agreement stipulates is that the profits of an enterprise would be exigible to tax only in a country where the enterprise is a resident. The exception to this has been carved out in Article 7, which stipulates that an enterprise can also be liable to tax in another country where the enterprise has a permanent establishment. However, only so much of profits of such enterprise shall be taxed in the country where there is a permanent establishment other than the country of residence to the extent the same is attributable to that permanent establishment or in respect of sales of goods or merchandise of same or similar kind as sold through the permanent establishment or other business activities effected through that permanent establishment.

52. Clause 2 of Article 7 stipulates that attributability in each contracting State of profits would be only to the extent, such profits would arise in case the enterprise

was a distinct and independent enterprise engaged in same or similar activity. The purport of the said clause is that where the enterprise carries on business through a permanent establishment, the profits would be calculated on the basis of an arm's length principle which really implies that if two independent entities were carrying on business with each other. The profit that the enterprise would earn through the said permanent establishment would be the profit that an independent enterprise would have earned if it was dealing with the enterprise in question. However, in case the profits were not so determinable than the reasonable profits on estimation basis would be carried out.

53. Clause 3 of Article 7 lays down the deductible expenses which an enterprise would be entitled to while computing the profits attributable to the permanent establishment. The permanent establishment is permitted to deduct expenses that are

incurred for the purposes of conduct of business of the permanent establishment. The broad expenses that are permitted to be deducted relate to execution, in general administrative expenses, research and development expenses, interest and other expenses incurred for the purposes of an enterprise as a whole irrespective of the fact whether the same are incurred in the country of residents of an enterprise or in a country where the permanent establishment is situated. The clause further stipulates that no deduction towards expenses would be allowed in respect of royalties, fees or other similar payments in return for the use of patents, knowhow or other rights or commission or other charges for management etc. are permitted. This is subject to limitations of the taxation laws of the State.

54. Article 5 of the Indo US DTAA defines Permanent Establishment in Article 5 as under:

"Permanent establishment - 1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:

(a) a place of management ;

(b) a branch ;

(c) an office ;

(d) a factory ;

(e) a workshop ;

(f) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources ;

(g) a warehouse, in relation to a person providing storage facilities for others ;

(h) a farm, plantation or other place where agriculture, forestry, plantation or related activities are carried on ;

(i) a store or premises used as a sales outlet ;

(j) an installation or structure used for the exploration or exploitation of natural

resources, but only if so used for a period of more than 120 days in any twelve-month period ;

(k) a building site or construction, installation or assembly project or supervisory activities in connection therewith, where such site, project or activities (together with other such sites, projects or activities, if any) continue for a period of more than 120 days in any twelve-month period ;

(l) the furnishing of services, other than included services as defined in Article 12 (Royalties and Fees for Included Services), within a Contracting State by an enterprise through employees or other personnel, but only if:

(i) activities of that nature continue within that State for a period or periods aggregating more than 90 days within any twelve-month period ; or

(ii) the services are performed within that State for a related enterprise

[within the meaning of paragraph 1 of Article 9 (Associated Enterprises)].

3. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include any one or more of the following:

(a) the use of facilities solely for the purpose of storage, display, or occasional delivery of goods or merchandise belonging to the enterprise ;

(b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or occasional delivery ;

(c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise ;

(d) the maintenance of a fixed place of business solely for the purpose of

purchasing goods or merchandise, or of collecting information, for the enterprise ;

(e) the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research or for other activities which have a preparatory or auxiliary character, for the enterprise.

4. Notwithstanding the provisions of paragraphs 1 and 2, where a person—other than an agent of an independent status to whom paragraph 5 applies - is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned State, if :

(a) he has and habitually exercises in the first-mentioned State an authority to conclude on behalf of the enterprise, unless his activities are limited to those mentioned in paragraph 3 which, if exercised through a fixed place of

business, would not make that fixed place of business a permanent establishment under the provisions of that paragraph ;

(b) he has no such authority but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise, and some additional activities conducted in the State on behalf of the enterprise have contributed to the sale of the goods or merchandise ; or

(c) he habitually secures orders in the first-mentioned State, wholly or almost wholly for the enterprise.

5. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent, or any other agent of an

independent status, provided that such persons are acting in the ordinary course of their business.

However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise and the transactions between the agent and the enterprise are not made under arm's length conditions, he shall not be considered an agent of independent status within the meaning of this paragraph.

6. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other."

55. Article 5 of the DTAA defines and lays down the number of conditions both positive and negative when

an establishment would have a permanent establishment in the other contracting State.

56. In the present case, it is an admitted position that the Respondent Assessee has a branch office in India which is a permanent establishment as defined in Article 5 of the DTAA. Since the Assessee has a permanent establishment in India in terms of the law as laid down by the Supreme Court of India in ***AZADI BACHAO ANDOLAN (SUPRA)***, the Assessee be liable to tax in India and as held hereinabove the chargeability to tax of the income of the Assessee would have to be governed by the provisions of the Indo US DTAA and the provisions of the Agreement would prevail over the provisions of the Act even if they are inconsistent with the same.

57. Article 12 of the DTAA with USA stipulates as under:

Royalties and fees for technical services

1. Royalties or fees for technical services arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such royalties or fees for technical services may also be taxed in the Contracting State in which they arise, and according to the laws of that State, but if the beneficial owner of the royalties or fees for technical services is a resident of the other Contracting State the tax so charged shall not exceed 10 per cent. of the gross amount of the royalties or fees for technical services.

3. The term "royalties " as used in this article means:

(a) payments of any kind received as consideration for **the use of, or the right to use, any copyright** of a literary, artistic, or scientific work, including cinematograph films or work on film, tape or other means of reproduction for use in

connection with radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience, including gains derived from the alienation of any such right or property which are contingent on the productivity, use or disposition thereof; and

(b) payments of any kind received as consideration for the use of, or the right to use, any industrial, commercial or scientific equipment, other than payments derived by an enterprise described in paragraph 1 of article 8 (Shipping and Air Transport) from activities described in paragraph 2(c) or 3 or article 8.

(Emphasis supplied)

4. For purposes of this article, "fees for included services " means payments of any

kind to any person in consideration for the rendering of any technical or consultancy services (including through the provision of services of technical or other personnel) if such services:

(a) are ancillary and subsidiary to the application or enjoyment of the right, property or information for which a payment described in paragraph 3 is received; or

(b) make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design.

5. --------

6. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties or fees for included services, being a resident of a Contracting State, carries on business in the other Contracting State, in

> which the royalties or fees for included services arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the royalties or fees for included services are attributable to such permanent establishment or fixed base. In such case the provisions of article 7 (business profits) or article 15 (Independent Personal Services), as the case may be, shall apply.
>
> 7. ....

58. Clause 1 of Article 12 lays down that royalty or fees for included services arising in a contracting State and paid to a residents of the other contracting State may be taxed in that other state.

59. Clause 2 of Article 12 lays down that royalty and fees for included services may also be taxed in a contracting State in which they arise. However, if the beneficial owner of the royalties or fees for included services paid to the residents of the other contracting

State then the tax has been limited in percentage depending upon the number of years the convention has effect.

60. Clause 3 of Article 12 lays down that the term royalty means payment of any kind received as consideration for the use of, or the right to use, any copyright of a literary, artistic, or scientific work............., including gains derived from the alienation of any such right or property which are contingent on the productivity, use of deposition thereof. The term royalty has been defined by clause 3 of Article 12 as payment received for the use of, or the right to use any copyright.

61. The amount received by the Assessee company had been treated as royalty income by the AO and the CIT(A) on the basis of Explanation 2 to Section 9(1)(vi) of the Act holding that there was transfer of some rights (including the granting of a licence) in respect of the copyright.

62. In terms of the law as laid down by the Supreme Court of India in ***AZADI BACHAO ANDOLAN (SUPRA)*** and since the Assessee is governed by the Indo US DTAA, the income of the Assessee would be chargeable to tax in terms of the provision of the Indo US DTAA, if the same is more advantageous or beneficial. The AO and the CIT (A) have applied by the definition of the word 'Royalty' as defined in Explanation 2 to Section 9(1)(vi) of the Act which is clearly contrary to the law as laid down by the Supreme Court of India in ***AZADI BACHAO ANDOLAN (SUPRA)***. Since the Assessee is governed by the provisions of the DTAA, the more onerous provisions of the Act could not have been applied. If the provision of the Act were more beneficial that the provisions of the DTAA then only reliance on the same could have been placed by the AO.

63. What is thus required to be examined is whether income of the Assessee is royalty income as covered by Article 12 of the DTAA if not then the same would

be taxable as business income as covered by the provisions of Article 7 of the DTAA.

64. To be taxable as royalty income covered by Article 12 of the DTAA the income of the Assessee should have been generated by the "use of or the right to use of" any copyright.

65. The issue whether consideration for software was royalty came up for consideration before the Special Bench of the Tribunal in Delhi in the case of ***MOTOROLA INC VS DEPUTY CIT AND DEPUTY CIT VS NOKIA (2005) 147 TAXMAN 39 (DELHI).*** The Tribunal has held as under:

> 155. It appears to us from a close examination of the manner in which the case has proceeded before the Income-tax authorities and the arguments addressed before us that the crux of the issue is whether the payment is for a copyright or for a copyrighted article. If it is for copyright, it should be classified as royalty both

under the Income-tax Act and under the DTAA and it would be taxable in the hands of the Assessee on that basis. If the payment is really for a copyrighted article, then it only represents the purchase price of the article and, therefore, cannot be considered as royalty either under the Act or under the DTAA. This issue really is the key to the entire controversy and we may now proceed to address this issue.

156. We must look into the meaning of the word "copyright" as given in the Copyright Act, 1957. Section 14 of this Act defines "Copyright" as "the exclusive right subject to the provisions of this Act, to do or authorize the doing of any of the following acts in respect of a work or any substantial part thereof, namely:

It is clear from the above definition that a computer programme mentioned in Clause (b) of the section has all the rights mentioned in Clause (a) and in addition also the right to sell or give on commercial rental or offer for sale or

for commercial rental any copy of the computer programme. This additional right was substituted w.e.f. 15.1.2000. The difference between the earlier provision and the present one is not of any relevance. What is to be noted is that the right mentioned in Sub-clause (ii) of Clause (b) of Section 14 is available only to the owner of the computer programme. It follows that if any of the cellular operators does not have any of the rights mentioned in Clauses (a) and (b) of Section 14, it would mean that it does not have any right in a copyright. In that case, the payment made by the cellular operator cannot be characterized as royalty either under the Income-tax Act or under the DTAA. The question, therefore, to be answered is whether any of the operators can exercise any of the rights mentioned in the above provisions with reference to the software supplied by the Assessee.

157. We may first look at the supply contract itself to find out what JTM, one of the cellular operators, can rightfully do with reference to

the software. We may remind ourselves that JTM is taken as a representative of all the cellular operators and that it was common ground before us that all the contracts with the cellular operators are substantially the same. Clause 20.1 of the Agreement, under the title "License", says that JTM is granted a non-exclusive restricted license to use the software and documentation but only for its own operation and maintenance of the system and not otherwise. This clause appears to militate against the position, if it were a copyright, that the holder of the copyright can do anything with respect to the same in the public domain. What JTM is permitted to do is only to use the software for the purpose of its own operation and maintenance of the system. There is a clear bar on the software being used by JTM in the public domain or for the purpose of commercial exploitation.

158. Secondly, under the definition of "copyright" in Section 14 of the Copyright Act, the emphasis is that it is an exclusive right

granted to the holder thereof. This condition is not satisfied in the case of JTM because the license granted to it by the Assessee is expressly stated in Clause 20.1 as a "non exclusive restricted license". This means that the supplier of the software, namely, the Assessee, can supply similar software to any number of cellular operators to which JTM can have no objection and further all the cellular operators can use the software only for the purpose of their own operation and maintenance of the system and not for any other purpose. The user of the software by the cellular operators in the public domain is totally prohibited, which is evident from the use of the words in Article 20.1 of the agreement, "restricted" and "not otherwise". Thus JTM has a very limited right so far as the use of software is concerned. It needs no repetition to clarify that JTM has not been given any of the seven rights mentioned in Clause (a) of Section 14 or the additional right mentioned in Sub-clause (ii) of Clause (b) of the section which relates to a computer

programme and, therefore, what JTM or any other cellular operator has acquired under the agreement is not a copyright but is only a copyrighted article.

159. Clause 20.4 of the supply contract with JTM is as under:

20.4 In pursuance of the foregoing JT MOBILES shall:

(a) not provide or make the Software or Documentation or any portions or aspects thereof (including any methods or concepts utilized or expressed therein) available to any person except to its employees on a "need to know" basis;

(b) not make any copies of Software or Documentation or parts thereof, except for archival backup purposes;

(c) when making permitted copies as aforesaid transfer to the copy/copies any copyright or other marking on the Software or Documentation.

(d) Not use the Software or Documentation for any other purpose than permitted in this Article 20, Licence or sell or in any manner alienate or part with its possession.

(e) Not use or transfer the Software and/or the Documentation outside India without the written consent of the Contractor and after having received necessary export or re-export permits from relevant authorities.

This clause places stringent restrictions on the cellular operator so far as the use of software is concerned. It first says that the cellular operator cannot make the software or portions thereof available to any person except to its employees and even with regard to employees it has to be only on a "need to know basis" which means that even the employees are not to be told in all its aspects. What the Assessee can do is only to tell the particular employee what he has to know about the software for operational purposes. The cellular operator has been denied the right to make copies of the software or parts thereof except for archival

backup purposes. This means that the cellular operator cannot make copies of the software for commercial purposes. This condition is plainly contrary to Section 14(a)(i) of the Copyright Act which permits the copyright holder to reproduce the work in any material form including the storing of it in any medium by electronic means. We may also notice Section 52(1)(aa) of the Copyright Act which lists out certain acts which cannot be considered as infringement of copyright. The particular clause permits the making of copies or adaptation of a computer programme by the lawful possessor of the copy and the computer programme in order to utilize the public programme for the purpose for which it was supplied or to make backup copies purely as a temporary protection against loss, destruction or damage. Therefore, merely because the cellular operator has been permitted to take copies just for backup purposes, it cannot be said that it has acquired a copyright in the software.

160. Clause 20.4(c) makes it mandatory for the cellular operator, while making copies of the software for backup purposes, to also mark the copied software with copyright or other marking to show that the rights of the Assessee are reserved. This is one more indication that what the cellular operator acquired is not a copyright.

161. Clause 20.4(d) says that the cellular operator cannot use the software for any other purpose than what is permitted and shall not also license or sell or in any manner alienate or part with its possession. This has to be read with Clause 20.5 which says that the license can be transferred, but only when the GSM system itself is sold by the cellular operator to a third party. This in a way shows that the software is actually part of the hardware and it has no use or value independent of it. This restriction placed on the cellular operator (not to license or sell the software) runs counter to Section 14(b)(ii) of the Copyright Act which permits a copyright holder to sell or let out on

commercial rental the computer programme. For this reason also it cannot be said that JTM or any cellular operator acquired a copyright in the software.

162. A conjoint reading of the terms of the supply contract and the provisions of the Copyright Act, 1957 clearly shows that the cellular operator cannot exploit the computer software commercially which is the very essence of a copyright. In other words a holder of a copyright is permitted to exploit the copyright commercially and if he is not permitted to do so then what he has acquired cannot be considered as a copyright. In that case, it can only be said that he has acquired a copyrighted article. A small example may clarify the position. The purchaser of a book on income-tax acquires only a copyrighted article. On the other hand, a recording company which has recorded a vocalist has acquired the copyright in the music rendered and is, therefore, permitted to exploit the recording commercially. In this case the music recording

company has not merely acquired a copyrighted article in the form of a recording, but has actually acquired a copyright to reproduce the music and exploit the same commercially. In the present case what JTM or any other cellular operator has acquired under the supply contract is only the copyrighted software, which is an article by itself and not any copyright therein.

163. We may now briefly deal with the objections of Mr. G.C. Sharma, the learned senior counsel for the Department. He contended that if a person owns a copyrighted article then he automatically has a right over the copyright also. With respect, this objection does not appear to us to be correct. Mr. Dastur filed an extract from Iyengar's Copyright Act (3rd Edition) edited by R.G. Chaturvedi. The following observations of the author are on the point:

"(h) Copyright is distinct from the material object, copyrighted:

It is an intangible incorporeal right in the nature of a privilege, quite independent of any material substance, such as a manuscript. The copyright owner may dispose of it on such terms as he may see fit. He has an individual right of exclusive enjoyment. The transfer of the manuscript does not, of itself, serve to transfer the copyright therein. The transfer of the ownership of a physical thing in which copyright exists gives to the purchaser the right to do with it (the physical thing) whatever he pleases, except the right to make copies and issue them to the public" (underline is ours).

The above observations of the author show that one cannot have the copyright right without the copyrighted article but at the same time just because one has the copyrighted article, it does not follow that one has also the copyright in it. Mr. Sharma's objection cannot be accepted.

164. It is not necessary, therefore, to consider the alternative argument of Mr. Dastur, namely, that even assuming that the Department is

right in saying that if you have the copyrighted article, you also have the copyright right therein, still it would mean that the copyright rights are transferred (acquired by JTM) and it would not be a case of merely giving the right to use and consequently Article 13 of the DTAA would not apply. Mr. Dastur, however, was fair enough to concede that if the Department is right in saying that if you have the copyrighted article, you also have the copyrighted rights, then Clause (v) of Explanation 2 below Section 9(1) of the Income-tax Act will apply because this clause ropes in "transfer of all or any rights" and is not restricted to "use" or "right to use", the copyright. However, he added that since the basic proposition of the Department has been demonstrated to be wrong, Clause (v) of Explanation 2 below Section 9(1) is not an impediment to accepting the assessee's contention.

165. We may also usefully refer to the Commentary on the OECD Model Convention (dated 28.1.2003) which is of persuasive value

and which throws considerable light on the character of the transaction and the treatment to be given to the payments for tax purposes. Paragraph 14 of the Commentary, a copy of which was filed in Paper book No. V is relevant:

COMMENTARY ON ARTICLE 12 - PAPER BOOK V

"14. In other types of transactions, the rights acquired in relation to the copyright are limited to those necessary to enable the user to operate the program, for example, where the transferee is granted limited rights to reproduce the program. This would be the common situation in transactions for the acquisition of a program copy. The rights transferred in these cases are specific to the nature of computer programs. They allow the user to copy the program, for example onto the user's computer hard drive or for archival purposes. In this context, it is important to note that the protection afforded in relation to computer programs under copyright law may differ from country to country. In some countries the act of copying the program onto

the hard drive or random access memory of a computer would, without a license, constitute a breach of copyright. However, the copyright laws of many countries automatically grant this right to the owner of software which incorporates a computer program. Regardless of whether this right is granted under law or under a license agreement with the copyright holder, copying the program onto the computer's hard drive or random access memory or making an archival copy is an essential step in utilizing the program. Therefore, rights in relation to these acts of copying, where they do no more than enable the effective operation of the program by the user, should be disregarded in analyzing the character of the transaction for tax purposes. Payments in these types of transactions would be dealt with as commercial income in accordance with Article 7."

166. We may also usefully refer to the proposed amendments to the regulations of the Internal Revenue Service (IRS) in the USA.

Again these regulations may not be binding on us but they have a persuasive value and throw light on the question before us, namely the difference between a copyright right and a copyrighted article. These regulations have been placed at pages 136 to 157 of Paper book No. II. The actual regulations as well as the explanatory Note explaining the object and the purpose of the proposed regulations have also been given. In paragraph 1 of the Note titled "Background", it has been stated that the proposed regulations require that a transaction involving a computer programme may be treated as being one of the four possible categories. Two such categories are the transfer of copyright rights and the transfer of a copyrighted article. The U.S. regulations distinguished between transfer of copyright rights and transfer of copyrighted articles based on the type of rights transferred to the transferee. Briefly stated, if the transferee acquires a copy of a computer programme but does not acquire any of the rights identified in certain sections (of the U.S. Regulations), the

regulation classified the transaction as the Transfer of a copyrighted article. Paragraph 3 of the Explanatory Note says that if a transfer of a computer programme results in the transferee acquiring any one or more of the listed rights, it is a transfer of a copyright right.

167. Paragraph 4 says that if a person acquires a copy of a computer programme but does not acquire any of the four listed copyright rights, he gets only a copyrighted article but no copyright.

168. The actual regulations bring out the distinction very clearly between the copyright right and a copyrighted article. They also specify the four rights which, if acquired by the transferee, constitute him the owner of a copyright right. They are:

(a) The right to make copies of the computer programme for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease, or lending.

(ii) The right to prepare derivative computer programmes based upon the copyrighted computer programme

(iii) The right to make a public performance of the computer programme.

(iv) The right to publically display the computer programme.

169. A copyrighted article has been defined in the regulation (page 147 of the paper book) as including a copy of a computer programme from which the work can be perceived, reproduced or otherwise communicated either directly or with the aid of a machine or device. The copy of the programme may be fixed in the magnetic medium of a floppy disc or in the main memory or hard drive of a computer or in any other medium.

170. So far as the transfer of copyrighted articles and copyright rights are concerned, the regulation goes on to say (page 148 of the paper book) that the question whether there

was a transfer of a copyright right or only of a copyrighted article must be determined taking into account all the facts and circumstances of the case and the benefits and burden of ownership which have been transferred. Several examples have been given below these regulations to find out whether a particular transfer is a transfer of a copyright right or a transfer of a copyrighted article.

171. The Commentary of "Charl P. du TOIT" on this question has been placed at pages 202 to 204 of Paper book No. II. The Commentary is titled "Beneficial ownership of royalties in Bilateral Tax Treaties." He has opined that articles such as Books and Records are copyrighted articles and if they are sold, the user does not obtain the right to use any significant rights in the underlying copyright itself, which is what should determine the characterization of the revenue as sale proceeds rather than royalties. He has further opined that consideration relating to sale of

> software can amount to royalty only in limited circumstances.
>
> 172. For the above reasons, we are of the view that the payment by the cellular operator is not for any copyright in the software but is only for the software as such as a copyrighted article. It follows that the payment cannot be considered as royalty within the meaning of Explanation 2 below Section 9(1) of the Income-tax Act or Article Article of the DTAA with Sweden.
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>
> 184. In view of the foregoing discussion, we hold that the software supplied was a copyrighted article and not a copyright right, and the payment received by the Assessee in respect of the software cannot be considered as royalty either under the Income-tax Act or the DTAA.

66. Referring to the Commentary on the OECD Model Convention (dated 28.1.2003), which was considered

to be of persuasive value, the Tribunal noticed that the rights acquired in relation to the copyright are limited to those necessary to enable the user to operate the program, for example, where the transferee is granted limited rights to reproduce the program. This would be the common situation in transactions for the acquisition of a program copy. The rights transferred in these cases are specific to the nature of computer programs. They allow the user to copy the program, for example onto the user's computer hard drive or for archival purposes. Copying the program onto the computer's hard drive or random access memory or making an archival copy is an essential step in utilizing the program. Therefore, rights in relation to these acts of copying, where they do no more than enable the effective operation of the program by the user, should be disregarded in analyzing the character of the transaction for tax purposes. Payments in these types

of transactions would be dealt with as commercial income in accordance with Article 7.

67. The Tribunal further referred to the proposed amendments to the regulations of the Internal Revenue Service (IRS) in the USA not as binding but as having persuasive value and throwing light on the question i.e. the difference between a copyright right and a copyrighted article. The Tribunal noticed that the U.S. regulations distinguished between transfer of copyright rights and transfer of copyrighted articles based on the type of rights transferred to the transferee. Briefly stated, if the transferee acquires a copy of a computer programme but does not acquire any of the rights identified in certain sections (of the U.S. Regulations), the regulation classified the transaction as the Transfer of a copyrighted article. If a transfer of a computer programme results in the transferee acquiring any one or more of the listed rights, it is a transfer of a copyright right. If a person

acquires a copy of a computer programme but does not acquire any of the four listed copyright rights, he gets only a copyrighted article but no copyright. The four rights being:

> (i) The right to make copies of the computer programme for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease, or lending.
>
> (ii) The right to prepare derivative computer programmes based upon the copyrighted computer programme
>
> (iii) The right to make a public performance of the computer programme.
>
> (iv) The right to publically display the computer programme.

68. The Tribunal further noticed that a copyrighted article has been defined in the regulation as including a copy of a computer programme from which the work can be perceived, reproduced or otherwise communicated either directly or with the aid of a machine or device.

The copy of the programme may be fixed in the magnetic medium of a floppy disc or in the main memory or hard drive of a computer or in any other medium.

69. The Tribunal has held and rightly so that the question whether there was a transfer of a copyright right or only of a copyrighted article must be determined taking into account all the facts and circumstances of the case and the benefits and burden of ownership which have been transferred.

70. The appeal filed by the Revenue against the Judgment of the Special Bench of the ITAT was dismissed by the High Court of Delhi in the case of **DIT v. M/s Nokia Networks OY (2012) 253 CTR (Del) 417**. The bench approved of the findings of the Special Bench of the Tribunal in the Motorola case supra that Copyright is distinct from the material object, copyrighted. It is an intangible incorporeal right in the nature of a privilege,

quite independent of any material substance, such as a manuscript. He has an individual right of exclusive enjoyment. The transfer of the manuscript does not, of itself, serve to transfer the copyright therein. The transfer of the ownership of a physical thing in which copyright exists gives to the purchaser the right to do with it (the physical thing) whatever he pleases, except the right to make copies and issue them to the public. Just because one has the copyrighted article, it does not follow that one has also the copyright in it.

71. In the case of ***DIT v. ERICSSON A.B. (2012) 343 ITR 470 (DEL)***, one issue that the Delhi High Court was considering was whether the consideration for supply of software was payment by way of royalty and hence assessable both under Section 9(1)(vi) and the Double Taxation Avoidance Agreement between the government of India and Sweden? The High Court relying on the Judgment of the Supreme Court of India in **TATA CONSULTANCY SERVICES VS. STATE OF ANDHRA**

PRADESH, (2004) 271 ITR 401 (SC), held that software incorporated on a media would be goods and liable to sales tax. The High Court has held as under:

> 56. A fortiorari when the assessee supplies the software which is incorporated on a CD, it has supplied tangible property and the payment made by the cellular operator for acquiring such property cannot be regarded as a payment by way of royalty.
>
> ....
>
> 59. Be that as it may, in order to qualify as royalty payment, within the meaning of section 9(1)(vi) and particularly clause (v) of Explanation 2 thereto, it is necessary to establish that there is transfer of all or any rights (including the granting of any licence) in respect of copyright of a literary, artistic or scientific work. Section 2(o) of the Copyright Act makes it clear that a computer programme is to be regarded as a "literary work". Thus, in order to treat the consideration paid by the cellular operator as royalty, it is to be

established that the cellular operator, by making such payment, obtains all or any of the copyright rights of such literary work. In the present case, this has not been established. It is not even the case of the Revenue that any right contemplated under section 14 of the Copyright Act, 1957, stood vested in this cellular operator as a consequence of article 20 of the supply contract. Distinction has to be made between the acquisition of a "copyright right" and a "copyrighted article".

60. Mr. Dastur is right in this submission which is based on the commentary on the OECD Model Convention. Such a distinction has been accepted in a recent ruling of the Authority for Advance Ruling (AAR) in Dassault Systems KK 229 CTR 125. We also find force in the submission of Mr. Dastur that even assuming the payment made by the cellular operator is regarded as a payment by way of royalty as defined in Explanation 2 below Section 9 (1) (vi), nevertheless, it can never be regarded as royalty within the meaning of the said term in

article 13, para 3 of the DTAA. This is so because the definition in the DTAA is narrower than the definition in the Act. Article 13(3) brings within the ambit of the definition of royalty a payment made for the use of or the right to use a copyright of a literary work. Therefore, what is contemplated is a payment that is dependent upon user of the copyright and not a lump sum payment as is the position in the present case.

We thus hold that payment received by the assessee was towards the title and GSM system of which software was an inseparable parts incapable of independent use and it was a contract for supply of goods. Therefore, no part of the payment therefore can be classified as payment towards royalty.

72. The Delhi High Court further in **ERICSSON CASE (SUPRA)** further held that once it is held that payment in question is not royalty which would come within the mischief of clause (vi), the Explanation will have no application and that the question of applicability of the

Explanation would arise only when payment is to be treated as "royalty" within the meaning of clause (vi) or "fee for technical services" as provided in clause (vii) of the Act.

73. In the case of ***DASSAULT SYSTEMS K. K., IN RE (2010) 322 ITR 125 (AAR)*** the Authority on Advance Ruling has held as under:

> Passing on a right to use and facilitating the use of a product for which the owner has a copyright is not the same thing as transferring or assigning rights in relation to the copyright. The enjoyment of some or all the rights which the copyright owner has, is necessary to trigger the royalty definition. Viewed from this angle, a non-exclusive and non-transferable licence enabling the use of a copyrighted product cannot be construed as an authority to enjoy any or all of the enumerated rights ingrained in a copyright. Where the purpose of the licence or the transaction is only to establish access to the copyrighted product for internal business

purpose, it would not be legally correct to state that the copyright itself has been transferred to any extent. It does not make any difference even if the computer programme passed on to the user is a highly specialized one. The parting of intellectual property rights inherent in and attached to the software product in favour of the licensee/customer is what is contemplated by the definition clause in the Act as well as the Treaty. As observed earlier, those rights are incorporated in section 14. Merely authorizing or enabling a customer to have the benefit of data or instructions contained therein without any further right to deal with them independently does not, in our view, amount to transfer of rights in relation to copyright or conferment of the right of using the copyright. However, where, for example, the owner of copyright over a literary work grants an exclusive licence to make out copies and distribute them within a specified territory, the grantee will practically step into the shoes of the owner/grantor and he enjoys the copyright to the extent of its grant to the exclusion of

others. As the right attached to copyright is conveyed to such licencee, he has the authority to commercially deal with it. In case of infringement of copyright, he can maintain a suit to prevent it. Different considerations will arise if the grant is non-exclusive that too confined to the user purely for in-house or internal purpose. The transfer of rights in or over copyright or the conferment of the right of use of copyright implies that the transferee/licensee should acquire rights either in entirety or partially co-extensive with the owner/ transferor who divests himself of the rights he possesses pro tanto. That is what, in our view, follows from the language employed in the definition of "royalty" read with the provisions of the Copyright Act, viz., section 14 and other complementary provisions.

We may refer to one more aspect here. In the definition of royalty under the Act, the phrase "including the granting of a licence" is found. That does not mean that even a non-exclusive licence permitting user for inhouse purpose

> would be covered by that expression. Any and every licence is not what is contemplated. It should take colour from the preceding expression "transfer of rights in respect of copyright". Apparently, grant of "licence" has been referred to in the definition to dispel the possible controversy a licence whatever be its nature, can be characterized as transfer.

74. The Authority on Advance Ruling in the case of ***DASSAULT SYSTEMS K. K., IN RE (SUPRA)*** negated the contention of the revenue that the right permitting the licensee to make a copy of the programme by loading the programme on the hard disk of the computer amounted to assignment of a right in the copyright in terms of section 14 of the Copyright Act as under:

> It has been contended on behalf of the Revenue that the right to reproduce the work in any material form including the storing of it in any medium by electronic means (vide section 14(a)(i) of the Copyright Act) must be deemed to have been conveyed to the end-

user. It is pointed out that a CD without right of reproduction on the hard disc is of no value to the end-user and such a right should necessarily be transferred to make it workable. It appears to us that the contention is based on a misunderstanding of the scope of right in sub-clause (i) of section 14(a). As stated in Copinger's treatise on Copyright, "the exclusive right to prevent copying or reproduction of a work is the most fundamental and historically oldest right of a copyright owner". We do not think that such a right has been passed on to the end-user by permitting him to download the computer programme and storing it in the computer for his own use. The copying/ reproduction or storage is only incidental to the facility extended to the customer to make use of the copyrighted product for his internal business purpose. As admitted by the Revenue's representative, that process is necessary to make the programme functional and to have access to it and is qualitatively different from the right contemplated by the said provision because it is only integral to the

use of copyrighted product. Apart from such incidental facility, the customer has no right to deal with the product just as the owner would be in a position to do. In so far as the licensed material reproduced or stored is confined to the four corners of its business establishment, that too on a non-exclusive basis, the right referred to in sub-clause (i) of section 14(a) would be wholly out of place. Otherwise, in respect of even off-the-shelf software available in the market, it can be very well said that the right of reproduction which is a facet of copyright vested with the owner is passed on to the customer. Such an inference leads to unintended and irrational results. We may in this context refer to section 52(aa) of the Copyright Act (extracted supra) which makes it clear that "the making of copies or adaptation" of a computer programme by the lawful possessor of a copy of such programme, from such copy (i) in order to utilize the computer program, for the purpose for which it was supplied or (ii) to make back up copies purely as a temporary protection against loss,

destruction, or damage in order to utilize the computer programme for the purpose of which it was supplied" will not constitute infringement of copyright. Consequently, customization or adaptation, irrespective of the degree, will not constitute "infringement" as long as it is to ensure the utilization of the computer programme for the purpose for which it was supplied. Once there is no infringement, it is not possible to hold that there is transfer or licensing of "copyright" as defined in the Copyright Act and as understood in common law. This is because, as pointed out earlier, copyright is a negative right in the sense that it is a right prohibiting someone else to do an act, without authorization of the same, by the owner.

It seems to us that reproduction and adaptation envisaged by section 14(a)(i) and (vi) can contextually mean only reproduction and adaptation for the purpose of commercial exploitation. Copyright being a negative right (in the sense explained in paragraph 9 supra), it

> would only be appropriate and proper to test it in terms of infringement. What has been excluded under section 52(aa) is not commercial exploitation, but only utilizing the copyrighted product for one's own use. The exclusion should be given due meaning and effect; otherwise, section 52(aa) will be practically redundant. In fact, as the law now stands, the owner need not necessarily grant licence for mere reproduction or adaptation of work for one's own use. Even without such licence, the buyer of product cannot be said to have infringed the owner's copyright. When the infringement is ruled out, it would be difficult to reach the conclusion that the buyer/licensee of product has acquired a copyright therein.

75. The Authority on Advance Ruling in the case of ***DASSAULT SYSTEMS K. K., IN RE (SUPRA)*** further approved the reasoning of the Special Bench of Income-tax Appellate Tribunal in ***MOTOROLA INC. (SUPRA)*** and noticed that the said decision has been

followed in several decisions of the Income-tax Appellate Tribunal till date.

76. The Authority on Advance Ruling following the decision in the ***DASSAULT CASE (SUPRA)*** in the case of **GEOQUEST SYSTEMS B.V. V. DIT (INTERNATIONAL TAXATION-I) [(2010)234CTR(AAR)73]** held as under:

> 9. The revenue has sought to place reliance on the proviso to section 9(1)(vi) and sub-section (1A) of section 115A in order to contend that the Act contemplated charging of 'royalty' for authorization to use computer software as such and it is not necessary that the copyright therein should be specifically transferred. We are not impressed by this argument. The expression 'computer software' has been defined by Explanation 3 to section 9(1)(vi) for the purpose of the second proviso to the said clause. The computer software is defined to mean any computer programme recorded on any disc, tape, perforated media or other information storage device and includes any such programme or any customized electronic

data. Under the second proviso the income by way of 'royalty' consisting of lump sum payment made by a resident for the transfer of all or any rights (including the grant of licence) in respect of the computer software by a non-resident manufacturer along with a computer based equipment under a scheme approved as per the 1986 Policy on computer software export, software development and training, is excluded from the purview of 'royalty' clause. It does not, however, mean that wherever computer software is transferred on outright sale basis or is leased or licensed, it would become royalty income. Whether or not the income is in the nature of royalty has to be judged with reference to the exhaustive definition in Explanation 2. In this context, sub-clause (v) of Explanation 2 which has been referred to by both sides become relevant. It is in the light of the language of that clause one has to see whether the income in question ought to be treated as 'royalty'. The transfer of rights envisaged by sub-clause (v) should be in respect of the 'copyright' among others. Mere

> transfer of computer software dehors any copyright associated with it does not fall within the ambit of the said clause (v). That is what has been held in the two rulings referred to earlier.

77. The Supreme Court of India in **TATA CONSULTANCY CASE (SUPRA)** was considering the question whether the sale of software was sale of goods and thus exigible to sales tax. The Supreme Court held that software may be intellectual property and contained on a medium was a marketable commodity and an object of trade and commerce. The Supreme Court of India held as under:

> "15. Sorabjee submitted that the question as to whether software is tangible or intangible property has been considered by the American Courts. He fairly pointed out that in America there is a difference of opinion amongst the various Courts. He submitted that, however, the majority of the Courts have held that a software is an intangible property. He showed

to the Court a number of American Judgments, viz., the cases of Commerce Union Bank v. Tidwell 538 S.W.2d 405; State of Alabama v. Central Computer Services. INC 349 So. 2d 1156; The First National Bank of Fort Worth v. Bob Bullock 584 S.W.2d 548; First National Bank of Springfield v. Department of Revenue 421 NE2d 175; Compuserve, INC. v. Lindley 535 N.E. 2d 360 and Northeast Datacom, Inc., et al v. City of Wallingford 563 A2d 688. In these cases, it has been held that 'computer software' is tangible personal property. The reasoning for arriving at this conclusion is basically that the information contained in the software programs can be introduced into the user's computer by several different methods, namely, (a) it could be programmed manually by the originator of the program at the location of the user's computer, working from his own instructions or (b) it could be programmed by a remote programming terminal located miles away from the user's computer, with the input information being transmitted by telephone; or (c) more commonly the computer could be

programmed by use of punch cards, magnetic tapes or discs, containing the program developed by the vendor. It has been noticed that usually the vendor will also provide manuals, services and consultation designed to instruct the user's employees in the installation and utilization of the supplied program. It has been held that even though the intellectual process is embodied in a tangible and physical manner, that is on the punch cards, magnetic tapes, etc. the logic or intelligence of the program remains intangible property. It is held that it is this intangible property right which is acquired when computer software is purchased or leased. It has been held that what is created and sold is information and the magnetic tapes or the discs are only the means of transmitting these intellectual creations from the originator to the user. It has been held that the same information could have been transmitted from the originator to the user by way of telephone lines or fed directly into the user's computer by the originator of the programme and that as there would be no tax in those cases merely

because the method of transmission is by means of a tape or a disc, it does not constitute purchase of tangible personal property and the same remains intangible personal property. It has been held that what the customer paid for is the intangible knowledge which cannot be subjected to the personal property tax. In these cases, difference is sought to be made between purchase of a book, music cassette/video or film and purchase of software on the following lines: "When one buys a video cassette recording, a book, sheet music or a musical recording, one acquires a limited right to use and enjoy the material's content. One does not acquire, however, all that the owner has to sell. These additional incidents of ownership include the right to produce and sell more copies, the right to change the underlying work, the right to license its use to other and the right to transfer the copyright itself. It is these incidents of the intellectual, intangible competent of the software property that Wallingford has impermissibly assessed as tangible property by

linking these incorporeal incidents with the tangible medium in which the software is stored and transmitted."

16. It has been fairly brought to the attention of the Court that many other American Courts have taken a different view. Some of those cases are South Central Bell Telephone Co. v. Sidney J. Barthelemy 643 So.2d 1240; Comptroller of the Treasury v. Equitable Trust Company 464 A.2d 248; Chittenden Trust Co. v. Commissioner of Taxes 465 A.2d 1100; University Computing Company v. Commissioner of Revenue for the State of Tennessee 677 S.W.2d 445 and Hasbro Industries, INC. v. John H. Norberg, Tax Administrator 487 A.2d 124. In these cases, the Courts have held that when stored on magnetic tape, disc or computer chip, this software or set of instructions is physically manifested in machine readable form by arranging electrons, by use of an electric current, to create either a magnetized or unmagnetized space. This machine readable language or code is the

physical manifestation of the information in binary form. It has been noticed that at least three program copies exist in a software transaction: (i) an original, (ii) a duplicate, and (iii) the buyer's final copy on a memory device. It has been noticed that the program is developed in the seller's computer then the seller duplicates the program copy on software and transports the duplicates to the buyer's computer. The duplicate is read into the buyer's computer and copied on a memory device. It has been held that the software is not merely knowledge, but rather is knowledge recorded in a physical form having a physical existence, taking up space on a tape, disc or hard drive, making physical things happen and can be perceived by the senses. It has been held that the purchaser does not receive mere knowledge but receives an arrangement of matter which makes his or her computer perform a desired function. It has been held that this arrangement of matter recorded on tangible medium constitutes a corporeal body. It has been held that a software recorded in

physical form becomes inextricably intertwined with, or part and parcel of the corporeal object upon which it is recorded, be that a disk, tape, hard drive, or other device. It has been held that the fact that the information can be transferred and then physically recorded on another medium does not make computer software any different from any other type of recorded information that can be transferred to another medium such as film, video tape, audio tape or books. It has been held that by sale of the software programme the incorporeal right to the software is not transferred. It is held that the incorporeal right to software is the copyright which remains with the originator. What is sold is a copy of the software. It is held that the original copyright version is not the one which operates the computer of the customer but the physical copy of that software which has been transferred to the buyer. It has been held that when one buys a copy of a copyrighted novel in a bookstore or recording of a copyrighted song in a record store, one only acquires ownership

of that particular copy of the novel or song but not the intellectual property in the novel or song.

…….

19. Thus this Court has held that the term "goods", for the purposes of sales tax, cannot be given a narrow meaning. It has been held that properties which are capable of being abstracted, consumed and used and/or transmitted, transferred, delivered, stored or possessed etc. are "goods" for the purposes of sales tax. The submission of Mr. Sorabjee that this authority is not of any assistance as a software is different from electricity and that software is intellectual incorporeal property whereas electricity is not, cannot be accepted. In India the test, to determine whether a property is "goods", for purposes of sales tax, is not whether the property is tangible or intangible or incorporeal. The test is whether the concerned item is capable of abstraction, consumption and use and whether it can be transmitted, transferred, delivered, stored,

> possessed etc. Admittedly in the case of software, both canned and uncanned, all of these are possible."

78. The Supreme Court of India in **TATA CONSULTANCY CASE (SUPRA)** referred to the Judgment of the Supreme Court in **ASSOCIATED CEMENT COMPANIES LTD. VS COMMISSIONER OF CUSTOMS (2001) 4 SCC 593** as under:

> 43. Similar would be the position in the case of a programme of any kind loaded on a disc or a floppy. For example in the case of music the value of a popular music cassette is several times more than the value of a blank cassette. However, if a prerecorded music cassette or a popular film or a musical score is imported into India duty will necessarily have to be charged on the value of the final product. In this behalf we may note that in State Bank of India v. Collector of Customs MANU/SC/0017/2000 : (2000) 1 SCC 727 the Bank had, under an agreement with the foreign company,

imported a computer software and manuals, the total value of which was US Dollars 4,084,475. The Bank filed an application for refund of customs duty on the ground that the basic cost of software was US Dollars 401.047. While the rest of the amount of US Dollars 3,683,428 was payable only as a licence fee for its right to use the software for the Bank countrywide. The claim for the refund of the customs duty paid on the aforesaid amount of US Dollars 3,683,428 was not accepted by this Court as in its opinion, on a correct interpretation of Section 14 read with the Rules, duty was payable on the transaction value determined therein, and as per Rule 9 in determining the transaction value there has to be added to the price actually paid or payable for the imported goods, royalties and the licence fee for which the buyer is required to pay, directly or indirectly, as a condition of sale of goods to the extent that such royalties and fees are not included in the price actually paid or payable. This clearly goes to show that when technical material is supplied whether in the

form of drawings or manuals the same are goods liable to customs duty on the transaction value in respect thereof.

44. It is a misconception to contend that what is being taxed is intellectual input. What is being taxed under the Customs Act read with the Customs Tariff Act and the Customs Valuation Rules is not the input alone but goods whose value has been enhanced by the said inputs. The final product at the time of import is either the magazine or the encyclopaedia or the engineering drawings as the case may be. There is no scope for splitting the engineering drawing or the encyclopaedia into intellectual input on the one hand and the paper on which it is scribed on the other. For example, paintings are also to be taxed. Valuable paintings are worth millions. A painting or a portrait may be specially commissioned or an article may be tailormade. This aspect is irrelevant since what is taxed is the final product as defined and it will be an absurdity to contend that the value for the

purposes of duty ought to be the cost of the canvas and the oil paint even though the composite product, i.e., the painting, is worth millions.

……

48. The above view, in our view, appears to be logical and also in consonance with the Customs Act. Similarly in Advent Systems Ltd. v. Unisys Corporation 1925 F 2d 670 it was contended before the Court in the United States that software referred to in the agreement between the parties was a "product" and not a "good" but intellectual property outside the ambit of the Uniform Commercial Code. In the said Code, goods were defined as "all things (including specially manufactured goods) which are moveable at the time of the identification for sale". Holding that computer software was a "good" the Court held as follows : "Computer programs are the product of an intellectual process, but once implanted in a medium they are widely distributed to computer owners. An analogy

can be drawn to a compact-disc recording of an orchestral rendition. The music is produced by the artistry of musicians and in itself is not a 'good', but when transferred to a laser-readable disc it becomes a readily merchantable commodity. Similarly, when a professor delivers a lecture, it is not a good, but, when transcribed as a book, it becomes a good. That a computer program may be copyrightable as intellectual property does not alter the fact that once in the form of a floppy disc or other medium, the program is tangible, moveable and available in the marketplace. The fact that some programs may be tailored for specific purposes need not alter their status as 'goods' because the Code definition includes 'specially manufactured goods'."

79. The Supreme Court of India in **TATA CONSULTANCY CASE (SUPRA)** further held as under:

25. To be noted that this authority is directly dealing with the question in issue. Even though

the definition of the term "goods" in the Customs Act is not as wide or exhaustive as the definition of the term "goods" in the said Act, it has still been held that the intellectual property when it is put on a media becomes goods.

....

27. In our view, the term "goods" as used in Article 366(12) of the Constitution of India and as defined under the said Act are very wide and include all types of movable properties, whether those properties be tangible or intangible. We are in complete agreement with the observations made by this Court in Associated Cement Companies Ltd. (supra). A software programme may consist of various commands which enable the computer to perform a designated task. The copyright in that programme may remain with the originator of the programme. But the moment copies are made and marketed, it becomes goods, which are susceptible to sales tax. Even intellectual property, once it is put on to a media, whether it be in the form of books or

canvas (In case of painting) or computer discs or cassettes, and marketed would become "goods". We see no difference between a sale of a software programme on a CD/floppy disc from a sale of music on a cassette/CD or a sale of a film on a video cassette/CD. In all such cases, the intellectual property has been incorporated on a media for purposes of transfer. Sale is not just of the media which by itself has very little value. The software and the media cannot be split up. What the buyer purchases and pays for is not the disc or the CD. As in the case of paintings or books or music or films the buyer is purchasing the intellectual property and not the media i.e. the paper or cassette or disc or CD. Thus a transaction sale of computer software is clearly a sale of "goods" within the meaning of the term as defined in the said Act. The term "all materials, articles and commodities" includes both tangible and intangible/incorporeal property which is capable of abstraction, consumption and use and which can be transmitted, transferred, delivered, stored, possessed etc.

The software programmes have all these attributes.

80. S.B. Sinha J. in **TATA CONSULTANCY CASE (SUPRA)** concurring with the decision of the Majority referred to the Judgment in the case of South Central Bell Telephone Co. v. Sidney J. Barthelemny, et al. [643 So. 2d 1240 : 36 A.L.R. 5th 689], the Supreme Court of Louisiana as under:

> 26. The court, however, noticed that the shift in the trend was not uniform. Having regard to the fact that the computer software became the knowledge and understanding and upon discussing the characteristics of computer software and classification thereof as tangible or intangible under Louisiana law, it was held:
>
> > "The software itself, i.e. the physical copy, is not merely a right or an idea to be comprehended by the understanding. The purchaser of computer software neither desires nor receives mere knowledge, but rather receives a certain

arrangement of matter that will make his or her computer perform a desired function. This arrangement of matter, physically recorded on some tangible medium, constitutes a corporeal body.

We agree with Bell and the court of appeal that the form of the delivery of the software-magnetic tape or electronic transfer via modem- is of no relevance. However, we disagree with Bell and the court of appeal that the essence or real object of the transaction was intangible property . That the software can be transferred to various media i.e. from tape to disc, or tape to hard drive, or even that it can be transferred over the telephone lines, does not take away from the fact that the software was ultimately recorded and stored in physical form upon a physical object. See Crockett, supra, at 872-74; Shontz, at 168-70; Cowdrey, supra, at 188-90. As the court of appeal explained, and as Bell readily

admits, the programs cannot be utilized by Bell until they have been recorded into the memory of the electronic telephone switch. 93-1072, at p. 6, 631 So.2d at 1342. The essence of the transaction was not merely to obtain the intangible "knowledge" or "information", but rather, was to obtain recorded knowledge stored in some sort of physical form that Bell's computers could use. Recorded as such, the software is not merely an incorporeal idea to be comprehended, and would be of no use if it were. Rather, the software is given physical existence to make certain desired physical things happen.

One cannot escape the fact that software, recorded in physical form, becomes inextricably intertwined with, or part and parcel of the corporeal object upon which it is recorded , be that a disc, tape, hard drive, or other device. Crockett, supra, at 871072; Cowdrey, Supre, at

> 188-90. That the information can be transferred and then physically recorded on another medium is of no moment, and does not make computer software any different than any other type of recorded information that can be transferred to another medium such as film, video tape, audio tape, or books."

It was further opined :

> "It is now common knowledge that books, music, and even movies or other audio/visual combinations can be copied from one medium to another. They are also all available on computer in such forms as floppy disc, tape, and CD-ROM. Such movies, books, music, etc .can all be delivered by and/or copied from one medium to another, including electrical impulses with the use of a modem. Assuming there is sufficient memory space available in the computer hard disc drive such movies, books, music, etc .can also be recorded into the permanent memory of the computer such as was done with the software in this case. 93-

1072, at p. 4, 5. 631 So.2d at 1346-47 (dissenting opinion). See also Shontz. Supra, at 168-170; Harris, supra, at 187. That the information, knowledge, story, or idea, physically manifested in recorded form, can be transferred from one medium to 15 another does not affect the nature of that physical manifestation as corporeal, or tangible. Shontz, supra, at 168-170. Likewise, that the software can be transferred from 1248 one type of physical recordation, e.g., tape, to another type, e.g., disk or hard drive, does not alter the nature of the software, Shontz, supra, at 168-170; it still has corporeal qualities and is inextricably intertwined with a corporeal object. The software must be stored in physical form on some tangible object somewhere..."

27. Reversing the findings of the court below that the computer software constitutes intellectual property, it was opined :

"In sum, once the "information" or "knowledge" is transformed into physical existence and recorded in physical form, it is

corporeal property. The physical recordation of this software is not an incorporeal right to be comprehended. therefore we hold that the switching system software and the data processing software involved here is tangible personal property and thus is taxable by the City of New Orleans."

81. The Supreme Court in **TATA CONSULTANCY CASE (SUPRA)** have thus laid down that Computer programs are the product of an intellectual process, but once implanted in a medium they are widely distributed to computer owners. That a computer program may be copyrightable as intellectual property does not alter the fact that once in the form of a floppy disc or other medium, the program is tangible, moveable and available in the marketplace.

82. The Supreme Court has further held that a software programme may consist of various commands which enable the computer to perform a designated task. The copyright in that programme may remain with the

originator of the programme. But the moment copies are made and marketed, it becomes goods, which are susceptible to sales tax. Even intellectual property, once it is put on to a media, whether it be in the form of books or canvas (In case of painting) or computer discs or cassettes, and marketed would become "goods". There is no difference between a sale of a software programme on a CD/floppy disc from a sale of music on a cassette/CD or a sale of a film on a video cassette/CD. In all such cases, the intellectual property has been incorporated on a media for purposes of transfer. Sale is not just of the media which by itself has very little value. The software and the media cannot be split up. What the buyer purchases and pays for is not the disc or the CD. As in the case of paintings or books or music or films the buyer is purchasing the intellectual property and not the media i.e. the paper or cassette or disc or CD. The software itself, i.e. the physical copy, is not merely a

right or an idea to be comprehended by the understanding.

83. It has been further held that the purchaser of computer software neither desires nor receives mere knowledge, but rather receives a certain arrangement of matter that will make his or her computer perform a desired function. This arrangement of matter, physically recorded on some tangible medium, constitutes a corporeal body. The form of the delivery of the software-magnetic tape or electronic transfer via modem- is of no relevance. That the software can be transferred to various media i.e. from tape to disc, or tape to hard drive, or even that it can be transferred over the telephone lines, does not take away from the fact that the software was ultimately recorded and stored in physical form upon a physical object. Recorded as such, the software is not merely an incorporeal idea to be comprehended, and would be of no use if it were. Rather, the software is given physical

existence to make certain desired physical things happen. One cannot escape the fact that software, recorded in physical form, becomes inextricably intertwined with, or part and parcel of the corporeal object upon which it is recorded , be that a disc, tape, hard drive, or other device. That the information can be transferred and then physically recorded on another medium is of no moment, and does not make computer software any different than any other type of recorded information that can be transferred to another medium such as film, video tape, audio tape, or books. It is now common knowledge that books, music, and even movies or other audio/visual combinations can be copied from one medium to another. They are also all available on computer in such forms as floppy disc, tape, and CD-ROM. Such movies, books, music, etc. can all be delivered by and/or copied from one medium to another, including electrical impulses with the use of a modem.

Assuming there is sufficient memory space available in the computer hard disc drive such movies, books, music, etc. can also be recorded into the permanent memory of the computer. That the information, knowledge, story, or idea, physically manifested in recorded form, can be transferred from one medium to another does not affect the nature of that physical manifestation as corporeal, or tangible. Likewise, that the software can be transferred from one type of physical recordation, e.g., tape, to another type, e.g., disk or hard drive, does not alter the nature of the software, it still has corporeal qualities and is inextricably intertwined with a corporeal object. The software must be stored in physical form on some tangible object somewhere. In sum, once the "information" or "knowledge" is transformed into physical existence and recorded in physical form, it is corporeal property. The physical recordation of this

software is not an incorporeal right to be comprehended.

84. To further elucidate the nature of the transaction in the case of the Assessee it is necessary to examine some of the clauses of the Licensing software agreement entered into by the Assessee with its customers:

INFRASOFT LICENCE AGREEMENT.

2. GRANT, SUPPLY AND USE OF LICENCE

a) Infrasoft grants Licensee a non-exclusive, non-transferable licence to use the software in accordance with this Agreement and the Infrasoft Licence Schedule. The licence is perpetual unless identified as being for a specified term in the Infrasoft Licence Schedule.

b) Any third party software incorporated in the software is licensed only for use with the software.

c) Infrasoft will supply one copy of the software for each site and, when applicable,

one set of support information to the Licensee. Licensee shall pay Infrasoft a fee for additional copies of any printed support information supplied by Infrasoft.

d) Liecensee may make one copy of the software and associated support information for backup purposes, provided that the copy shall include Infrasoft's copyright and other proprietary notices. All copies of the Software shall be the exclusive property of Infrasoft.

e) The Software includes a licence authorisation device, which restricts the use of the Software as specified in the Infrasoft Licence Schedule.

f) The Software shall be used only for Licensee's own business as defined within the Infrasoft Licence Schedule and shall not, without prior written consent from Infrasoft:

(i) be loaned, rented, sold, sublicensed or transferred to any third party

(ii) used by any parent, subsidiary or affiliated entity of Licensee

(iii) Used for the operation of a service bureau or for data processing

g) If Licensee was granted an educational licence, as identified on the Infrasoft Licence Schedule, the Software may only be used for instruction or research purposes and not for any commercial purposes.

h) Licensee may not copy, decompile, disassemble or reverse-engineer the Software without Infrasoft's written consent. The Licensee's rights shall not be restricted by this Clause 2(h) to the extent that local law grants Licensee a right to do so for the purpose of achieving interoperability with other software and in addition thereto Infrasoft undertakes to make information relating to interoperability available to Licensee subject to such reasonable conditions as Infrasoft may from time to time impose including a reasonable fee for doing so. To ensure Licensee receives the

appropriate information, Licensee must first give Infrasoft sufficient details of its objectives and the other software concerned. Requests for the appropriate information should be directed to the Vice president Technical of Infrasoft.

3. LICENCE FEES, PAYMENT AND TAXES

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87. In order to qualify as royalty payment, it is necessary to establish that there is transfer of all or any rights (including the granting of any licence) in respect of copyright of a literary, artistic or scientific work. In order to treat the consideration paid by the Licensee as royalty, it is to be established that the licensee, by making such payment, obtains all or any of the copyright rights of such literary work. Distinction has to be made between the acquisition of a "copyright right" and a "copyrighted article". Copyright is distinct from the material object, copyrighted. Copyright is an intangible incorporeal right in the nature of a privilege, quite independent of any material substance, such as a manuscript. Just because one has the copyrighted article, it does not follow that one has also the copyright in it. It does not amount to transfer of all or any right including licence in respect of copyright. Copyright or even right to use copyright is distinguishable from sale consideration paid for

"copyrighted" article. This sale consideration is for purchase of goods and is not royalty.

88. The license granted by the Assessee is limited to those necessary to enable the licensee to operate the program. The rights transferred are specific to the nature of computer programs. Copying the program onto the computer's hard drive or random access memory or making an archival copy is an essential step in utilizing the program. Therefore, rights in relation to these acts of copying, where they do no more than enable the effective operation of the program by the user, should be disregarded in analyzing the character of the transaction for tax purposes. Payments in these types of transactions would be dealt with as business income in accordance with Article 7.

89. There is a clear distinction between royalty paid on transfer of copyright rights and consideration for transfer of

copyrighted articles. Right to use a copyrighted article or product with the owner retaining his copyright, is not the same thing as transferring or assigning rights in relation to the copyright. The enjoyment of some or all the rights which the copyright owner has, is necessary to invoke the royalty definition. Viewed from this angle, a non-exclusive and non-transferable licence enabling the use of a copyrighted product cannot be construed as an authority to enjoy any or all of the enumerated rights ingrained in Article 12 of DTAA. Where the purpose of the licence or the transaction is only to restrict use of the copyrighted product for internal business purpose, it would not be legally correct to state that the copyright itself or right to use copyright has been transferred to any extent. The parting of intellectual property rights inherent in and attached to the software product in favour of the licensee/customer is what is contemplated by the Treaty. Merely authorizing or enabling a customer to have the benefit of data or instructions contained therein without any further right to deal with them independently does not, amount to transfer of rights in relation to copyright or conferment of the right of using the

copyright. The transfer of rights in or over copyright or the conferment of the right of use of copyright implies that the transferee/licensee should acquire rights either in entirety or partially co-extensive with the owner/ transferor who divests himself of the rights he possesses pro tanto.

90. The license granted to the licensee permitting him to download the computer programme and storing it in the computer for his own use is only incidental to the facility extended to the licensee to make use of the copyrighted product for his internal business purpose. The said process is necessary to make the programme functional and to have access to it and is qualitatively different from the right contemplated by the said paragraph because it is only integral to the use of copyrighted product. Apart from such incidental facility, the licensee has no right to deal with the product just as the owner would be in a position to do.

91. There is no transfer of any right in respect of copyright by the Assessee and it is a case of mere transfer of a copyrighted article. The payment is for a copyrighted

article and represents the purchase price of an article and cannot be considered as royalty either under the Income Tax Act or under the DTAA.

92. The licensees are not allowed to exploit the computer software commercially, they have acquired under licence agreement, only the copy righted software which by itself is an article and they have not acquired any copyright in the software. In the case of the Assessee company, the licensee to whom the Assessee company has sold/licensed the software were allowed to make only one copy of the software and associated support information for backup purposes with a condition that such copyright shall include Infrasoft copyright and all copies of the software shall be exclusive properties of Infrasoft. Licensee was allowed to use the software only for its own business as specifically identified and was not permitted to loan/rent/sale/sub-licence or transfer the

copy of software to any third party without the consent of Infrasoft.

93. The licensee has been prohibited from copying, de-compiling, de-assembling, or reverse engineering the software without the written consent of Infrasoft. The licence agreement between the Assessee company and its customers stipulates that all copyrights and intellectual property rights in the software and copies made by the licensee were owned by Infrasoft and only Infrasoft has the power to grant licence rights for use of the software. The licence agreement stipulates that upon termination of the agreement for any reason, the licencee shall return the software including supporting information and licence authorization device to Infrasoft.

94. The incorporeal right to the software i.e. copyright remains with the owner and the same was not transferred by the Assessee. The right to use a

copyright in a programme is totally different from the right to use a programme embedded in a cassette or a CD which may be a software and the payment made for the same cannot be said to be received as consideration for the use of or right to use of any copyright to bring it within the definition of royalty as given in the DTAA. What the licensee has acquired is only a copy of the copyright article whereas the copyright remains with the owner and the Licensees have acquired a computer programme for being used in their business and no right is granted to them to utilize the copyright of a computer programme and thus the payment for the same is not in the nature of royalty.

95. We have not examined the effect of the subsequent amendment to section 9 (1)(vi) of the Act 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 the DTAA, the provisions of which are more beneficial.

96. The amount received by the Assessee under the licence agreement for allowing the use of the software is not royalty under the DTAA.

97. What is transferred is neither the copyright in the software nor the use of the copyright in the software, but what is transferred is the right to use the copyrighted material or article which is clearly distinct from the rights in a copyright. The right that is transferred is not a right to use the copyright but is only limited to the right to use the copyrighted material and the same does not give rise to any royalty income and would be business income.

98. We are not in agreement with the decision of the Andhra Pradesh High Court in the case of ***SAMSUNG ELECTRONICS CO. LTD (SUPRA)*** that right to make a copy of the software and storing the same in the hard

disk of the designated computer and taking backup copy would amount to copyright work under section 14(1) of the Copyright Act and the payment made for the grant of the licence for the said purpose would constitute royalty. The license granted to the licensee permitting him to download the computer programme and storing it in the computer for his own use was only incidental to the facility extended to the licensee to make use of the copyrighted product for his internal business purpose. The said process was necessary to make the programme functional and to have access to it and is qualitatively different from the right contemplated by the said provision because it is only integral to the use of copyrighted product. The right to make a backup copy purely as a temporary protection against loss, destruction or damage has been held by the Delhi High Court in DIT v. M/s Nokia Networks OY (Supra) as not amounting to acquiring a copyright in the software.

99. In view of the above we accordingly hold that what has been transferred is not copyright or the right to use copyright but a limited right to use the copyrighted material and does not give rise to any royalty income.

100. The question of law is thus answered in favour of the Assessee and against the Revenue that the Income Tax Appellate Tribunal was right in holding that the consideration received by the respondent Assessee on grant of licences for use of software is not royalty within the meaning of Article 12(3) of the Double Taxation Avoidance Agreement between India and the United States of America.

101. The appeal is accordingly dismissed leaving the parties to bear their own costs.

SANJEEV SACHDEVA, J.

22nd st NOVEMBER, 2013 **SANJIV KHANNA, J.**