

Tax Hotline

February 22, 2021

SOFTWARE BATCH APPEALS - COURTROOM PROCEEDINGS (DAY 6: FEBRUARY 18, 2021)

Oral hearings before the Supreme Court in the Software batch of appeals drew to a close on February 18, 2020 with rebuttals to the Revenue's arguments.

Arvind Datar, Senior Advocate, representing IBM India (a distributor of packaged software) reiterated that the Supreme Court in *TCS* held that packaged software constituted "goods". As such, he argued, the mere use of the term "license" in the end-user agreement does not imply that the purchaser had received an interest in the underlying copyright of the "goods".

1. Nomenclature not conclusive of the true nature of an agreement

Datar referred to the Supreme Court's judgement in *Sundaram Finance*¹ wherein an agreement referred to as a "sale letter" was found to be a "hire-purchase agreement", based on the terms of the agreement and the intention of the parties. He also referred to the Madras High Court's judgement in *Thiruvenkata Mudaliar*,² which reiterated the position that whilst construing the nature of a document, only the substance of the document mattered, and not its nomenclature. Relying on these precedents, Datar argued that since the agreement did not confer any interest in the copyright, it should not be construed as a "license" agreement, regardless of its nomenclature. Thus, he submitted that the consideration paid for the software could not be characterised as royalty, because the agreement in substance was for the sale of goods.

He also argued that the end-user agreement would not affect the distributor in any case, as the distributor had paid consideration only for the goods and not for any interest in the copyright.

2. Clickwrap Agreements and the Equalization Levy

The Bench questioned Datar on whether his argument on the "sale of goods" would apply to cases where software could be directly downloaded from the internet. In response, Datar stated that the agreement for the use of "shrink-wrap software" that was received in a box gives the buyer the right to make a copy of the software on a hard disk. In the case of a digital download, which is known as "clickwrap software", the copy would be directly downloaded onto a hard disk once the agreement was accepted. He argued that since the effect of acceptance of a clickwrap agreement was the same as that of a shrink-wrap agreement, the clickwrap software would constitute goods as well. Hence, its purchase would qualify as a sale of goods.

He further stated that an Equalization Levy on e-commerce transactions had been introduced last year to tax the online sale of goods by non-resident e-commerce operators, at a rate of 2% of their revenue. He argued that the sale of clickwrap software would be taxed through this levy, and as such the consideration paid would still not constitute royalty. It must be noted however, that the Finance Bill, of 2021 has issued a clarification stating that on payments which are taxed as royalty, the equalization levy will not apply.

S. Ganesh, Senior Advocate, representing Sonata IT (a distributor of packaged software) assailed the Revenue's position that tax treaty provisions should not be accounted for whilst determining withholding tax obligations. The Revenue had argued that withholding obligations ought to be determined solely under the Income Tax Act ("ITA"), whilst the impact of tax treaties should be accounted for only by the non-resident recipients, i.e., the taxpayers, to claim a refund during the assessment stage. Ganesh premised his rebuttal on the following arguments.

1. CBDT is bound by Circular No. 728 of 1995

Ganesh directed the attention of the Court to Circular No. 728 of 1995, wherein the Central Board of Direct Taxes ("CBDT") clarified that the payer could consider the provisions of the relevant tax treaties at the stage of deducting taxes on royalty payment. He argued that the Revenue was bound by this circular and could not advance a contrary position.

2. Tax treaties should be interpreted pragmatically

Ganesh referred to *Azadi Bachao Andolan*,³ in which the Supreme Court had observed that tax treaties should be interpreted in a manner that aids commercial relations between countries. The Court also observed that tax treaties should not be interpreted as though they were statutes, but rather their interpretation should be acceptable to both "lawyer and layman alike".

Therefore, Ganesh contended that the Commentary on the OECD Model Tax Convention is a pragmatic document that businesses have relied upon to understand their international tax obligations, and to plan their transactions. He submitted that the guidance on interpretation of tax treaties in the OECD Commentary meets the standard of interpretation set out in *Azadi Bachao Andolan*. He further stated that if the Indian exchequer were permitted to tax

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software purchases as royalty despite its tax treaty obligations, India would isolate itself from international tax jurisprudence, which should be avoided. He justified the relevance of the OECD Commentary, on the basis of the Supreme Court's reliance on the Commentary, in the cases of *Azadi Bachao Andolan*, *Formula One*,⁴ and *E-Funds*.⁵ He pointed out that the erstwhile Attorney General had also relied upon the OECD Commentary in *Formula One*.

3. India's Reservation to the OECD Commentary should not be relied upon

India had expressed a reservation to the interpretation of "royalties" in the OECD Commentary, which was relied upon by the ASG. In response, Ganesh contended that India had merely expressed that its position might differ from the OECD Commentary with respect to some payments, and had neither delineated these payments nor explained the rationale for India's difference from the OECD position. He argued that such a muted reservation should not be relied on strongly. He also pointed out that this reservation was expressed in 2008, and submitted that if the Central Government had been keen on establishing this reservation, it would have appealed the advance rulings and High Court judgments which relied on the OECD Commentary. The Government could have also attempted to renegotiate its tax treaties post-2008, but had chosen not to.

In support of his argument, Ganesh relied on *New Skies Satellite*,⁶ in which the Delhi High Court held that India's reservation to the OECD Commentary could not influence the interpretation of the term "royalties" as defined in tax treaties. Therefore, Ganesh submitted that the India's reservation should not be considered whilst interpreting tax treaties.

Ajay Vohra, Senior Advocate, representing Sasken Communications (an end user of shrink-wrap software) also rebutted the Revenue's submissions that tax treaties were inapplicable during the withholding stage. He pointed out that the Supreme Court in *GE India Tech*⁷ had already accepted that tax treaties could be accounted for at the withholding stage. In *that case*, the Supreme Court had set aside decision of the Karnataka High Court and had remitted the matter back to the Karnataka High Court for a fresh consideration on merits. The Karnataka High Court had followed the Supreme Court's instructions and passed a judgement on merits, which is now being appealed in the extant batch of appeals. Vohra submitted that the issue of relevance of tax treaties had already been settled in *GE India Tech*, and that a contrary position could not be taken before the Court at this stage, since it was the second round of litigation concerning the same cases.

Representing the Revenue, Balbir Singh, Additional Solicitor General of India, made the following submissions in response to the arguments above.

1. Consequences of imposing the OECD Interpretation

Singh submitted that forcing India, a non-OECD country, to accept the interpretation of the OECD on tax treaties, despite her having raised a red flag about the interpretation of a given provision, would have "disastrous consequences". This proposition was premised on the observation that the OECD also recommended interpretations for "defence treaties, intellectual property treaties, and so on". This appears to be a suggestion that the Court's acceptance of the OECD interpretation of the term "royalties" might inadvertently bind India to the OECD's guidance in other topics of national importance, thus impinging her sovereignty.

2. Payer of income not an "assessee"

According to Singh, Section 90 of the ITA provided for treaty benefits to an "assessee". It was argued on behalf of the taxpayers that ITA defined the term "assessee" to include "assessee in default". Therefore, the benefits of Section 90 should be available to the payers as well, as they were considered to be "assessees in default" in the instant case. Drawing the court's attention to subsections (3) and (4) of Section 90, however, Singh disagreed with that argument. He contended that those subsections set out that only a non-resident could be treated as an assessee under Section 90. Therefore, he argued, a payer who was tax resident of India could not avail the benefits of Section 90. Singh also relied on *GE India Tech*, wherein it was held that a payer of income could not be considered an assessee in such cases.

Finally, he submitted that the license under the end-user agreement was essential for the owner of the copyright to retain her rights over the software. Therefore, he contended, these agreements could not be viewed a mere sales of goods.

- Arijit Ghosh & Dhruv Sanghavi

(*We would like to acknowledge input from Pranav Mihir Kandada for the preparation of these notes.)

You can direct your queries or comments to the authors

¹ (1966) 2 SCR 828
² (1977) 107 ITR 661
³ (2004) 10 SCC 1
⁴ (2017) 15 SCC 602.
⁵ (2018) 13 SCC 394.
⁶ (2016) 382 ITR 114.
⁷ (2010) 10 SCC 29.

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