Treaty Characterization of Software Income: The Indian Supreme Court’s Landmark Decision of 2 March 2021

This article considers the recent decision of the Indian Supreme Court (ISC) of 2 March 2021 regarding the characterization of income derived from software under tax treaties (as well as domestic law), together with the implications of the ISC’s judgment.

1. Introduction

The treaty characterization of software income has been a heavily litigated international tax issue in India over the last 10 years. In that period, the Indian courts and the Income Tax Appellate Tribunal (ITAT) have expressed divergent opinions on whether a non-resident vendor’s income from software transactions amounts to “royalties” under the relevant tax treaty. On 2 March 2021, the Indian Supreme Court (ISC) issued a 226-page landmark decision on the issue. The ISC examined various aspects of the issue, including transaction characterization, whether the domestic tax law definition of “royalties” was relevant for the interpretation of the treaty definition of that term, the relevant aspects of the Indian copyright law and certain treaty interpretation principles. This article provides an in-depth analysis of the ISC’s landmark decision.

2. Relevant Domestic Tax Law

2.1. Section 5 of the Indian Income Tax Act: Taxability of income of non-residents

According to section 5(2) of the Income Tax Act 1961 (ITA), a non-resident’s income is taxable in India if that income is:

(a) received or deemed to be received in India during the relevant tax assessment year; or
(b) actually accrues or arises in India or is deemed to accrue or arise in India during the relevant tax year.

2.2. Section 9(1)(vi) of the ITA: Royalties deemed to arise in India

Under section 9(1)(vi) of the ITA, a non-resident’s royalty income is deemed to arise in India if it is payable by:

(a) the Government of India;

(b) a person who is resident of India, except if the royalty is payable in respect of any right, property or information used or services utilized for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India; or

(c) a person who is a non-resident, where the royalty is payable in respect of any right, property or information used or services utilized for the purposes of a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India.

The term “royalty” is defined in Explanation 2 to section 9(1)(vi) of the ITA. This definition was amended in 2012 with retroactive effect. Prior to that amendment, the term was defined as meaning:

consideration (including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head “capital gains”) for:

(i) the transfer of all or any rights (including the granting of a licence) in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property;

(ii) the imparting of any information concerning the working of, or the use of, a patent, invention, model, design, secret formula or process or trade mark or similar property;

(iii) the use of any patent, invention, model, design, secret formula or process or trade mark or similar property;

(iv) the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill;

(iv) the use or right to use any industrial, commercial or scientific equipment but not including the amounts referred to in section 44BB;

(v) the transfer of all or any rights (including the granting of a licence) in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films; or

(vi) the rendering of any services in connection with the activities referred to in sub-clauses (i) to (iv), (iva) and (v).

Explanation 3 to section 9(1)(vi) of the ITA defines “computer software” as follows:

Explanation 3.—For the purposes of this clause, “computer software” means 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.

Prior to 2012, the ITA did not contain a source rule regarding software transactions. However, in several cases, the

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2. IN: Income Tax Act 1961, sec. 5(2), Primary Sources IBFD.
3. A non-resident’s income is taxable in India if it is received in India, regardless of whether the income accrues or arises in India.
Indian courts examined the tax treatment of the income of foreign companies from software transactions with Indian customers. Some of these judicial precedents are considered in section 4.

The Finance Act (FA) 2012, by inserting the following explanations to section 9(1)(vi) of the ITA, implemented a retroactive amendment to the aforementioned definition of “royalty”:

**Explanation 4** — For the removal of doubts, it is hereby clarified that the transfer of all or any rights in respect of any right, property or information includes and has always included transfer of all or any right for use or right to use a computer software (including granting of a licence) irrespective of the medium through which such right is transferred.

**Explanation 5** — For the removal of doubts, it is hereby clarified that the royalty includes and has always included consideration in respect of any right, property or information, whether or not —

(a) the possession or control of such right, property or information is with the payer;
(b) such right, property or information is used directly by the payer;
(c) the location of such right, property or information is in India.

**Explanation 6** — For removal of doubts, it is hereby clarified that the expression ‘process those quotes includes an shall be deemed to have always included transmission by satellite (including up-linking, amplification, convergent for down-linking of any signal), cable, optic fibre or by any other similar technology, whether or not such processes are secret.

3. Definition of “Royalties” in Tax Treaties

In general, the definition of “royalties” in the tax treaties that India has concluded with other states follow the OECD Model Convention or the UN Model Convention, and it includes, inter alia, payments of any kind as consideration for the use of, or the right to use:

- any copyright of a literary, artistic or scientific work;
- any patent, trademark, design or model, plan, secret formula or process; or
- information concerning industrial, commercial or scientific experience.

4. Significant Judicial Developments in India Regarding this Issue Prior to March 2021

4.1. Tata Consultancy Services v. State of Andhra Pradesh (2004)\(^4\)

In this sales tax decision of the ISC, Tata Consultancy Services (TCS) was a tax resident of India. It was engaged in the business of providing software consultancy services. TCS resold certain off-the-shelf (third-party) software to customers. The ownership of the intellectual property (IP) in respect of the software remained with the developers of the software.

According to the Indian sales tax authorities, the off-the-shelf software were “goods” liable to sales tax. TCS was unsuccessful in its appeals before the Sales Tax Appellate Tribunal (STAT)\(^3\) and the Andhra Pradesh High Court (HC).\(^4\)

The Constitution Bench (of five judges) of the ISC held that, once software had been copied onto a medium (for example, a compact disc (CD)), it became tangible property, i.e. goods liable to sales tax. According to the ISC, software placed on a medium was similar to a music CD.

4.2. CIT Alcatel v. DCIT (2007)\(^7\)

In this decision of the Indian Income Tax Appellate Tribunal (ITAT), CIT Alcatel was a tax resident of France. It was engaged in the business of manufacturing and selling telecommunications networks. CIT Alcatel had entered into a contract with an Indian company (the “Indian customer”) for supplying telecommunications equipment, which included hardware and software.

According to CIT Alcatel, its income from the supply of software amounted to business profits, the tax treatment of which was governed by article 7(1) of the France-India Income and Capital Tax Treaty (1992).\(^7\) CIT Alcatel also claimed that the income was not taxable in India, as it was not attributable to a permanent establishment (PE) in India. However, the Indian tax authorities rejected that position and held that the entire value of software was taxable as royalties at the rate of 30% of the gross amount, i.e. without any deduction for any related expenses.

The ITAT noted that the Indian customer was not authorized to make permanent copies or to sell or distribute the software. Accordingly, in the ITAT’s view, this was a case of the use of a copyrighted article (software), rather than a licence for copyright in respect of the software. Consequently, the ITAT held that the income of CIT Alcatel from the supply of software did not amount to royalties. As a result, and as the income was not attributable to a PE in India, the income was not taxable in India. The ITAT’s approach in this case was similar to that of the Commentary on Article 12 of the OECD Model.\(^8\)

4.3. Microsoft Corporation v. ADIT (2010)\(^10\)

4.3.1. The background

This landmark decision of the ITAT involved separate appeals by three taxpayer companies belonging to the Microsoft Corporation Group – Microsoft Corporation (MS), Microsoft Regional Sales Corporation (MRSC) and Gracemac Corporation (GC) (hereafter collectively purchased hardware and software.

The Indian tax authorities rejected that position and held that the entire value of software was taxable as royalties at the rate of 30% of the gross amount, i.e. without any deduction for any related expenses.

5. IN: STAT, decision dated 1 Apr. 1996.
6. IN: HC, the Andhra Pradesh High Court’s decision dated 12 Dec. 1996.
10. IN: ITAT, 26 Oct. 2010, Microsoft Corporation v. ADIT, ITA No. 1392 (Del.) of 2005, Case Law IBFD.

\(^{4}\) IN: ISC, 5 Nov. 2004, Tata Consultancy Services v. State of Andhra Pradesh, Appeal (civil) 2582 of 1998, 271 ITR 401 (SC) and 2005 (1) SCC 308, Case Law IBFD.


\(^{9}\) OECD Model Tax Convention on Income and on Capital: Commentary on Article 12 paras. 12 to 18 (1992), Treaties & Models IBFD.

\(^{10}\) IN: ITAT, 26 Oct. 2010, Microsoft Corporation v. ADIT, ITA No. 1392 (Del.) of 2005, Case Law IBFD.
referred to as “the taxpayer companies”). All three taxpayer companies were tax residents of the United States.

MS was the leading developer, IP owner and the seller of the Microsoft group of computer software. Until 1998, MS had directly entered into agreements on a principal-to-principal basis with various Indian distributors for the sale of off-the-shelf Microsoft software products. The Indian distributors, in turn, sold the software products to resellers and/or end-users. However, from 1999, MS modified its business model, such that the products were sold to the Indian distributors by MRSC’s branch office in Singapore.

The chain of transactions, originating with MS and ending with sales to Indian distributors and/or end-users, can be summarized in the following five stages:

1. on 1 January 1999, MS entered into an agreement with its wholly owned subsidiary GC and granted an exclusive licence to reproduce and distribute various Microsoft software products in the retail territory. While MS continued to own the IP in Microsoft software products, it agreed to provide master copies of the software products to GC for a consideration of 20 shares of GC’s common stock at the par value of USD 0.01;
2. GC, in turn, entered into a licence agreement with Microsoft Operations Pte. Ltd, Singapore (the “Singapore Company”). Under the licence agreement, the Singapore Company obtained a non-exclusive licence to reproduce Microsoft software in Singapore and distribute this to retailers and certain end-users. As consideration, the Singapore Company agreed to pay a royalty to GC. With regard to the Microsoft products that were eventually distributed to Indian distributors by MRSC through its non-exclusive distribution agreement (see (3)) with the Singapore Company, the amount of royalty payable by the Singapore Company to GC ranged from 35% to 40% of the net selling price received by MRSC;
3. the Singapore Company, under a non-exclusive distribution agreement, appointed MRSC as a distributor to sell copies of Microsoft software. In the final step, MRSC entered into agreements with various (unrelated) distributors in various countries, including India. The distributors had a right to distribute copies of software in their countries;
4. copies of the Microsoft software were delivered by MRSC to the Indian distributors’ former warehouse in Singapore. The distributors distributed the products to the resellers in India who, in turn, sold them to the end-users. MS, as the owner of the IP in the Microsoft software products, entered into an end-user licence agreement (EULA); and
5. the Microsoft software was distributed in India by way of two alternative models: (i) Full Packaged Product (FPP); and (ii) Volume Purchase Product (VPP). In the case of FPP, the Singapore Company made a copy of software by embedding the software in a medium (for example, a CD) and provided the program to MRSC for onward distribution in India. In the case of VPP, the end-user was provided with one set of media containing the software and was permitted to make a specific number of copies for internal use. The amount charged to the end-user was based on the number of copies that could be made.

MS, in its Indian tax return for the tax year 1996/97, included its income from the licensing of software to original equipment manufacturers. But MS did not include its income from the sale of software products to Indian distributors. The Indian tax authorities held that the income received by MS from the Indian distributors amounted to royalties in terms of section 9(1)(vi) of the ITA and article 12 of the India-United States Income Tax Treaty (1989).

MRSC, in its Indian tax return for the tax assessment years 1999/2000 to 2001/02, did not include any part of the income received by it from the Indian distributors. The Indian tax authorities concluded that all of the income received by MRSC from the Indian distributors amounted to royalties taxable in India.

With regard to GC, for the tax years 1999/2000 to 2004/05, the Indian tax authorities held that 35% to 40% of the net sales received by MRSC from Indian distributors amounted to royalties taxable in hands of GC, according to the terms of section 9(1)(vi) of the ITA and article 12 of the India-United States Income Tax Treaty (1989). In the first appeal, the Commissioner of Income Tax (Appeals) (CIT(A)) increased the amount of taxable income to 100% of the net sales consideration received by MRSC from Indian distributors on the ground that MRSC and the Singapore Company were a legal facade or sham.

4.3.2. The ITAT’s decision

4.3.2.1. Initial remarks

The ITAT held that the income of the taxpayer companies from Indian distributors amounted to royalties taxable in India in terms of section 9(1)(vi) of the ITA and article 12 of the India-United States Income Tax Treaty (1989). The ITAT reached this decision on the grounds outlined below.

4.3.2.2. End-user consideration as royalties under the ITA and the India-United States Income Tax Treaty

The ITAT held that the income of the taxpayer companies derived from the software distributed in India amounted to royalties under section 9(1)(vi) of the ITA and article 12(3) of the India-United States Income Tax Treaty (1989) for the following reasons:

- The ITAT observed that the definitions of “royalties” in Explanation 2 to section 9(1)(vi) of the ITA and article 12(3) of the India-United States Income Tax Treaty (1989) were identical.


12. IN-CIT(A).
The ITAT rejected the contention of the taxpayer companies that the word “of” ought to be inserted between the words “copyright” and “literary” in the definition of the term “royalties” in clause (v) to Explanation 2 to section 9(1)(vi) of the ITA, as:

(v) the transfer of all or any rights (including the granting of a licence) in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films.

The ITAT noted that it was a settled law that, where the language of a legal provision was plain and unambiguous, it must be interpreted in a literal manner. According to the ITAT, the language used in the clause was plain, clear and unambiguous and was not capable of having two meanings. Consequently, the ITAT held that there was no need to insert the word “of” in place of the punctuation mark “,” as contended by the taxpayer companies.

The ITAT observed that although the term “copyright” appeared in the definition of “royalties” in the ITA and the India-United States Income Tax Treaty (1989), the term was defined neither in the ITA nor in the tax treaty in question. It was, therefore, necessary to refer to the Indian Copyright Act, 1957 (CA).

A combined reading of sections 2(fic) and 2(o) of the CA revealed that the term “computer program” was included in the meaning of a literary work that was protected by copyright. Consequently, according to the ITAT, the consideration for the transfer of all or any rights, including the granting of a licence, in respect of a computer program, or software, was in the nature of royalties.

The ITAT rejected the contentions of the taxpayer companies that the consideration paid by an end-user of the Microsoft software was for a copyrighted product and not for the use of copyright in software. In the ITAT’s view, as MS had granted a right to the end-users to copy the software on a hard disc, the consideration paid by the end-user was in respect of the granting of the copyright by MS to the end-users. Accordingly, such consideration amounted to royalties under the ITA and the India-United States Income Tax Treaty (1989).

According to the ITAT, the ISC’s decision in Tata Consulting Services (see section 4.1.), which was relied on by the ITAT in its earlier decisions regarding the taxation of the income of foreign companies from software transactions, did not apply in the context of the ITA and tax treaties. Consequently, in the ITAT’s view, its earlier decisions on the issue were not sound precedents.

Again, according to the ITAT, neither section 9(1)(vi) of the ITA nor article 12(3) of the India-United States Income Tax Treaty (1989) stated that, once an item of income was in respect of copyright, the same income could not be (simultaneously) regarded as the consideration for the use of a patent, invention, process, etc. In the ITAT’s view, the consideration paid by end-users of Microsoft software amounted to royalties, even if paid on account of a patent, invention or process, for the following reasons:

- the ITAT observed that the Microsoft products were patented in the United States, and, therefore, the payments made by the end-users were in the nature of consideration for a right to use such patents. Consequently, in the ITAT’s view, the consideration amounted to royalties in terms of section 9(1)(vi) of the ITA and article 12(3) of the India-United States Income Tax Treaty (1989);
- the ITAT also accepted the contention of the tax authorities that the Microsoft software products were original inventions, and, for this reason, the consideration for the use of the software amounted to royalties in terms of section 9(1)(vi) of the ITA and article 12(3) of the India-United States Income Tax Treaty (1989);
- in addition, the ITAT accepted the contention of the Indian tax authorities that a computer program was a set of instructions designed to provide a certain result to end-users. In the ITAT’s view, it was clear that a computer program was a process when it executed instructions in a passive state. Accordingly, payments by end-users for the use of a computer program involving a process amounted to royalties in terms of section 9(1)(vi) of the ITA and article 12(3) of the India-United States Income Tax Treaty (1989); and
- on the basis of various clauses in the EULA, the ITAT decided that the Microsoft products were not sold but were, rather, licensed to the end-users. For that reason, according to the ITAT, the consideration paid by the end-users in respect of the licences amounted to royalties in terms of section 9(1)(vi) of the ITA and article 12(3) of the India-United States Income Tax Treaty (1989). While reaching that conclusion, the ITAT noted that MS had filed numerous injunction petitions in the courts to prevent certain individuals and/or entities from violating copyright in the Microsoft software products.

4.3.2.3. Indian source of royalties under the ITA and the India-United States Income Tax Treaty (1989)

The ITAT opined that the royalties relating to the software distributed in India arose in India under the ITA as well as the India-United States Income Tax Treaty (1989).

4.3.2.4. The tax liability of MS, GC and MRSC

The ITAT held that:

- for the tax year 1996/97, the royalty income of MS was taxable in India because it arose in India;
the royalty income of GC, which could be traced to the software distributed to Indian distributors and end-users in India, was taxable in India; and

as MRSC had reproduced certain software products and distributed them through distributors in India, MRSC had a “business connection” in India. However, as the Indian tax authorities had opted to tax the entire income as royalties in the hands of GC, MRSC’s income could not be taxed again.

4.3.2.5. Relevance of Commentary on Article 12 of the OECD Model (2010)\textsuperscript{14} in interpreting Indian tax treaties

The ITAT opined that, in interpreting the provisions of the ITA and the India–United States Income Tax Treaty (1989), it was inappropriate to rely on the Commentary on Article 12 of the OECD Model (2010).

4.4. DIT v. Infrasoft Ltd. (2013)\textsuperscript{15}

In Infrasoft Ltd., the Delhi HC (DHC) recognized the distinction between copyright of software and software as a copyright-protected product. The DHC noted that copyright was an intangible incorporeal right in the nature of a privilege, independent of any material substance, such as a manuscript. Just because someone had the copyrighted product did not imply that that person also had the copyright in that product. Accordingly, the DHC opined, a transfer — for example, a sale — of a copyrighted product did not, in itself, involve the transfer of copyright in that product. Accordingly, in the DHC’s view, a non-exclusive and non-transferable licence enabling the use of a copyrighted product, such as a piece of software, could not be construed as an authority to enjoy any or all of the enumerated rights, such as copyright, in article 12 of the OECD Model (2010).

4.5. Samsung Electronics Co. Ltd. v. ITO (2011)\textsuperscript{16}

4.5.1. The taxpayer’s view

In this decision of the Karnataka HC (KHC), the taxpayer company was a tax resident of India. It was engaged in the business of developing computer software. In the relevant tax years, it had imported software from vendors from the United States and some other countries. It did not withhold any tax on the payment of the purchase price to the vendors, as, in its view, the incomes of the vendors were not taxable in India.

4.5.2. The view of the Indian tax authorities

The Indian tax authorities, however, concluded that the income received by the vendors from the sale of the software to the taxpayer company amounted to “royalties” under the terms of the ITA as well as article 12 of the India–United States Income Tax Treaty (1989). Accordingly, the Indian tax authorities concluded that the incomes of the vendors were taxable in India.

4.5.3. The KHC’s decision

The KHC held that the incomes of the vendors amounted to “royalties” in accordance with article 12 of the India–United States Income Tax Treaty (1989).

Before the KHC, the Indian tax authorities contended that, inter alia, as the taxpayer company was licensed to copy software on its computer hard disk, the incomes of the vendors were in the nature of “royalties”. On the other hand, the taxpayer company contended, inter alia, that it was not granted any copyright in respect of the software, and, therefore, that the incomes of the vendors could not be regarded as “royalties”. The taxpayer company also pointed out that, as clarified by the Commentary on Article 12 of the OECD Model,\textsuperscript{17} a mere permission to make a copy of the software — which was incidental to the sale of the software, and which was necessary to let the purchaser use the software — could not lead to the characterization of the payment as “royalties”.

The KHC observed that, according to Indian copyright law, the software was copyrighted and the copyright vested in the foreign supplier. It clarified that a copyright was in “negative right”. In the KHC’s view, the taxpayer company was licensed to make use of the copyright contained in the software, as the taxpayer company was permitted to make a copy of the software. Accordingly, the KHC opined that the payments by the taxpayer company to a vendor amounted to “royalties” in accordance with article 12 of the India–United States Income Tax Treaty (1989).

As a result, the KHC held that the income of the vendors was taxable in India. Consequently, the KHC also held that the taxpayer company had to withhold tax on the payments to the vendors.

5. The ISC’s Decision of 2 March 2021\textsuperscript{18}

5.1. Background to the ISC’s decision

The ISC combined more than 100 appeals by various taxpayers and the Indian tax authorities on the issue of the characterization of software income derived from the perspective of the applicable tax treaties. The ISC grouped those appeals into the following four categories:

1. the purchase of software by end-users, who were tax residents of India, from foreign non-resident suppliers or developers;

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14. OECD Model Tax Convention on Income and on Capital: Commentary on Article 12 (22 July 2010), Treaties & Models IBFD.


18. Engineering Analysis Centre (2021), supra n. 1.
(2) the distribution by Indian (tax resident) companies of software from foreign, non-resident, developers and/or suppliers;
(3) the distribution, by foreign, non-resident, vendors, to end-users in India, as those vendors had purchased the software from other foreign entities; and
(4) the software embedded in hardware or equipment and sold as an integral part of the hardware or the equipment.

In one of the appeals, which the ISC treated as the lead case, an Indian company purchased shrink-wrapped software from a US company. The Indian company distributed the software to the Indian customers, the relevant tax years being 2001/02 and 2002/03. The Indian tax authorities had characterized the US company’s income as “royalties” under the ITA as well as in accordance with article 12(3) of the India–United States Income Tax Treaty (1989). The Indian tax authorities had concluded that the Indian company had to withhold tax on the payments to the US company. Another key appeal in the case concerned a taxpayer company tax-resident in India, which had entered into software transactions with a Singapore company.

5.2. The ISC’s ruling on the income characterization issue

One of the taxpayers in the case was a non-exclusive distributor of a Singapore company’s shrink-wrapped software. That taxpayer submitted that it was not a party to the EULA between the Singapore company and the Indian end-users. Further, the distribution between the taxpayer and the Singapore company did not confer on the taxpayer any right, title or interest in the copyright or any other IP owned by the Singapore company.

The taxpayer relied on the decision of the ISC in Tata Consultancy Services (see section 4.1). On that basis, the taxpayer argued that the aforesaid software product amounted to “goods”. The taxpayer also argued that the definition of “royalties” did not extend to derivative products of the copyright – such as a book, music CD, software product, etc. Further, in view of section 90(2) of the ITA, an applicable tax treaty prevailed over the ITA to the extent that it was beneficial for the taxpayer. Accordingly, even if the Singapore company’s income amounted to “royalty” under section 9(1)(vi) of the ITA, it did not amount to royalties under the India–Singapore Income Tax Treaty (1994).

The ISC examined the distribution agreements between some of the taxpayer companies, i.e. the tax residents of India and the foreign software vendors. It found that those agreements conferred on the Indian companies merely non-exclusive, non-transferable licences in respect of the computer software. The Indian companies were not granted any right in respect of the copyright in the software. Further, even the Indian end-users were not granted any right to sub-license, transfer, reverse engineer, modify or reproduce in any manner the software otherwise than as permitted under the EULA. Accordingly, in the ISC’s view, what the Indian companies had paid to the foreign vendors represented merely the price of the computer program as goods either in a medium that stored the software, such as a CD, or in a medium, i.e. the hardware or the equipment, in which the software was embedded. Moreover, the Indian companies, as distributors, did not possess any right to use the software.

In the case of transactions involving the direct sale of software by the foreign companies to the Indian end-users, these end-users could only use the software by installing it in the computers owned by the end-users. The end-users were prohibited from reproducing, selling, transferring, etc. the software, contrary to the terms stated in the EULAs.

The ISC opined that the transactions between the foreign vendors and the Indian distributors or the end-users did not involve a licence of copyright in terms of section 30 of the CA. Rather, the transactions involved restrictions or conditions for the use of computer software.

In view of the foregoing, the ISC opined that, undoubtedly, what the foreign vendors had “licensed” to the Indian distributors or the end-users was the de facto sale of a physical object, containing an embedded computer program, and, therefore, that those transactions were in respect of the sale of goods, rather than the licence of copyright in software. As a result, in the ISC’s view, its earlier decision in Tata Consultancy Services applied in the present case.

The ISC also opined that the consideration for reproduction of software – but not the consideration for mere use of software – amounted to royalty. Accordingly, the ISC approved the decision of the DHC in InfraSoft (see section 4.4) and rejected the KHC’s decision in Samsung Electronics (see section 4.5).

5.3. Distinction between copyright and copyrighted product

One taxpayer in the ISC’s decision also sought to distinguish between a “copyright in an original work” and a “copyrighted product” as recognized in section 14(b) of the CA. That section referred to a “computer program” per se, and a “copy of a computer program”, as two distinct subject matters. In making such a distinction, that taxpayer also relied on the Commentary on Article 12 of the OECD Model. The ISC approved that distinction.

21. See discussion at para. 45 in the ISC’s decision.
22. See discussion at para. 46 in the ISC’s decision.
23. Id.
24. See discussion at para. 52 in the ISC’s decision.
27. See discussion at para. 98 in the ISC’s decision.
5.4. Was article 30 of the India-United States Income Tax Treaty (1989) applicable?

The Indian tax authorities sought to invoke article 30 of the India-United States Income Tax Treaty (1989), which fixed different dates for the entry into force of the treaty provisions regarding withholding taxes and other taxes. On that basis, the Indian tax authorities argued that the persons who were responsible for withholding taxes, i.e. the Indian end-users and the Indian distributors of the software of foreign vendors, could not invoke the India-United States Income Tax Treaty (1989). The ISC, however, rejected that proposition.

5.5. The ISC’s decision on the relationship between domestic law dealing with royalties and tax treaties

5.5.1. Tax treaty prevailed over the domestic tax law

5.5.1.1. Initial remarks

The ISC took into account section 90 of the ITA and noted that the relevant provisions of the ITA apply only to the extent that it is more beneficial to the taxpayer. It also noted that, according to section 90(4) of the ITA, a reference could be made to the ITA regarding the interpretation of treaty terms only in respect of the undefined treaty terms.

5.5.1.2. Relevant aspects of the CA

The ISC noted, inter alia, that, under section 2(o) of the CA, a “literary work” included a computer program. Section 2(ffc) of the CA defined “computer program” as a set of instructions expressed in words, codes, schemes or any other form capable of causing a computer to perform a particular task or achieve a particular result. The ISC further noted that section 14 of the CA clarified that “copyright” meant the “exclusive right”, subject to the provisions of the CA, to do or authorize the doing of certain acts “in respect of a work”. When an author in relation to a “literary work” – which included a computer program – created such a work, that author had the exclusive right, subject to the provisions of the CA, to do or authorize the doing of several acts in respect of such work or any substantial part thereof. The term “copyright” included a right to reproduce the work in any material form, issue copies of the work to the public, perform the work in public, or make translations or adaptations of the work.

Moreover, the ISC noted that, according to section 51(b) of the CA, making copies of or adapting a computer program to utilize it for the purpose for which it was supplied, or to make backup copies as a temporary protection against loss, destruction or damage to be able to utilize the computer program for the purpose for which it was supplied, did not constitute an act of infringement of copyright under section 52(1)(aa) of the CA.

5.5.1.3. Definitions of royalties in domestic tax law and tax treaties

In comparing the definitions of “royalties” in domestic tax law and tax treaties, the ISC considered article 12(3) of the India-Singapore Income Tax Treaty (1994). The ISC noted that the definition in the India-Singapore Income Tax Treaty (1994) included the word “means”. Accordingly, in the ISC’s view, “royalties” were defined in the India-Singapore Income Tax Treaty (1994) in an “exhaustive manner”.

5.5.1.4. FA 2012 amendments to domestic tax law – Could they apply retrospectively?

As a general principle, only the amendments of a clarificatory nature (and not of a substantive nature) can operate with retroactive effect. The ISC rejected the argument of the Indian tax authorities that Explanation 4 to section 9(1)(vi) of the ITA, introduced by the FA 2012 with retroactive effect from 1 June 1976 (see section 2.2.), was of a mere clarificatory nature. The ISC noted that insofar as section 9(1)(vi) of the ITA related to computer software, Explanation 3 to section 9(1)(vi) referred to “computer software” for the first time with effect from 1 April 1991 when it was introduced, before being subsequently amended in 2000. Accordingly, in the ISC’s view, Explanation 4 could not apply to any right for the use of or the right to use computer software before the term “computer software” was introduced in the ITA. Further, even in the CA, the term “computer software” had been introduced only in 1994.

For similar reasons, the ISC rejected the argument of the Indian tax authorities that Explanation 6 to section 9(1)(vi) of the ITA could apply with effect from 1 June 1976, when the technology relating to transmission via satellite, optic fibre or other similar technology was only regulated by the Indian Parliament for the first time by way of the Cable Television Networks (Regulation) Act 1995.28

As a result, the ISC opined that Explanation 4 was not of a mere clarificatory nature. Rather, it was of a substantive nature.

5.5.1.5. The doctrine of first sale or the principle of exhaustion

The Indian tax authorities argued that, as the “doctrine of first sale”, also known as “the principle of exhaustion”, was not recognized in section 14(b) of the CA, the foreign vendors should be regarded as having parted with a right or interest in the copyright in software. On that basis, the Indian tax authorities argued that there was “parting of a right or interest in copyright” in the software. Accordingly, the Indian tax authorities contended that the consideration received by the foreign vendors had to be regarded as royalty. The ISC rejected this position.

The ISC referred to a decision of the Court of Justice of the European Union (ECJ) in UsedSoft GmbH v. Oracle
International Corp (Case C-128/11). It noted that, in the ECJ’s view, the copyright owner exhausted his distribution right in copies of a computer program on making the first sale, provided that the copy was made usable by the first acquirer. However, the ISC explained that the doctrine of first sale and/or the principle of exhaustion depended on whether the relevant legislation recognized or disregarded the said doctrine. The ISC also noted that under the CA, it was the exclusive right of the owner of the software to sell or to give a commercial rental to “any copy of the computer program”. Section 14(b)(ii) of the CA, in the context of a computer program, aimed to interdict reproduction of the computer program and consequent transfer of the reproduced computer program to subsequent acquirers and/or end-users. In contrast, once a book was sold, on further resale of the same book, the original purchaser, who further resold that book, lost the material book altogether – as such, the original purchaser parted with the book once and for all. Further, section 65A of the CA punished circumvention of technological protection measures by way of methods, such as encryption codes, product keys, etc., which were designed to ensure that the first acquirer’s copy was made unusable. Consequently, once it was understood that the object of section 14(b)(ii) of the CA was not to interdict the sale of computer software that was “licensed” to be sold by a distributor, but that, rather, it was to prevent copies of computer software once sold being reproduced and then transferred by way of sale or otherwise, it was clear that any sale by the author of a piece of computer software to a distributor for onward sale to an end-user could not possibly be hit by the said provision. Further, the distributor could not use the computer software at all and had to pass on the software, as shrink-wrapped by the owner, to the end-user for a consideration. As a result, the ISC did not find merit in the argument of the Indian tax authorities that the distribution of copyrighted computer software constituted the granting of an interest in the copyright in the software.

5.5.2. Treaty interpretation principles and the relevance of the Commentaries on the OECD Model

The ISC opined that the tax treaties that India had concluded had to be interpreted in a liberal manner with a view to implementing the true intention of the contracting states and, as the definitions of royalties in all of the relevant tax treaties were identical or similar to the definition of that term in the OECD Model, the Commentaries on the OECD Model were relevant. In that context, the ISC took into account the Commentary on Article 12 of the OECD Model (1992).

5.5.3. The Commentaries on the OECD Model and bilateral tax treaties

It is important to note that while the ISC recognized the relevance of the Commentaries on the OECD Model, it opined that mere positions on the OECD Commentaries could not alter the provisions of a bilateral tax treaty unless that tax treaty was renegotiated and amended. In that context, the ISC approved the DHC’s decision in DIT v. New Skies Satellite BV (2016).

5.5.4. The ISC’s conclusions

The ISC held that the income of the foreign software vendors could not be regarded as royalties under the applicable tax treaties. Accordingly, the ISC also held that the income was not taxable in India.

The ISC rejected the KHC’s decision in Samsung Electronics (see section 4.5.) and upheld that of the DHC in InfraSoft (see section 4.4.).

6. Conclusions

As evident from the discussion in this article, the ISC’s decision of 2 March 2021 is a landmark ruling on the issue of software income characterization from the perspective of tax treaties. It will have far-reaching implications for a very large number of foreign enterprises engaging in software transactions with Indian customers. The decision may also be relevant elsewhere on the issue of treaty classification of software payments from a global perspective.


31. It is important to note this aspect, and it deserves to be highlighted separately from the earlier discussion in this article because the Indian tax authorities have heavily relied on the position taken by them in the OECD Commentaries.


33. Samsung Electronics (2011), supra n. 16.

34. InfraSoft (2013), supra n. 15.