Retro-amendment to the definition of 'royalty' can't be imported into Articles of treaty

Summary – The Mumbai ITAT in a recent case of Baan Global BV, (the Assessee) held that Consideration received by assessee for pure sale of 'shrink wrapped software' off shelf, cannot be considered as a 'royalty' within meaning of Article 12(4) of DTAA as same is consideration for sale of copyrighted product and not for use of any copyright

If any amendment is carried out under domestic law, same cannot be read into treaty

Facts

- The assessee-Dutch company was engaged in the business of development and sale of computer software and provides other services in relation to its software product. The assessee in India had entered into a 'Distribution Agreement' with INFOR India which is an Indian subsidiary company for supply of its software to Indian customer on which INFOR India would receive a fix percentage sum. INFOR India was an independent distributor of computer software which sells under the brand name of 'INFOR' and is sold as 'off the shelf' software in the market used by the customers in various businesses, like in connection with financial accounting, inventory management, HR management etc. The customer in India would place an order with INFOR India which in turn passes on the order to the assessee for the purchase of the software. The assessee then had the exclusive right to accept or reject the order. However, once the order was accepted by the assessee, the CD containing the software was sent to India and in turn INFOR India distributes the CD to the customer in India. The assessee also deliverd the license-key for the software directly to the customer and the customers pay the consideration for the sale of software to INFOR India, which in turn after retaining the distributor's margin remits the balance amount to the assessee. The assessee also carried out through INFOR India 'other general services' related to software.
- During the year, the assessee had received a sum of Rs. 3.75 crore as sales consideration for the computer software products supplied by it to IFOR India and sum of Rs. 4.79 crore as 'other general services' (OGS fees) from the said Indian subsidiary. Since the assessee did not have a permanent establishment (PE) in India, only the amount of Rs. 4.79 crore received as 'OGS fee' was offered for tax in India as 'fees for technical services', however, so far as the income from sale of software products of Rs. 3.75 crore was concerned same was treated as business profit. Hence, this amount was not shown chargeable to tax in India in absence of any PE in India. In response to the show cause notice by the AO, as to why the said amount received from sale of computer software should not be taxed in India as 'royalty', the assessee submitted that, the receipts from the sale consideration of computer software cannot be treated as 'royalty' both under the 'Income-tax Act' as well as under the 'Tax Treaty' between India and Netherland.
- The Assessing Officer held that, the payment received by the assessee for sale of software was nothing but 'royalty' not only under the Income-tax Act but also within the meaning of India-

Netherland DTAA and accordingly, assessed receipts at the rate of 15 per cent being tax rate applicable to the 'royalty income' as per article 12 of DTAA.

- On appeal, the Commissioner (Appeals) held that the payment received by the assessee emanated only from sale of a copyrighted article and therefore, it does not amount to 'royalty' within the meaning of article 12(4) of the India-Netherland DTAA.
- On appeal to the Tribunal:

Held

- The computer software is sold "off shelf" which is mainly used by the Indian customer in their business for financial accounting, inventory management, HR management etc. INFOR India carries out marketing and sale of the software in India and places order with the assessee. The software supplied is then distributed to the Indian customers through INFOR. The consideration charged by INFOR India is based on terms agreed between the assessee and INFOR India as per the 'distribution agreement'. Under the terms of the agreement, as noted by the Commissioner (Appeals), there is no transfer of any copyright in the software product. The payment received by the assessee is purely towards a copyrighted software product as against the payment for any copyright itself. The assessee does not give any right to use the copyright embedded in the software. In other words, the Indian Customer (or INFOR India) except for the limited right to access the copyright software for its own business purpose does not acquire any kind of right to exploit the copyright in the computer software. These facts have not been controverted by the department and, therefore, what has been incorporated and stated by the Commissioner (Appeals) in his order is reckoned as admitted facts.
- From the plain reading of article 12, it can be inferred that, it refers to payments of any kind received as a consideration for the *use of*, or the *right to use* any *'copyright'* of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience. Thus, in order to tax the payment in question as "royalty", it is *sine qua non* that the said payment must fall within the ambit and scope of Para 4 of Article 12. The main emphasis on the payment constituting 'royalty' in Para 4 are for a consideration for the 'use of' or the 'right to use' any copyright. . . . . . The key phrases 'for the use' or 'the right to use any copyright of'; 'any patent. . . . . .; 'or process', 'or for information. . . . . . . ,'; 'or scientific experience', etc., are important parameter for treating a transaction in the nature of 'royalty'. If the payment doesn't fit within these parameters then it doesn't fall within terms of 'royalty' under article 12(4). The computer software does not fall under most of the term used in the article barring 'use of process' or 'use of or right to use of copyrights' Here first of all, the sale of software cannot be held to be covered under the words 'use of process', because the assessee has not allowed the end user to use the process by using the software, as the customer does not have any access to the source code. What is available for their use is software product as such and not the process embedded in it. Several processes may be involved in making computer software but what the customer uses is the software product as such and not the process, which are involved into it. What is required to be examined in the

impugned case as to whether there is any use or right to use of copyright? The definition of copyright, though has not been explained or defined in the treaty, however, the various Courts have consistently opined that the definition of 'copyright' as given in the 'Copyright Act, 1957' has to be taken into account for understanding the concept.

- Thus, the definition of 'copyright' in section 14 is an exhaustive definition and it refers to bundle of rights. In respect of computer programming, which is relevant for the issue under consideration before us, the copyright mainly consists of rights as given in clause (b), that is, to do any of the act specified in clause (a) from (i) to (vii) as reproduced above. Thus, to fall within the realm and ambit of right to use copyright in the computer software programme, the aforesaid rights must be given and if the said rights are not given then, there is no copyright in the computer programme or software. As noted by the Commissioner (Appeals), under the terms of the agreement between the assessee and INFOR India, the agreement specifically forbids them from decompiling, reverse engineering or disassembling the software. The agreement also provides that the end user shall use the software only for the operation and shall not sub-license or modify the software. None of the conditions mentioned in section 14 of the Copyright Act are applicable. If the conclusions of Commissioner (Appeals) are based on these facts and agreement, then he has rightly concluded that the consideration received by the assessee is for pure sale of "shrink wrapped software" off the shelf and hence, cannot be considered as a "royalty" within the meaning of article 12(4) of the DTAA, as the same is consideration for sale of copyrighted product and not to use of any copyright.
- The retrospective amendment brought into statute with effect from 1-6-1976 in form of insertion of in Explanation 4 to section 9(1)(vi) cannot be read into the DTAA, because the treaty has not been correspondingly amended in line with new enlarged definition of 'royalty'. The alteration in the provisions of the Act cannot be *per se* read into the treaty unless there is a corresponding negotiation between the two sovereign nations to amend the specific provision of "royalty" in the same line. The limitation clause cannot be read into the treaty for applying the provisions of domestic law like in article 7 in some of the treaties, where domestic laws are made applicable. Here in this case, the 'royalty' has been specifically defined in the treaty and amendment to the definition of such term under the Act would not have any bearing on the definition of such term in the context of DTAA. A treaty which has entered between the two sovereign nations, then one country cannot unilaterally alter its provision. Thus, there is no merit in the contention of the revenue that the amended and enlarged definition should be read into the Treaty.
- The payment received by the assessee for sums amounting to Rs. 3.75 crores does not amount to 'royalty' within the meaning of article 12(4) of Indo-Netherland DTAA and accordingly, the same is not taxable in India. Since, admittedly, the assessee has no PE in India; therefore, same cannot be taxed as business income under article 7. Accordingly, ground raised by the revenue stands dismissed.
- A non-exclusive, non-transferable license (without any right to sub-lease or sub-license) with a very limited right has been given for right to use the component system and there is no covenant to grant

any copyright or right to use. Limited right to operate the copyrighted article cannot be reckoned as royalty within the scope of article 12(4); and *secondly,* the use source code is also for a particular component system to modify such component system for its own internal computing operations. This right is again is with the riders and limitations given therein. There is no right given for the 'use of copyright' or any kind of copyright has been given. Thus, nothing turns on with this observation as made by the DRP that source code is some kind of process and, accordingly, the finding given will apply *mutatis mutandis* in this appeal also. Thus, the impugned issue is decided in favour of the assessee and the amount which has been taxed as 'royalty' is held to be non-taxable in India in terms of DTAA.