India: ITAT clarifies tax treatment of software supply

The Mumbai Income Tax Appellate Tribunal (ITAT) issued a decision on 24 February 2016 concluding that where software is supplied predominantly as a part of a supply of equipment/machinery and the software is embedded in the equipment/machinery that is the main object of the transaction, the transaction constitutes a sale of equipment/machinery, rather than a sale of software. Hence, the payment for the supply cannot be considered a royalty subject to withholding tax under India’s domestic law.

The classification of software payments as royalties under India’s Income Tax Act, 1961 (ITA) has been controversial and the subject of litigation before various Indian tribunals and courts, with decisions both in favor of and against the argument that a payment made for software/licensed products is not in the nature of a “royalty” under India’s domestic tax law and tax treaties. The classification took on greater importance when the source rule for the taxation of royalties under the ITA was amended in 2012 (on a retroactive basis). The definition now clarifies that a royalty is deemed to arise in India if there is a transfer in respect of any right, property or information, including the right for the use of/to use computer software (and the granting of a license), regardless of the medium through which the right is transferred or where the property is situated. As long as the underlying rights, property, information or services are used in India, a royalty will be deemed to exist. However, the change in the ITA created a new controversy – whether the expanded definition of a royalty under domestic law prevails over the definition in India’s tax treaties where royalties are defined narrowly (typically, to mean consideration for the use of, or the right to use, a copyright of a literary, artistic or scientific work), so that withholding tax is triggered only if there is a transfer of a copyright.

Another controversy relating to the classification of software payments involves the tax treatment of software that is embedded in hardware/equipment and sold with the hardware/equipment as a single package. This issue also has been subject to inconsistent rulings. Taxpayers typically argue that since the software is embedded in hardware, the software is an integral part of the hardware and has no purpose other than to make the hardware operational; hence, the transaction should be taxed as income from the sale of goods (i.e. the hardware). This argument is based on the premise that a customer would not be able to use the software independently without the hardware/equipment, and no copyright/license in the software passes to the customer. Accordingly, income from the sale of software along with hardware should be characterized as a single source of income, i.e. income from sale of goods, and not split into two parts as income from the sale of goods (hardware/equipment) and royalty income (software). However, the Indian tax authorities have taken the position that a sale of software embedded in hardware, even though it is part of the hardware/equipment sold, gives rise to a transfer of a license/copyright and, hence, the relevant income constitutes a royalty.

In the case before the Mumbai ITAT, an Israeli company sold a diamond and gem scanning machine to customers in India. Software was an integral part of the equipment that was needed to make the machinery operational. However, the value of the software and the value of the machinery were separately quoted by the taxpayer. The Indian tax authorities determined that the payments received for the software component were taxable as royalties. However, the taxpayer argued that there was no separate transaction involving a sale of
software and that the transaction predominantly was a sale of the equipment, so it could not be subject to tax as a royalty. The ITAT agreed with the taxpayer and held that the customer had no interest in the software except to the extent it enabled the equipment to function. Thus, the transaction had to be treated as a sale of equipment and the amount allocated to software could not be treated differently as consideration in the nature of a royalty.

The ITAT went on to note that changes to domestic law cannot automatically be read into tax treaties unless the relevant treaty is renegotiated and revised. Hence, the expanded domestic law definition of a royalty will not override the royalty article (article 12) of India’s tax treaties. The ITAT decision somewhat parallels a recent decision issued by the Delhi High Court in the New Skies Satellite case, in which the High Court held that the domestic law definition of the term royalty, as expanded in 2012, will not override the definition of royalties under a relevant tax treaty.

Comments

The ITAT decision should be beneficial to foreign companies that sell equipment to Indian customers where software is an integral part of the supply of the equipment/machinery, as well as in cases involving the expanded definition of royalties (e.g. payments for the use of telecommunication services, such as bandwidth and transponders). It will add further credence to the position taken by various courts that the tax authorities’ broader interpretation of the definition of a royalty goes too far.

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