MOOT PROPOSITION
DRAFT PROBLEM

The Deputy Director of Income-Tax, International Taxation (1), Chennai has filed an appeal to the Honorable High Court of Madras under Section 260A of the Income Tax Act, 1961 against the order of the Income Tax Appellate Tribunal, Chennai ("Tribunal") passed in the case of "Vulcan Telecommunications & Technology Corporation (VTTC USA) c/o SAPR Advocates, Chennai" ("assessee") for the Assessment Year 2006-07. The appeal has been admitted by the High Court and it is fixed for final hearing.

For sake of brevity, the following substantial question of law, as has been admitted by the Honorable High Court, are herein below enunciated:

1. *"Whether on facts and circumstances of the case and in law, the Tribunal was correct in holding that payments received by VTTC USA on sale of its off-the-shelf software products to end-users through distributors was not Royalty under Section 9(1)(vi) of the Indian Income Tax, 1961 and India-USA DTAA"*

In relation to the matter at hand, the following Annexures form part of the record of the case:
Annexure A: The impugned order of the Tribunal
Annexure B: The appeal filed before the Tribunal by the assessee
Annexure C: The order of the CIT(A)-III
Annexure D: The appeal filed before the CIT(A)-III
Annexure E: The assessment order

Annexure A
IN THE **INCOME-TAX APPELLATE TRIBUNAL**, CHENNAI
BEFORE Mr.D.T.A.Senapati ., JUDICIAL MEMBER
AND Mr.T.P.Vardon,ACCOUNTANT MEMBER
ITA No. 007/Che/2008
Assessment Year 2006-2007

VTTC (USA)
C/o M/s. SAPR Advocates
Chennai, India……….………………………………………………………………………….Appellant
Vs.
Dy. Director of Income-tax,
International Taxation
1(1)…………………………………………...…………………………………………Respondent

Assessee represented by: Mr.P.Anthony.
Department represented by: Mr.F.Rebello

Per Bench:

The present appeal arises out of the order of the Commissioner of Income-tax (Appeals)-III. The single issue in this appeal is regarding the taxability or otherwise in India of the payments received by the assessee for sale of its software products to end-users through its distributors.

The assessee company VTTC USA. C/o SAPR Advocates, is a corporation registered in USA. The assessee does not have a Permanent Establishment (PE) in India as per Article 5 of DTAA between India and USA.

The only issue arises out of the assessee's software division which is basically involved in the supply of the off-the-shelf shrink-wrap software to large IT companies in India in the banking domain. The assessee did not find any reason to declare any income in India in the hands of the assessee for the reason that the software sold by the company to Indian entities were "shrink-wrap" off-the-shelf software which is only the sale of copies of "copyrighted articles". The assessee therefore assumed that the transactions did not fall within the purview of Royalty as defined u/s 9(1)(vi) of the IT Act 1961 which did not call for any taxable income in India and hence filed returns declaring NIL income.

The Assessing Officer took the view that as regards the sale of the software to Indian entities that it generated royalties in the hands of the assessee companies and therefore they are liable for taxation. Thus, the AO therefore completed the assessment by determining positive income by way of making additions which were confirmed in the first appeals. Aggrieved the assessee are in appeal before us.

We heard the Learned Counsel of the assessee and Learned Department Representative (DR) for the Department in great detail.

The order of the Learned CIT(A) goes into great depth about all the facts and circumstances of the case and analyzes the same from various angles. The first stance the CIT(A) takes is the absence of the definition of the phrase "copyrighted article" in the Income Tax Act as well as the India-USA DTAA. We do not find the need for defining the normal language usage of said term ('copyrighted article'), for from its very usage it is clear what it refers to. The fact that the definition is not specifically provided for in the Act or the DTAA cannot be a ground to reject the contentions of the Appellant.

Also, we believe that the OECD Commentary provides for practical guidance on a vast number of issues and ignoring them would be at our own peril. We believe the facts and circumstances in the decision of *CIT v P.V.A.L. Kulandagan Chettiar (2004) 137 Taxman 460 (SC)* are totally different from the instant case.

We also find that the ITAT decisions relied on by the Appellant, especially *Velankani Mauritius vs DDIT (ITA No.985 & 986/Bang/2009), Kansai Nerolac Paints vs. ADIT (ITA No.568/Mum/2009) and Dassault Systems (229 CTR 105 AAR)* squarely cover the instant case in favour of the assessee.

We would like to take this opportunity to elucidate the difference between *obtaining a copyrighted software* as opposed to *obtaining a copyright in such software.* Consider buying a book from a bookstore, it results in the buying of a copyrighted article; buying the copyright to the book results in one obtaining the right to print copies of the book and commercially exploit it. The former is "obtaining a copyrighted article" whereas the latter is "obtaining a copyright in the article". Applying a similar ratio here, **it is evident that the transaction with the end-user involves a transfer of copyrighted software product containing the software program and not the copyright in such software.** Neither the end-user (nor the distributor) has any right whatsoever in the copyright of the software product of the assessee in as much as it would enable them to commercially exploit the same. Therefore consideration received by assessee cannot be construed in the nature of Royalty.

Furthermore, we do not find it agreeable that simply by making use or having access to the computer programs embedded in the software product it could be said that the end-user is using the *process* that has gone into the end product or that he/she has acquired any rights in relation to the process as such. Furthermore, simply following a series of instructions to use a software product cannot be termed a *process.* Similarly terming a software product as a *patent or invention* would be diluting their definitions too much in our view.

Turning our attention to the End User License Agreement (EULA), we find that this is a standard boilerplate agreement that is nothing but a set of conditions by the copyright holder on an end user of a copyrighted article. It is similar to the restrictions and limitations imposed by a copyright owner in a book published and sold at a time when a buyer buys the book for his use. The expression 'the product is licensed not sold' is nothing but a standard clause in the EULA and cannot vitiate or alter the status of the transaction which had happened through an entire supply-distribution channel at an arms' length. In short, the EULA entered between VTTC USA and end users is more like a legal agreement/notice enlisting the terms of the usage of the software programme by the end user upon sale.

We do not feel the need to comment on the CIT(A)'s hypothetical dealing of conflicts between Treaty and Act given the fact that in the instant case we believe the payments are clearly not in the nature of Royalties but merely business profits of the assessee company.

We also do not find any reason to believe that the Hon'ble Madras High Court granting injunction in favour of the Appellant in the matter of piracy of its software products by third-parties affects the case of the Appellant under the Indian Income Tax Act, 1961 or the India-USA DTAA.

Finally, once it is established that this is a sale (i.e., business profits) of the Appellant and not Royalty income, the fact that the Appellant does not have a permanent establishment (PE) in India means that the income is not taxable in India under the Indian Income Tax Act, 1961 as well as the India-USA DTAA.

We therefore allow this Appeal in favour of the assessee company.

Sd/-	Sd/-
(T.P.Vardon)	(D.T.A. Senapati)
Accountant Member	Judicial Member

Chennai: Dt 23-11-2009

Copy to:

1. Parties
2. The CIT(A)-III;
3. The CIT
4. The DR, A-Bench

(True Copy)

By Order
Assistant Registrar
ITAT, Chennai

Annexure B

VTTC C/o M/s. SAPR Advocates

Assessment Year 2006-2007.

Grounds of Appeal before The Income-tax Appellate Tribunal, Chennai

The Commissioner of Income-tax (Appeals)-III erred in confirming the view of the Deputy Director of Income-tax, International Taxation 1(1), Chennai (the AO) that the income from the sale of shrink-wrap off-the-shelf software through distributors to Indian entities is in the nature of royalty as defined u/S 9(1)(vi) of the I.T Act and the India-USA DTAA and is taxable in India

The CIT(A)-III has erred in passing order taxing software sales income as royalty taxable in India disregarding the decisions of the Honourable Income Tax Tribunals (ITAT) that are squarely applicable with respect to the income for which the Appellant has been assessed and ignoring the Doctrine of Binding Precedents

The CIT(A)-III has erred in ignoring the key fact that the software products supplied to the end-users through distributors was in the nature of sale of copyrighted articles which would constitute business profits of the assessee company not taxable in India (as opposed to the transfer of copyright in the software product which would envisage the right to commercially exploit the software products by the end-user and which is not the case factually).

The CIT(A)-III erred in ignoring the fact that the end-user had perpetual possession of the software products purchased from the assessee through its distributors.

The CIT(A)-III has erred in holding that the rationale laid down by the Hon'ble Supreme Court in the decision of *Tata Consultancy Services [271 ITR 401 SC]* is not applicable in the instant case

The CIT(A)-III has erred in law and on facts in arriving at following conclusions:

a) That the source of revenue derived by the Appellant is from licensing of software and utilization/exploitation of license granted to the users in India completely disregarding the fact that such revenue is from sale of Appellant's products and not from licensing
b) That the consideration received from Indian distributors for sale of software is towards *use of any patent, invention, model, design, secret formula or process* (OR) *the transfer of all or any rights (including the granting of a licence) in respect of any copyright, literary, artistic or scientific work.*
c) That the Appellant has licensed software copyright to end users in India (based on the End User License Agreement i.e., EULA accompanying the software)

The Appellant seeks leave to add to, amend or withdraw any of the aforesaid ground of appeal.

Chennai:
For VTTC USA C/o M/s. SAPR Advocates
Date: 10.10.2008.
Director

Annexure C

IN THE OFFICE OF THE COMMISSIONER OF INCOME-TAX (APPEALS)-III, CHENNAI
Date of Order: 28.08.2008
Appeal No. : CIT(A) III / Int Tax 1(1)/187/2006-07

1. Date of the institution of appeal: 18.05.2008
2. Designation of the Officer who made the assessment : Deputy Director of Income-tax, International Taxation 1(1), Chennai
3. Assessment Year: 2006-2007
4. Name of The Appellant: VTTC, USA c/o M/s SAPR Advocates
5. Income Assessed: Rs. 7,41,26,375
6. Income-tax Demanded: Rs. 1,29,72,115.625
7. Section under which order appealed against was passed: Section 143(3) of the I.T. Act, 1961
8. Date of hearing: As per Order Sheet
9. Present for the appellant : Mr.P.Anthony
10. Present for Department: None

APPELLATE ORDER AND GROUNDS OF DECISION

This is an appeal against order under section 143(3) dated 28.03.2008 passed by the Dy. Director of Income-tax, International Taxation 1(1), Chennai. Mr.P.Anthony attended and discussed the case. In support of the grounds raised in this appeal, the learned Chartered Accountant raised several issues.

The Appellant's key contention is that there is a difference between "copyright" and "copyrighted article". The sale of their off-the-shelf software is akin to that of the sale of a copyrighted article and in the context of the Hon'ble Supreme Court in the case of *Tata Consultancy Services vs. State of A.P (2004 271 ITR 401)* it is merely a sale of goods and not royalty as envisaged u/S 9(1)(vi) of the Act. The Learned Counsel of the Appellant supported his argument by placing reliance on the OECD Commentary as well as a number of ITAT decisions given below:

- *Motorola Inc. Vs. DCIT, Non-resident circle (2005) (95 ITD 269) (SB Delhi)*
- *Velankani Mauritius vs DDIT (ITA No.985 & 986/Bang/2009)*
- *Kansai Nerolac Paints vs. ADIT (ITA No.568/Mum/2009)*
- *Dassault Systems (229 CTR 105 AAR)*
- *Lucent Technologies International Inc. vs DCIT (120 TTJ 929) (Delhi)*
- *Sonata Information Technology Ltd. vs DCIT (2006) (7 SOT 465)(Mum.)*
- *Sonata Software Ltd. vs. ITO (Int. Tax) (2006) (6 SOT 700)(Bang)*
- *Hewlett – Packard (India) (P) Lt.d vs. ITO (2006) (5 SOT 660)(Bang)*

I have carefully gone through the assessment order and the reasoning given by the AO for holding that the income from the sale of software is taxable in India as Royalty. I have also given a careful consideration to the arguments made before me by the learned Counsel for the assessee. The issue under consideration is decided as follows:

The expression 'copyrighted article' is not defined neither in the Income-tax Act nor in Indo-US DTAA. The Law Lexicon talks about the term 'copyrighted', which means when a copyright is registered. As per section 2(o) of Patents Act, 1970, 'patented article' and 'patented process' means respectively an article or process in respect of which a patent is in force. However, there is no such definition in the Copyright Act, 1957 defining "copyrighted article" on the lines as has been done in the Patents Act, 1970. The term “copyrighted article” is nowhere used even under the IT Act or Indo-US DTAA. The expression 'copyrighted article' finds its origin in U.S. regulations and then found its way in the OECD commentary. In the case of Motorola the Special Bench has differentiated between ‘copyright’ and ‘copyrighted article’ by placing reliance on U.S. regulations and the OECD commentary.

In *CIT v P.V.A.L. Kulandagan Chettiar (2004) 137 Taxman 460 (SC)*, before the Hon’ble Madras High Court, the Revenue tried to justify the levy of tax by assessing officer relying on OECD commentary. While confirming the order of ITAT, Hon’ble Madras High Court rejected the application of commentaries on the Article of Model Convention of 1977 presented by the Organization for the Economic Co-operation and Development (OECD) as it would not be a safe or acceptable guide or aid for such construction.

The Learned Counsel for the assessee has not pointed anything to substantiate that the language used in section 9(1)(vi) Explanation 2 or Article 12(3) of the India-USA treaty defining the term “Royalty” is ambiguous. In fact the words “copyrighted article” do not find any mention in the Act or in the Treaty or even the Copyright Act, 1957. Thus, respectfully following the decision of Hon’ble Supreme Court in the case of P.V.A.L. Kulandagan Chettiar (supra) it is held that for the purposes of interpretation of term ‘royalty’ in respect of computer software reliance cannot be placed on the differences made in the OECD Commentary or in the US Regulations between the expressions “transfer of a copyright right” and “transfer of a copyrighted article”.

Further, Hon’ble Supreme Court in the case of TCS Ltd (supra) observed that in case of a computer software programme the copyright in the programme remains with the originator. The moment copies are made and marketed, it becomes goods which are susceptible to Sales-tax. This decision was rendered by Hon'ble Supreme Court under Sales Tax Act. The ld. AR of the assessee had fairly conceded that the decision is not applicable to Income-tax proceedings but it will be relevant while deciding the issue of royalty in respect of computer software programmes as Hon'ble Supreme Court has made distinction between 'copyright' and 'copyrighted article'. In this connection we would like to say that the copies made from master copies of computer programme cannot be used by the users without obtaining activation code which is given on signing of agreement known as “EULA” (“End User License Agreement”). Therefore, it cannot be said that the consideration received by the assessee was in respect of computer programme recorded on CD. It consists of the cost of the CD, the cost of recording the programme on it AND the cost of licence granted to by the user on signing of the agreement. The Authority for Advance Ruling [AAR] in the case of Airport Authority of India 304 ITR 216 has observed that the issue of transfer of right to use the goods did not come up for consideration in that case. While holding that the decision of Hon'ble Supreme Court in the case of Tata Consultancy Services Vs. State of Andhra Pradesh (supra) was not applicable to Income-tax the AAR has observed as under :-

> *“”" 20 ……….It may be mentioned that the legislative scheme of Sales tax law and Income-tax law are very different. While the object of the Sales tax law is to tax transactions of sale of movable properties, Income-tax law is concerned with taxing incomes and profits of individuals, companies and other entities in whatever manner earned………. Delivery of goods on hire purchase and transfer of right to use goods are deemed under this branch of law as amounting to same. There is no provision with regard to royalty under the Sales tax law. As could be seen from Tata Consultancy's case (2004) 271 ITR 401 (SC), the court has treated the disc / floppy containing the software as goods, whose value has been greatly enhanced because of the intellectual property input incorporated in it. Passing off the right to use intellectual property as such has not been regarded as a taxable event. On the other hand, under the*

Income-tax Act as well as the DTAA the payment made in lieu of transfer of right to use copyright is a royalty income. The transfer of disc / floppy on which the copyrighted software has been inscribed is immaterial for this purpose."””

From the decision of AAR it is clear that the issue of royalty was not before the Hon'ble Supreme Court nor was it required to be adjudicated upon in the Sales-tax provisions. **Therefore, the decision of Hon'ble Supreme Court in the case of TCS Ltd. (supra) cannot be applied to the facts of the assessee's case**. In the case of TCS Ltd (supra) the Hon’ble Supreme has decided the issue in the context of sales tax. Passing off the right to use intellectual property as such has not been regarded as a taxable event by the Hon’ble Supreme Court.

Furthermore, I would also like to point out the recent decision of *Infotech Software Dealers Association vs. UOI (W.P.Nos 3811 & 18886 of 2009, Madras High Court)* where in it was held that though software is ‘goods’ (as per TCS judgment {supra}), its supply may be regarded service and not a sale. It was held that “*accordingly, the argument that as software is ‘goods’, all transactions of canned / packaged software or customized software is a sale is not acceptable. The question whether a transaction amounts to a sale or service depends upon the individual transaction”* Hence depending on the facts and circumstances of each case, it has to be seen whether the software sale is to be treated as goods sold or otherwise.

Also, it is settled law that that the words of a statute are first understood in their natural, ordinary or popular sense and phases and sentences are construed according to their grammatical meaning unless that leads to some absurdity or unless there is something in the context, or in the object of the statute to suggest the contrary. There is no ambiguity in the definition of term “royalty” as appearing in Explanation 2 to section 9(1)(vi) of the Act or article 12(3) of Indo-US DTAA and therefore, **there is no need for importing the expression “ Copyrighted Article” from OECD Commentary or US guidelines for the purposes interpretation of term “royalty” Hence for the purposes of income tax a copyrighted article cannot be treated as product.**

Coming to S.9(1)(vi) of Income tax Act 1961, income by way of royalty shall be deemed accrue or arise in India:

(i) royalty payable by the Central Government or any State Government;

(ii) royalty payable by a resident, except where the payment is relatable to a business or profession carried on by him outside India or to any other source of his income outside India; and

(iii) royalty payable by a non-resident if the payment is relatable to a business or profession carried on by him in India or to any other source of his income in India.

Explanation 2 to clause (vi) of section 9(1) which defines the term “royalty” is wide enough to cover both industrial royalties as well as copyright royalties. It reads as under:

“”“Explanation 2.—For the purposes of this clause, “royalty” means 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 trademark or similar property ;

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

(iva) the use or right to use any industrial, commercial or scientific equipment but not includingg 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).""

The term "royalty" covers industrial and copyright royalties. Transfer of the "right in the property" is not the subject matter rather it is the transfer of the "right in respect of the property". The two transfers are distinct and have different legal effects. In the first case, rights are purchased which enable use of those rights, while in the second category, no purchase is involved, only right to use has been granted. Ownership denotes the relationship between a person and an object forming the subject-matter of his ownership. It consists of a bundle of rights, all of which are *rights in rem*, being good against the entire world and not merely against a specific person and such rights are indeterminate in duration and residuary in character as held by Hon'ble Supreme Court in *Swadeshi Ranjan Sinha Vs. Hardev Banerjee AIR 1992 SC 1590*. When rights in respect of a property are transferred and not the rights in the property, there is no transfer of the rights in rem which may be good against the world but not against the transferor. In that case the transferee does not have the rights which are indeterminate in duration and residuary in character. Lump sum consideration is not decisive of the matter. That sum may be agreed for the transfer of one right, two rights and so on all the rights but not the ownership. Thus, the definition royalty in respect of the copyright, literary, artistic or scientific work, patent, invention, process etc. does not extend to the outright purchase of the right to use an asset. In case of royalty the ownership on the property or right remains with owner and the transferee is permitted to use the right in respect of such property. A payment for the absolute assignment and ownership of rights transferred is not a payment for the use of something belonging to another party and, therefore, not royalty. In an outright transfer to be treated as sale of property as opposed to licence, alienation of all rights in the property is necessary.

In view of the above we now examine the true nature of the transaction involved in this Appeal. The Learned counsel for the assessee argued that since computer programme is protected under the Copyright Act, the reliance should be placed on Copyright Act only and not on other Intellectual Property Rights laws. The Learned Counsel for the assessee has stated that in order to constitute a copyright there should be commercial production. The act of reproduction as envisaged in section 14(a) of the Copy-right Act, 1957 is a right to exploit the copyright commercially whereas the expression used in Section 52(1)(aa) of the Copyright Act is the making of copies by lawful possessor of a copy is not infringement of copyright right. According to the Learned Counsel for the assessee the installation and storage on hard disc of computer programme is not a copy right.

Section 14 of the Copyright Act, 1957 defines the term "copyright". Clauses (a) and (b) of section 14 of the Copyright Act, 1957 which are relevant for deciding of the issue are extracted as below:

“”“14. Meaning of copyright - For the purposes of this Act, "copyright" means 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, --

(a) in the case of a literary, dramatic or musical work, not being a computer programme, -

(i) to reproduce the work in any material form including the storing of it in any medium by electronic means;

(ii) to issue copies of the work to the public not being copies already in circulation;

(iii) to perform the work in public, or communicate it to the public;

(iv) to make any cinematograph film or sound recording in respect of the work;

(v) to make any translation of the work;

(vi) to make any adaptation of the work;

(vii) to do, in relation to a translation or an adaptation of the work, any of the acts specified in relation to the work in sub-clauses (i) to (vi);

(b) in the case of a computer programme, --

(i) to do any of the acts specified in clause (a);

(ii) to sell or give on commercial rental or offer for sale or for commercial rental any copy of the computer programme;

PROVIDED that such commercial rental does not apply in respect of computer programmes where the programme itself is not the essential object of the rental.”””

The expression “exclusive right” used in section 14(a) or section 14(b) of the Copyright Act refers to the rights of author/creator and not the “exclusive right” to be given by him to some party to reproduce the copyrighted work or sell the computer programme etc. It also does not mean that non-exclusive right given by the owner of the copyright to some other party to do one or more acts will not have copyright in respect of the property. Even grant of one right in respect of a copyright or work would amount transfer or the use of copyright. Section 30 of the Copyright Act, 1957 empowers the owner of the copyright in any existing work or in future work to grant any interest in the right by licence in writing signed by him or by his duly authorised agent. Therefore, for the purposes of a licence there is no requirement in Copyright law that the author should grant exclusive right to other person to do all or any of the acts to which the author is having exclusive rights. The expression ‘reproduce’ used in section 14(a)(i) is explained in Govt. of India Publication “Handbook of Copyright Law” to mean the right to make “one or more copies”. There is no contemplation that reproduction will arise only if mass copies are produced or only if these are produced for sale or commercial exploitation. We are not dealing with an issue whether or not; there is any infringement of copyright for which reference to section 51 or section 52 of the Copyright act, 1957 should be made. The issue of royalty is to be decided as provisions of Income tax Act and Indo-US DTAA. We can only refer to the provisions of the Copyright Act for limited purposes of definition of term “copyright”.

Section 2(ffc) of the Copyright Act defines the expression “Computer programme” as a set of instructions expressed in words, codes, schemes or in any other form, including a machine readable medium, capable of causing a computer to perform a particular task or achieve a particular result. Authorship of the source code (and the object code) are protected by the copyright Act as literary work. Furthermore, as per section 2(o) of the Copyright Act, literary work includes computer programme, table and compilations including data basis. Thus from the combined reading of sections

2(ffc) and 2(o) of the Copyright Act, **it is clear that "computer programme" is a literary work.** Since the computer programme is a literary work within the meaning of 2(ffc) and 2(o) of the copyright Act, the consideration received will be in nature of royalty if it is in respect of the transfer of all or any rights (including the granting of a licence) in respect of the same under clause (v) of Explanation 2 of section 9(1)(vi) of the Act.

There is no dispute that the VTTC products are patented in USA which is evident from The EULA also refers that the product is protected by copyright and other intellectual property rights. There can be overlap between copyright and patent. Both are mutually exclusive. Indian Patent Act, 1970 differentiates patentable and non-patentable inventions. Under section 2(m) of the Patent Act, 1970 defines a patent to mean a patent for any invention granted under the Act. Clause (iii) of Explanation 2 of section 9(1)(vi) defines royalty as consideration for the use of any patent, invention, model, design, secret formula or process or trade mark or similar property. **Therefore, the payments made by the end users as a consideration for the use or the right to use of such patents will be in nature of royalty**. Hence the case is covered by the clause (iii) of Section 9(1)(vi) of IT Act, 1961 and also by the definition of term “royalty” appearing in Article 12(3) of Indo-US DTAA.

Learned Counsel for the assessee has submitted that since the Parliament has chosen to classify computer programs as literary work under section 2(o) of the Copyright Act, the other category of the IPR’s which are patent, invention, secret formula or process will not operate. However, even if computer software is to be considered as falling under process, the term 'process' has to be interpreted as an intellectual property right rather than as being interpreted in the ordinary sense. Reliance is placed on the following judicial precedents:

Philips NV v. Commissioner of Income-tax 172 ITR 521 (Calcutta);
DCM Ltd v. Income-tax Officer 29 ITD 123 (Delhi ITAT); and
Modern Threads (I) Ltd v. Deputy Commissioner of Income-tax 69 ITD 115(TM) (Jaipur ITAT).

He has further submitted that the expression “process” appearing in Explanation 2(ii) to section 9(1)(vi) of the Act cannot be invoked as consideration paid by the end user is towards the product and not towards the working of a process. He placed reliance on the Delhi High Court decision in case of *Asia Satellite Telecommunications Co. Ltd vs. DCIT* and on the decision of the Bangalore Bench in the case of *Sonata Software Ltd. Vs DCIT (Supra)* wherein it has been held that “computer programme” being specifically covered under copyright, it cannot be again said to be covered under the “process”.

The decisions cited are distinguishable from the instant case on the basis of facts and circumstances. Furthermore, it is well understood from dictionary definitions that a process is instance of a computer programme that is being executed. It contains the programme code and its current activity. Depending on the operating system (OS), a process may be made up of multiple threads of execution that execute instructions concurrently. Thus computer programme is a passive collection of instructions; a process is the actual execution of those instructions. Several processes may be associated with the same programme; for example, opening up several instances of the same programme often means more than one process is being executed. It is **clear that computer programme is a process when it executes instructions lying in it in passive state. Therefore, any consideration made for the use of process would amount to royalty.**

Coming to the question whether computer software/programme is an invention, there is no dispute that VTTC USA softwares are patented in USA . No doubt the computer software are provided protection under Copyright Act as literary work, it does not mean that the computer programme will not be an invention. These software are held to be original inventions. The assessee has himself asserted in their agreements that what is being distributed by VTTC is patented software. EULA refers that the product is protected by copyright and other intellectual property rights. Even though as per section 3(k) of the Patent Act, 1970 a computer programme per se other than its technical application to industry or a combination with hardware, is not invention to be patented but the fact remains that VTTC USA programmes being patented are inventions. In section 9(1)(vi) a patent and an invention are two different items. Under section 2(m) of the Patent Act, 1970 defines a patent to mean a patent for any invention granted under the Act. **Hence , I am of the view that VTTC USA computer programmes are inventions and the payment made for the use or the right to use the same would amount to royalty.**

The owner of a copyright may grant an interest in the copyright by a licence. The licence may be confined to one or more interests or to the entire copyright. A licence is an authorization of an act which without such authorization would be an infringement. In the case of a licence the licencee gets the right to exercise particular right subject to the condition of the licence, but does not become the owner of that right whereas an assignee becomes the owner of the interest assigned. In the case of a sale the purchaser becomes the owner of the property and acquires the right to sell, lease, licence etc. In order to decide the nature of the transaction in the present appeals it is important to refer to various clauses of the End User Licence Agreement (EULA) a sample of which is reproduced below:

“””END-USER LICENSE AGREEMENT FOR ‘VulcanExpress Banking Suite 3.0’ IMPORTANT PLEASE READ THE TERMS AND CONDITIONS OF THIS LICENSE AGREEMENT CAREFULLY BEFORE CONTINUING WITH THIS PROGRAM INSTALL: VTTC USA End-User License Agreement ("EULA") is a legal agreement between you (either an individual or a single entity) and VTTC USA. for the VTTC USA software product(s) identified above which may include associated software components, media, printed materials, and "online" or electronic documentation ("SOFTWARE PRODUCT"). By installing, copying, or otherwise using the SOFTWARE PRODUCT, you agree to be bound by the terms of this EULA. This license agreement represents the entire agreement concerning the program between you and VTTC USA, (referred to as "licenser"), and it supersedes any prior proposal, representation, or understanding between the parties. If you do not agree to the terms of this EULA, do not install or use the SOFTWARE PRODUCT.

The SOFTWARE PRODUCT is protected by copyright laws and international copyright treaties, as well as other intellectual property laws and treaties. The SOFTWARE PRODUCT is licensed, not sold.

1. GRANT OF LICENSE.
The SOFTWARE PRODUCT is licensed as follows:
(a) Installation and Use.
VTTC USA grants you the right to install and use copies of the SOFTWARE PRODUCT on your computer running a validly licensed copy of the operating system for which the SOFTWARE PRODUCT was designed [e.g., Windows 95, Windows NT, Windows 98, Windows 2000, Windows 2003, Windows XP, Windows ME, Windows Vista].
(b) Backup Copies.
You may also make copies of the SOFTWARE PRODUCT as may be necessary for backup and archival purposes.

2. DESCRIPTION OF OTHER RIGHTS AND LIMITATIONS.

(a) Maintenance of Copyright Notices.
You must not remove or alter any copyright notices on any and all copies of the SOFTWARE PRODUCT.
(b) Distribution.
You may not distribute registered copies of the SOFTWARE PRODUCT to third parties. Evaluation versions available for download from VTTC USA's websites may be freely distributed.
(c) Prohibition on Reverse Engineering, Decompilation, and Disassembly.
You may not reverse engineer, decompile, or disassemble the SOFTWARE PRODUCT, except and only to the extent that such activity is expressly permitted by applicable law notwithstanding this limitation.
(d) Rental.
You may not rent, lease, or lend the SOFTWARE PRODUCT.
(e) Support Services.
VTTC USA may provide you with support services related to the SOFTWARE PRODUCT ("Support Services"). Any supplemental software code provided to you as part of the Support Services shall be considered part of the SOFTWARE PRODUCT and subject to the terms and conditions of this EULA.
(f) Compliance with Applicable Laws.
You must comply with all applicable laws regarding use of the SOFTWARE PRODUCT.

3. TERMINATION
Without prejudice to any other rights, VTTC USA may terminate this EULA if you fail to comply with the terms and conditions of this EULA. In such event, you must destroy all copies of the SOFTWARE PRODUCT in your possession.

4. COPYRIGHT
All title, including but not limited to copyrights, in and to the SOFTWARE PRODUCT and any copies thereof are owned by VTTC USA or its suppliers. All title and intellectual property rights in and to the content which may be accessed through use of the SOFTWARE PRODUCT is the property of the respective content owner and may be protected by applicable copyright or other intellectual property laws and treaties. This EULA grants you no rights to use such content. All rights not expressly granted are reserved by VTTC USA.

5. NO WARRANTIES
VTTC USA expressly disclaims any warranty for the SOFTWARE PRODUCT. The SOFTWARE PRODUCT is provided 'As Is' without any express or implied warranty of any kind, including but not limited to any warranties of merchantability, noninfringement, or fitness of a particular purpose. VTTC USA does not warrant or assume responsibility for the accuracy or completeness of any information, text, graphics, links or other items contained within the SOFTWARE PRODUCT. VTTC USA makes no warranties respecting any harm that may be caused by the transmission of a computer virus, worm, time bomb, logic bomb, or other such computer program. VTTC USA further expressly disclaims any warranty or representation to Authorized Users or to any third party.

6. LIMITATION OF LIABILITY
In no event shall VTTC USA be liable for any damages (including, without limitation, lost profits, business interruption, or lost information) rising out of 'Authorized Users' use of or inability to use the SOFTWARE PRODUCT, even if VTTC USA has been advised of the possibility of such damages. In no event will VTTC USA be liable for loss of data or for indirect, special, incidental, consequential (including lost profit), or other damages based in contract, tort or otherwise.

VTTC USA shall have no liability with respect to the content of the SOFTWARE PRODUCT or any part thereof, including but not limited to errors or omissions contained therein, libel, infringements of rights of publicity, privacy, trademark rights, business interruption, personal injury, loss of privacy, moral rights or the disclosure of confidential information."""

Referring to the this End User License Agreement (EULA) and the Activation process, the Learned Counsel for the assessee has submitted that the objective of EULA, which is typical of the software industry and a feature of almost all software products, is to ensure protection against misuse, abuse or piracy of software and is nothing but a set of instructions or conditions, imposed by a copyright holder on an end user of a copyrighted article. It mandates an end user to be cautious in using the product or the copyrighted article in a manner governed by the local territory's statutory laws alongwith contractual limitations and conditions. It is similar to the restrictions and limitations imposed by a copyright owner in a book published and sold at a time when a buyer buys the book for his use. In the case of a book, the conditions and limitations form part of the published book. In the case of a copyrighted article in the nature of computer programme/software, the EULA may form part of the product or may be given as a separate printed document, along with the sale of the products. Further, the EULA makes clear distinction between owning the copyright and selling copyrighted articles. It clearly provides that product is protected by copyright and the other intellectual property laws and treaties, and that VTTC USA (or its suppliers of software code, if any) own the title, copyright and other intellectual property rights in the product. The expression 'the product is licensed not sold' is nothing but a standard clause in the EULA and cannot vitiate or alter the status of the transaction which had happened through an entire supply-distribution channel at an arms' length. The EULA reasserts that copyright is never sold or handed over and the end user at no point of time should assume owning any copyright. Also 'Activation' is a technological mechanism meant to prevent illegal copying of the copyrighted article and consideration paid by the end user is towards acquiring the copyrighted article and not directly or indirectly for the activation. VTTC USA, the sole registered owner of the copyright in the software, does not deal or sell copyrighted products outside the US and supply chain dealing with the copyrighted articles has nothing to do with the rights available to the owner of copyright in the software. The Counsel submitted further that under EULA, the end user has perpetual possession and only in case of violation of the terms of the agreement, software needs to be destroyed/returned back to VTTC USA. In short, the EULA entered between VTTC USA and End users, which is more like a legal agreement/notice enlisting the terms of the usage of the software programme by the End user upon sale.

However, from the plain reading of the above EULA it is clear that VTTC products have not been sold, but licenced. In case of sale the purchaser becomes the owner and question of further agreement for the use of the property will not arise. Apart from the above warning there are other terms and conditions attached to End User Licence Agreement. This conditions of End User Licence Agreement itself proves that the software is licenced and not sold. This fact is further buttressed by the wordings of the preamble clause . Another important feature of the transaction is the "Activation code" which is given by VTTC USA. Corporation. Before activation code is granted the end user has to enter into agreement with VTTC known as EULA. Unless activation code is given the computer programme embedded on an electronic media cannot be used. It has explicitly been clarified in EULA that VTTC USA or its suppliers own the title, copyright, and other intellectual property rights in the product. Thus on combined reading of of the EULA, including the termination clause, it is clear that the end users have not purchased copy of software products on electronic media as contended by the assessee but a licence to use such software products. We have held that copyrighted article means a work in which copyright subsists. Therefore the end user is not simply using the CD but the programme contained in the CD, which is protected by copyright and right to copy the programme has to be exercised before it can be put to use. Therefore, the payments made by the end users is for the granting of license in copyright and other intellectual property rights in the product and will amount to royalty u/s 9(1)(vi) of the Act.

The Learned Counsel of the Assessee has raised a point that under Article 12(7) of the India-USA DTAA deals with source rule for taxation of royalty which provides for the situation under which a royalty can be considered as arising in India under Article 2(2). He has further submitted that there is no use of copyright in India by the end-user and the transaction is in the nature of sale of copyrighted article effected by VTTC USA in USA and, therefore, copyright was not used in India. He further submitted that the Revenue can invoke Article 12(7)(b) of Indo-US DTAA for imposition of tax only if VTTC USA instead of manufacturing and distributing products in USA chooses to do from India, in which case by virtue of expression 'use in India' would get the domain power to tax. But in assessee's case the use of copyright is the right to copy the master copy of the assessee and this right to copy the mastercopy was exercised. Accordingly, Article 12(7)(b) is not attracted. I do not agree with the contention of the assessee as a reading of Article 12 clearly shows that it is in consonance with Section 9(1)(vi) and in both the Act as well as Treaty the royalties are deemed to arise in the State in which the payer is situated. I would go so much to say that even assuming there was a conflict between the Act and DTAA, which is not being raised by the Learned Counsel in the instant case, the proposition that the DTAA will prevail over the Act is not infallible. Later domestic tax legislation can over-ride treaty provisions if there is an irreconcilable conflict (Gramophone Company of India AIR 1984 SC 667 followed). Given that the India-USA DTAA was entered on 20.12.1990, the subsequent retrospective amendment to s. 9 which provides that royalties will be deemed to accrue or arise in India even if the non-resident has no place of business in India will apply irrespective of any contrary provision in the India-USA DTAA

Furthermore, a copy of decision of Hon'ble Madras High Court granting injunction on a plaint filed by VTTC USA & Another against V.K.R.M. Jain & Others for infringement of copyrights in the softwares has been obtained by the AO and is filed on the records. The Learned Counsel for the assessee has filed comments. The plaint has been admitted by Hon'ble Madras High Court and the request of the plaintiff i.e. VTTC USA & Another for investigation of the matter has been granted and order has been passed on May 25th, 2009 appointing the Commissioner to investigate the matter with reference to the plaint. VTTC USA & Another, the plaintiff in the plaint have stated that VTTC USA is the owner of copyrights in various software products and their grievance was that the defendants were using un-licenced / pirated versions of the plaintiff's softwares in their computer system for their business purposes. It has been stated in the plaint that when an entity has a large number of computer systems it normally opts for multiple licences rather than individual packs as volume purchases of individual packs are not feasible from a cost point of view and the plaintiff has a record of all multiple licences held by every customer. The plaintiffs have contended that the fact that the defendants have hundreds of computer systems and the number of licences held by the defendants does not match with their usage indicates that the defendants were indulging in multiple unlicenced use of licences of VTTC USA. So, in short, at one hand the assessee is contending that the VTTC products sold to the end users are copyrighted articles are products and do not contain copyright. On the other hand, under Copyright Act they are enforcing their rights stating that the use of unlicenced/pirated copy of software products involves infringement of copyrights. VTTC has got injunction orders from Hon'ble Madras High Court in such cases. The assessee is thus blowing hot and cold in the same breath on the same issue. **When payment of tax is concerned, it is sale of "copyrighted" article and not a licence, but when question of infringement comes, plaints are filed before Hon'ble Madras High Court claiming that the end users have indulged in use of unlicenced/pirated products**. **From the decision of Hon'ble Madras High Court granting**

injunctions under the Copyright Act it is proved beyond doubt that computer programmes licenced by the assessee contain copyright in them.

So in short, from all the above discussions, it is clear that <u>copyright subsists in computer programme</u>. <u>It is a literary as also a scientific work</u>. <u>The computer programme is</u> <u>also a patent, invention or process</u>. Explanation 2 to section 9(1)(vi) deals with the royalty of two types i.e. industrial royalties which arises on transfer or any rights (including the granting of a licence) in respect of a patent, invention or use of any patent, invention or process. Therefore, if the end-users have made payment for transfer of rights (including the granting of a licence) in respect of copyright, patent, invention, process, literary or scientific work, such payment would be in the nature of royalty. Clause (v) of section 9(1)(vi) deals with transfer of all or any rights (including the granting of licence) in respect of any copyright, literary, artistic or scientific work. <u>Thus the payment will be in the nature of royalty.</u>

The Finance Act, 2010 substituted the Explanation to section 9 with retrospective effect from 1/06/1976, which reads as follows: *" Explanation.—For the removal of doubts, it is hereby declared that for the purposes of this section, income of a non-resident shall be deemed to accrue or arise in India under clause (v) or clause (vi) or clause (vii) of sub-section (1) and shall be included in the total income of the non-resident, whether or not, (i) the non-resident has a residence or place of business or business connection in India; or (ii) the non-resident has rendered service in India"* From plain reading of the Explanation it is clear that income of a non-resident shall be deemed to accrue or arise in India under clause (v) or clause (vi) or clause (vii) irrespective of the fact whether the non-resident has a residence or a place of business or business connection in India or the non-resident has rendered services in India. Thus, once consideration is received by non-resident for the transfer or all or any rights including the granting of a licence in respect of a patent, invention, model, design, secret formula or process or similar property or any copyright literary, artistic or scientific work, the consideration received shall be deem to accrue or arise in India and will be taxable in India. Above, I have held that the payments made by end-users to VTTC USA are in the nature of royalty and hence, by virtue of amendment made by inserting Explanation to section 9(1)(vi) royalty income will be taxable in India. **Therefore the contention of assessee that in the absence of any business connection or PE in India the payments received by non-resident assessees cannot be taxed India, is rejected.**

I therefore dispose of the appeal filed by the Appellant. For the reasons discussed above, the payments received by the Appellant from end-users through distributors in respect of sale of off-the-shelf software products will be taxable as Royalty u/s 9(1)(vi) of the Act. **Thus, this Appeal stands dismissed.**

COMMISSIONER OF INCOME-TAX (APPEALS)-III, CHENNAI

Copy to:-

1. The appellant with DN
2. The C.I.T., City IV, Chennai
3. DDIT, Intl Taxation 1(1), Chennai
4. CIT(A)-II, Chennai

Annexure D

VTTC, USA c/o M/s SAPR Advocates
Assessment Year 2006-2007.

Grounds of Appeal before the CIT(A)

The Dy. Director of Income-tax 1(1), International Taxation, Chennai (AO) erred in concluding that the income from the sale of software was in the nature of Royalty and therefore taxable u/s 9(1)(vi) of the Indian Income Tax Act, 1961 and the India-USA DTAA.

The AO erred in ignoring the fact that the transactions between the assessee company and the end-users were in the nature of "transfer of copyrighted article" as opposed to "transfer of copyright" itself.

The AO erred in not appreciating the fact that transfer of copyright implies that the end-user has the right to produce commercial copies of the assessee's software products which is not the case. The AO erred in ignoring the fact that the end-user has perpetual possession of the purchased software product from the assessee.

The AO erred in concluding that the assessee's supply of software could be viewed as patent or invention or process.

The AO erred in not applying the Hon'ble Supreme Court decision in Tata Consultancy Services

The AO erred in not appreciating the fact that the assessee company had no PE in India and all its transactions with its end-users were not in the nature of Royalty but its business profits which could not be taxed in India

The appellant seeks leave to add to, amend or withdraw any of the aforesaid ground of appeal.

Chennai
For VTTC USA, c/o M/s SAPR Advocates
Dated: 18.05.2008
Authorised Signatory
M/s SAPR Advocates
Assessment Year 2006-2007

Statement of Facts

The appellant seeks leave to substantiate the above ground at the time of hearing.
Chennai
For VTTC, USA c/o M/s SAPR Advocates
Date: 18.05.2008
Authorised Signatory

Annexure E

INCOME-TAX DEPARTMENT

1. Name of the Assessee: VTTC, USA c/o M/s SAPR Advocates, Chennai
2. Address: No.105-A, Dr.Radhakrishnan Salai, Chennai
3. P.A.N. / G.I.R. No.: RRRNG 1234 M
4. District / Ward / Circle No.: Dy. Director of Income-tax 1(1), International Taxation, Chennai
5. Status: Company
6. Assessment Year: 2006-2007.
7. Whether resident / resident but not ordinarily resident / non-resident: Non Resident
8. Method of accounting: Mercantile
9. Previous Year: 2005-2006
10. Date of order: 28.03.2008
11. Section and sub-section under which the assessment is made: 143(3)

ASSESSMENT ORDER

The return of income declaring NIL income was filed on 30.09.06. The return was processed under section 143(1) of the Income-tax Act, 1961 ("the Act"). Thereafter, the case was selected for scrutiny by issuing notices under section 142(1) and 143(2) of the Act.

During the assessment proceedings, the Chartered Accountant, of the assessee Mr. Aziz Alam, attended on behalf of the assessee and furnished the various details called for.

The assessee is a corporation incorporated in USA and does not have a Permanent Establishment in India as per the India-USA DTAA. The assessee files its returns through M/s. SAPR Advocates, a law firm situated in Chennai.

The assessee is basically involved in the supply of the off-the-shelf software to Indian entities in the banking domain.

Section 9(1)(vi) and Article 12 of the India-USAA define Royalty and it is clear that the transactions of the assessee company in supplying software products to the end-users through distributors will come under this definition in multiple ways. Specifically, both clause (iii) and clause (v) of Section 9(1)(vi) would apply:

"""

> ***(iii)the use of any patent, invention****, model, design, secret formula* ***or process*** *or trademark or similar property ;*
>
> ***(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*

"""

Similarly, Article 12(3) of the India-USA DTAA would squarely apply:

> *“””(a) payments of any kind received as a consideration* ***for the use of, or the right to use, any copyright or 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, trade mark, 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 of Article 8.”””*

It is clear that the software supplied by the assessee is in the form of a *process* (i.e., a series of steps executed) and can also be construed as an *invention or patent* (given that patents were filed for it in the USA) by the assessee company. Furthermore clearly such computer software programmes will fall under the realm of *literary and scientific work* and the transactions in question between the assessee company and the end-users through distributors involve the transfer of rights especially the granting of license in the form of the End User License Agreement (EULA).

I would like to note that the wording of the sample End User License Agreement (EULA) submitted by the assessee company clearly buttresses the point that transactions between assessee and end-users are nothing but a license of copyright and are definitely not a sale.

Also, the assessee also has won injunctions in the Madras High Court against piracy of its software products and in its plaint, the grievance was that the defendants were using “*un-licenced / pirated versions”* of the plaintiff’s softwares in their computer system for their business purposes.

Explanation to Section 9 substituted with retrospective effect makes it clear that whether or not the assessee has a PE here in India it is taxable in India for the Royalty income.

Furthermore, I find that the Hon’ble Supreme Court decision in *Tata Consultancy Services* [271 ITR 401 SC] was rendered in the context of the Sales Tax Act and is not applicable to the facts and circumstances of this case.

In view of all the above, the income of the assessee from end-users is clearly in the nature of Royalty as defined u/S 9(1)(vi) of the Income Tax Act as well as the India-USA DTAA. The total income of the assessee company is thus computed as under:

Computation of Total Income:

Income as per the return of income filed:		NIL
Add: Income from supply of software products to Indian entities through distributors	7,41,26,375	
TOTAL INCOME		7,41,26,375

Assessed under 143(3) of the Act. Charge interest under section 234A, 234B and 234C as applicable. Issue Demand Notice / Challan accordingly.
Copy to assessee
Deputy Director of Income-tax, 1-1
International Taxation, Chennai