TITLE: IS ROYALTY ARISING OUT OF COPYRIGHTED SOFTWARE TAXABLE?

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Abstract

This paper explores the relationship between **Intellectual Property** and Indian Tax regime, which lays emphasis by mapping intellectual property with various forms of taxation. Our paper while addressing intellectual property taxation will cover both general and special tax principles prevalent in India. Intellectual property is a common concept in changing the way in which business are conducted in this knowledge era. In this epoch of **globalization**, all nations have combined together into a single nation through treaties, double taxation agreements with certain countries and the Information Technology sectors are the trend setters today. **Copyrighted software** denotes a right over a property contained in copyright in software, in the terminology that it is a copy of computer software from which the work can be perceived and reproduced, or otherwise communicated. The main issue of our paper is on the business transactions between foreign software companies and Indian software markets including the emerging conflict of royalty which comes under the ambit of taxation. The practices prevailing in the software industry is that the company acquires the copyright of the software thenceforth grants an End User License Agreement for mere usage of that product and to create **backup copies** for non-commercial purposes. The copyright owner then receives a lump – sum amount of royalty through the overseas permanent establishment. A copyright is perpetual right to reproduce for commercial usage which subsists in the owner of the software. Let us now consider the taxing aspect which is creating a mass confusion on the question that whether to pay royalty on an Intellectual property software. The Double Taxation Avoidance Agreement (DTAA) provides for a particular mode of computation of **royalty** irrespective of the domestic income-tax statutes. The point of conflict arises with the royalties only when there is a business connection between a non-resident assessee company and a resident (overseas territory) where the notion of **'permanent establishment'** of the company is of great importance. The central conception of our study is that if payments of lump-sum consideration accrues or arise in India through the selling of copyrighted software, does amounts to royalty which may be taxable under circumstances of different nature.

Keywords: Intellectual Property, globalization, copyrighted software, backup copies, royalty, permanent establishment.

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Introduction

In the emergence of global economy and technology, business transaction has become advanced and taxpayers in the world, taxation laws has been unified with various nations due to foreign venture in any international business transaction. Due to the globalization of economies, Intellectual property has got a major attention in technologically advanced contemporary world and is becoming one of the greatest in commercial circles. Taxation of goods along with distinguishing classes has been the custom over a long period of time. Deliberately taxing of intellectual property has been included in taxation legislations of economy of various international states for certain objectives. In India, intellectual property is taxed indirectly. India is entering into trade agreements with various countries which are promoting the inflow and outflow of technology, capital, skills and technological knowhow in faster scientific and technological advancement. Particularly the creation, ownership, purchase, license or sale of a copyright may exert significant tax implications. It would take an entire treaty to fully discuss the relevant tax issues that copyright holder may confront. There has been prevailing a huge aspect of difficulty regarding the tax complexities in India. The key challenge in this aspect is about the incidence of taxation and the assessment of the I.P. instruments. Royalties is regarded as the consideration received by the service provider from its customer and the government levies different tax rates in these transactions. Royalties are payments of any kind, received as consideration for the use of, or right to use, any copyright of literary, artistic or scientific work including cinematographic films, or films or tapes used for radio or television broadcast or right to use, industrial commercial or scientific equipment for information concerning industrial, commercial and scientific experience. As per Section 14 of the Indian Copyrights Act 1957, a Copyright is an exclusive right in relation to a literary, dramatic, musical, artistic work along with computer software programmes. Thus, this paper is aimed to investigate the holistic view the balancing interests in the technological society, to intensify trade for the advancement of intellectual property from the weapon of taxation.

Background Of The Study

Intellectual Property has been the key component under international taxation due to cross-border movement of various multinational companies offering intellectual property rights, widening the scope for taxation of these rights. India has opened up its economy in 1991 which enhanced the spheres of taxation of customs, central excise duties and service tax. Indian scheme of taxation has a three tier structure where the income tax is collected by the Central Government under the heads of salaries, income from house property, capital gains, profits and gains of business or other profession and income from other sources along with customs duties, central excise, sales tax and service tax. The taxes levied by the State governments are sales tax, stamp duty, state excise, land revenue, duty on entertainment and tax on professions and callings. The local

bodies are empowered to levy tax on properties, buildings, octroi, tax on markets, user charges for utilities like water supply, drainage, etc. A software company may license its software for usage, the consideration from selling the certain right to use is known as the Royalty. Payments under Intellectual property remarkably the copyright includes the acquisition of partial rights, representing royalty where the consideration is for granting the right to use the program in a manner that would, without such license, constitutes an infringement of copyright. Computer software means a computer programme recorded on any disc, tape, perforated media or other information storage device. It is a programme which contains instructions to the computer. The source code and the object code are protected by the Copyright Act, under literary works. Royalty is a consideration including a lump-sum consideration, for transfer of all or any right in respect of a Copyright, Patent, Trademark, design and model or secret formula etc. is taxable.[1] Royalty also includes the right as a part of technology transfer or leasing machinery equipment or sale. In the case of TCS v. State of Andhra Pradesh, the Hon'ble Supreme Court held that the "software sold off the shelf" are to be considered as 'goods' and therefore can be taxed under the Andhra Pradesh General Sales Tax Act, which meant that intellectual properties are also levied for taxation. The incidence of taxation may also lead its entry in the field of intellectual property as the royalties earned does compute for themselves under the Income Tax Act in India.

Double Taxation Treaties & Intellectual Property

Territorial nexus for the purpose of determining the tax liability is an internationally accepted principle. India is a party to a comprehensive range of Double Tax Treaties, the majority of which deal expressly with royalties arising from one contracting state which are paid to resident from another contracting state. The majority of treaties give exclusive taxing rights to the contracting state where royalties arise through a permanent establishment or a fixed base. Where treaty relief is not available, the country of residence usually gives unilateral relief for the foreign tax. Section 90 of the Income Tax Act has authorized the Central Government to enter into DTAA treaties with other countries.[2] The provisions in DTAA which India has entered with other countries, in most of the cases where non-residents receive any income for any of their included services, they may not be subjected to tax in India. The profits of the Double Taxation Avoidance Agreements entered into by India with different countries, if the said non-residents or foreign company carries on business in India through a branch, sales office etc. or through any agent and habitually exercises an authority to conclude contracts then such income of the non-resident is attributed to taxation in India.[3]

Royalties & Taxation

Royalties comes into question when the party is a resident of the contracting State and has a permanent establishment or fixed base, then such royalties shall be deemed to arise in the state in which the permanent

establishment is situated. Source based taxation depends on the connection between a country and the generation of income.[4] Thus, a business may be carried on in the country or income may be accruing from investments located in that country. Generally income from 'royalty' and 'fees for technical services' are subject to withholding tax in the source country under the treaties.[5]

The advent of DTAA is to prevent and discourage any such taxation which may contribute to the free flow of international trade, international investment and international transfer of technology. The agreements solely have given the right of taxation in respect of the income of the nature of interest, dividend, royalty and fees for technical services to the country of residence. However, the source country has to be limited as per the rate of taxation prescribed in the agreement. The SC in the case of TCS v. State of Andhra Pradesh has observed that tax is to be paid, in the case of software for the purpose software and media cannot be split up, termed as sale of goods.

Present Situation

Computer software can be sold or may be licensed along with the end-user licence agreement. It is a settled position of law that the actual movement of goods is necessarily meant for the purposes of sale.[6] But this position may be true for tangible goods, the position of intangibles are therefore in question. The movement of goods through internet like software's are taxable is a technical matter. There is no mechanism in India to monitor the movement of IPRs for the purposes of taxing.

Case Study: A Practical Approach

Cases have been coming before the different judicial forums for issues regarding whether the considerations paid to the nonresident company was taxable as royalty or whether the business income will be exempted as there was no Permanent Establishment of the foreign supplier in India. In the *Samsung Electronics Ltd. case*,[7] the Bangalore Tribunal observed that payments for the copyrighted articles are to be taxable in India.

"Proximity Of Taxation Of Intellectual Properties"

The necessity for the assessment needs to have an established connection founded on the basis of residence of the person which would be sufficient to establish a territorial connection.[8] With the criteria of a business connection, the territory of the taxing state or the specific situs in it for making money or from other source of Income from the business activity due to which the taxable income is derived, thereby it is enough for the nexus based on situs that the source of income is derived from that state.[9] In case of composite payments certain 'income' is chargeable as tax. The legislative amendment of Explanation to Section 9 of the Income Tax Act, is substituted with retrospective effect makes it clear that whether or not the assessee has a Permanent Establishment here in India for the Royalty income.

"Incidence Of Taxation From Intellectual Property"

Several non-resident foreign companies are coming to India for trade, where they have licensed computer software's in lieu of a consideration amount from its end-users. Section 9 (1) of the Income Tax Act, 1961 states that income accrued in India should be taxed.[10] The case defining Business Connection has been decided by the Rangoon High Court which states that the expression of "business connection" must denote something, which produces profits or gains and not a mere state or condition which is favorable to the making of profit.

Further, the business connection has been explained in the Explanation 2 of the section 9 (1) (i) of the Income Tax Act, 1961, paving the way through the business connection which should include any business activity who is acting on behalf of the non-resident, comprising of a broker, general commission agent or any other agent having an independent status. In order to constitute a business connection, some continuity of relationship between the person in India making the profit and the person outside India who receives or realizes the profit, the business connection in this case is necessary. The Hon'ble Supreme Court of India held that 'business connection' postulates a real and intimate relation between trading activity carried on outside the taxable territories between the distributor customers.[11] Therefore, in Asia Satellite v. Director of Income Tax,[12] it was held that to bring the consideration in the ambit of royalty under the Section 9 (1) (vi), the appellant has to prove that there was a business connection in India with Indian company to contribute to the earning of the profit by the non-resident in his business.[13]

Tax consequence arises when a copyright is assigned or licensed. The consideration from the copyright is giving the right to use the property. For the qualification of 'business profit' the subject matter transferred must be considered to be a sale of property. Copyright subsists in computer program which is a literary as also a scientific work for which royalty is constituted. It apparently establishes that the product is protected by copyright and that the assessee company has the possession of the title, copyright and other intellectual property rights in the product. The expression 'the product is licensed not sold'. Consequently the consideration received by the non-resident company was from the license of the copyrighted software and hence it is taxable.

"Copyright And Royalty"

"Royalties" are payments or consideration for usage of any commodity. The expression "right" denotes "entitlement". The transaction in the copyright software is a sale or merely a license or royalties depends upon the right to use the software. Transfer of all rights means some consideration of conveys royalty. The copyright holder has to bear the risk of the product failure. A "copyright work" means literary, dramatic, musical, or artistic works in comply with the criterion of originality in order to be protected in which copyright subsists. A copyrighted article merely allows a use of information contained therein. The

incorporeal right to software is "copyright". Computer software's are considered under the Copyright Act.[14] Model Commentaries provide that in many countries, the copyright laws specifically classify software as a "literary or scientific work" and in the absence of the terms; software could be treated as "scientific work". The transfer of computer program which in return yields royalty made for acquisition of rights in the copyright of the software is taxable.

Conclusion And Recommendations

The tax policies should be promoted for the development of Intellectual Property and their creation with innovation for the promotion of trade. As such in the present situation, there are no such facilities that are available for Intellectual Property creation or technology transfer under the taxing statutes. The era of globalization have a huge impact in India, for which the Government of India, should legislate upon an enactment in the field of taxation for the growth and providing incentive to the I.P. industry and further to, add impetus to the nation's economic growth. Today, IPRs are indirectly taxed at many levels. The barriers to scientific progress should be removed for which the double taxation avoidance agreements must be implemented effectively. There is no reward for the industry in which innovation and inventions may lead for which investments are needed to get boosted up. The taxation statutes should make such regulations for which people might get encouraged from the policies by which technical innovation may be made possible. The capital value in India should be re-assessed by taking into account of the intangible properties of every company in India. A committee must be made up in order to check the relationships between Intellectual Properties and taxation in India for acting as a catalyst to innovation. It will lead to lower the transaction cost of I.P., benefitting the domestic companies and attractive policies for the foreign companies also. Creation of a flexible I.P. taxation regime should be developed in accordance with world taxation statutes. The taxation regime should not be a burden on the IP service sector in the country. Taxing the income of IPRs is gaining in number which needs to be stopped with codified laws.

Endnotes

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