

Tax Hotline

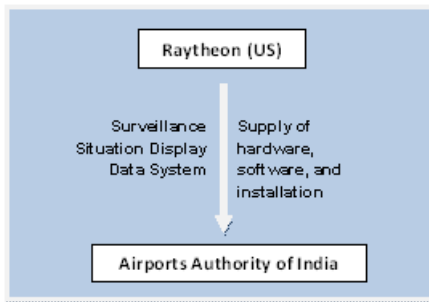
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SUPPLY OF SOFTWARE BY RAYTHEON TO AIRPORT AUTHORITY OF INDIA HELD TAXABLE IN INDIA: E-COMMERCE ONCE AGAIN IN TROUBLED WATERS

The Authority for Advance Rulings (“AAR”), in its recent decision dated July 28, 2008¹ has once again added to the existing confusion concerning the taxation of e-commerce transactions in India². Re-affirming its counter-OECD stance, the AAR has added fuel to the department’s fire by characterising payments for the transfer of software as royalty income taxable in India.

BACKGROUND

The application was filed by the Airports Authority of India (“AAI”) for seeking a ruling on the tax liability of a US based, non-resident company, Raytheon which had entered into a contract with AAI for the supply and testing of a Surveillance Situation Display Data system (“system”). The contract essentially involved the supply of hardware and software, and the provision of installation, testing and training services.



FACTS IN PICTURE

The contract provided a non-transferable, non-exclusive, royalty-free licence to use the executable software code and technical documentation for operating the system. It also specified that AAI would not have any rights to make copies of the software or commercially exploit it in any manner. The contract, however, also stated that consideration for patents owned or controlled by Raytheon in any device, system or process used under the contract would be deemed to be part of the contract price.

The issue that confronted the AAR was whether the income received by Raytheon for supply of deliverables under the contract was taxable in India.

AAR’S RULING

The AAR did not agree with the contentions of the applicant that the consideration received by Raytheon for supply of both, hardware and software was classifiable as business profits and not taxable in India due to the absence of any permanent establishment of Raytheon in India. Focussing on the clause in the contract which stated that consideration for patents owned by Raytheon with respect to the deliverables was part of the contract price, the AAR said that the licence for use of the software was clearly not royalty-free.

Under the Act³ and the India-US treaty⁴, royalty has been defined to include consideration for the use of, or the right to use any copyright of a literary, artistic or scientific work. The AAR highlighted the fact that the contract merely gave AAI the right to use the software in the prescribed manner and did not contemplate an outright sale. The software licence provided a right to use the copyright and hence the consideration received by Raytheon would qualify as royalty. Consequently, this would be taxable in India, both under the Act and the India-US treaty.

The AAR also said that the applicant was not justified in relying on the OECD commentaries since Article 12 of the India-US treaty differed from the OECD model clause and that there was no unanimity among the OECD members on the relevant paragraphs of the OECD commentary. It further held that the decision of the Supreme Court in *Tata Consultancy Services*⁵ where software was construed as ‘goods’ could not provide any support to the applicant’s case as it was given in the different context of a State sales tax law.

With respect to the other services provided by Raytheon under the software licence contract, the AAR noted the definition of ‘fees for included services’ under the India-US treaty⁶ which includes technical or consultancy services that are ancillary to the enjoyment of the intellectual property rights transferred by the tax payer. Since the licence provided a right to use a copyright, the consideration received for installation, testing and training services in respect of this was held to be in the nature of fees for included services and hence taxable in India.

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The decision of the AAR in *Airports Authority of India* has virtually turned back the wheels of time. It has surprisingly ignored the jurisprudence developed over a series of cases beginning with the decision of the Special Bench of the Delhi Tribunal in the case of *Motorola Inc. v. DCIT*⁷ wherein Courts have differentiated a sale of a copyrighted article from a transfer of the underlying copyright⁸. These cases have categorically held that receipts from an ordinary sale of software not involving a transfer of copyrights would be classified as business profits.

In addition to this, the decision of the AAR suffers from several glaring infirmities. The AAR had merely looked at the superficial terms of the contract instead of considering the real nature of the transaction in its industry-specific context. It failed to appreciate that the standard industry practice of transferring software is by way of a licence which specifies the terms of usage but does not transfer any right in the copyrights that subsist in the software.

Many Indian Courts have relied on the OECD Commentaries⁹ as well as the decision in *Tata Consultancy Services* while determining the taxability of e-commerce transactions. The Andhra Pradesh High Court observed that by virtue of the adoption of the OECD model treaties by various countries, a new area of genuine 'international tax law' is in the process of developing¹⁰. Moreover, ever since India had been appointed as an observer country to the OECD Committee on Fiscal Affairs, it has been playing an increasingly proactive role in various deliberations in the arena of international taxation. India's reservations to specific clauses of the OECD commentaries have also been included in the 2008 update to the model convention.

The AAR's premature rejection of the OECD Commentaries as a tool of interpretation is therefore not in line with the prevailing view in India. There have also been several cases where the income tax department has ignored the principles laid down by the OECD. In fact, in a recent order in the case of *Microsoft*¹¹, the Commissioner of Income tax (Appeals) took the view that OECD Commentaries are not relevant since India is not an OECD member.

It is evident that the income tax department seems to be unable to appreciate the inherent dynamics of e-commerce transactions and has consequently developed a penchant for relying on generalised principles of income characterisation that have no connection with industry accepted standards. The present situation is clearly reflective of the double standards adopted by the government. On one hand the government acknowledges the contribution of the IT industry to the economy and on the other hand it fosters a tax regime that stifles cross-border e-commerce transactions. In fact, similar ambiguities exist even in the context of indirect taxation of software.

The exponential growth of the internet and the blurring of conventional borders thanks to seamless connectivity, has entirely transformed the face of trade and commerce. The strength of the IT wave greatly depends on the extent to which the regulatory framework manages to preserve some of the core attributes of the sector which include borderless trade, low transaction costs and high value generation. Judicial pronouncements that fail to appreciate the ground-level realities of e-commerce can have a negative impact on cross-border trade and investment.

The time now seems to be ripe for the Supreme Court to step in as it did in *Azadi Bachao Andolan*¹² to put an end to the ambiguities plaguing the taxation of e-commerce.

- Mahesh Kumar, & Parul Jain

Vaibhav Parikh, Partner, Nishith Desai Associate on Tech, M&A, and Ease of Doing Business

March 19, 2025

SIAC 2025 Rules: Key changes & Implications

February 18, 2025

1. Airports Authority of India v. DIT, AIT-2008-248-AAR
2. Earlier, in *IMT Labs (India) (P.) Ltd.*, In re, [2006] 157 TAXMAN 213 (AAR) and *Headstart Business Solutions Pvt. Ltd.*, Re., (2006) 285 ITR 530 (AAR), the AAR held that receipts from the license of software by a non-resident to a resident would be taxable in India.
3. Explanation 2 to Section 9(1)(vi)
4. Article 12(3)(a)
5. (2004) 271 ITR 401 (SC)
6. Article 12(4)(a)
7. (2005) 95 ITD 269 (DELHI) (SB).
8. The other cases where such a view has been taken are *Samsung Electronics Co. Ltd. India Software Operations v. ITO* [2005] 94 ITD 91 (Bang.); *Sonata Information Technology Ltd. v. ADCIT* [2006] 9 SOT 305 (Delhi); *Hewlett-Packard (India) (P.) Ltd. v. ITO* [2006] 5 SOT 660 (Bang.); and *DCIT v. Metapath Software International Ltd* [2006] 9 SOT 305 (DELHI).
9. The broad principle for income characterization has been discussed in the Report of OECD's Technical Advisory Group on Treaty Characterization Issues arising from E-Commerce transactions.
10. *CIT v. Vishakhapatnam Port Trust*, (1983) 144 ITR 146 (AP)
11. Unreported. In this case, income arising to Microsoft on license of shrink-wrap software was held to be taxable in India as royalty income.
12. *Azadi Bachao Andolan and Anr.*, (2003) 263 ITR 706 (SC)

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