Royal Flush: Taxation of Database and Cloud Computing Services

By

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ABSTRACT: This paper discusses the tax liability of foreign vendors/providers of goods and services in India. The paper tells us how these foreign nationals who earns out of software supply transaction can be brought back within the purview of Section 9(1)(vi) of the Income Tax Act, 1961. Further it explains what will be the case when copyright or intellectual property is transferred during these transactions or not. EULA helps licensor to retain the license with him. This paper conclude by stating that the online database and cloud computing can be very much included in explanation 5 of Income Tax provision 9(1) (vi).

INTRODUCTION

The subject of this paper is the implication of "royalty" under Section 9(1) (vi) of the Income Tax Act, 1961 ("IT Act") in the context of the clarificatory amendment inserted by the Finance Act, 2012, having retrospective application from 1-6-1976. This has relevance for the tax liability in India for non-resident or foreign vendors/providers of good/services.

Judicial interpretation of whether consideration paid to non-resident vendors in the case of Software Supply Transactions (SST) would amount to "royalty", and therefore taxable under the IT Act had been haphazard, with different judicial authorities taking opposite stances. Explanation 4 added by the Finance Act provides that such consideration has always been, and shall continue to be treated as "royalty", thus providing a statutory basis to tax such transactions in India. In these strings of cases, the assessees argued that the conceptual basis on which such consideration was not to be characterized by royalty was the distinction between transfer of "copyright" and a "copyrighted article".

In this paper, I argue that there even though the distinction between "copyright" and "copyrighted article" is not central since there is no over-the-counter element involved in database and cloud computing service transactions, the consideration for such services cannot

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usually be characterized as "royalty". I draw from the software experience to contend that there is there is no actual transfer of intellectual property to justify the payment of "royalty" as it is understood in existing copyright law and jurisprudence. Admittedly, the tax law may allow for deviations from meanings and understandings in other areas of law. However, I argue that such deviation in not justified in the present case for two reasons. The first one has its basis in the legal principle of *nomen juris* and the second is a policy-based contention that is guided by considerations of commercial reality.

"ROYALTY" UNDER THE IT ACT - TOO EXPANSIVE FOR ITS OWN GOOD?

Section 9 of the IT Act provides for "income deemed to accrue and arise in India." Clause (vi), dealing with "income payable by royalty" of Section 9(1) was inserted by the Finance Act, 1976. Explanation 2 of Section 9(1)(vi) deals with the kinds of consideration that can be characterized as "royalty". From a copyright perspective, Explanation 2(v) is most relevant.

Explanation 4 clarifies that the transfer of all or any rights in respect of any right, property or information "includes and has always included transfer of all or any right for use or right to use a computer software (including granting of license) irrespective of the medium through which such right is transferred." Explanation 5 clarifies that the term royalty covers "consideration in respect of any right, property or information" regardless of the payer retaining possession or control and the location of the right.

This has directly addressed arguments that can be taken in favour of not treating database and cloud computing services transactions as royalty. In typical cloud computing models, the possession or control might not be with the payer but a third party server which is located in some place outside the country.[2]

TAXATION OF DATABASE AND CLOUD COMPUTING - IS THERE ANY TRANSFER OF INTELLECTUAL PROPERTY?

In this part of the paper, I look at the nature of database and cloud computing services to see if transfers that are typically carried out with respect to such services involve an actual transfer of an underlying copyright. Explanation 4 provides a clear-cut statutory basis for the taxation of

[2] Naqeeb Ahmed Kazia, "An overview of cloud computing and its legal implications in India", 18(2) COMPUTER AND TELECOMMUNICATIONS LAW REVIEW, 47, 47-48 (2012).

off-the-shelf SSTs. Yet, several judicial decisions and also commentary on the point makes it clear that this position is flawed.[3] The conceptual basis of the reasoning in such decisions and commentary is the distinction between "copyright" and "copyrighted article." The characterization of off -the-shelf software as "goods"[4] and "copies"[5] has aided in making this distinction.

In the case of remote technology services (which are not expressly covered by the Explanations 4 and 5) the distinction between "copyright" and "copyrighted article" may not apply due to the lack of an "article", so to speak. However, I borrow from the software experience to contend that there is no actual transfer of intellectual property to justify the payment of "royalty", as it is normally understood in copyright law and jurisprudence.

When is copyright transferred - Lessons from the software experience

To see whether there is an actual transfer of the underlying intellectual property in a product/service, it is necessary to see whether the payer has any of the rights held by the copyright owner. It is the copyright law which lays down what the rights held by the copyright owner are. Section 14 of the Indian Copyright Act, 1957 gives certain rights to the copyright owner. These are commonly referred to as "exclusive economic rights."[6] Section 16 of the Copyright Act lay down that no person shall be entitled to copyright or any similar right in any work otherwise than under and in accordance with the provisions of the Copyright Act or any other law in force.

In the context of SST, it has been contended by the Revenue that the "license to use" involves the transfer of the underlying copyright in the software.[7] But it has been pointed out that invariably the End User License Agreement (EULA) in a software product itself provides that all intellectual property rights in the product will lie with the licensor.[8] In fact, it has been pointed out that "adoption of licensing as the main form of exploitation of computer software is to bypass

[3] See GN Gopalrathnam, "Intellectual Property and Income Tax" in INTELLECTUAL PROPERTY AND TAXATION (ed., Sudhir Raja Ravindran), 17, 26 (2007). Also see, *Sonata Information Technology* vs. *Additional Commissioner of Income Tax,* (2007) 106 TTJ Bang 797.
[4] See *Tata Consultancy Services* vs. *State of Andhra Pradesh*, 271 ITR 401.
[5] *Id.*
[6] Alka Chawla, COPYRIGHT AND RELATED RIGHTS, 91 (2007).
[7] For instance, *Gracemac Corporation* vs. *Assistant Director of Income Tax*, (2010)134 TTJ Delhi 257.
[8] V. Niranjan, "A software transfer agreement and its implication for contract, sale of goods and taxation", 8 JOURNAL OF BUSINESS LAW, 799, 801-802 (2009).

any incidental ownership rights that pass through a normal contract of sale."[9] Here, it is important to make a distinction between licensing and assignment in the context of exploitation of copyright. In *Sonata Information Technology*,[10] the Bangalore ITAT observed that in essence, "an assignment is transfer of ownership even if it is partial". A license, on the other hand, "is a permission to do something which but for the license would be an infringement." Therefore, a licensee's freedom to alter the work is much more limited than that of an assignee. Additionally, the EULA is in most cases a non-exclusive license.

Taxation of database

The term database does not have a precise definition. At its most generic, it has been defined as "a collection of independent components, such as pieces of information, data, or works, arranged in a systematical or methodical way and which are individually accessible by electronic or other means."[11] In the Indian Copyright Act, there are no specific meanings attached to the word "databases" or "computer databases." Section 2(o) of the Act, however, includes compilations as literary works. Access to database is usually by payment of a subscription fee.

But it is submitted that the test to be applied in this case is to see whether there is transfer of any of the rights that constitute the bundle of rights in a copyright. Just as in the case of SST, a mere "license" to use a database does not amount transfer of any of the "exclusive economic rights" that are capable of being infringed. This was also the view taken by the Authority of Advanced Ruling (AAR), New Delhi in *Fact Set Research Systems Inc.* vs. *Director of Income Tax (International Taxation-I)*.[12] While construing the import of "grant of license" in Clause (v) of Explanation 2, the Authority noted that,

> "the expression 'granting of license' placed within brackets takes colour from the preceding expression 'transfer of all or any rights'. It is not used in the wider sense of granting a mere permission to do a certain thing nor does the grant of licence denude the owner of copyrights all or any of his rights."

[9] *Ibid*, at 801.
[10] *Sonata Information Technology* vs. *Additional Commissioner of Income Tax*, (2007) 106 TTJ Bang 797.
[11] Charles Brill, "Legal Protection of Collection of Facts", 1 COMPUTER LAW REVIEW AND TECHNOLOGY JOURNAL, 2 (1998).
[12] [2009] 317 ITR 169 (AAR).

The recent decision of the Karnataka High Court in *Commissioner of Income Tax* vs. *Wipro*[13] is based on a wider sense of the term "granting of license". Holding the non-exclusive license to access the database as a transfer of copyright, the High Court allowed the appeal from the ITAT, Bangalore Bench, which had held the payment of annual subscription fee to access the database as not amounting to royalty.

Taxation of Cloud Computing Services

Cloud computing allows "users to employ a variety of protocols, applications, and transmission techniques to store data and harness the processing power of remote servers, often controlled by third-party providers."[14] Nearly all manner of computer users, and an even greater number of internet users, utilize some method of cloud computing in their activities.[15] The three major delivery mechanism for cloud computing are:[16]

1. **Infrastructure as a Service (IaaS)**: Under this arrangement, the provider makes available a specific portion of physical infrastructure available for use by the payer.
2. **Software as a Service (SaaS)**: The payer makes use of standard software that is available over the cloud.
3. **Platform as a Service (Paas)**: In such a model, the customer sends the data to the cloud service provider to be processed using the service provider's computing infrastructure and software.

To see whether any copyright is transferred in SaaS transaction, the license-assignment test can be applied. Typically, SaaS providers service several clients at once, thereby making the license non-exclusive. The appropriate i.e. narrow reading of the term "granting of license" will lead to the conclusion that the consideration for such services cannot be characterized as royalty.

Just like database service providers, non-resident IaaS and PaaS service providers will find themselves inconvenienced with the addition of Explanation 5. It is very likely that the framers had such services in mind while drafting the clarificatory amendment. The non-resident's servers

[13] [2011] 203 TAXMAN 621 (Kar).
[14] Marc Aaron Melzer, "Copyright Enforcement in the Cloud", 21 FORDHAM INTELLECTUAL PROPERTY, MEDIA AND ENTERTAINMENT LAW JOURNAL, 403, 404 (2011).
[15] *Ibid.*, at 405.
[16] Kazia, at 48-49.

are generally located abroad. There are many cases in which the payer does not use the service directly. Also, as we have already seen, the possession or control of such right, property or information is not necessarily with the payer. These, in fact, are some of the distinct features of cloud computing. But Explanation 5 makes these factors irrelevant for the royalty provision under the IT Act, thereby disregarding the true meaning of "royalty" as consideration for the transfer of a right or rights that are inherent in a form of intellectual property.

IS THE DEVIATION FROM THE INTELLECTUAL PROPERTY MEANING OF "ROYALTY" JUSTIFIED- AN ARGUMENT FROM LEGAL THEORY AND ANOTHER FROM POLICY

I have contended that the import of "royalty" under the IT Act is far more expansive than the its understanding in intellectual property law. Admittedly, certain concepts and terms have a different meaning in tax law. However, in this part I contend that the deviation in the IT Act in the context of royalty is not justified on two grounds.

1. Nomen juris

When an expression is said to be *nomen juris*, it is construed in its legal sense. The decision of the Supreme Court in *State of Madras* vs. *Gannon Dunkerly*[17] famously invoked the principle of *nomen juris* to construe the expression "sale of goods" in Entry 48 of List II (Seventh Schedule) of the Government of India Act. The expression was held to have the same meaning as in the Sale of Goods, 1930. In the case of *Fact Set*,[18] the Authority of Advanced Ruling relied on *nomen juris* to conclude that there has been no actual transfer of copyright. The expression "copyright" is not defined in the IT Act. The Authority goes on to say that,

> "When the term is not defined in the taxation law (IT Act), the definition in the law governing the subject-matter ought to be adopted, more so when there is no basic difference between the statutory definition and the ordinary legal concept."

This reasoning in the *Fact Set* decision was relied on even in a subsequent decision of the same authority in *Geoquest Systems* vs. *Director of Income Tax.*[19] It is submitted that the other terms

[17] AIR 1958 SC 560.
[18] [2009] 317 ITR 169 (AAR).
[19] [2010] 327 ITR 1 (AAR).

used in the royalty provisions of the IT Act such as patent and trademark are also *nomen juris*. The implication of this is that it is necessary to refer to the Patent Act and Trademark Act to determine what the rights granted to a patentee or a trademark holder are.

2. Commercial reality

The deviation from an intellectual property understanding of "royalty" in the IT Act and also that part of its judicial interpretation that endorses such deviation seems to have been unmindful of the commercial reality. It is conceivable that any consideration for any transaction involving any product/service with an intellectual property basis can be characterized as royalty under this view. This conclusion is particularly absurd in the context of technology-based products/services which usually have as their basis some form of intellectual property like copyright or patent.

Section 9(1)(vi) is among the clauses Palkhivala refers to as the "most powerful fiscal deterrents to keep away foreign collaborators." He also refers to these clauses as "contrary to the well-settled international norms of taxation on a foreigner in respect of his income accruing, arising and received outside the taxing state."[20] The recent amendment has only served to confirm the lack of foreign investor confidence in India.

CONCLUSION:

This paper considers how services like online database and cloud computing must be treated by the royalty provision in the IT Act. It has been contended that there is usually no actual transfer of propriety right with respect to such services. Drawing from the software experience, it has been submitted that the test to determine whether consideration is to be characterized as royalty is to see if the payer has been conferred any of the rights of the copyright holder. In this context, the most useful distinction is the one between assignment and license. Both online database and cloud computing service providers usually issue a license similar to a software license. It is clear from Explanation 5 that the authorities sought to bring remote technology such as online database and cloud computing within the ambit of the royalty provision.

Not only is this a deviation from the well-established principle of *nomen juris*, it is also grounded in a poor understanding of commercial reality. It is indeed hard to think of more investor

[20] Kanga, Palkhivala and Vyas, THE LAW AND PRACTICE OF INCOME TAX, VOL I, 385 (9th edn., 2004)

unfriendly provisions than Section 9(vi) of the IT Act. Of course, such income can be treated as business income, and therefore taxable in India. But the IT Act contemplates taxing business income only if the non-resident has a permanent establishment in India. Consideration is treated as royalty even though there is no transfer of intellectual property right, as it is understood under existing intellectual property legislation, only so that entities who don't have permanent establishments in India can be taxed. Unfortunately, the short-sightedness of both legislators and the Revenue has caused even well-reasoned judicial decisions to be nullified by the recent clarificatory amendments.