Pakistan; Netherlands

# Pakistan Supreme Court Rules that Payments for Use of Software are Royalties

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The Supreme Court of Pakistan has ruled that payments paid from Pakistan to a non-resident under an agreement for the lease of software for oil field data processing and log interpretation were royalties and subject to a 15% withholding tax under the Netherlands-Pakistan tax treaty. The ruling handed down in the case of Commissioner of Income Tax v. M/s. Inter Quest Informatics Services (2023) 128 TAX 193 (S.C. Pak.)on 8 September 2023 overturned the High Court ruling that had found in favour of the taxpayer.

(a) Facts. The taxpayer is a company incorporated in the Netherlands, with no place of business in Pakistan and thus a non-resident for Pakistan income tax purposes. It entered into an agreement to lease certain software programmes developed by it for use in oilfield data processing and log interpretation to Schlumberger Seaco Inc. (SSI), which has a place of business in Pakistan.

In its tax returns for the assessment years 1987 to 2003, the taxpayer took the position that the rentals received in respect of the lease were business profits and, since it did not have a permanent establishment in Pakistan, were exempt from tax in Pakistan under article 7 (business profits) of the Netherlands-Pakistan tax treaty. However, the tax authority held that the payments were in the nature of royalty receipts and thus subject to withholding tax of 15% under article 12 (royalties) of the treaty.

The taxpayer's appeals before the Commissioner Income Tax (Appeals) and the Income Tax Appellate Tribunal were unsuccessful. However, the Sindh High Court held in favour of the taxpayer, deciding that the payments were not royalties.

The case was thereafter appealed to the Supreme Court.

(b) Issue. The primary issue was whether the payments received by the taxpayer for the lease of software programmes constituted royalties as defined in article 12(3) of the Netherlands-Pakistan tax treaty.

(c) Decision. The Supreme Court decided against the taxpayer in a 2-1 majority, holding that the payments constituted royalties.

The majority judges held that the taxpayer had not clearly set out its case as to why the payments were not royalties nor did it provide proper explanations of the nature of the payments or the services it provided to support its contention that they were business profits. The majority judges were also critical of the taxpayer for not availing of the mutual agreement procedure under the treaty because they opined that it was always preferable to avail of such a mechanism when available and to resolve matters

amicably. The view of the competent authority of the Netherlands could have been considered, and if it had supported the taxpayer's contention the two countries could have mutually resolved the matter and/or made the relevant regulations.

The majority ruling asserted that the High Court had proceeded to a factual determination of a complex area without the requisite technical expertise, a determination that had already been made in the lower forums, instead of limiting itself to considering and deciding questions of law as was its jurisdiction. The High Court had incorrectly relied on the interpretation of article 12 in the OECD Model, rather than the UN model on which article 12 of the Netherlands-Pakistan treaty was based (which allows source taxation compared to the OECD Model), and had failed to note that if the taxpayer was taxed in Pakistan, the tax would have been offset by a tax credit in the Netherlands since it was entitled to double tax relief under the tax treaty.

The dissenting judge, in finding for the taxpayer, ruled that the payments did not fall within the definition of royalties under the treaty, analysing each component of the definition in turn and agreeing with the taxpayer's distinction between the use of copyright and the use of a copyright product. No copyrights were leased out to the lessee which had merely acquired a copy of the software for its operations without a licence to reproduce and distribute to the public software incorporating the copyrighted programme, or to modify and publicly display the programme. Further, the lease did not involve payments made for the use of or the right to use secret formula or process, or information concerning industrial, commercial or scientific experience. There was no transfer of rights to use the programme in a manner that would, without such licence, constitute an infringement of copyright, nor was there any transfer of the full ownership of the rights in the software. The judge relied on various case law in his conclusion, including the finding that the right to use a copyrighted product, granted through a non-exclusive and non-transferable licence, being restrictive in nature only allows for specific uses and should not be considered as a licence granting the enjoyment of all or any rights related to the copyright (Engineering Analysis Centre of Excellence Private Limited v. The Commissioner of Income Tax 2022 (3) SCC 321). Notably, he compared the Indian case of *Geoquest Systems B.V. Gevers Deynootweg v. Director of Income Tax*, which had similar facts and issues to this case (*see* Ruling that supply of software is not liable to tax as royalty or fees for technical services (3 October 2012)).

The dissenting judge disagreed that the High Court had erred in its judgement. Rather, it had addressed the sole point of contention between the parties on whether the payments received by the taxpayer constituted royalties as defined in the treaty, which was very much a question of law within its jurisdiction. He also disagreed with the majority view that it would not make a difference to the taxpayer if it was taxed in Pakistan since it would not be double taxed, and if it was not taxed in Pakistan it may still have been taxed in the Netherlands, because "our duty is to decide the question based on law, not extraneous and utilitarian considerations in disregard of the law". Rather than definitively addressing whether the amounts received by the taxpayer constituted royalties, the majority judges had instead moved to discussions that were not in contention. On the majority assertion that the High Court had incorrectly relied on the OECD Model, the dissenting judge also disagreed, stating that the issue was not about the taxing rights of Pakistan over royalties arising in the country, but whether the income derived by the taxpayer constituted royalties. Since there was no real difference between the definition of royalties provided in the two models, the High Court's reliance on the UN Model had no material effect on its determination.