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International Taxation of Software

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Introduction :

Indian software companies are in the limelight due to their high-growth potential and sustainable global cost advantage. There is a global short supply of trained manpower which is needed for software projects ranging from maintenance, migration[1], ERP implementation, internet applications and e-commerce.

India has the second largest pool of computer programmers in the world. India is currently graduating 60,000 computer professionals per annum. This strength has come very handy for the software companies servicing Y2K contracts. India is well known as a low-cost software development center. It is also used for sub-contracting some of the software service jobs.

The worldwide market for IT services is estimated at US$ 300 billion annually with approximately 75% of the demand located within the US and Europe. The US market is very large and fragmented. The growth of the US service providers is constrained by shortage of skilled IT labor. They are being forced to import programmers from abroad and to sub-contract work to IT service companies abroad. However, very few Indian companies have developed software products and succeeded in marketing them worldwide. Therefore, the issues related to cross-border sale of software products have only recently begun to surface in India. In some of the developed countries like the U.S., these issues have been discussed and debated for a very long time.

The United States Internal Revenue Services (**IRS**), Treasury, has published their draft Regulations on tax treatment of transactions involving computer programs. These regulations have been proposed to clarify the treatment under certain provisions of the

[1] Transition of data from the mainframe to the PCs

Internal Revenue Code (**IRC**) - the Tax code in the US and tax treaties of income from transactions involving computer programs.

What is Software?

The New Oxford Dictionary for the Business World defines 'software' as programs used with a computer (together with their documentation), including program listings, program libraries, and user and programming manuals.

The IRS, Treasury, in their draft Regulations on Tax Treatment of transactions involving computer programs, have defined a computer program as a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result.

The Working Party's recommendation on the revision of the commentary on Article 12 of the OECD Model convention describes software as a program, or series of programs, containing instructions for a computer required either for the operational processes of the computer itself (operational software) or for the accomplishment of other tasks (application software).

Definitions in India :

In India, "software" has been defined under the Income tax Act and under the Copyright Act. Explanation (b) to Section 80 HHE of the Income tax Act, 1961 defines "computer software" to mean any computer programme recorded on any disc, tape, perforated media or other information storage device and includes any such programme or any customised electronic data which is transmitted from India to a place outside India by any means.

Under the Indian Copyright law (Copyright Act, 1957), computer programme and computer data bases are considered literary works. Section 2(ffc) defines "computer Programme" as a set of instructions expressed in words, codes, schemes or any other form, including a machine readable medium, capable of causing a computer to perform a particular task or achieve a particular result.

In India, computer software is protected by the Copyright law but can not be patented. In many developed countries of the world, computer programs are protected by the Copyright law and certain types of software are protected by patents as well.

As per the Copyrights Act, 1957, ‘computer program’ is regarded as literary works. Some of the statutory rights[2] attached with a copyright right in a computer program are :

- Right to make copies of the computer programs based upon the copyrighted computer program in any material form including the storing of it in any medium by electronic means
- Right to issue copies of the computer program to the public
- Right to make translation of the computer program

[2] Section 14 of the Copyright Act, 1957

- Right to prepare derivative computer programs based upon the copyrighted computer program
- Right to make a public performance of the computer program
- Right to sell or give on hire, or offer for sale or hire, any copy of the computer program

Different Types of Software :

In technical sense, there are two types of software - Systems software and Applications Software.

“Systems software” is the software required to produce a computer system acceptable to the end-users, providing a good environment for writing, testing, running and storing users' programs, and including programs that are essential to the effective use of system. Operating systems, compilers, utility programs, database management systems, and communication systems are examples of systems software. Systems software is generally provided by the manufacturer and is bought along with the computer.

“Applications software” are computer programs designed for a particular purpose or application. Accounts programs, games programs and educational software are application software. Application software is written for end-users of a computer system. An Application software may be a standard software or a special software which is tailor-made for single users.

There are some more terms which are commonly used to describe the different modes of delivery of software. These are as follows –

“Shrink-wrap software” is the readily available software which is sold 'off-the-shelf'. Against this, "customized software” is the software which is tailor-made based on the specific needs of the customer. In a 'shrink-wrap', the software is packaged with the license agreement. The License gives the endorser the limited right to use the software for perpetual period. The right is not transferable and nor can the buyer sub-license the software. Any user opening the package is deemed to have the knowledge of the copyright of the software.

“Bundled software” is one which is embedded with the hardware and is bought along with the computer when it is purchased from the manufacturer. Most of the systems software generally comes in the bundled form. Most of the applications software will be available in “unbundled” form especially if it is bought subsequent to the purchase of computer.

"Canned Software" is an independent software that can be used by a variety of hardware and may be applied for management, consulting and administration.

Software are also often classified as follows :

- Computer software
- Video/audio Software
- Telecom Software

Generally, the word ‘software’ is read to mean ‘computer software’. Computer software is the program used to run the computer. Taxation of computer software has been a subject of concern to most of the developed countries. OECD has commentaries on taxation of computer software which have been discussed in this paper.

Media software i.e. video and audio software often gets a special treatment under the domestic law and under the tax treaties. Video films or cinematograph films are excluded from the definition of "Royalty" and included in the Article 7 on "Business Profits". Telecom software is the software which is used by the telecommunications industry. This software has special application and hence forms a separate category. For the purposes of this paper, I have restrained the discussions only to computer software.

Some Typical Transactions in Software :

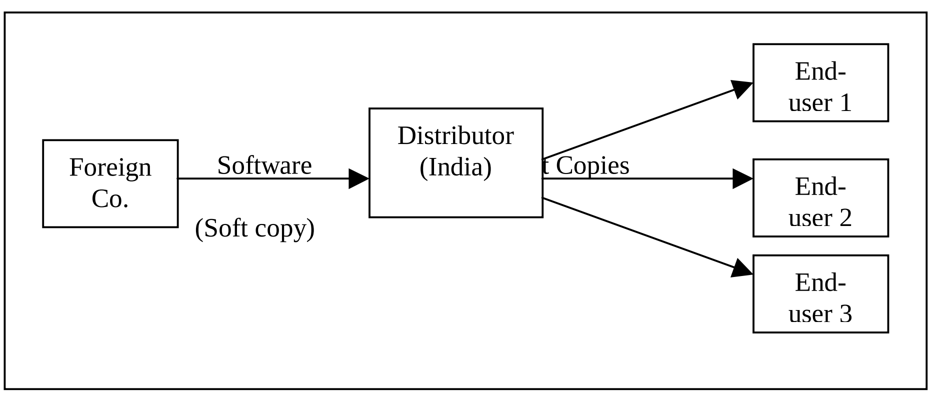
Any transaction in transfer of a computer software would fall in any one of the following categories :

1. Transfer of a copy of the computer program (a copyrighted article)
2. Transfer of a copyright right in the computer program
3. Provision of services for the development or modification of the computer program; or
4. Provision of know-how related to computer programming techniques

Inbound Software Transactions :

<u>A) ‘Distribution’ Model :</u>

A typical transaction is where the foreign supplier sends soft copies (floppies) to the local distributor for onward distribution to the retail end-users.



This type of transmission of software is popularly known as 'shrink-wrap'. In order to determine the nature of payment that passes hands in a typical transaction in software, it is important to understand whether there is a sale of a copyright or a sale of a copyrighted article. Generally, the payment for a sale of a copyright will be treated as 'royalty' and the payment for a sale of a copyrighted article will be regarded as business profits.

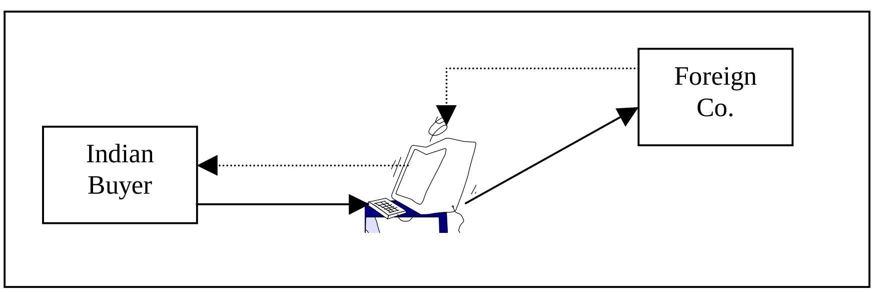
In this case, the payment is only for sale of software and there is no transmission of copyright right. Therefore, the payment made by the Indian buyer to the foreign software supplier will be treated as a sale and characterized as 'business profits' in the hands of the foreign supplier. Such profits are generally not taxed in India unless the foreign supplier has a Permanent Establishment (**PE**) in India and such profits are attributable to the PE.

B) ‘Copy and Distribution’ Model :

In this transaction, the distributor is given the license to make copies and distribute soft copies to the customers. Here, the supplier only sends a single floppy. The local distributor is given the license to make further copies and distribute to the customers. So long as the distributor does not have the copyright right in the computer software, such payment would also be characterized as 'business profits'. For every copy distributed by the distributor, he is allowed (by the Reserve Bank of India) to pay a royalty of up to 30 per cent to the developer (licensor)[3]. Royalty in excess of 30 per cent may also be allowed, with special approval of the Reserve Bank of India.

C) ‘Distribution through Internet’ Model :

Another transaction could be that of transmission of the software through electronic media. Most likely, an Indian buyer may place an order for the computer software through the internet and on payment (charge of international credit card), may be able to download the software from the internet. In this case, there is no physical delivery of software.



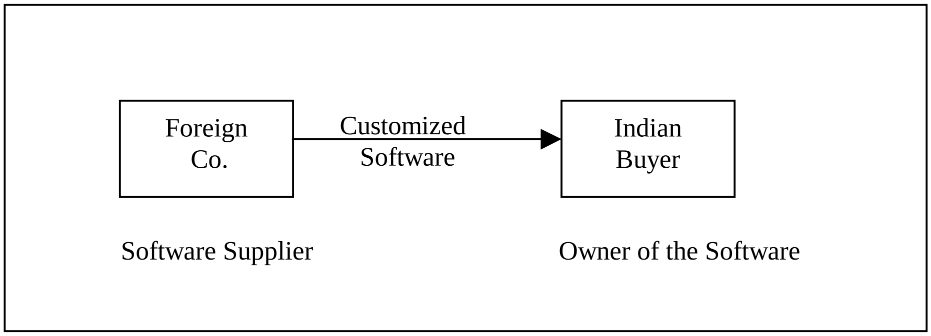
In the case of transmission through internet or through data lines, the position is not much different from that in case of physical delivery. There can not be any customs duty implications as there is no physical import of software. Characterization of payment will depend upon the rights associated with the software.

D) ‘Customization’ Model :

In another type of transaction, the foreign software supplier will customize the software as per the specifications of the Indian buyer. The software could be sent through any mode - either physical or in electronic form. The main distinction between this transaction and the

[3] RBI Circular No. 17 A.D. (M.A. Series) dated June 6, 1998,

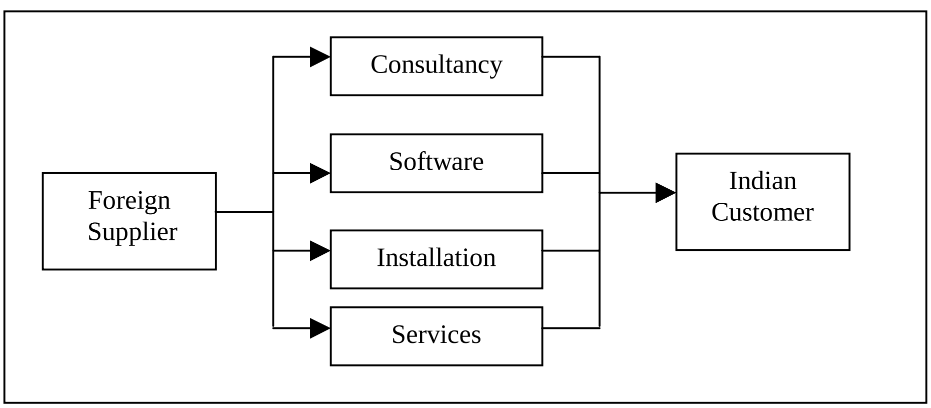
other transactions is that the customized software is owned by the Indian buyer. Again the characterization of payment in the present case would be that of "business profits" and not as "royalties".



Customized software could be either bundled or unbundled.

E) 'ERP' Model :

Enterprise Resource Planning (**ERP**) is the latest buzzword. ERP software is designed to model and automate many of the basic processes of a company, from finance to the shop floor, with the goal of integrating information across the company and eliminating complex, expensive links between computer systems that were never meant to talk to each other.

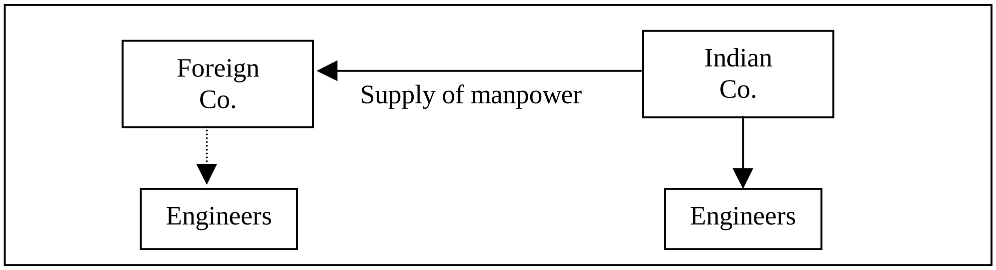


In ERP, the foreign supplier provides total solutions. It would include consultancy, software-standard as well as customized, installation and implementation, support services, etc. In a typical ERP solution, the supplier will first study the customer's system and requirements. On the basis of the study, it would offer solution which would fit the customer's requirement. The solution would generally have software that would depend on the type of industry the customer is in. The software is then customized to the requirements of the customer. The supplier then installs the software. The installation is charged separately. The supplier's expert then sits with the customer to ensure the implementation of the ERP Solution. The implementation also requires extensive training of the customer's personal.

Outbound Software Transactions :

A) Body Shopping :

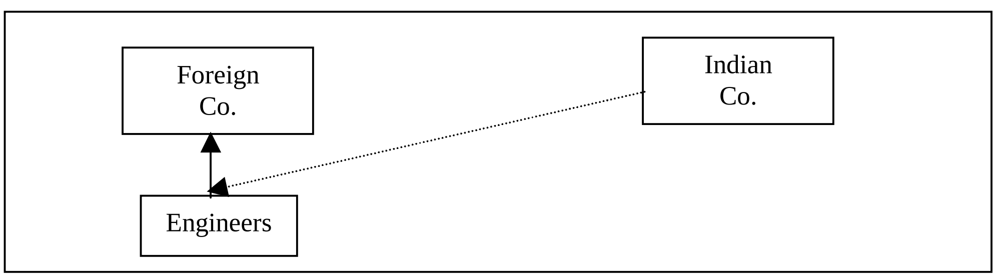
Outbound software transactions traditionally started with body shopping. The transaction would be as follows:



India has traditionally been a supplier of skilled engineers for development of software abroad. The role of the Indian company is limited to source the engineers and send them abroad. Once abroad, they are employed by foreign companies and they perform services on behalf of the foreign company.

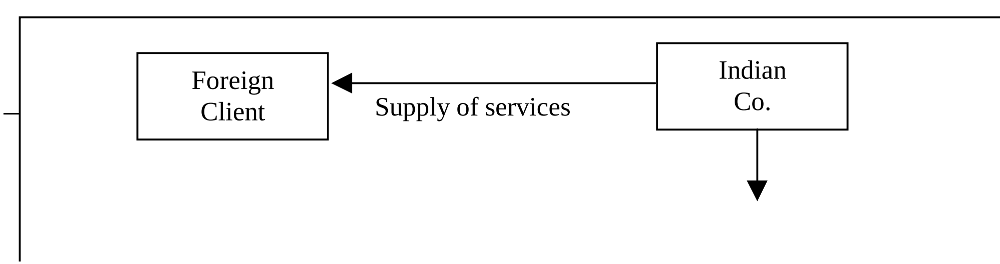
Tax implications of such transactions are discussed under the section on 'Taxation' under section 80HHE.

B) On-site Development :



In this type of a transaction, the Indian company takes up the contract on its name. It then sends its engineers abroad to render services on the foreign clients' site.

C) Off-site Development :



Engineers

In this case, the Indian company develops the software off-site, mostly in India. After development, it transmits its developed software to its client overseas. In many cases, there may be a combination of this and the immediately previous transaction. Some work may be done on-site by the engineers employed by the Indian company who work on the site of the foreign client. When they leave the work, the next day, the Indian engineers working in India can continue with the work, from the point where their foreign counterparts have left it. This is popularly known as "24-hour productivity".

This could lead to interesting tax issues related to allocation of revenues between the two countries. Presence of the Indian company's engineers in the foreign country beyond a certain period may give rise to the exposure to a Permanent Establishment of the Indian company in that country. Once a PE is established, the profits attributable to such PE will be taxable in the foreign county. In the US, for example, presence of engineers of the Indian company beyond a certain period in the US, may deem them to be a branch of the Indian company in the US.

<u>D) Value added software:</u>

In this case, the Indian Company develops software which 'adds on' to its parent software. The 'add on' software has to be used only with its parent software. Typically, the Indian Company develops the software and either sells directly in India and abroad along with the parent software or sells such 'add on' software directly to the parent company.

International Pricing of Software :

Research and development costs form a major part of the cost of software. During the development of software, some of the research projects may result in development of a very profitable software product whereas other projects may be abandoned without any commercial exploitation. Generally, one profitable product may have to compensate for the economic loss of the other. Therefore, the royalty rates on software are often higher than the other products. For example, a royalty rate of 25% of sales is very common for software products. Also, another point to be borne in mind while pricing software is that the technical obsolescence is very fast.

The primary factors that may be considered in pricing software in foreign markets are [4]:

[4] International Pricing of Software by Fred Greguras and Michael Egger, Fenwick & West (Website:www. fenwick.com)

- Cost of development
- Cost of research
- Cost of support and maintenance obligations
- Cost of product localization
- The purchasing power of the people in the market
- Taxes payable by the vendor

It may be prudent to price a product in the currency stronger than the one in which costs are incurred. Besides the direct and indirect R&D costs, it is important to consider the cost of providing maintenance facility to the customers in foreign markets. One must also keep in mind that there exists some risk in providing maintenance facility, such that in some countries, service agents may be construed to be "Permanent Establishment" of the software vendors. Localization of a software product in the local language and cultural orientation is also very critical to the success of a software product in the foreign market.

It is quite often that the price of a product is increased to include the withholding tax on the royalty, wherever relevant.

Tax Treatment of Software in India :

Information Technology is a very privileged sector in India. All the governments have encouraged this sector and offered sops in terms of tax concessions and otherwise. The Indian Finance Minister Mr. Yashwant Sinha announced major tax incentives for the IT industry in the Finance Bill, 1998. The incentives are based on the recommendations of the National Task Force on IT set up by the Prime Minister on May 22, 1998. The recommendations were made on July 6, 1998.

As a part of these incentives, import of IT software has been exempted from custom duty. At present, there is no custom duty on import of computer software and non-embedded telecom software. However, import of telecom software is subject to a custom duty of 23% (minimum). Software is considered to be a 'commodity' under the Indian customs law and is liable to a duty though currently, no duty is levied on the same.

Taxation of Foreign Companies

Royalties

Section 9 of the ITA deals with certain incomes which are deemed to accrue or arise in India and hence are taxable in the hands of the non-residents in India. Section 9(1)(vi) of the ITA deals with taxation of royalty income in the hands of the non-residents. Explanation 2 to section 9(1)(vi) defines royalty to mean (among other things) any consideration for the transfer of all or any rights (including granting of a license) 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 cinematograph films.

Since computer software is covered within copyright, as such, consideration for the right or license to use it should be subject to royalty. It is interesting to note that as per the provisions of the Indian ITA even if all the rights in a computer program are transferred, the consideration for the same could be treated as 'royalty'.

In India, royalty paid by an Indian resident to a non-resident is subject to a withholding tax of 20 per cent. Section 9(1)(vi) of the ITA provides that any royalty payable by a non-resident shall also be deemed to accrue or arise in India and hence taxable in India, if such royalty is payable in respect of any right, property or information used for services utilized for the purposes of a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India.

In order to avoid dual taxation of systems software (customs duty as well as income tax), Section 9(1)(vi) of the ITA was amended to provide that any lump sum payment for acquisition of any right in relation to or for the use of systems software supplied by a non-resident manufacturer along with the computer hardware will not be subject to income tax[5]. With effect from April 1, 1991, payments to a non-resident for supply of software along with a computer or computer-based equipment under an approved scheme[6] is exempted from taxation as 'royalty'. Since the scope of this exemption is fairly narrow, any sale of unbundled software may be subject to taxation as 'royalty'.

ERP :

Since most of the ERP software is likely to be imported in unbundled form (separately from the hardware), it is likely that import of such software will be subject to the withholding tax applicable to royalty.

Taxation of Indian Companies

Section 80HHE :

Section 80HHE of the ITA provides complete exemption to Indian residents in respect of profits earned from export of computer software and for provision of technical services outside India in connection with the development or production of computer software, on satisfaction of certain conditions. Such exemption is available on export of software not only through magnetic media but also through satellite data link and consultancy services rendered at the location of a foreign client outside India. In last budget, export of data transmission has also been included in section 80HHE. The benefits of section 80HHE have also been extended to support software developers. This will benefit the domestic Indian companies immensely as they can now transmit software to their customers abroad through telecom network and claim tax exemption under section 80HHE.

[5] CBDT Circular No. 588 dated January 2, 1991
[6] Scheme approved under the Policy on Computer Software Export, Software Development and Training, 1986 of the Government of India (Second Proviso to Section 9(1)(vi) of the ITA.

Section 10A/10B :

In addition to the tax concession for export of software, a five-year tax holiday is also available to industries engaged in development of software meant for export out of India. Investments in Free Trade Zones (**FTZ**), electronic hardware and Software Technology Parks (**STP**), and Export-Oriented Units (**EOU**) are eligible for a 100 per cent tax holiday for any five consecutive tax years falling within a period of eight years beginning from the year in which production commences. Also, these taxpayers are exempt from import duty on capital goods, components, raw materials etc. (generally 25-50 per cent), and from the excise duty (generally 15 per cent) on the manufacture of goods in India. Industries set up in a FTZ, STP, or as an EOU are permitted to have up to 25 per cent of their total sales in any year within India. If the minimum level of 75 percent export sales required under these rules can not be achieved, an ordinary (e.g., non-FTZ/TP/EOU) undertaking may be formed. Such undertakings are eligible for exemption of profits to the extent that goods (including computer software) are exported. They would also be eligible for exemption or reduction of customs duty on import of capital goods (generally 25 per cent) against specified export obligations, and exemption from excise duty in respect of goods exported.

Depreciation :

Under the last budget, the depreciation rate on all IT products has been increased from 25% to 60%.

Y2K Expenses :

The Indian position on tax deductibility of expenses incurred in making the company Y2K compliant is not certain. However, the same principles which are applied for classification of expenses into capital and revenue should apply. In most cases, it should be possible to treat such expenses as revenue expenses, except where there may be improvement of the software along with it. In such cases, appropriate amortization may have to be done.

Transfer Pricing :

Transactions between Indian residents and non-residents are required to be at arm's length and tax authorities are given wide powers in reallocating items of income and expenses to achieve the desired arm's length result. Transfer pricing is a concern to Indian tax authorities only when it involves transactions with a non-resident person. Domestic transactions are rarely scrutinized for transfer pricing issues. In practice, transactions with foreign persons are also seldom examined. This may change as Indian tax authorities gain more experience in the area. Meanwhile, the high customs duty can be a deterrent to aggressive transfer pricing planning.

Sales Tax :

There is a landmark decision of the Andhra Pradesh High Court in the case of *Tata Consultancy Services v. State of Andhra Pradesh 105 STC 421 (1996)*. In this case, computer software was mainly described under two heads – branded software and unbranded software. According to the High Court, branded software can be treated as 'goods' and hence were liable to sales tax, whereas unbranded software can not be treated as 'goods' and hence was exempt from sales tax. As per this judgement, floppies/discs containing software programs like Oracle, Lotus, Masterkey, N-Export, Ex-Unigraphic, etc. are goods and hence liable to sales tax.

If the same ratio was applied to the Income tax law, sale of these types of software should be treated as sale of goods and the consideration for the same should be taxable as 'business profits' and not as 'royalties'. However, that is not the case and in general, tax on royalty is levied in respect of consideration received for the sale of software in India.

Customs Duty :

Software is regarded as a commodity under the Customs Law and hence customs duty is leviable on the same. Currently, there is no customs duty on import of software in India. The only exception is telecom software, which attracts customs duty at the rate of 23% (plus CVD). Circumventing the customs duty on telecom software is difficult as it can not be easily downloaded from the internet. Computer software can be imported by the users under *Open General License*. It is quite common for most of the systems software to be bundled into the computer at the time of sale of computers. Such software is often given "free". The computers are subject to an import duty of 10(+5+4)% plus CVD. If the price of software is not disclosed separately, the importer may end up paying this customs duty on the total amount shown in the invoice for purchase of computers.

Tax Treatment of Software in Other Countries :

United States

Under the IRS-Treasury's - Draft Regulations, "the transfer of a computer program in perpetuity for internal use only on a single disk or set of disks in return for a one-time payment, in a transaction styled as a license of copyright rights, is treated as the sale of a copyrighted article and not the transfer of a copyright right." A copyrighted article is a copy of the computer program from which work can be perceived, reproduced or otherwise communicated either directly or with the aid of a machine or device. The copy of the program may be fixed in the magnetic medium of a floppy disk or in the main memory or hard drive of a computer. Generally, the payment for a sale of a copyright is treated as 'royalty' and the payment for a sale of a copyrighted article is regarded as business profits.

Y2K Software-Tax Deductible?

The IRS has recently issued guidelines to be followed by the tax officers while examining the tax returns of entities incurring expenses for replacing their existing software with Year 2000 compliant software. According to these guidelines, if the software is produced in-house, the entire cost should be allowed as revenue expenditure. If the software is purchased from outside, it should be amortized over a period of five years (or such shorter period as may be justified by the tax payer). If the software is leased, the lease rentals can be claimed as revenue expense.

If the tax payer incurs expense on repair of their existing software to make it Year 2000 compliant, the tax deductibility of that would depend upon the facts of the case like nature of work done, how it is reflected in the contracts and other documentation etc.

Australia[7]

In Australia, as a matter of policy, the tax officer does not tax any part of the purchase price of "shrink-wrap" software as royalty. A payment for software is treated as royalty where it is in consideration for –

- Granting of a license to reproduce or modify a computer programme in a manner which, without such a license, would constitute infringement of a copyright; or
- Supply of know-how

The following payments are not considered as royalty –

- For transfer of all rights relating to copyright to the programme
- For transfer of right for simple usage of software
- For services in the modification or creation of software
- For sale of software and hardware (when they are bundled)

Taiwan

In Taiwan, for a very long time, the practice was to treat software sale as a sale of goods. As a result, most importers of software did not withhold any tax from the payment made to the software providers. However, in 1993, the National Tax Administration responded that withholding tax should be applied. This is not a published ruling and tax office's position on the subject is not very clear.

Vietnam

The position in Vietnam is also quite similar to that in Taiwan. So far, payments for software are generally characterized as sale of goods. However, it is expected that the tax office may adopt an aggressive stand in future and apply withholding tax.

OECD Commentary on Article 12 (Royalties) :

The Organization for Economic Co-operation and Development has published a report on "Software : An emerging Industry" in 1985. The development and transfer of software across national borders is an issue of concern to the OECD as trade in software is a substantial part of the total work on "trade in services".

Transactions involving software often grant buyers the right to subsequent improvements in the software or the right to request installation, maintenance and performance review

[7] Asia Pacific Tax Bulletin, November 1997

services. Payments for these services may be separately identified, included in a gross price or form part of installment payments. The fundamental economic characteristics of the arrangements may represent a transaction in goods, in services, in intellectual property, or a combination of all three.

The Committee on Fiscal Affairs, OECD had set up a Working Party No. 1 to recommend changes in the Commentary on Article 12 of the Model treaty, concerning software payments. The revision of the commentary as suggested by the Working Party, is enclosed with this paper as an *Appendix*.

The main objective of this revision is to describe the analysis by which the software payments are bifurcated between 'business profits' and 'royalties'. It has to be noted that this revision does not change any fundamental principles on the basis of which this analysis has to be made.

In Para 12.1, it is proposed to amend the commentary to recognize the modern means of transmission. It is becoming quite common to transfer software through electronic medium.

In Para 12.2, it is proposed to lay strong emphasis on the rights that a buyer receives in the software, in order to analyze the characterization of payment for software. Also, a distinction is being made between a copyright in the program and the software which incorporates a copy of the copyrighted program.

Para 13 takes cognizance of the fact that the buyer may acquire full or partial rights in the underlying copyright or in the copy of the program. It reaffirms that the media used for transfer is not material in determining characterization of the software payment.

Para 13.1 provides that where the payment is for a right to use the program in the manner that would, without such license, result in infringement of a copyright, the payment can be characterized as 'royalty'. Some of the examples of this type of payment are the payment for the license to reproduce and distribute or to modify and publicly display the programs. In many countries there is a problem in analyzing the character of the software payment based on the above parameters as generally, a copyright is defined to mean a literary, artistic or scientific work. Software may not fall within any of these categories. However, some countries have corrected this problem by specifically classifying software as a literary or scientific work.

Para 14 deals with transactions under which the buyer gets merely to operate the software for his own use. He may get the license to copy the program on his memory (hard drive) or for archival purposes. Such payments should be regarded as 'business income' and taxed according to the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services).

Para 14.2 deals with arrangements which are known as 'site licenses', 'enterprise licenses' or 'network licenses'. In large organizations, multiple copies of the programs have to be made for utilization within the organization. In this case, even thought the buyer will get the right to make multiple copies, the nature of payment would be that of 'business profits' and not 'royalties'.

Para 14.3 deals with payments for transfer of know-how. Where the software developer transfers the logic, algorithms, program language or techniques to the buyer, that part of the payment which is relatable to transfer of know-how should be treated as 'royalties'.

Paras 15 and 16 comment on the transactions where consideration is paid for the transfer of full rights in the copyright. The payment could be for granting exclusive right of use within a specified time or in certain geographical area. Such payments may fall in either Article 7 or Article 14 as 'business profits' or under Article 13 as 'capital gains'.

Para 17 relates to 'mixed contracts' where the computer hardware is purchased with built-in software (also known as bundled or embedded software). Also, the payment for the right to use software is combined with the support services. In such cases, it is always better to break-up the consideration among different elements so that differential tax treatment can be applied to each element, as required.

In conclusion, the Committee's view was as follows –

- The payment for software whether 'bundled' or 'unbundled' should not be taxable as royalty if the software is purchased for the personal (corporate) use of buyer.

- Payment for alienation of all rights in the software could be taxable either as 'business profits' or as 'capital gains'; but should not be taxable as 'royalty'.

- Payments for mixed contracts like hardware with built-in software and sale of software along with ancillary services should be broken up into different categories if possible. If not, the tax treatment applicable to the main component of the contract should be applied to the whole contract.

Although these commentaries help in analyzing the tax treatment, they are not binding. Some of the member countries may choose to adopt a different approach under some circumstances. In the case of non-member countries, they are any way not applicable.

Tax Planning through DTAAs :

India has an extensive network of double tax avoidance agreements. The withholding tax rates on payments of dividends, interest, royalties and capital gains are fairly uniform for tax treaty partners. However, some of the treaties have become more popular for routing certain types of income.

<u>Mauritius :</u>

Mauritius is perhaps the most favoured jurisdiction for inbound investment into India. Dividends are in any case, tax exempt in the hands of the shareholders. India-Mauritius tax treaty reduces the capital gains taxes in India to zero. However, it does not offer a very attractive reduction in the withholding tax on royalties. The normal withholding tax on royalties is 20 per cent in India, which gets reduced to 15 per cent under India-Mauritius tax treaty. This treaty does not have an article on technical service fees. Therefore, it may be a good jurisdiction to structure service agreements. In the absence of a specific article, provisions of Article 22 on 'Other income' will apply. If the Mauritius company does not have a Permanent Establishment in India, such services will not be taxable in India.

U.A.E. :

U.A.E. also has a favourable treaty with India. Article 12 on royalties reduces the withholding tax to 10 per cent. This treaty also does not have an article on technical service fees. The definition of royalty is wider than that used in case of India-Mauritius tax treaty. However, structuring of an agreement through U.A.E. may be a tricky exercise.

U.S.A. :

India-U.S. tax treaty is the conventional treaty used for software transactions. This is because a majority of the software trade of India is with the U.S. Article 12 on Royalties and fees for technical services provides for a 15 per cent rate where the payer is the Government, a political sub-division or a public sector company. In other cases, the withholding tax was 20 per cent which has been reduced to 15 per cent with effect from 1995-96. Royalties received for the use of or the right to use any industrial, scientific or commercial equipment is generally subject to the lower withholding rate of 10 per cent. Any services which are ancillary and subsidiary to the enjoyment of the industrial, commercial or scientific equipment is also subject to the lower withholding rate of 10 per cent. This treaty also has a memorandum of understanding concerning fees for included services which gives some interesting examples.

Netherlands :

The Netherlands has recently emerged as a popular jurisdiction for structuring royalty payments because of its 'Most Favoured Nation' (**MFN**) clause. India signed a new tax treaty with Germany in December 1995 which provides for the withholding tax of 10 per cent in respect of royalties and fees for technical services. India-Netherlands treaty provides for the withholding rate of 20 per cent for royalties and fees for technical services. The Netherlands has a signed a protocol with India on July 30, 1988 which provides that whenever India signs a tax treaty with any other OECD member country providing for a withholding tax rate for royalties and fees for technical services, which is lower than 20 per cent, as from the date of such tax treaty, the lower withholding rate will also apply in the case of India-Netherlands treaty.

France :

France has a similar MFN clause which means that any royalties or fees for technical services arising in India and payable to a resident in France, the withholding tax of 10 per cent would apply. A similar MFN clause is also there in respect of reduction in Research and Development Cess. Paragraph 9 of Protocol signed on September 29, 1992 provides that royalties, fees for technical services and payments for the use of equipment arising in France and payable to a resident in India will not be taxable in France.

U.K. :

Taxation of royalties and fees for technical services under India-U.K. tax treaty is quite similar to that under India-U.S. tax treaty.

Israel :

Israel is also a very popular center for software development. India-Israel tax treaty provides for a 10 per cent withholding rate for royalties and fees for technical service fees.

Conclusion :

It may be possible to structure the software developments such that the tax implications on the payments (mainly for royalties) made to the developer are minimized. Worldwide, there are many countries which are positioning themselves as ‘Software Development Center’. India is also one of such countries which offers substantial sops for software companies setting up their development center in India. Ireland is prominent among the European countries. Because of its extensive participation exemption regime, Netherlands is also emerging as a popular jurisdiction for setting up the holding company for worldwide software operations. However, due consideration must be paid to the “substance over form” principle or else, tax benefits under some of the tax treaties (mainly with the U.S.) may not be available.
