Publication: Economic Times Mumbai; Date: 2006 Sep 08; Section: Economy; Page Number 17

You may have to pay more for imported software

AAR has held that companies have to deduct tax at source on payments made for foreign software

Hema Ramakrishnan PUNE

IMPORTED software could become more expensive for companies buying and distributing it in India, if the principles laid down in a verdict by the Authority for Advance Ruling (AAR) becomes the norm. The pinch will be more for buyers who enter into commercial contracts with vendors without factoring in taxes.

In a recent ruling to Delhi-based solution provider Headstart Business Solutions (HBSPL), the authority has held that the company deduct tax at source payments made for buy ing software from Microsoft Regional Sales Corporation, Singapore, which is a nonresident company.

This is based on the principle that a payment to a nonresident — which includes trading receipts that may not be pure income — will attract withholding tax in India. The AAR is a quasi-judicial body and its rulings are binding on the taxpayer and the revenue department. It also has a persuasive value.

"The ruling will have implications in all cases where a payment is made to a non-resident. In the absence of obtaining a nil or lower withholding certificate from tax authorities, the AAR observed that taxes would have to be withheld on any payment made to a non-resident. This would lead to a flurry of applications to obtain these certificates," said Bijal Ajinkya, senior associate, Nishith Desai Associates.

In this case, Microsoft Regional Sales Corporation (MRSC), Singapore, entered into a solution provider agreement (SPA) with HBSPL to supply packaged business software solutions. The product is sent in physical form through a compact disc along with a software license key delivered through the Internet. A ruling was sought on whether HBSPL had the legal obligation to withhold taxes for payments made to MRSC. HBSPL held that payments on software are taxable as "royalty" only if the imported software is accompanied by copyrights enabling the importer to replicate it. The company held that the agreement with MRSC was without any copy-rights and granted only distribution rights. So it does not have to withhold tax on the remittance to MRSC.

The revenue department disputed HBSPL's claim, saying the agreement with MSRC allows the company to make copies of software and also customise software for its clients. This means MRSC is providing technical know-how and the payment it receives has an element of "royalty". Hence, it will attract withholding tax.

The department's stand was based on the provisions of the Income Tax Act which says any person paying interest or "any other sum chargeable" (except salary) to a foreign company will have to deduct income tax.

The AAR held that there was no substance in HBSPL's contention that the expression "any sum chargeable" would not include cases where a sum payable to the non-resident is a trading receipt which may or may not be pure income. The authority cited the principles laid down by the Supreme Court in the case of Transmission Corporation, while ruling that the company has to deduct tax at source.

According to Bharat Varadachari, partner, E&Y, the ruling has not addressed the issue of characterisation of income arising from software transactions for tax purpose, i.e., whether 'royalty' or 'sales income', either under the Act or under an applicable Double Taxation Avoidance Agreement (DTAA). The AAR was of the view that this was beyond the scope of consideration and subject matter of the application.