Publication: Economic Times Mumbai; Date:2008 Apr 07; Section:Policy; Page Number 16

ROYAL BIZ: Microsoft case exposes opaque tax policy

New Income Tax Code Should Clarify How Software Revenue Of Multinationals In India Would Be Taxed

AHEAD of this year's Budget, Software Coalition, an industry body representing many of the world's leading software companies, shot off a letter to the finance ministry seeking clarity on the tax treatment of cross-border payments made for computer software.

The association said that a tax on profits from software products sold to Indian users would inflate business costs of multinational companies. But the government remained silent on the issue.

A month later, the world's largest software company, Microsoft, was asked to pay past tax dues aggregating to Rs 700 crore on the licence fee charged to Indian users for its software. An appellate authority ruled that the company was liable to pay tax in India as the transaction involved royalty.

Microsoft, which sells its software in India through a circuitous route involving many group companies, had held that no royalty payment was involved in the transaction. It also contended that the transaction was a sale and not a licence agreement. This was rejected by the appellate authority. Microsoft said it was "reviewing the order and would determine the course of action".

This is not a one-off case. Withholding tax demands were raised in the past on other multinational software companies as tax officers had categorised profits made from software product sales as royalty.

Such demands sparked off legal disputes and tribunals ruled in favour of the taxpayer. In a case between Tata Consultancy and the Andhra Pradesh government, for instance, the Supreme Court said that the sale of "off-the-shelf" software products by distributors formed sale of goods rather than licences under the Sales Tax Act and Customs Act.

In yet another instance—Sonata Software—the Income Tax Appellate Tribunal (ITAT) considered the case of an Indian distributor importing and re-selling offthe-shelf software products to Indian customers. The tax officer had argued that the Indian distributor's payments to companies abroad constituted "royalties" and would hence attract withholding tax. But the ITAT turned down this ruling.

The issue at stake is the way one treats software revenues of MNCs doing business here. Should it be treated as business profits or royalty income?

A US headquartered software company can escape tax here if income from sale of software in India is treated as its business profits. Under the Indo-US tax treaty, the business income of a US company is tax-free in India if it does not have a permanent establishment here. Royalty income attracts a 10% tax under the domestic law.

In most countries, income from sale of copyrighted articles is treated as business profits. But grant of rights to commercially exploit copyrights is treated as royalty income.

Such a distinction is in sync with the Organisation of Economic Cooperation and Development (OECD) norms. Tribunals in India too have gone by this norm. They have differentiated between software product sales and grant of rights to reproduce and commercially distribute software products.

"From standalone software programmes in Tata Consultancy, Lotus and Sonata to software products bundled with hardware in Lucent, CIT Alcatel and the consolidated Motorola case, courts have employed the same legal analysis," according to Software Coalition.

It reckons that despite judicial rulings, assessing officers continue to charge a tax on outbound payments for software products, saying it is royalty income.

"The US Treasury Regulations also treats profits from shrink-wrapped software as business income. If there is a mismatch of characterisation, MNCs may not get a credit in their home countries for the withholding taxes paid in India. Besides, any extra tax burden will have to be absorbed by Indian clients using the software," says Shefali Goradia, head, International Taxes, Nishith Desai Associates.

A circular from the CBDT on software revenue characterisation would help MNCs. However, the board is not keen on a circular as the government has challenged some of the tribunal decisions that have gone in favour of some software companies. Cases are pending in the high courts of Karnataka and Delhi.

"Besides, a CBDT circular is binding on the department and not on the taxpayer. The CBDT would prefer to wait for the high court to say the last word as the revenue implications are huge," said a senior government official. The government could look at proposing the tax treatment on cross-border payments for computer software in the new income-tax code. The norms can be finalised, based on the

feedback from taxpayers.