**Paper 4**

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**Tax Aspects of Transfer and Enhancement of Technology with a Particular Focus on Software©**

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**Synopsis**

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   Free trade zone in cyberspace
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Transfer of technology has come a long way. Earlier restricted to transfer of goods and

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services, it now covers even transfer of intellectual property. Transfer of software programs, led to a plethora of rules and regulations relating to patents, copyrights, anti piracy regulations et all. However, the recent phenomenon of sale of goods and services via the Internet baffles tax practitioners and tax administrations world over. The concept of a permanent establishment, one of the fundamental criteria in international taxation governed predominantly by double tax avoidance agreements (**DTAAs**) will gradually lose ground.

### A. Permanent establishment. Is it redundant?

Right from downloading your favorite newspaper to purchase of the latest software package, everything is possible over the world wide web. *Article 5* of the OECD model defines a permanent establishment (PE) as a fixed place of business through which the business of an enterprise is wholly or partially carried on. There are however subtle differences in the definition of a PE under various DTAAs. In general under DTAAs, a foreign entity can be taxed on its income arising in another country only if it has a PE in such country. While an independent agent may not constitute a permanent establishment (as has been held by the Authority of Advance Rulings in several cases in India), it is not known whether a web-site would constitute a PE. Infact, this answer continues to baffle tax administrations the world over.

Tax authorities may however overcome this scenario as well and adopt some sort of presumptive tax mechanism. An interesting analogy can be drawn to the guidelines issued by the Central Board of Direct Taxes (CBDT) in India.

These guidelines *(circular no.742 dated May 2, 1996)* relate to the taxation of foreign telecasting companies. The Board laid down that in cases of foreign telecasting companies which are not having any branch office or permanent establishment in India or are not maintaining country-wise accounts, the assessing officers shall compute their income by adopting a presumptive profit rate of ten per cent of the gross receipts meant for remittance abroad or the income returned by such companies, whichever is higher and subject the same to tax at the prescribed rate. This rate has now been reduced from 55 per cent to 48 per cent, by the Finance Act 1997.

In its circular the Board pointed out that: out of the gross amount of bills raised by a foreign telecasting company, the advertising agent retains commission @ 15 per cent or so. Similarly the Indian agent of the foreign telecasting company retains his service charges @ 15 per cent or so of the gross amount. The balance amount of approximately 70 per cent is remitted abroad to the foreign company. So far as the income of the Indian advertising agent and the agent of the non-resident telecasting company are concerned, the same is liable to tax as per the accounts maintained by them. As regards, the foreign telecasting companies which are not having any branch office or PE in India, tax has to be deducted and paid at source in accordance with the provisions of Section 195 of the Income Tax Act, 1961 by the persons responsible for paying or remitting the amount to them.

The Board introduced a presumptive scheme of taxation for such foreign telecasting companies, as it recognized that in the absence of country-wise account and keeping in view the substantial capital cost, installation charges and running expenses etc, in the initial years of operation, it would be fair and reasonable if the taxable income is computed at ten per cent of the gross receipts (excluding the amount retained by the advertising agent and the Indian agent of the non-resident foreign telecasting company as their commission/charges) meant for remittance abroad. These guidelines are however applicable only up to March 31, 1998, subsequent to which the rate of profit (ten per cent currently), which is subject to tax will be reviewed.

Maybe, one can guess that all sale transactions carried out over the Internet where the buyer is a resident in India, will be subject to some sort of presumptive tax rate.

On the other hand, if a presumptive basis of tax is decided upon, ignoring in toto the actual income and losses, if such actual income is less than the presumptive income, the mechanism may not be sustainable in courts, if challenged. This aspect also needs consideration.

Meanwhile, *different theories* relating to taxation of Internet transactions have been propounded. *BIT TAX* has been suggested by Dr Arthur Cordell of Canada. The speed of information over the world wide web is measured in bits per second. This tax attempts to levy a flat, per unit tax on each bit. The White Paper released by the US Treasury titled *"Selected Tax Policy Implications of Global Electronic Commerce"* emphasizes that source based taxation could lose its rational and be rendered obsolete by electronic commerce[1].

This White Paper raises several issues. For example, if activities of a person engaged in electronic commerce are equivalent to mere solicitation of orders from US customers without any other activities carried out in the US, it may not be appropriate to treat such activities as US trade or business. Circumstances where telecommunications or computer equipment is owned or used by a foreign person engaged in electronic commerce raises a question on whether this could constitute a PE in the US.

For a business that sells information instead of goods, a computer server may be considered the equivalent of a warehouse (which generally does not denote a PE) Defining the characteristic of income may prove exceedingly difficult, would it denote royalty or income from sale of goods.

Recently, however Bill Clinton advocated a *free trade zone* in cyber space. According to a Reuteur newsreport dated July 8, 1997, The United States of America (a mere observer at

1 Source: Internet site -- http:\\www.ustreas.com

the *European Unions Global Information Network Conference*) stole some of the conference's thunder as president Bill Clinton presented a framework on electronic commerce calling for a free-trade zone in cyberspace. US commerce secretary Mr William Daley, carrying Mr Clinton's framework to Europe, said governments should let the marketplace decide on Internet standards and controls and invited European support for Clinton's initiative. Consumer commerce via the Internet is expected to surge to $50 billion per year by 2000 from around $2 billion now.

*Cyber-laundering, the latest white collar crime*

E-cash, the almost perfect substitute for hard paper currency, will create its own problems of money laundering. In the absence of any trial detection of such activities will be almost impossible. The value of money laundered throughout the world is estimated to be about $ 300 billion per annum[2]. In India, the proposed Money Laundering Bill is expected to take care of cyber-laundering activities as well. But, at present things are still at a nascent stage.

Though Internet transactions are a reality, taxation of such transaction remains to be a futuristic exercise. It is now time, to delink from the discussion relating to taxation of Internet and concentrate on other modes of technology transfers, answers to which are readily available.

**B. Technology and Transfer defined**

Technology encompasses a broad field. According to *P.M. Bakshi's -- Law on Transfer of Technology,* it denotes “an intellectual equipment coupled with the necessary physical equipment which is required for being applied in the field of trade, business, manufacture or other profitable activity, being intellectual equipment in which a legal right is recognized.” Technology would thus encompass confidential information and trade secret, patents for inventions, copyrights, designs, semi-conductor chip protection, trademarks etc.

Transfer as defined in the Oxford dictionary means conveyance from one place or person to another. In the tax regime, especially in the Indian context, transfer is clearly defined under Section 2(47) of the Income Tax Act, 1961 and Section 2(xxiv) of the Gift Tax Act, 1958.

**C. Tax implications arising on transfer of technology**

Transfer of technology gives rise to a consideration (ie income). Depending upon the mode of the transfer, this can take diverse hues such as royalty, fees for technical services or even business profits. The tax implications in each case are bound to vary. Domestic tax laws may offer added benefits in case of outbound transfer of technology (such as tax

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2 Source: The Economic Times, July 22, 1997.

benefits under Section 80-O, Section 80-HHE of the Income Tax Act, 1961). Certain imports of technology may be exempted by custom duties or the foreign entity which is supplying the requisite technology may escape withholding taxes. All these aspects must be taken into cognizance.

*Double Tax Avoidance Agreements*

India has entered into DTAAs with almost all its major trading partners. DTAAs provide some degree of stability in interpretation of tax laws and determining the tax incidence or the incidence of withholding tax vis a vis the foreign entity, which is supplying the technology in case of an inbound transfer or to whom the technology is provided in case of outbound transfers. Use of DTAAs leads to a tax efficient structure in international transfers of technology.

Section 90 of the Income Tax Act, 1961 empowers the Central Government to enter into agreements with the government of another country to grant relief to avoid double taxation.

Section 90(2) says: Where the central government has entered into an agreement with the government of any other country outside India under sub-section (1) for granting relief of tax or as the case may be, for avoidance of double taxation, then in relation to the assessee to whom such agreement applies the provisions of this Act shall apply to the extent they are more beneficial to the assessee (resident of the foreign country).

In other words, the provisions of this section, bestow the right upon the resident of the foreign country to choose between the provisions of the applicable DTAA and those of the Income Tax Act, 1961. While switching between the provisions of the Indian Income Tax Act and the DTAAs is permissible, it would be an anomaly to chose those provisions of the Act and ignore those which are not in relation to the same transaction. Switching however, is possible for two sources or two heads of income under one particular contract.

*CBDT's circular no 333 dated April 2, 1982 (F/506/42/81 -- FTD)* however seems to denote otherwise, this at times leads to litigations. As per this circular, where a double taxation avoidance agreement provides for a particular mode of computation of income, the same should be followed, irrespective of the provisions in the Income Tax Act. Where there is no specific provision in the agreement, it is the basic law (ie the Income Tax Act) that will govern the taxation of income.

However, Section 90(2) makes it clear that an option is available to the foreign resident to choose those provisions which are more beneficial. In this context, it is pertinent to note CBDT's *circular no 728 dated October 30, 1995* which provides: In case of remittance to a country with which a DTAA is in force, the tax should be deducted at the rate provided in the Finance Act of the relevant year or at the rate provided in the DTAA whichever is more beneficial to the assessee. This circular supports the intention of Section 90(2).

## D. Inbound transfer of technology

*Nature of income and tax incidence of the foreign entity*

As mentioned earlier, transfer of technology results in income which can be in the nature of royalty, fees for technical services, business profits, independent personal services or even other income. Section 9 of the Income Tax Act, 1961 specifies incidence of income which would be deemed to accrue or arise in India. If exemption is available under a DTAA agreement then the beneficial provisions of such DTAA would obviously apply. Most DTAAs which India has entered into prescribe for taxation of gross royalties and fees for technical services at rates varying between ten to twenty per cent. On the other hand, if such royalty or fees which are paid to a foreign entity can be attributed to a place of business in India (ie a permanent establishment), then such income can be taxed in the hands of the foreign entity, under the Articles pertaining to business profits. Further only that income, which can be attributed to the PE will be subject to taxes in India.

The Indo-Mauritian treaty throws up an interesting facet. There is no provision in the DTAA for taxation of fees for technical services. Thus such services would either be covered by the Article 7 governing Business Profit or Article 22 governing Other Income. However, in such an eventuality in the absence of a PE the fees received by the Mauritian based company cannot be taxed in India.

Generally the Article pertaining to business profits permits deductions towards the expenses incurred by a PE based in India. Under most DTAAs and even as per one of the rulings of the Authority for Advance Rulings in India, no account is taken, in the determination of the profits of a permanent establishment for amounts charged (otherwise than towards reimbursement of actual expenses) by the PE to the head office of the enterprise or any of its other offices by way of royalties, fees or other similar payments in return for the use of know-how or other rights, or by way of commission or other charges for specific services performed or for management by way of interest on money lent to the head office of the enterprise or any of its other offices.

On the other hand, DTAAs call for taxation of royalties and fees for technical services on a gross basis. Moreover, Section 44D of the Income Tax Act, 1961 overrides the provisions of Sections 28 to 44C and prohibits the deduction of any expenditure which may have been incurred by the foreign entity, while computing the royalties and fees for technical services which may be deemed to accrue or arise in India.

At present under the Indian Income Tax Act, a foreign entity is taxed at the rate of 48 per cent on its business profits. Section 115 A prescribes a lower rate of taxation of 20 per cent (gross basis) in respect of income from royalties or fees for technical services in the hands of foreign companies, if the relevant agreement has been made after May 31, 1997. If such fees or royalties are received by the foreign entity pursuant to an agreement entered before this date, then the rate of taxation is 30 per cent.

In relation to software, some procedural relaxations are also available under Section 115 A. Where the royalty is paid in consideration of any computer software to a person resident, the agreement entered into between a foreign company and an Indian concern need not be approved of by the Central government.

It is pertinent to note that Section 115A relates to royalties or fees for technical services received by a foreign company. Similarly the overriding provisions of Section 44D which call for taxation on the gross amount of such income, the provisions relate to royalties or fees for technical services arising in the hands of a foreign company. It can be effectively argued that if the transferor is not a foreign company but any other foreign entity, tax levied in India on income which accrues or arises in India, should be on a net basis, even if it is in the nature of royalties or technical fees.

*Withholding taxes and grossing up of income*

The rules and regulations relating to withholding taxes as enumerated in Section 195 must also be kept in cognizance, as also the tax laws relating to grossing up of income for determining the tax liability of a non resident.

CBDT via its *circular no 155 dated December 21, 1974* says that in cases where "the amount payable to a non-resident is stipulated to be paid to him net of taxes (ie where the tax payable by the non-resident is borne by the person making the payment), the income chargeable to tax in the hands of the recipient is to be determined by grossing up the net of tax payment to such an amount as would, after deducing the tax on such gross amount, leave the stipulated net amount of income." In other words, the sum chargeable to tax in the hands of the non-resident would be the grossed up amount and against this sum tax would be deducted at source as per the provisions of Section 195.

As regards royalties and fees for technical services, the Finance Act, 1983 inserted new sub-section (6A) in Section 10 of the Income Tax Act, 1961 effective from the assessment year 1984-85 to provide that : the provisions for grossing up of income and/or tax for the purpose of determining the liability to income-tax in case of a foreign company would not apply in cases where the tax on the income by way of royalties or fees for technical services payable to the foreign company is paid by the government or an Indian concern in pursuance of an agreement entered into after April 1, 1976 and approved of by the Central Government. Accordingly the tax paid/payable by the Indian entity or government for and on behalf of the foreign company would not be treated as a part of the total income chargeable to tax in the hands of the foreign company.

However, this benefit is available only to a foreign company and not any foreign entity or resident. Further it is available only in respect of royalty income or fees for technical services. Thanks to the on-going wave of liberalization in India, the relevance of obtaining approvals has diminished considerably, in some cases automatic approval by The Reserve Bank of India (RBI) is accorded. Tax laws have however,not kept pace with these rapid procedural changes.

Another circular issued by the CBDT would come in handy in technology transfers relating to software. *Circular no 588 dated January 2, 1991* states: Where a tax payer engaged in the business of export of software for computer application, imports any systems software, supplied by the manufacturer of the computer hardware along with the hardware itself, the lumpsum payment made to the foreign supplier for acquisition of any right in relation to, or for the use of, such systems software will not be liable to tax in India as payment by way of royalty or otherwise. Such lumpsum payment will henceforth be allowed to be made without deduction of tax at source under the provisions of Section 195.

Care must also be taken to examine the Articles relating to Dependent Personal Services, relating to the tax incidence of expatriate personnel. DTAAs generally provide for taxation in the country in which services are rendered if the person receiving the salary is in that country for a particular period. In fact, under some DTAAs a PE arises if the services are performed for a specified continuous number of days. This dangerous situation must be avoided while entering into a technology transfer agreement.

For example: Under Article 5 of the DTAA between India and USA a permanent establishment includes (l): the furnishing of services other than (included services) within a contracting state by an enterprise through employees or other personnel but only if : activities of that nature continue within that State for a period or periods aggregating to more than 90 days within a twelve month period or the services are performed within that state for related enterprise.

The solution in such a case seems to be splitting up the stay of the technician within a year.

To sum up, the tax impact on net business profits and on gross income as royalties or fees for technical services in the hands of the foreign entity should be borne in mind before formulating a suitable tax structure. A lower rate of taxation on the gross amount may not necessarily be beneficial

## E. Rulings given by the Authority for Advance Rulings

*Case study 1:*

Payment of royalty abroad for use of a trademark in India will result in taxes in India

Firms paying royalty abroad will face taxman here[3]

Companies paying royalty abroad for use of know-how in India, may now have to think twice. The Authority for Advance Rulings (AAR) has held that the consideration paid abroad by one non-resident to another for use of know-how by a resident in India is taxable in India.

The AAR is a body set up to give advance rulings to non-residents on the tax implications in India pertaining to their transactions. AAR's rulings are given with reference to a particular transaction and do not automatically set a precedent.

In this case, *White Consolidated Industries (WCI)*, a US-based subsidiary of the Swedish Company -- Electrolux received royalty from *Whirlpool Corporation* (incorporated in the United States). This royalty was paid to enable Kelvinator of India (KOI) to continue to use the trademark “Kelvinator” for a further period (phase-out period) of 24 months, in respect to refrigerators and other licensed products.

WCI approached the AAR seeking a ruling on “Whether the royalty paid outside India amounting to US$ 5,295,756 by Whirlpool Corporation to it, as a consideration for granting the license and right to Kelvinator of India Limited, a company in which Whirlpool (Mauritius) Limited has 51 per cent equity holding, to use the trademark “Kelvinator” in India is liable to Indian Tax.”

In other words, Kelvinator (India) did not pay for use of the royalty. This payment was not made by its holding company (Whirlpool Mauritius) either, but by the parent of its holding company -- Whirlpool Corporation (USA). The payment was made by one US-based entity to another outside India.

Earlier, under an agreement between WCI and KOI, the latter had the right to use the trademark in India. This agreement was terminated in December 1994. Later WCI entered into two agreements. A “share sale and purchase” agreement was entered into on December 29, 1994. Whirlpool (Mauritius) Limited was incorporated to purchase 20.86 lakh shares held by WCI in KOI. The payments for such purchase of shares aggregating to US$ 10,524,477 was also made by Whirlpool Corporation (USA). A second agreement `Trademark License Agreement' was also entered into, on the same date between WCI and Whirlpool Corporation (USA). On payment of the one-time royalty payment by Whirlpool Corporation, KOI was permitted to continue to use the trademark and trade name “Kelvinator” during the phase out period of 24 months. A third document “Registered User Document” between WCI and KOI

[3] Source: The Economic Times, December 14, 1996.

provided for continued usage of the trademark and trade name.

Based on the terms and conditions in the Indo-US double tax avoidance agreement (DTAA), White Consolidated Industries (WCI) argued that the royalty is not taxable in India, as it is not “deemed to accrue or arise in India.” The reason --utilization of the trademark in India is by KOI and not by Whirlpool Corporation, which had made these payments. On the other hand, the contention of the tax department was that the royalty was payable by KOI but the transaction was arranged in a different manner. After analyzing various provisions in the DTAA, the AAR concluded that the royalty was taxable in India. One important factor in arriving at this conclusion was that the royalty related to the use of trademark in India.

In the case of this unreported judgment, the tax department also raised the plea that Whirlpool (Mauritius) was incorporated to avail of a reduced tax on dividend income received from Kelvinator of India. As the AAR can only deal with those questions issued to it by the applicant (in this case -- WCI), it could not deal with this issue. The AAR restricted itself to the taxability of royalty payments.

*Case Study 2:*

An independent agent in India, does not constitute a permanent establishment

The importance of independence[4]

One of the top three courier service company based in the United States (USA) -- *UPS Worldwide Forwarding Inc* entered into a service agreement with an Indian company Elbee Services Limited. The business activities consisted of two segments -- outbound and inbound.

In case of outbound services, Elbee picked up consignments from all over India and delivered them to an international hub closest to the foreign destination. From here, the US international courier company took over and ensured that the package reached the door of the addressee. As regards inbound services (packages coming into India), the international company picked up parcels from all over the world and delivered them to Mumbai, Delhi or Madras. From here Elbee ensured their delivery to the correct domestic address.

As regards outbound services the foreign courier service company received payments from its Indian agent , who in turn was also paid for inbound services rendered by it. Remittances to and fro depended upon the net result of transactions during a particular period.

[4] Source: The Economic Times, March 28, 1997.

The US company approached the AAR to determine whether it is liable to tax in India in respect of income received by it for services provided to Elbee. The AAR agreed with the contention of the tax authorities that Elbee is acting as the agent of the foreign courier company for booking goods in India where such goods are transported outside India and a business connection did exist[5].

Business profits can be taxed in the hands of a non-resident entity only if it has a permanent establishment (PE) in India. The AAR then examined Article 7 of the Indo-US DTAA. This states that a non-resident will not be said to have a PE if its intermediary has an independent status and is acting in the ordinary course of its business. Further, only if the agents activities are not wholly devoted to the business of the non-resident enterprise and the transactions are carried out on an arm's length principle can it be said to have an independent status.

In this case, Elbees domestic courier business was substantial and it could not be said that its activities were devoted almost wholly to the US corporation. Secondly, based on the facts made available to the AAR, the transactions were regarded as having been carried on at arms length.

In the absence of any permanent establishment in India and owing to its operations via an independent agent, the US corporation was held as not liable to tax on income received from services rendered.

### F. Cascading effect of the Indo-German Treaty

The recently notified DTAA between the Indian and German government (Notification number 10235 dated November 29, 1996), effective in Germany from January 1, 1997 and in India from April 1, 1997 (AY 1997-98) has set the rate of tax to ten per cent of the gross amount of the royalties or fees for technical services. This tax rate was the lowest as compared to other DTAAs entered into by India during 1995-96.

Consequently, it led to a simultaneous decline in tax rates, under the relevant Articles in various other DTAAs which include the Indo-French DTAA, Indo-Canadian DTAA, Indo-Norwegian DTAA (restricted only to fees for technical services), Indo-Netherlands DTAA owing to an express clause in such treaties.

### G. Outbound transfer of technology

The aim in outbound transfer of technology should be to reduce the overall tax incidence to the barest minimum and at the same time, full advantage should be taken of the tax

5 Under the provisions of Section 9 of the Income Tax Act, 1961 all income accruing or arising, whether directly or indirectly, through or from any business connection in India constitutes `Income deemed to accrue or arise in India' and is taxed accordingly.

breaks available under domestic laws relating to exports. It should be seen whether an underlying tax credit is available for the foreign taxes paid and excess tax credits should be avoided at all costs. An offshore company can be used as a channel for bringing funds into India, moreover the nature of income flow should be structured to optimize the tax advantages.

In fact the provisions of DTAAs enumerated above, would apply to an Indian entity exporting technology. Export of technology however results in tax reliefs. The most important sections in the Income Tax Act, 1961 relating to exports of technology are perhaps Section 80-O and Section 80-HHE.

Section 80-O has been recently amended by the Finance Act, 1997. Earlier Section 80-O provided for deduction in respect of royalty, commission, fees or any similar payment received by an assessee from a foreign government or foreign enterprise in consideration of technical and professional service rendered outside India, up to 50 per cent of such income, received in India in convertible foreign exchange. This tax incentive was contemplated to encourage the export of Indian know-how and skills abroad.

The Finance Act, 1997 has restricted the deduction available under this section only to any income received from the foreign government or foreign enterprise in consideration for the use outside India of any patent, invention, design or registered trademark. This amendment is applicable from the AY 1998-99 and subsequent years.

Thus, the benefits under this section for rendering technical and professional service abroad are available only upto the AY 1997-98. Ironically, only recently the CBDT via its *circular no 700 dated March 23, 1995 (F No 473/7/94 -- FTD)* had broadened the sphere of benefits available under this section vis a vis technical and professional services. This circular stated that:

Section 80-O of the Income Tax Act, 1961 provides for a deduction of 50 per cent from the income of an Indian resident by way of royalty, commission, fees or any similar payment from a foreign government or enterprise --(a) in consideration for the use outside India of any patent, invention, model, design, secret formula or process etc or (b) in consideration of technical or professional services rendered or agreed to be rendered outside India to such foreign government or enterprise.

The circular added: It has been clarified in the explanation (iii) to Section 80-O that service rendered or agreed to be rendered outside India (item b) above shall include services rendered from India but shall not include services rendered in India. A question has been raised as to whether the benefits of Section 80-O would be available if the technical and professional law services, though rendered outside India are used by the foreign government or enterprise in India.

The matter has been considered by the Board. It is clarified that as long as the technical and professional services are rendered from India and are received by a foreign government or enterprise outside India, deduction under Section 80-O would be available to the person rendering the services even if the foreign recipient of the services utilizes the benefit of such services in India.

Prior to the issue of this circular, the Bombay High Court in the case of *Hindustan Thompson v/s Chief CIT (Writ petition number 604/1992/Bombay)* denied this benefit. Here, the assessee Hindustan Thompson was engaged by a foreign enterprise to conduct market surveys. The results of the survey were submitted outside India to the foreign enterprise. As the services were rendered from India to an enterprise outside India, the assessee sought to claim the benefits under Section 80-O. This benefit was denied as such market information would be used by the foreign enterprise for exploring and exploiting the market for their products in India[6].

Another issue of dispute however remains unsolved in relation to the provisions of Section 80-O of the Income Tax Act, 1961. Is the deduction under this section, available against the net convertible foreign exchange received in or brought into India or is it available after further deducting those expenses incurred in India, that can be attributed or allocated towards earning such foreign exchange? It largely remains a debatable issue.

The Appellate Tribunal Calcutta bench, in the case of *M.N.Dastur and Co v/s the Deputy Commissioner of Income Tax (40 ITD 521)* held that deduction should be allowed on the gross amount brought into India in convertible foreign exchange without taking into consideration the expenses incurred in India. It was held that Section 80-AB is inapplicable for computing deductions under Section 80-O. A similar stance was adopted by the Bombay bench in the case of *J.B. Boda and Co Pvt Limited (ITA Nos 1850/51).*

So what exactly does Section 80-AB say? It requires that income with reference to which Section 80-O deductions are claimed has to be computed in the manner laid down under the Income Tax Act, ie by deducting from the gross receipts all the expenditure and other deductions admissible for earning that income. Based upon this inference, the Bombay tribunal bench in the case of Tata Unisys Ltd (47 TTJ 8) directed some deductions of expenses incurred in India, prior to calculating the benefits under Section 80-O.

It can however be effectively argued that the benefits under Section 80-O be available on the net foreign exchange brought into India and not after further deduction of related expenses incurred in India. The Finance Act, 1974 clearly changed the wording of Section 80-O to include the net convertible foreign exchange received or brought into India. Earlier the section referred merely to income earned abroad from royalties and fees. Thus the intention of the legislature is to provide relief on the net foreign

6 Source: The Economic Times, December 29, 1995.

exchange brought into the country and not the net foreign exchange further reduced by expenses incurred within the country.

Section 80-HHE provides a deduction in respect of profits from export of computer software et al. Where an a resident in India (including an Indian company) is engaged in the business of export out of India of computer software or its transmission from India to a place outside India by any means or providing technical services outside India in connection with the development or production of computer software, then based on a laid out formula a deduction is available from the profits derived by the assessee from such business.

The words used are transmission by any means and would also cover sale of computer software over the internet. Moreover, for calculating the amount of book profits under the Minimum Alternative Tax regime, the amount of profit eligible as a deduction under Section 80-HHE is also allowed to be reduced from book profits.

Likewise, Section 80-HHC offers tax benefits for exports of goods or merchandise covered under the provisions of this section. Recently, the tax authorities made a distinction between exports of goods and merchandise and lease exports. The Commissioner, Income Tax (Appeals) in Bombay issued an order that earnings arising from export of films, including TV are fully taxable. The rationale for denying an exemption under Section 80-HHC was that leasing of film rights do not constitute a sale and the benefits under this section are available only to sale of goods and merchandise[7].

**H. Transfer pricing and the proposed Anti-avoidance legislation**

Rules and regulations pertaining to transfer pricing are not well defined in the Income Tax Act, 1961. However an arms length distance is essential if the mode of transfer is via an agent to ensure that such agent is not constituted as a permanent establishment. This view has been adopted by the Authority for Advance Rulings in several instances.

At present under the provisions of Section 40A(2)(a): If a business transaction (including a transaction between a resident and a non-resident) is structured in a manner that it results in no profit or less than ordinary profit, the tax authorities may determine a reasonable amount of profit from the transaction. The profit which has been so “deciphered” by the tax authorities is added to the taxable income of the resident assessee. The profit may be determined with reference to the value of the transaction by applying the ratio of total business profits to total business receipts or any other appropriate method.

The Income Tax Bill, 1997 which is proposed to be presented in the houses of the Parliament this winter, has however introduced a new provision relating to anti-

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[7] Source: The Economic Times, August 14, 1997.

avoidance.

The expert group set up to formulate this Bill has taken the view that Section 33 of the Singapore Income Tax Act, with a few changes is best suited to Indian conditions. The proposed provisions are as under:

Sub-section (1) Where the assessing officer is satisfied that the purpose or effect of any arrangement is directly or indirectly -- (a) to alter the incidence of any tax which is payable or which would otherwise have been payable by any person or (b) to relieve such person from any liability to pay tax or to make a return under this Act, or (c) to reduce or avoid any liability imposed or which would otherwise have been imposed on any person by this Act; the assessing officer may, without prejudice to such validity as it may have in any other respect or for any other purpose, disregard or vary the arrangement and make such adjustments he thinks appropriate. He can compute or recompute the gains or profits, or the imposition of liability to tax, so as to counteract any tax advantage obtained or obtainable by that person from or under that arrangement.

These provisions are not proposed to embrace ordinary and/or bonafide commercial transactions. As an added precaution against misuse, the assessing officer also has to take the permission of the Commissioner before utilizing such powers proposed to be bestowed upon him.

**I. Additional local tax laws**

In India, the latest litigation facing software companies is under the State Sales Tax Laws. While several states treat software as a good liable to sales tax, the contention of software companies is that software is an intellectual property outside the ambit of State Tax.

In the absence of any strict demarcation between what constitutes an intellectual property and what is a good, litigations continue. In several cases, the matter is pending before the Supreme Court of India.

In this context, the proposed regulations and guidelines issued by the Internal Revenue Service (IRS) addressing the tax treatment of software programs make interesting reading. The proposed regulations provide that a transaction involving the transfer of a computer program will be classified as either the transfer of a copyright, the transfer of a copyrighted article, the provision of services relating to the development of a computer program, or the provision of know-how[8].

[8] Source: Tax Notes International, December 9, 1996.Article by A Levenson, Alan Shapiro & Ned Maguire

These proposed regulations treat a transfer of a computer program as a transfer of a copyright right, if the transferee acquires one or more of the following rights:(1) the right to make copies of the program for distribution to the public by sale, by other ownership transfer, or by rental, lease or lending (2) the right to prepare derivative computer programs based on the copyrighted program (3) the right to make a public performance of the program or (4) the right to publicly display the program. A transfer of a computer program without any of these rights will be treated as the transfer of a copyrighted article.

In case of a copyright right, if there has been a transfer of all substantial rights the transaction is regarded as a sale, else it amounts to a license. On the other hand, on transfer of a copyrighted article, if the benefits and burden of ownership of the article are transferred it results in a sale or exchange. In other cases, such transfer is tantamount to a lease.

The provision of information with respect to a computer program will not be treated as the provision of know-how unless the information relates to computer programming techniques, is not capable of being copyrighted and is subject to trade secret protection.

In the United States such classification will lead to varying tax ramifications even in the realm of cross border transfer of such technology. If a software transfer is a sale of a copyrighted article for US tax purposes the source of income will be 50 per cent foreign source if the title and risk of loss pass outside the United States and 100 per cent US source if the title passes within the United States. Thus software export agreements may have to be so structured so as to qualify them as a license or a lease.

The proposed regulations have however, not clarified whether the transfer of a copyrighted article is a transfer of tangible property or of intangible property. Some tax treaties to which the United States is a party classify income from leases of tangible property as industrial or commercial profits that would not be subject to US tax, including withholding tax in the absence of a permanent establishment. The need for such distinction thus should be brought out in the regulations, argue the authors of this article.

In India, classification of a software program is important for domestic sales tax purposes alone. The 46th Constitutional Amendment inserted Clause 29A in Article 366 to provide an inclusive definition of `tax on the sale or purchase of goods.' Accordingly the transactions specified in clauses (a) to (f) are treated as deemed sales, which are otherwise not sales within the meaning of The Sale of Goods Act, 1930. Thus, the sales tax net as contemplated in the Constitution has been widened. Sub-clause (d) of Clause 29(A) specifies that tax on the sale or purchase of goods includes a tax on the right to use any goods for any purpose (whether or not for any specified period) for cash, deferred payment or other valuable consideration.

This led to several state government introducing a legislation for levy of tax on the right to use goods including software. For example: By a notification dated March 29, 1994 the state government of Maharashtra amended wef April 1, 1994 the schedule to the Transfer of Right to use any goods for any purposes Act, 1985 to include the the transfer of the right to use software. It imposed a sale tax levy of 1.5 per cent on such transactions.

The *National Association of Software and Service Companies (NASSCOM)* which is a society engaged in the development of software all over the country has challenged this legislation. It submits that software is an intellectual property and any transfer of a right to use such intellectual property does not come within the purview of the term goods. Thus the State Legislatures are incompetent to impose a tax on the license fees which arise on the transfer of right to use software which are neither goods as defined in the Transfer of Right to use any goods Act nor goods as understood in common or trade parlance. The matter is presently pending in the apex court.

Whether software packaged and licensed by *Tata Consultancy Services* to its clients constitute goods and whether the disputed turnover comprising license fee received by it can be brought to tax as turnover under the Andhra Pradesh Sales Tax Act was another contentious case. The basis for challenge once again was the fact that software packages are an intellectual property and not goods.

In this case, the Andhra Pradesh Appellate Tribunal observed that “Software is a set of instructions which when integrated into the computer enables it to bring out the desired results by carrying out certain complex calculations, re-arrangements of numerical data and other items of stored information. The storing of information is done on the hard disk of the computer, which is then marshaled and re-arranged as required, only with the help of software. However, composing the software is an intellectual exercise which every user of the computer may not be capable of. Here comes the role of the specialist consultant who composes software either to meet the individual requirements of clients or in a standardized form for the use of a class of clients having similar functions and requirements. Software for such clients is available off the shelf in the market.

It can be transferred or communicated from the author to the user, who is removed from him by time and distance using media like the floppy, disk, diskette drive or via the telephone or satellite.”

The Tribunal added that: Software employed in instructing or communicating without a media, examples of which are the internet and the e-mail, cannot be treated as “goods” within the ambit of the sales tax Act as it exists today. Yet there is no doubt that software conveyed through tangible magnetic media with which we are concerned in this case, stands on a different footing.

The tribunal bench concluded its verdict by stating that software is of two categories: (i) software which is specialised and exclusively custom-made to cater to the needs of individual clients (ii) software which is standardized and marketed for the use of certain classes of clients like Oracle, Lotus, Master key, N-Export, EX, Unigraphics etc.

The turnover relating to software which is custom made and exclusive to some clients cannot be taxed as goods because such software is to be classified as knowhow. However, standardized software is a good and can be taxed as such. To this extent, the stance adopted by the assessing officer was upheld.

## J. Modes of Technology Transfer

Direct sale and assignment, direct end licensing, strategic alliances with third parties (which includes agents, distributors, representatives, and franchising), setting up of joint ventures, cost share arrangements, mergers and acquisitions are the various modes of technology transfers. Moreover, in international technology transfers, the characterization of a transfer of technology under one country's tax laws may not necessarily follow the treatment of a transfer under its commercial laws. For example, a license in exchange for a periodic royalty may be considered to be either a license or a sale of technology depending upon the facts[9]. In addition, in certain circumstances, an assignment for a lumpsum consideration may be characterized as a license and not a sale. In the United States a clear cut distinction has been laid out, it is not so in India.

Courts in India, including the Authority for Advance Rulings in some cases has come up with interesting rulings, relating to transfer of technical know-how.

*Case study 1*

In an outright sale the consideration received by a foreign company does not constitute royalty *CIT v/s Davy Ashmore (I) Limited (190 ITR 626 --Cal)*

In this case, the Indian company paid consideration for the transfer of drawings and designs by the non-resident company in UK. The question arose whether such payments could be treated as royalty income chargeable to tax in India. The amount was paid for import of drawings and designs with the prior approval of the Reserve Bank of India and the income tax authorities treated the amount paid as income by way of royalty in the hands of the foreign collaborator by invoking Explanation 2 to Section 9(1)(vi) of the Income Tax Act. The levy of tax on the non-resident was challenged in appeal on the ground that the definition of royalty under this provision is different from the definition of royalty under the DTAA. In view of the specific provisions of the DTAA the general provisions of tax would not apply. As there was an outright sale/purchase in this case, the consideration was held to be for the transfer of such designs, secret formula etc and could not be said to consitute royalty.

[9] Source: International technology transfers, published by Graham & Trotman/Martinus Nihhoff.

*Case study 2*

License fees constitute royalty income *(British Aerospace Aircraft Group v/s ITO (21 ITD 26 Delhi bench ITAT)*

In this case, it was held that income by way of royalty derived by the non resident would attract liability to tax in India even if it is called license fees. License fees received for imparting technical know-how were held taxable as royalty income. The DTAA between India and UK and relief for avoidance of double taxation, were also held to be necessary to be taken into account for taxing the income as per the rates provided for in the treaty.

*Case study 3*

Setting up of a subsidiary can constitute a business connection under domestic laws

We have seen in an earlier case study that an independent agent does not constitute a PE. However, in a recent case the Authority for Advance Rulings had to determine whether setting up an Indian subsidiary constitutes a PE *(223 ITR 416)*.

A *Swiss company* trading in commodities worldwide planned to set up an international trading business in India. The company declared that it did not want to set up a place of business in India, but at the same time it proposed to set up an India subsidiary to provide the parent consultancy services from India but for use outside India. Would such subsidiary be tantamount to having a business connection in India? If yes, the Swiss company desired to know the extent to which the income of the parent would be considered to have accrued in India and the extent to which such income would be taxed. These questions were raised in an application before the AAR.

The scope of activities of the Indian subsidiary were set out in a service agreement between the parent and the subsidiary. This work encompassed clerical and secretarial assistance, exchange of information about global tenders, signing and submitting tenders on behalf of the parent within the parameters fixed by the latter, negotiating the terms of tenders with the tendering authority within the parameters fixed by the parent, following-up on the tenders and finally signing the agreement.

The AAR noted that service agreements of such nature, were in general initially valid for a year and could be terminated at short notice. They could also continue indefinitely being automatically renewed at the end of each year.

This agreement further specified that the relationship between the parent and the subsidiary would not be based on any stray transaction but would be a continuous process involving a series of purchase and sale transactions undertaken by the foreign parent in India. As regards all such transactions the Indian subsidiary would do the work as envisaged in the service agreements. Although the subsidiary was not barred from catering to other parties, a confidentiality clause in the agreements considerably curtailed its ability to do so. The AAR thus held that such an intimate and continuous relationship would constitute a business connection.

Next was the issue of determining whether a PE could be said to exist in India. The AAR took into cognizance Article 5 of the DTAA. Here the term PE includes -- the furnishing of services other than included services as defined in Article 12 within a contracting state, by an enterprise through employees or other personnel but only if:

(i) the activities of that nature continue within that state for a period or periods aggregating more than 90 days within any twelve months period; or

(ii) the services are performed within that state for a related enterprise (within the meaning of Paragraph 1 of Article 9) for a period aggregating more than 30 days within any twelve month period.

Based on the definition of a PE in Article 5 and on the conditions of the proposed service agreements between the applicant and the subsidiary, the AAR concluded that the subsidiary would constitute a PE in India. However, at this stage the total activities which would be carried out by the subsidiary in India and the extent to which the services would be rendered to the parent company and other companies controlled by the parent could not be determined. Thus the AAR opined that the subsidiary would have to be treated as a PE of the Swiss company unless it has significant independent activities of its own or for persons other than the parent and unconnected with it.

To conclude it can be said that before plunging into a cross border transfer of technology, be it for software or otherwise, the tax implications and commercial laws must be examined. Establishment of a PE in India should preferably be avoided, unless it is more tax efficient to obtain business deductions in the hands of the PE. This is because, royalties and fees from technical services are taxed at a lower rate, although on a gross basis. Commercial justification of having routed the transaction through another jurisdiction has to be proved at all costs, else the Authority for Advance Rulings is likely to reject the application made. As mentioned earlier, rejection of a ruling, does not imply that treaty benefits will be denied. But, tax authorities are likely to take cognizance of the remarks or observations made in the ruling, at the appellate level, if the matter comes up for appeal under normal tax procedures. Transfer pricing norms in India, are not strict at present. But tax authorities in India are becoming increasingly vigilant. With the new Income Tax Bill on the anvil, this is another aspect which should be kept in mind. Keeping in view, the tax and commercial laws and the recent rulings of the AAR, the most efficient and effective structure should be adopted.

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**The contents of this paper should not be construed as legal opinion or professional advice.**