Taxation of software supplied by foreign companies

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Introduction

With the growth of information technology, business process outsourcing and bio-informatics industry in India, there have been increasing instances of Indian companies acquiring software from foreign companies. Depending on the needs of the parties, at one end of the spectrum, the software may be exclusively developed for the Indian company and the foreign company would transfer all rights in relation to such software to the Indian company. At the other end, the Indian company may just acquire license or shrink-wrap product (*e.g.* Windows or Microsoft Office) from the foreign company. There could be instances where the Indian company acquires only partial rights in the software. Taxation in India of the payments made by the Indian company to a foreign company for software would depend on the nature of the transaction. This paper examines the issues in relation to characterisation of income in the hands of the foreign company and its tax implications in India.

What is Software?

It may be useful to understand the meaning of the term software. As per the New Oxford Dictionary for the Business World, "software" means programs used with a computer (together with their documentation), including program listings, program libraries, and user and programming manuals.

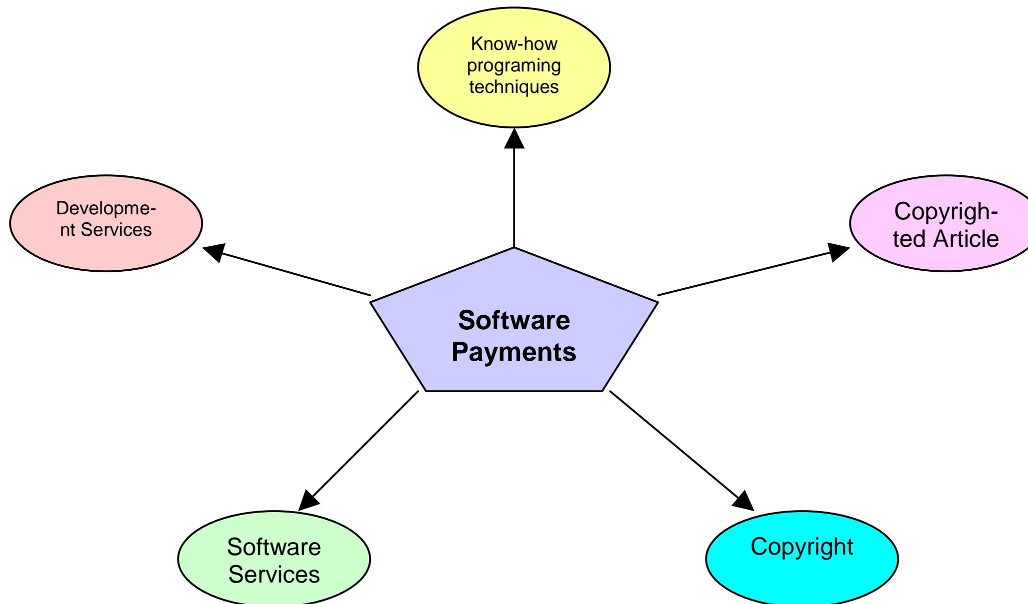
In India, "software" has been defined under the Income Tax Act, 1961 ("**ITA**") and under the Copyright Act, 1957. Sections 10A, 10B and 80HHE of the ITA, dealing with export of computer software define "computer software" to mean –

(a) any computer programme recorded on any disc, tape, perforated media or other information storage device; or
(b) any customised electronic data or any product or service of similar nature as may be notified by the Central Board of Direct Taxes, India.

Section 2(ffc) of the Indian Copyright Act, 1957 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. Thus, software necessarily connotes "programme" in relation to a computer.

Some Typical Transactions in Software :

Broadly speaking, transactions in relation to computer software would fall in any one of the following categories :



1. Transfer of a copyright right in the computer program: The copyright rights in a computer program would generally include the following:
   - Rights to make copies of a computer program for distribution to public by sale or other transfer of ownership, or by rental, lease or lending;
   - Right to make derivative of the computer program;
   - Right to make public performance of the computer program; or
   - Right to publicly display the computer program.[1]

   In this situation, a person acquires almost all the rights in relation to the computer program rather than just acquiring a right to use the same for personal use.

2. Transfer of a copy of the computer program (a copyrighted article): A copyrighted article would generally include a copy of a computer program from which the work can be perceived, reproduced or otherwise communicated, either directly or with the aid of a machine or device. In such a situation, a person acquires merely a copy of the computer program, giving him only the right to use the same for personal use and does not grant him any other rights in relation thereto.

3. Provision of services for the development or modification of the computer program: Under this scenario, typically a customer engages a software development company to develop or modify software for the former, whereby all the rights in relation to such software will belong to the customer. Currently, the export of software by the Indian software companies largely falls in this category.

[1] The US Treasury Regulation s. 1.861-18(c)(1).

4. Provision of software related services: Services other than those related to the development or modification of the computer program, such as installation, maintenance, training, etc. would fall in this category.

5. Provision of know-how related to computer programming techniques: Under this scenario, information which is considered subject to trade secret protection is provided relating to the computer programming techniques and is furnished under conditions preventing unauthorised disclosures, specifically contracted for between the parties.[2]

Any and all of the above may be provided in physical form or electronically. Taxability of the payment to the foreign company in India would depend on how it is characterised. The payments made by an Indian company to a foreign company towards such transactions could be characterised as royalty, fees for technical services, capital gains or business profits depending on the nature of the transaction.

Royalty

If the payment is characterised as royalty, it is subject to withholding tax at 20%[3] on gross basis (this rate may be reduced by the provisions of a Double Taxation Avoidance Agreements ("**DTAA**") between India and the country of residence of the foreign company). The payer would thus be required to withhold tax at such applicable rate on gross basis while making the payment or crediting the amount in its books to the foreign company.

Business Income

A payment characterised as business income is subject to taxation in India only if the foreign company has a business connection (permanent establishment in case there exists a DTAA between India and the country of residence of the concerned foreign company) in India. In such a scenario, only that portion of income that is attributable to a business connection or the permanent establishment ("**PE**"), as the case may be, in India, will be subject to tax in India at the rate of 40% on net basis.

Fees for Technical Services

If the fees paid by an Indian company to a foreign company for availing of services in relation to computer software are regarded as "fees for technical / included services", they could be subject to withholding tax in India at the rate of 20% on gross basis (this rate may be reduced by the provisions of a DTAA between India and the country of residence of the foreign company).

Capital Gains

[2] The US Treasury Regulation s. 1.861-18.
[3] All tax rates in this paper are exclusive of surcharge as may be applicable.

If the payment is characterised as capital gains realised by the foreign company on disposal of a capital asset situated in India, then the same would be taxed in India as long term or short term capital gains, depending on the period for which the asset was held by the foreign company. Capital gains realised from a capital asset of this nature held for more than 36 months would be characterised as long term capital gains and taxed at the rate of 20% and capital gains from the capital asset held for 36 months or less would be characterised as short term capital gains and taxed at the rate of 40%.

Now, let us examine the issues related to characterisation of the payment made in respect of the software by an Indian company.

Characterisation issues

Is it Royalty or Business Income?

Under section 9(1)(vi) of the ITA, in Explanation 2, royalty is defined as the **consideration** (including lump sum payment) **for** the transfer of all or any rights (including the granting of a license) in respect of a patent, invention, model, design, secret formula, process, trademark, copyright, literary, artistic or scientific work. It further includes **consideration for** the use of any patent, invention, model, design, secret formula, process, trademark or similar property. It may be observed that the most important aspect of this definition is the use of the words "consideration for ……..". This clearly implies that the purpose for which the consideration is paid is of paramount importance for the interpretation of the expression 'royalty'. Thus, only if some right in respect of a patent, invention, model, design, secret formula, process, copyright, literary or scientific work or the use of the right in a patent, invention, model, design, secret formula or process or trademark or similar property are transferred, it cannot be regarded as royalty. If the consideration is for the right to commercially exploit the intellectual property in the software, then the same could tantamount to royalty.

It is evident that where the consideration paid is for the purchase of a product, as envisaged in category (2) described above, and not for the transfer of the intellectual property *per se,* it may not be regarded as royalty. For example, the purchase of a book by a customer does not tantamount to the purchase of the copyright in the book, even though the publisher publishes the book by purchasing the copyright. Drawing a parallel from this example, purchase of a shrink-wrap product by an Indian company from a foreign company should not be regarded as purchase of a copyright but only a purchase of a copyrighted article and thus the payment therefor should not be regarded as royalty.

An important aspect that has been emphasised by the Indian courts is that while characterising the income, one should look at the predominant purpose for which the consideration is paid in a transaction.[4] Thus, where the consideration is primarily for the purchase of the product and not for the use of the intellectual property therein, and the use of such intellectual property is merely incidental to the purchase of the product, the payment

[4] Commissioner of Income-tax v. Neyveli Lignite Corporation Ltd reported in [2000] 243 ITR 459 (Madras High Court).

would be characterised as purchase of a product and not as royalty. Accordingly, the payment must be classified as business income.

When the software is delivered electronically and the Indian customer copies it onto his computer, on-line, the situation becomes more complicated. The High Powered Committee, in its report[5] has characterised the payment for the purchase of computer software in the form of shrink-wrap products on-line as "royalty", arguing that the customer "copies" the software onto his computer and hence the payment should be treated as *"*consideration*"* for the "copyright". With all due respect, this argument is very slim since, apart from the mode of delivery, there is no difference in the purchase of software in physical form and in digitised form. Further, it goes against the principle of neutrality of the mode of transaction as between traditional commerce and e-commerce. Even when the customer is buying the software by downloading it in digital form, he is paying the consideration only for the purchase of the "product" and **not** for any rights in the intellectual property of such software. In view of this, the payment should be characterised as business income under the ITA.

Definition of the term royalty varies under the DTAAs entered into by India with other countries. Under Article 12(3) of the India-USA DTAA, the term royalty has been defined as Payments of any kind received as a consideration <u>for the use of, or the right to use</u>, any copyright of a literary, artistic, or scientific work, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience including gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof. Similar definition is there under several DTAAs, including that with the UK.

Even in a DTAA scenario, the payments made for purchase of a product, which embodies intellectual property in it, can not be regarded to have been made for the *use of* or the *right to use* any intellectual property and the amount would fall outside the above definition of royalty under the India-US DTAA and should be taxed as business income. However, if the payment is made for commercial exploitation of intellectual property, then the same could be regarded as royalty.

<u>Mixed Transactions</u>

The complexities may arise if full rights are not given to the purchaser, for example, where the use of the property may be permitted only within India. Paragraphs 15 and 16 of the commentaries on Article 12 of the OECD Model Convention dealing with royalty acknowledge that difficulties could arise in such scenarios. While each case will depend upon its particular facts, in general, such payments are likely to be business income or capital gains rather than royalties.

<u>Is it Fees for Technical Services?</u>

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[5] The report of the High Powered Committee set up by the Government of India to make recommendations for characterisation of income from e-commerce transaction and their taxability in India.

Under Sec 9(1)(vii) of the ITA in Explanation 2 the term 'fees for technical services' is defined as any consideration (including any lump sum consideration) for the rendering of any managerial, technical or consultancy services (including the provision of services of technical or other personnel). In other words, if the services rendered in relation to computer software are in the nature of managerial, technical or consultancy services, the payment for the same could be regarded as fees for technical services.

"Fees for technical (or included) services" is given a restricted meaning under the DTAA as against a wider import attributed to it under the ITA. Article 12(4) of the India-USA DTAA defines "fees for included services" to mean payments of any kind to any person in consideration for the rendering of any technical or consultancy services (including through the provision of services of technical or other personnel) if such services:

(a) are ancillary and subsidiary to the application or enjoyment of the right, property or information for which royalty is paid; or
(b) ***make available*** technical knowledge, experience, skill, know-how, or processes, or consists of the development and transfer of a technical plan or technical design.

Similar definition of fees for included services appears in several of he DTAAs signed by India, such as that with the UK.

In order for technology to have been made available, the person acquiring the service should be enabled to apply the technology embedded in the services provided to him. The mere fact that the provision of the service may require technical input by the person providing the service would not *per se* mean that technology has been made available. Similarly, the use of a product, which embodies technology, shall not *per se* constitute technology being made available.[6] Thus, if the Indian company is in a position to apply technical knowledge, experience, skill, know-how, or processes, by virtue of the services rendered by the foreign company to the Indian company, it will be regarded as fees for included/technical services.

If such services consist of the development and transfer of a technical plan or technical design, the same would be regarded as fees for included/technical services. In this connection, the Memorandum of Understanding dated August 15, 1989, signed between India and USA in relation to the India-USA DTAA clarifies that the services rendered in relation to modification of computer software would consist of the transfer of technical plans or technical designs, and thus be regarded as fees for included/technical services.

Examples

<u>Scenario 1</u>

A foreign company ("**FCO**") owns the copyright in a computer program, Program X. An Indian company ("**ICO**") purchases from FCO a box in which discs are placed and it is covered with a wrapper bearing the caption "shrink-wrap license". The license is stated to be perpetual and under this license no reverse engineering, decompilation, or disassembly of

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[6] AAR No. 475/1999 decided by the Authority for Advance Rulings, India.

Program X is permitted. The transferee receives, first, the right to use Program X on a computer and, second, the right to make one copy of Program X on the hard drive of the computer as an essential step in utilization of Program X.

Here, the payment is made for the purchase of Program X for personal use, which embodies intellectual property in it. ICO is permitted to make a copy of Program X on the hard drive of its computer merely so that Program X can run on its computer. This right to make the copy is therefore incidental to the use of Program X and not for the purposes of commercial exploitation of Program X. Hence the payment should be regarded as business income. This is an example of category 2 described earlier.

Scenario 2

The facts are the same as in Scenario 1, except that instead of selling discs, FCO decides to make Program X available on its website. ICO, in return for a payment made to FCO, downloads Program X via a modem onto the hard drive of his computer.

Apart from the mode of delivery, there is no difference in the purchase of Program X in Scenario 1 and 2. Even when ICO is buying Program X by downloading it in digital form, it is paying the consideration only for the purchase of the "product" and **not** for any rights in the intellectual property of the software. Copying of Program X on the hard drive of its computer is merely so that Program X can run on its computer. In view of this, the payment in this Scenario also should be characterised as business income for FCO. This is an example of category 2.

Scenario 3

The facts are the same as in Scenario 1, except that instead of selling "shrink-wrap" product, FCO grants the license to ICO to make copies of Program X and sell or distribute Program X within the territory of India. For each copy sold by ICO, it would be required to pay 20% of the sales consideration to FCO.

Here, the payment is made for receiving copyright right in Program X for its sale and distribution in the Indian territory. This right to make the copy is for the purposes of commercial exploitation of Program X. Hence the payment should be regarded as royalty. This is an example of category 1.

Conclusion

To conclude, in general, if the consideration paid is for purchase of a shrink-wrapped product *i.e.* a right other than a right in the intellectual property, then the payment made should not be treated as royalties and should be classified as business income. However, if the consideration is for right to commercially exploit the intellectual property in the software, then the same could tantamount to royalty. If the services rendered by the foreign company in relation to the computer software makes available technical knowledge, experience, skill, know-how, or processes, or consists of the development and transfer of a technical plan or

technical design, the same would be regarded as fees for included or technical services. The taxability of a payment can only be determined after examining and analyzing the particular facts of each case.