

Tax Hotline

September 05, 2006

WITHHOLDING TAX ON PURCHASE OF SOFTWARE

The Authority for Advance Rulings ("**Authority**") has recently held that in the case of an Indian company there exists a legal obligation to withhold taxes while making payments for the software purchased from a foreign company.

The applicant, Headstart Business Solutions Pvt. Ltd. ("**Headstart**"), an Indian company had entered into a Solution Provider Agreement with Microsoft Sales Corporation, Singapore ("**Microsoft**") for the purchase of business software solutions. It had sought a ruling from the Authority on whether it was required to withhold taxes while making payments for the purchase of such software from the foreign company.

The applicant contended that the payments for software would be taxable as royalty only if the software imported was accompanied by copyright thereby enabling the applicant to replicate the software. In the present case, as the imported software did not confer any copyright on the applicant, the remittance made by the applicant to the foreign company for the purchase of software did not entail deduction of taxes. Further, the income arising in India to the foreign company from the sale of such software is business income and in the absence of any linkage to a 'permanent establishment' of the foreign company in India, the same is not liable to tax.

For the purposes of determining the obligation to withhold taxes, the Authority did not take the nature of payment into consideration and did not find it necessary to deliberate over the issue as to whether any copyright had been conferred on the applicant. The Authority said: "The arguments advanced by the learned counsel for the applicant with regard to there being no royalty income or the statement that MRSC has no PE (Permanent Establishment) in India are beyond the scope of consideration and subject matter of this application." The Authority solely relied on Section 195 (1) of the Income Tax Act, 1961 ("**ITA**"), holding that the expression "any other sum chargeable under the provisions of this Act" brings within its ambit not only the amounts, the whole of which are taxable without deduction, but also amounts of a mixed composition, where only a part of it may be liable to tax, as well as other disbursements which are of the nature of gross revenue receipts.

Thus, the Authority ruled that there was indeed a legal obligation to withhold taxes when making payment for the purchase of software from a foreign company, as such a payment falls within the scope of section 195 (1) of the ITA.

Impact: The rulings of the AAR are private and binding only on the applicant and tax authorities, in the case of the applicant. However, they do have persuasive value. This ruling will have an impact on many Indian companies, which buy off-the-shelf software products from abroad. The ruling does not discuss the India-Singapore tax treaty provisions and their overriding effect on the ITA.

- Bijal Ajinkya & Archana Rajaram

Source: AAR/103/2005-06/349

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