

PAYMENTS FOR SOFTWARE SERVICES

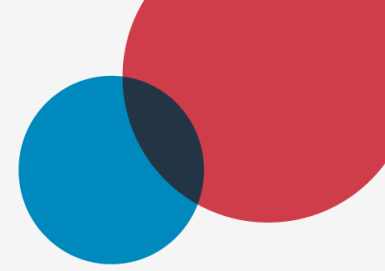
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**SOFTWARE
SERVICES**

MEANING OF SOFTWARE



- ❖ Commentary to Organization for Economic Co-operation and Development (“OECD”) Model Tax Convention on Income and on Capital [referred to as “OCED Model Tax Convention 2014”] states that *“Software may be described as a program, or series of programs, containing instructions for a computer required either for the operational processes of the computer itself (operational software) or for the accomplishment of other tasks (application software)”*
- ❖ Oxford Dictionary for the Business World definition
 - *“Software means programs used with a computer (together with their documentation), including program listings, program libraries, and user and programming manuals”*

TYPES OF SOFTWARE PAYMENTS

1/2



❖ **Transfer of copyright rights**

- Transfer is of rights in relation to the computer program for commercial exploitation

❖ **Transfer of copyrighted articles**

- Transfer is merely of a copy of the computer program and not the copyright itself

❖ **Site License / Enterprise License / Network License Arrangements**

- Licensing agreement that grants the purchaser permission to use the software on a network on a single site, with an unlimited number of end users

TYPES OF SOFTWARE PAYMENTS

2/2



❖ **Supply of information**

- Information supplied could represent the use of, or the right to use, secret formulas or for information concerning industrial, commercial or scientific experience which cannot be separately copyrighted

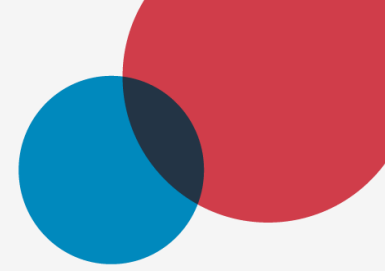
❖ **Transfer of ownership**

- Ownership of the software is sold / transferred

❖ **Development services**

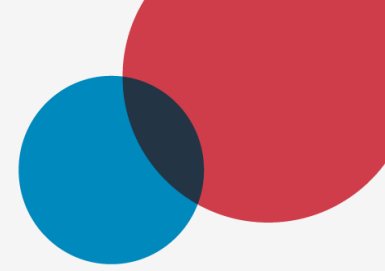
- Typically a customer engages a software development company to develop or modify software for the former, whereby all the rights in relation to such software will belong to the customer

KEY ISSUES



- ❖ Do payments made for purchase of “shrink-wrapped” or “off-the-shelf” software in the nature of royalty?
- ❖ Is payment made for a copyright the same as payment made for a copyrighted article?
- ❖ Is payment for access to an online database considered as a license or transfer of copyright?
- ❖ Is payment for Business Information Reports in the nature of royalty?
- ❖ Is payment for online advertisements (made on Facebook, Google) considered to be in the nature of royalty?

ROYALTY – MEANING



- ❖ Royalty means *“a share of the product or profit reserved by the owner for permitting another to use the property”*
- ❖ Black’s Law dictionary – *“a payment made to an author or inventor for each copy of a work or article sold under a copyright or patent”*
- ❖ OECD Model Tax Convention 2014 – *“The term ‘royalties’ means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematographic films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience”*

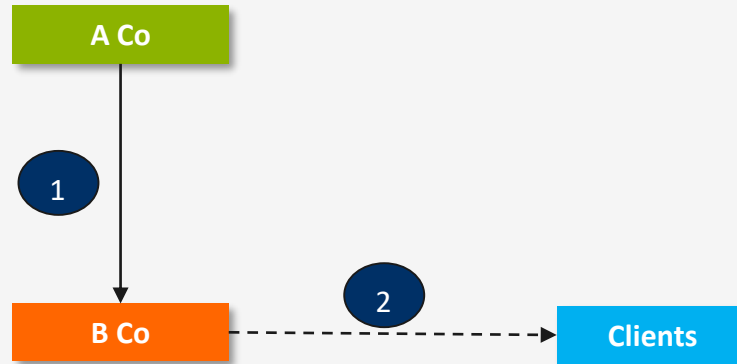
[Note: The concept of “equipment royalty” was removed under the OECD Model]



**CASE STUDIES
ON SOFTWARE
PAYMENTS**

CASE STUDY – 1

1/2



Mechanics

- 1 B Co purchases software from the manufacturer (A Co)
- 2 B Co supplies the software to clients

The software supplied to clients is “shrink-wrapped” software

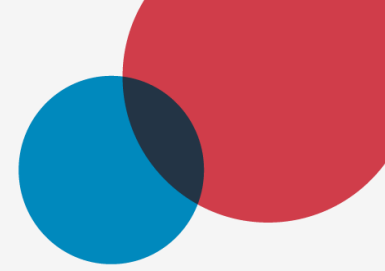
The clients can access the “shrink-wrapped” software only after purchase

Is sale of “shrink-wrapped” software sale of copyright or simply for material that is protected by copyright?

If the software is embedded in the hardware, can the total cost of hardware and software be split and taxed as separate sources of income?

CASE STUDY – 1

2/2

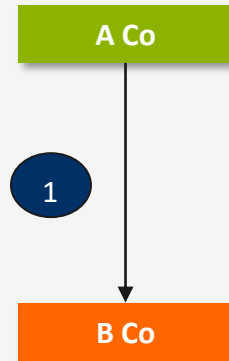
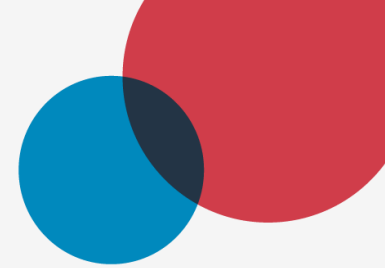


Ruling

- 1 A computer software when put into a media and sold, becomes goods like any other audio cassette or painting on canvas or book
- 2 This payment was an outright purchase of the software; the purchaser does not get any right in copyright but gets a right only to use the software
- 3 Hence, the amount paid cannot be treated as royalty

CASE STUDY – 3

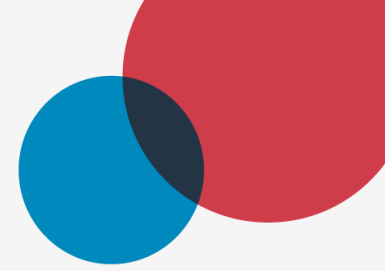
1/2



Mechanics

- 1 B Co was granted a license by A Co to access the database maintained by A Co for a certain sum of money

Will the right of access amount to transfer of right to use the copyright held by A Co?

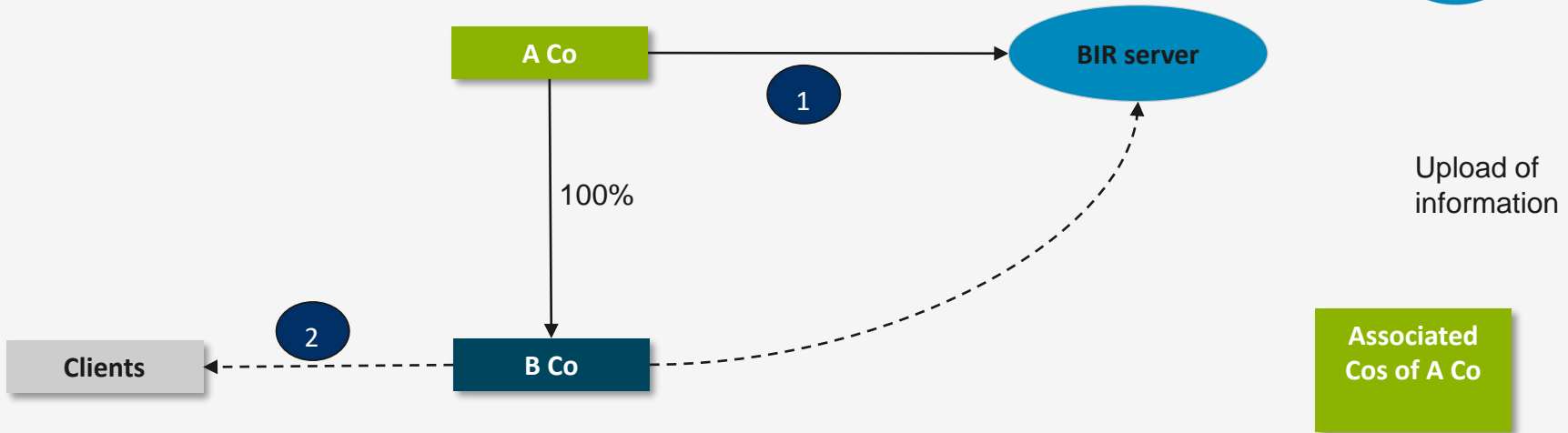


Ruling

- 1 Payments made are towards obtaining of market data and clients strategy details, etc
- 2 The amounts paid are for publications and not for an information or advice given individually
- 3 No license was granted to B Co to use such information in any manner or quote to anyone else
- 4 Such payments for use of database cannot qualify as '*payments of any kind received as consideration for the use of, or the right to use any copyright of a literary, artistic, or scientific work, etc*'
- 5 Hence, fees paid for access to database does not constitute royalty

CASE STUDY– 4

1/2



Mechanics

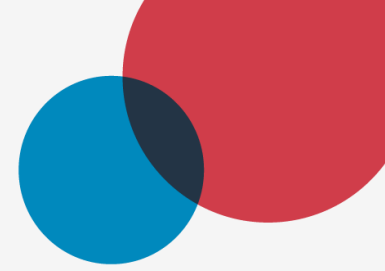
- 1 A Co compiles Business information Reports ('BIR') from various Associated Companies on to a server. BIRs are copyright protected. A Co provides BIRs to clients and other Associated Enterprises for a fee
- 2 B Co also sells BIRs to its clients. On receipt of an order, it accesses the BIR server, downloads and provide a printed copy of the relevant BIR to its clients; B Co pays the same fee as any third party client to A Co

B Co's clients are not permitted to make copies, reproduce BIR or sell to any other person

Will the payment for BIRs amount to royalty in the hands of A Co?

CASE STUDY– 4

2/2



Ruling

- 1 If a group of companies collects information in each country and all information is maintained on a central computer which is accessible to each constituent of the group in each country, then supply of such information electronically on payment of price cannot be treated as royalty
- 2 Sale of BIR is akin to sale of a book, which does not involve any transfer of intellectual property
- 3 Copyright in BIR is neither licensed nor assigned to either B Co or its clients
- 4 Accordingly, price paid for supply of BIR cannot be treated as royalty

In contrary to the above, if the information compiled on the website is for a specific purpose, then supply of such information can be treated as scientific work having a characteristic of intellectual property and hence could qualify as “royalty”



E-COMMERCE

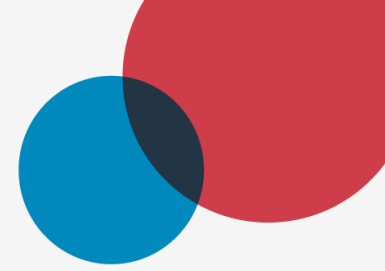
The graphic features a large yellow circle on the left containing the text 'E-COMMERCE'. To its right are three overlapping circles: a blue one at the top, a red one at the bottom, and a smaller dark blue one overlapping the intersection of the blue and red circles. The circles overlap in a way that creates a dark blue area in the center where all three meet.

E-COMMERCE



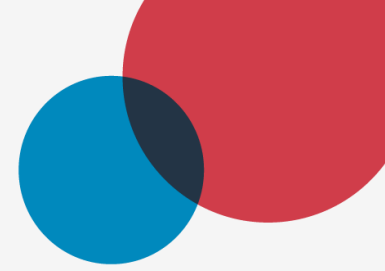
- ❖ Dictionary definition – “*commerce that is transacted electronically, as over the internet*”
- ❖ Challenges in taxation of e-commerce:
 - No separate rules for taxation
 - Place of transaction and source of income difficult to determine due to absence of physical activity
 - Classification of the transaction for levy of tax
- ❖ OECD had constituted an international committee of Technical Advisory Group (“TAG”)
- ❖ TAG report lays down certain key principles on taxation of e-commerce transactions

E-COMMERCE



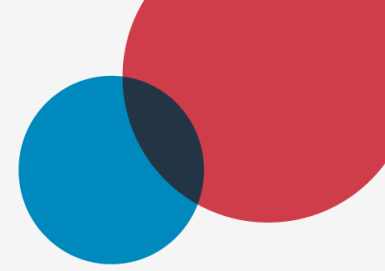
- ❖ India had set up a high powered committee (“HPC”) followed by an ecommerce Taxpert Group (“Group”) to examine implications associated with e-commerce transactions
- ❖ Action Plan 1 of the OECD /G20 Base Erosion and Profit Shifting (‘BEPS’) Project calls for work to address the tax challenges of digital economy

HIGHLIGHTS OF TAG REPORT 1/4



- ❖ Following principles must be conferred to:
 - **Neutrality** between taxation of e-commerce and commerce
 - **Efficiency** – full protection to taxpayer against double tax and facilitate international flow of trade, investment and technology
 - **Certainty and Simplicity** – clear and transparent framework for easy understanding of taxpayer and tax authorities
 - **Effectiveness & Fairness** – with respect to tax sharing between countries
 - **Flexibility** – in adapting changing technology
- ❖ Laid down 29 categories of e-commerce transactions with respective tax treatment. Some categories:
 - **Shrink-wrap licensing software** – Not royalties
 - **Downloaded software** – Not royalties

HIGHLIGHTS OF TAG REPORT 2/4



- Under OECD approach medium of delivery should not change the characterization
- **Site licensing** arrangements – Not royalties
 - Reproduction rights are limited to those required for effective utilization
- ❖ Test of characterization to be:
 - Right to use copyright – Royalty
 - If use of copyright is incidental – Business income
 - Payment for copyrighted article – Business income

HIGHLIGHTS OF TAG REPORT 3/4

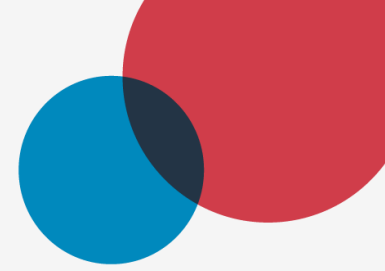


- ❖ Test of characterization for equipment royalty as laid out in US Internal Revenue Code and adopted by TAG. Once applied these indicate a lease (i.e., royalty characterisation) rather than a service:
 - The customer is in physical possession of the property
 - The customer controls the property
 - The customer has significant economic or possessory interest in the property
 - The provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is non-performance under the contract

HIGHLIGHTS OF TAG REPORT 3/4

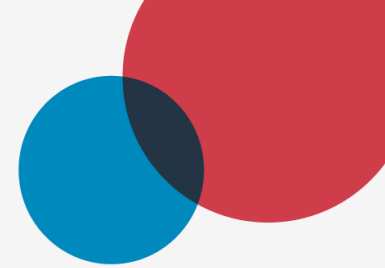


- The provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and
- The total payment does not substantially exceed the rental value of the computer equipment for the contract period

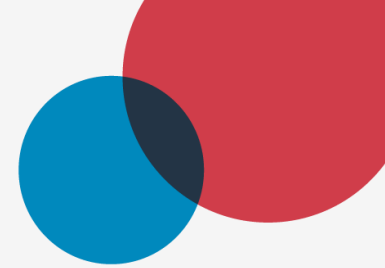


Addressing the tax challenges of the Digital Economy

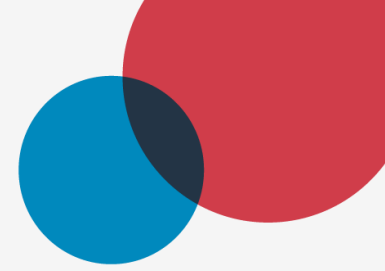
- ❖ With the rapid penetration of digitization, it is impossible to ring-fence the digital economy from rest of the economy for tax purposes
- ❖ Digital economy and its business models present some key features which are potentially relevant from a tax perspective *viz* mobility, reliance on data, network effects, the spread of multi-sided business models
- ❖ Digital economy raises the following broader tax challenges for policy makers:
 - **Nexus** - Reduced need for physical presence raises question whether current rules to determine nexus with a jurisdiction are appropriate



- **Data** - Data is a primary input into process of value creation in digital economy and possibility to gather and use information from various sources creates problem as to how to attribute value to such data
- **Characterization** – Development of new digital products or means of delivering services creates uncertainties in relation to characterization of payments made in context of new business models, cloud computing in particular
- **Collection of VAT** - Absence of an effective international framework to ensure VAT collection in the jurisdiction of consumption as well as a significant administrative burden in managing tax liabilities generated by high volume of low value transactions



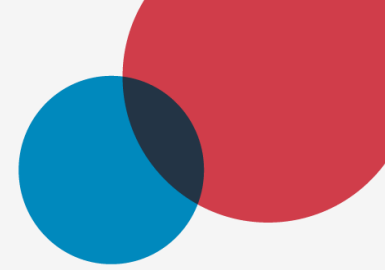
- ❖ Task Force on Digital Economy (“TFDE”) discussed and analyzed potential options to address broader tax challenges, and recommended the following:
 - Modify list of exceptions to the definition of Permanent Establishment (“PE”) to ensure that it is not possible to benefit from the ‘preparatory or auxiliary’ activities exception
 - Apply principles of International VAT/ GST Guidelines and introduce collection mechanisms included therein to address issue in collection of VAT /GST on cross-border transactions, particularly in case of B2C transactions



- Other options analyzed by TFDE but not recommended at this stage include:
 - New nexus based rules on significant economic presence
 - Withholding tax on certain types of digital transactions
 - Equalization levy to ensure 'equal treatment' of foreign and domestic suppliers
- Aforesaid options could, however, be introduced by countries in their domestic laws, provided they respect existing treaty obligations, or in their bilateral tax treaties

EQUALISATION LEVY IN INDIA

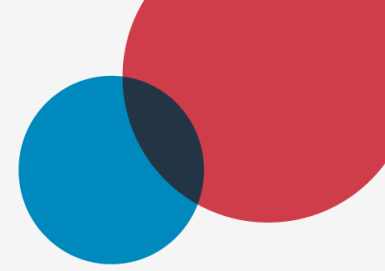
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- ❖ India introduced Equalisation levy into domestic tax laws vide Finance Bill, 2016 as a separate chapter – not forming part of the Income-tax Act, 1961, based on recommendation of the Committee on Taxation of E-Commerce
- ❖ **Charge:** Equalisation levy to be charged at the rate of 6 percent of amount of gross consideration received /receivable by a non-resident for any ‘specified service’ from –
 - a) a resident in India and who carries on business or profession, or
 - b) a non-resident having a PE in India
- ❖ **‘Specified service’** defined to mean online advertisement, any provision for digital advertising space, or any facility for the purpose of online advertisement or any other service notified by the Central Government

EQUALISATION LEVY IN INDIA

2/3



- ❖ **Mechanics:** To be deducted by payer at time of making payment to non-resident and deposited with Government within specified time. Subsequently, payer to furnish specified statement (yet to be prescribed) to tax officer
- ❖ **No 'income' in hands of recipient:** Income arising to non-resident service provider from 'specified service' and subjected to an equalization levy – exempt from income-tax

EQUALISATION LEVY IN INDIA

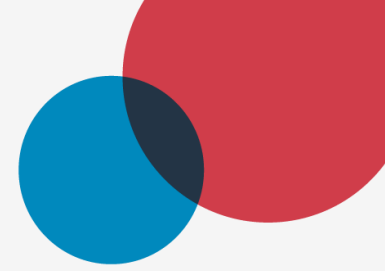
3/3



- ❖ **Exceptions:** Not to be charged in following cases:
 - non-resident providing the specified service has a PE in India and specified service is effectively connected with such PE;
 - aggregate amount of consideration \leq INR 0.1 million
 - payment not for purposes of carrying out business or profession
- ❖ **Date of applicability:** May 14, 2016

TAXING THE CLOUD

1/2



- ❖ An abstract computing and data storage business model where dynamic IT capabilities such as hardware, software and tools are provided by the provider to the customer over the internet to enable the latter to store, access and process data and applications virtually from anywhere

SaaS



Web access to commercial software

Users are provided licenses to applications

PaaS



Platform for creation of software

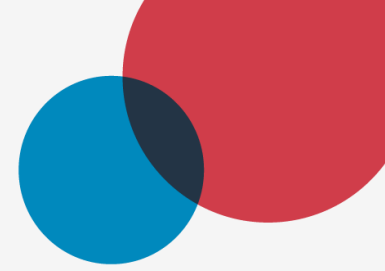
Deployment of customer applications

IaaS



Storage

Computing resources



- ❖ Characterisation of payments under cloud computing – whether royalty under current principles?:
 - Transfer is of rights in relation to the computer program for commercial exploitation
 - No possessory rights, physical access given to the customers
 - Customer has no economic interest
 - Customers are in fact not aware of the processes involved



THANK YOU

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