Praxity, AISBL Global Tax & Fiscal Group

CROSS-BORDER TAXATION OF SOFTWARE CONTRACTS

Serving Technology Companies

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INDEPENDENT FIRMS

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1. Introduction

1.1 – Background Discussion

In April 2012, the Praxity, AISBL Global Tax and Fiscal Group met in Dublin, Ireland, to discuss global tax implications and planning approaches related to "Serving Technology Companies."

The final regulations are ambiguous when referring to the point where "title" passes and source of income for the sale of software via electronic download. This issue presents subjectivity and complexity regarding characterization of revenue and applicable withholding tax rates. The various tax and nontax implications, as well as the regulations overseeing such, were examined in 17 countries.

Properly characterizing revenue in a cross-border software transaction and determining the appropriate taxation on such revenue requires the ability to identify the type of transaction that produced the revenue. Royalty revenues generally are treated differently than income derived from sales or exchanges, so a thorough analysis is needed to determine which rights the software purchaser obtains and to what extent title has been transferred. Income also may be generated from the provision of know-how and services related to computer programs and their development or maintenance. This income may be treated differently from the sale, lease or licensing of the computer software itself.

Income tax treaties also play a significant part in the treatment of cross-border transactions. The withholding rates on different types of income vary from one country to another, and additional complexities arise from a country's tax system itself if value-added tax (VAT) or other indirect taxes exist.

In 2012, Praxity conducted a survey across 20 countries to assess the taxation of cross-border software transactions in their respective jurisdictions. Here, we present the findings of our survey. It can be useful to see how other countries approach this growing issue and to consider ways existing regulations on these types of transactions might be improved.

1.2 – List of countries surveyed in 2012

Argentina	Denmark	Israel	Singapore
Austria	France	Japan	Thailand
Canada	Germany	Mexico	Ukraine
China	India	Netherlands	United Kingdom
Cyprus	Ireland	Russia	United States

1.3 – Definitions & Terms[1]

Computer programs: A set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result … (including) any media, user manuals, documentation, data base or similar item … (which) is incidental to the operation of the computer program.

Complete transfer of a copyrighted article – a sale of tangible property: A complete transfer of a copyrighted article is a sale of the article, which will generally be inventory in the hands of the seller. A sale of a copyrighted article occurs if sufficient benefits and burdens of ownership have been transferred to the buyer, taking into account all facts and circumstances. This is the same test generally applied to determine whether transfers of tangible personal property are sales or leases. In the case of conventional tangible property, the benefits and burdens include the risks of loss or destruction, wear and tear and obsolescence. In the case of software, the risk of obsolescence is particularly important since software is generally not subject to wear and tear. Although software is subject to the risk of loss or destruction, the software publisher frequently will replace the destroyed program copy at no charge or a nominal price. Therefore, the most important benefit and burden of ownership normally is the risk of obsolescence. If the transferee acquires the right to use the program for the remainder of its useful life, the transferee bears the benefit or burden that the useful life of the program will be either longer or shorter than anticipated. These transactions commonly occurred pursuant to what were called "shrink-wrap licenses" as a result of the shrink-wrap plastic packaging in which such software is packed, the opening of which created the user's obligations under the license agreement. The term "shrink-wrap license" is merely illustrative; the determination is based on the terms of the agreement between the parties and on the nature and extent of the rights transferred, not the means of packaging or distributing the computer program. Therefore, this category of transactions includes both inexpensive mass-market programs and sophisticated enterprise programs that sell for millions of dollars and are licensed pursuant to negotiated and signed user agreements.

Partial transfer of a copyrighted article – a lease: If less than all of the benefits and burdens associated with a copyrighted article have passed to the transferee, the transaction is a lease. This is a necessary corollary to the characterization of transfers of all benefits and burdens of ownership as sales. If copyrighted articles are to be treated as goods for tax purposes, it is necessary to accept that they can be leased as well as sold. Computer programs do not involve the same risk of physical deterioration as most other goods. The primary risk involved in transactions involving copyrighted articles is not the risk of physical destruction but the risk of technological obsolescence, including loss of compatibility with newer applications. If this risk is assumed by the transferee, generally through a transaction in which the transferee makes a single payment in return for the right to use the

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[1] All definitions are courtesy U.S. Income Portfolios (BNA) *Portfolio 555: Federal Taxation of Software and E-Commerce*.

program copy in perpetuity, then the transferee has assumed the risk of obsolescence and should be treated as the owner of the program copy. If the transferee instead makes periodic payments and can cease its use of the program when it chooses, the transferee has not assumed the relevant benefits and burdens of ownership and the transaction should be considered a lease. For example, the terms of the license agreement prohibit reverse engineering, recompilation or disassembly of the computer program, authorizes the transferee to make a copy of the program as an essential step in utilizing the program and to use the program on two computers provided that only one copy is in use at any time. However, unlike the perpetual license, this license is only for a period of one week. At the end of the week, the transferee must return the copy of the program to the transferor and destroy any copies it has made. This transaction is treated as a lease. Since the transferee does not acquire copyright rights, the transaction only involves a copyrighted article. But since the transferee only has the right to use the program for a week, the transferee has not obtained all of the benefits and burdens of ownership; therefore, it does not bear the risk of obsolescence, which results in lease characterization.

Complete transfer of copyright rights – a sale of the copyright: If the transaction involves copyright rights and all substantial rights to the underlying copyright are transferred, it is a sale of the underlying copyright. For example, a software contract could involve the transfer of a disk containing a copy of a computer program and give the transferee the exclusive right, for the remainder of the copyright term, to copy and distribute an unlimited number of copies of the work in an entire country, to prepare derivative works and make public performances and public displays of the computer program. In exchange, the transferor will receive a fixed annual payment, labeled a royalty, for three years, which is the expected remaining useful life of the program. The transaction involves copyright rights. Although a disk is transferred, it is accompanied by the grant of significant copyright rights, such as the right to reproduce and distribute copies of the program and prepare derivative works. The disk is therefore only a *de minimis* component of the transaction. Under the "all substantial rights" test, the transferee has obtained all substantial rights to the copyright since it has obtained exclusive copyright rights for a specified territory for the remaining life of the copyright. The fact that the payment is labeled as a "royalty" is irrelevant. The transaction is a sale of copyrights.

Know-How: Know-how is defined narrowly in this instance. A transaction will be treated as the provision of know-how only if it (i) involves information that relates to computer programming techniques and is furnished under conditions preventing unauthorized disclosure, (ii) is specifically contracted for between the parties, and (iii) is considered property subject to trade secret protection. As a practical matter, a transaction will be characterized as the provision of know-how only when it is limited to the transmission of proprietary computer programming skills or techniques. This would exclude from know-how classification software product deliveries to users in the normal case. In addition, teaching a class or selling a book on computer programming techniques available to the public

does not result in the provision of know-how because the information is not furnished under conditions preventing unauthorized disclosure.

Partial Transfer of Copyright Rights – A License: If the transaction involves the transfer of copyright rights and less than all substantial rights in the copyright are transferred, the transaction is a license of copyright rights. Therefore, if the transferee acquires nonexclusive rights in the copyright, or rights that are for less than the term of the copyright, the transaction is a license. For example, a software contract provides the transferee with a disk containing a copy of a copyrighted program, and the transferee also is granted the nonexclusive right to reproduce and distribute an unlimited number of copies of the program for sale to the public in exchange for a payment based on the number of copies made. The agreement is for a two-year term. This arrangement is a license. The transferee has obtained the right to both reproduce and distribute copies of the program to the public, making it a transaction in copyright rights. Although a disk containing a copy of the program is transferred, it is only a *de minimis* element since the purpose of the transaction is to permit the transferee to exercise certain copyright rights. Since the licensee's rights in the program are nonexclusive and limited in time, it is not a transfer of "all substantial rights," and the payments made thereunder are consequently royalties.

Provision of Services: A transaction involving a newly developed or modified computer program may be treated as the provision of services, depending on which party is to own the copyright rights in the computer program and how the risks of loss are allocated. When the copyright to the underlying program is transferred to the commissioning party in connection with the transaction and the commissioning party bears the risk of loss arising from the creation of the program, the commissioning party is treated as the owner of the copyright *ab initio* for tax purposes. The commissioning party bears the risk of product failure if it must pay for services rendered, even if the results are not what was desired or anticipated. Consequently, the commissioning party has not acquired the copyright by purchase, and the person who created the program is treated as having provided services.

Software Maintenance: Business application vendors typically offer software maintenance contracts to users, renewable on an annual or other periodic basis. Software maintenance contracts typically provide for both updates/upgrades and technical support services that do not constitute programming services, although in some cases only updates/upgrades or technical support are offered. If the contract offers only updates/upgrades, the transaction should be regarded as a copyrighted article transaction, so if the user obtains the right to the update/upgrade for a perpetual term (even if the term of the maintenance agreement is limited) without the right to reproduce for distribution to the public (or one of the other specified rights), the fees payable should be regarded as payments for a copyrighted article, *i.e.*, sale of tangible property. Similarly, if only technical support such as access to a help desk is provided, the contract would be solely that of services. In many cases, software maintenance contracts

provide for both product updates/upgrade and access to technical support, for a single fee. Therefore, it may be advantageous to segregate the payments for each revenue stream into separate components.

2.   Analysis of Data

2.1 – Does Your Country Distinguish Software Contract Revenue Streams?

The countries involved in the survey were asked to distinguish software contract revenue streams based on the following transaction types:

1. Sale of a copy of a computer program (copyrighted article)
2. Lease of a copy of a computer program (lease of copyrighted article)
3. Sale of copyright rights
4. License of copyright rights
5. Provision of services in connection with the creation of a computer program
6. Provision of know-how relating to computer programs

Of the 15 nations that responded to this question, nine distinguish revenues based on the categories listed above. A few countries recognize some, but not all, of these revenue categories. In Austria, Cyprus, France and the Netherlands, none of these types of transactions are specifically identified for any special tax treatment. In many instances where a country does not distinguish a certain transaction type, the income is taxed at regular corporate tax rates.

2.2 – Does Your Country Follow the OECD Committee on Fiscal Affairs Commentary to Article 12 (Royalties) OECD Model Tax Convention (2003) for Characterizing Computer Software Transactions?

Due to a disagreement within the Software Regulations, the Organization for Economic Co-operation and Development (OECD) revised the Commentary to Article 12 OECD Model Tax Convention to update its principles for characterizing computer software transactions. Under the OECD Commentary, the payment cannot be a royalty if the transferee obtains full ownership in the copyright. Rather, the royalty will arise if the transferee acquires partial rights in the copyright, such as the right to reproduce and distribute public copies of the program. The Commentary notes, however, that this distinction may be difficult in countries where it is not certain that software is a literary or scientific work for purposes of Article 12 of the OECD Model Tax Convention.

In cases where the transferee obtains rights only to the extent that the user is able to operate the program, these rights should be disregarded for characterization properties. When determining whether a payment constitutes a royalty, the emphasis is on "that for which the payment is essentially made." In response to this survey, a slight

majority indicated they follow the OECD Committee on Fiscal Affairs Commentary to Article 12 OECD Model Tax Convention for characterizing computer software sales.

| Yes	No
• Austria	• Argentina
• Canada	• Cyprus
• Denmark	• Japan
• France	• Russia
• Germany	• Thailand
• Ireland	• Ukraine
• Israel	
• Singapore	
• United States	

For those countries that are not OECD members, many (such as Argentina) will still follow Article 12 with regards to the provisions of the Double Taxation Agreements (DTA). Russia is expected to become an OECD member.

2.3 – What Statutory Withholding Tax Rate Applies to Each of the Following Software Contract Revenue Streams?

The countries involved in the survey were asked to provide the withholding tax rates applied to software contract revenue streams based on the following transaction types:

1. Sale of a copy of a computer program (copyrighted article)
2. Lease of a copy of a computer program (lease of copyrighted article)
3. Sale of copyright rights
4. License of copyright rights
5. Provision of services in connection with the creation of a computer program
6. Provision of know-how relating to computer programs

It is important to appropriately characterize the source of income before determining how cross-border payments will be taxed. Historically, a payment considered a "royalty" would be subject to withholding tax, whereas income from a "sale or exchange" of property would be exempt from source country taxation (assuming lack of permanent establishment (PE) or other taxable presence).

Software Revenue Withholding Rates
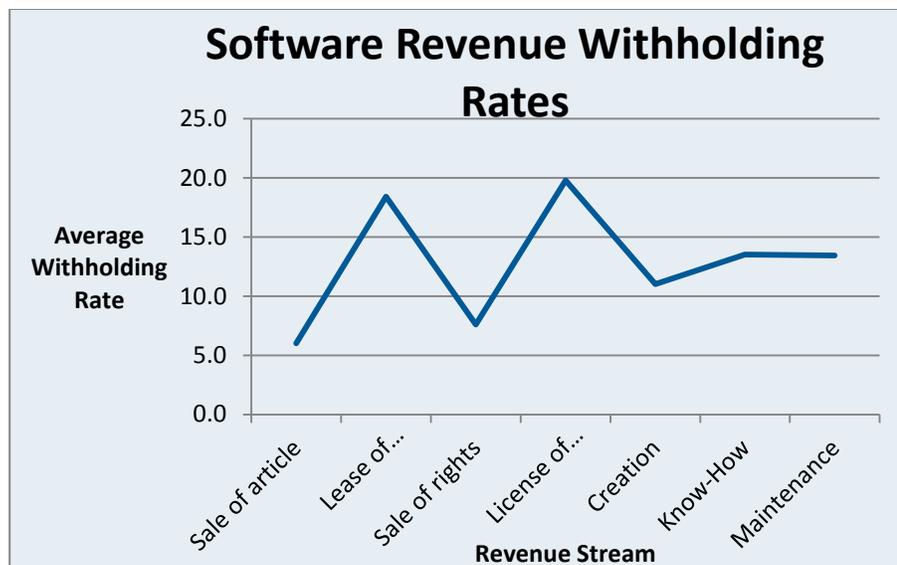
The statutory withholding tax rate applied in each country depends on several factors. These factors include residency status, treaty jurisdiction and income classification, *i.e.*, ordinary income, capital gains, dividends or royalties.

After removing data for transactions on which there is no tax, respondents indicated withholdings on each type of sales are levied at an average of 18-20 percent. Fewer than half of those surveyed indicated there is any tax withheld on the sale of an article, the sale of rights or services related to the creation of software. In the chart above, the 0 percent withholding rates were included in averages, producing significant variances between revenue types, but where a rate is levied, it is fairly consistent with that applied to other types and other jurisdictions.

In Austria, Canada, Denmark, Ireland, Israel, Singapore, Ukraine and the U.S., there is no withholding on the outright sale of a copyrighted article or sale of copyright rights. Each of these countries does, however, report withholding on the lease of copyright articles and copyright rights of 10 percent or higher.

2.4 – Provision of Services Related to Creation of a Computer Program – Does Country Where Services Are Performed Impact Withholding Tax?

With respect to the provision of services in connection with the creation of a computer program, does the country location where services are provided impact the application of withholding tax, *e.g.*, services provided within versus outside your country? Several countries indicated the location has an impact on withholding tax. In countries where location matters, it may determine the specific rate applied or if there is any withholding at all. In some jurisdictions, such as Cyprus, Israel and Germany, the rendering of service is not taxable unless it creates a PE. In some jurisdictions, *e.g.*, Japan, no withholding tax is levied on services performed outside of the country.

Yes	No
• Argentina	• China
• Austria	• Denmark
• Canada	• Germany
• Cyprus	• Ireland
• France	• Israel
• Japan	• Netherlands
• Singapore	• Russia
• Thailand	• Ukraine
	• United States

Of those countries that reported no impact, some do have withholding on this type of service income regardless of where the service is performed, like Russia, and some have no withholding regardless of location, such as the Netherlands.

2.5 – Provision of Services Related to Know-How – Does Country Where Services Are Provided Impact Withholding Tax?

With respect to the provision of services relating to know-how, does the country where services are provided impact the application of withholding tax, *e.g.*, services provided within versus outside your country?

Yes	No
• Austria	• Argentina
• Canada	• Germany
• China	• Ireland
• Cyprus	• Israel
• Denmark	• Netherlands
• France	• Russia
• Japan	• Ukraine
• Singapore	• United States
• Thailand	

Of the countries surveyed, the tax treatment of services related to know-how was consistent with that applied to services related to creating a computer program. The only exceptions to this consistency are Argentina, China and Denmark. While location has no bearing on withholding on software creation services in China and Denmark, it does

affect withholding on know-how-related services in those jurisdictions. In Denmark, for example, taxes are withheld from royalties unless they are paid to domestic entities.

Argentina recognizes withholding tax when advisory or technical assistance services are provided abroad; otherwise, country location does not matter. Denmark does not impose withholding tax on income and capital gains, only on dividends, interest and royalties for services in connection to creation of a computer program. However, royalties paid to entities located in Denmark are not subject to withholding tax with regards to services related to know-how.

2.6 – Provision of Services Related to Software Maintenance – Does Country Where Services Are Provided Impact the Application of Withholding Tax?

With respect to the provision of services relating to software maintenance, does the country where services are provided impact the application of withholding tax, *e.g.*, services provided within versus outside your country?

Yes	No
• Argentina	• Denmark
• Austria	• Germany
• Canada	• Ireland
• China	• Israel
• Cyprus	• Netherlands
• France	• Russia
• Japan	• Ukraine
• Singapore	• United States
• Thailand	

Responses from Argentina, China and Denmark were again the only inconsistencies in the application of withholding taxes on computer software services. Software maintenance services rendered outside of Argentina are not taxable, so location has a significant impact on the treatment of these services. This is consistent with that country's treatment of creation services but not with know-how services. Like know-how services (and unlike creation services), maintenance services are taxable under Chinese tax law. Any income from software maintenance services is included in licensing fee income, meaning taxes are withheld. Denmark does not withhold taxes on income or capital gains, so there is no withholding on maintenance services. Location only has an impact on withholding for royalty income in Denmark, so know-how-related services are the only services impacted by where they are performed.

2.7 – Is it Advantageous to Segregate Contract Payments Between Payments for Updates/Upgrades and Technical Support? If so, do Amounts Need to be Segregated on the Customer Invoice or Separate Invoice Issued?

Yes	No
• Argentina	• China
• Austria	• Denmark
• Canada	• Netherlands
• Cyprus	• Russia
• Germany	
• Ireland	
• Israel	
• Japan	
• Singapore	
• Thailand	
• Ukraine	
• United States	

Responses to the first question were overwhelmingly affirmative. Of the 17 countries that responded to this question, 12 indicated segregation of these payments would be advantageous. This is because, in general, income generated from technical support is taxable while income from maintaining updates and upgrades is considered part of the acquisition cost of the software and not taxable. Separate invoicing is mandatory in most jurisdictions, though not all. In countries such as China, there is no advantage to segregate contract payments because upgrades and technical support are both considered part of the licensing fee income and, ergo, both components of the payments are taxable.

2.8 – Describe the Role of Income Tax Treaties in Reducing Withholding Tax on the Following Streams of Income Under a Software Contract

The countries involved in the survey were asked to assess the impact of income tax treaties on software contract revenue streams based on the following transaction types:

1. Sale of a copy of a computer program (copyrighted article)
2. Lease of a copy of a computer program (lease of copyrighted article)
3. Sale of copyright rights
4. License of copyright rights
5. Provision of services in connection with the creation of a computer program
6. Provision of know-how relating to computer programs

7. Provision of software maintenance services

A variety of responses were provided for this question. Almost every responding country indicated that withholding taxes on some or all of the listed income streams would be eliminated or reduced by income tax treaties and/or double taxation agreements. In the Netherlands, the presence of a PE dictates that all revenues be subject to the general corporate income tax, so those seeking reduced withholding rates under their laws must be careful to avoid forming a PE. Many respondents said treaties only reduce the withholding rates on royalty income.

2.9 – Please Discuss the Application of Value-Added Tax or Other Indirect Taxes on the Following Software Contract Revenue Streams:

1. Sale of a copy of a computer program (copyrighted article)
2. Lease of a copy of a computer program (lease of copyrighted article)
3. Sale of copyright rights
4. License of copyright rights
5. Provision of services in connection with the creation of a computer program
6. Provision of know-how relating to computer programs
7. Provision of software maintenance services

Most respondents indicated that several, if not all, of these revenue streams are subject to a VAT or similar tax scheme. When it is applied, the value-added tax is typically levied at about a 20 percent rate. Sometimes the rate can be reduced or certain exemptions may be offered, depending on the type of program sold.

In some jurisdictions, such as Russia, there is no VAT when dealing with the sale of tangible software items. Argentina reports there is no VAT applied if a copyrighted article of software is economically utilized in another jurisdiction. In countries such as Japan, there is no tax for foreign enterprises selling software-related services as long as no PE exists.

The U.S. does not employ a value-added tax scheme, but various sales taxes may apply to a transaction depending on the state and/or municipality in which a sale originates. In Canada, all of the sales types listed above are subject to the goods and services tax/harmonized sales tax (GST/HST). The harmonized sales tax brackets consist of both a federal and a provincial rate portion, and provincial rates vary slightly.

3. Other Factors for Consideration

3.1 – Future of Cloud Computing

The largest emerging tax issue in most countries is the growing use of cloud computing to do business. Cloud-based business models pose many issues because it is difficult to classify the type and source of income related to the transfer of intangible property and/or provision of services that can be delivered electronically. U.S. tax law offers guidance for characterizing software transactions, generally as transfers of programs (leases, rentals, sales) or services that generate service income.

In determining the character of income, it is important to consider how the contracted price of the software compares to its actual value. One also should consider whether the customer takes physical possession of the software, has control over how and when the software is accessed, bears the costs of maintaining the software, has any recourse if the software fails and has exclusive rights to access the software.

Once the income is characterized, it can be sourced. Service income generally is sourced to the location in which it is performed, but this is difficult to determine in the context of cloud computing, so other analyses may be needed. In some instances, income has been sourced according to the location of capital assets, such as servers, and where any labor was done to prepare the product or service for delivery to the client. To the extent software services are automated, the location of servers can be a good indicator of where income should be sourced. This should not be the only criterion, however, because it is relatively simple to manipulate the placement of servers to reduce one's taxable presence in one jurisdiction or another. Assuming one follows the OECD principles, a server constitutes a taxable nexus if it is owned or leased, operated, in a fixed location and used to perform core functions of the business. Other factors to consider include the location(s) where payments are received, where correspondences are mailed and where disputes are to be resolved. According to the OECD, dependent agents concluding contracts also can create a taxable nexus.

4. Conclusion

In summary, the difficulties posed by characterizing cross-border software transactions for taxation are approached very differently in the various tax jurisdictions surveyed. Most jurisdictions attempt to identify transactions as one of the six basic categories that we provided, and a majority indicate they follow the principles of the OECD's example in characterizing these transactions. In sourcing service transactions related to creating programs, know-how and software maintenance, some jurisdictions consider the location where a service is performed, or whether or not a PE has been created. For various reasons, just as many respondents indicated these location factors matter as those who said location makes no difference.

A strong majority found that segregation of payments between maintenance and technical support aspects is beneficial. Nearly all respondents reported that tax treaties reduce or eliminate the withholding tax on these revenues. In those countries with a VAT system, most of these revenue types are subject to that tax.

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The information published here is intended as a brief summary of selected, recent legal developments. It is not intended to provide consulting advice and should not be relied on for that purpose. For this reason, do not rely on this information as tax advice or formal opinion or regard it as a substitute for detailed advice about your particular situation. Contact your Praxity, AISBL advisor for more detailed information.

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