Taxation issue of Indian software companies in Japan-Tabrez Ahmad

1 - 1 Japan is a significant business opportunity for growth of Indian software industry. Despite language being an apparent hindrance, the Indian software industry has shown combative skills and has trained its software engineers in the Japanese language. Now even large customers have started appreciating the IT solutions provided at competitive rates. While business credentials have been well established, tax issues are the single most important irritant for Indian IT sector in Japan. The following note explains the relevant provisions of Japanese domestic law and the Double Taxation Avoidance Agreement between India and Japan (DTAA) and also the vicious circle in interpreting the relevant provisions of domestic law and DTAA.Japanese domestic law:As per the domestic law, income from services, which are not rendered in Japan, is not sourced in Japan and hence the income is not liable to tax in Japan. However, the domestic law in Japan also provides that where Japan has entered into a tax treaty with any country then the provisions of the tax treaty shall prevail ('treaty override'). DTAA between India and Japan:As per the DTAA between India and Japan (Article 12), fees for technical services arise in the country where the payer is resident. As the customers of Indian software companies in Japan are resident in Japan, the payment made to Indian software companies for the off-shore (India based services) work is deemed to arise in Japan. Stand taken by National Tax Authority (NTA) in JapanThe NTA holds the view that consideration for offshore work is in the nature of "fees for technical services" liable to tax @ 20% on gross sales as per Article 12 of the India- Japan tax treaty.Ideal interpretation based on internationally accepted taxation principles:Income derived from both on-site business and off-shore business is in the nature of business profits. If the Indian software companies have a Permanent Establishment (PE) in Japan (through the branch) it is Article 7 of the DTAA that is relevant. Article 7 deals with the taxation of business profits that are attributable to the PE in Japan. This Article 7 deals with taxation of net income (profit) and not gross income as in Article 12. Further, only the net income that is attributable to the PE can be taxed in Japan. With this principle, the entire profit derived from on-site business in Japan can be taxed in Japan. Further, a small portion of the profit derived from off-shore business also can be taxed in Japan as the branch plays only a small role for these activities. Thus, the off-shore business should not suffer tax @ 20% of gross sales.

2 - 2 Vicious circle in interpretation of domestic law and DTAA:Assuming for a moment that the payments for off-shore services are in the nature of "fees for technical services" and covered by Article 12 (and not by Article 7 on business profits), then Article 12 states that the Japan may also tax it in accordance with its domestic laws of Japan but at a rate not exceeding 20% of the gross amount. Thus, in turn domestic law has to be applied, which does not permit taxation of income from services that are not rendered in Japan.The key issue is that the domestic law in Japan envisages a treaty override while the treaty directs the application of domestic law. This is a vicious circle, which has to be broken in favour of the tax payer.Proposal:Clarify the scope of Article 5: Permanent Establishment so that the business income from on-site development of software alone becomes liable to tax in Japan.Clarify that payment for software development based on specifications provided by customers in Japan does not amount to "fees for technical services".If the above clarification do not fructify for any reason, negotiate for reducing the rate of taxation to 10% instead of the existing 20%.Conclusion:The stand of NTA has upset the economics altogether It also makes no commercial sense in earning a profit through contracts and finally ending up with a post tax loss, owing to the stiff withholding rate of 20% on gross payments made.With such a heavy tax burden, it may not be profitable to carry on business in Japan. In order to ensure economically viable exports to Japan, the withholding tax aspect will have to be addressed forthwith. In this regard, the following proposal is put forth.Note: For more information, please feel free to contact: **Tabrez Ahmad Sr. Assistant Director – IT** Federation of Indian Chambers of Commerce & Industry Federation, HouseTansen Marg, New Delhi-1 Ph: +91-11-9891022688, Email: tabrez@ficci.com