BATES | COSGRAVE

FACTSHEET: IT SERVICES PERFORMED OVERSEAS SUBJECT TO ROYALTY WITHHOLDING TAX

IT SERVICES PERFORMED OVERSEAS SUBJECT TO ROYALTY WITHHOLDING TAX

INTERNATIONAL TAX FACTSHEET

Foreign businesses in Australia need to understand the difference between royalties and business profits – and how each are taxed in Australia.

If you are considered a foreign resident and have business interests in Australia, then it is vital to understand what, where and how you will pay tax in Australia. This is especially so if there is a double tax agreement in place.

It's even more important for companies with an Australian 'permanent establishment' to be aware of how international tax treaties treat relevant payments between countries.

When a business uses a mix of Australian and off-shore employees to deliver services, then it's possible that payments relating to services delivered overseas maybe considered as royalties rather than business profit and subject to withholding tax accordingly.

WHAT IS PERMANENT ESTABLISHMENT?

Permanent establishment typically includes a place of management; a branch; an office; a factory; or a construction site in a country that it does business.

The Australian Tax Office looks at multiple factors in determining what tax should be paid, such as:

- Whether Australia has taxing rights for the permanent establishment created in Australia.

- The relationship between the business profits in Australia and activities carried out overseas;
- Any payments relating to the offshore services .

The existence of the permanent establishment may be determined differently under our domestic law and under each double tax treaty.

A CASE STUDY: ROYALTIES AND TAX

The case before the Australian Federal Court focuses on the relationship between permanent establishment and royalties and how IT services are taxed in Australia.

The taxpayer was an Indian resident company that provided IT services to Australian customers. The company had offices in Australia that provided the IT services to Australian companies, however some of the services were also partly provided by employees in India.

The business services included computer technology services, such as the development, maintenance and enhancements of software in addition to one-off consulting and advisory services to their customers' IT infrastructure.

The taxpayer included income from both its Indian and Australian services in its 2008 income tax return and subsequently formed the view that income from its Indian services was not subject to Australian tax because it was not attributable to its permanent establishment in Australia.

The taxpayer lodged an objection to the assessment for income that year to exclude income and expenses referable to the Indian business.

The Australian Tax Office denied the objection on the basis that the Indian services revenue was assessable income and that gross revenue was subject to 15% royalty withholding tax (RWT).

The taxpayer disputed that Australia had taxing rights for the services. However the judge held that certain types of payments referable to the Indian services were in fact royalties as described in the taxation treaty that exists between Australia and India. This meant that the payments would be taxed on the gross basis as royalties as opposed to a net basis as business profits. Assuming that the ATO collects much more tax on the gross base however on royalties, the headline rate is 15% and half the company rate.

THE COURT'S VIEW

The core issue in the case was whether Australia had any taxing rights regarding the Indian services. This in turn, flags two additional issues:

- What is the relationship between the business profits and the royalties articles under the tax treaty?
- Are the payments in relation to the services performed in India in fact royalties?

The Full Federal Court concluded that the business profits article is to apply to business profits of an enterprise not covered by the royalty article that are attributable to a permanent establishment.

The paymen article may also apply to payments

that are effectively connected with permanent establishment.

However, it is not a case where a royalty may fall outside of the scope of the source State's taxation right by virtue of the exclusion under the royalties' article if the royalty is connected with a permanent establishment i.e when the business profits article does not give taxing rights to the source State in respect of that royalty, the royalty article will operate.

The payments in this case were held to be royalties because they were made in consideration for the services that made available technical knowledge, experience, skill and strategy, know-how and preferences that enabled the business to develop or transfer the technical plan or design.

MANAGING THE RISK

What this case exposed is that there is a tax risk under Australian tax treaties which include technical services within an expanded definition of royalty.

Working with an international tax expert can help companies to manage the risks.

For more information or assistance, please contact us on 02 9957 4033.

ABOUT US

Our Expertise

Domestically

Bates Cosgrave advises domestic and international businesses.

We provide highly personalised services across a wide range of industries with in-depth knowledge in real estate, renewable energy, import and distribution, health professionals, inbound and outbound investments, and innovative/start-up businesses.

Internationally

Although we are a boutique firm based in Sydney, we have access to a strong global network and specialise in advising cross-border transactions and global structuring.

OUR TEAM

Directors

MATT ZHOU

DIRECTOR

CA, B. COMM, M ACC, M TAX, MINTAX, CTA

VIEW ONLINE PROFILE

Matt joined Bates Cosgrave in April of 2007 as a manager and was promoted to Director from 1 July 2009. Matt has a reputation for his technical expertise and experience in specialist advice to professionals including medical doctors, professional investors and family offices, multinational companies.

His diverse knowledge on International tax, expatriates tax, employee share schemes, business structuring including cross border issues, CGT and GST is formidable.

His industry knowledge is broad and includes medical services, real estate, pharmaceuticals and technology companies. As tax advisors, we must think ahead and consider not just the current situation but the future.

Good advice reflects not simply value now, but lasting value.

GLENN COSGRAVE

DIRECTOR

CA, B.COMM, FTIA

VIEW ONLINE PROFILE

Glenn is passionate about business improvement and works with our clients to get the fundamentals of their business right, serving as a mentor through their business journey of establishment, growth and exiting when the time is right. His approach has helped many businesses evolve from start-up to commericalisation and ultimately setting up their business in the best possible position for sale.

Glenn's extensive experience as a strategic advisor ensures his clients have a clear focus for their personal and business goals, including a roadmap for future success and alignment of multidisciplinary advice to achieve best outcomes.

Glenn is also a professional adviser to engineers, valuers, project managers, accountants, lawyers and high net worth individuals, with a strong portfolio of clients in import and distribution, professional advisory and innovative businesses.

contact us

Bates Cosgrave

Chartered Accountants

Ground flour, 123 Walker Street

North Sydney NSW 2060

PO Box 497

North Sydney NSW 2059

P: +61 2 9957 4033

F: +61 2 9964 0610

E: enquiry@batescosgrave.com.au

BATESICOSGRAVE