Software companies, take heed: If you are doing business internationally or considering doing so — as most software companies are — you need to be aware of the withholding tax rules in the foreign countries in which you are doing or plan to do business. Companies that fail to consider and proactively minimize withholding taxes on international software transactions can see their after-tax income erode quickly.

Software companies need to be cognizant of the withholding tax rules in the countries where they are doing or planning on doing business. Withholding taxes can be 30 percent or more of gross software licensing income in many countries — an unpleasant surprise for an unprepared software vendor. For example, a U.S. company selling its software to a customer in Korea may negotiate certain payment terms, such as a percentage of the Korean customer’s top-line sales for embedding its software into their product. Many governments, including Korea’s, have rules that require the payer (customer) to withhold a large portion of its payment to the U.S. company and remit it to the local taxing authorities on the U.S. company’s behalf.

On the upside, U.S. companies may be eligible to claim withholding taxes as a credit against their U.S. income tax liability on their U.S. income tax return. However, given today’s economic environment, many U.S. software companies are not paying U.S. income taxes due to operating losses. Consequently, the tax credit is of little use. In a down economy, the last thing that most technology companies want is 30 percent of their revenues going to a foreign jurisdiction. As a result, companies should consider ways to reduce foreign withholding taxes to the greatest extent possible, which requires some advance planning.

Income tax treaties
One way to reduce foreign withholding taxes is through reliance on the network of U.S. income tax treaties. Among other things, income tax treaties provide for a reduced withholding rate on cross-border payments of royalties, interest and dividends. The treaty reduced rate is typically far more favorable than the local country domestic withholding tax rate (e.g., 30 percent). In some cases, withholding rates are reduced to zero percent. In order to take advantage of the favorable treaty rates, a U.S. company must submit formal documentation to its customers. The customers, in turn, submit this documentation to the local governments when a payment is made.
This documentation must specify that the U.S. company is electing to apply the terms of the treaty instead of the local country domestic law. In many countries, including the U.S., even if a treaty exists, without the proper documentation, customers that are residents in these countries will have no choice but to withhold the maximum rate under that jurisdiction’s domestic law.

From the customer’s perspective, failing to withhold income tax can result in severe consequences. While the income tax liability generated by the royalty/license fee belongs to the U.S. company, most governments hold both the customer and the service provider responsible for paying the income tax liability. In practice, the tax authorities frequently choose to pursue the local company for the tax payment instead of trying to collect from the service provider. Because of this joint liability, most customers/payers take a conservative position toward withholding tax.

Another approach is to draft the license agreement to ensure that the income stream is of a character that is not subject to withholding tax under that country’s domestic law. For example, most royalty payments are subject to local country withholding taxes. However, most countries do not impose a withholding tax on income from services performed outside of their country, or income from the sale of tangible personal property. Taking time initially to understand the income characterization rules of a particular country and how those rules apply to your product or service is often much more efficient than trying to convince your customer to stop withholding local country taxes after the contracts are signed and withholding has already begun. Worse yet is trying to get a refund from a government where taxes were erroneously withheld.

**Treaty shopping**

In cases where the U.S. does not have an income tax treaty with a country, another method is to use a third country with a favorable income tax treaty with the U.S. and the country of your customer. This is commonly referred to as treaty shopping. For example, assume you are about to sign a license contract with a customer in Country X. Your tax adviser informs you that the U.S. and Country X do not have an income tax treaty in place; therefore, your customer will be required to withhold local country taxes at the rate of 30 percent. However, Country M and the U.S. have a favorable income tax treaty with each other. Your adviser also informs you that Country M and Country X have a favorable income tax treaty in effect with each other. So, instead of receiving the licensing income directly from your customer in Country X, you establish a wholly owned subsidiary in Country M and enter into a license agreement with your subsidiary, which in turn enters into a back-to-back license with the customer. By using the back-to-back licensing arrangement, you may be able to avoid or reduce the Country X withholding taxes, without creating a withholding tax liability for your subcontractor in Country M.

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However, governments around the world are acutely aware of treaty shopping and are taking steps to reduce a taxpayer’s ability to use treaty shopping to avoid withholding taxes. Governments are preventing treaty shopping by revising treaties and adding limitations of benefit provisions, which now state that the favorable withholding rates will not apply to intermediary paper/shell companies. Since treaty-shopping provisions are becoming more prevalent, companies are advised to examine the recent changes to income tax treaties to determine whether their planned approach is acceptable under that particular treaty.

It’s also important to note that U.S. income tax treaties do not exist with all countries or in all parts of the world. While the United States has numerous treaties in Europe and Asia, it has very few income tax treaties with countries in South America.

In today’s economy, few software companies can afford to be caught unaware of international withholding taxes. It’s in all companies’ best interests to know what to expect and then do what they can in advance to minimize the tax implications, whether through income tax treaties or other approaches.

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For more information, contact:

**John R. Barber**
Partner
International Tax Services

T 408.346.4350
E John.Barber@gt.com

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