



Challenges On Taxation of Digital Economy

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Meaning of Digital Economy

- **Digital Economy**- Coined by Don Tapscott in 1994 in his book 'Digital Economy: Promise and Peril in the Age of Networked Intelligence'
- **Oxford Digital Economy Collaboration Group:**

The digital economy enables and conducts the trade of goods and services through electronic commerce on the internet. The digital economy is based on three pillars:

- a. supporting infrastructure (hardware, software, telecoms, networks, etc.),
- b. e-business (processes that an organisation conducts over computer-mediated networks) and
- c. e-commerce (transfer of goods online).

In the present situation where the use of Information Technology (IT) is more and more prevalent in our society, economic activities classified as digital economy are expanding their scale, and becoming diversified in their transaction forms.

Key Features of Digital Economy

Report of the Committee on Taxation of E-commerce:

As per the BEPS Report on Action 1, the following features being increasingly prominent in the digital economy and potentially relevant from a tax perspective characterise the digital economy:

- Mobility of (i) the intangibles on which the digital economy relies heavily, (ii) users, and (iii) business functions as a consequence of the decreased need for local personnel to perform certain functions as well as the flexibility in many cases to choose the location of servers and other resources.
- Reliance on data, including in particular the use of so-called “big data”.
- Network effects, understood with reference to user participation, integration and synergies.
- Use of multi-sided business models where, two sides of the market may be in different jurisdictions.
- Tendency toward monopoly or oligopoly in certain business models relying heavily on network effects.
- Volatility due to low barriers to entry and rapidly evolving technology.

All the features may not be present at the same time in any particular business.

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- India has a territorial system of taxation for non-residents
 - Global Taxation of its Residents
 - Companies are taxable only if Registered in India or Control and Management is wholly in India

Domestic Law on Digital Economy

- Section 5 of the Income Tax Act, 1961
- Subject to the provisions of this Act, the total income of any previous year of a person who is a non-resident includes all income from whatever source derived which
 - (a) is received or is deemed to be received in India in such year by or on behalf of such person; or
 - (b) accrues or arises or is deemed to accrue or arise to him in India during such year.

Explanation 1: Income accruing or arising outside India shall not be deemed to be received in India within the meaning of this section by reason only of the fact that it is taken into account in a balance sheet prepared in India.

Explanation 2: For the removal of doubts, it is hereby declared that income which has been included in the total income of a person on the basis that it has accrued or arisen or is deemed to have accrued or arisen to him shall not again be so included on the basis that it is received or deemed to be received by him in India.

Business Connection Definition

- Section 9(1) of the Income Tax Act, 1961

The following incomes shall be deemed to accrue or arise in India :—

- (i) all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, [* * *] or through the transfer of a capital asset situate in India

Explanation: For the removal of doubts, it is hereby declared that for the purposes of this section, income of a non-resident shall be deemed to accrue or arise in India under clause (v) or clause (vi) or clause (vii) of sub-section (1) and shall be included in the total income of the non-resident, whether or not,—

- (i) the non-resident has a residence or place of business or business connection in India; or
- (ii) the non-resident has rendered services in India.]

Domestic Law Consequence's

- **Section 40(a)(i) of the Act : Amounts not deductible.**

40. (1) Notwithstanding anything to the contrary in sections 30 to [38], the following amounts shall not be deducted in computing the income chargeable under the head "Profits and gains of business or profession",—

(a) in the case of any assessee— [(i) any interest (not being interest on a loan issued for public subscription before the 1st day of April, 1938), royalty, fees for technical services or other sum chargeable under this Act, which is payable,— (A) outside India; or (B) in India to a non-resident, not being a company or to a foreign company, on which tax is deductible at source under Chapter XVII-B and such tax has not been deducted or, after deduction, has not been paid [on or before the due date specified in sub-section (1) of section 139] : [**Provided** that ...]

Explanation.—For the purposes of this sub-clause,—

(A) "royalty" shall have the same meaning as in *Explanation 2* to clause (vi) of sub-section (1) of section 9;

(B) "fees for technical services" shall have the same meaning as in *Explanation 2* to clause (vii) of sub-section (1) of section 9;

Domestic Law Consequence's

- **194J.** (1) Any person, not being an individual or a Hindu undivided family, who is responsible for paying to a resident any sum by way of—
 - (a) fees for professional services, or (b) fees for technical services, [or] [(ba) , or] [(c) royalty, or (d) ,] shall, at the time of credit of such sum to the account of the payee or at the time of payment thereof in cash or by issue of a cheque or draft or by any other mode, whichever is earlier, deduct an amount equal to [ten] per cent of such sum as income-tax on income comprised therein :

Explanation.—For the purposes of this section,—

(a) "professional services" means services rendered by a person in the course of carrying on legal, medical, engineering or architectural profession or the profession of accountancy or technical consultancy or interior decoration or advertising or such other profession as is notified by the Board for the purposes of section 44AA or of this section;

(b) "fees for technical services" shall have the same meaning as in *Explanation 2* to clause (vii) of sub-section (1) of section 9;

[(ba) "royalty" shall have the same meaning as in *Explanation 2* to clause (vi) of sub-section (1) of section 9;]

(c)

Domestic Current Law on International Transactions

- Can be assessed in India if attributable to a business connection
- Meaning of Business Connection

CIT v. R D Aggarwal & Co 56 ITR 20 (SC) :

- 1) Element of continuity between the business of the non-resident and the activity in the taxable territories
- 2) A stray or isolated transaction is normally not to be regarded as business connection
- 3) A relation to be a business connection must be real and intimate and through or from which income must accrue or arise whether directly or indirectly to the non-resident

Held: Sales made through an agent in India not taxable

Challenges on Taxation of Digital Economy

- Characterization
- Source v/s Residence
- There is great ambiguity surrounding determination of jurisdiction where income can be said to be sourced at or accrued and hence the questions.
 - a. How enterprises in the digital economy add value and make their profits?
 - b. How the digital economy relates to the concepts of source and residence or the characterization of income for tax purposes

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- Income can be assessed without Business Connection if Royalty or Fees for Technical Services
 - Sale of goods manufactured and sold outside India not taxable in India

Ishikawajima-Harima Heavy Industries Ltd v. DIT 288 ITR 408 (SC)

Carborandum Co. v. CIT 108 ITR 335 (SC)

CIT v. Toshoku 125 ITR 525(SC)

Consequences of treatment as taxable either as Business Income or Royalty/FTS

- Withholding Obligations / Possibility of treatment as representative assessee
- Disallowance of expenses {u/s. 40(a)(i)}
- In hands of recipients, all consequences of withholding, penalty, interest, return filing obligations, etc

We love the 1960's – Part 1

- Section 90 has been amended by the following Finance Act(s)
 - Finance (No 2) Act 2009
 - Finance Act 1972
 - Finance (No 2) Act 1991 (w.r.e.f. 1-4-1972)
 - Finance Act 2001 (w.r.e.f. 1-4-1962)
 - Finance Act 2003
 - Finance (No.2) Act 2004 (w.r.e.f. 1-4-1962)
 - Finance Act 2013
 - Finance Act 2012 (Explanation-3 w.r.e.f. 1-10-2009)

We love the 1960's – Part 2

- *Section 9(1) of the Act, retrospective amendment*

Explanation 4.—For the removal of doubts, it is hereby clarified that the expression "through" shall mean and include and shall be deemed to have always meant and included "by means of", "in consequence of" or "by reason of".

Explanation 5.—For the removal of doubts, it is hereby clarified that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India.

We love the 1960's – Part 3

- Section 9(1)(vi) amended retrospectively by Finance Act, 2012

Explanation 4.—For the removal of doubts, it is hereby clarified that the expression "through" shall mean and include and shall be deemed to have always meant and included "by means of", "in consequence of" or "by reason of".

Explanation 5.—For the removal of doubts, it is hereby clarified that the royalty includes and has always included consideration in respect of any right, property or information, whether or not—

- a) the possession or control of such right, property or information is with the payer;
- b) such right, property or information is used directly by the payer;
- C) the location of such right, property or information is in India

We love the 1960's – Part 4

- *Explanation 6.*—For the removal of doubts, it is hereby clarified that the expression "process" includes and shall be deemed to have always included transmission by satellite (including up-linking, amplification, conversion for down-linking of any signal), cable, optic fibre or by any other similar technology, whether or not such process is secret;

Ishikawajma-Harima Heavy Industries Ltd v/s DIT

288 ITR 408

- Sufficient territorial nexus with India necessary for taxation of income
- Two Conditions working simultaneously
 - A) Must be utilized in India
 - B) Must be rendered in India

Sympathy with Government

- Notification No 91 of 2008 dated 28/08/2008 defines the expression 'may be taxed'
- Wherever the term 'may be taxed' occurs in any DTAA has to be understood as chargeable under the domestic law, subject only to any relief in accordance with the provisions of the agreement.

Current International Treaty Law

- Residence v/s Source
- Article 5 – Definition of Permanent Establishment
- Article 7 – Business Income
- Article 12 – Royalty and FTS
- Article 13 – Capital Gains
- Article 23 – Other Income

E-commerce and Treaties - Issues..

- Income taxation a worry?
- Old concepts of taxation may no longer be relevant particularly under the treaties
- Lot more than mere selling through the internet
- Characterization of payments a vexed issue
- Server/ website – a fixed place of business
- UN/OECD/India/ other countries and courts have expressed their views on e-commerce taxation
- No solution found to source taxation

Selling intangibles through the internet

- Sale of intangibles – know-how, copyrights, trademarks etc.
- Electronic ordering and downloading of F co's digital products
- Updates and add-ons
- Limited duration software and other digital information licences
- Royalty or Business profits?
- OECD/UN and India's view

Article 5 – Permanent Establishment

- Fixed Place PE
- Service PE
- Agency PE
- DIT v. B4U International Holdings Ltd. 374 ITR 453 (Bom)
- Set Satellite (Singapore) Pte. Ltd. V. DDIT 307 ITR 205 (Bom)

Article 7 – Business Income

- Characterisation
- Taxability
- Source
- Attribution

Article 12 – Royalty and FTS

- Characterisation
- Intellectual Property Rights v/s Goods
- License v/s Sale
- License v/s Use
- Copying
- Make available
- Whether technical in nature?
- DIT vs. New Skies Satellite, 382 ITR 114 (Del)
- DIT v. Haldor Topsoe 369 ITR 453 (Bom)
- DIT vs. Infracsoft Ltd. 264 CTR 329 (Del)

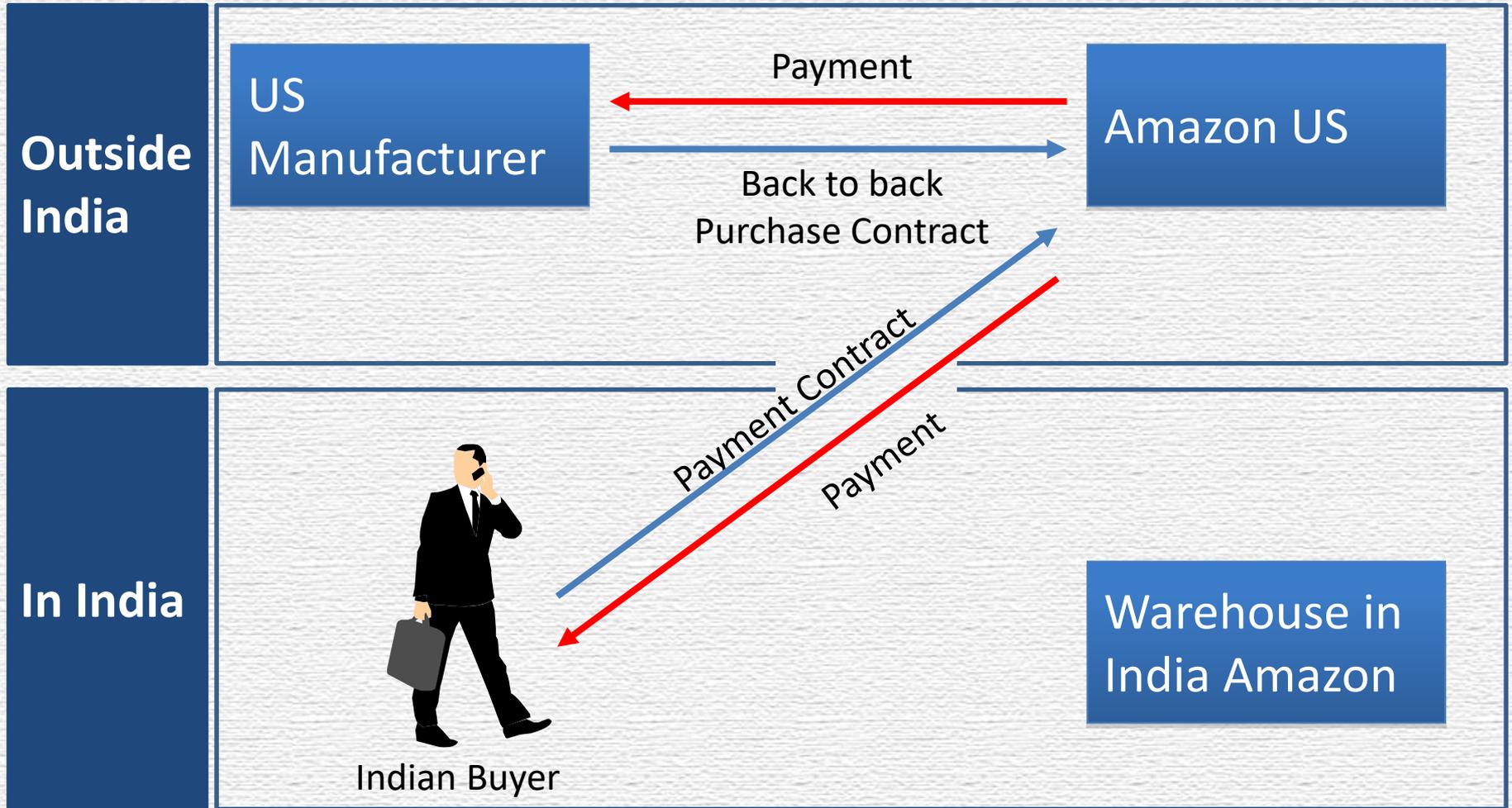
Article 13 – Capital Gains

- Situs of assets
- CUB Pty Ltd. v. UOI, 388 ITR 617 (Del)
In case of transfer of intangible asset, situs of owner of an intangible asset would be closest approximation of situs of an intangible asset. Accordingly, income accruing to assessee from transfer of its right, title or interest in trademark was held not taxable in India.
- Sanofi Pasteur Holding SA, 354 ITR 316 (AP)
Situs of asset being shares of French company held to be situated outside India

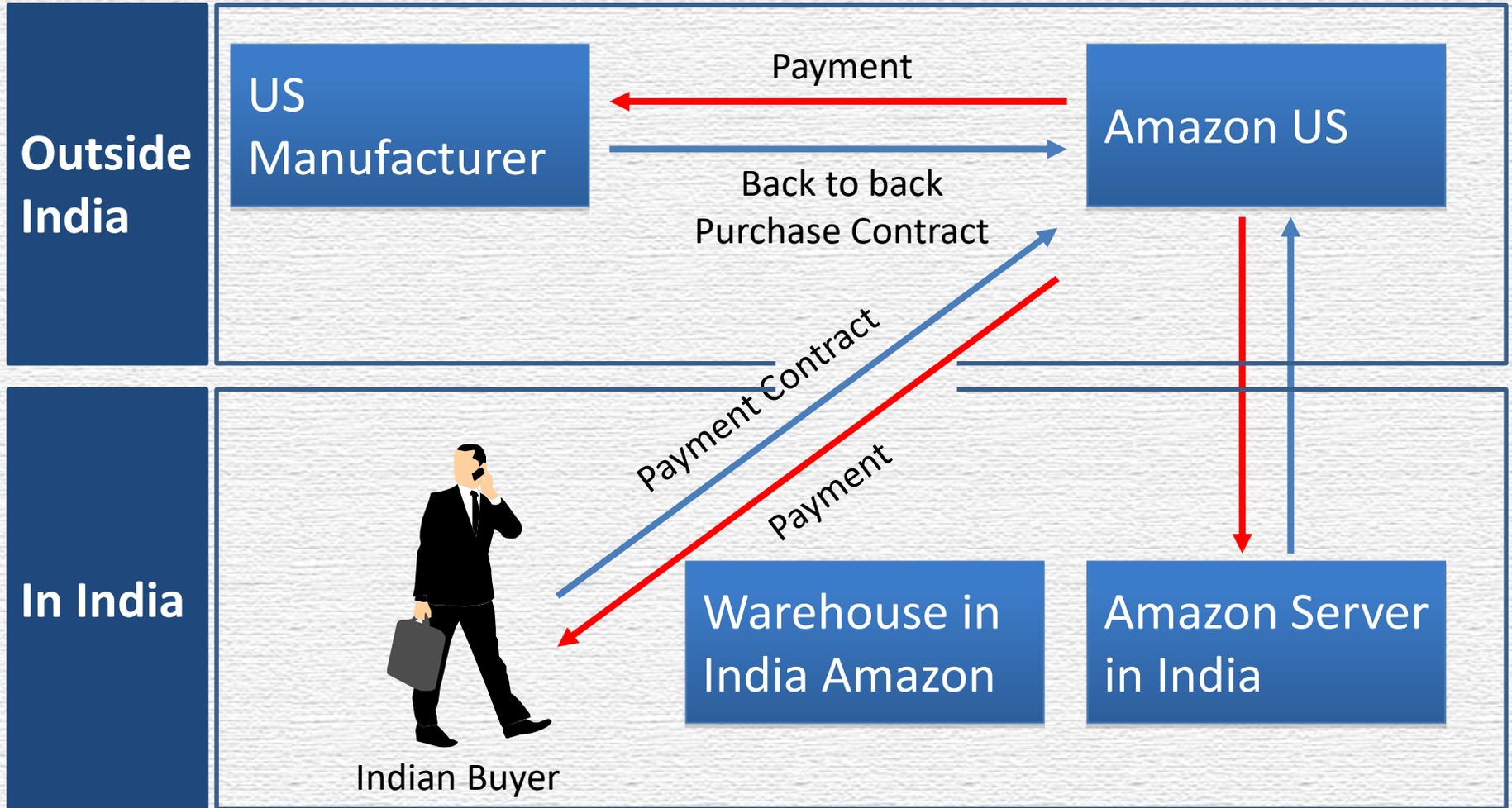
Article 23 – Other Income

- None of the above articles / clauses applies

Sale of Goods



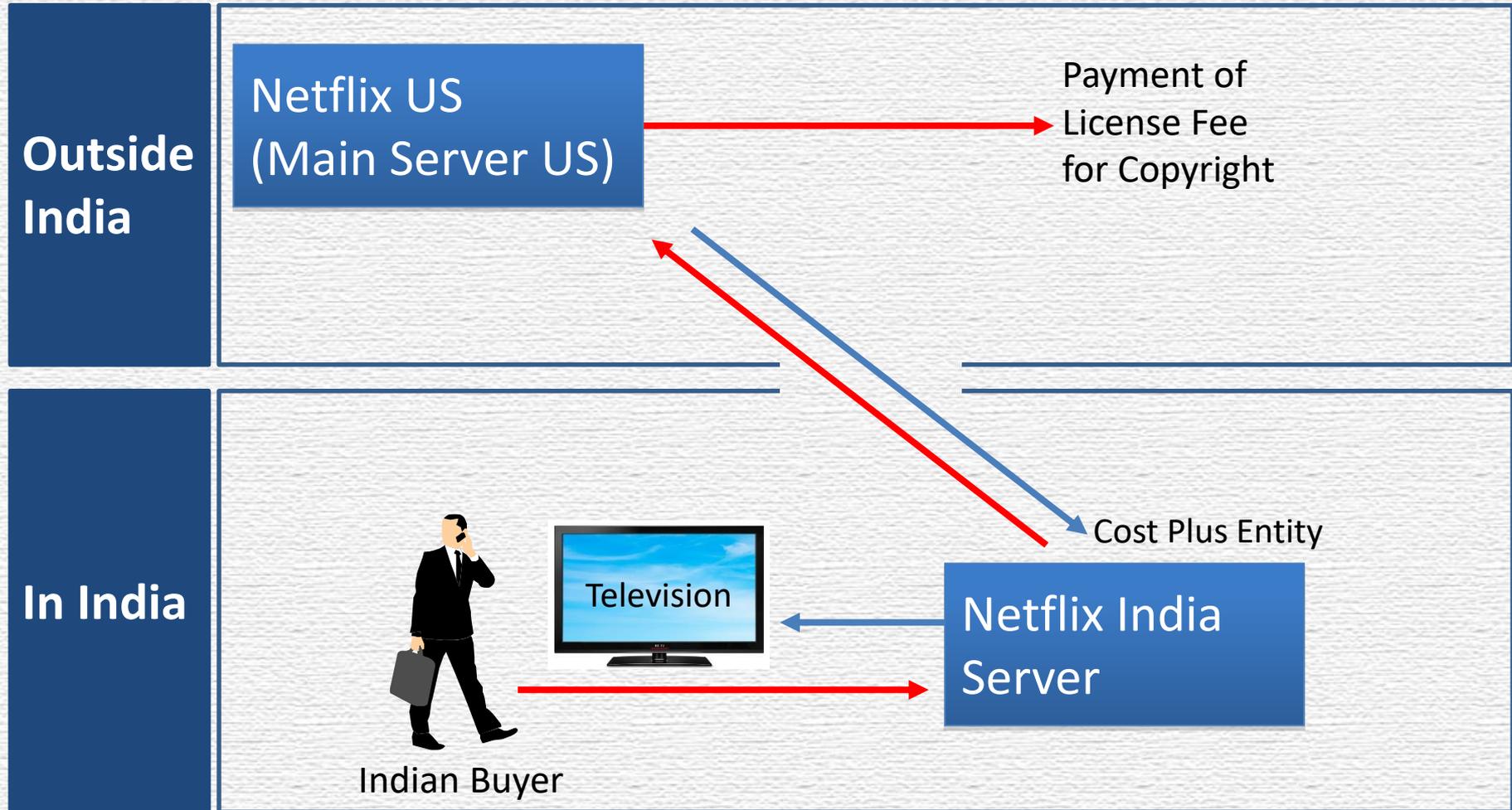
Sale of Goods



Issues

- Where is the sale complete?
- Is the payment for use of Amazon Server Royalty or FTS
- Is there relevance of warehouse in India (Agent)

Sale of Services/Intangible Right



Determination of Source

- Is the payment for streaming service Royalties and therefore taxable in India?
- Place where payment of License fee for Copyright is made by Netflix US?
Outside India
- Place where the main server resides?
Outside India
- Place where payment for Streaming Service is made i.e. where the viewer resides?
In India

Leading Indian Decisions

Tata Consulting services 271 ITR 401 (Sc)

- Computer programs are the product of intellectual process, but once implanted in a medium they are widely distributed to computer owner
- The copyright in that programme may remain with the originator of the programme
- Moment copies are made and marketed, it becomes goods, which are susceptible to sale tax
- Even intellectual property once it is put on media, whether it be in the form of book or canvas or computer discs or cassettes and marketed would become good

Google and Yahoo Payments

Right Florists (P.) Ltd. 143 ITD 445 (Kol)

- Online advertising fees paid to foreign search engine company is not fees for technical services and is not taxable in India due to absence of permanent establishment of such foreign company in India

Pinstorm Technologies (P.) Ltd 54 SOT 78 (Mum)

- Payment made by assessee to non-resident for uploading and display of banner advertisement on non-resident's portal would not be liable for tax deduction at source in absence of any PE of non-resident in India

Dun & Bradstreet Espana S.A. 272 ITR 99 (AAR) and In re. ABC Ltd 284 ITR 1 (AAR)

- Taxability of payments for standardized ‘Business Information Reports’ publicly available on the Internet upon payment of subscription charges
- Such reports typically provide factual information about a company such as location, existence, operation, financial condition, pending litigation, etc along with rating of the company
- Emerging judicial view:
 - Even though such reports are copyright protected, payments for purchase of such reports are akin to payments for copyrighted article and not constituting “royalty”

Digital sale whether sale of good or license of Royalty

Positive decisions

- DIT v/s Nokia Network OY 358 ITR 259 (Del)
- DIT v/s Ericsson A.B 343 ITR 470 (Del)
- DIT v/s Infracsoft Ltd 264 CTR 329 (Del)
- CIT v/s Dynamic Vertical Software India (P.) Ltd 332 ITR 222 (Del)

Negative decision

- Samsung Electronics Co. Ltd. 345 ITR 494 (kar)
- Sonata Information Technology Ltd 207 Taxman 108 (Kar)
- CGI Information Systems & Management Consultants (P.) Ltd 275 CTR 72 (Kar)
- SkillSoft Ireland Ltd., In re 376 ITR 371 (AAR)
- ThoughtBuzz (P.) Ltd., In re 346 ITR 345(AAR)

Reservation on OECD Commentary

Right Florists (P.) Ltd. 143 ITD 445 (Kol)

- The Government of India 's reservations on the OECD Commentary are relevant only to the extent that OECD Commentary, to that extent, cannot be treated as a fair index of intention of the Government of India and as contemporanea expositio in respect of tax treaties entered into by India after so expressing its reservations. Beyond that, these reservations have no role in judicial analysis

Equalisation Levy

- India introduced Chapter VIII – Equalisation Levy in Finance Act, 2016 aiming to bring income generated by the digital economy within the ambit of taxation in India.
- The provisions of this chapter are applicable to an Indian resident who carries out business or profession, or a non-resident having PE in India making payment of more than one lakh rupees to a non-resident not having PE in India, to avail of ‘specified services’

Oil & Natural Gas Corporation Ltd. V Commissioner of Income-tax 376 ITR 306

- Payment for providing various services in connection with prospecting, extraction or production of mineral oil, would be assessed under section 44BB, and not under section 44D

Indian Judiciary's Role in solving International Tax Disputes

- Maximum International tax judgements from India, more than all countries put together
 - Onerous responsibility on judiciary
 - True for both domestic and international disputes
 - NTT – CJ Bharucha
 - HC must be involved
 - Executive interference in Judiciary
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IFA

- Largest non sectoral tax organization in the world
- Established in 1938
- Signature annual congresses held across the world
 - 2014 Mumbai

History of Tax Treaty

- Earliest Treaty was adopted by Prussia around the start of the Twentieth Century
- First Treaty was with Austria signed in 1899
- In 1920 league of nations began to play a leadership role
- 1928 published the first internationally important Model Tax Conventions
- After World War I, Germany signed a treaty with Czechoslovakia in 1921 and with Austria in 1922
- The league of Nations began publication on tax treaties in 1923
- The OECD become the organization for economic Cooperation and Development

Object of Tax Treaties

- Treaties cannot levy tax but can give relief- Azadi Bacho Andolan 263 ITR 706 (Sc)
- The Andhra Pradesh High Court in Sanofi's 354 ITR 316 (AP) made some key observations about the importance of DTAA's and their relevance in the global scenario
- In recognition of the pejorative effect of double taxation on exchange of goods and services and movement of capital, technology and persons, agreements/treaties/conventions/ protocols were entered into for removing obstacles that double-taxation presents to development of economic relations between nations
- Treaties or Conventions are thus instruments signaling sovereign political choices negotiated between States to avoid double taxation through restriction of tax claims in areas where overlapping tax claims are expected, or at least theoretically possible

Leading International Tax models and commentary

- OECD Model Tax Convention on Income and on Capital
- United Nations Model Double Taxation Convention between Developed and Developing Countries
- United States Model conventions
- Klaus Vogel on Double Taxation Convention
A Commentary to the OECD, UN and US Model Conventions
- Philip Baker on Double Taxation Convention

Adjudicating Forums in India

- High Court / Supreme Court
- Tribunal
- Mutual Agreement Procedure
- Advance Pricing Agreement
- Authority of Advance Ruling
- Settlement Commission
- Union Cabinet

Adjudicating Forums not available in India

- Arbitration (Article 25 of the OECD and UN Convention)

Basic Treaty Principles

- Treaty commitments must be honored by the parties in good faith.
- A party may not invoke the provisions of its internal law as justification for its failure to honor its treaty commitments.
- A treaty should be interpreted in good faith in accordance with the ordinary meaning of its terms, in their context and in light of its object and purpose.

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- General rule of interpretation [Article 31]
 - “A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.”
 - “The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:
 - (a) any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty; ...”

Ram Jethmalani v.s Union of India 339 ITR 107(SC)

India

- The **Courts** in India freely use International Court decisions especially from the Commonwealth countries and the United States and is fairly receptive to the OECD Commentary and views of International academicians
- Azadi Bachao Aandolan 263 ITR 706(SC)
- Drafted by Diplomats and not by lawyers
- Application of Principle of good faith
- Vienna Convention - Article 31
- Ram Jethmalani v. UOI 339 ITR 107(SC)



*International case
laws/judgements*

Zimmer Ltd. (France, March 2010)

- Facts: Starting in 1995, UKCo distributed orthopedic products through a French related company acting as a *commissionnaire* (after the French company had been a full distributor for many years)
 - Does UKCo have a PE in France under the dependent agent provision of France-UK treaty?
-

Dell Products (Norway)

- Supreme court of Norway
- Decision of 2 December 2011
- Agency PE
- Parallel with Zimmer Ltd

Dell Products (Norway)

Netherlands

Incorporation



Ireland

POEM and Residence

No employees



Commissionnaire
for sales to
enterprises



Norway

Taxable income:
1% of gross sales

Dell Products (Norway)

Supreme court's decision –

- No agency PE
- Independence was not argued in Supreme Court
- Legally binding vs “in reality” binding
- Undisputed that Dell Products will not be legally bound by the contracts
- Paragraph 32: only activities from “persons having the authority to conclude contracts can lead to a PE”
- Refers to Zimmer decision
 - Clarifies the part of Zimmer dealing with “du contrat de commission ou de tout autre élément de l’instruction”
- Refers to the fact that Dell has similar agreement in 15 countries; none has argued that there is a PE (see, however, subsequent Spanish decision)

Dell Products (Spain)

- Decision of TEAC (*Tribunal Económico-Administrativo Central*, an administrative tribunal) *dated 15 March 2012*
- Decision under appeal
- Basic facts similar to those of the Norwegian case

Dell Products (Spain)

TEAC decision:

- There is a fixed place of business PE because:
 - “At the disposal” is a factual concept, not requiring a formal legal right entitlement; the premises of the subsidiary were, *de facto*, used to provide services and to allow the Irish company to perform its activity in Spain
 - Art. 5(7) does not mean that a subsidiary cannot be a PE if the activity of a related entity is carried on through the fixed place of business of that subsidiary
 - The functions performed by the subsidiary corresponded to the business activities of the Irish company
 - The Irish company used the personnel of the subsidiary and supported the related costs

Dell Products (Spain)

- There is a fixed place of business PE because:
 - Personnel of the subsidiary rendered services related to the website
 - In any case, Spain's observation on paragraphs 42.1 to 42.10 of the Commentary should be taken into account
 - The functions and activities performed by the subsidiary were an essential part of the core commercial activity of the Irish company

Dell Products (Spain)

- There is an agency PE because:
 - Substance over form approach to the conditions of Art. 5(5); reference to para. 34 of the OECD Commentary; facts showed that the subsidiary acted as a dependent agent (e.g. instructions, decision on prices, inspections, purchase authorization, trademark control etc.)
 - Reference to para. 32 and 38 of the OECD Commentary
 - Reference to the *Roche* decision and para. 40 and 41 of the OECD Commentary on Art. 5(7): a subsidiary can be a dependent agent PE
 - Spanish subsidiary acted “on behalf of” Irish company (“indirect representation”), which is the situation envisaged in para. 38.7 of the Commentary [*but this paragraph refers to the meaning of “acting in the ordinary course of their business” in Art, 5(6)*]
 - The agency activity of the Spanish subsidiary was exclusively performed for the Irish company