

EXECUTIVE SUMMARY

The Indian Government had constituted the High Powered Committee (“HPC”) in December 1999, to examine the position of e-commerce transactions under existing taxation laws, to determine changes, if any, required to be made and the implementation of the taxation of e-commerce transactions. The HPC submitted its report to the Government in July 2001, which was made open to the public for comments in September 2001. At the outset we would like to applaud the HPC for having undertaken a herculean task of attempting to address the issue of e-commerce taxation. The HPC has made a laudable effort in addressing the complex issues relating to taxation of this new economy form of business. The Government, realising the significance of e-commerce to the Indian economy, in a welcome move has invited public comments on the report of the HPC (“Report”). We believe that the Indian Government recognises that the observations of the HPC reflect only one view, and hope that the Indian Government will reserve judgment on the subject until all propositions have been heard.

With a view to provide a global perspective on the taxation of e-commerce to the Government of India, Mr. Nishith Desai, the founder member of Nishith Desai Associates (“NDA”), a legal and tax counselling firm has through his firm NDA, approached renowned and eminent experts in the field of international taxation, including academicians, professionals and industry experts around the world both from developed and the developing countries and convened a group called the “eComTaxpert Group”.

The eComTaxpert Group (“Group”) comprises the following individuals (in alphabetical, first name order):

Academicians & Professionals

Duncan Bentley

*Dean, School of Law, Bond University,
Australia*

Gary Sprague

Partner, Baker & McKenzie, United States

Gurbachan Singh

*Partner, Head of Tax & Estate Management,
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Prof. Hubert Hamaekers

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Industry Representatives

Bill Sample

*Senior Director, Tax & Tax Affairs,
Microsoft Corporation, United States*

Jeanne Goulet

*Director, Taxes-Software, IBM, United
States*

Kiran Karnik

*President, National Association of
Software and Service Companies
(NASSCOM), India*

Academicians & Professionals

Dr. Klaus Vogel

Professor, Munich, Germany

Nishith M. Desai

*Founder, Nishith Desai Associates, India and
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Dr. Philip Baker

*Barrister and Professor, Queen Mary,
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Peter Barnes

*Tax Counsel - International, GE
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Raymond Chin

*Head, Group Tax Department,
Usaha Tegas Sdn Bhd, Malaysia*

Suresh C. Senapaty

*Corporate Executive Vice President-
Finance, Wipro Limited, India*

The Objectives

The objectives of the Group are:

- To give constructive feedback on the Report to the Government, taking into account views of eminent academicians, tax professionals and industry experts across the globe;
- To examine the Report as to whether:
 - the interpretation of Indian law is correct;
 - the interpretation of tax treaties is in line with the international principles of treaty interpretation
- To examine whether the policies recommended by the HPC are appropriate and whether they are in sync with global policies, and examine the implications of the implementation of the Report in India and in other countries, especially in relation to double taxation treaties;
- To enable the public to present a global perspective on e-commerce tax before the income tax authorities in India.

The Methodology

The approach adopted by the Group in the preparation of this report was to first understand in depth how the transactions happen in the e-commerce arena with due consideration to the technological aspects. The Group then extensively read, reviewed and studied the

reports of the Technical Advisory Groups of the Organisation for Economic Co-operation and Development (“OECD”), Article 12 of the OECD commentaries, the US treasury rules on software revenue characterisation and several other books. The members of the Group held numerous meetings, conference calls and corresponded extensively to study the Report and provide their inputs on international law related to the taxation of e-commerce and its implications on the Indian economy. The Indian tax professionals, Mr. Soli Dastur and Mr. Nishith Desai, have discussed at great length issues arising in relation to the Indian tax laws and other international tax aspects were discussed with other members of the Group. Further, the Group also had the benefit of the reports submitted by, renowned accounting firms, Pricewaterhouse Coopers LLP, USA, and Bharat S Raut & Co. The Group has read the representations as given by the aforementioned firms while formulating its report.

The Observations

The Group believes that Indian economy will continue to prosper in the e-commerce arena given the reduced barriers to entry and India’s highly trained English-speaking, low-cost workforce. Generally, the macroeconomic effects of e-commerce should be to expand the aggregate economic profits in the global economy rather than to merely shift existing profits among jurisdictions. In a fashion similar to the industrial revolution, e-commerce can affect business in all spheres across the world. E-commerce efficiencies will increase the gross national product of all countries. The economic benefits of e-commerce business models have already provided various efficiencies to existing businesses and should allow new entrants into the marketplace at all levels of commerce. New and established domestic enterprises of all countries should be able to enjoy exactly the same distribution and other efficiencies. Accordingly, while it cannot be denied that it is likely that e-commerce (much like the industrial revolution) will change the nature of existing businesses, the Group believes that the net effect on business will be positive across the global economy, and especially so in India.

The Group also observes that India would be playing a leading role in the development of e-commerce, technology, e-business models, IT outsourcing and call centers. The Group firmly believes that it is incorrect to assume that e-commerce will shift economic growth and tax base away from India. On the contrary, the Group is of the view that the Indian economy is poised to gain immensely from the growth of e-commerce. The Group believes that the imposition of entry barriers such as improper taxation of e-commerce may ultimately harm developing countries like India. As in the industrial revolution, some existing businesses will prosper as a result of e-commerce, while others may fail. Most importantly, however, new

businesses, jobs and levels of expertise in many unanticipated areas (e.g., data warehousing) will be created.

The OECD has formed the Technical Advisory Group on Treaty Characterisation Issues arising from E-Commerce (“**IC TAG**”). The OECD has laid down the principles of neutrality, efficiency, flexibility, certainty, simplicity, effectiveness and fairness (Ottawa framework conditions). The Group appreciates that the HPC has expressed conformity with the basic fundamental principles laid down by the OECD. However, while characterising some of the transactions identified by the IC TAG, the HPC has deviated from these principles. e.g. the HPC has accepted the proposition that difference in the mode of delivery should not result in change in characterisation of income. However, in the characterisation of Category 1 and 2 by the HPC, where the only difference is the mode of delivery, HPC has changed the characterisation of income. In Category 1 the mode of delivery is physical, whereas in Category 2 the mode of delivery has changed to digital.

The characterisations recommended by the HPC are also in conflict with the existing OECD Commentary on Article 12; and generally in conflict with most existing and emerging rules regarding the characterization of software transactions. In respect of the above it may be noted that no reasoning has been given by HPC for its divergence from these views. It would also be important to take into consideration observations made by the Indian court¹ on OECD commentaries in 1983:

“In view of the standard OECD models which are being used in various countries, a new area of genuine ‘international tax law’ is now in the process of developing. Any person interpreting a tax treaty must now consider decisions and rulings worldwide relating to similar treaties. The maintenance of uniformity in the interpretation of a rule after its international adaptation is just as important as the initial removal of divergences. Therefore, the judgments rendered by courts in other countries or rulings given by other tax authorities would be relevant.”

The Group is in agreement with certain segments of the Report wherein the HPC has expressly stated that there is no policy justification to exempt net income derived from e-commerce from all direct taxation and that technological neutrality is a fundamental policy point.

In order to avoid an assumed, but unsubstantiated, erosion of the Indian tax base, the HPC has examined the “base erosion approach”² as an alternative method to tax e-commerce.

1. *Commissioner of Income Tax v. Visakhapatnam Port Trust*, [1983] 144 ITR 146 (Andhra Pradesh High Court).

2. This is an approach advocated by Prof. Richard Doernberg where tax at low rates on all cross border payments would be imposed for goods and services on a gross basis in lieu of an income tax.

This approach is contrary to the international consensus that, withholding taxes are appropriate only in certain limited cases (*e.g.*, on source based interest, royalty, and dividend payments). The base erosion approach is a radical departure from this consensus, and is in conflict with the internationally accepted standards on when a jurisdiction has the right to impose an income tax on a non-resident enterprise. The Group cautions that any unilateral move on India's part to adopt such an approach may stifle the growth of e-commerce in India and may lead to disputes between India and its various treaty partners. Further, in the formation of its taxation rule, India should also consider the issues relating to the World Trade Organisation ("**WTO**"), since it might expose India to intricate issues in relation to the WTO.

The Group does not agree with the apparent macroeconomic assumption in the Report that e-commerce will cause a significant tax base erosion for India. On the contrary, it can be expected that India and other developing economies will be significant beneficiaries of e-commerce business efficiencies. E-commerce business methods are available to any enterprise, and because the communication efficiencies created by e-commerce reduce barriers to entry for producers of many goods and services, it is inappropriate to assume that any particular state will be in a permanent net importation position for e-commerce goods and services. In principle, there is nothing that prevents any state from developing a globally competitive export sector. The technology necessary to achieve these benefits is available globally. The principal e-commerce benefits of enhanced procurement, distribution, and communication efficiencies can be enjoyed by any enterprise in any jurisdiction. Accordingly, the additional profits generated by traditional enterprises that adopt e-commerce business models will be spread across all jurisdictions in which the traditional enterprises operate. Cost savings normally enhance taxable profit, which becomes liable to tax in those jurisdictions in which the enterprise operates.

E-commerce has created new job markets and joint venture allegiances between both developed and developing economies. Thus, for example, the proliferation of e-commerce has created an entirely new and vibrant community of software engineers in India whose primary function is to co-design and create both traditional and new internet-based software solutions for enterprises in other jurisdictions. The HPC itself notes that exports from this sector to North America alone will reach \$4 billion annually by 2005.³ Similarly, an entire new industry of call centers, retailers and service organisations have arisen in India to support and service both local and non-local customers. The Internet also has created new entrepreneurial opportunities for web hosting providers, application software providers,

3. The Report at page 13.

bandwidth providers, *etc.* Given India's pre-eminence in the field of e-commerce and its rapid emergence as a major exporter of e-commerce solutions, there is no reason to believe that a base erosion approach is needed to protect India's tax revenues.

The Group believes that international tax harmonization is extremely important for positioning India in the lead of the global e-commerce market. It is not in India's best interest to take an adverse stand to the reasonably well-accepted principles. It may cause serious problems of mismatch of tax credits and non-availability of tax credit in the home jurisdictions of Indian and foreign companies conducting business globally. Many jurisdictions may not respect the proposed withholding tax as a creditable income tax as it would not be based on net income. To avoid double taxation, foreign suppliers would be likely to either avoid doing business with India or increase the cost of their supplies to India so as to offset the extra tax burdens resulting from India's adoption of such a base erosion approach. Similarly, the Indian companies' cost of doing business globally will also increase. This may seriously hamper India's growth.

The Group is in conformity with the views of the HPC that the e-commerce transactions do not lead to anonymity. The Group also concurs to the view of the HPC that the Indian Government should participate at an international platform alongside international bodies like the OECD to reach a consensus on the various enforcement issues.

Conclusion

The Group is of the view that India should participate in the international dialogue on the subject of taxation of e-commerce. It believes that India should not rush to create unilateral changes to the taxation of e-commerce transactions under current rules but should work with the international community on this issue, and not risk jeopardizing the current increased efficiencies and economic benefits offered by e-commerce. The Group is of the view that the Government should formulate a policy, which would not lead to an increase in costs for doing business with/in India. There is no doubt that given India's competitive advantage at the moment, the Indian government needs to carefully formulate a policy that is clear and transparent and which is consistent with the international norm of characterisation of revenues. Failure to do the above, may force foreign companies and entrepreneurs to re-align their businesses if there should be increased costs due to taxation. Creating a trust-based environment is better than creating a draconian legislation, since it will encourage multinationals to continue outsourcing work to India.

Further, the Group is of the view that the Government should honour the principle of neutrality as laid down by the OECD and endorsed by the HPC in its characterisation of income from e-commerce transactions. It is pertinent to note that interpretation under the domestic and treaty laws supported by judicial precedents on the subject are in conformity with the interpretations given by the OECD IC TAG on the characterisation of income. In the interest of growth of international trade and commerce and to consolidate the advantageous position India has attained in the arena of e-commerce, the Government should formulate policies, which are in harmony with international consensus on the subject. Finally, the Group strongly believes that it is important that all professionals and affected persons articulate their views clearly so that a meaningful dialogue may be facilitated, leading to a consensus. This is important, as an international consensus is the key to evolving a lucid tax policy on e-commerce.