Taxation of Electronic Commerce in India

presented to
Central Board of Direct Taxes, India

by
The eComTaxpert Group

Comprising

Bill Sample, Senior Director of Tax & Tax Affairs - Microsoft Corporation, USA

Duncan Bentley, Dean-School of Law, Bond University, Australia

Gary Sprague, Partner, Baker & McKenzie, USA

Gurbachan Singh, Partner, Khattar Wong Partners, Singapore

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Convened by

Nishith Desai Associates

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Disclaimer

The views expressed in the Report are those of the members of the eComTaxpert Group and are only in the nature of recommendations to the Government of India, in response to the Government's invitation for public comments on the report of the High Powered Committee. They should not be relied on as professional advice or construed as legal opinions of individual members of the Group or the eComTaxpert Group or the organizations represented by them. No responsibility for any loss occasioned to any person acting or refraining from action as a result of material in this publication is accepted by the group members, convener or publisher. If advice concerning individual problem or other expert assistance is required, the service of a competent professional adviser should be sought.

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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

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Partner, Baker & McKenzie, United States

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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 court[1] 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.

1. COMMENTS ON THE REPORT

Based on the Group's discussions and deliberations, the Group has expressed its observations on the Report, its interpretations of the existing tax provisions and its suggestions in relation to taxation of e-commerce. For the sake of convenience, the comments have been structured in the same order as the HPC Report.

1.1 Definition of e-Commerce

E-commerce has been defined by various international organizations, like the OECD, the International Fiscal Association and National Association of Software and Service Companies ("**NASSCOM**"), with each of them covering a different scope.

The HPC, in its Report has stated that there is no need to define e-commerce for the purposes of the Indian Income Tax Act, 1961 ("**ITA**"). The Group is in agreement with the view taken by the HPC that for purposes of the ITA there is no need to define e-commerce separately. Further, if any special tax treatment is to be given to e-commerce transactions then there may be a need to exhaustively and broadly define e-commerce so that the incentive is not marred by the ambiguity resulting in loss of credibility of the country. If the Indian Government were to decide to define e-commerce separately, then the same definition should be consistently applied for the purpose of the entire ITA.

1.2 Growth of e-Commerce

The Indian Software and Services industry is the fastest growing sector in India. This segment accounts for 16% of the country's overall exports, for 500,000 jobs, and about US$ 1.6 billion in investments. The revenues from software exports have been constantly rising. A recent survey conducted by NASSCOM on the performance of the Indian software industry showed the following results:

Period 2001-2002	Software Exports (Rs. Crores)	Software Exports (US $ million)[4]
April - June, 2001	8,600	1,800
July - September, 2001	8,900	1,850
October - December, 2001	9,100[5]	1,900

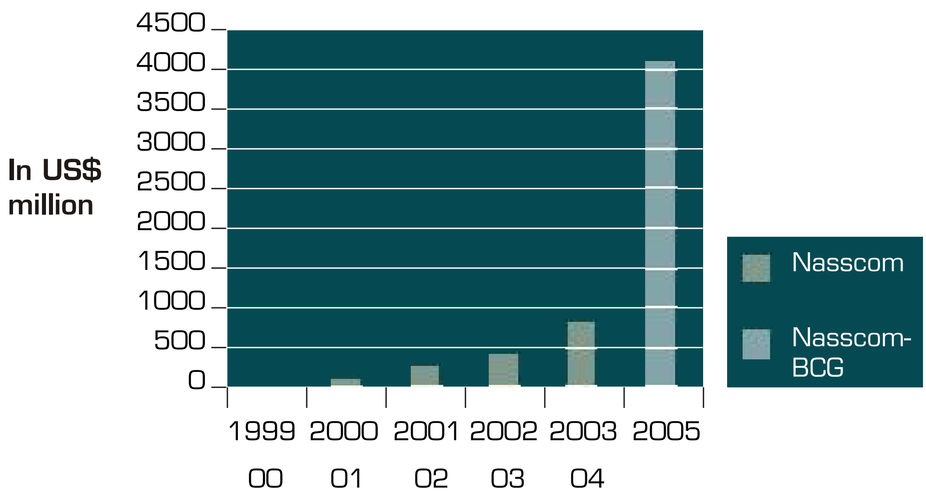
The global economic slowdown has been largely responsible for the poor quarter-on-quarter growth in the financial year 2001-2002. However, even stagnant quarter-on-quarter exports for this year would yield an overall growth of over 25 per cent in 2001-

4. At the approximate conversion rate of 1 US$ = INR 48.
5. This was up from Rs. 7270 crores for the corresponding period in the previous year, and represented a growth of 25%.

-02.[6]

According to a Goldman Sachs study, the number of Indian internet users is expected to grow from 0.5 million in 1998 to 9 million in 2003, which translates to a compounded annual growth rate ("**CAGR**") of 76 percent - the fastest in Asia. According to a NASSCOM survey, there would be about 10 million internet subscribers (32 million internet users) by March 2003. The use of cable television to facilitate access to the internet may result in faster growth of the number of internet users in India, since the number of cable connections are projected to grow up to 70 million by 2008.[7]

India E-commerce Statistics



	1999 00	2000 01	2001 02	2002 03	2003 04	2005
Nasscom	93.7	479.1	1562.5	4166.7	8333.3	
Nasscom-BCG						40625

6. See, *http://www.nasscom.org/articles/q3_indian_sw_logs.asp, (As visited on May 3, 2002).*
7. See, *http://www.tradepromotion.org/promoteIT/india/India%20situation.htm, for a study conducted on the growth of e-commerce in India as of 2000, (As visited on May 3, 2002).*

While the HPC has pointed out that amongst the Asian nations, the growth of e-commerce in India between 1997 and 2003 is expected to be the highest with a CAGR of 246 percent as against the CAGR of Australia (84 percent), South Korea (145 percent), China (243 percent) and Hong Kong (110 percent), it may be noted that if the regulatory framework is not conducive to the growth of e-commerce and is out of sync with the international practices, the anticipated growth will remain only a mirage.

According to a NASSCOM survey[8], e-commerce is expected to grow from US$ 93.75 million (INR 450 crores) in 1999-2000 to US$ 8,350 million (INR 40,000 crores) in 2003-2004. According to the NASSCOM-BCG report on "E-commerce Opportunities for India Inc., 2001" e-commerce is expected to grow to US$ 40,625 million (INR 195,000 crores) in 2005. The NASSCOM-BCG also states that out of US$ 40,625 million (INR 195,000 crores) the B2B and B2C components would be US$ 40,000 million (INR 192,000 crores) and US$ 625 million (INR 3,000 crores) respectively.

From the above statistics, it is evident that India is poised to be a major beneficiary of the e-commerce revolution. It may be noted that India has a bigger role to play in B2B transactions. However, according to International Data Corporation, a US-based research firm, India is expected to have only US$3 billion in e-commerce revenue in 2002 despite having one of the largest markets.[9] On the other hand, China is expected to have $12 billion, South Korea $22 billion, and Taiwan $13.5 billion in 2002. To reduce this gap and benefit from an increase in commerce through the e-commerce revolution, the Indian Government must introduce unambiguous e-commerce taxation laws in line with internationally accepted principles. The Indian Government should also help promote e-commerce in India so that India can capitalize on the advantageous position she has achieved in the technology sector and specifically in software development.

The HPC's apprehension with regard to the potential loss of revenues in relation with e-commerce is unfounded. 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. India, as evident from the statistics above, is likely to be a major developer and exporter of software over the coming years. 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 this, may force foreign companies and entrepreneurs to re-align their businesses if there should be increased costs due to

8. See, *www.nasscom.org/it_industry/ecomm_survey.asp,* (As visited on May 3, 2002).
9. "Ebay to Buy NeoCom of Taiwan In Bid to Expand Into the Region" *Wall Street Journal*, February 26, 2002.

increased taxation. For example, Governments in which its residents have dealings with Indian e-commerce business establishments or software developers might likewise be pressurised to seek protective actions to ensure that their revenues are not affected through the protective actions of their foreign counterpart in e-commerce business. In this respect, the Government must take cognisance of generally accepted international norms for the characterisation of revenue such as those laid down by the IC TAG unless there are exceptional circumstances that justify a deviation from the same.

1.3 Exemption of e-Commerce from Tax

The HPC has accepted the principle of neutrality, which signifies tax equity between e-commerce and commerce through traditional means. The HPC is of the view that there is no need to exempt e-commerce transactions from taxation. The Group is of the view that there should be tax neutrality between electronic and conventional commerce. The Group does not advocate any special tax exemptions for e-commerce transactions. Further, the Group is of the view, that once neutrality is achieved, then if considered desirable for the economic purposes, the Government may consider offering tax benefits to encourage the development of e-commerce businesses.

1.4 How should e-Commerce be Taxed?

The Group concurs with the HPC as regards the following aspects that need to be kept in mind by the policy makers while formulating a tax system for e-commerce. These are:

- Neutrality of taxation of e-commerce with reference to traditional commerce;
- Integrity of tax base through constant monitoring of trade flows, changes in technology and business practices; and
- International consensus while protecting the national interest.

While the Group agrees in principle with the HPC, it is important to understand that national interest is protected only when national economy is integrated into the global economy, therefore the benefit should be looked at from a long term perspective. Revenue interest will be protected only if the policy measures do not create any impediments in the growth of trade and commerce.

The Group would like to emphasise that while formulating rules for the taxation of e-commerce, it is pertinent to bear in mind that India has attained an advantageous position in terms of human resources, geographical positioning and a recognition globally in the arena of e-commerce and software development. The e-commerce arena has helped India exploit its vast resources of highly proficient technical personnel to participate at a global level by exporting its information technology and engineering services. It is important that India capitalises on this position that it has etched out for itself and ensure that the opportunity is not lost as it was during the hardware revolution. During the hardware revolution, countries such as China, Malaysia and some other far eastern countries gained the entire advantage of India's negative approach.

Another factor to be borne in mind is that if India is viewed as an unfriendly tax jurisdiction, it would have a negative impact for enterprises desirous of doing business with India. Hence, if India formulates rules on the taxation of e-commerce that are out of step with internationally accepted principles, it would be a deterrent for companies to operate in India instead of providing them with a comfort zone.

1.5 Domestic Tax Issues

The HPC is of the view that domestic e-commerce does not raise new issues for direct taxation. Further, it states that e-commerce leads to anonymity of the source party, evasion of tax and difficulty in recovery of taxes due to the virtual nature of the transactions. Furthermore, it has also so stated that in most of the transactions the mode of delivery and payment would remain traditional, thereby leaving audit trails and hence would not be anonymous. In fact, increased use of credit and debit cards, electronic banking facilities, enactments of money laundering laws and enhanced responsibilities on the banks to follow "know your client" compliance standards and sophistication in security systems would make it more convenient to trace the originator of the transaction and all concerned parties to the transaction. Most businesses, small or big, in the e-commerce arena, need to tap global capital markets from venture capitalists and public markets, which require high standards of transparency.

If Indian taxation rules are out of sync with those followed internationally, it may encourage the evasion of tax by small players and migration of big business out of India. The Group is of the view that in order to reduce evasion, India should form rules, which are consistent with globally accepted norms. Also, when rules have been relaxed and liberalization allowed to take its own form, it has lead to a constructive response from foreign parties. Creating a trust-based environment is better than creating a draconian legislation, since it will encourage multinationals to continue outsourcing work to India. An important illustration of the above fact is the liberalization of exchange controls. It is seen that the Indian as well as foreign investors have responded well to the liberalisation and there has been a higher foreign exchange inflow, which has been reflected in the current foreign exchange reserves. From nearly bankruptcy levels in 1989-90, India today boasts of US$ 57 billion reserves.

1.6 Tax issues in Cross-Border e-Commerce

1.6.1 Residence based taxation:

In order to address the issue on determination of residential status, the HPC has considered the concept of 'place of effective management'. The Report states that this concept has no real alternative and has to be used. The Group is of the view that the concept of 'place of effective management' is not used in the Indian tax laws and has a limited role to play in determining residential status while applying the tie-breaker rule. As per section 6(3) of the ITA, a company is treated as a resident of India for Indian tax purposes and taxed in India in respect of its worldwide income only if it is either incorporated under the laws of India or *wholly* managed from India. Broadly speaking, as per the provisions of Article 4 of the Double Taxation Avoidance Agreement ("**DTAA**") (that India has entered into with UK and USA), the residential status of a person would have to be determined in accordance with the domestic laws of respective countries. Thus, for the purposes of the said DTAA's, in order for a company to be resident in India, it would have to be either incorporated in India or controlled and managed *wholly* from India. Therefore, if only a fraction of the control and management lies in India, a company would not be regarded as an Indian resident company. Further, in the event that, a company is regarded as a resident under the domestic laws of both the member nations to a DTAA, then the residential status would be determined by its place of effective management. Thus, 'place of effective management' is a tie-breaker concept and comes into play only where dual residency exists.

The issue of determination of the residential status is important, since, enterprises today are globally integrated and decision makers are located in different jurisdictions. The advancement of technology has enabled the key decision makers sitting in different jurisdictions to participate in the decision making process through video conferencing and other like facilities. Thus, it may so happen that a decision maker sitting in India could participate in control and management of a non-resident company. But it would be important to note that in such an event only a part of the control and management would be situated in India as opposed to whole control and management to be situated in India as required under section 6(3) of the ITA.

The HPC further states that where the 'place of effective management' concept cannot be applied the source rule of taxation should be applied. The Group feels that rather than discarding the concept of 'place of effective management', the countries should endeavour to formulate effective rules for applying this test in the context of e-commerce.

1.6.2 Source based taxation:

The HPC is of the view that since source based taxation requires a fixed place of business, in an e-commerce environment, which is virtual in nature, implementation of the source rule will face complexities. Certain e-commerce transactions change the mode of delivery from physical to electronic form, which may raise characterisation issues. The above contradicts with what has been stated, on Page 15 of the Report wherein, the HPC has stated that characterisation of income should not change with the change in mode of delivery from physical to digitised form.

As recognised by the HPC, in the case of cross border commerce, income derived by a person may be taxed in the source country "having connection with generation of income". Historically, the international community has agreed that a sufficient connection for this purpose would require the foreign enterprise to have a Permanent Establishment ("**PE**") in the host jurisdiction. The HPC seems to conclude that "with the emergence of the internet, the need for physical presence in the source country does not exist even where the volume of business is large."[10]

Non-resident enterprises that maintain no physical presence in a jurisdiction generally are not able to achieve the same level of economic success as companies that are physically established in the jurisdiction. Companies find that there are upper limits to the degree of market penetration an offshore vendor can achieve without establishing a local presence. Put simply, it does not seem likely that a large number of offshore enterprises with no physical presence in a jurisdiction will be able to establish the same volume of sales as retailers or distributors who are physically located in the jurisdiction. It is thus quite unlikely that remote sellers will manage to achieve a substantial market share in a jurisdiction consequentially displacing local vendors, without even maintaining a physical presence in that country, as evidenced by the recent collapse of so many dot.com companies. It is noteworthy that many of these failed companies attempted to operate solely under the remote vendor business model.

10. The Report at page 65.

To successfully penetrate a market requires satisfying customers to make them repeat customers. Successfully achieving this goal requires a significant commitment to invest in local resources. On the other end of the spectrum, it certainly may be possible to make some "one-time" sales to customers from a website, but it is not likely that a vendor could build a successful business from random "one-time" sales.

In considering whether the existing treaty rules are adequate, a bit of historical perspective might be useful. New business models have emerged in the past, and industries have migrated across borders. For example, in the past the manufacturing activities of entire industries, such as consumer electronics, footwear or clothing, have migrated from developed to less developed economies. Yet, the change in location of that value-adding activity was accommodated within the existing international tax framework. Today's economic shifts, though significant, should not necessarily cause any greater disruption to the accepted global allocation of tax revenue than did past shifts.

This is especially true in India's case. The proliferation of new enterprises within India's borders under the "new" economy has been exceedingly positive. There is every reason to expect that India and other developing economies will continue to be significant beneficiaries of e-commerce efficiencies. E-commerce has created, and can be expected to continue to create, new job markets and joint venture allegiances between developed and developing economies. Recent history has shown that the macroeconomic effects of e-commerce is to expand the aggregate economic profits in the global economy, especially in India since India is a source of a low-cost, but highly skilled, workforce. India is strategically poised to continue to be a major beneficiary of these increased profits. The Group believes that the net effect on business will be positive across the global economy, and, as shown so far, it should be especially so in India.

1.6.2.1.*Concept of PE:* The Group believes that the PE concept remains the appropriate standard upon which taxation of foreign enterprises should be based. The Group recognises that when the PE concept was introduced, the possibility of e-commerce transactions was not envisaged. Nonetheless, taxation based on physical presence remains the appropriate threshold for income taxation. Income tax should apply only in that place where an enterprise is engaged in value-creating activities. Value adding activities require capital and labour, both of which would require some physical presence.

The purpose of the PE standard is to define when a foreign enterprise has sufficient nexus with the state to warrant the enterprise being subject to a local income tax. Under the current rules, nexus is determined by whether the foreign enterprise or its agents actually conduct core business income-producing activities in the state. Historically, it has been accepted that the conduct of such activities normally requires the foreign enterprise to have some physical presence in the state, by way of labour and/or property.

The integration of e-commerce efficiencies and/or solutions into a business enterprise does not undermine this conclusion. The "new" economy, just as much as the "old" economy, requires an enterprise to utilize capital, labour and other property in its core income-producing activities to develop, market and deliver its products and services. Even if the nature of those inputs and outputs may differ somewhat under the "new" economy (*e.g.,* from manufacturing capacity to knowledge workers on the input side; and tangible property to services on the output side), the essential fact remains the same: physical activity somewhere, as reflected by an entrepreneur's risk assumption, labour deployment, and property investments, remains a necessary component to an enterprise's creation of products and services.

Nothing in the "new" economy changes the proper justification for a state to impose an income tax on an enterprise. The policy conclusion, which underlies the existing rule, is that only activities, which create value, are relevant in determining a state's right to impose an income tax. The mere fact that an enterprise is able to sell into a jurisdiction's marketplace, standing alone, is not a relevant factor in this analysis. This is because market accessibility does not indicate that the foreign enterprise is creating value in the state. Accessibility to a market does not necessarily entail an enterprise's "participation *in* the economic life of a country." It simply reflects the enterprise's "participation *with* the economic life of a country."

Enterprises using the communications efficiencies of the internet create wealth by developing, producing, and distributing products and services. Some enterprises are able to sell remotely using the internet, but those transactions represent an extremely small portion of the global Internet-enabled economy. There is nothing in the general business models used by companies employing internet communications, which suggests that the historic principles of taxation of income where value is created should be discarded.

It remains appropriate therefore to limit the right of income taxation to those jurisdictions that serve as the origin of that income by virtue of providing the economic life that made possible the yield or the acquisition of the wealth.[11]

The Group believes that the concept of PE should continue to determine a jurisdiction's taxation rights, and certain clarification may be necessary in light of the e-commerce arena.

1.6.2.2 *Alternative to the concept of PE:* The only alternative to the concept of PE considered in the Report is the adoption of what is referred to as a 'base erosion' approach.

This proposal entails deduction of tax at source from any payment to a foreign enterprise, if such payment is tax deductible in the source country (i.e. India). According to the HPC, this 'base erosion' approach offers a possible solution for equitable tax sharing between residence and source countries provided:

- The concept is applied to all commerce and not just e-commerce.
- The tax is implemented through a low withholding tax on all tax-deductible payments to the foreign enterprise.
- Preferably, the withholding tax is final without option of tax on net income being given to the taxpayer or the tax administration.

The HPC's recommendation of the base erosion approach is based on the prejudiced proposition that absent such an approach, e-commerce businesses will escape taxation.

> *Exempting e-commerce creates horizontal inequity as an enterprise earning income from business carried on in a traditional manner would be taxed while another earning the same income from same business carried on by using networks would pay no tax. For instance, a bookshop, which*

11. See, *e.g.*, Professors Bruins, Einaudi, Seligman and Sir Joshia Stamp, **Report on Double Taxation** at 23, submitted to the Financial Committee of the League of Nations, April 5th 1923 (Doc. E.F.S.73.F.19) (the "1923 Report"). See also, **Report of Technical Experts, Double Taxation and Tax Evasion, Report and Resolutions,** submitted to the Financial Committee of the League of Nations, February 7th 1925 (the "1925 Report"). Except for minor points of details, drafters of the 1928 Model Convention adopted all resolutions adopted under the 1925 Report. In turn, the 1925 Report provides that the 1923 Report served as a basis for its work.

retains the traditional style, will pay tax on its profits, but another using a website to advertise inventory and taking orders online would not be paying any tax even if the mode of delivery of books and payment remains traditional.[12]

It would indeed be unfair if the above were the case. However, it is not. Enterprises using communication efficiencies require capital and labour, and must assume risk, much like any traditional business enterprise. Additionally, on par with their business counterparts in the "old" economy, those enterprises will bear the full burden of income taxation in those jurisdictions where they assume risks, invest capital, and deploy labour.

Presumably, the HPC's apprehension is not that these businesses will escape taxation, but that they will not be subject to taxation in India. As previously discussed, the Group believes this apprehension is ill-founded and not justified on the facts. As reflected in the explosive expansion of India's software export producing industry, the value-add activities of an e-commerce business will generally involve substantial investments of research and development, significant amounts of individual labour and creativity, and the initiative, skill, and entrepreneurial endeavours of those individuals who can create the intellectual capital of an e-commerce business. These are precisely the value-add resources that India's technologically advanced and English-speaking work force has in ample supply. As a major supplier of such capital, India stands in a prime position to benefit from the current system, which affords jurisdictions providing these ingredients the primary right to tax the income generated from such core income producing activities.

The Group also believes that the base erosion approach advocated by the HPC is essentially an indirect tax, which essentially creates additional customs duties on all imports of goods and services. This would expose India to intricate issues in relation to the WTO.

The Group would also like to point out that in discussing the equitable distribution of tax revenue it is important to focus on a jurisdiction's net tax revenue. This would include tax revenues from both income and consumption taxes. A tax, which is imposed with regard to the place of consumption, may

12. See, *e.g.*, Report at page 49.

be appropriate in the context of consumption taxes. However, it is not appropriate in the case of an income tax.

The OECD in its report on "Taxation and Electronic Commerce Implementing" in the Ottawa Taxation Framework Conditions states that "In the field of consumption taxes, the core elements of the Taxation Framework Conditions were developed as follows:

- Rules for the consumption taxation of cross-border trade should result in taxation in the jurisdiction where consumption takes place and an international consensus should be sought on the circumstances under which supplies are held to be consumed in a jurisdiction."[13]

Since there is a consensus in the international community that a transaction tax based on consumption should be imposed in the country where consumption takes place, it is unlikely that the goal of ensuring a more equitable sharing of revenues between countries could be achieved consistently over the long term if both income and consumption taxes were imposed at source on the basis of consumption.

When the sources of tax revenue are examined, all types of taxes should be included in the analysis and the sources of government revenue should be evaluated as a whole.

India's adoption of a base erosion approach to income taxation at this point in time would also be contrary to the current international movement of lowering and/or eliminating withholding taxes as a means of encouraging cross-border trade.[14] Withholding taxes are also onerous to new business and stifle innovation. In general, any new venture requires up front investment, which may not be profitable for many years. In a withholding tax regime, governments impose tax immediately when the revenue flow begins, without regard for recovery of expenses. Typically new ventures generate losses, and thus taxes in addition to the losses reduce motivation for new development. Stifling innovation is detrimental to both developed as well as developing countries.

13. The Report at page 18.
14. This movement is reflected for example in (i) the recently negotiated U.S.-U.K. income tax treaty which affords a zero withholding rate on dividends; (ii) the OECD's recommendation that royalty withholding rates be lowered to zero; and (iii) the OECD's elimination of payments for the use of industrial or scientific equipment as royalties subject to withholding.

Finally, the Government needs also to consider very carefully before introducing a flat rate tax on all those supplying goods and services to India residents, the impact of that flat rate tax on those suppliers in their home countries. The assumption that the impact of flat rate tax would be offset by tax credit under any applicable double taxation convention is highly doubtful and will also have an impact on the tax position of these suppliers.

1.6.3 <u>Tax Credit issues in 'Base Erosion' approach:</u>

Many of the suppliers come from countries where relief from double taxation is by the credit method (*e.g.* USA, UK). The credit may be available under the relevant double taxation convention or unilaterally (under the tax law of the country concerned). If relief is provided under the convention, then it will only be granted for taxes covered by the convention, which are imposed in accordance with the convention. If the view is taken by the foreign revenue authority that this flat rate tax is not the same as or similar to existing taxes covered by the convention, no credit will be available. Under domestic law it is unlikely that a flat rate tax on the supply of goods and services will be recognised as an income tax: it is effectively a turnover tax on non-resident suppliers. Flat rate taxes on the supply of services are not generally regarded as creditable taxes in most countries, which apply the credit method.

The overall result is that the country of residence of the supplier is unlikely to grant relief from double taxation by credit for this new, Indian tax. Double taxation will not be relieved, and non-residents making supplies to India will have to bear the extra tax burden. In practice, they are likely to increase their charges to Indian companies to shift the burden on to their Indian customers. In the long-term, this will damage the growth of all commercial sectors in India.

A similar problem arises if the other party to a convention does not accept India's interpretation of the scope of the royalties article in the convention. Any Indian tax imposed contrary to the convention would not be allowable for Any Indian tax imposed contrary to the convention would not be allowable for credit purposes. Instead, the foreign supplier is likely to initiate the competent authority procedures on the grounds that the taxation imposed in India is not in accordance with the convention.

The only solution to this problem would be to re-negotiate India's tax treaties with the countries of origin of overseas suppliers of services. This will be time consuming, and there is no reason to believe that other countries would be willing to accept proposed amendments to include India's proposed base erosion approach given that the approach does not reflect a generally accepted standard of international taxation.

To put very simply, however attractive a "base erosion" approach might seem, it is not a generally accepted part of existing international tax practice, and other countries are unlikely to accept it. Since it does not comply with existing systems to relieve double taxation, its introduction will result in double taxation.

Select country analysis

Based on the above scenario, can a taxpayer who has suffered this withholding tax claim a foreign tax credit in his country of residence? The Group has analysed this question by referring to what the position is in the following countries:

Australia

Article 24(1)(a) of the Australia/India DTAA provides for credit against Australian tax of tax paid in India under Indian law and in accordance with the DTAA. The DTAA covers the Indian income tax including any surcharge and the surtax imposed on company profits. It extends to any identical or substantially similar taxes. Although it covers flat-rate withholding taxes, these are taxes on income from dividends, royalties and interest.

The specific definition of royalties would not be seen to extend to all tax deductible payments made to Australian resident enterprises. Australia would interpret the royalty definition in accordance with the OECD commentaries, to the extent that they apply, and this would extend to the recent amendments for e-commerce.

It is also unlikely that the DTAA would be considered to include as a creditable tax a flat-rate withholding tax on the supply of goods or services that is unrelated to income or profits. Such impost would not represent a tax on income, profits, or identical or similar tax under the DTAA.

Australia is unlikely to provide unilateral domestic tax relief. Under Section 6AB(2) *Income Tax Assessment Act 1936 (Cth)* the definition of a creditable foreign tax is essentially limited to taxes on income and profits or gains. The definition does not cover foreign imposts on turnover, receipts or on any other similar basis.

Belgium and Netherlands

In Belgium and the Netherlands a tax credit is only granted if the tax treaty allows India to apply a withholding tax. If the tax treaty grants such a right, the credit would be equal to the tax withheld. If the treaty does not provide for such withholding tax, tax may only be imposed if the Belgian or Dutch company has a PE in India.

Pursuant to the fact that neither the tax treaty on income and capital of April 26, 1993 between Belgium and India nor the tax treaty on income and capital of July 30, 1988 between the Netherlands and India provides for a withholding tax on e-commerce payments, neither the Belgian or Dutch tax authorities would grant a tax credit. Also, the taxpayer would not be able to claim the withholding tax as a deductible expense.

If India intends to apply such a withholding tax, a renegotiation of these treaties would be necessary, as it is very unlikely that either Belgium or the Netherlands would agree that their existing treaty provisions allow for a withholding tax on e-commerce transactions.

It would be also important to note the special provisions concerning withholding taxes under the tax treaties with Belgium and the Netherlands:

Part 1 of the tax treaty between India and Belgium contains a most-favoured nation clause with respect to royalties and technical service fees.

Part IV of the protocol to the India-Netherlands tax treaty contains a most-favoured nation clause with respect to interest, dividends, royalties and technical service fees.

France

French domestic tax law does not provide for any unilateral double taxation relief and thus, relief may only be obtained under the terms of the France-India tax treaty. However, it should be noted that under French domestic tax law, the Indian withholding tax will be treated as a deductible expense for the purposes of French (individual and corporate) income tax and thus no tax credit will be available for the same.

Germany

Under Article 23(1)(b) of the DTAA between Germany and India credit for

Indian withholding tax is to be granted by Germany only for (i) dividends unless an exemption for dividends received applies, (ii) interest, (iii) royalties and fees for technical services, (iv) gains from the alienation of shares in a company, (v) directors' fees, and (vi) income of artistes and sportspersons. "Royalties" are defined in Article 12(3) of the said DTAA similar to the OECD Model, yet including cinematograph films or films or tapes used for radio or television broadcasting and the use of, or the right to use, industrial, commercial or scientific equipment. "Fees for technical services" are defined in Article 12(4) as meaning payments of any amount in consideration for the services of managerial, technical or consultancy nature, including the provision of services by technical or other personnel, but not payments for independent services.

It is evident that the latter definition does not apply to the e-commerce payments. The royalty definition will without doubt be interpreted by Germany in accordance with the OECD commentaries, which would include the 2001 amendments recently adopted for e-commerce payments. Thus a base erosion tax levied from a consideration for the sale of digital products will not be treated also creditable under the treaty with India by Germany unless the German resident taxpayer receives the consideration through a PE in India or the sale involves the transfer of a copyright.

Where a treaty does not avoid an existing double taxation, s. 34c(6)(3) of the German Income Tax Law provides unilateral relief for double taxation (credit or, optionally, deduction from the income tax base), if, inter alia, the foreign income tax was levied from foreign income. The term "foreign income", however, is defined restrictively by s. 34d of the German Income Tax Law. It includes income received by a PE in a foreign state and income received for permitting the use of a right situated in a foreign state, but not income from sales whether of material or digital products.

Italy

Pursuant to Article 7 of the income tax treaty, of February 19, 1993, between Italy and India, profits of an enterprise of Italy shall only be taxable in Italy, unless that enterprise carries on business in India through a PE situated therein. Also, Article 24(2)(a) of the treaty provides that Italy may relieve juridical double taxation by way of ordinary foreign tax credits.

Assuming that profits derived by the Italian enterprise from the e-commerce transactions with Indian residents are business profits, the application of the Indian tax would appear to conflict with Article 7 of the treaty. If so, Italy would not be obliged to grant a credit for the tax levied in India.

However, Italy also grants unilateral relief for juridical double taxation. According to Article 15 of Presidential Decree No. 917/1986 (Income Tax Code - hereinafter "**ITC**"):

> "*If income earned abroad is included in the computation of the aggregate income, taxes definitively paid abroad upon such income shall be allowed as credit against the net tax due in an amount equal to that part of the Italian tax which is proportional to the ratio between foreign source income and aggregate income, without diminution for losses of prior tax periods carried forward*".

Since the above provision does not require the foreign tax to be levied according to the provisions of a treaty, it may be concluded that, in the case at hand, a credit would be granted for the Indian withholding tax.

The applicability of this unilateral relief, in spite of the treaty provisions, could be argued on the basis of the general principle of the domestic rules, which would prevail if it is more favourable than the provisions of a treaty. This principle is explicitly stated in Article 24(1) of the treaty and, even more clearly, in Article 128 of ITC.

The Italian tax administration has made direct application of this principle with specific regard to double taxation relief. In Circular Letter No. 33 of October 4, 1984, the Ministry of Finance recognised the entitlement of taxpayers to the unilateral relief even if a specific treaty relief exists.

However, the application of the domestic credit, if granted, would be subject to all of the requirements and limits laid down in Article 15 ITC. In particular, the Indian-source income would have to be included in the aggregate income of the Italian recipient taxpayer and the Indian tax would have to be a definitive (non-reimbursable) tax. Moreover, credit would be granted to the extent of the Italian tax, which is proportional to the ratio that the foreign source income bears to the aggregate income.

It should be noted that the Italian tax administration recently ruled out the domestic credit in a circumstance similar to the one at hand. By resolution of No. 104 of July 3, 2001, the Ministry of Finance found that, in a tax treaty situation, if the source state levies a tax exceeding the tax allowed under the treaty, the Italian resident recipient is not entitled to the unilateral relief in respect of the excess levy. According to the Ministry, in these circumstances the Italian taxpayer should apply to the source state for a refund of the excess tax.

Malaysia

There is a provision in the India/Malaysia tax treaty for bilateral tax credit to be given in Malaysia to the extent that residents of Malaysia have a tax payable in respect of Indian income. The scope of taxation in Malaysia is territorial, i.e. only on income derived in Malaysia or accruing in Malaysia. Prior to 1997, income derived outside Malaysia and received in Malaysia by residents were also subject to income tax. In this situation, the Malaysian tax authorities are obliged to provide tax credit where it has been shown that the foreign income have suffered tax. However, in 1997, the Malaysian Government issued a Ministerial Exemption Order, which exempts resident companies (other than those companies carrying on banking, sea or air transport businesses) from income tax in respect of income derived from sources outside Malaysia and received in Malaysia. As a result, resident companies, which have derived income from overseas, say from India, and have suffered Indian tax, would no longer be granted tax credit since such income is no longer taxed in Malaysia. 'Income' is not defined in the Malaysian tax legislation. Accordingly, it can mean any form of revenue (and there is no capital gains tax in Malaysia). It is uncertain how long the Ministerial Order would remain in force, as it can be withdrawn anytime. If the Exemption Order is withdrawn sometime in the future, it would lead to a reversion to taxation on foreign income received by residents in Malaysia. If this situation arose and the HPC were to characterise certain payments as subject to Indian tax in the absence of a PE, and which does not fall under the treaty definition of 'royalty', there could be double taxation. The treaty definition of 'royalty' is rather restricted and not as wide as has been considered by the HPC in the context of e-commerce. In this respect, the Malaysian tax authorities may not necessarily grant a credit, if they do not ascribe to the view that such payments received from India constitute royalties under the treaty regardless of whether the domestic legislation is expanded to include such payments. Despite a possible loss of revenue, if this were to occur, the tax authorities of both nations should agree on a mutual treatment in the interests of international trade, so that residents of each of the contracting states are not adversely affected.

Singapore

In Singapore, tax is imposed on income accruing in or derived from or received in Singapore. Therefore foreign sourced income received in Singapore will be subject to tax in Singapore. However, relief from double taxation is available in the form of a foreign tax credit under Article 25 of the DTAA between India and Singapore. Foreign tax paid in India will be allowed as a credit against Singapore tax payable in respect of the income. The amount of credit allowable is however limited to the Singapore tax paid on the foreign income. Therefore the credit to be allowed is the foreign tax paid or the Singapore tax on that income, whichever is the lower. Where the foreign tax paid is equal to or higher than the Singapore tax attributable to that income, no further Singapore tax is payable after credit for the foreign tax on that income is allowed. Further, no deduction is available under Singapore domestic laws for the withholding tax suffered in the foreign country.

There are no separate provisions within the Singapore Income Tax Act that deal only with e-commerce transactions. Therefore, where relevant, the general tax laws would be applied to e-commerce transactions. Whether double taxation of income can be mitigated will depend on the existence of a DTAA between Singapore and the foreign country as well as the terms of the DTAA. A person wishing to claim for foreign tax credit in Singapore will need to submit documentary evidence to substantiate that tax has been paid in another country. In the absence of such evidence, relief may be given upon a submission of a certification by either a director of the company, a public accountant in Singapore or a public accountant in the other country, that tax has been paid.

Where tax has been deducted at source in a country that does not have a DTAA with Singapore, unilateral tax credit may be given in Singapore on specific services to countries listed in the First Schedule of the Income Tax (Unilateral Tax Credits) Regulations under section 50A of the Singapore Income Tax Act.

The Singapore Inland Revenue had issued guidelines on the income tax treatment on e-commerce to provide some guidance on the circumstances under which income from e-commerce would be deemed to be sourced in

Singapore and therefore subject to tax in Singapore. The guide is an expansion of the broad principle of "operations test" used to determine whether income from e-commerce transactions is derived from Singapore. If the business operations are carried out in Singapore, then income derived from those operations is said to be sourced in Singapore and thus liable to tax in Singapore. The guide does not address the tax treatment or position that may be adopted by other countries in cross-border transactions. It does not preclude a foreign tax authority from seeking to treat the income differently, resulting in possible double taxation or withholding tax in the foreign country. Tax credit would not be granted in Singapore for income, which is regarded as being derived from Singapore under the guidelines.

USA

The U.S. is unlikely to grant foreign tax credits for any taxes withheld under the proposed base erosion regime. For a foreign-imposed income tax to be creditable in the U.S. it must be based on net income. An across the board withholding tax based on gross income would not satisfy this requirement. To be creditable, a foreign income tax must be "likely to reach net gain."[15] To satisfy this requirement, the foreign tax system would have to allow for a recovery of significant costs and expenses attributable to the gross receipts.[16]

UK

Article 24(1) of the UK-India double taxation convention of 25th January 1993 provides for relief against double taxation to be given in the UK by way of a credit for Indian tax imposed in accordance with the convention. "Indian tax" is defined as the Indian income tax or any substantially similar tax which is imposed subsequent to the conclusion of the convention. It is extremely unlikely that the flat-rate withholding tax on payments to non-residents would be regarded either as falling within the existing income tax or as a substantially similar tax. Nor would the proposed tax be imposed in accordance with the convention.

As a consequence, credit would not be given under the convention in the UK for the proposed new tax. It is extremely unlikely that the UK government

15. Treas. Reg. Sec. 1.901-2(a)(3)(i).
16. Treas. Reg. Sec. 1.901-2(b)(4).

would agree to an amendment to the convention to include the new tax: it would be entirely contrary to the existing policy of the UK government to do so.

Credit may also be granted unilaterally under UK domestic law.[17] However, it is a requirement of the provisions for unilateral relief that the foreign tax must correspond to UK income tax.[18] The proposed flat-rate withholding tax would not be a corresponding tax: relief would not be available unilaterally.

Where the proposed flat-rate withholding tax is imposed on the business profits of a UK enterprise not having a permanent establishment in India, this would be taxation not in accordance with the convention. UK enterprises affected in this way would be entitled to initiate the competent authority procedure or might challenge the imposition of the tax through the Indian tribunals.

In conclusion, the international community has been working for decades to reduce withholding taxes and to encourage international trade. A return to withholding tax regimes, especially those leading to double taxation, would likely harm rather than help the tax revenues of those implementing such a regime. Most importantly, the macroeconomics of e-commerce as applied to India also does not indicate any reason to believe that such an approach is needed to protect India's income tax base.

The Group is of the view that the Indian Government should participate at the OECD and other international organisations to develop a consensus view on these issues.

1.7 Characterisation of e-Commerce Payments

The HPC maintains that it is in agreement with the basic principle of neutrality as laid down by the OECD on the formulation of a tax policy for e-commerce transactions, i.e. characterization of income should not change with the mode of delivery from physical to digitised form. This is evident from Page 15 of the Report. However, while analysing the 28 categories of transactions, the HPC has taken a contrary stance. The HPC differs in its view from that laid down by the IC TAG in 13 categories, generally because of the mode of delivery involved and/or the type of product (generally software) being delivered. In doing so the HPC has ignored the basic principle of 'neutrality' (that is the

17. Section 790, Income and Corporation Taxes Act, 1988.
18. Section 790(12), Income and Corporation Taxes Act, 1988. See also, *Yates (Inspector of Taxes)* v. *GCA International Ltd.;* [1991] STC 157 *(Chancery Division)*.

characterisation of income should not change with the mode of delivery from physical to digitised form).

The Group observes that in the HPC's characterisation of the 13 categories of transactions, where its view differ from the IC TAG, the same is at variance with the ITA, the judicial precedents and the treaty law. The following paragraph deals with this subject in detail.

Interpretation under the ITA:

Section 9 of the ITA defines royalty and fees for technical services as having deemed source in India. Such income is taxed under section 115A of the ITA at a flat rate of 20% on gross amount of receipt subject to reduced (prescribed) rate under appropriate DTAA. In case of business income the same is subject to tax in India only if there is sufficient business connection in India. If there happens to be in existence a comprehensive DTAA, the business income would be subject to tax only if there is a PE. This principle is long established in the theory of nexus. Now let us turn to the specific discussion on royalty under the ITA.

Section 9(1)(vi)[19] of the ITA defines royalty as the "***consideration*** *(including lump sum payment but excluding any consideration which would be the income of the recipient chargeable under the head "Capital Gains")* ***for***-

i. *The transfer of all or any rights (including the granting of a license) in respect of a patent, invention, model, design, secret formula or process or trademark or similar property;*

ii. *The imparting of any information concerning the working of or use of a patent, invention, model, design, secret formula or process or trademark or similar property;*

iii. *The use of any patent, invention, model, design, secret formula or process or trademark or similar property;*

iv. *The imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill;*

iv.a *The use or right to use, any industrial, commercial or scientific equipment but*

19. The abovementioned provision related to taxation of royalty was first introduced by the Finance Act, 1976 by inserting clause (vi) to section 9(1) of the ITA.

not including the amounts referred to in section 44BB;[20]

v. *The transfer of all or any rights (including the granting of a license) in respect of any copyright, literary, artistic or scientific work including films or video tapes for the use in connection with television or tapes for the use in connection with radio broadcasting, but not including consideration for sale, distribution or exhibition of cinematographic films; or*

vi. *Rendering of any services in connection with activities referred to in sub-clauses (i) to (v)."*

At the outset, it may be observed that the term royalty means a *consideration for* …….. the transfer of any right in respect of the copyright, literary, artistic or scientific work or in respect of the patent, invention, model, design, secret formula or process or trademark or similar property. Even a consideration for the use of the patent, invention, model, design, secret formula or process or trademark or similar property could be regarded as royalty. Therefore, unless there is a transfer of any right or the use of the right in patent, invention, model, design, secret formula or process or trademark or similar property, it cannot be regarded as royalty. It is evident that where the consideration paid is for the purchase of a product and not the transfer of an intellectual property *per se*, it cannot be regarded as a royalty. A recent amendment in the ITA has brought, the *consideration for* use or right to use, any industrial, commercial or scientific equipment under the purview of the expression 'royalty'. A closer look at the sub clauses (i) to (vi) of the definition of the term royalty under section 9 of the ITA would show that the word 'copyright' is not used in sub clause (i) to (iv), but is specifically dealt with in sub clause (v) of the said section. Therefore, copyright cannot be construed to have been included in the words 'similar property' of the sub clauses (i) to (iv). For example, the purchase of a book by a customer does not tantamount to the purchase of the copyright in the book, even though the publisher publishes the book by purchasing the copyright.

Thus, the most important aspect of this definition is the use of the words **"*consideration for ……..*"**. This clearly implies that the purpose for which the consideration is paid is of paramount importance for the interpretation of the expression 'royalty'. The Indian courts have emphasised that where the predominant transaction was the sale of the product and use of intellectual property is incidental to the sale of the products the same cannot be regarded as royalty. Now let us examine what would be the nature of transaction when

20. The Finance Act, 2001 introduced the concept of equipment royalty as part of the definition of royalty, which till then was not covered under the ITA.

right given in an intellectual property is only incidental to the primary transaction. In this regard Madras High Court[21] has observed that:

> "*In a contract for the design, manufacture, supply, erection and commissioning of machinery which does not involve license of the patent concerning the machinery, or copyright of its design, mere supply of drawings before the manufacture is commenced to ensure that the buyer's requirements are fully taken care of and the supply of diagram and other details to enable the buyer to operate the machines, and also to assure the buyer, that the machines will perform to the specification required by the buyer, such supply is* ***only incidental*** *to the performances of the total contract which includes design, manufacture and supply of the machinery.*
>
> *The price paid by the assessee to the supplier is a total contract price which covers all the stages involved in the supply of machinery from the stage of design to the stage of commissioning. The design supplied is not to enable the assessee to commence the manufacture of the machinery itself with the aid of such design. The limited purpose of the design and drawings is only to secure the consent of the assessee for the manner in which the machine is to be designed and manufactured, as it was meant to meet the special design requirements of the buyer.*"

One can observe from the above that, the term 'royalty' normally connotes the payment made to a person who has exclusive right over a thing for allowing another to make use of that thing which may be either physical or intellectual property or thing. The exclusivity of the right in relation to the thing for which royalty is paid should be with the grantor of that right. Mere passing of information concerning the design of a machine which is tailor made to meet the requirement of a buyer does not by itself amount to transfer of any right of exclusive use, so as to render the payment made therefore being regarded as 'royalty'. In a case where information concerning the working of the machine is supplied with the machinery, the courts have held that this information would not attract sub-clause (vi) of section 9(1) of the ITA as the supply of the design was only **preliminary** to the manufacture and integrally connected therewith.

It can therefore be inferred that, when the payment is made for the machinery and the supply of design etc, is only ***incidental*** to the sale of machinery, in order to utilise the machine in the best possible way, there is no license of any patent involved and the amount payable would essentially be taxed as business profits in the hands of the

21. *Commissioner of Income Tax* v. *Neyveli Lignite Corporation Ltd.*, [2000] 243 ITR 459 (Madras High Court).

recipient.

A similar proposition was laid down in a case decided by the Jaipur High Court[22] wherein it was held that the payment for supply of Basic Process Engineering documentation for designing, construction and operation of the plant was for creating an asset in the shape of the plant and therefore the same does not fall within the purview of royalty, but is business profits for supply of technical know-how and documentation.

The Group appreciates the Indian legal position and it would be interesting to note that a similar position has been independently taken by the IC TAG and the United States in their specific regulations for the tax treatment of certain transactions involving the transfer of computer programs which are effective from October 2, 1998.[23] Even the IC TAG has concluded that, in any given transaction, **the main question to be addressed is the identification of the consideration for the payment**. Thus, as per the IC TAG, where the essential consideration is for something other than the use of, or right to use, rights in the copyright (such as to acquire other types of contractual rights, data or services), and the use of copyright is limited to such rights as are required to enable downloading, storage and operation on the customer's computer, network or other storage, performance or display device, such use of copyright should be disregarded in the analysis of the character of the payment for treaty purposes. Thus, it is encouraging to note that the Indian legal position is in line with that followed internationally.

Thus, if the consideration is paid ***for*** a right other than a right in the intellectual property then in that event, the payment made should not be treated as royalties as it is a purchase for the purpose of use of the product. Thus the principle that emerges while dealing with e-commerce transactions is as follows :

> **In e-commerce transactions where a use of intellectual property is merely incidental to the use of the product and is put to use merely due to advancement in technology, i.e. like a medium, payment in respect of such products should not be classified as royalty since, the consideration is not made for using the intellectual property but for use of the product. The intellectual property merely passes incidental to the use of the product.**

Software payments

The HPC has stated that the payments made towards use of software could fall within

22. *Modern Threads (India) Ltd.* v. *Deputy Commissioner of Income Tax*, [2000] 243 ITR 60 (Rajasthan High Court).
23. *Treas*. Regs. Dec. 1.861-18.

clause (i), (iii) and (v) of Explanation 2 of Section 9 of the definition of the term royalty under the ITA. The Group is of the view that the amount cannot fall within clause (i), (iii) and (v) of Explanation 2 of Section 9 of the definition of the term royalty under the ITA because:

- There is no transfer of any right **in respect of** the copyright, literary, artistic or scientific work;
- There is no transfer of any right **in respect of** the patent, invention, model, design, secret formula or process or trademark or similar property;
- There is **no "use"** of the patent, invention, model, design, secret formula or process or trademark or similar property;
- The consideration is being paid **for** the **use of the product** and not for any right in respect of the copyright, or in the patent, invention, model, design, secret formula or process or trademark or similar property; (it may also be noted that under the Indian law no assignment of copyright is valid unless it is in writing)
- Lastly, the copy which takes place is only **incidental** to the use of the product and not for the **purpose of acquiring any right** in the copyright and thus should be ignored for the purposes of characterisation.

Thus, the Group is of the view that the income earned is from the activity of sale of the product and cannot be classified as royalty under clause (i), (iii) and (v) of the ITA. The consideration paid is for the purchase of the product and does in no manner result in the transfer of a copyright in the product. Hence, it must be classified as business income. However, if the consideration is for right to commercially exploit the intellectual property in the software, then the same could tantamount to royalty.

Equipment royalty

If the payments are made for the use of the industrial, commercial or scientific equipment, then it could be regarded as equipment royalty, provided that the customer has **possession or control** over the equipment. When the service provider allows the customer the use of the equipment along with other customers and does not give the control or possession of the equipment, the payments made cannot be regarded as having been made for the use of the equipment, thereby cannot amount to equipment royalty. Thus, such a payment should be regarded as payment made for the use of services.

The above situation is similar to the booking of a seat in an aeroplane where, a purchaser of the ticket uses the equipment i.e. the aeroplane, but does not have the possession or the control over the aeroplane. Such type of payments are not and cannot be regarded as royalties as the user does not get possession or control of the equipment.

Here it would be important to note the observations of the IC TAG made in this regard. The IC TAG have stated that where, a particular convention included a definition of royalties that covers "payments for the use of, or the right to use, industrial, commercial or scientific equipment", the question is, whether these words can be applied to all or part of the payments arising from the transaction such as the one described above. In this situation, it was necessary to determine whether the payments are for "the use of, or the right to use, industrial, commercial or scientific equipment". In order to determine this, it is necessary to consider the following factors:

(a) the customer is in physical **possession** of the property;

(b) the customer **controls** the property;

(c) the customer has a significant **economic or possessory interest** in the property;

(d) the provider **does not bear any risk** of substantially diminished receipts or substantially increased expenditures if there is non-performance under the contract;

(e) the provider **does not use the property concurrently** to provide significant services to entities unrelated to the service recipient; and

(f) the total payment **does not substantially exceed the rental value** of the computer equipment for the contract period.

In light of the above discussion, the IC TAG concluded that in the absence of these factors these transactions should generally give rise to ***services income*** **as opposed to rental payments**.

While each category has been specifically dealt with in section 2, the elaborations of the principles stated above, are explained through the following two illustrations.

Illustration 1*: Downloading of software*

Mr. A selects an item (say for example Microsoft Office) from an online catalogue of software and orders the same electronically from a commercial provider for his use. The digital product is downloaded onto Mr. A's hard disk. The question arises as to whether payments made for the same could fall within the ambit of the definition of the term royalty.

Analysis:

The payments would not fall within the definition of the term royalty as the consideration is not made **for** the use of or the transfer of any right in respect of the patent (assuming that the product is patented), invention, model, design, secret formula or process or trademark or similar property, or copyright or literary work for the following reasons:

- The payment is merely made for the use of the software program, i.e. a patented product and not the patent itself. Mr. A is not using the patent or the like. He is merely using the software program. Even if in the remotest possibility it is argued that there is a use of a patent, or the like it could be said that the use of the patent is merely incidental to the use of the software program and thus has to be ignored for the purposes of the characterisation of the payments made. It may be noted that in India patents are not granted for software products although copyright protection is available.

- The consideration is not paid **for** the "*transfer of all or any rights in the copyright*". Even if a minimal downloading is done it is merely incidental to the use of the software (which is a copyrighted product) and such **incidental** activity is to be ignored for the purposes of characterisation of a payment as royalty. Here, there is no transfer of any right **in** respect of the copyright. The copyright at all times remains with the copyright holder. Consideration is paid for the software. Thus, the amount cannot be construed as being paid for "copyright".

- Literary work[24] as defined by the Indian Copyright Act, includes computer software. However, in such a case Mr. A has not acquired any right in the software, i.e. he is not authorised to deal with the software as he pleases, but is merely authorised to *use* the software. Copyright cannot be validly assigned unless there is a written contract. According to the Group, although the '*transfer of a literary work*' has been included in the definition of the term royalty, the '*use of a literary work*' falls out of the ambit of this definition. Had the Parliament ever intended to cover the use of a literary work, the same would have been expressly provided by the definition, as have been brought out in the earlier sub-clauses (such as patents, invention, etc.).

24. "Literary Work" includes computer programmes, tables and compilations including computer databases.

Illustration 2: *Equipment royalty*

Mr. A establishes a server in his country and provides some space on the same to Mr. B who wishes to host his company's website on it. Mr. A maintains the server and receives payment from Mr. B for the use of the services provided by Mr. A.

Analysis:

The payments made would not fall under the definition of the term royalty i.e. equipment royalty due to the following reasons:

- The server is owned and maintained by Mr. A, and Mr. A merely provides access to his many customers. Mr. A has a right to remove and replace the server at his will. Mr. B does **not have any control and possession** over the server. Further, Mr. A is in the business of providing such services and collects such income in the normal course of his business. Thus, the payments made for the same would be for the purpose of services rendered by Mr. A to Mr. B and hence it should be characterised as business profits.

- There is a remote possibility that such payments could be characterised as fees for technical services. However, as has been held in a recent case decided by the Madras High Court,[25] installation and operation of sophisticated technical equipment with a view to earn income by allowing customers to avail of the benefit of the user of such equipment does not result in the provision of technical services to the customer for a fee. It was further held that mere collection of a 'fee' for use of a standard facility provided to all those willing to pay for it does not amount to the fee having been received for technical services. The case of Mr. B is similar to that decided by the Madras High Court and thus the fees paid by Mr. B cannot be characterised as a fee for technical services.

Interpretation under the DTAA:

HPC has taken India-US and India-UK DTAA's as illustrations for the interpretation of the term royalty under a DTAA. It may be noted here that the definition of royalty under the DTAA's is different from that under the ITA. The definition is reproduced here under;

25. *Skycell Communications Ltd.* v. *DCIT*, [2001] 251 ITR 53 (Madras High Court).

As per Article 12(3) of the India-US DTAA royalty is defined to mean:

(a) *Payments of any kind received as a consideration for the use of, or the right to use, any copyright of a literary, artistic, or scientific work, including cinematography films or work on film, tape or other means of reproduction for use in connection with radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience including gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof; and*

(b) *Payments of any kind received as consideration for the use of, or the right to use, any industrial, commercial, or scientific equipment, other than payments derived by an enterprise described in paragraph 1 of Article 8 (Shipping and Air Transport) from activities described in paragraph 2(c) or 3 of Article 3.*

Article 13(3) of the India-UK DTAA also defines the term royalty on similar lines.

From the above, one can observe that, if the consideration is paid for the use or right to use any copyright of a literary, artistic, or scientific work or any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience or for the use of, or the right to use, any industrial, commercial, or scientific equipment would be regarded as royalty.

Software payments

The payments made for purchase of a product, in which intellectual property is embodied, cannot be regarded to have been paid for the use or right to use any copyright of a literary, artistic, or scientific work or any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience. The amount cannot fall within clause 3(a) of Article 12 and clause 3(a) of Article 13 of the definition of the term royalty under the India-US and India-UK DTAA respectively. However, if the payment is made for commercial exploitation of intellectual property, then the same could be regarded as royalty.

Equipment royalty

As discussed above under the definition of ITA, if the payments are made for the use of the industrial, commercial or scientific equipment, then it could be regarded as equipment royalty, provided that the customer has **possession or control** over the equipment. When the service provider allows the customer the use of the equipment along with other customers and does not give the control or possession of the equipment, the payments made cannot be regarded as having been made for the use of the equipment, thereby cannot amount to equipment royalty. Thus, such a payment should be regarded as payments made for the use of services.

With regard to the meaning of the term royalty under Article 12 of the India-US DTAA, the Authority for Advance Rulings (**"AAR"**) in a recent ruling[26] has held that -

> *"It is to be noted that the meaning of royalty as given in paragraph 3(a) deals with payments as consideration 'for the use of, or right to use' of the things mentioned in clause (a) of paragraph 3. This includes copyright, literary or artistic or scientific work, including cinematographic films or work on film, tape or other means of reproduction for use in connection with radio or television broadcasting, any patent, trade mark, design, or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience. These payments must be for the use or the right to use the things specified in clause (a) and not for out and out sale thereof. However, there is a clause relating to alienation of property. That clause which is the concluding words of paragraph 3(a) speaks of 'gains derived from alienation of any such right or property which are contingent on the productivity, use or disposition thereof.' In other words, if any alienation of right or property is made for consideration and such consideration is payable contingent upon productivity, use for disposition, as the case may be, of that property, such payment may come within the expanded definition of royalty."*

In the same ruling, the AAR while analysing when a technology will be regarded to have been made available, observed that:

> "*The principle that emerges from an analysis of situation illustrated in the memorandum in this aspect, is that technology would be considered made available when the person acquiring the service is enabled to apply the technology embedded in the services provided to him. The mere fact that the provisions of the service may require technical input by the person providing the service would not per se mean that technology has been made available. Similarly, the use of a product, which embodies technology, shall not per se constitute technology being made available*."

26. AAR No. 475/1999 decided by the Authority for Advance Rulings.

In another case decided by the Calcutta High Court,[27] which observed the following while examining what constitutes royalty:

> **"***What is important to consider is that, in order that a payment may be treated as royalty for the purposes of Article XIII of the Agreement for Avoidance of Double Taxation between India and the U. K., the person who is the owner of such patents, designs or models, plans, secret formula or process, etc., retains the property in them and permits the use or allows the right to use such patents, designs or models, plans, secret formula, etc. In other words, where the transferor retains the property right in the designs, secret formula, etc., and allows the use of such right, the consideration received for such use is in the nature of royalty. Where, however, there is an outright sale or purchase, as in the present case, the consideration is for the transfer of such designs, secret formula, etc., and cannot be treated as royalty."*

Here, an Indian company had purchased drawings and designs for a plant from a company based in UK. The UK resident seller provided complete rights to the design and drawings to the Indian company. The assessing officer sought to tax this income in India as royalty. The question for consideration before the Calcutta High Court was whether this was a correct stance. It was pointed out to the High Court that the definition of royalty under the ITA was different from those in the provisions of the DTAA. The High Court ruled that as there was an outright sale of design and drawings by the foreign company to the Indian company and hence the amount of consideration received by the foreign company could not be taxed in India as royalty income.

Thus, it can be said that if the agreement gives full rights to use, enjoy and exploit the property (such as design and drawings) in any manner as may be deemed fit by the purchaser thereof and if there is a complete alienation of the property, then the income arising in the hands of the recipient cannot be treated as royalty under the DTAA. However, complexities may arise if full rights are not given to the purchaser. For example, use of the property may be permitted only within India. Some guidance is available under the OECD Model commentary relating to software. Paragraphs 15 and 16 of Article 12 of the OECD Model admits that difficulties would arise in cases of extensive but partial alienation of rights. While each case will depend upon its particular facts, in general such payments are likely to be Commercial Income

27. *Commissioner of Income Tax* v. *Davy Ashmore India Limited,* [1991] 190 ITR 626 (Calcutta High Court).

(covered by Article 7 or Article 14) or Capital Gains (covered by Article 13), rather than Royalties (covered by Article 12). Thus, if the payment is in substance for alienation of substantial rights, it should not be treated as royalty. Otherwise, the entire amount will be taxable as royalties. The word royalty should be construed on its own terms and substance and not on the basis of its label or form.[28]

It may be worth reproducing Article 1(3) of the UN convention on "Multilateral Convention For The Avoidance Of Double Taxation Of Copyright Royalties ("**UN Convention**")" of which India is a party:

> *"With the exception of payments made in respect of the "droit de suite", **the following shall not be considered as copyright royalties for the purposes of this Convention: payments for the purchase, rental, loan or any other transfers of a right in the material base of a literary, artistic or scientific work**, even if the amount of this payment is fixed in the light of the copyright royalties due or if the latter are determined, in whole or in part, by that of the said payment. When a right in the material base of work is transferred as an accessory to the transfer of the entitlement to use a copyright in the work, only the payments in return for this entitlement are copyright royalties for the purposes of this Convention."*

Thus, when the payments are made for the purchase, rental, loan or any other transfers of a right in the material base of a literary, artistic or scientific work the payment made cannot be regarded as copyright royalties. India has however, expressed its reservations on the above article and has expressly stated that it shall not be bound by this article.[29] However, India has not necessarily taken any adverse view. Nevertheless, the provisions of this article (i.e. the mere definition of what is copyright royalty) would have a persuasive value since it is an internationally accepted principle.

Relevance of the OECD Commentaries

Section 90(2) of the ITA provides that in case where there exists a DTAA between India and resident of another country, the provisions of the ITA shall apply to the extent they are more beneficial to the assessee. Most of the Indian DTAA's are based on the OECD/United Nation **("UN")** model convention depending upon whether the DTAA is entered into with a developed/ developing country respectively.

28. *Inderjit Singh Sial* v. *Karam Chand Thapar*, [1995] 6 SCC 166 (Supreme Court of India).
29. India deposited its instrument of accession to the UN Convention on January 31, 1983.

In the characterisation of the 28 categories of income from e-commerce transactions the TAG has relied on the commentaries of OECD for the interpretation of the term 'royalty'. It may be noted that the OECD/UN commentaries are external aids of interpreting a tax treaty. They are an important source of interpretation. If the text of the OECD model has been adopted unchanged, it is assumed that the Contracting States intended to conform to the commentaries. Commentaries do not form part of the text of a tax treaty. They may form *travaux preparatories*.[30] A treaty is the result of negotiations spreading over a long period of time. The final draft owes its origin and actual wording to some prior treaty preparing process. Reference to *travaux preparatories* as an aid to interpretation has been recognised by the Vienna Convention on the Law of Treaties of 1969.[31] In the same manner as 'legislative history' forms a part of the legislative enactment.[32] The courts are entitled to consider the OECD commentaries in determining the construction of a treaty.[33] Subsequent commentaries on a treaty have a persuasive value only, depending on the cogency to their reasoning .[34]

It may be pertinent to note that though the HPC has referred to the OECD commentaries on software royalties, it has differed in its characterisation under the India-US and India-UK DTAA. The HPC has given no reasons for its deviation from the same.

It may be worthwhile to note that when the India-UK DTAA was signed (February 11, 1994), the OECD commentary on software was available as it was already issued in the year 1992. Thus, while interpreting the India-UK DTAA, regard must be had to the commentary available on the subject, as the parties to the aforementioned treaty must have signed the treaty on the understanding that the commentary was acceptable to them. Further, in the Group's view if any commentaries exist at the time of entering into a DTAA and a language similar to that under the model convention is adopted, the intent/interpretation of the commentaries cannot be ignored. Further, a country unilaterally cannot change its view on the interpretation of a DTAA.

30. *Travaux preparatories* is a term that designates those intrinsic materials which have the formative effect on the final draft of the treaty, and which, therefore, assist in the disclosure of the parties aims and intentions.

31. Articles 31 and 32 of the Vienna Convention on the Law of Treaties, 1969 codify the already existing practice of such reference by the national courts.

32. D.P. Mittal, **Indian Double Taxation Agreements & Tax Laws** at 1.69(2001).

33. See, *Fothergill* v. *Monarch Airlines Ltd.,* (1981) AC 251, *Sun Life Assurance Co. of Canada* v. *Pearson,* [1986] STC 335 and *Theil* v. *FCT* 89 ATC 4015 cited in *Ibid.*

34. D.P. Mittal, **Indian Double Taxation Agreements & Tax Laws** at 1.65 (2001).

Thus to summarise, tax agreements are special rules and in this sense they override the domestic tax laws on the basis of the doctrine of *Generalia specialibus non-derogant*. This maxim is ordinarily applied where there is a conflict between a special and a general statute. It is subject to the provision that there is nothing in the general provision expressed or implied indicating an intention to the contrary. In other words, to invoke the said maxim, the general and special rules shall occupy the same field. In case of a conflict, the special provision must prevail. Tax agreements are special rules and, therefore, they "precede" tax laws and the parties must follow the principle of *Pacta sunt servanda.*

The Indian courts in the decision given by the Andhra Pradesh High Court[35] as early as 1983, have substantiated the above principles. The observations made by Andhra Pradesh High Court 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 Indian Courts and AAR have been relying on the OECD commentaries while interpreting the DTAA.

In light of the above definitions, royalty could be broadly considered to be having the following characteristics:

- A payment made to the owner of a property, for grant of right of access, use, exploitation;
- The exclusive ownership remains with the owner;
- The grant of right enables the receiver to commercially exploit the property and create an article, or thing or intellectual property from such exploitation;
- The grant of right does not give the receiver ownership right in the property

From the above discussions it may be observed that the interpretation of the term

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

royalty under the ITA and/or the DTAA would lead to the same results as interpreted by the TAG. Before proceeding with a detailed analysis of the 28 categories of income characterisation the Group would like to express its views on the specific enforcement issues that have been identified by the HPC in their Report.

1.8 Enforcement Issues

The HPC has in great depth studied the various tax related enforcement issues including *inter alia* identity-location of parties, anonymity of transactions-accounts, dis-intermediation, transfer pricing, *etc.* that are likely to arise in this new economy form of business. The Group appreciates the stand taken by the HPC that in a majority of the e-commerce transactions, the parties are not anonymous and audit trails are traceable. The Group appreciates and concedes with the point put forward by the HPC that the Government should get involved in the initiatives taken by the OECD and any other similar international bodies so that an international consensus can be reached on the various enforcement issues.

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2. CHARACTERISATION

The Group has observed that in its analysis of the 28 categories of e-commerce transactions identified by the IC TAG, the HPC has not explained the basis for its views when they differ from the characterisations as laid down by the OECD. The Group has also analysed these 28 categories of income characterisation as laid down by the IC TAG. In doing so the Group has elucidated its reasons for each characterisation whenever the views of the Group are at divergence with that of the HPC.

The following is the analysis carried out by the Group on the 28 categories for income characterisation:

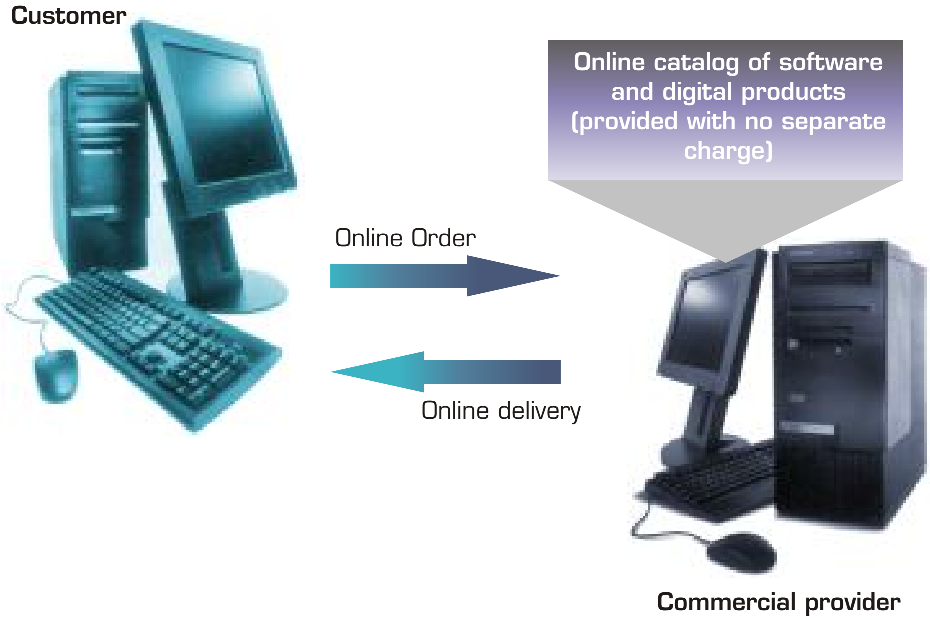
2.1 Category 1: *Electronic order processing of tangible products*

Definition

The customer selects an item from an online catalog of tangible goods and orders the item electronically directly from a commercial provider. There is no separate charge to the customer for using the online catalog. The product is physically delivered to the customer by a common carrier.

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business profits	Business profits	Business profits	Business profits

2.2 Category 2: *Electronic ordering and downloading of digital products*



Definition

The customer selects an item from an online catalogue of software or other digital products and orders the product electronically directly from a commercial provider. There is no separate charge to the customer for using the online catalogue. The digital product is downloaded onto the customer's hard disk or other non-temporary media

Before the Group proceeds with a discussion on this category, it may be observed that between the first two categories of income characterisation, the only point of differentiation is the mode of delivery of the products. Though the HPC in their Report, on Page 15, have accepted that the mode of delivery should not change characterisation of income payments, they have differed on their conclusion on that very point. Thus, following the principle of neutrality there should be no change in the characterisation of income from category 1.

IC TAG (OECD) View	HPC View ITA	Group View (ITA)
Business profits	Royalty	The amount cannot fall within clause (i), (iii) and (v) of Explanation 2 of section 9 of the definition of the term royalty under the ITA because: ● There is no transfer of any right **in respect of** the copyright, literary, artistic or scientific work ● There is no transfer of any right **in respect of** the patent, invention, model, design, secret formula or process or trademark or similar property; ● There is **no "use"** of the patent, invention, model, design, secret formula or process or trademark or similar property; ● The consideration is being paid **for** the **use of the product** and not for any right in respect of the copyright, or in the patent, invention, model, design, secret formula or process or trademark or similar property; ● Lastly, the copy which takes place is only **incidental** to the use of the product and not for the **purpose of acquiring any right** in the copyright and thus should be ignored for the purposes of characterisation. Thus, the Group is of the view that the income earned is from the activity of sale of the product and cannot be classified as royalty under clause (i), (ii) and (v) of the ITA. The consideration paid is for the purchase of the product and does in no manner result in the transfer of a copyright in the product. Hence, it must be classified as business income.

IC TAG (OECD) View	HPC View India-US & India-UK DTAA	Group View (India-US & India-UK DTAA
Business profits	Royalty	The amount cannot fall within clause 3 of Article 12 and clause 3 of Article 13 of the definition of the term royalty under the India-US and India-UK DTAA respectively because: • The consideration is not paid for the use or right to use any copyright of a literary, artistic, or scientific work or any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience; • The consideration is not for the use of, or the right to use, any industrial, commercial, or scientific equipment. The Group is of the view that the income earned is from the activity of sale of the product and cannot be classified as royalty under the provisions of the respective treaties. Thus, following the principle of neutrality there should be no change in the characterisation of income from category 1. The amount paid is for the purchase of the product and does in no manner result in the use of a copyright in the product. Hence, it must be classified as business income. The Group observes that the HPC has not given adequate reasoning for determination of the payments made as royalty. It would be important to note that if such a view is taken by India, it may hamper the growth of software industry in India. It may so happen that other countries may regard the payments made to Indian software companies as royalties and thus impose a withholding tax on the same. *E.g.* The Group understands that Japan has characterized payments made to Indian software companies as royalties and imposed withholding tax on

IC TAG (OECD) View	HPC View India-US & India-UK DTAA	Group View (India-US & India-UK DTAA
Business profits	Royalty	the same. The Indian tax authorities, under the competent authority proceedings, have taken a view that such payments should not be regarded as royalties. Thus, the Group fails to understand the rationale for the views expressed by the HPC. It would be also important to take into consideration observations made by the Indian court in the case of Commissioner of Income Tax vs. Visakhapatnam Port Trust [1983] 144 ITR 146(Andhra Pradesh High Court)_ on OECD commentaries: *"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 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."* Thus, the Group feels that the HPC should have taken into account the OECD commentaries on software payments while interpreting the provisions of the DTAA. It would be also important to note that, India has entered into DTAA with the UK in 1994, which is after the OECD had provided its commentaries on payments made for computer software in 1992. Thus, if India was in disagreement with the OECD commentaries on software payments, India should have expressed a reservation on such interpretation either through providing appropriate language in the DTAA or through a protocol. Since the

IC TAG (OECD) View	HPC View India-US & India-UK DTAA	Group View (India-US & India-UK DTAA
Business profits	Royalty	same was not done, one could have reasonable belief that India would take a position consistent with the one taken by the OECD.

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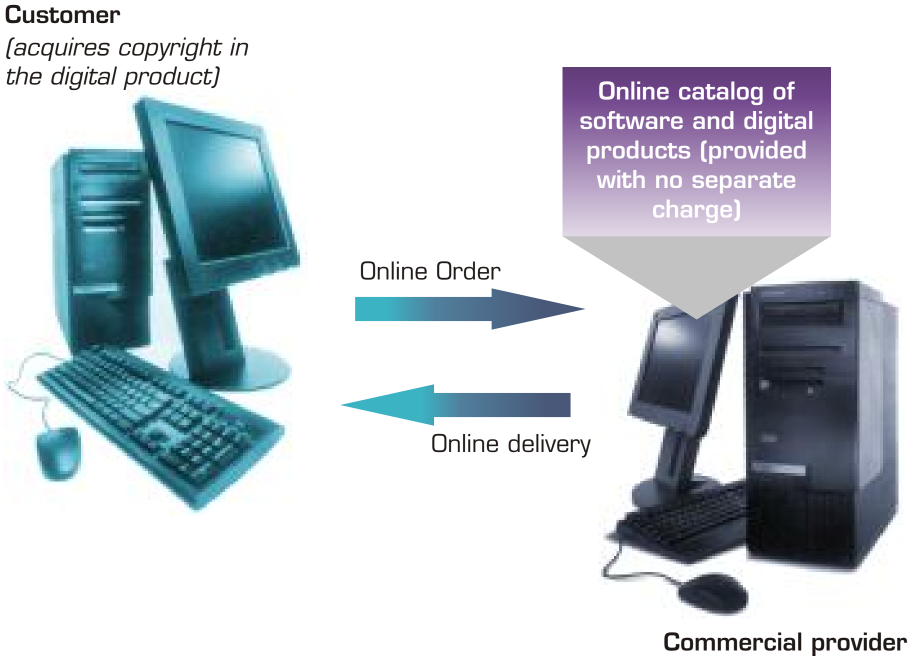
2.3 Category 3: *Electronic ordering and downloading of digital products for the purposes of copyright exploitation*



Definition

The customer selects an item from an online catalogue of software or other digital products and orders the product electronically directly from a commercial provider. There is no separate charge to the customer for using the online catalogue. The digital product is downloaded into the customer's hard disk or other non-temporary media. The customer acquires the right to commercially exploit the copyright in the digital product (e.g. a book publisher acquires a copyrighted picture to be included on the cover of a book that it is producing).

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Royalty	Royalty	Royalty	Royalty

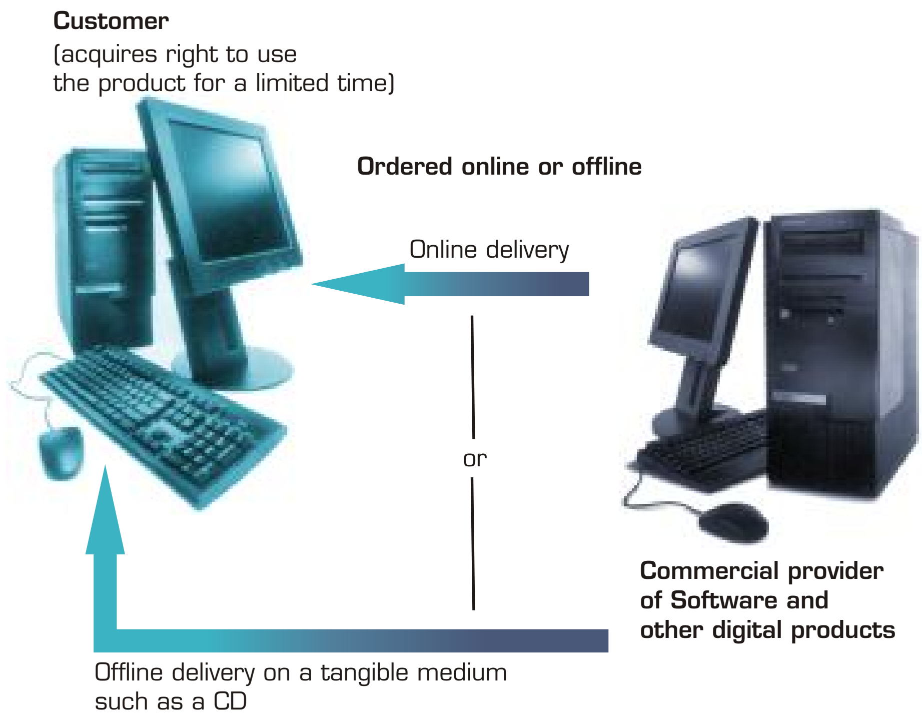
2.4 Category 4: *Updates & Add-ons*

Definition

The provider of software or other digital product agrees to provide the customer with updates and add-ons to the digital product. There is no agreement to produce updates or add-ons specifically for a given customer.

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits	Royalty	Royalty	Business Profits • The Group is of the view that the medium of delivery of the add-ons to the digital product would not change the manner of the characterisation; • Thus, payments for this transaction would be characterised in the same manner as have been characterised in Categories 1 and 2, for the reasons mentioned in Category 2 above.

2.5 Category 5: *Limited duration software and other digital information licenses*

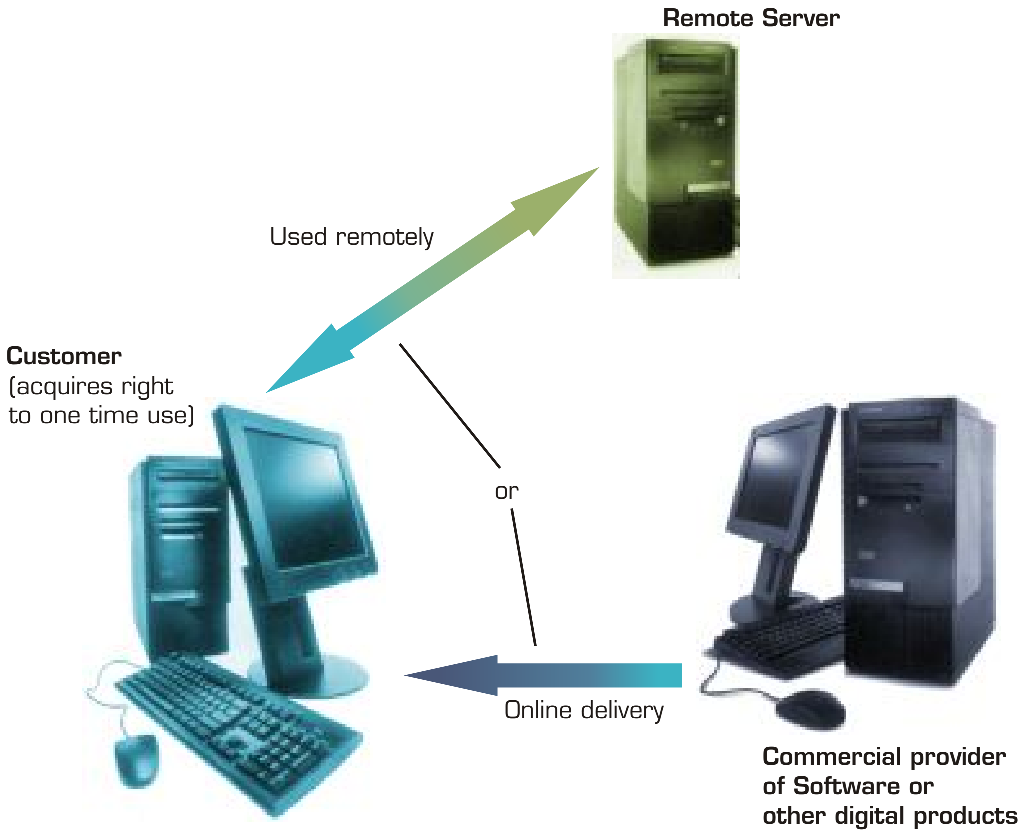


Definition

The customer receives the right to use software or other digital products for a period of time that is less than the useful life of the product. The product is either downloaded electronically or delivered on a tangible medium such as a CD. All copies of the digital product are deleted or become unusable upon termination of the license.

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits	Royalty	Royalty	Business Profits • The time duration of the software should not change the characterisation so long as the user is not acquiring any rights in the intellectual property; • Thus, payments for this transaction would be characterised in the same manner as have been characterised in Categories 1 and 2, for the reasons mentioned in Category 2 above.

2.6 Category 6: *Single-use software or other digital product*

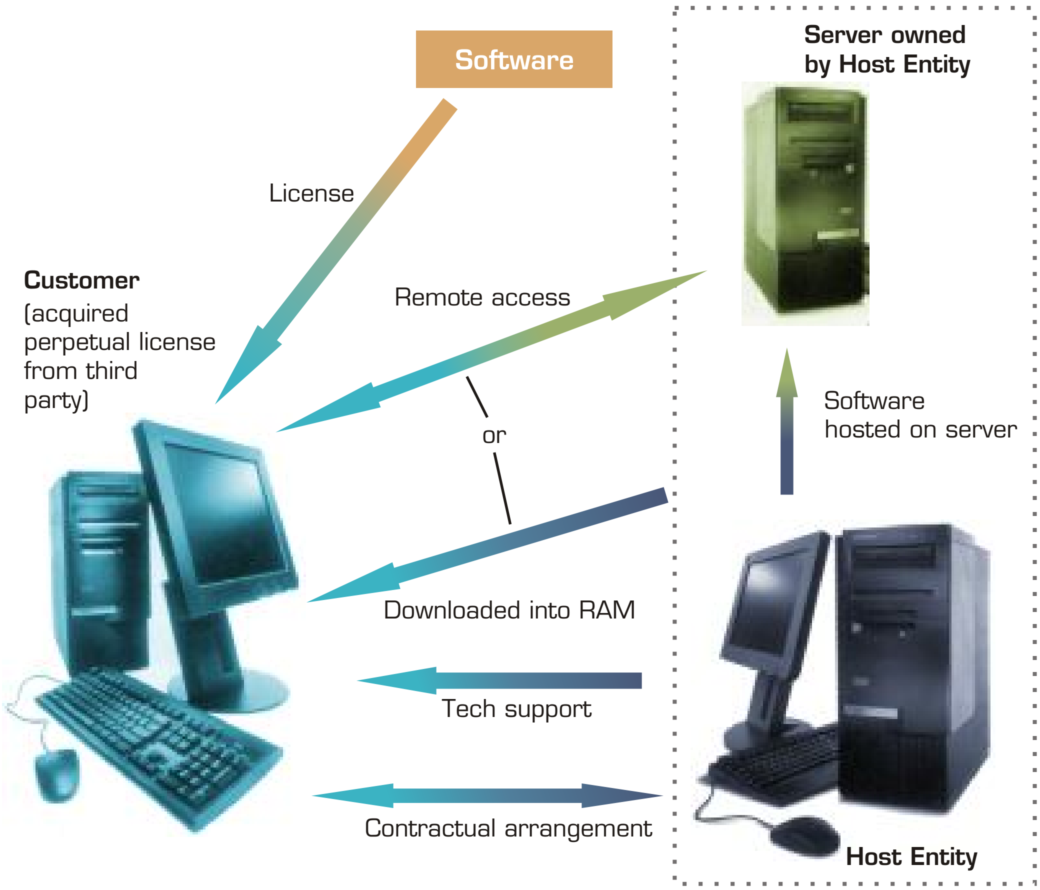


Definition

The customer receives the right to use software or other digital products one time. The product may be either downloaded or used remotely (e.g. use of software stored on a remote server). The customer does not receive the right to make copies of the digital product other than as required to use the digital product for its intended use.

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits	Royalty	Royalty	Business profits • In this transaction, the software is neither made available to the user for commercial exploitation of the downloaded product nor for exploitation of the intellectual property therein. Thus, as mentioned above the number of times the software can be used would not make a difference for characterisation purposes; • Thus, payments for this transaction should be characterised as business profits, for the reasons mentioned in Category 2 above.

2.7 Category 7: *Application Hosting - Separate License*



Definition

A user has a perpetual license to use a software product. The user enters into a contract with a host entity whereby the host entity loads the software copy on servers owned and operated by the host. The host provides technical support to protect against failures of the system. The user can access, execute and operate the software application remotely. The application is executed either at a customer's computer after it is downloaded into RAM or remotely on the host's server. This type of arrangement could apply, for example, for financial management, inventory control, human resource management or other enterprise resource management software applications.

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits	Royalty	Royalty	Business Profits • HPC has *inter alia* relied on the ruling of the AAR reported in 238 ITR 296. At the outset the Group observes that the view taken by the HPC contradicts with that expressed in the said ruling. Please refer to the ***Annexure*** for a detailed discussion on the aforementioned ruling; • In the transaction described above, the payments made cannot be regarded as having been made for the use of the equipment, thereby amounting to equipment royalty, as, the customer does **not have possession or control** over the equipment and will utilize the equipment concurrently with other customers. Thus, such a payment cannot be regarded as having been made for the use of equipment, but should be regarded as payment made for the use of services. The above situation is similar to the booking of a seat in an aeroplane where, a purchaser of the ticket uses the equipment i.e. the aeroplane, but does not have the possession or the control over the aeroplane. Such type of payments are not regarded as royalties as the user does not get any possession or control of the equipment. • Here it would be important to note the

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits	Royalty	Royalty	Business Profits observations of the **IC TAG** in this regard. The IC TAG have stated that where, a particular convention included a definition of royalties that covers "payments for the use of, or the right to use, industrial, commercial or scientific equipment", the question is, whether these words can be applied to all or part of the payments arising from the transaction such as the one described above. In this situation, it was necessary to determine whether the payments are for "the use of, or the right to use, industrial, commercial or scientific equipment". In order to determine this, it is necessary to consider the following factors: (a) the customer is in physical **possession** of the property; (b) the customer **controls** the property; (c) the customer has a significant **economic or possessory interest** in the property; (d) the provider **does not bear any risk** of substantially diminished receipts or substantially increased expenditures if there is non-performance under the contract; (e) the provider **does not use the**

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits	Royalty	Royalty	Business Profits **property concurrently** to provide significant services to entities unrelated to the service recipient; and (f) the total payment **does not substantially exceed the rental value** of the computer equipment for the contract period. In light of the above discussion, the IC TAG concluded that these transactions should generally give rise to ***services income* as opposed to rental payments**. HPC in its characterisation has drawn support from the ruling reported in 238 ITR 296 to express its views for this category. The Group is of the view that the characterisation of the transaction referred to in the aforementioned ruling should be akin to the transaction referred to in Category 13 ● Now let us examine whether the payments for such services can be characterised as fees for technical/included services. In view of the Group, such payments cannot be regarded as fees for technical/included services because there are no technical services being rendered. Support can be drawn from the recent case decided by the Madras

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits	Royalty	Royalty	Business Profits High Court[36] where it was held that, use of sophisticated technical equipment with a view to earn income by allowing customers to use such an equipment for a fee does not result in the provision of technical services to the customer. It was further held that mere collection of a 'fee' for use of a standard facility provided to all those willing to pay for it does not amount to the fee having been received for technical services.

36. *Skycell Communications Ltd.* v. *DCIT*, [2001] 251 ITR 53 (Madras High Court).

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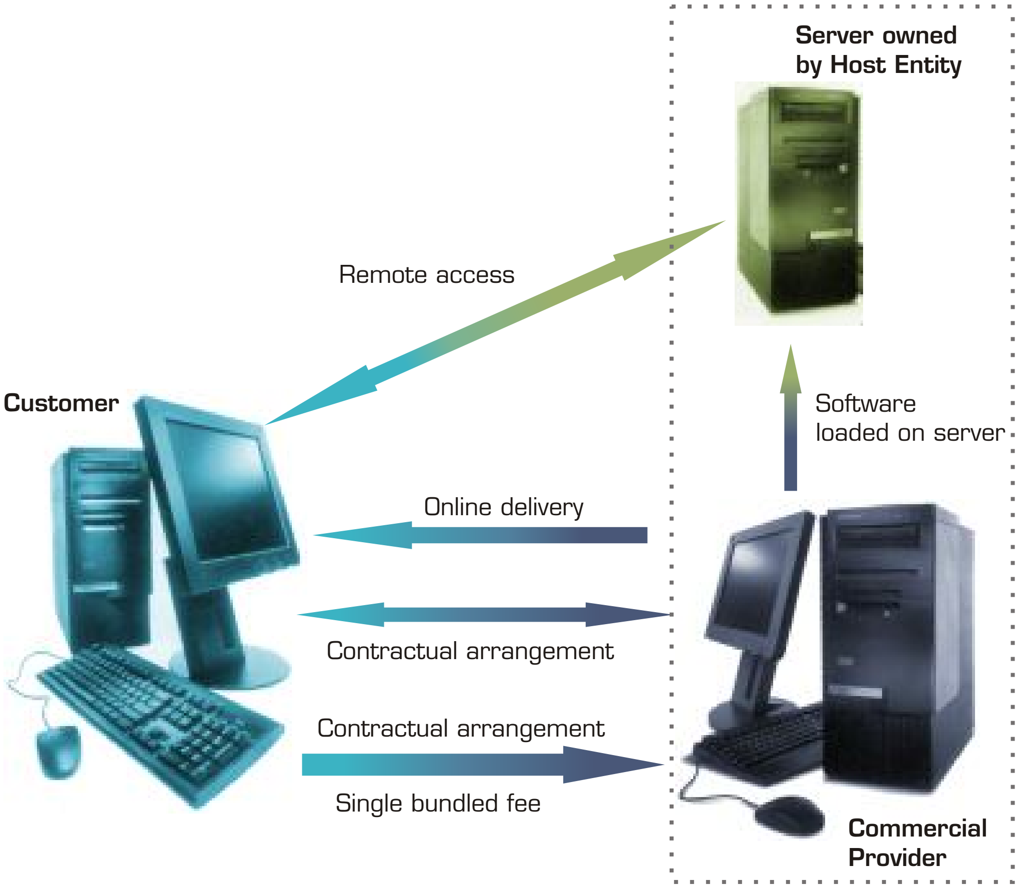
2.8 Category 8: *Application Hosting - Bundled Contract*

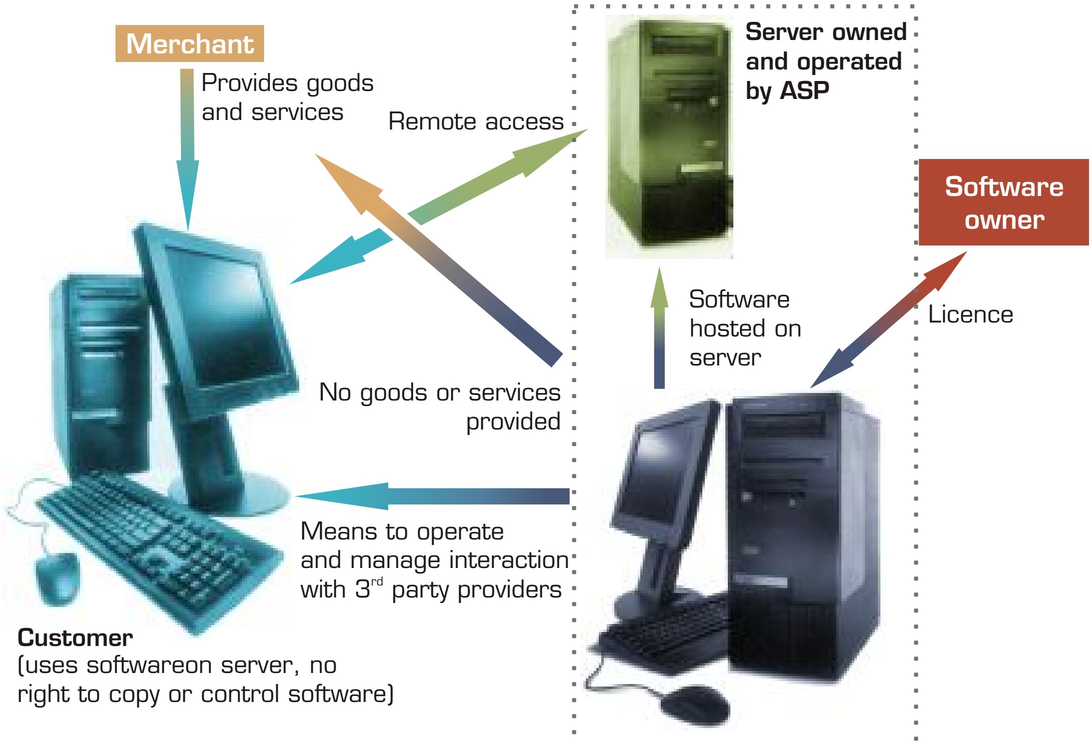


Definition

For a single, bundled fee, the user enters into a contract whereby the provider, who is also the copyright owner, allows access to one or more software applications, hosts the software applications on a server owned and operated by the host, and provides technical support for the hardware and software. The user can access, execute and operate the software application remotely. The application is executed either at a customer's computer after it is downloaded into RAM or remotely on the host's server. The contract is renewable annually for an additional fee.

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits	Royalty	Royalty	Business Profits • As mentioned above, payments made for this category cannot be regarded as having been made for the use of equipment or for the use of technical services due to the reasons mentioned in Category 7 above; • Further, the amount would not be considered as royalty due to the reasons mentioned in Category 2 above.

2.9 Category 9: *Application Service Provider ("ASP")*

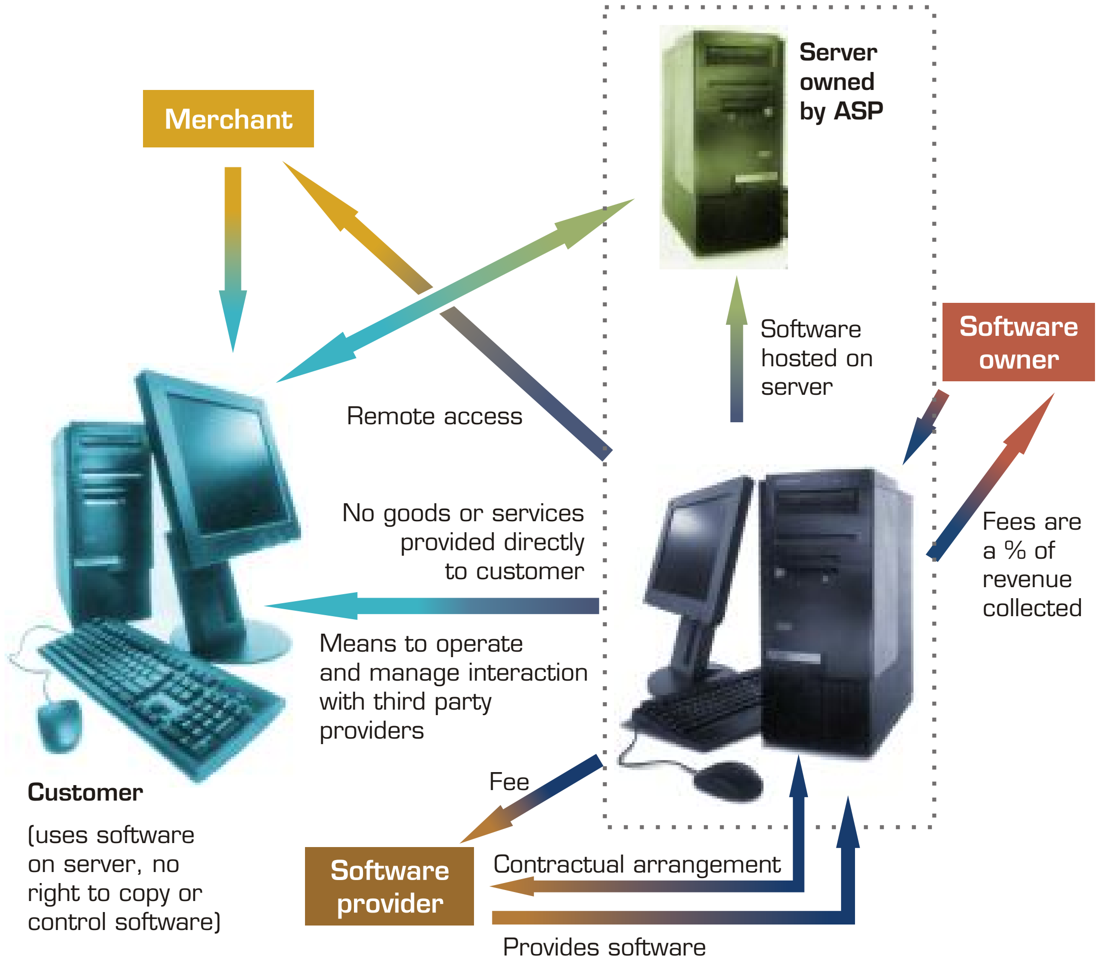


Definition

The provider obtains a license to use a software application in the provider's business of being an application service provider. The provider makes available to the customer access to a software application hosted on computer servers owned and operated by the provider. The software automates a particular back-office business function for the customer. For example, the software might automate sourcing, ordering, payment, and delivery of goods or services used in the customer's business, such as office supplies or travel arrangements. The provider does not provide the goods or services. It merely provides the customer with the means to automate and manage its interaction with third-party providers of these goods and services. The customer has no right to copy the software or to use the software other than on the provider's server, and does not have possession or control of a software copy.

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits	Royalty	Royalty	Business Profits • As mentioned above, payments made for this category cannot be regarded as having been made for the use of equipment or for the use of technical services due to the reasons mentioned in Category 8 above.

2.10 Category 10: *ASP License Fees*

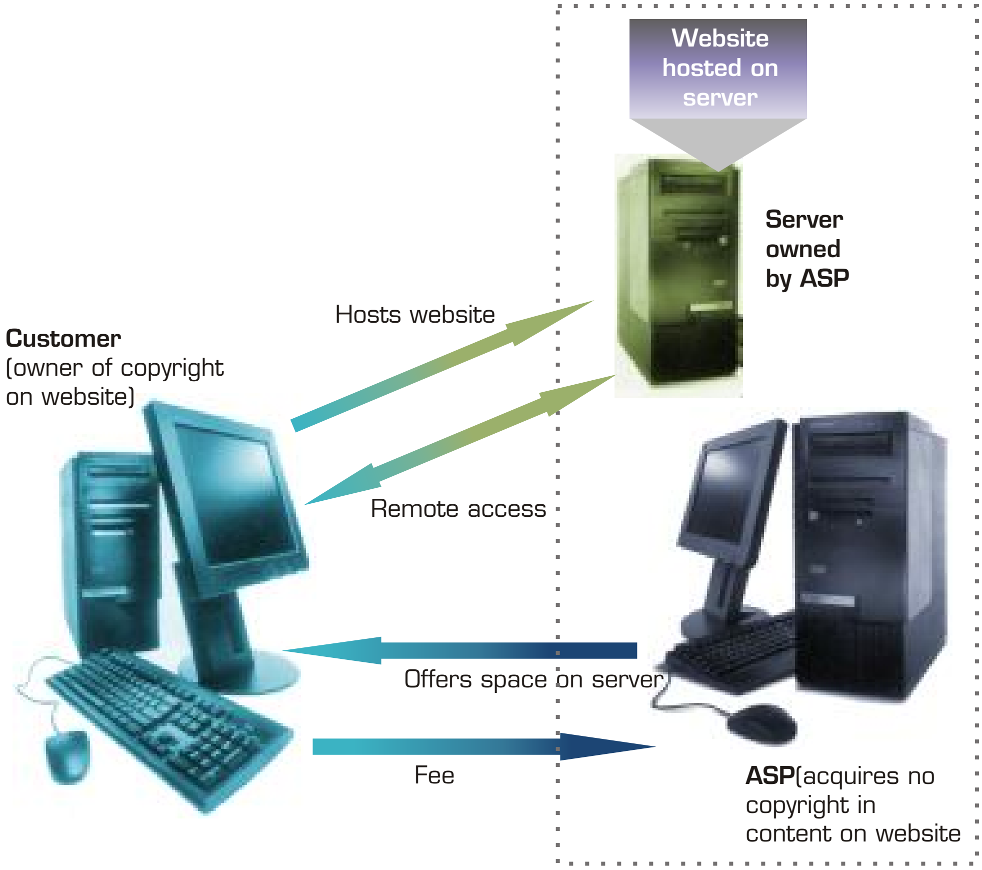


Definition

In the example above, the ASP pays the provider of the software application a fee which is a percentage of the revenue collected from customers. The contract is for a one year term.

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits	Royalty	Royalty	Business Profits • The fact that the ASP pays the provider of the software application a fee which is a percentage of the revenue collected from customers would not make a difference as the ASP is not getting any right to commercially exploit the software. • As mentioned above, payments made for this category cannot be regarded as having been made for the use of equipment or for the use of technical services due to the reasons mentioned in Category 8 above.

2.11 Category 11: *Website Hosting*

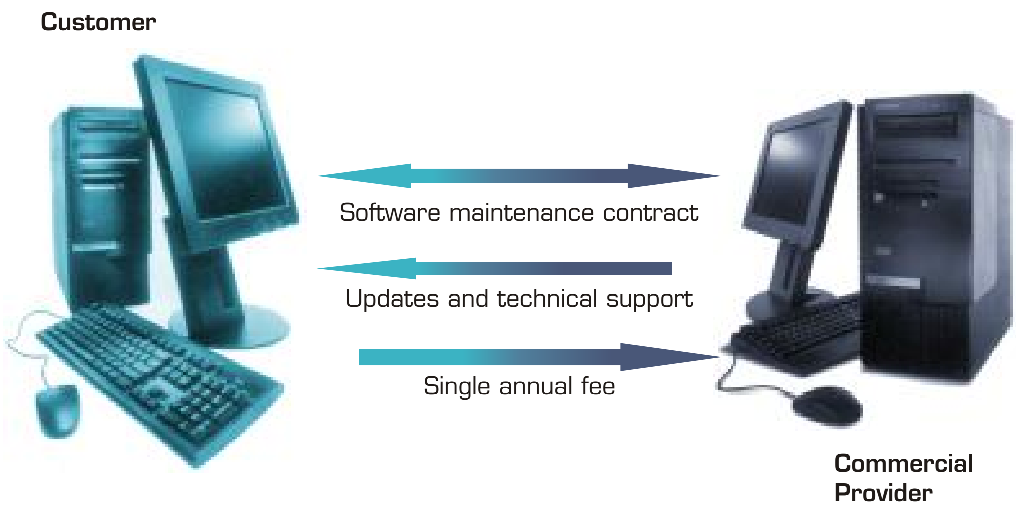


Definition

The provider offers space on its server to host websites. The provider obtains no rights in the copyrights created by the developer of the website content. The owner of the copyrighted material on the site may remotely manipulate the site, including modifying the content on the site. The provider is compensated by a fee based on the passage of time.

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits	Royalty	Royalty	Business Profits In this case the user does not have any control over the equipment. As mentioned above, payments made for this category cannot be regarded as having been made for the use of equipment due to the reasons mentioned in Category 7 above and thus would be characterised as business income both under the DTAA and the ITA.

2.12 Category 12: *Software Maintenance*



Definition

Software maintenance contracts typically bundle software updates together with technical support. A single annual fee is charged for both updates and technical support. In most cases, the principal object of the contract is the software updates.

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits/ Fees for Technical Services	Fees for Technical Services	Fees for Technical Services	Business Profits • The principal consideration being paid under this Category is for the updates and the characterisation would be similar to that under Category 4; • Since providing of the technical support would be merely incidental to the main contract, which is for the provision of the software updates, such incidental portion should be ignored for the purposes of characterisation.

2.13 Category 13: *Data Warehousing*

Definition

The customer stores its computer data on computer servers owned and operated by the provider. The customer can access, upload, retrieve and manipulate data remotely. No software is licensed to the customer under this transaction. An example would be a retailer who stores its inventory records on the provider's hardware and persons on the customer's order desk remotely access this information to allow them to determine whether orders could be filled from current stock.

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits	Royalty	Royalty	Business Profits • In this case the user does not have any control over the equipment. This is because the user is only using the services of the host entity and is not using the equipment of the host entity. Thus, the payments made cannot be characterised as having been made for the use of the equipment and thus be subjected to tax as income from equipment royalties due to the reasons mentioned in Category 7.

2.14 Category 14: *Customer Support over Computer Network*

Definition

The provider provides the customer with online technical support, including installation advice and trouble-shooting information. This support can take the form of online technical documentation, a trouble-shooting database and communications (e.g. by e-mail) with human technicians.

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits/ Fees for Technical Services	Fees for Technical Services	Fees for Technical Services	Business Profits / Fees for technical services ● Here the service provider provides the customer with online technical support, including installation advice and trouble-shooting information. This support is generally provided after a product is sold. It would mainly relate to online technical documentation, a trouble-shooting database, and communications (*e.g.* by e-mail) with human technicians, which is incidental to the sale of the product. ● Mere provision of access to a trouble- shooting database would not require more than having available such a database and necessary software to access it. The payment relating to the provision of such an access would be akin to payments made for use of a standard facility and thus should not be regarded as fees for technical services. ● The Group is of the view that in such transactions, no transfer of know-how is involved and hence such payments cannot be regarded as royalties and should be characterised as business profits. ● **If the provision of online advice through communications with**

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits/ Fees for Technical Services	Fees for Technical Services	Fees for Technical Services	**technicians are for the application of special skill and knowledge and are not incidental to the sale of a product, then, it may constitute fees for technical services.**

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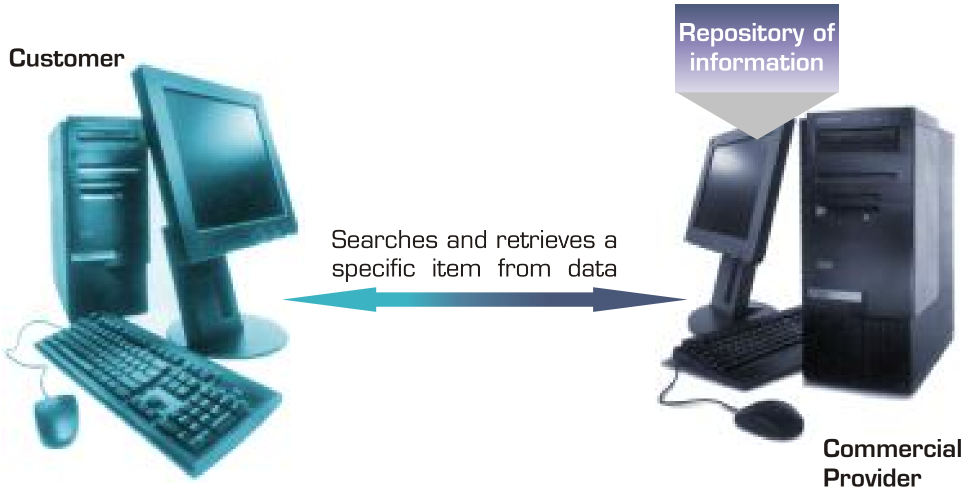
2.15 Category 15: *Data Retrieval*

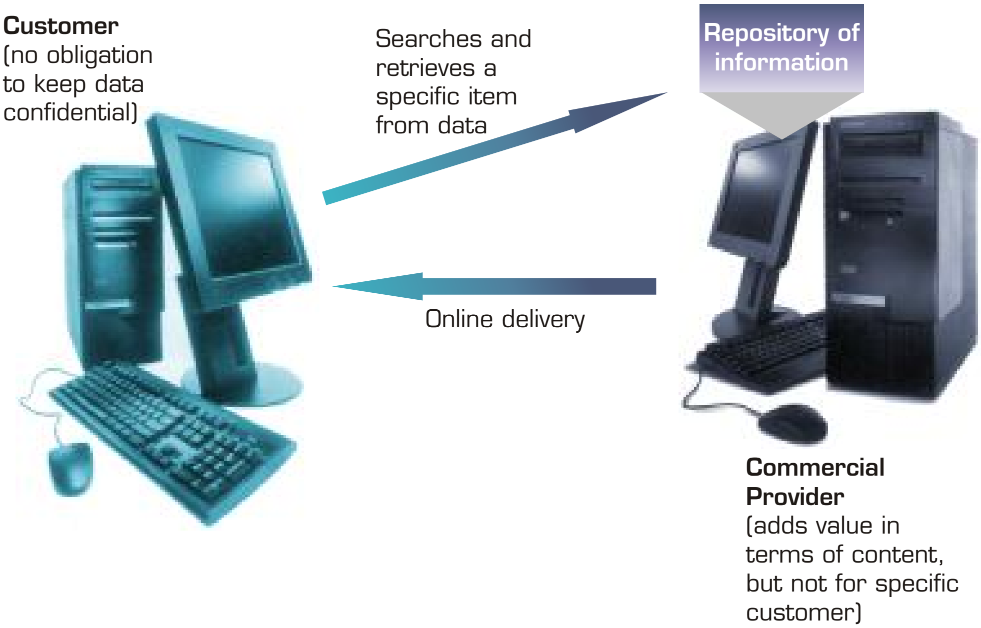


Definition

The provider makes a repository of information available for customers to search and retrieve. The principal value to customers is the ability to search and extract a specific item of data from amongst a vast collection of widely available data.

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits	Business Profits	Business Profits	Business Profits

2.16 Category 16: *Delivery of Executive or other high-value data*



Definition

As in the previous example, the provider makes a repository of information available to customers. In this case, however, the data is of greater value to the customer than the means of finding and retrieving it. The provider adds significant value in terms of content (e.g. by adding analysis of raw data) but the resulting product is not prepared for a specific customer and no obligation to keep its contents confidential is imposed on customers. Examples of such products might include special industry or investment reports. Such reports are either sent electronically to subscribers or are made available for purchase and download from an online catalogue or index.

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits	Business Profits	Business Profits	Business Profits

2.17 Category 17: *Advertising*

Definition

Advertisers pay to have their advertisements disseminated to users of a given website. So-called "banner ads" are small graphic images embedded in a web page, which when clicked by the user will load the web page specified by the advertiser. Advertising rates are most commonly specified in terms of a cost per thousand "impressions" (number of times the ad is displayed to a user), though rates might also be based on the number of "click-throughs" (number of times the ad is clicked by a user).

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits	Business Profits	Business Profits	Business Profits

2.18 Category 18: *Electronic access to professional advice (e.g Consultancy)*

Definition

A consultant, lawyer, doctor or other professional service provider advises customers through e-mail, video conferencing or other remote means of communication.

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits/ Fees for Technical Services	Business Profits	Fees for Technical Services	Business Profits / Fees for technical service • The category deals with electronic access *(i.e.* mode of delivery) in respect of professional advise. It is the Group's view that mere change in the mode of delivery will not change the characterisation and therefore the services of a doctor, lawyer or any other professional otherwise not falling within the purview of section 9(1)(vii) of the ITA will not make the consideration fall within this clause.

2.19 Category 19: *Technical Information*

Definition

The customer is provided with undivulged technical information concerning a product or process (e.g. narrative description and diagrams of a secret manufacturing process).

<table>
<tr><th rowspan="2">IC TAG (OECD) View</th><th colspan="2">HPC View</th><th rowspan="2">Group View</th></tr>
<tr><th>India-US & India-UK DTAA</th><th>ITA</th></tr>
<tr><td>Royalty</td><td>Royalty</td><td>Royalty</td><td>Royalty</td></tr>
</table>

2.20 Category 20: *Information Delivery*

Definition

The provider electronically delivers data to subscribers periodically in accordance with their personal preferences. The principal value to customers is the convenience of receiving widely available information in a custom-packaged format tailored to their specific needs.

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits	Business Profits	Business Profits	Business Profits

2.21 Category 21: *Subscription-based interactive website access*

Definition

The provider makes available to subscribers a website featuring digital content, including information, music, video, games and activities (whether or not developed or owned by the provider). Subscribers pay a fixed periodic fee for access to the site. The principal value of the site to subscribers is interacting with the site while online as opposed to getting a product or services from the site.

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits	Business Profits	Business Profits	Business Profits

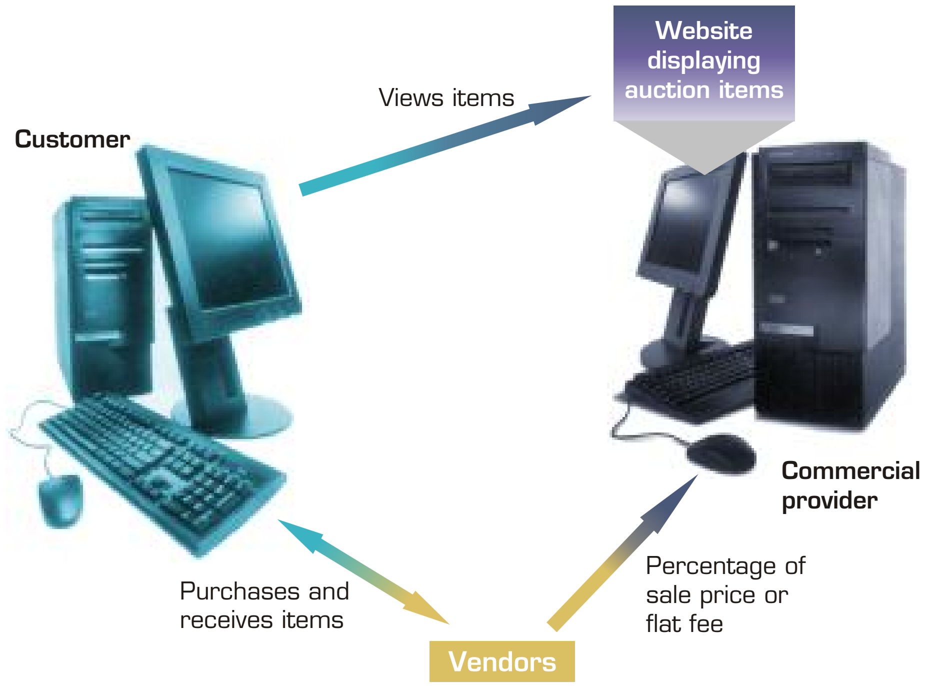
2.22 Category 22: *Online shopping portals*

Definition

A website operator hosts electronic catalogues of multiple merchants on its computer servers. Users of the website can select products from these catalogues and place orders online. The website operator has no contractual relationship with shoppers. It merely transmits orders to the merchants, who are responsible for accepting and fulfilling orders. The merchants pay the website operator a commission equal to a percentage of the orders placed through the site.

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits	Business Profits	Business Profits	Business Profits

2.23 Category 23: *Online Auctions*



Definition

The provider displays many items for purchase by auction. The user purchases the items directly from the owner of the items, rather than from the enterprise operating the site. The vendor compensates the provider with a percentage of the sales price or a flat fee.

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits	Business Profits	Business Profits	Business Profits

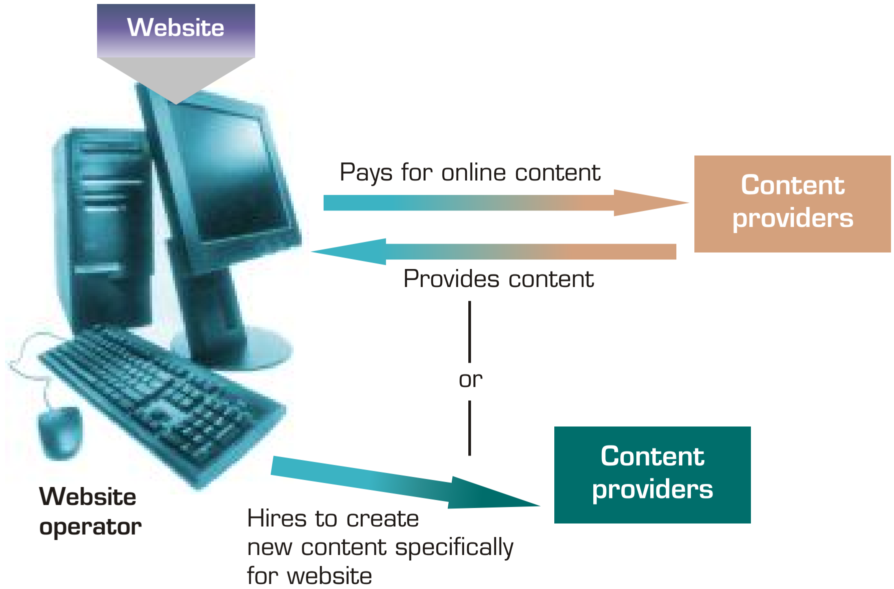
2.24 Category 24: *Sales referral program*

Definition

An online provider pays a sales commission to the operator of a web site that refers sales leads to the provider. The website operator will list one or more of the provider's products on the operator's web site. If a user clicks on one of these products, the user will retrieve a web page from the provider's site from which the product can be purchased. When the link on the operator's web page is used, the provider can identify the source of the sales lead and will pay the operator a percentage commission if the user buys the product.

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits	Business Profits	Business Profits	Business Profits

2.25 Category 25: _Content acquisition transactions_



Definition

A website operator pays various content providers for news stories, information and other online content in order to attract users to the site. Alternatively, the website operator might hire a content provider to create new content specifically for the website.

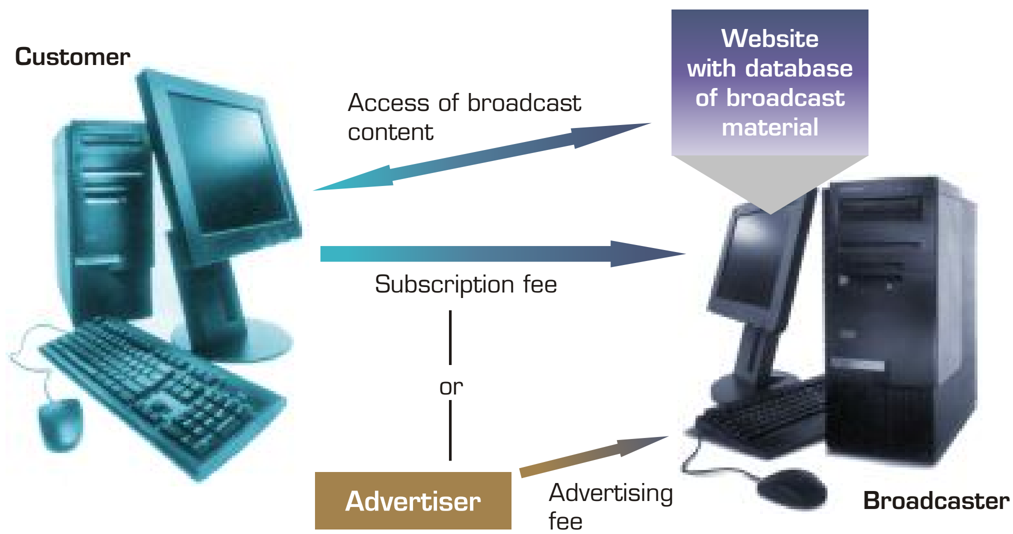
Thus such a transaction gives rise to two types of payments:

(a) Payment to content providers for a right to display copyrighted material; and

(b) Payment for creation of new content as a result of contractual arrangements.

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
(a) Royalty	(a) Royalty	(a) Royalty	(a) Royalty or Business Profits Please note that if the content (news, information, *etc.*) is in the public domain and the primary value was in the reporting of the news, collection and organisation of the information, *etc.* then the payment would seem more in the nature of a payment for the reporting and organisation services *etc.* Thus, in such a situation, the payment could be considered as a service fee and therefore taxed as business income.
(b) Business Profits	(b) Business Profits	(b) Business Profits	(b) Business Profits

2.26 Category 26: *Streamed (real time) web-based broadcasting*

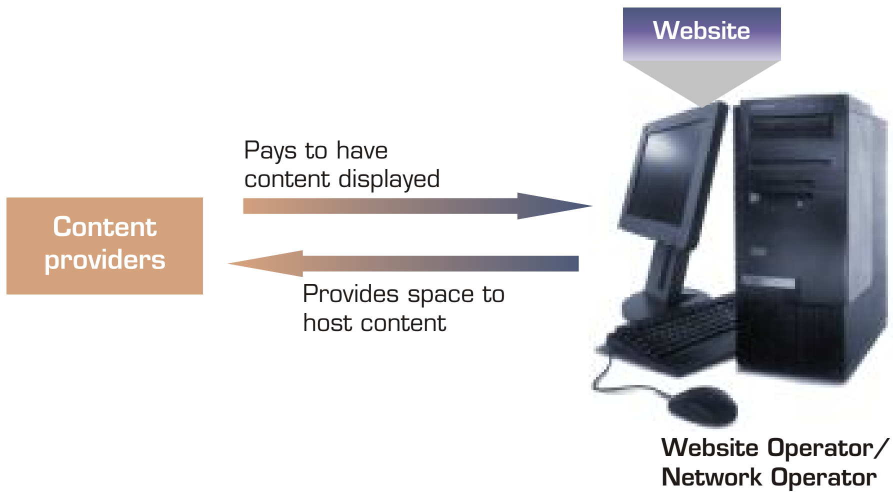


Definition

The user accesses a content database of copyrighted audio and/or visual material. The broadcaster receives subscription or advertising revenues.

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits	Business Profits	Business Profits	Business Profits

2.27 Category 27: *Carriage fees*

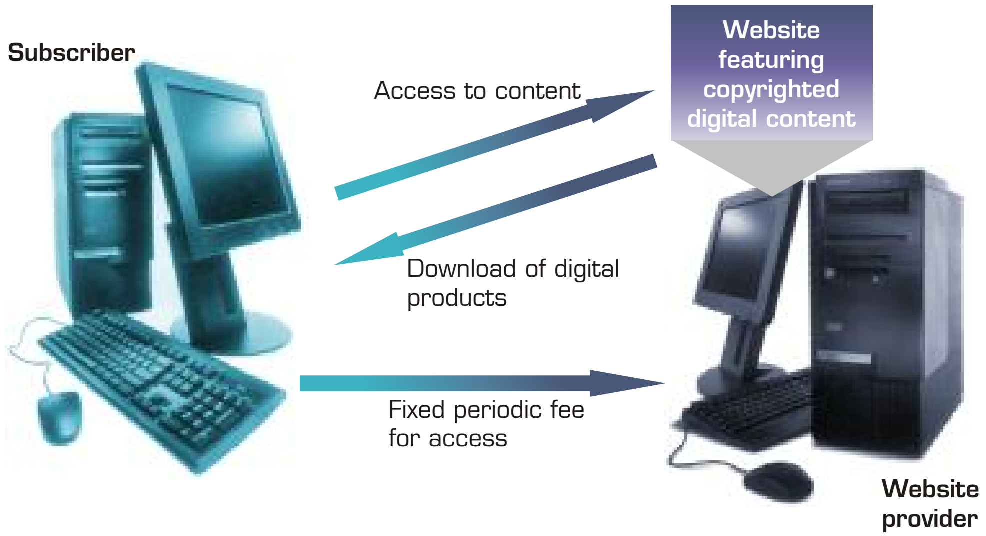


Definition

A content provider pays a particular website or network operator in order to have its content displayed by the web site or network operator.

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits	Business Profits	Business Profits	Business Profits

2.28 Category 28: *Subscription to a website allowing downloading of a digital products*



Definition

The provider makes available to subscribers a website featuring copyrighted digital content (e.g. music). Subscribers pay a fixed periodic fee for access to the site. Unlike category 21, the principal value of the site to subscribers is the possibility to download these digital products.

IC TAG (OECD) View	HPC View		Group View
	India-US & India-UK DTAA	ITA	
Business Profits	Royalty	Royalty	Business profits • The consideration is paid for access to the site; • Since the consideration is for the possibility to download digitised products, the characterisation is akin to that under Category 2 and hence the payment would be taxed as business profits.

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 jeopardising 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.

Signed

Nishith M. Desai
(On behalf of the eComTaxpert Group)

Place: Mumbai, India
Date: June 5, 2002

ANNEXURE

[Referred to on Page 56 of the Report]

Applicability and interpretations of the Advance Ruling P. No. 30 of 1999[37]

In this ruling, the AAR has examined the taxability of income of foreign companies engaged in the operation of credit cards and travellers' cheques. The AAR has held that the payment made by an Indian company for accessing the foreign company's computer system and data stored on the system in USA is in the nature of royalty income and therefore taxable in India. The brief description of the transaction in this case is discussed below:

Facts:

Y is a company incorporated in USA and belongs to 'ABC' group of companies, which operates in the worldwide credit card and travel business. All the transactions and related data in respect of each credit card holder and travellers' cheques holders are stored in the Central Processing Unit ("**CPU**") maintained by Y in the US. Y also maintains a computer set up in Hong Kong, called the Consolidated Data Network ("**CDN**"). Y has a worldwide information processing telecommunication centre ("**WPIT Centre**") in the US.

XT, an Indian company provides customer services as a high technology centre for data management and information analysis and control, to companies of ABC group and other companies situated in Asia, Europe and elsewhere.

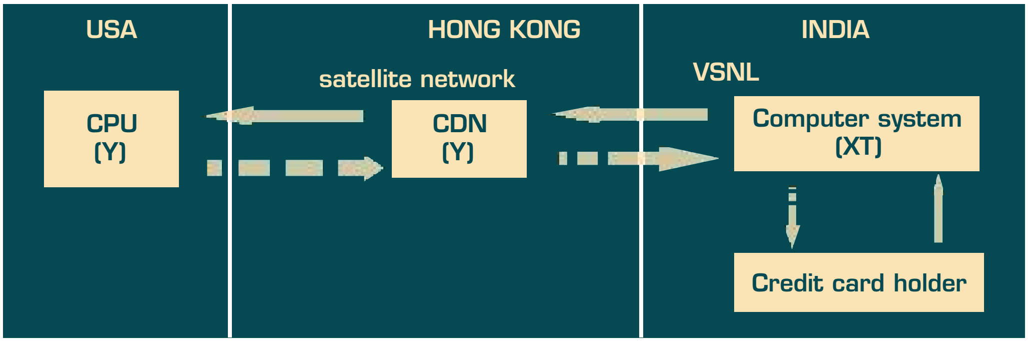
Against payment, Y allows its customers, which includes XT, to use its CPU. Y's CPU is also accessed by various 'ABC' entities located worldwide through a CDN maintained in Hong Kong. XT has a link up to CDN through dedicated international leased circuit lines of Videsh Sanchar Nigam Limited ("VSNL"), which is the gateway for international telephony in India.

The transaction is explained as follows:

Transactions executed by credit card holders and travellers' cheques holders in India and the Asia Pacific region are reported to XT. XT accesses Y's CPU through the CDN in Hong Kong. It accesses the data on the CPU, updates it and validates the transactions of the credit card holders. XT pays a certain fee to Y for accessing the data and using the CPU.

The transaction is depicted in the diagram overleaf.

37. 238 ITR 296 (AAR).



Questions raised and ruling delivered:

1. Whether payment due to Y from XT under the transaction is liable to tax in India?

Answer: Yes

2. If the answer to question No. 1 is in the affirmative, whether the payment due to Y from XT is covered under Article 12(3)(a) or Article 12(3)(b) of the DTAA between India and the US?

Answer: The transaction would be covered by Article 12(3)(a) of the DTAA between India and the US.

[Article 12(3)(a) of the India-US DTAA refers to royalty in respect of intangible property whereas Article 12(3)(b) refers to equipment royalty.]

AAR's Observation

The AAR, at the outset has stated that there were limited facts available to them in analysing the character of the transaction. Having said that, they have still gone ahead to analyse the transaction and given a judgement on the character of the payment. In paragraph 29 of the ruling, the AAR have stated, "*As is the practice in Canada, USA and other developed countries, allowing the use of protected software for a consideration by way of a contract amounts to income by way of royalties covered under Article 12(3)(a) of the DTAA between India and USA.*" It has relied on Dr. Klaus Vogel's commentaries on Double Taxation Conventions (in paragraph 29 on page 784). However, these commentaries appear to be misconstrued. As stated in paragraph 30 of the ruling, which has reproduced the commentaries, it may be observed that the commentaries are in relation to the acquisition of software and not with respect to availing services. In the said ruling, the payment being made is for availing of services and not for acquisition of software.

The AAR has in paragraph 37 of the ruling, stated that it would be useful to refer to the revision made to Article 12 concerning the payment for the use of software. Further, the AAR in the ruling has quoted from Dr. Philip Baker's book entitled "Double Taxation Conventions and International Tax Law" (2nd edition, page 272). They have stated that "*The treatment of the aforesaid transaction has to conform to the revised commentary to accommodate the emerging developments relating to computer software.*" Ironically, HPC has chosen not to take cognisance of the revised OECD commentaries on software.

In paragraph 39 of the ruling, the AAR has observed that the use of XT of CP and CDN is not merely the use of the equipment, but is more than that. It is the use of embedded software, which falls in Article 12(3)(a) and not 12(3)(b) of the DTAA between India and the US.

HPC View on similar transactions

The HPC in their report have treated payments made for the above transactions as having been made for the use of equipment thereby giving rise to equipment royalty. The HPC has stated that after the amendment of section 9(1)(vi) of the ITA, which introduced the concept of 'equipment royalty', the said payment would be treated as equipment royalty under the ITA. In fact the HPC has stated in their report that the AAR, in the ruling cited above, has taken a *similar* view, which is *contrary* to what has actually been held by the AAR in the ruling.

Group's View

Applying the logic and conclusions arrived at by the IC TAG to the Indian case discussed above, the payment made by XT to Y should be characterised as business income. The payment made by XT to Y is made for the use of services of Y, which is its business and is not a consideration for the use of a secret formula. Hence, the payment made cannot be characterised as royalty.

The AAR, in the above cited case has held that the payment for the use of application software cannot be treated as equipment royalty. However, it has, *albeit wrongly,* held that such payment should be treated as royalty taxable under Article 12(3)(a) of the India-US DTAA.

The AAR does not seem to have appreciated the fact that the user does not in fact use the intellectual property embedded in the software but actually pays for use of services. Thus the essential consideration is paid for the services and not for the use of the intellectual property. Hence, in view of this, it would be incorrect to characterise this payment as "royalty". With due respect, the ruling needs reconsideration.

Taxation can facilitate or thwart the growth of e-commerce where India has a significant global competitive advantage. The Organisation for Economic Co-operation and Development identified 28 business models ('categories') and suggested how should they be taxed.

The Government of India set up a High Powered Committee ('HPC') to look into the taxation of e-commerce, which submitted its recommendations in the final report in July 2001. The HPC took a differing view on as many as 13 categories. Since these differing recommendations, if accepted, would have wide ramifications on the growth of e-commerce in India, it was thought appropriate to assist the Government by providing global input on the subject. Therefore, a group of eminent international tax experts, academicians, professionals and industry representatives (eComTaxpert Group) was convened by Nishith Desai Associates. The group submitted its report to the Government in June 2002.

About the Convener

Nishith Desai Associates is a research-based law firm with offices in Mumbai (India) and Silicon Valley (USA) with a global legal practice in the areas of international taxation, cross-border listings, mergers & acquisitions, private equity funds, infrastructure, media & entertainment, information technology and biotechnology. The firms' research focus has helped the firm make important public policy contributions in a number of areas including the regulatory framework for venture capital funds and employee stock options in India, infrastructure development law for the State of Andhra Pradesh and various WTO related issues particularly in the context of ecommerce.

The International Financial Law Review (a Euromoney publication) awarded the firm with the *Indian Law Firm of the Year 2000* award for its role in the revitilisation of the Asian region and in the development of legal services in India and the *Asian Law Firm of the Year 2001 (Probono)* award in recognition of its work with various social sector organisations.

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