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INSIGHT: Taxing Cross-Border Digital Services—Need for Consistency



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Language used in drafting contracts in information technology and digital transactions from an intellectual property protection perspective has been picked up by tax authorities and some courts this year resulting in adverse tax consequences.

Taxation of cross-border transactions often involves a number of complex issues. In the case of cross-border payments, especially for the use of software, online facilities or IT infrastructure, one of the most litigated issues is the nature or characterization of these payments.

Conflicting opinions have been expressed by different tribunals and courts on payments made to foreign services providers for cloud services or services on an online platform namely whether such payments should be considered as ''royalty, ''fee for technical services'' (''FTS'') or just ''business income.''

This characterization is significant as India's taxing rights under its tax treaties are different for different kinds of income. Remittance for royalty and FTS are subject to withholding tax in India. However, business income earned by a nonresident is generally not taxable in India unless such income may be attributed to a permanent establishment (''PE'') of such nonresident in India. As a result, the tax authorities often argue in favor of treating such remittances as royalty payment or FTS, where they are unable to make a strong case for the existence of a PE of a nonresident in India.

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Amazon Case A recent example is the case involving the provision of web hosting services by Amazon. In this case an Indian customer entered into a service contract with Amazon Web Services LLC (''Amazon''), U.S. The payment of web hosting service fees to be paid to Amazon was held to be royalty by the Indian tax authorities.

Therefore, the tax authorities argued that the Indian customer should have withheld tax while making these payments to Amazon. This was contested by the Indian customer. The Income Tax Appellate Tribunal (''Tribunal'') observed that Amazon had not ceded any control over the server space to its customer while providing its services and that no right in relation to intellectual property had been obtained by the customer from Amazon under the web hosting agreement. The Tribunal concluded that the payments made to Amazon for use of server space were not royalty but business income and hence, should not be taxable in India.

Evolving Business Models and Challenges The reason the taxation of information technology and digital transactions has been fraught with challenges in India is in part because of the innovative nature of the digital

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economy itself as business models and products keep changing rapidly and the law makers often struggle to keep pace with such developments.

For instance, imposing tax on the sale of software in the form of CDs was a vexing issue for the tax authorities a few years ago. This is because they were unsure whether to treat the CD as a good and levy excise duty on its manufacture, or to treat this sale as a provision/supply of service and levy service tax on such transactions.

Similarly, the sale of software embedded in hardware continues to be an issue which is heavily litigated. In recent years, with the growth of e-commerce and cloud computing, new business models have come to the fore such as Infrastructure-as-a-service (''IAAS''), where a virtualized computer environment is delivered as a service over the Internet (such as provision of servers by Amazon); platform-as-a-service (''PAAS'') where a third-party provider delivers hardware and software tools to users over the internet (e.g. Microsoft Azure) and software-as-a-service (''SAAS'') where an application is delivered over the internet. Tax authorities and courts are often unable to grasp the technical intricacies of the arrangements used by such business models and, hence, often come to conclusions which are not always factually correct.

Need for Change in Approach to Drafting Standard Language While deciding such cases, in order to be able to ascertain the nature of the income, the courts necessarily have to undertake an examination of the terms of the relevant agreement. This is where the drafting of the agreement becomes extremely important. Recently, we have come across numerous instances where parties have inserted standard language in their contracts which has been picked up by courts/tax authorities to make adverse conclusions. Such standard language often may not necessarily depict the real nature of the transaction between the parties.

For instance, the inclusion of standard language regarding assignment of any intellectual property (''IP'') created by a distributor/contractor in favor of the nonresident customer has led to courts taking a view that the contract is one of assignment of IP, hence the payments being characterized as royalty. For example, the approach taken by the tax department and the lower courts in the case of the provision of line production services by Endemol South Africa (Proprietary) Ltd to its Indian affiliate.

A more well-known example would be that of the Google Adword case where a limited license given to the Indian distributor to use Google Ireland's IP for incidental or ancillary purposes while marketing Google Ireland's product (i.e., the ad space) in India led to the court treating the contract as being one for license of IP (and hence, payments being in nature of royalty).

In case of service contracts, the nature of services may be drafted broadly, leading the tax authorities to believe that services may be in the nature of managerial, technical or consultancy services (and hence, payments for such services being FTS) when this is not the factual position. India's tax treaties with certain countries (such as the U.S., Netherlands, U.K. and Singapore) also specify an additional requirement that the services ''make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design'' for such services to be taxable as FTS.

In these situations, it is important that the documents specifically demonstrate whether any such knowledge, experience or skills are in fact being ''made available'' to the Indian customer to avoid courts treating the consideration for services as FTS.

Thus, we find that common risk mitigation practices where clarificatory language is included while drafting a contract as a measure of abundant caution or definitions are broadly worded to provide flexibility have led to adverse tax demands. It is settled law that courts should not adopt a dissecting approach while interpreting contracts and should give due weight to the intention of the parties by adopting a holistic approach. However, for this to happen it is very important that the intention of the parties is adequately borne out from a reading of the text of the relevant contract.

Also, it is pertinent to remember that unlike other commercial disputes caused by ambiguity in the text of a contract, a tax dispute is more cumbersome simply because the tax authorities will follow their own interpretation to raise adverse tax demands for multiple assessment years.

As a result, parties embroiled in a tax dispute are forced to spend more time and effort contesting tax claims than ordinary commercial disputes. In some cases, especially those involving related parties, such expansive contractual language may not even be necessary as the chances of a commercial dispute are low.

Planning Points

■ To avoid tax litigation, taxpayers and lawyers should adequately consider the wording of any IP protection clause in their contracts as opposed to inserting standardized language, without diluting the position on IP.

■ This would involve avoiding expansive language regarding assignment, etc., when it comes to intragroup arrangements, as such language may result in the agreement being construed as one relating to transfer of intellectual property. As mentioned earlier, the risk of commercial disputes in such situations is quite low.

■ Further, parties should try and ensure that the nature of the transaction is also borne out from the recitals of the agreement in order to support their stance later.

■ Based on recent case law, parties should review their current operational structure and the tax risks resulting from housing several verticals in the same entity. It is possible that some verticals which may require use of IP from a nonresident party could potentially create a tax risk in respect of income from another vertical that is otherwise not taxable in India.

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