Issues and challenges in digital economy

What constitute Digital Economy

- OECD Defines the digital economy **consisting of a range of digital and tangible goods and services, including inter alia smartphones, tablets, computers, telecommunication digital content, availability of user data, cloud based services, the Internet of Things, virtual currencies, advanced robotics, 3D printing, and peer to peer sharing of goods and services through the internet.**

- India has not sought to make a distinction and continues to take a broad approach in line with the OECD.

Residence jurisdiction and source jurisdiction

- Residence jurisdiction arises because of the nexus between the country and the person earning the income.
- Source jurisdiction arises on account of the nexus between the country and the activities that generate income.
- This source-based taxation often gives rise to the problem of double taxation, where the same income could be taxed twice - in India, and also in the country of residence of the taxpayer.

What is double taxation?

- Double taxation means taxing the same income twice, once in the home country and again in host country.
- No rules of international law prohibit international double taxation. So it is for the countries in the international arena to solve double taxation problems.

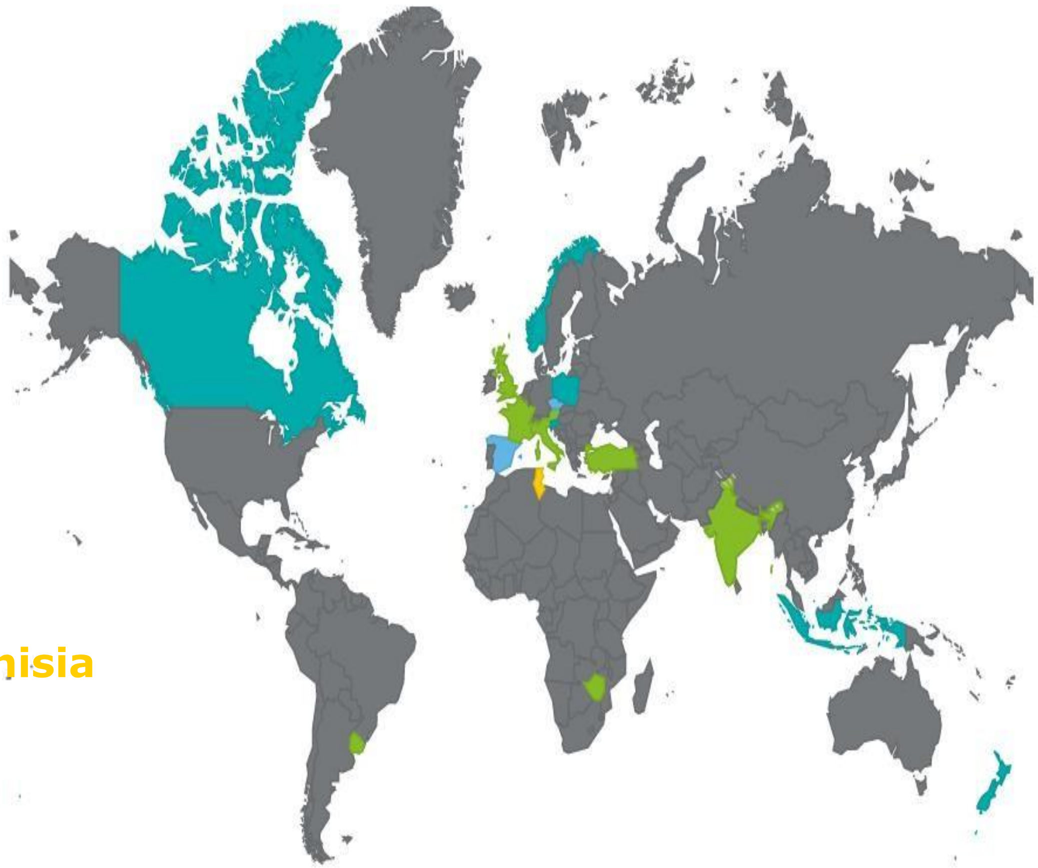
Why Do We Need Special Rules for Taxing the Digital Economy?

- **Erosion of source income (physical presence).**
- ***Fair* share on the income of digital transactions (war of unilateral measures).**
- **Supply-side, demand-side or both dimensions? *Different ways of addressing source***
- **OECD principles for taxing digital economy**
  - *Increase of source taxation*
  - *No ring-fencing*
  - Taxation should be "*fair*" among the jurisdictions involved

Digital services taxes on the march

Status

- In force
- Approved
- Proposed
- Statement of intent
- No material proposals



Austria India Turkey Uruguay

France Italy UK Zimbabwe

Tunisia

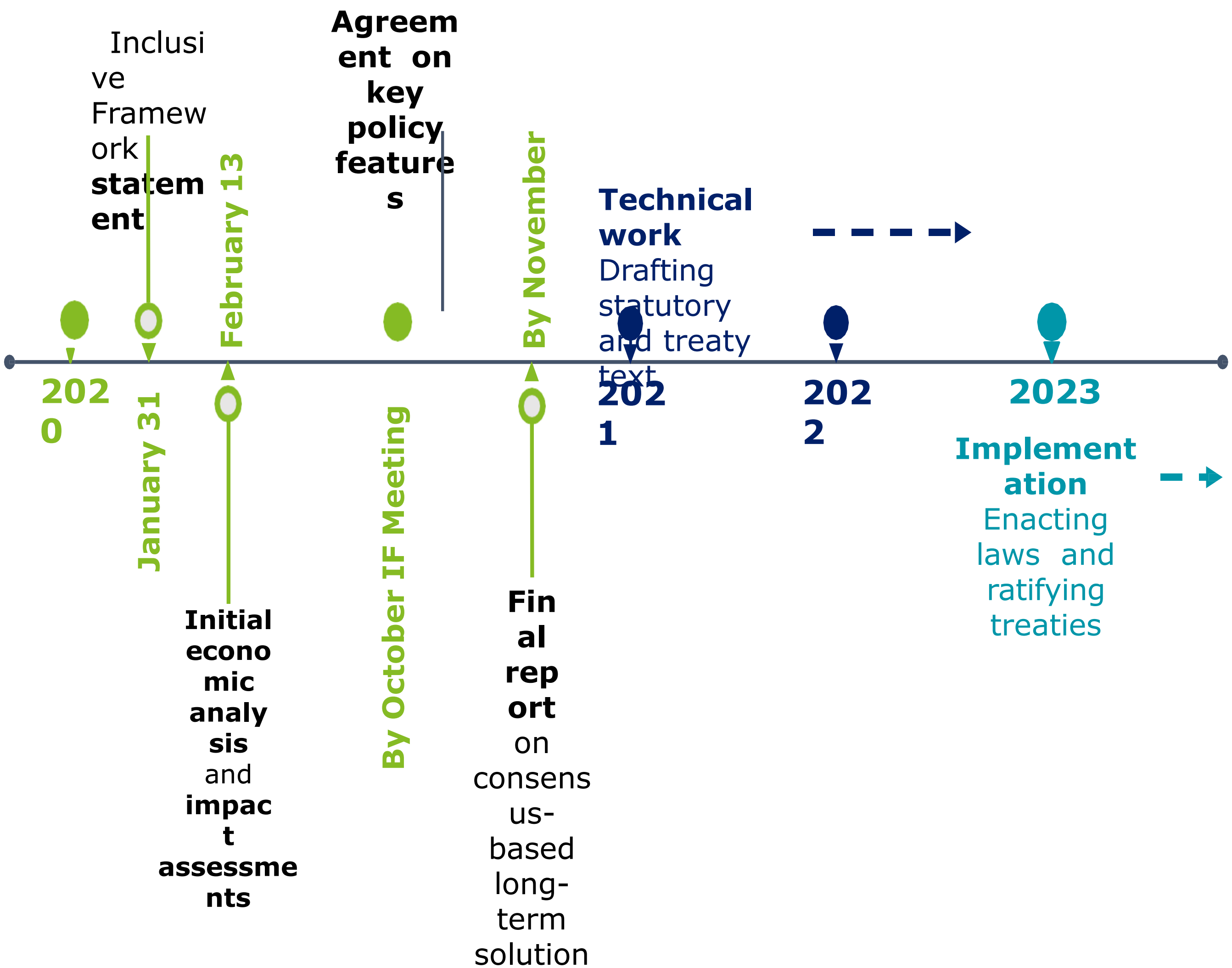
Czech Republic Spain

Canada Poland Norway

Indonesia New Zealand Slovenia

Timeline

Pre COVID-19



How to Allocate taxing right to the market states?

Digitalisation Impact

User Data

Scale on Internet

Intangibles

Pillar One: Three-tier mechanism Profit allocation

Amount A

New taxing right—beyond the arm's-length principle

Allocates a **portion of deemed residual profit** to market jurisdictions using a **formulaic** approach

B

Fixed "baseline" return for marketing and distribution functions,
based on the arm's length principle

C

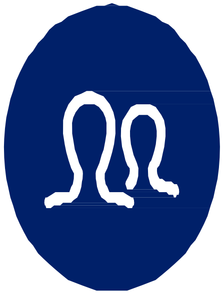
Additional return beyond Amount B based on transfer pricing
analysis and subject to robust dispute resolution processes

Amount A: New taxing right Scope

Two broad groups of business have been identified as in scope, which:

- Can participate in a **"sustained and significant manner"** in the economic life of a market country,
- **With or without local physical operations**

Automated digital services



Consumer-facing businesses

Activities may need to be segmented to separate in-scope from out-of-scope segments.

Amount A: New taxing right
Thresholds

A number of thresholds are being considered but are not yet agreed:

Group gross revenue threshold
Possibly in line with the €750 million revenue threshold used for country-by-country reporting

De minimis test on the total aggregated group **in-scope revenue** from consumer-facing activities and/or automated digital services

A carve-out where the total profit to be allocated under Amount A does not meet a de minimis amount

Amount A: New taxing right New profit allocation rules

1 **Determine the total before-tax profit or loss of the group**

- Use consolidated group financial statements
- Consideration is being given to the use of business line and/or regional segmentation

2 Exclude "deemed" routine profit to **calculate a deemed residual or excess profit**

- Fixed percentages
- Possible variation by market jurisdiction size and industry

3 **Treat a total percentage of deemed residual profit as attributable to market jurisdictions**

- A "rough justice" approach

4 **Allocate profits between eligible market jurisdictions** using allocation key

- Based on sales generating nexus
- Possible variation by business model

Pillar I Amount A

- Pillar 1 Amount A destination based or consumer base taxation [no ALP] [no PE] three condition to get to implicate taxation. IFRS reporting standards. SEP is a number-based impact but not necessary a physical presence.
- GAFA tax, Google Apple Facebook and Amazon are being tax later and were able to evade liabilities.

Pillar I Amount B

Amount B simplified transfer proceeding for baseline marketing and distribution activities [mimicking the TP rules of international market implication] not very high value type of activity

Amount A and B and Resolution of Conflicts

Prevention and resolution of conflicts

1. Appointment of cooperative entity for calculation of Amount A
2. Appointment of a panel to review the self-assessment
3. Binding methods for the resolution of conflicts

Controversial!

Indian Approach:

Source vs Residence

- Income tax in India is levied under the Income Tax Act, 1961 ("ITA"). Under the ITA, residents are taxed on their worldwide income while non-residents are only taxed on income arising from sources in India. Thus, where EdTech or IT services are offered by a resident legal entity, the global income of such entity will be subject to tax in India.

Guiding Principles for determination of Place of Effective Management (POEM) of a Company

"Place of effective management" is defined in the Act to mean a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance, made.

POEM Applicability

- **The Finance Act, 2016 has changed the effectivity of the said amendment to section 6(3) of the Act, the amended provision would now be effective from 1 st April 2017 and will apply to Assessment Year 2017-18 and subsequent assessment years.**

- **India recognizes the concept of 'place of effective management for determination of residence of a company as a tie-breaker rule for avoidance of double taxation**

- **Not applicable on foreign Companies having turnover or gross receipt of 50 Crore or less.**

What India Follows:

- BEPS Action Plan 1 recognizes that tax on income of foreign entities may be imposed by **implementing virtual PE mechanism**. However, it emphasizes that such implementation should be through bilateral negotiations with treaty partners.

- In a few cases, the Indian judiciary has unilaterally digressed from the principles of PE towards application of "virtual PE". **The Delhi Tribunal in the cases of Galileo International and Amadeus Global Travel v. Deputy Commissioner Income Tax**, concluded that non-resident companies providing computerized reservation system providing real time access to airline fares and enabling bookings are liable to be taxed in India to the extent of booking fees received from Indian residents. The Tribunal came to such conclusion on the ground that these companies have a "virtual" presence in India which constitutes a "virtual" PE.

What India Follows:

- the introduction of the new concept of significant economic presence ("SEP"), further expands the definition of business connection such that a non-resident would be deemed to have a SEP in India if it carries out any of the following:

- **transaction in respect of any goods in India above a specified value, including digital goods; or**
- **transaction in respect of any services in India above a specified value, including digital services; or**

- **transaction in respect of any property in India above a specified value, including download of data or software; or**

- **systematic and continuous solicitation of business from India from prescribed number of users through digital means;**

Indian Conundrum on other select issues

Taxation of Crypto currency

- **Union Budget 2022 Outcome:**

  1. Income from transfer of virtual digital assets such as crypto, NFTs will be taxed at 30%.
  2. No deduction, except the cost of acquisition, will be allowed while reporting income from transfer of digital assets.
  3. Loss from digital assets cannot be set-off against any other income.
  4. Gifting of digital assets will attract tax in the hands of receiver.
- Losses incurred from one virtual digital currency cannot be set-off against income from another digital currency.

Equalization Levy

- Equalisation Levy was introduced in India in 2016, with the intention of taxing the digital transactions i.e. the income accruing to foreign e-commerce companies from India. It is aimed at taxing business to business transactions.
- Equalisation Levy is a direct tax, which is withheld at the time of payment by the service recipient. The two conditions to be met to be liable to equalisation levy:
- The payment should be made to a non-resident service provider;
- The annual payment made to one service provider exceeds Rs. 1,00,000 in one financial year.

Sec.9(1)(vi)

- income by way of **royalty** payable by—
- (*a*) the Government ; or
- (*b*) a person who is a resident, except where the royalty is payable in respect of any right, property or information used or services utilised for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India ; or
- (*c*) **a person who is a non-resident, where the royalty is payable in respect of any right, property or information used or services utilised for the purposes of a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India**
- **TATA Consultancy services vs State of AP .**
- **Software or any licensed products sold into packages is good and not a patent or design or model…**

Explanation 2

- royalty" means consideration (including any lump sum consideration 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 licence) in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property ;**
- (*ii*) the imparting of any information concerning the working of, or the use of, a patent, invention, model, design, secret formula or process or trade mark or similar property ;
- (*iii*) the use of any patent, invention, model, design, secret formula or process or trade mark or similar property

Contd..

- (*iv*) the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill ;
- (*iva*) the use or right to use any industrial, commercial or scientific equipment but not including the amounts referred to in section 44BB;
- **(*v*) the transfer of all or any rights (including the granting of a licence) in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films ; or**
- (*vi*) the rendering of any services in connection with the activities referred to in sub-clauses (*i*) to (*iv*), (*iva*) and(*v*)

Explanation 3

- "computer software" means any computer programme recorded on any disc, tape, perforated media or other information storage device and includes any such programme or any customized electronic data.

Explanation 4 (introduced by the Finance Act,2012 w.r.e.f. 01-06-1976)

- the transfer of all or any rights in respect of any right, property or information includes and has always included transfer of all or any right for use or right to use a computer software (including granting of a licence) irrespective of the medium through which such right is transferred.

Explanation 5

- royalty includes and has always included consideration in respect of any right, property or information, whether or not—
- (*a*) the possession or control of such right, property or information is with the payer;
- (*b*) such right, property or information is used directly by the payer;
- (*c*) the location of such right, property or information is in India.

Explanation 6

- the expression "process" includes and shall be deemed to have always included transmission by satellite (including up-linking, amplification, conversion for down-linking of any signal), cable, optic fibre or by any other similar technology, whether or not such process is secret

Sec.9(1)(vii)

- income by way **of fees for technical services** payable by
- the Government or
- a person who is a resident, except where the fees are payable in respect of services utilised in a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India
- a person who is a non-resident, where the fees are payable in respect of services utilised in a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India
- **Exclusion**- fees for technical services payable in pursuance of an agreement made before the 1st day of April, 1976, and approved by the Central Government

Explanation 2

- "fees for technical services" means any consideration (including any lump sum consideration) for the rendering of any
- managerial,
- technical or
- consultancy services (including the provision of services of technical or other personnel)
- but **does not include** consideration for any construction, assembly, mining or like project undertaken by the recipient or consideration which would be income

Amendment in 2010

- For the removal of doubts, it is hereby declared that for the purposes of this section, income of a non-resident shall be deemed to accrue or arise in India under clause (v) or clause (vi) or clause (vii) of sub-section (1) and shall be included in the total income of the non-resident, whether or not,-
- (*i*) the non-resident has residence or place of business or business connection in India; or
- (*ii*) the non-resident has rendered services in India

Managerial services

- The words "person concerned in the management of the business" mean a person not only directly participates or engages in the management of the business but also one who indirectly controls its management through the managerial staff, from behind the scenes. Management includes the act of managing by direction, or regulation or administration or control or superintendence of the business R. Dalmia v. CIT (1977) 106 ITR 895 (SC)

Consultancy service

- The term "consultancy" has been defined in the Dictionary as "the work or position of a consultant; a department of consultants." "Consultant" itself has been defined, inter alia, as "a person who gives professional advice or services in a specialized field."
- The word "consultant" is a derivative of the word "consult" which entails deliberations, consideration, conferring with someone, conferring about or upon a matter. Consult has also been defined in the said Dictionary as "ask advice for, seek counsel or a professional opinion from; refer to (a source of information); seek permission or approval from for a proposed action".
- It is obvious that the service of consultancy also necessarily entails human intervention. The consultant, who provides the consultancy service, has to be a human being. A machine cannot be regarded as a consultant

Technical service

- "technical services" have got to be read in the narrower sense by applying the rule of noscitur a sociis, particularly, because the words "technical services" in section 9(1)(vii), read with Explanation 2 comes in between the words "managerial and consultancy services".
- Managerial and consultancy services" and, therefore, necessarily "technical services", would obviously involve services rendered by human efforts.

Credit Lyonnais [2016] 238 Taxman 157 (Bombay)

- The assessee was appointed by State Bank of India (SBI) as an arranger for mobilizing deposits in its India Millenium Deposits Scheme (IMDS). The assessee was entitled to appoint sub-arrangers for mobilizing IMDs both inside and outside India.
- The assessee mobilized deposits worth Rs. 1235.8 crores and SBI accordingly provided it a long-term deposit of Rs. 617.9 crores for a period of 5 years. Besides, the assessee received a sum of Rs. 22.19 crores from SBI as arranger fees and commission.

- the services rendered by non-resident sub-arrangers to the respondent-assessee would not fall within the category of managerial, technical or consultancy services in terms of the *Explanation 2* to section 9(1)(vii) so as to deemed to accrue or arise in India.

CIT v. *Bharti Cellular Ltd.* [2011] 330 ITR 239 (SC)

- Bharti Cellular, BSNL, MTNL, Hutchison are all service providers.
- They are all governed by National Standards issued by Telecom Engineering Centre. Under the National Standards by virute of which Bharti Cellular Limited is required to connect its network with the network of BSNL (the service provider) and similar concomitant agreement is provided for under which BSNL is required to interconnect its network with Bharti Cellular Limited.
- Bharti Cellular Ltd. had Interconnect Agreement with BSNL/MTNL.
- Under such agreement, Bharti Cellular Ltd. pays interconnect/access/port charges to BSNL/MTNL

Issue

- **whether TDS for FTS was deductible by assessee on interconnect/access/port charges paid to BSNL/MTNL?**

Held

- in absence of any expert evidence from department to show how mutual intervention was involved in technical operations by which assessee was given facility by BSNL/MTNL for interconnection, matter could not be decided

CIT v. Kotak Securities Ltd

- The Bombay Stock Exchange provided facilities of a faceless screen based transaction to all its members including the assessee Kotak Securities Ltd.
- Besides a constant upgradation of the services was made available and surveillance of the essential parameters connected with the trade including those of a particular/ single transaction that would lead credence to its authenticity is provided for by the Stock Exchange.
- All such services, fully automated, are available to all members of the stock exchange in respect of every transaction that is entered into. There is nothing special, exclusive or customised service that is rendered by the Stock Exchange.

Issue

- whether transaction charges paid by a member of the Bombay Stock Exchange to transact business of sale and purchase of shares amounts to payment of a fee for 'technical services' rendered by the Bombay Stock Exchange ?

Difference between Services provides and facilities offered

- "Technical services" like "Managerial and Consultancy service" would denote seeking of services to cater to the special needs of the consumer/user as may be felt necessary and the making of the same available by the service provider.
- It is this feature that distinguish/identify a service provided from a facility offered.
- While provisioning service is special and exclusive to the seeker of the service, facility offered, even if termed as a service, is available to all and would therefore stand out in distinction to the former.
- It is only service of the above kind that should come within the ambit of the expression "technical services" appearing in Explanation 2 of Section 9(1)(vii) of the Act.

- The service made available by the Bombay Stock Exchange [BSE Online Trading (BOLT) System] for which the charges in question had been paid by the assessee are common services that every member of the Stock Exchange is necessarily required to avail of to carry out trading in securities in the Stock Exchange.
- A member who wants to conduct his daily business in the Stock Exchange has no option but to avail of such services. Each and every transaction by a member involves the use of the services provided by the Stock Exchange for which a member is compulsorily required to pay an additional charge (based on the transaction value) over and above the charges for the membership in the Stock Exchange.
- The service provided by the Stock Exchange for which transaction charges are paid fails to satisfy the aforesaid test of **specialized, exclusive and individual requirement of the user or consumer** who may approach the service provider for such assistance/service.

Held

- only payment for services which are specialized, exclusive and according to individual requirements of user or consumer who may approach service provider for such services would come within ambit of 'fees for technical services in terms of Explanation 2 to section 9(1)(vii) so as to attract TDS under section 194J

ITO v. Right Florists

- Right Florists, the assessee was an Indian company providing services in India as a florist.
- It entered into agreements with Google Ireland Limited ("**Google Ireland**") and Overture Services Inc. USA ("**Yahoo USA**") for advertisement of its services on their search engines
- Right Florists made payments to Google Ireland and Yahoo USA for advertising services and a claimed deduction for these payments.
- As per AO, the assessee should have deducted tax while making payment

Issue

- whether income tax was required to be withheld in respect of payments made to non-residents for rendering advertising services over the internet

Held

- the lowest common factor in the scope of 'managerial, technical or consultancy services' as used in Section 9 of the ITA was human intervention.
- the service rendered by Google & Yahoo is generation of certain text on the search engine result page. This is a wholly automated process. In the services rendered by the search engines, which provide these advertising opportunities, there is no human touch at all. The results are completely automated.
- Consequently, the whole process of actual advertising service provided by Google & Yahoo, even if it be a technical service, is not covered by the limited scope of s. 9(1)(vii).