

Issues and challenges in digital economy

What constitute Digital Economy

- OECD Defines the digital economy as consisting of a range of digital and tangible goods and services, including among other things 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.

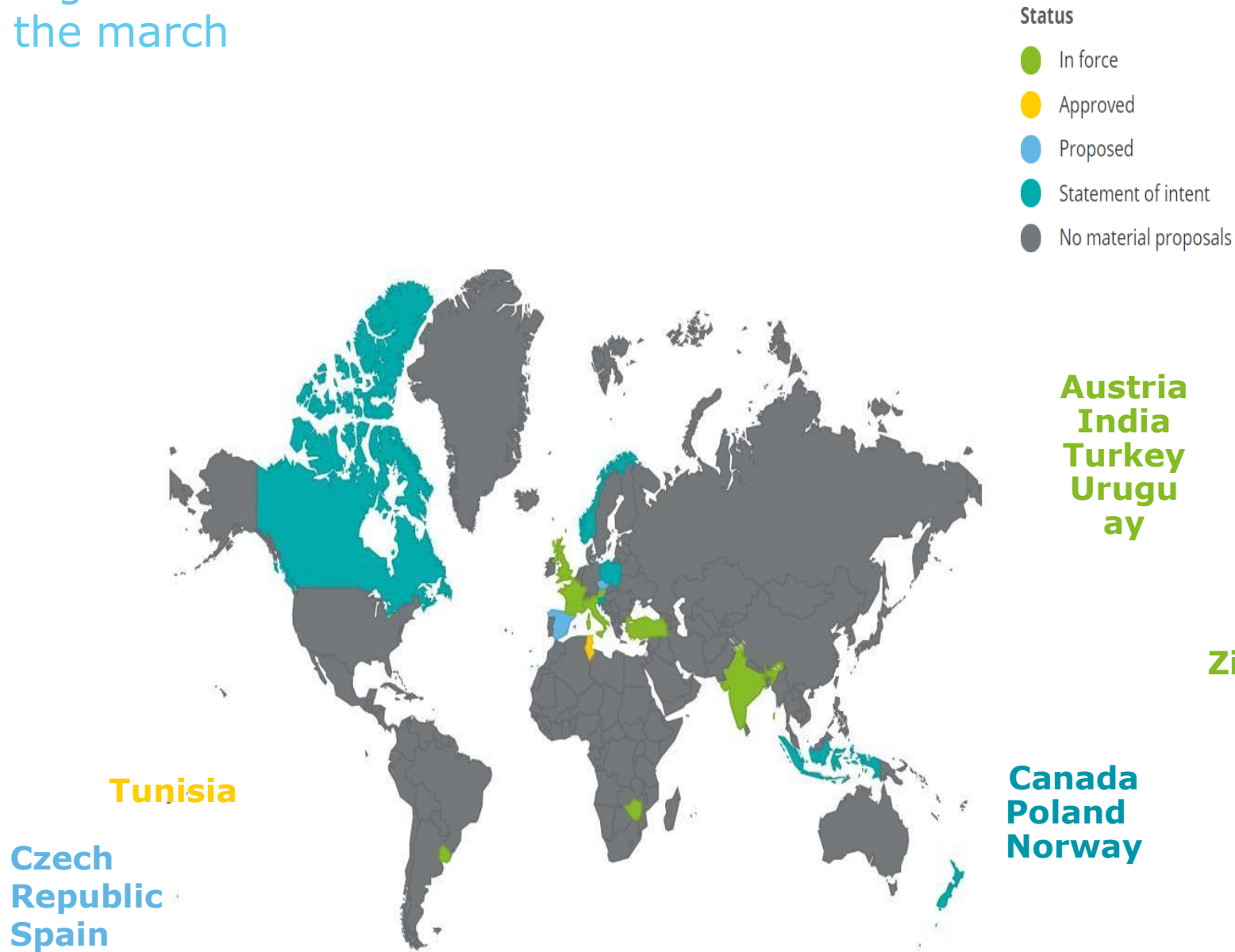
What is double taxation?

- ▶ 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?

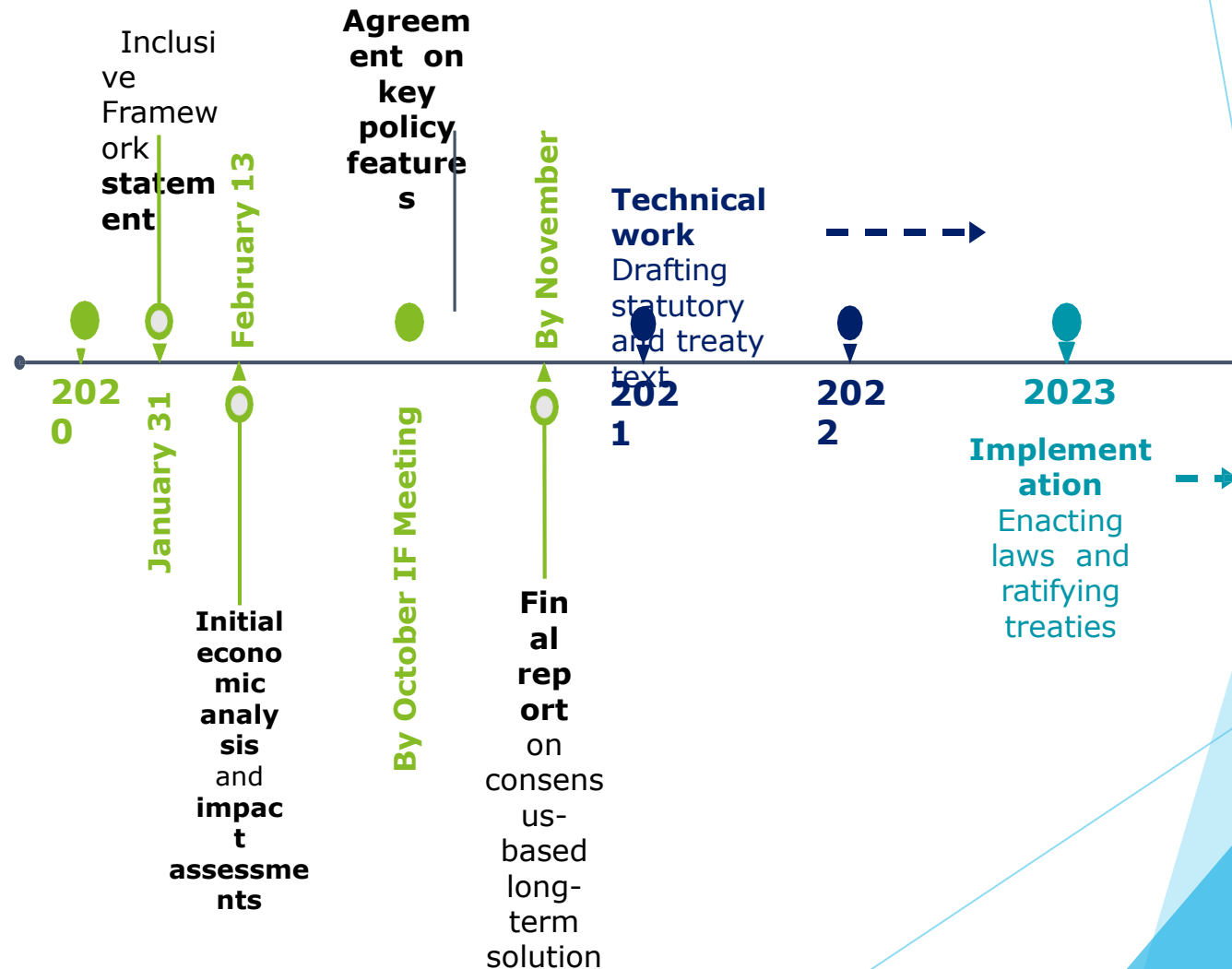
- ▶ **Erosion of source income (physical presence).**
- ▶ ***Fair* share of the income of digital transactions (war of unilateral measures).**
- ▶ **Supply-side, demand-side, or both dimensions? *Different ways of addressing the source***
- ▶ **OECD principles for taxing the digital economy**
 - ▶ *Increase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

Digital services taxes on the march



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

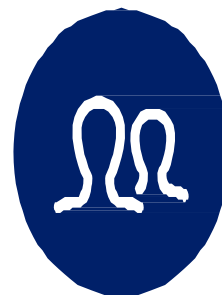
Amount A: New taxing right Scope

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:

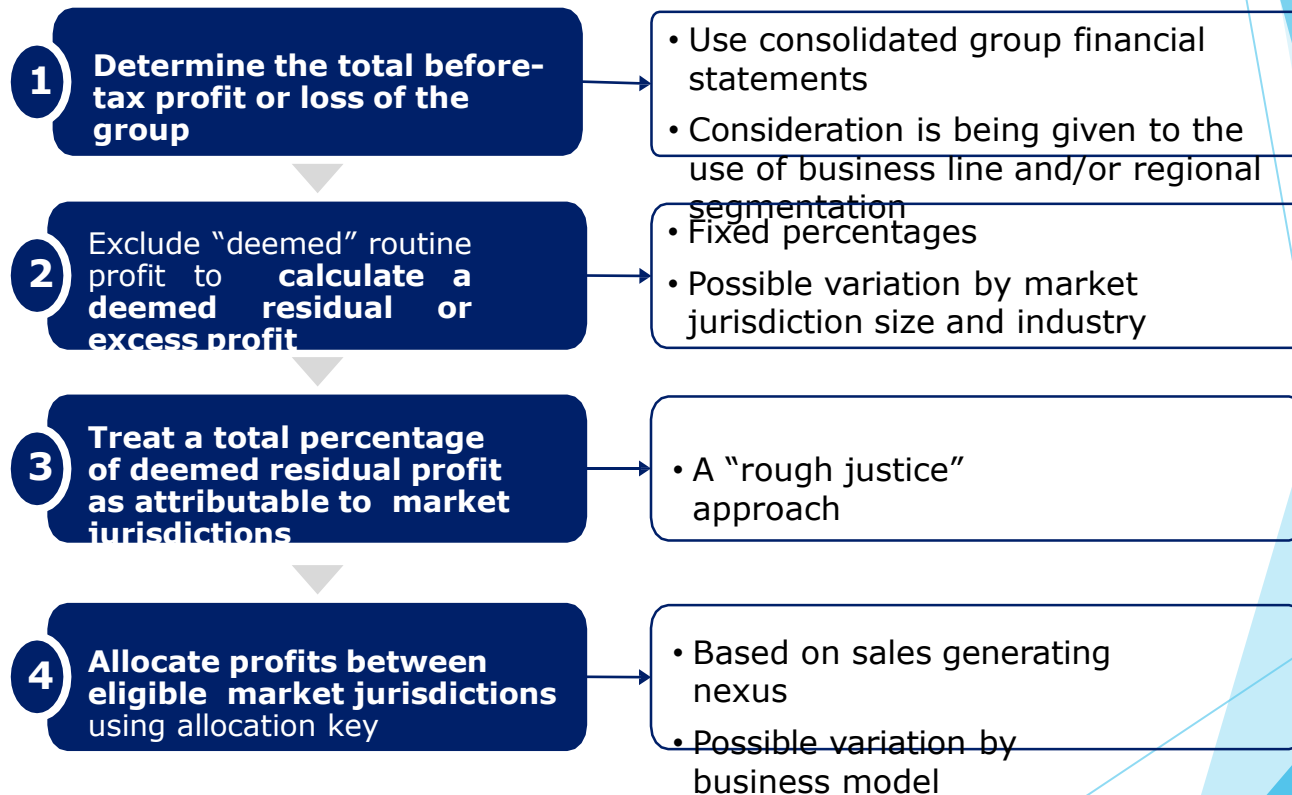
Group gross revenue threshold

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



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!

Source vs Residence

- ▶ Income tax in India is levied under the Income Tax Act, of 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.

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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 1st 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 the income of foreign entities may be imposed by **implementing a 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 the 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 systems 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 a conclusion on the ground that these companies have a “virtual” presence in India which constitutes a “virtual” PE.

Indian Conundrum on other select issues

Equalization Levy

- The Equalisation Levy was introduced in India in 2016, to tax 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 equalization 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.

Significant Economic Presence

- The Finance Act, of 2020 brought the concept of SEP
- 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 a prescribed number of users through digital means;

Taxation of Crypto currency

- ▶ The Finance Act, of 2022 has introduced the much-awaited taxation regime for VDAs in India. Specifically, FA 2022 introduced the following:
 - Section 2(47A): An expansive definition for VDA;
 - Section 115BBH: Taxation of income from the transfer of VDA at the rate of 30%;
 - Section 56(2)(vii)&(x): Gift tax on VDAs-definition of 'property' expanded to include VDAs;
 - Section 194S: Withholding tax("WHT")

Taxation of Crypto currency

► Union Budget 2022 Outcome:

1. Income from transfer of virtual digital assets such as crypto, and NFTs will be taxed at 30%.
2. No deduction, except the cost of acquisition, will be allowed while reporting income from the 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 the receiver.

► Losses incurred from one virtual digital currency cannot be set off against income from another digital currency.

GST changes and Budget proposals are likely to impact the e-commerce companies.

- ▶ To enable higher commercial activity online, the Government of India is creating sovereign digital platforms like the Open Network for Digital Commerce (ONDC).
- ▶ 1st January 2022, food delivery apps like Zomato and Swiggy, for deliveries made by the platforms, will have to collect GST from customers on behalf of the restaurant and deposit with the government.
- ▶ TCS is to be collected by the e-commerce operator on the net value of taxable supplies made by other suppliers.
- ▶ **Union Budget proposals recently announced have focussed on two aspects of e-commerce**

A. Enabling composition “goods” sellers on online platforms

B. Expanding coverage of ‘online’ services

Contd..

- ▶ the Indian government has overhauled the erstwhile indirect tax regime regarding different rates of tax applying to gaming (18%) and gambling (28%). Now October 1, 2023, there is no distinction between a 'game of skill' and a 'game of chance'
- ▶ According to Section 115BBJ, income in the nature of winnings from online games shall be taxed at the rate of 30% flat plus cess and surcharge (if any), with effect from FY 2023-24.
- ▶ TDS of 30% shall be deducted under section 194BA for winnings from any online game without any threshold limit.

Other provisions to tax e-commerce and digital transactions

Sec.9(1)(vi) Royalty

- ▶ 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 utilized for a business or profession carried on by such person outside India or to make or earn 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 utilized for a business or profession carried on by such person in India or to make or earn 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 license) 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 program recorded on any disc, tape, perforated media, or other information storage device and includes any such program 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 the transfer of all or any right for use or right to use computer software (including granting of a license) irrespective of the medium through which such right is transferred.

Sec.9(1)(vii) FTS

- ▶ 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 utilized in a business or profession carried on by such person outside India or to make or earn any income from any source outside India
- ▶ a person who is a non-resident, where the fees are payable in respect of services utilized in a business or profession carried on by such person in India or to make or earn 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

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 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 because the words "technical services" in section 9(1)(vii), read with Explanation 2 come in between the words "managerial and consultancy services".
- ▶ Managerial and consultancy services" and, therefore, necessarily "technical services", would involve services rendered by human efforts.

Credit Lyonnais [2016] 238 Taxman 157 (Bombay)

- ▶ The assessee was appointed by the 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 5 years. Besides, the assessee received a sum of Rs. 22.19 crores from SBI as arranger fees and commission.

Held :

- ▶ 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 *Explanation 2* to section 9(1)(vii) 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 virtue 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 amount to payment of a fee for 'technical services' rendered by the Bombay Stock Exchange?

Held

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

ABB FZ - LLC v Deputy Commissioner of Income Tax (IT(TP))

- ▶ More recently, the Bangalore Tribunal held that in order to determine whether a service PE under the UAE - India tax treaty has been established, it is not important to determine the number of days the employees of the non-resident company have been in India, but rather the number of days the non-resident company has been providing services in India on a continuous basis.