

Taxation of Digital Economy

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Presentation Layout

Sr. No.	Particulars
1	Taxation of Digital Economy
2	BEPS Action 1 Reports
3	Equalisation Levy
4	Significant Economic Presence
5	Interplay between Equalisation Levy & Significant Economic Presence
6	What next?

Digital Economy – What is it?

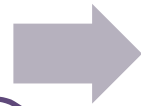
- ▶ Use of digital means to do business
- ▶ Transcending geographical borders and eliminating technological barriers
- ▶ Services re-engineered – Intermediaries replaced
- ▶ Logistics reimaged – Remote vehicles, drones, etc.
- ▶ Production redefined – 3D Printers, Robots, etc.
- ▶ Assets revolutionised – Data, data, data.
- ▶ A paradigm shift in how the world does business
 - ▶ Asset-free – only connecting customer and businessman
 - ▶ Free, freemium, pay-per-view models – earning through ad revenue
 - ▶ Customer is king & Data is the new oil

Taxation of Digital Economy – the system till now

Section 5 of ITA

- *Not taxable unless:*
- *Received or Deemed to be received in India; or*
- *Accrues or Arises in India*

- NR does not have any activities in India and receives income directly abroad



Section 9 of ITA

- *Not taxable unless there is a Business Connection in India*

- NR does business from outside India and has no business connection in India



Art. 5 of DTAA

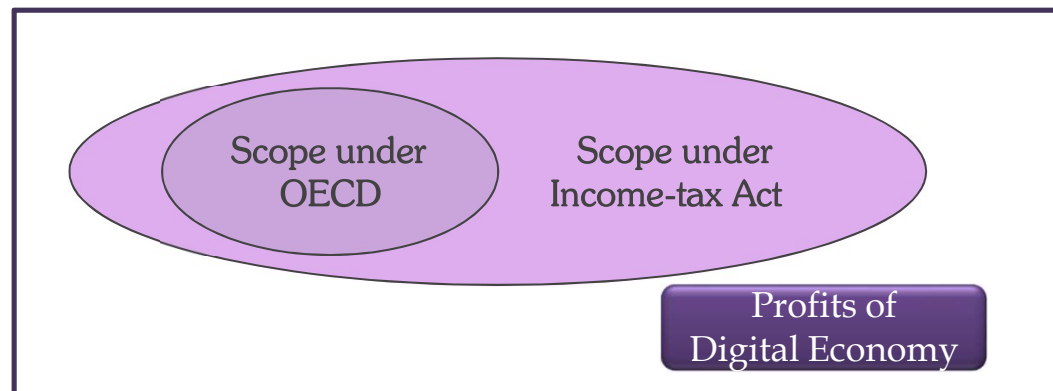
- *Art. 5 requires PE of NR in India*
- *PE is defined as "fixed place of business"*
- *Exempt if no PE*

- NR does not require physical presence in India

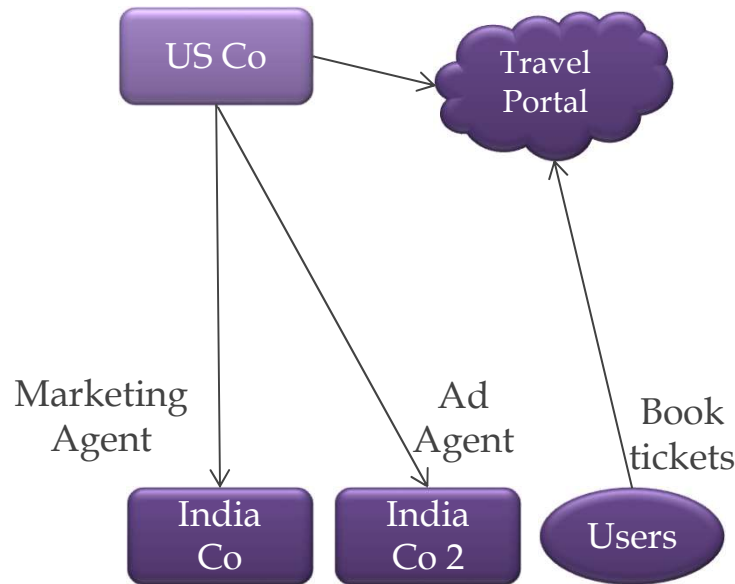
Even if taxable under the Act provisions of the DTAA will prevail as more beneficial

Taxation of Digital Economy – How is it different?

- ▶ Digital Economy does not require physical presence
- ▶ Digital Economy ignores geographical barriers
 - ▶ Amazon, Google & Facebook
- ▶ Tax avoidance under Digital Economy was the primary reason for BEPS discussion to start.
- ▶ New threshold is required.
 - ▶ PE definition linked to physical location - archaic and obsolete



Case Study – E-commerce



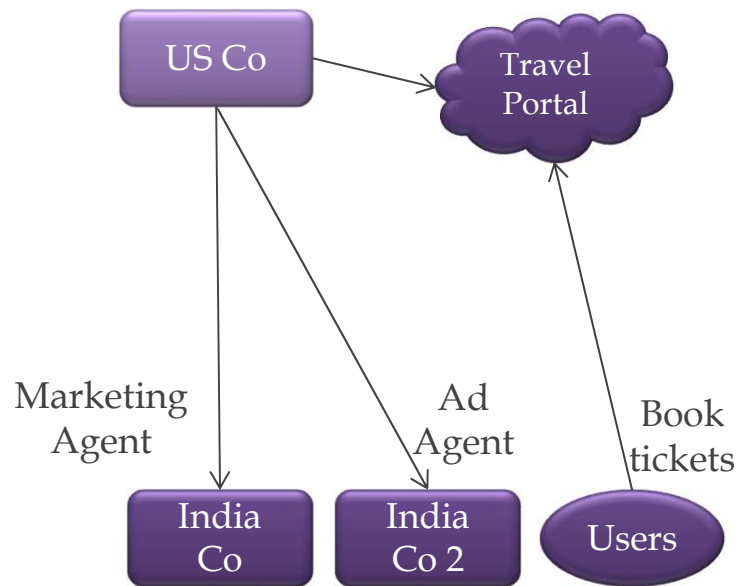
Facts:

- US Co provides online portal for travel services
- Portal hosted on cloud services managed by independent service provider
- Portal targeted for Indian users
- Accessed by Indian users from India for concluding transactions
- US Co appoints India Co. as Agent for marketing portal
- US Co appoints India Co 2 as Agent for soliciting customers for targeted ads at Indian users on travel portal

Issue:

- What are the tax issues that will be faced by US Co in India?

Case Study – E-commerce



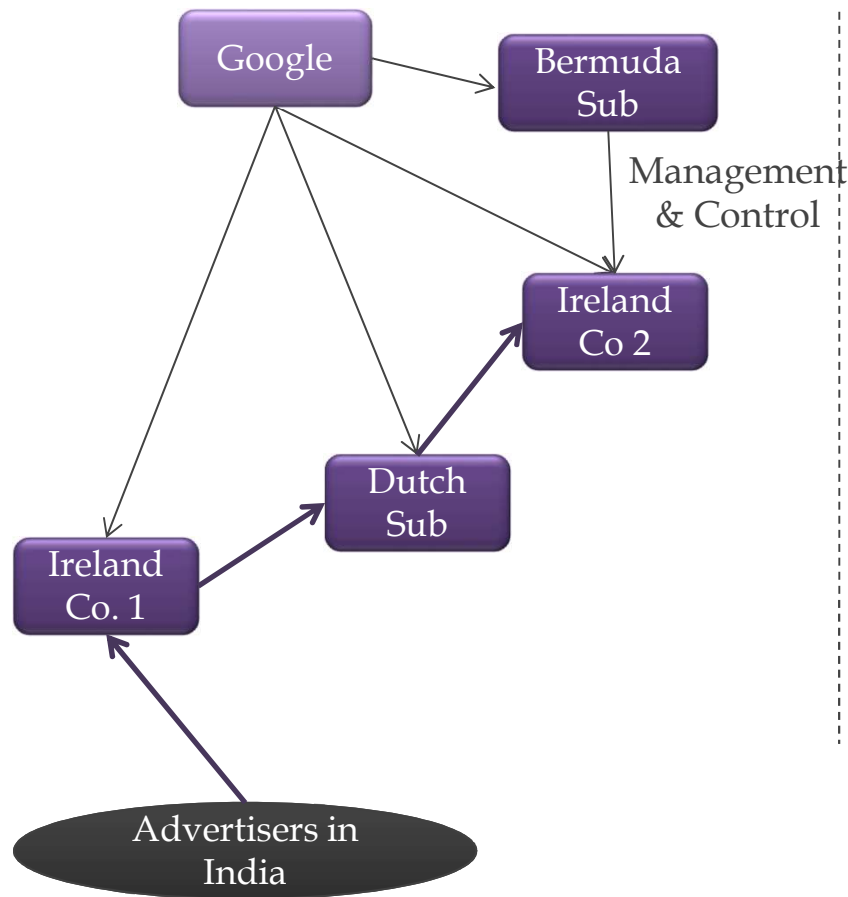
Constitution of PE:

- Virtual business activity
- PE definition based on Fixed Place
 - No Server, no fixed place in India

To consider:

- Google India Pvt Ltd
- eBay International AG
- Right Florists Pvt Ltd
- Google's tax issues in UK and USA

Digital economy aided tax avoidance



Double-Irish Dutch Sandwich:

1. Advertiser in India pays to Google Ireland Co. 1
2. Ireland Co. 1 pays out most of its incomes as royalty to Dutch Subsidiary of Google - no WHT within EU
3. Dutch Sub pays to Ireland Co. 2
4. Ireland Co. 2 is controlled and managed by Bermuda Sub and hence a NR in Ireland - no tax in Ireland
5. No tax in Bermuda

Google moved around \$19 Billion in 2016 alone through this structure.

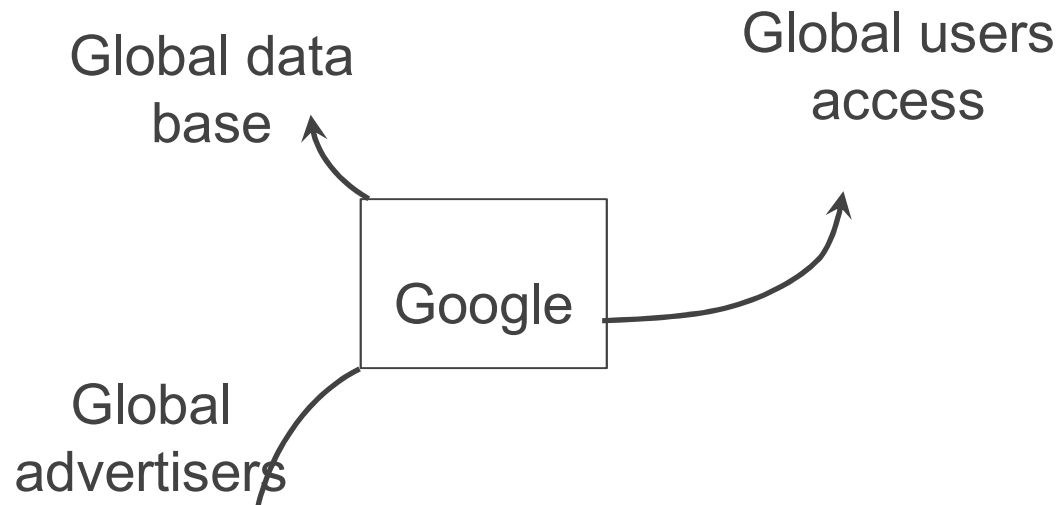
Structure set to close in 2020 after pressure from many governments.

Effective tax rate much lower than 0.1%.

The need for taxing Digital Commerce

- ▶ To bring a level playing field by taxing all business activities irrespective of the manner in which they are conducted
- ▶ Possible to do business from any place in the world without physical presence anywhere! Software selling software!
- ▶ Digital commerce is the real commerce – borders thinning and businesses moving online
 - ▶ Countries are already feeling the pinch as huge revenue goes out untaxed
- ▶ Indirect tax on supply and borne by customer, no tax on income of NR earned from sale to customer

Digital Economy – How to tax?



- ▶ What should be considered as source:
 - ▶ Users of database.
 - ▶ Servers where database is stored.
 - ▶ Servers where search software is stored.
 - ▶ Advertisers.
- ▶ What should be considered for attribution of profits?
 - ▶ Activities in COS

BEPS Report on Digital Economy - Key findings...

- ▶ Because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes.
- ▶ While the digital economy and its business models do not generate unique BEPS issues, some of its key features exacerbate BEPS risks.
- ▶ **Measures in other BEPS Actoins:**
- ▶ Modify the list of exceptions to the definition of PE
 - ▶ to ensure that each of the exceptions is restricted to “preparatory or auxiliary” activities; and
 - ▶ to introduce a new anti-fragmentation rule to ensure that it is not possible to benefit from these exceptions through the fragmentation of business activities among closely related enterprises.

BEPS Report on Digital Economy – Key Findings ...

- ▶ Modify the definition of PE
 - ▶ to address artificial arrangements resulting in conclusion of contracts relating to the sales of goods or services of one company in a multinational group - such sales to be treated as if they had been made by that company.
- ▶ The revised transfer pricing guidance makes it clear that legal ownership alone does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible
 - ▶ Group companies performing the important functions, contributing the important assets and controlling economically significant risks will be entitled to an appropriate return.
- ▶ The recommendations on the design of effective CFC include definitions of CFC income that would subject income that is typically earned in the digital economy to taxation in the jurisdiction of the ultimate parent co.

BEPS Report on Digital Economy – ...Key Findings

- ▶ Other options were not recommended:
 - ▶ New nexus in form of significant economic presence
 - ▶ Withholding tax on certain digital transactions
 - ▶ Equalisation levy
- ▶ Countries can introduce any of these three options in domestic law, however respecting existing treaty obligations

BEPS Reports on Digital Economy – What next?

- ▶ BEPS Report only focuses on Base Erosion & Profit Shifting
- ▶ No new treaty rule proposed.
- ▶ Existing rules tightened
- ▶ Reliance on other BEPS measures
- ▶ **Review in 2020**
- ▶ Interim Report in March 2018 is silent on any recommendation
 - ▶ Only points out differences between countries impacted
 - ▶ Unilateral measures being resorted to by countries

BEPS Report on Digital Economy – Behind the Scenes

- ▶ USA vs the Rest of the World
- ▶ USA is Country of Residence for world's biggest Ecommerce Companies
 - ▶ China is a big player but in a closed economy and hence not bothered
- ▶ USA is not interested in sharing the tax revenue with the world
- ▶ USA took big part in negotiation and even drafting the reports

Digital Economy – USA dominates the charts

Rank by Revenue	Company	Industry	Revenue (\$B)	FY	Employees	Market Cap (\$B)
1	 Amazon	E-Commerce, Cloud	\$177.86	2017	566,000	\$737.692
2	 Alphabet Inc.	Search, Cloud, Advertising, parent company of Google	\$110.8	2017	80,110	\$780.601
3	 JD.com	E-commerce	\$55.7	2017	137,975	\$64.26
4	 Facebook	Social	\$40.65	2017	25,105	\$528.22
5	 Tencent	Social, Gaming, Investment	\$21.90	2014	38,775	\$563.55
6	 Alibaba	E-commerce	\$22.99	2014	50,092	\$510.05
7	 Booking	Travel	\$12.23	2014	18,500 ^[14]	\$92.94
8	 Baidu	Search	\$10.16 ^[16]	2016	45,887	\$88.11
9	 eBay	E-commerce	\$8.98	2016	12,600	\$43.73
10	 Netflix	Entertainment	\$11.7	2017	5,400	\$146.43
11	 Expedia, Inc.	Travel	\$8.77	2016	20,000	\$16.17
12	 Salesforce.com	Cloud Computing	\$8.39	2017	25,178	\$85.06
13	 Uber	E-commerce	\$6.5 ^[27]	2016	12,000	
14	 Rakuten	E-commerce	\$6.3	2015	14,826	\$12.28
15	 Meituan-Dianping	E-commerce	\$5.4	2017	19,000	\$30

Source: Wikipedia

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Equalisation Levy

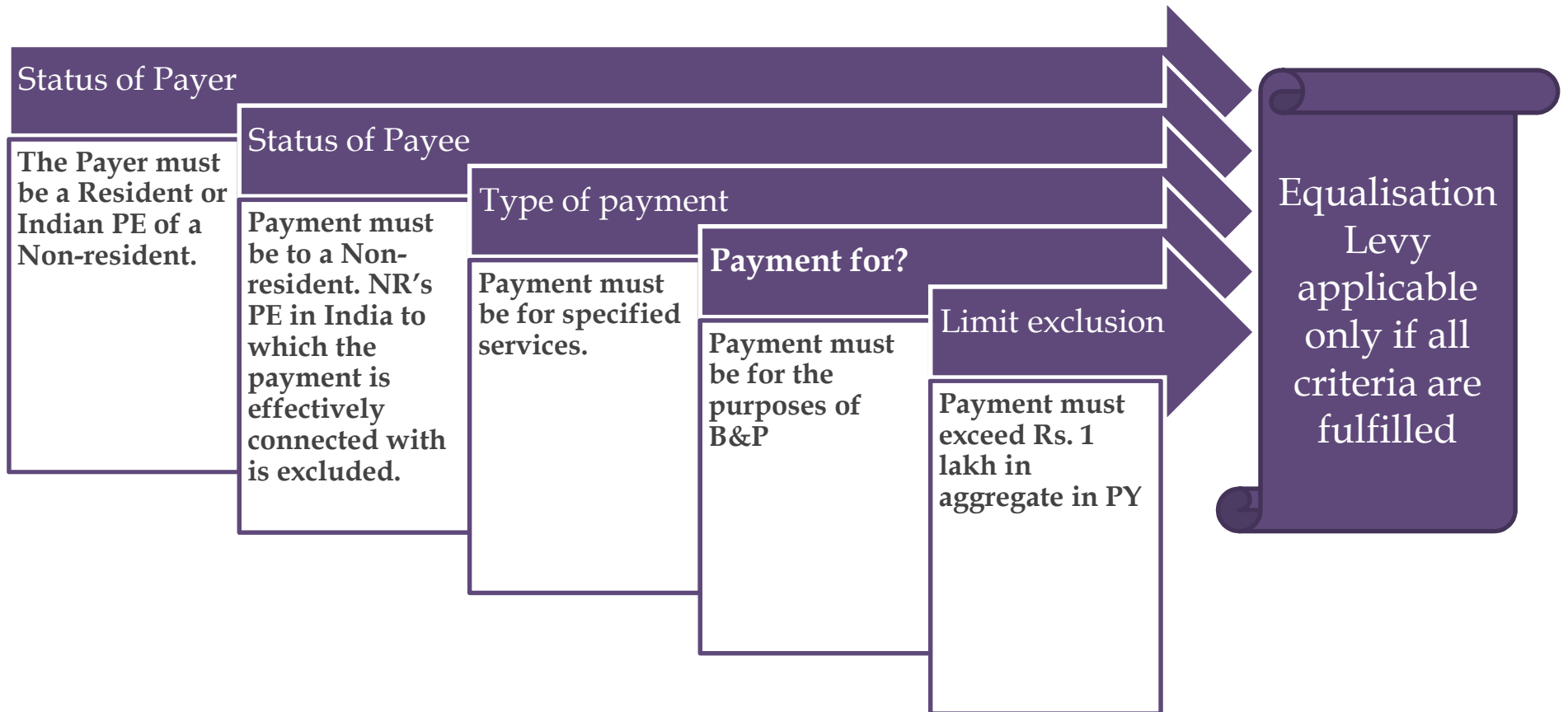
- ▶ Born out of options mentioned in BEPS Action 1
- ▶ E-commerce committee constituted by CBDT
- ▶ Submitted report in February 2016
- ▶ Report recommends a flat 6-8% levy on specified digital transactions

- ▶ Finance Act 2016 introduced Equalisation Levy
 - ▶ Chapter VIII of Finance Act 2016
 - ▶ Separate from the Income-tax Act

EL – Features

- ▶ Levy not a tax
 - ▶ To avoid DTAA overriding EL
- ▶ Levy on payment received by NR payee, but to be paid by Payer
 - ▶ Burden still not shifted on NR
 - ▶ Payment processing systems do not allow so
- ▶ Levy is not a deduction from income
 - ▶ Hence need not be grossed up
 - ▶ Can be expensed out if borne by payer
- ▶ No characterisation between different heads of income

EL - Applicability



EL – Important Terms

- ▶ Equalisation Levy: Means the tax leviable on consideration received or receivable for any specified service under the provisions of this Chapter.
 - ▶ Section 164(e)
- ▶ Specified Services: Means online advertisement, any provision for digital advertising space or any other facility or service for the purpose of online advertisement and includes any other service as may be notified by the Central Government in this behalf
 - ▶ Online: means a facility or service or right or benefit or access that is obtained through the internet or any other form of digital or telecommunication network.
 - ▶ Section 164 (i) r.w. Section 164(f)

EL – Issues based on definition of “specified services”

▶ Online Advertisement

- ▶ Does it cover review websites? Zomato, TripAdvisor, etc.
 - ▶ Data used to provide data – is that an advertisement?
 - ▶ Listing on such websites – is it an advertisement?

▶ Advertisement covers facility or service for the purpose of “online” advertisement

- ▶ What happens when facility or service is for both offline and online advertisement?
 - ▶ Ad spot created for both online and offline media
- ▶ Allocation may be required between online and offline

▶ Provision for digital advertising space

- ▶ Are Market-place models providing digital advertising space?
 - ▶ Goods sold through Alibaba; Apps listed on google playstore or Apple Appstore - are they advertised or only displayed for sale?
 - ▶ What happens when payment is made for higher or better listing?

EL – Issues based on character of levy

- ▶ Is EL a direct or indirect tax?

- ▶ If Direct tax, does not treaty override EL?
 - ▶ Art. 2 of DTAA defines 'Taxes covered'
 - ▶ If EL is covered in 'Taxes covered' then NR can resort to DTAA and no tax if no PE
 - ▶ If EL is outside the treaty network - No FTC available to NR for EL

- ▶ If Indirect tax, is it not double tax as Service tax/GST also applicable?

EL – Issues based on threshold

- ▶ Threshold issues
- ▶ Payments below limit – are they taxable under ITA?
 - ▶ Section 165 covers only payments beyond threshold limit
- ▶ Are payments for threshold limit to be counted from 1st June 2016 or 1st April 2016
 - ▶ Transitional issue

Tax on Digital Economy – a brief history

Reaction to EL:
India acted unilaterally



EL – What to expect in the future

- ▶ EL is a message by India to the world - that is not going to remain silent while others take action by inaction
- ▶ EL is simple and straight-forward
- ▶ Revenues growing: 1000 crore in 2017 as per newspaper reports

- ▶ EL seems to be an interim measure
- ▶ No further plans for expansion of “specified services”
- ▶ Once global consensus is reached and/or DTAAs are changed – EL may not be required

Significant Economic Presence

- ▶ Finance Act 2018 introduced SEP
- ▶ Concept raised in BEPS Action 1 Report on Digital Economy.
- ▶ It is already being used by some states within USA for inter-state indirect taxes on e-commerce.
- ▶ Strongly promoted by the European Union as an option to tax e-commerce.
- ▶ Removes requirements for a fixed place of business to constitute a PE.
 - ▶ Relies on other measurable factors to bring a NR to tax

SEP - Features

- ▶ SEP provides India with a right to tax NR if yet to be prescribed thresholds crossed
 - ▶ This right will be negotiated for in DTAAs too
 - ▶ Set the ball rolling for global consensus on this concept
- ▶ SEP is much broader than digital economy?
 - ▶ Clause (a): Transactions in respect of any goods, services or property covered
 - ▶ Covers all business transactions – not necessarily those done through digital means, or those only for digital goods
 - ▶ For example, if AramCo sells oil beyond threshold limit, SEP constituted. Is this the intention?
 - ▶ Avoids ring-fencing aspect of tax only on digital economy
 - ▶ But intention seems to be to cover only digitized businesses
 - ▶ Threshold limits, once prescribed, may resolve this

SEP – Analysis of provision

- ▶ **Explanation 2A** main clause –
- ▶ For the removal of doubts, it is hereby clarified that
- ▶ the significant economic presence
- ▶ of a non-resident
- ▶ **in India**
- ▶ shall constitute “business connection” in India

SEP – Analysis of clause (a)

- ▶ **Explanation 2A** clause (a) –
- ▶ “significant economic presence” for the purpose, shall mean –
- ▶ (a) transaction in respect of any goods, services or property
- ▶ **carried out by a non-resident in India**
- ▶ including provision of download of data or software **in India**
- ▶ if the aggregate of payments arising from such transaction or transactions during the previous year exceeds such amount as may be prescribed
- ▶ Provided that the transactions or activities shall constitute significant economic presence in India, whether or not the non-resident has a residence or **place of business** in India or renders **services in India**.

SEP – Analysis of clause (b)

- ▶ Explanation 2A clause (b) –
- ▶ “significant economic presence” for the purpose, shall mean –
- ▶ (b)(i): systematic and continuous soliciting of its business activities; or
- ▶ (b)(ii): engaging in interaction with such number of users
- ▶ as may be prescribed,
- ▶ **in India**
- ▶ through digital means

- ▶ Provided that the transactions or activities shall constitute significant economic presence in India, whether or not the non-resident has a residence or **place of business** in India or renders **services in India**.

SEP - Coverage

Particulars	Clause (a)	Clause (b)(i)	Clause (b)(ii)
Subject of tax	Transaction in respect of any goods, services or property	Solicitation of business activities through digital means	Engaging in interaction through digital means
Qualification	Carried out by a non-resident in India	Systematic & continuous activity in India	Activity in India
Threshold	Only if aggregate payments exceed prescribed limit	Is there a threshold?	Only if interaction with such number of users as prescribed
Undefined terms	Transaction, carried out,	Systematic, continuous, soliciting, digital means	Engaging, Interaction, users, digital means

SEP – Issues

- ▶ Many issues due to language used
- ▶ Clause (a) refers to transactions carried out by a NR in India
- ▶ “Carried out in India”:
 - ▶ General meaning of the phrase requires both parties to be present in India.
 - ▶ Is a transaction ‘carried out’ in India when one party is in India and the other party is outside India?
 - ▶ Or only when **both** parties are present in India?
 - ▶ Therefore a person transacting in India with an overseas website of a NR who is outside India may not get covered
 - ▶ Proviso removing need for services to be rendered in India contradictory to language above

A concept to remove the need for a geographical nexus is again limited by a geographical condition!

SEP – Issues in Clause (b)

- ▶ Systematic and continuous soliciting through digital means
 - ▶ No measurable marker for systematic and continuous soliciting
 - ▶ Plain language of act requires no threshold limit – once soliciting activities are systematic and continuous, SEP constituted
 - ▶ Circular dated 13th July points towards “users” as threshold!
 - ▶ Soliciting would be of users or customers? Not clear.
 - ▶ “Soliciting in India” – how to find out solicitation through digital means happened in India?
- ▶ Engaging in interaction with users in India
 - ▶ What is interaction?
 - ▶ For example, Facebook & Whatsapp – is there interaction by FB with users; or only by users with other users?
 - ▶ Interaction without engagement possible? If so, that is not covered.
 - ▶ For example, automated interaction not requiring NR to undertake any activity – is that covered?

SEP – Issues in Clause (a) & (b)

- ▶ “By” a non-resident:
 - ▶ Difficult to say in many e-commerce business models who or what has carried out the transaction.
 - ▶ For example, TV show hosted on a website for viewing. Indian user accesses website sitting from India.
 - ▶ Is this transaction or activity **by** NR or Indian viewer?
 - ▶ Similarly, data inputted in India in an online service to access search or social functions – is it a transaction **by** NR?
- ▶ Attribution of profits
- ▶ What will be the factors?
 - ▶ Functions, Assets and Risk may all be outside India
 - ▶ Need to bring in new factors related to Market
 - ▶ From FAR to FARM – a debate which never ends
 - ▶ Californian Oranges example

SEP - Issues

- ▶ An altogether new provision expanding the scope of taxability brought through an “Explanation”
- ▶ Can expansion be made in definition “For removal of doubts”?
- ▶ Prospective applicability unlike other past amendments
- ▶ Explanatory Memorandum states that these incomes were not covered under definition of business connection pre-amendment:
 - ▶ The scope of existing provisions of clause (i) of sub-section (1) of section 9 is restrictive as it essentially provides for physical presence based nexus rule for taxation of business income of the non-resident in India. Explanation 2 to the said section which defines ‘business connection’ is also narrow in its scope since it limits the taxability of certain activities or transactions of non-resident to those carried out through a dependent agent. Therefore, ***emerging business models such as digitized businesses, which do not require physical presence of itself or any agent in India, is not covered within the scope of clause (i) of sub-section (1) of section 9 of the Act.***
 - ▶ Consequences on existing litigation?

SEP – Technical issues

- ▶ SEP of a NR in India will constitute Business Connection
 - ▶ While SEP is explained, no provision to *deem* that SEP to be in India
 - ▶ Even if SEP constituted, is it “in India”??
 - ▶ Unlike indirect transfer provisions, where shares are deemed to be situated in India, SEP once constituted, is not *deemed* to be in India – language needs to be drafted in a better manner
 - ▶ For example, SEP constituted due to users in India – NR can claim while SEP is constituted, it is outside India as other users outside India are much more than users in India.
- ▶ While SEP is now Business Connection, is Business Connection now only SEP?
 - ▶ Possible view – but incorrect to say “Man is human, so all humans are only men.”

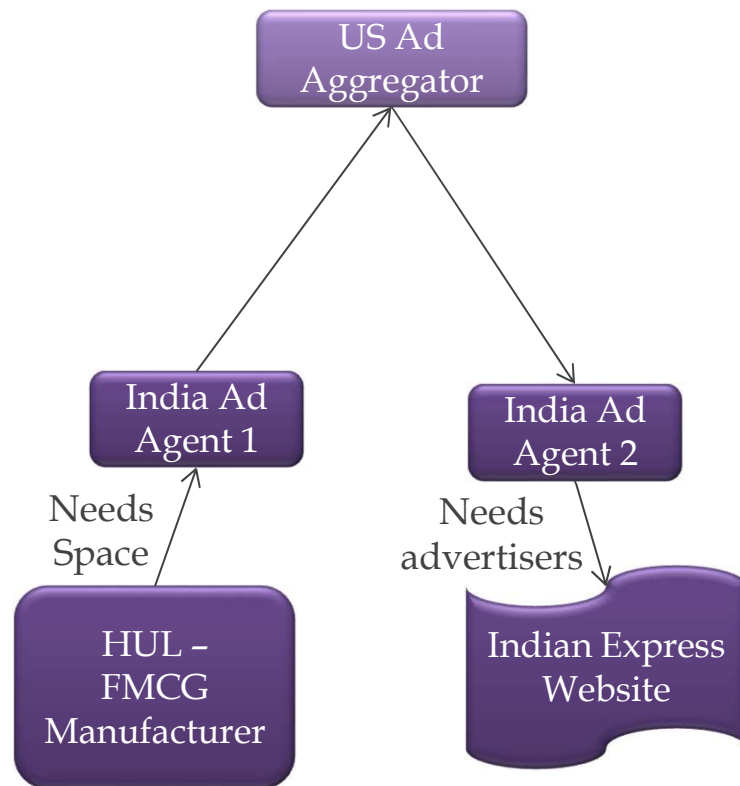
SEP – Applicability & inapplicability

- ▶ SEP effective from 1st April 2018
- ▶ NR covered under treaty with India may not get affected
 - ▶ However, if no TRC available, treaty relief may not be available
 - ▶ Similarly, no treaty with countries like Hong Kong, BVI, Bermuda, etc.
- ▶ SEP applicable only if prescribed limit crossed
 - ▶ However, no limit prescribed yet
 - ▶ CBDT has asked for suggestions for framing of threshold limits only on 13th July 2018 with time limit to submit till 10th August 2018
 - ▶ Whether NR needs to pay tax from 1st April 2018 once limits prescribed?

Interplay of SEP and EL

- ▶ SEP is broad enough to cover specified services under EL
- ▶ If a NR earns advertising revenue from India, he will be liable to which tax?
- ▶ If payment is for services covered under 'specified services' EL will be payable.
 - ▶ Any income which is chargeable to EL is exempt from tax u/s. 10(50)
 - ▶ Hence no applicability of SEP and hence no double tax.
- ▶ Can an assessee choose to be taxed under SEP instead of EL?
- ▶ No.
 - ▶ EL does not give any option to the assessee.
 - ▶ If he is liable to tax under EL, he has to pay tax as EL & get exemption under ITA.
 - ▶ Similarly, NR cannot choose to be taxed under EL instead of ITA

Interplay of SEP, EL and Royalty/FTS



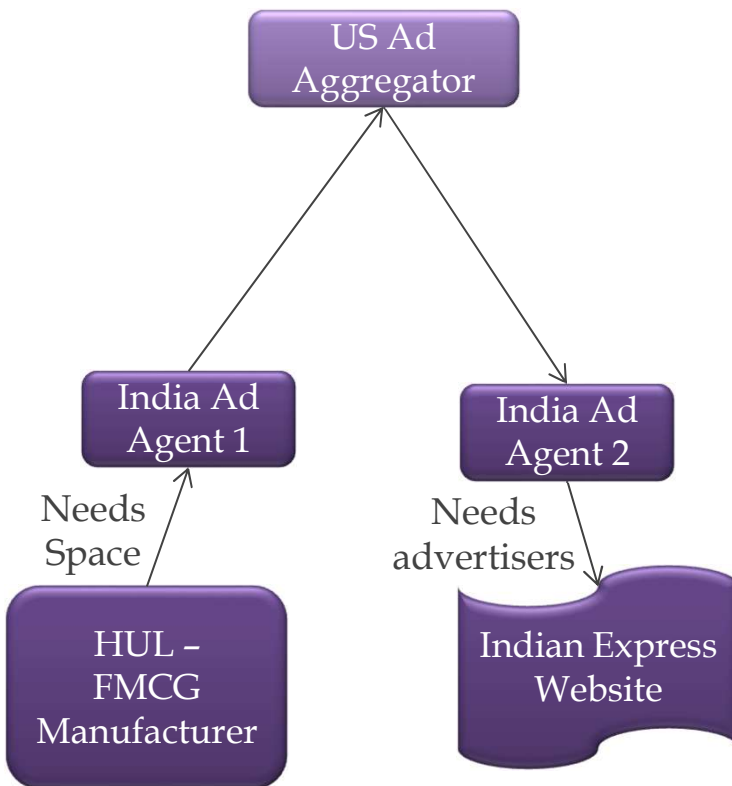
Facts:

- US Co provides online portal for ad aggregator and bidding services
- Accessed by Indian agents for placing and booking ads
- HUL appoints India Ad Agent 1 as Agent for placing ads with specific keywords to target ads to Indian customers
- News Website appoints India Ad Agent 2 as Agent for soliciting customers for its advertising space with specific requirements

Issue:

- What are the tax issues that will be faced by Indian Ad Agents, HUL and News Website?

Interplay of SEP, EL and Royalty/FTS



Analysis:

- HUL pays lumpsum for both advertising and agency commission to Indian Ad Agent 1 - no EL as payment not to NR.
- Indian Agent 1 pays to US Ad aggregator for finding advertising space as per requirements - EL or Royalty or FTS? Depends on contract terms. Royalty/FTS more specific than EL.
- Indian Express pays commission to Indian Ad Agent 2 for finding advertisers - No EL.
- Indian Ad Agent 2 pays US Ad Aggregator fees for finding advertiser as per requirements -FTS or Business income as per contract terms
- US Ad aggregator receives lumpsum from Agent 1, cuts its fees from both ends, and pays net to Indian Agent 2 - Could have SEP under clause (a) or (b) if thresholds crossed

Issues:

- Fees deducted in second leg by US Co - How to deduct tax at source when no payment!

What Next?

- ▶ We are in interesting times
- ▶ Clarity to Businessman not available
- ▶ SEP may become acceptable concept by consensus
- ▶ But language may change
- ▶ Payer making payment for digital services must be extra careful – the burden of non-payment largely lies with payer.



▶ Thank You!

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▶ Acknowledgements:

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