

A person wearing a teal shirt is seated at a table, interacting with a tablet computer. They are also holding a credit card. On the table, there is a white cup of coffee on a saucer with a spoon and a sugar packet. The background is blurred, suggesting an indoor setting like a cafe or office.

Taxation of digital economy

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WIRC

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Contents



Conventional commerce

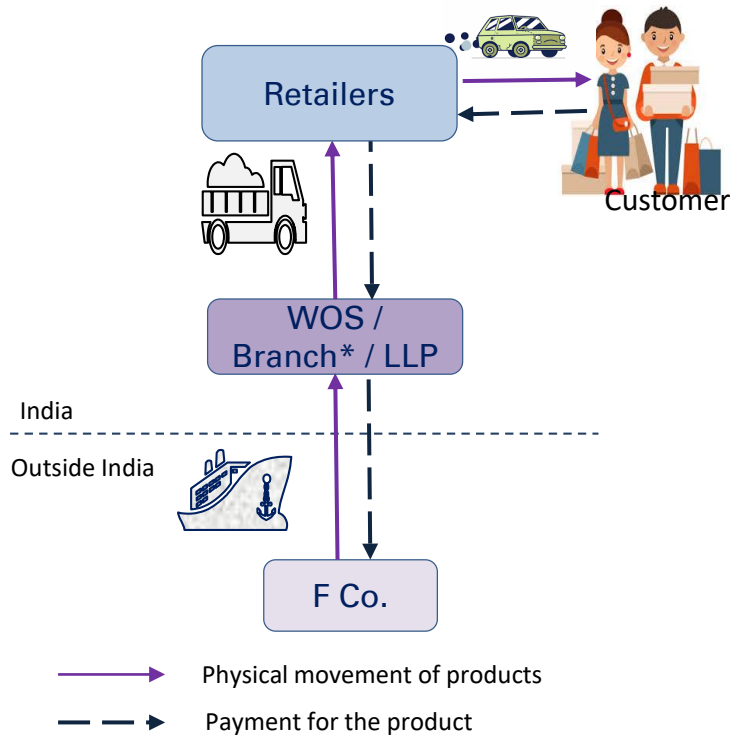
Digital economy

India tax considerations

Summing up

Conventional commerce

Conventional commerce



Mechanics

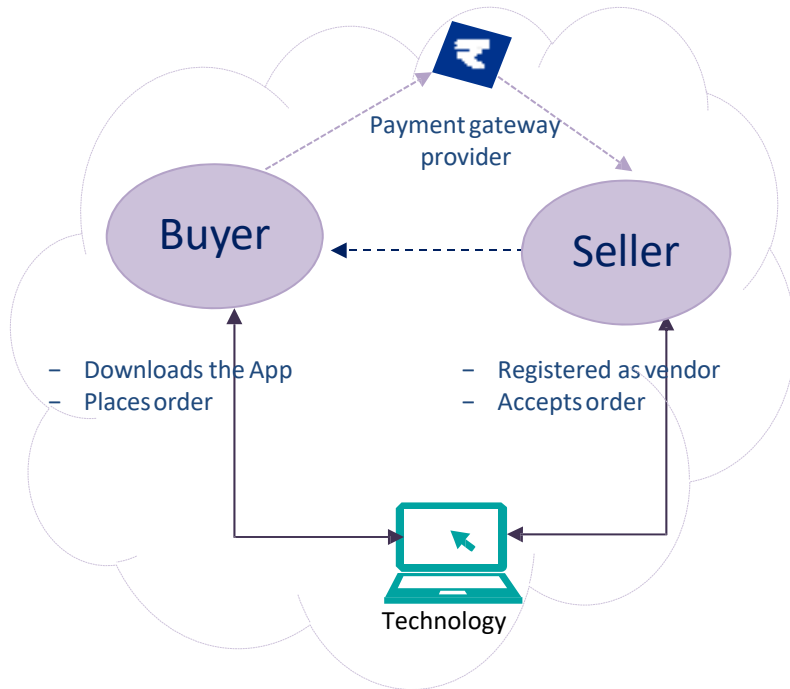
- F co. intends to sell smartphones (i.e. goods) in India
- For this purpose, F Co. incorporates WOS/LLP/Branch
- WOS/LLP/ Branch in turns sells goods to retailers at an x price
- Customer buy goods from retailers at x+y price

Retailers and WOS / branch / LLP by virtue of its physical presence in India pays tax on the net profit

** Permitted activity for a branch office in India of a person resident outside India*

Digital economy

Digital economy - an overview



- ↔ Contract with technology platform for use of App
- - - -> Delivery of goods
- - - -> Payment for goods

Digital Economy ('DE')

- Result of transformative process brought by information & communication technology - businesses mostly undertaken using the internet i.e. in an economy sans physical / geographical presence
- **Shift** from conventional commerce to **digital commerce**
- Who are the key stake holders? ([Annexure 1A](#))
- Characteristics of digital economy ([Annexure 1B](#))

DE is characterized by an unparalleled reliance on intangibles, massive use of data, widespread adoption of business models

Digital economy – operating models

Operating models in digital economy

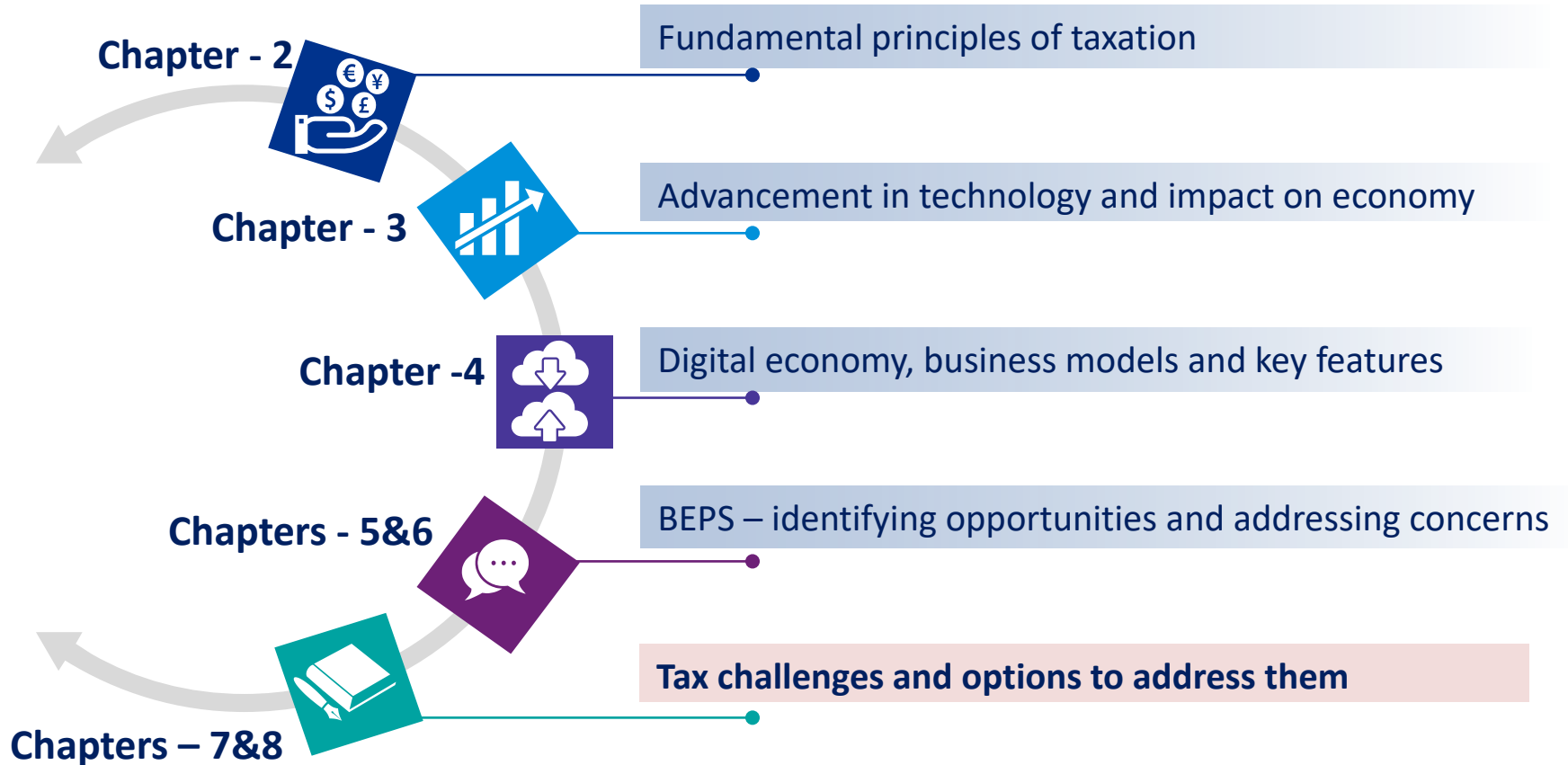
- Different **business models** evolving with advancement in technology – to illustrate
 - (a) E-tail model ([Annexure 2](#))
 - (b) Hotel aggregator ([Annexure 3](#))
 - (c) Online advertisement ([Annexure 4](#))

Taxation of digital economy

- Taxability of a non-resident - Section 5 of the Income-tax Act, 1961 r.w Section 9
- Beneficial provisions of the DTAA applicable under Section 90(2)
- **PE risk, in absence of physical presence, remote**

Task force was set up to identify the issues in 'digital economy' and 'options' to address these issues

BEPS AP 1 - coverage



Traditional tax rules to determine liability results in loss of revenue
BEPS AP 1 aims to address the tax challenges in digital economy

Digital economy – key challenges

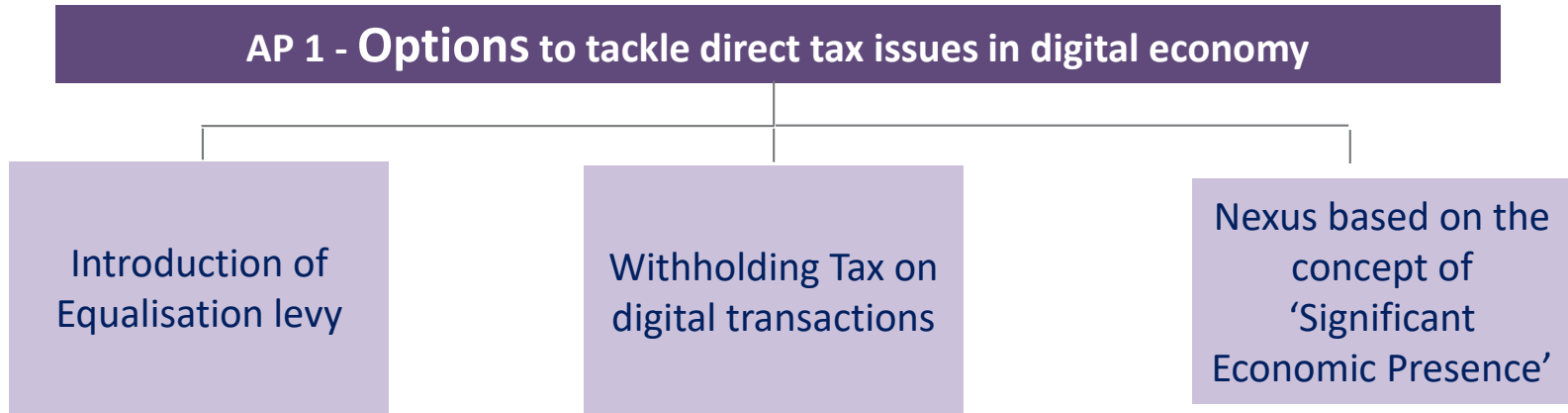
DIRECT TAX

Nexus	<ul style="list-style-type: none">• Taxation in source state without physical presence• Concept of PE under DTAA
Data	<ul style="list-style-type: none">• Attributing value created through data• Ownership of data
Characterization of income	<ul style="list-style-type: none">• Business profits / royalty / FTS• For eg: tax implications on the income earned by F Co

TAX ADMINISTRATION

Identity of seller / service provider	<ul style="list-style-type: none">• Difficult to identify the offshore seller, given that 'Market' jurisdiction does not require physical registration
Extent of activities undertaken	<ul style="list-style-type: none">• Impossible to ascertain without information from offshore seller in absence of sales records in 'Market' jurisdiction
Verification of information	<ul style="list-style-type: none">• Difficult for the revenue authorities to independently verify any information provided by the offshore seller

AP 1 - recommendations?

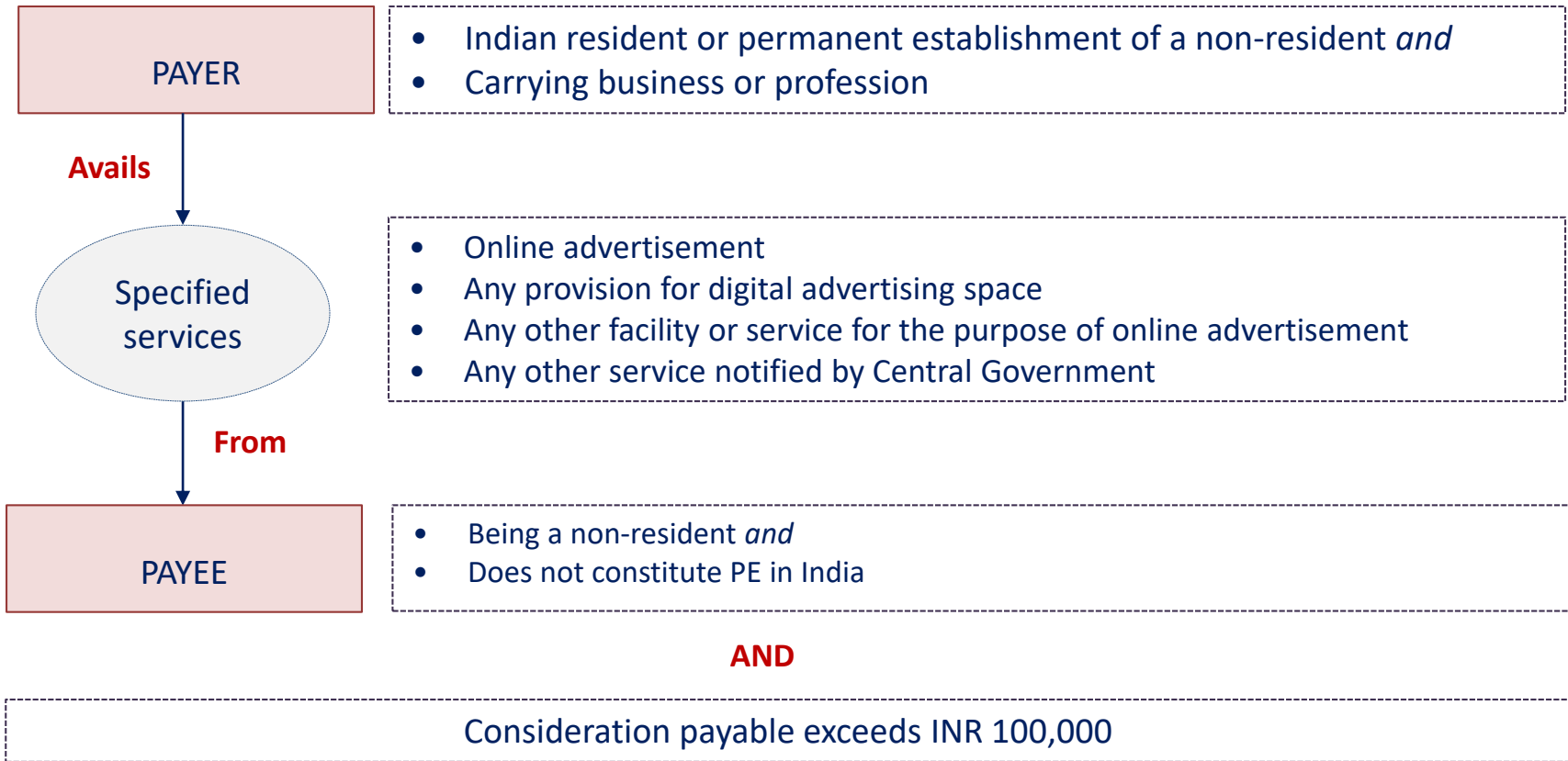


Global developments in context of digitalization

- *Alternative PE threshold measure*
 - ✓ Israel introduced SEP, under its domestic law, in 2016 – applicable to non-treaty countries
 - ✓ Saudi Arabia – has officially endorsed the concept of virtual service PE
- *Turnover tax measure*
 - ✓ Italy – Levy on Digital Transactions at 3 per cent effective from 1 January 2019
- *Diverted profit tax measure*
 - ✓ UK and Australia
 - ✓ US – BEAT
- EU Commission – proposes an interim levy ‘digital services tax’ to ensure that all companies pay fair tax in the EU *(European Commission – Press Release dated 21 March 2018)*

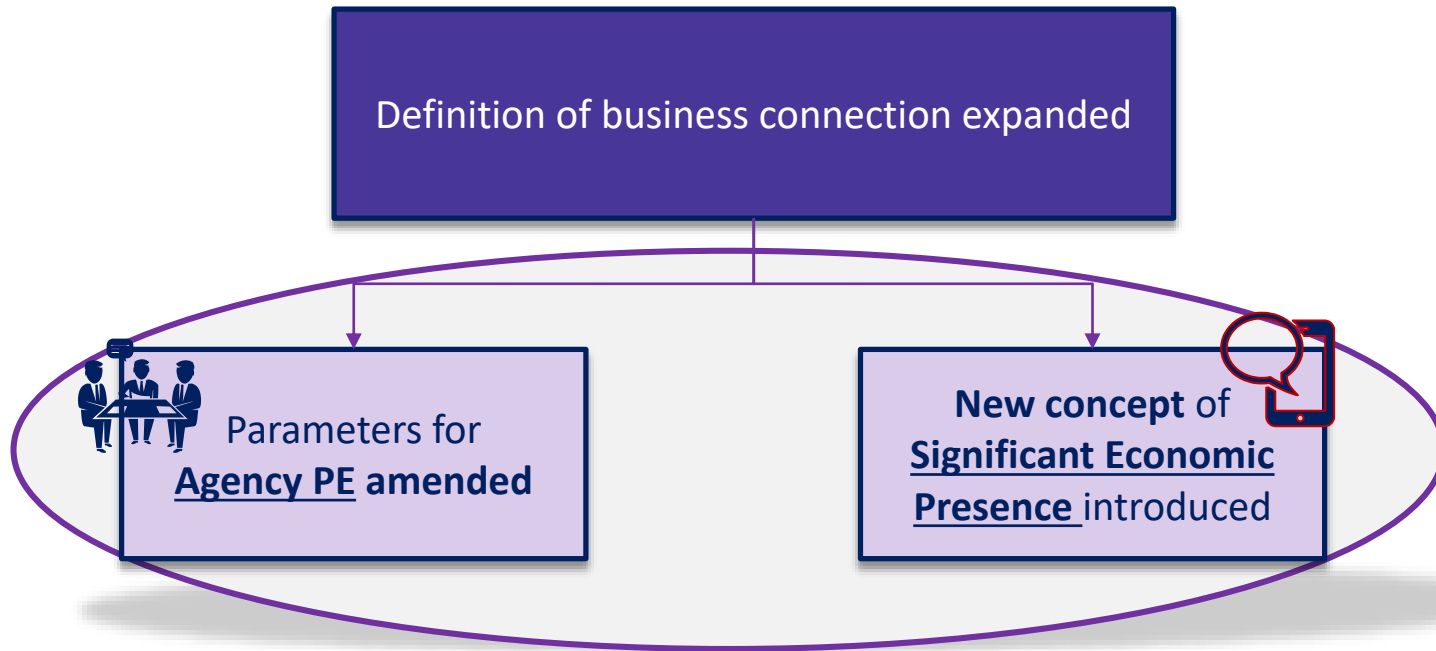
India tax considerations

Equalization levy



EL to be deducted at the rate of 6 per cent on the consideration payable and deposited with the Central Government within the due dates prescribed

Recent amendments u/s 9(1) of the Income-tax Act, 1961



Agency PE – parameters amended

Business connection

No PE case Pre-amendment

- **Agency scope** – No authority to **conclude contracts** for F Co
- Activities pertaining to purchase of goods or merchandise on behalf of non-resident excluded
- **Non-exclusivity of agency:**
 - agent not **rendering service solely** to F Co. in source state; and
 - agent not deriving **entire / almost entire revenue** from F Co.

Amendment (in line with BEPS AP 7)

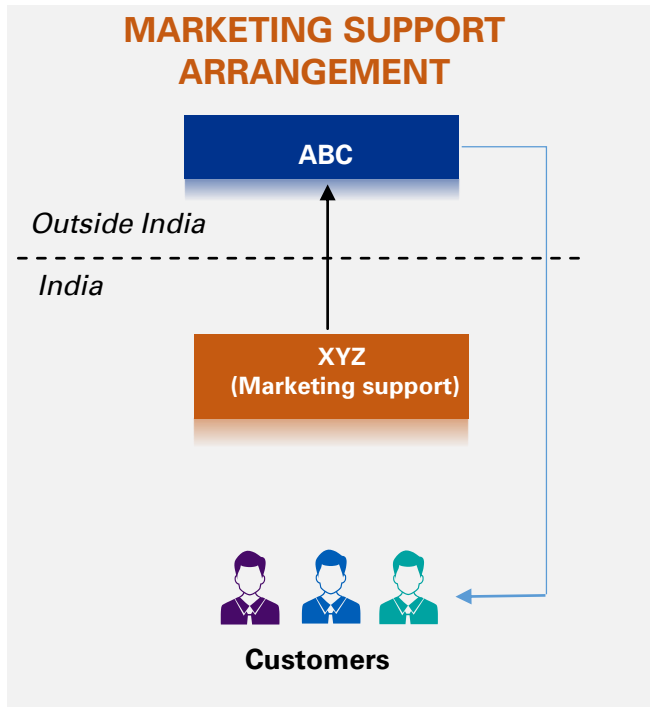
- **Scope** of PE expanded to include agent **playing principal role** leading to routine conclusion of contracts by Foreign Company **without material modification**
- Participation in **negotiation** may be **relevant** but not **sufficient** factor
- **Principal role not defined**

Key considerations ...

- Extent of reliance on the OECD MC Commentary for interpreting the proposed amendment in the Act
- Meaning of '*principal role*'? Guidance from OECD MC (as amended by the BEPS Action Plan 7)?
- Deletion of expressions like "**activities of a non-resident which are limited to the purchase of goods or merchandise for the non-resident**"
- Status of independent agent

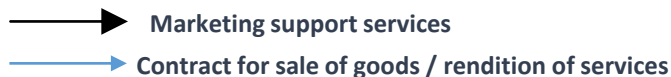
Agency PE - parameters amended

Business connection



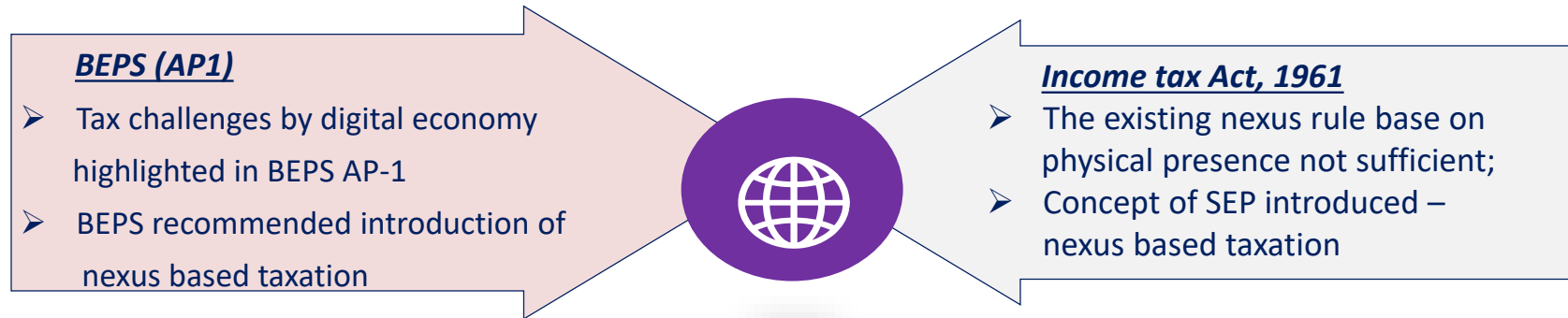
MECHANICS

- ABC a foreign company provides online travel booking services
- XYZ enters into a contract with ABC to provide the **marketing and support services** and is remunerated at cost plus mark up;
- XYZ interacts with prospective customers (in India) being airlines and hotels and convince them for contracting with Company ABC ;
- XYZ explain the standard terms of contract to prospective customers;
- XYZ is not authorized to modify the contracts (to be executed online) and the price is also fixed by ABC;
- Routine on-line contracts executed without material modifications between the customers and ABC;
- **Whether XYZ plays a principal role in conclusion of contracts?**



Significant economic presence - new concept

Business connection



Snippets from the Memorandum to Finance Bill, 2018

- Advancement in information and communication technology - no more need for physical presence – resulting in tax avoidance
- Right of taxation of source country – unfairly and unreasonably eroded
- Primacy to economic allegiance rather than physical location (long used as a proxy for economic allegiance)
- SEP a new nexus based rule – targets to include the emerging business models such as digitized businesses, which do not require physical presence of itself or any agent in India to constitute business connection

Significant economic presence – provision under the Act

Business connection

- Significant Economic Presence of a non-resident in India shall constitute “business connection” in India
- “Significant economic presence” 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** for such transactions exceeds such amount as may be **prescribed**; or
 - (b) systematic and continuous soliciting of business activities or engaging in interaction with such number of users** as may be **prescribed**, in India **through digital means**:
- Transactions or activities shall constitute significant economic presence in India, whether or not,-
 - i. The agreement for such transactions or activities is entered in India; or
 - ii. the non-resident has a residence or place of business in India; or
 - iii. The non-resident renders services in India.
- **Income as is attributable** to the transactions or activities referred to in clause (a) or clause (b) shall be deemed to accrue or arise in India.

Significant economic presence - clarity required

Business connection



Issues

- Whether clause (a) covers brick and mortar transactions or it is limited to digital transaction?
- Clause (a) and (b) refers to transactions or activities carried out in India, however, proviso states otherwise
- CBDT recently requested for suggestions from stakeholders with respect to:
 - (i) Revenue threshold of transaction in respect of **'physical goods or services'** carried out by a non-resident in India
 - (ii) Revenue threshold of transaction in respect of **'digital goods or services' or property** including provision of download of data or software carried out by a non-resident in India
 - (iii) Threshold for number of 'users' with whom a non-resident engages in interaction or carries out systematic and continuous soliciting of business activities in India through digital means

Points that may require further clarity

- What is meant by digital property?
- Whether user threshold would also include one time user base?
- Clarity on interplay between SEP and EL
- **No modification suggested to standard attribution rules - How profits will be attributed to a SEP associated with little or no physical presence ?**

Digital economy - Gist of tax considerations

Corporate tax

- Business connection and permanent establishment
- Characterization of income
- Deductibility of discounts
- Situs of intangibles
- Carry forward of losses
- Withholding tax

Transfer pricing

- Global transparency and alignment of FAR with value-chain in light of CbCR and Master File
- Recognition of value-drivers and distributing returns as per contributions
- Payments for technology and management cross charges under radar
- Difficulties in attribution of profits to Permanent Establishment, in line with FAR

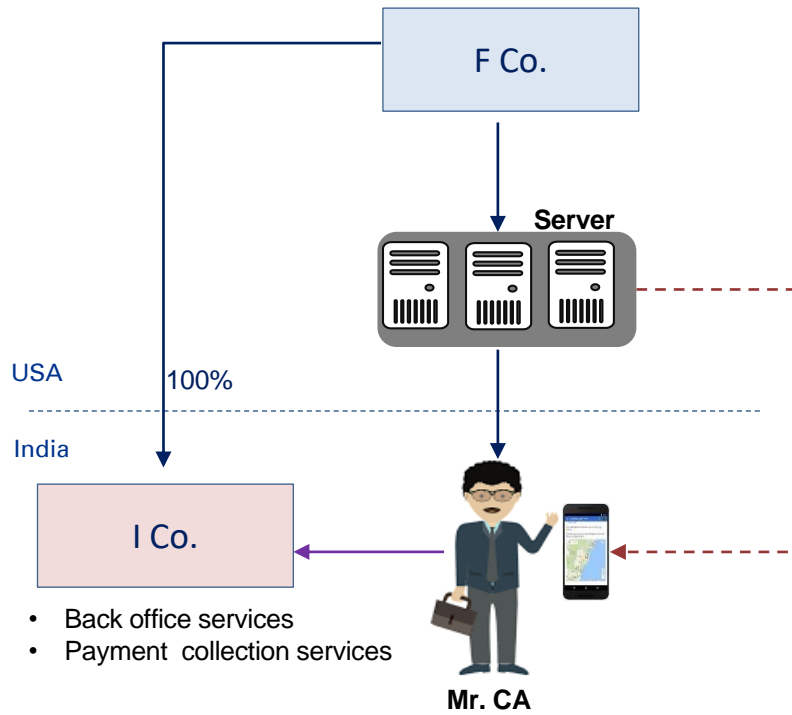


Goods and services tax

- Cross Border Transactions
- GST pre discount and post discount
- Compulsory registration;
- No Composition Scheme
- Increase in Compliance
- Credit loss to aggregators
- Goods return in a state different from purchase

Case study

Case study (1) – Application download



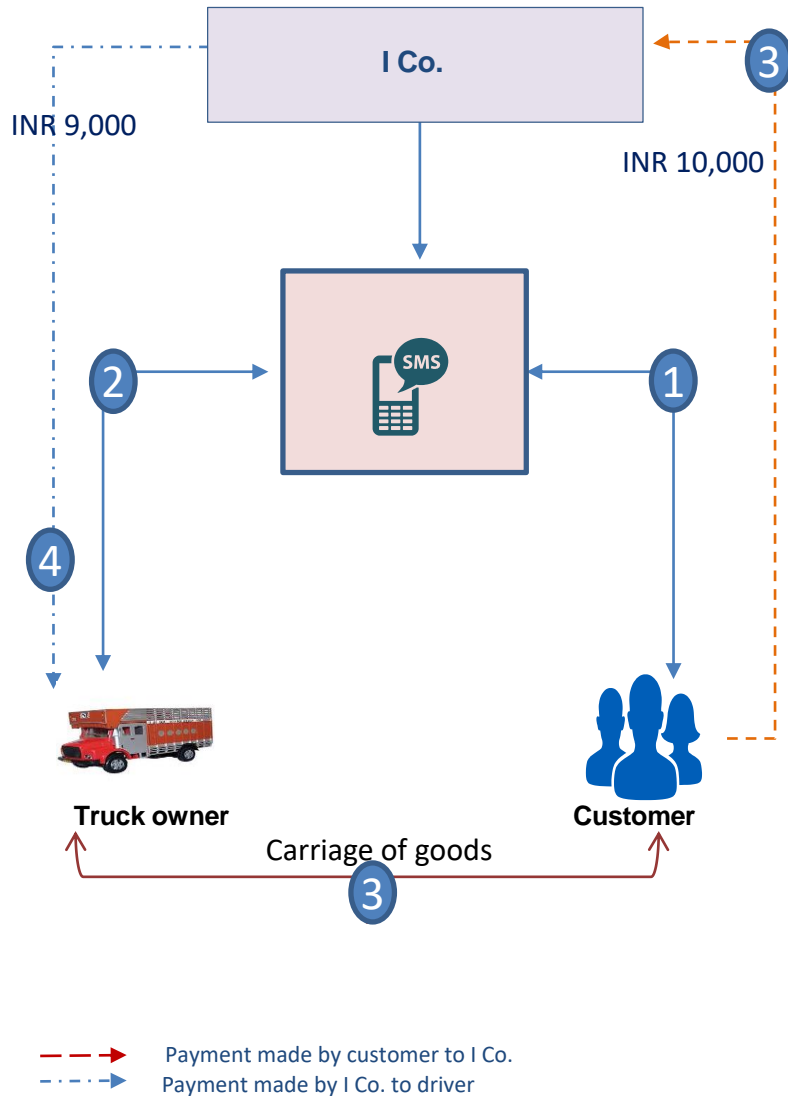
- > Download of map
- > Payment for advertisement

Facts of the case

1. F Co. is a tax resident of USA and owns maps which are available could be downloaded after payment of specified amount, i.e. USD 1 (approx. INR 70)
2. Maps are stored on a server located outside India
3. I Co. is a subsidiary of F Co. which provides back office support and payment collection services and is remunerated at cost plus appropriate mark up
4. Mr. CA download maps and pays INR 70 to I Co.
5. As per the terms and conditions, F Co. is the owner of IP or copyright in maps

Whether payment of INR 70 is taxable in India?

Case study (2) - Transport aggregator

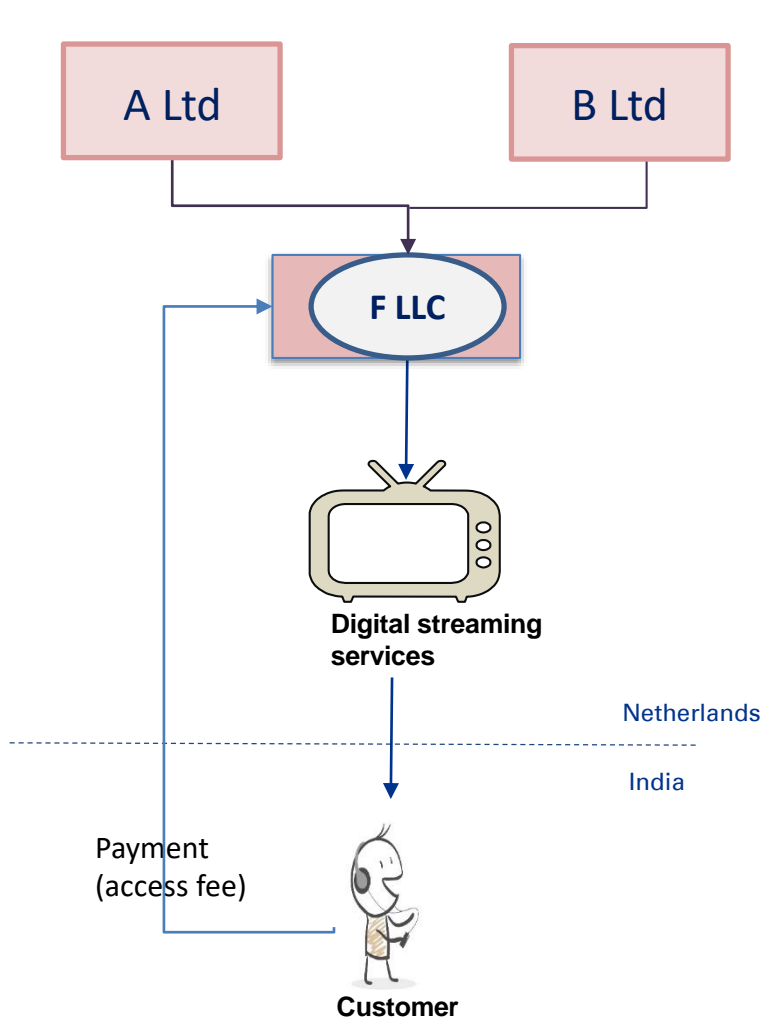


Facts of the case

- Customer downloads I Co.'s App on its smartphone, accepts digital terms and conditions thereafter raises a request for transportation of goods
- Lead generation
 - On entering the destination and pick up location, lead is generated and approximate charges are shared with the customer
 - Lead generated is shared with the truck owner who has a right to either accepts / rejects the lead
- On acceptance of lead, customer pays the charges to I Co. (acting as a collection agent of the truck owner) and goods are transported
- On completion of transportation, charges are remitted to the truck owner after retaining service charge

Whether withholding tax is applicable on INR 10,000 paid to I Co.?

Case study (3) - Digital streaming



Facts of the case

1. F LLC is a fiscally transparent partnership firm registered in the Netherlands, which is owned by A Ltd and B Ltd (both tax residents of the Netherlands)
2. F LLC provides online streaming services i.e. videos, music to customers across the globe
3. Customer in India accesses digital streaming App of F LLC for a fee
4. App of F LLC is hosted on a server outside India
5. Neither F co. nor A Ltd / B Ltd have any physical presence or PE in India

Whether 'access fee' paid to F co. is taxable in India?



Summing up

Parting thoughts

- ✓ Digital economy is the new norm with multiple tax considerations
- ✓ Thrust on 'Digital' or 'Virtual' presence unlike physical nexus
- ✓ MLI implications to be read with position of treaty partners

Next steps...

- Re-visit the business model and contractual arrangements
- Evaluate possibility of obtaining a lower withholding order or AAR
- Representation for specific provision to be introduced dealing with withholding tax on payments to e-commerce companies

Questions?

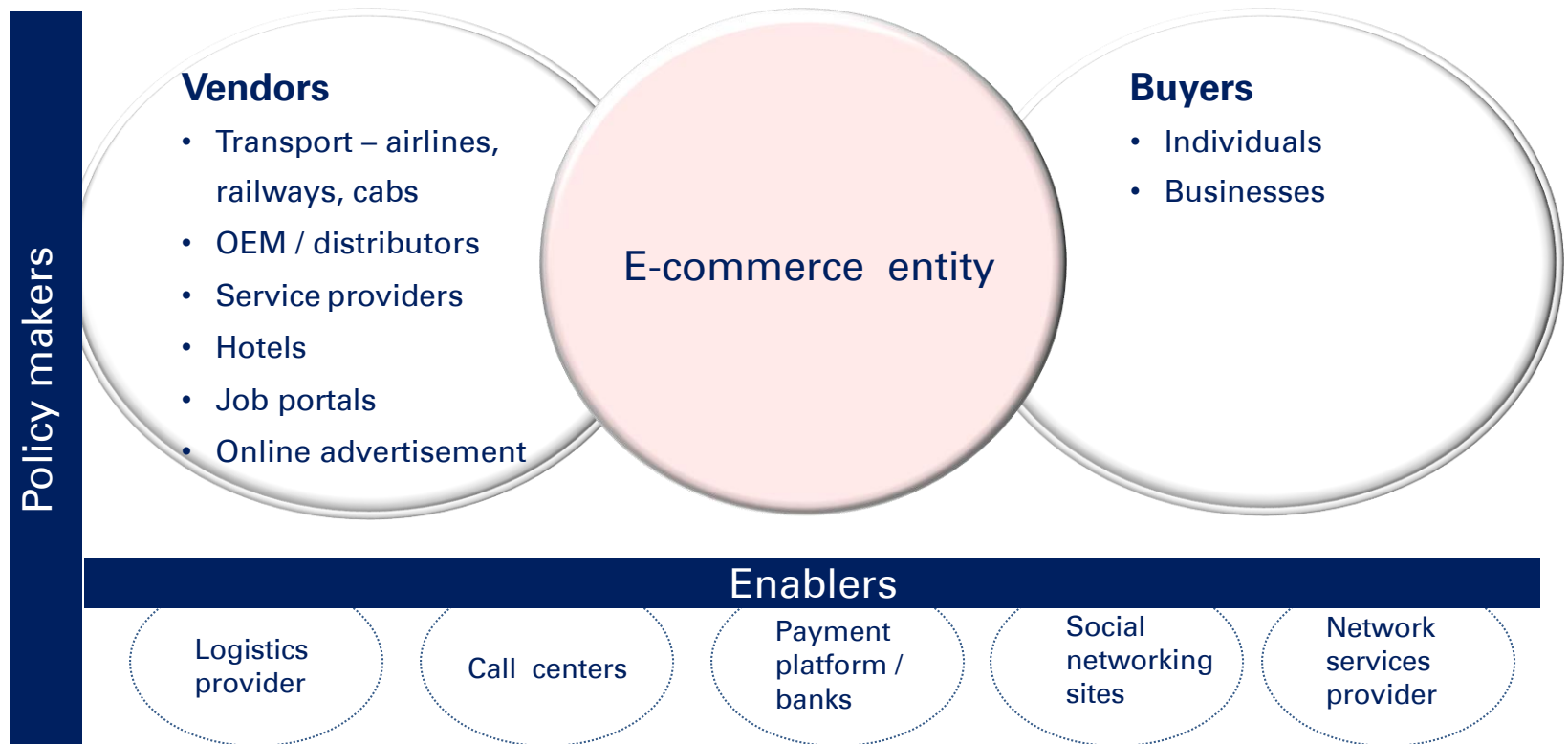
Thank You

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Annexure 1A - Key stakeholders in digital economy



Annexure 1B - Key characteristics of digital economy

Mobility

- Intangibles
- Users and customers
- Business functions

Data

- Collection
- Monetization

Network effects

- User participation i.e. review and tag products
- Integration and synergies

Multi-sided models

- Eg: Media company – content and online advertisement

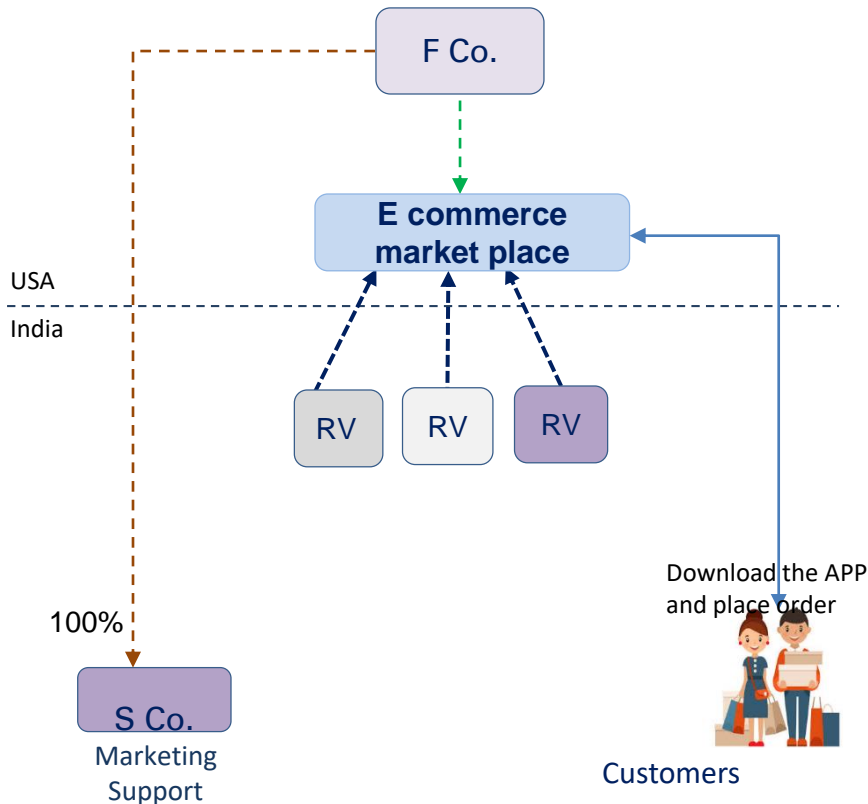
Others

- Monopoly or oligopoly
- Volatility

Digital Economy a 'Borderless Economy'



Annexure 2 - E-tail model



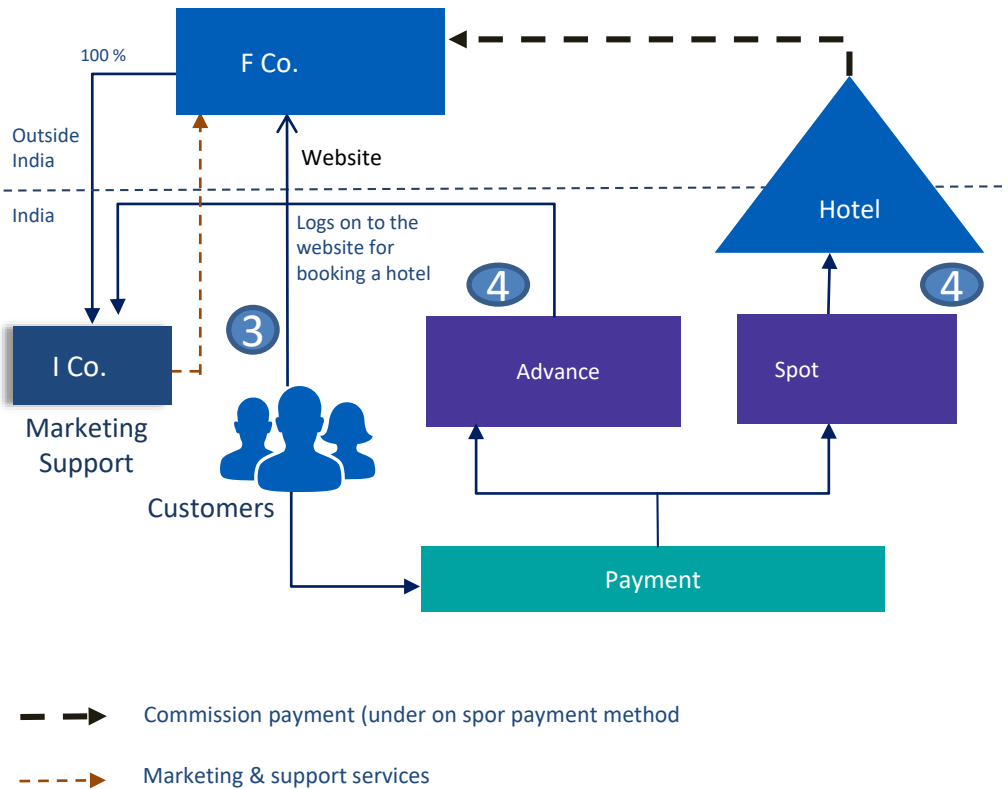
- RV Registered vendor
- - - - - Registered on e-commerce market platform
- Customers places order on the e-commerce marketplace

Mechanics

- F Co. owns and operates E-commerce market place APP which is hosted on server outside India;
- Vendors register themselves on the market place for selling their products;
- Customers browse through products and place order
- S Co. is a wholly owned subsidiary of F Co. which carries out the marketing support functions for F Co.
- While S Co is remunerated at cost plus appropriate markup, **F Co. earns commission income from vendors registered on its platform**

Whether commission income of F Co. is taxable in India? ←

Annexure 3 - Hotel aggregator



Does I Co. constitute F Co.'s PE in India?

Facts of the case

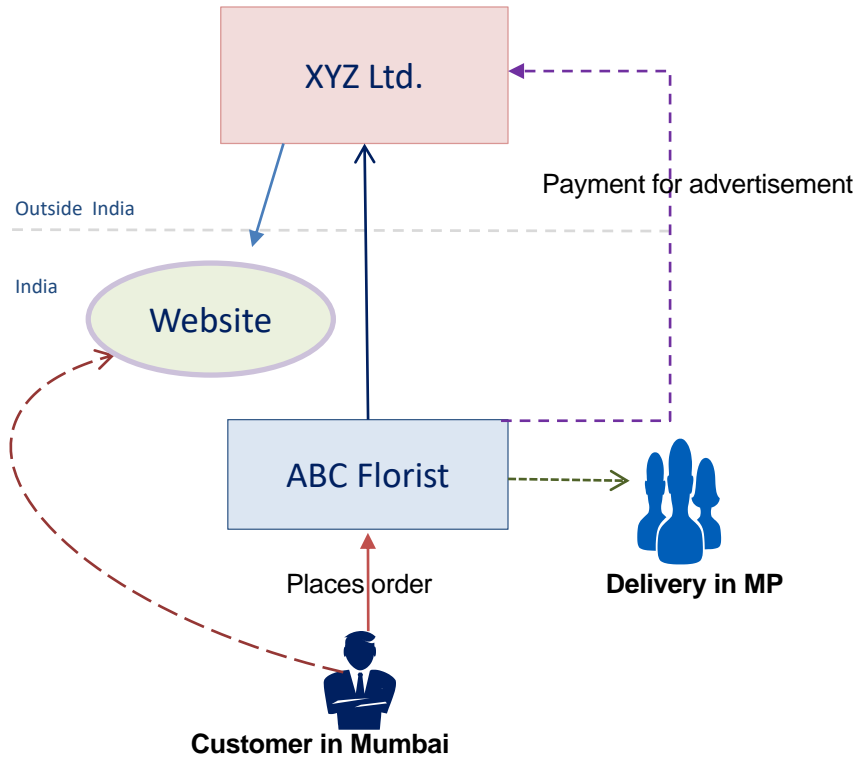
1. F Co. is hotel aggregator and has a website located on a server operating outside India
2. I Co. provides marketing support services to F Co. and is remunerated at cost plus appropriate mark up
3. Customers log on to F Co.'s website for booking a hotel
4. Customers has two options to make payment, i.e.
 - Advance – which is collected by I Co. on behalf of F Co.
 - Spot – which is directly collected by the hotel on check out
5. Depending on the type of payment
 - Commission is retained and balance remitted to the hotel on behalf of F Co.
 - Hotel pays commission to F Co. after customer checks out from the hotel

Functions of I Co.

- I Co. a wholly owned subsidiary of F Co. in India and provides marketing support and collection services to the latter
- I Co. sends e-mails, make telephone calls and carries out hotels surveys in order to list the hotel on the portal



Annexure 4 - Online advertisement



- Contractual arrangement for advertisement
- - - → Payment for advertisement
- - - → Undertakes a search on XYZ Ltd.'s search engine
- - - → Delivery of flowers


Facts of the case

1. XYZ Ltd., a foreign company, owns and operates a search engine
2. XYZ Ltd., for Indian advertisement business, has a website in India which is hosted on a server situated outside India
3. ABC enters into a contract for advertisement on XYZ Ltd.'s search engine
4. Payment to XYZ Ltd. is not subject to withholding tax in India

Whether payment by ABC Florist to XYZ Ltd. is liable to withholding tax? →

Annexure 4 – Online advertisement

Website a PE?

- Extant concept of PE has evolved with traditional commerce where tax is levied by Source State based on physical presence
- OECD position 
- India reservations on OECD's position CONTEMPORANEA EXPOSITIO

Royalty / FTS

- There is no transfer in any copyright
- Advertisement hosting services does not involve right to use any scientific, industrial or commercial equipment
- In absence of any human intervention, consideration for advertisement service cannot be characterized as FTS – display of advertisements determined by algorithms

EL was introduced to tax consideration payable for specific services including online advertisement



Annexure 4 - OECD's view on website and server

Para 124 of the revised OECD commentary

The distinction between a web site and the server on which the web site is stored and used is important since the enterprise that operates the server may be different from the enterprise that carries on business through the web site. For example, **it is common for the web site through which an enterprise carries on its business to be hosted on the server of an Internet Service Provider (ISP). Although the fees paid to the ISP under such arrangements may be based on the amount of disk space used to store the software and data required by the web site, these contracts typically do not result in the server and its location being at the disposal of the enterprise**, even if the enterprise has been able to determine that its web site should be hosted on a particular server at a particular location. In such a case, the enterprise does not even have a physical presence at that location since the web site is not tangible. In these cases, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement. However, **if the enterprise carrying on business through a web site has the server at its own disposal, for example it owns (or leases) and operates the server on which the web site is stored and used, the place where that server is located could constitute a permanent establishment of the enterprise if the other requirements of the Article are met.**



Annexure 5 - India-Netherlands DTAA

Article 3 – General Definitions

- (e) The term '**person**' includes an individual, a company, any other body of persons and any other entity **which is treated as a taxable unit**, under the taxation laws in force in respective states
- (f) The term 'company' means any body corporate or any entity which is treated as a company or body corporate under the taxation laws in force in the respective states...

Article 4 – Resident

1. For the purpose of this Convention, the term '**resident of one of the States**' means any person who, under the laws of that State, **is liable to tax therein by reason of his domicile**, residence, place of management or any other criterion of a similar nature
2. ...

