Taxation of Digital Economy: Analysis of Judicial Precedents and Developments and Indian Position

K. R. Sekar

Occasional Paper No. 13

June 11, 2018

All statements and opinions that appear in this paper are to be attributed to the author and not to International Tax Research and Analysis Foundation (ITRAF) or any other institution or individual unless specified.

International Tax Research and Analysis Foundation (ITRAF) is an independent and exclusive forum for tax policy research, analysis and support conducting Research and Analysis on important tax matters including those relevant to India.

The Occasional Paper Series

ITRAF Occasional Papers comprise advanced analysis of a fundamental area of taxation that has been completed by ITRAF researchers after considering and incorporating the comments received on earlier drafts. In a sense, it is produced at a final stage. Occasional Papers are addressed to a wide audience including policy-makers, tax and legal professionals, academicians, the media and the interested general public.

The Working Paper Series

ITRAF Working Papers usually comprise analysis of an emerging or developing area of taxation by ITRAF researchers. Researchers are encouraged to examine areas, which could have an immediate and crucial influence in the prevailing tax environment. Working Papers are published at short notice to stimulate discussion. Generally, modifications and enhancements may continue to be incorporated as comments are received.

The Occasional Paper Series and Working Paper Series are available on the ITRAF website: www.itraf.org. Comments are welcome; please address them to the authors listed below or to feedback@itraf.org mentioning the series number and title of the Occasional Paper or Working Paper on the subject line.

Author: **K. R. Sekar**
Email address: krsekar@itraf.org

Table of Contents

1. Taxation of Digital Economy- Analysis of Judicial Precedents

1.1 Dell Products Ltd (DPL) vs. General State Administration [STS 2861/2016, recurso no 2555/2015]

Introduction:

This case deals with the concept of fixed place PE wherein the term "availability" has been explained by the Spanish Supreme Court. It was observed that the conventional definition does not hold good in the digital economy where "virtual economic presence" is a key factor. Further, the case also laid down the parameters for testing a dependent agent PE.

Facts:

DESA (a wholly owned subsidiary of DPL) and its staff in Spain carried out a number of functions in relation to DPL's products – promotion, sale, attraction of customers, order management, control of receipts, distribution of products, marketing, advertising and collection management for all DPL's customers in Spain, warehouse and logistics services, installation services, solvency and credit control.

The Spanish Revenue assessed DPL for tax on profits attributable to DESA's activities on the ground that DESA constituted a "permanent establishment" ["PE"] of DPL.

Observations of the Lower courts:

Fixed place PE:

- The concept of fixed place PE includes any premises or facilities used to carry out the enterprise's economic activity, whether or not they are used exclusively for this purpose, regardless of the title under which such use is made. In order to be fixed, there must be a certain degree of permanence in time in the territory of the state; and activities carried out in those premises must be those of the enterprise.

- DESA's facilities were available to DPL for its activities, and were carried out through DESA's staff and such activities form the core of its corporate aim.

- Further, the activities carried out by DESA were much more than mere storage services, which are excluded from PE. The activities are not of an ancillary character. Therefore, DESA constituted a fixed place PE of DPI.

Dependent agent PE:

Based on the commercial agency agreement, DESA followed DPL's instruction; DPL had to authorise prices and commissions; DPL accepted or rejected requests for delivery; DESA submitted periodic reports to DPL; DPL had the right to inspect

DESA's records and premises; DPL had a right to authorise purchase of products; and DPL had control over intellectual property rights.

These activities prove that DESA was not an independent agent but a dependent agent of DPL, and hence, was a dependent agent PE of DPL.

Arguments of the assessee:

Fixed pace PE:

- The premises that are considered a fixed place of business have never been available to the assessee. It deems the term "availability" to refer only to actual availability, i.e., availability obtained through the consent of the owner of the facilities or person in possession thereof for their use. The concept of "availability" implies a direct relationship between the available facility and the non-resident entity and not an indirect one as pointed out by the lower authorities because a different clause relating to dependent agents is included for that case.

As per OECD's interpretation, the term "availability" must be interpreted as meaning that the non-resident entity can use the site and it, therefore, must not be interpreted as under supervision but must refer to physical use of the establishment. In order for DESA's facilities to be considered available to DPL and hence, to constitute a fixed place of business, DPL must have a regularly exercised right to use them, and this have not been proven at any court level.

- Further, it is not only necessary that a fixed place exists but also that business activity must be carried out through it. This is called the "functional aspect of the PE". DPL asserted that it carried out the activities constituting its corporate aim from Ireland and that is has sufficient staff there to carry out all its activities in Spain. There was either no involvement or only ancillary involvement of DESA.

Dependent agent PE:

- DPL argued that in terms of the Article 5(5) of the Ireland-Spain tax treaty, "conclude contracts in the name of the enterprise" refers to the bond between the third party and the principal, which does not arise in commercial agency agreements, where the agent acts in its own name and not in that of the principal. It necessarily requires the non-resident to be bound by the operations carried out by the agent and be a contracting entity to third parties. The lower authorities have taken a few clauses of the commercial agency agreement between DPL and DESA out of context and ignored that DESA is a legally and financially independent agent, acting in the ordinary course of its business.

- DESA not only assumes risk of local sales but also supports its own business risk. Merely because it belongs to the same group does not render DESA financially dependent. The local sales are in DESA's name and on its own behalf. It will continue to carry out its business even if it loses its account with DPL. Informing the progress and rendering accounts is like any customer-supplier service relationship. DESA is completely free to set sale prices both within the agreed range and above it. DESA decides on the approval or rejection of orders/transactions at prices other than those suggested by DPL. DESA also does not acquire ownership of the product but only sells it.

- Activities carried out by DESA are not absolutely fundamental for DPL, as DPL's corporate aim is marketing and distribution of Dell products whereas DESA's main activity is brokering of sales.

Spain Supreme Court Ruling:

Fixed Place PE:

- The term "availability" means use of fixed place of business by the non-resident through another entity who carried out activities at its request and under its control and such activities are part of its core corporate aim. This could be referred to as a mediate use but one which serves the same aim and purpose as direct use by the non-resident's staff. The scope of "availability" of the place is based on the premise that the same business activities as those of the non-resident enterprise must be carried out there.

- According to OECD's commentary, the term "place of business" includes any premises, facilities or material means used to carry out the enterprise's activities, whether or not they serve exclusively for that purpose. There can be a place of business even if there are no premises but a specific space is available. There is no requirement of a formal legal title to use it. The word "through" must be understood in its broadest sense to include business activities carried out at a specific space available to the enterprise for that purpose. Therefore, there is a high degree of flexibility given to the term fixed place of business to include another enterprise's facilities.

- Essentially, "availability" includes "acting on behalf of the enterprise". The function and the purpose of the convention, is to regulate aspects of international taxation, the new reality and commercial globalisation necessarily requiring an interpretation of the applicable laws adapted to this new reality, in which it is essential to address the substance of the new business activity models. It, thus, cannot be inferred that there is a requirement for a direct relationship and physical use of the establishment.

- Further, it is irrelevant whether the non-resident carries on business in Ireland or not, whether the number of people working is small or huge in Spain, and the fact that DPL assumes the risk of bad debts. Without prejudice to the activities carried out by DPL in Ireland, the substantial nature of the business activities/functions carried out by DPL through DESA's facilities and its staff have been established, proving that DESA is not acting as a mere ancillary body of DPL. These facts are deemed to have been proven in the lower courts. Therefore, DESA constitutes fixed place PE of DPL.

Dependent agent PE:

- In order to hold that there is a PE, the Ireland-Spain tax treaty requires the person to be acting on behalf of an enterprise and interpreting that "acting on behalf of the enterprise" necessarily requires direct representation would be going beyond the wording of the provision and does not follow from the application of the interpretation criteria. The phrase "on behalf of" must be understood to refer to the power the commission agents needs to have in order to bind the principal to the contract concluded, even if this does not give rise to a legal relationship between the principal and the contracting third party.

- DESA followed DPL's instruction; DPL had to authorise prices and commissions; DPL accepted or rejected requests for delivery; DESA submitted periodic reports to DPL; DPL had the right to inspect DESA's records and premises; DPL had a right to authorise purchase of products; and DPL had control over intellectual property rights. Considering these circumstances, there is a "relationship of dependence" between DPL and DESA. A commission agent acting in its own name on behalf of another must be considered a dependent agent. What must be looked into is whether the agent has sufficient authority to bind the non-resident. In view of DPL's extensive powers of supervision and direction, DESA could not be said to operate as an independent agent.

- In addition, there is organisational dependency as both companies belong to the same group company and are under the same management. DESA's intervention is essential for marketing and distribution of Dell products, which is DPL's corporate aim.

- In the global scenario today, the distinguishing feature would not be the way of formalising the contractual relationship but the existing functional and factual relationship, with the most characteristic feature for an independent agent to be financially and operationally distinct, and true and actual independence, which must be ascertained based on all the circumstances surrounding the conduct of its business. Therefore, there is no room for strict, formalist-literal and static interpretation.

Conclusion:

The Spanish Supreme Court ruled that DESA constituted DPL's fixed place PE even though there was no physical/ direct presence of DPL in Spain, based on the premise that DESA's facilities and staff carried out activities forming the core of DPL's corporate aim.

Further, the Spanish Supreme Court ruled that DPL had dependent agent PE in Spain considering the functional and factual circumstances and concluded that there is a relationship of dependence between DPL and DESA, irrespective of the contractual relationship. This view differs from courts in France and Norway, which have found that commissionaire arrangements do not give rise to a PE. Further, the OECD-BEPS initiative realised the need to reword Article 5 to cover such arrangements within the definition of PE, which suggests that the current treaties do not cover that. The Spanish Supreme Court's ruling, however, has ignored this aspect.

1.2 CUB Pty Ltd vs. Union of India and others [WPC No 6902/2008]

Introduction:

This case deals with the taxability of the gains arising on transfer of intellectual property rights/intangible rights in the context of Indian laws vis-à-vis international principles.

Facts:

- The petitioner (CUB Pty. Limited, formerly known as Foster's Australia Limited) had a 100 per cent subsidiary – Dismin India Private Limited (Dismin) – which held 100 per cent shares of FBG, Mauritius (FBG), which, in turn, held 100 per cent shares of Foster's India Limited (incorporated on September 29, 1995) (Foster's India).

- On October 13, 1997, a brand licence agreement (BLA) was executed between the petitioner and Foster's India. By virtue of the BLA, Foster's India was licensed to use in India four of the trademarks owned by the petitioner. In other words, the licensed trademarks continued to remain the absolute property of the petitioner. Foster's India was only permitted to use the said four licensed trademarks in India as a licensee. In consideration of this licence, the petitioner received royalty and was subjected to withholding tax in India.

- On August 4, 2006, an agreement, known as 'India sale purchase agreement' (ISPA), was executed in Melbourne between Dismin, the petitioner, Foster's Group Limited, SABMiller (A & A2) (hereinafter referred to as SABMiller) and SABMiller Africa & Asia B.V. The agreement provided for the sale of shares of FBG by Dismin to SABMiller and sale by the petitioner of trademarks (including the four licensed trademarks Foster's India was allowed to use), Foster's Brand Intellectual Property and grant of licence in relation to Foster's Brewing Intellectual Property confined to India, to SABMiller.

- As a result of the ISPA, SABMiller became the owner of FBG and hence, the owner of Foster's India and the 16 trademarks (including the four licensed trademarks), were sold/assigned to SABMiller and its nominee.

- Under the ISPA, prior to the completion of the sale and purchase of the shares, the trademarks, the Foster's Brand Intellectual Property and the licence of Foster's Brewing Intellectual Property were required to be terminated.

- On September 12, 2006, a deed of termination of the BLA was executed in Australia and on the very same day, a deed of assignment was executed in Australia, through which the petitioner assigned the 16 trademarks to Skol Breweries Limited [nominee of SABMiller].

- Thereafter, the petitioner moved an application before the Authority for Advance Rulings ("AAR") under Section 245-Q of the Income Tax Act, 1961, seeking an advance ruling on, inter-alia, the following question.

Question before the AAR

"On the facts and circumstances of the case, whether the receipt arising to the applicant, from the transfer of its right, title and interest in and to the trademarks, Foster's Brand Intellectual Property and grant of exclusive perpetual licence of Foster Brewing Intellectual Property, is taxable in India, having regard to the provisions of the Income Tax Act, 1961 and the Double Taxation Avoidance Agreement between India and Australia?"

AAR Held as under:

The income arising from the transaction of the transfer of the trademarks is to be deemed income accruing in India on the basis of its finding that the said intellectual property rights were capital assets situated in India. However, income attributable to the grant of licence in relation to Foster's Brewing Intellectual Property is not liable to be taxed under the Income-tax Act, 1961.

Aggrieved by the ruling of the AAR, the petitioner filed the petition before the High Court of Delhi.

Before High Court:

Arguments by the Petitioner:

- The origin of the Foster's mark was in Australia and the petitioner was the owner of the brand/mark and the petitioner is an Australian company. The petitioner has also granted licences to use the trademarks in various countries across the world (approximately between 70-100 countries), including India.

- Pursuant to the grant of the licence under the BLA, there was no shift in the situs ("location or place") of the trademarks to India since there was no transfer of any proprietary right. A licence to use a trademark confers only a limited right for the use of the mark and there is no assignment of any proprietary interest therein. Since the trademarks were originally adopted by the petitioner in Australia, the intellectual property rights therein vested in the petitioner and the situs of those rights was Australia.

- The rights in a trademark are of common law origin and are protected thereunder. A trademark does not derive its existence from any statute and is protected even in the absence thereof. The registration of trademarks in India did not imply the migration of the intellectual property rights to India. Registration of a trademark only recognizes a right that pre-exists in the trademark.

- The location of a trademark is governed by the common law maxim "mobilia sequuntur personam", which means that the personal property held by a person is governed by the same laws that govern that person. This principle has been applied to determine the situs of intangibles which entails that the situs of intangible assets are to be determined on the basis of the situs of the owner of such intangible assets. The principle behind this doctrine was that intangibles are subject to the immediate control of the owner and since the intangibles themselves do not have any real situs, the domicile of the owner is the nearest approximation to their location.

- Since, in India, the legislature has not specifically provided for the situs of trademarks, therefore, the common law rule of 'mobilia sequuntur personam' would be applicable.

Arguments by the tax department:

The tax department relied on the decision of the AAR and the following contentions were raised:

- The trademarks registered in India, together with other features of the Foster's brand, had generated appreciable goodwill in the Indian market and such goodwill had been nurtured in India. When the petitioner sold the trademark and the brand intellectual property rights with respect to the territory of India, substantial proceeds were received by them from SABMiller. The income that had accrued to the petitioner in respect of transfer of capital assets situated in India was liable to tax in India.

- The mere fact that some of the trademarks were used elsewhere also could not be used to deny their existence in India. The intellectual property belonging to the petitioner had its "tangible presence' in India at the time of the transfer. The registration of the petitioner's trademark was one of the relevant factors pointing to the roots that the trademarks had taken and the recognition they had gained in India.

- The transfer of intellectual property rights covered by the petition were only in respect of those rights that were within the territory of India since no other rights except India specific intellectual property rights were the subject matter of the transaction in question. Merely because the agreement of the transactions had taken place outside India did not render any income arising from the transactions non-taxable in India.

- The maxim of 'mobilia sequuntur personam' would not apply in the present case, since these are business intangibles and the situs of the same would be where the business is carried out and where the intangibles would be protected under local law. The trademarks and other intellectual property rights, to the extent they related to India, would have to be deemed to be located in India and it did not matter as to where the owner was located.

Decision of the High Court

The High Court observed as under:

- An intangible capital asset, by its very nature, does not have any physical form. Therefore, it does not exist in a physical form at any particular location.

- The legislature could have provided for the location of an intangible capital asset, such as intellectual property rights, but it has not done so insofar as India is concerned. The legislature, where it wanted to specifically provide for a particular situation, as in the case of shares, where the share derives, directly or indirectly, its value substantially from assets located in India, it did so. There is no such provision with regard to intangible assets, such as trademarks, brands, logos, i.e., intellectual property rights. Therefore, the well accepted principle of 'mobilia sequuntur personam' would apply.

- The situs of the owner of an intangible asset would be the closest approximation of the situs of an intangible asset. This is an internationally accepted rule, unless it is altered by local legislation. Since there is no such alteration in the Indian context, the situs of the trademarks and intellectual property rights, which were assigned pursuant to the ISPA, would not be in India since the owner thereof was not located in India at the time of the transaction.

- The Delhi High Court thus turned down the view taken by the AAR on the question placed before it and held that the income accruing to the petitioner from the transfer of its right, title or interest in and to the trademarks in Foster's brand intellectual property is not taxable in India under the Income Tax Act, 1961.

Conclusion:

The Delhi High Court, reversing the AAR ruling, has held that in the absence of any specific provision in the Act for the location of an intangible capital asset such as trademarks, brands, logos etc., the situs of intangible assets are to be determined on the basis of the situs of the owner of such intangible assets.

1.3 Formula One World Championship Ltd. vs. CIT (Int. Tax.)[Civil Appeal Nos. 3849, 3850 and 3851 of 2017]:

Introduction:

This case deals with the issue of fixed place PE in a scenario where the duration of the taxable event was very short.

Facts:

- FOWC (the taxpayer), a UK resident company; the Federation Internationale de I' automobile (FIA), an international motor sports events regulating association and Formula One Asset Management Limited (FOAM) entered into certain agreements whereby FOAM licensed all commercial rights in the FIA Formula One World Championship (Championship) to FOWC for a period of 100 years with effect from January 1, 2011.

- The taxpayer entered into a race promotion contract (RPC) with Jaypee Sports International Ltd. (Jaypee) on September 13, 2011, under which it granted the right to host, stage and promote the Formula One Grand Prix of India event at the Buddh International Circuit in Noida for a consideration of $40 million.

- An artwork licence agreement (ALA) was also entered into between FOWC and Jaypee on the same day under which FOWC permitted Jaypee to use certain marks and intellectual property belonging to FOWC for a consideration of $1 million.

- Various other agreements were also entered into between the parties to give effect to their understanding relating to racing event in India.

- The taxpayer and Jaypee both approached Authority for Advance Rulings (AAR) to determine their tax position.

- The AAR concluded that the consideration received by FOWC is in the nature of royalty and FOWC does not have a fixed place of business/PE in India.

- FOWC filed a writ challenging the ruling of the AAR on the issue of royalty and Revenue filed a writ challenging the ruling of the AAR regarding the issue of the existence of a PE in India.

- The High Court reversed the findings of the AAR on both the issues and held that the amount received by FOWC would not be treated as royalty. It was held that FOWC had a PE in India and therefore, consideration received shall be taxable in India.

Key arguments of the taxpayer:

- The Buddh International Circuit was not at the disposal of the taxpayer. Jaypee was responsible for conducting the event and had complete control over it.

- Total duration for which limited access to the race venue was granted to FOWC was not sufficient to constitute the degree of permanence necessary to establish a fixed place, PE, in India.

Issue for consideration before Apex Court:

The Hon'ble Supreme Court was required to examine the entire gamut of agreements between the parties to adjudicate the characterisation. Further, it was also required to adjudicate on withholding tax and attribution issues.

Ruling of the Apex Court:

The Court's observations on the factual matrix of the case are as follows:

- Buddh International Circuit is a fixed place. From this circuit, different races including the F-1 Grand Prix is conducted and income is generated which is an economic/business activity. Commercial rights vested with FOWC, which were exploited by conducting the event in India. Physical control of the circuit was with FOWC and its affiliates from inception until the conclusion of the event. The participating teams and paddock were controlled by FOWC and its affiliates.

- Against the FOWC contention that the duration of the event was three days only, the Apex Court observed that:

  - The race was to be conducted only for three days in a year and for the entire period of race, FOWC had full control and exclusive access to the circuit.

  - The control over the venue, i.e., Buddh International Circuit, continued at least two weeks prior to and one week after the event.

- The Court noted that a PE has to be a fixed place of business 'through' which the business of an enterprise is wholly or partly carried out. The fixed place of business need not be owned or leased by the foreign enterprise but it shall be at the disposal of the foreign enterprise in the sense of having some right to use the premises for the purposes of its business.

- Referring to Queen's Counsel Philip Baker's commentary, the Court held that a PE must have three characteristics – stability, productivity and dependence. The Court extensively relied upon the OECD commentary, commentaries of international tax authors, and leading domestic and international judicial precedents for adjudicating the PE issue.

The Court concluded that:

- Buddh International Circuit is a fixed place where the commercial/economic activity of conducting the F-1 Championship was carried out; it was a virtual projection of the FOWC in India.

- In the present case, all the characteristics mentioned above for a PE – stability, productivity and dependence – are present. Fixed place of business in the form of physical location, i.e., Buddh International Circuit was at the disposal of FOWC through which it conducted business.

- FOWC had made their earnings in India through the said track over which they had complete control during the period of the race.

- The taxable event has taken place in India and FOWC is liable to pay tax in India on the income earned in India.

- On attribution of income taxable in India, it was held that the portion of FOWC's income that is attributable to the Indian PE would be treated as business income of FOWC and subject to tax in India.

- The Apex Court has also held that as far as the issue of default in deducting Indian withholding tax is concerned, the same will be to the extent of profits that are considered attributable/taxable in India.

Conclusion:

This Apex Court decision is of considerable importance in the field of furthering international tax jurisprudence. The taxpayer will need to take cognizance of the principles laid down by the Apex Court with respect to fixed place PE in India. The Court has ruled that the provisions relating to collection and deposit of tax *via* TDS for non-resident payments are integral to the scheme of the Act and need to be appropriately considered while giving effect to such transactions.

1.4 Google India (P) Ltd. [86 taxmann.com 237 (Bang ITAT)]

Introduction:

This case deals with the taxability of payments made for online advertising related services/facility.

Background/Facts:

- Google India Private Limited ["Google India"], is a wholly-owned subsidiary of Google International LLC, US. Google India had been appointed by Google Ireland Ltd. ["GIL"] as a non-exclusive authorised distributor of "Adwords Programs" to advertisers in India.

- Under the Google Adwords Program Distribution Agreement, Google India was granted the marketing and distribution rights to the Adwords Program in India.

- During the financial year 2007-08 (relevant to Assessment Year 2008-09), Google India paid a distribution fee of Rs.119 crore to GIL towards distribution rights granted according to the agreement, without deducting tax at source in terms of section 195 of the Income-tax Act, 1961. ["the Act"]

- Google India contended that it is merely a reseller of advertisement space and is engaged in only performing marketing related activities to promote the sales of advertisement space in India. Hence, the amount payable by it to GIL, being an advertisement fee, is not in the nature of royalty under the Act. Besides, it contended, the server on which the Adwords program runs is located outside India and Google India does not have control over it. Consequently, neither Google India nor the advertisers have any right to use or exploit the underlying intellectual property and software.

- However, the Assessing Officer ["AO"] held that the distribution rights are in the nature of intellectual property rights covered by similar property under the definition of royalty as per section 9(1)(vi) of the Act. The AO treated distribution fee in the nature of royalty under the India-Ireland Double Taxation Avoidance Agreement (DTAA), being, among others, payment for the use of a secret process. Accordingly, the AO held that the distribution fee paid to GIL was subject to withholding tax in India under section 195 of the Act.

- The AO treated Google India as an "assessee in default" in terms of section 201(1) for not deducting tax at source, when the amount(s) in question were taxable in India.

- Aggrieved with the order of the AO, Google India appealed before the Commissioner of Income-tax (Appeals) ["CIT(A)"]. The CIT(A) upheld the order of the AO**.**

Observations and Ruling of the Tribunal:

Whether payment made by Google India to GIL is taxable in India?

The Tribunal ruled in favour of revenue and held that the payment made by Google India was in the nature of royalty. While doing so, the Tribunal *inter-alia* observed as under:

- The Adwords program distribution agreement allows Google India to access all intellectual property and confidential information used for activities related to the distribution agreement.

- For the purpose of marketing and distributing the Adwords program, Google India is given the right to use the valuable business asset of GIL, i.e., intellectual property in the products and services offered by GIL.

- Google India also has access to the IP address of the desktop/laptop/tablet, photographs of users and the time spent on the websites, eating habits, wearing preferences, etc. Further, the Google search engine has access to data pertaining to the user of the website in the form of name, sex, age, city, state, religion, etc.

- Based on these inputs, Google India was able to provide effective focussed ad campaigns to advertisers.

- Accordingly, the distribution agreement is not merely an agreement to provide advertisement space but is also an agreement for facilitating display and publishing of an advertisement to the targeted customer.

- Therefore, the agreement entered into between Google India and GIL is in the nature of services for displaying and promoting advertisement to target customers.

- Further, the IP of Google vests in the search engine, technology, associated software and other features, and hence, the use of these tools for performing various activities, including accepting advertisements and providing before/after sales services clearly falls within the ambit of royalty.

- The Tribunal further observed that even though Google India claimed to be separately earning revenue from the information technology enabled services ["ITeS"] segment under a separate outsourcing service agreement with GIL, inputs from ITeS are always required in the business model of Google India, without which there cannot be any targeted marketing for advertisements and promotion of sales of advertisers.

- Therefore, the services rendered under the ITeS agreement cannot be divorced from the activities undertaken by Google India under the distribution agreement and that both the agreements are inter-connected. Under the distribution agreement, Google India was duty bound to render various ITeS services, however Google India claimed that these services have been provided under the ITeS agreement. This is only a mechanism/ structure prepared by the GIL to avoid payment of taxes.

- The Tribunal also noted that as per the terms of the distribution agreement, Google India was permitted to use the trade name, trademarks, service marks, domains or other distinctive brand features of GIL solely under the distribution agreement on a non-exclusive, non-sub-licensable basis for the purposes of marketing and distribution of the Adwords program.

- Accordingly, it was held that the payments made by Google India under the agreement were not only for marketing and promoting the Adwords program but was also for the use of Google brand features.

- Hence, the Tribunal concluded that Google brand features were used by Google India as a marketing tool for promoting and advertising, which is the main activity of Google India. Hence, even on this count, the payment falls under the definition of royalty under the Act as well as the DTAA.

Whether withholding tax provisions are to be applied on receipt basis considering that the payment made to GIL is chargeable in the hands of GIL on receipt basis under India-Ireland DTAA?

- The argument of applying withholding tax provisions based on taxability in the hands of the recipient on a receipt basis under the India-Ireland DTAA has been rejected by the Tribunal by observing that the benefit under the DTAA is available to a non-resident and not to a resident payer.

- It further held that it is not the concern of Google India as to which method is being followed by GIL. Nonetheless, relying on the income-tax return form in the case of GIL, it noted that GIL follows the mercantile system of accounting and hence, the chargeability of the income would be in the year in which it is accrued and not in the year in which it is received.

- Further, in the opinion of the Tribunal, the DTAA can only provide characterisation of the income, the country where it is to be paid and the rate of tax. It is not within the scope of the DTAA to provide when the income is required to be charged to tax.

- The Bench also held that the literal rule of interpretation, which allows unscrupulous persons to misuse the provisions to avoid taxes, is not required to be followed when it defeats the intent of the provision.

Whether it is obligatory to approach the AO for determining taxability under section 195?

- The Tribunal observed that in terms of section 195 of the Act, there is an obligation on the part of Google India to deduct tax if it makes payment to a non-resident.

- Further, there are necessary safeguards provided under the Act, in the form of Section 195(2), which provides that in case an assessee has a doubt with respect to the chargeability of an income to tax, then it can make an application to the AO for the purposes of determining the chargeability of a sum to tax.

- In the present case, no such application was made; hence, Google India was duty bound to deduct tax.

Validity of the proceedings under section 201:

- In so far as the initiation of proceedings under section 201(1A) is concerned, the Tribunal turned down Google India's challenge on the initiation of proceedings beyond a four-year period, in view of the ruling of the Allahabad High Court in the case of Mass Awash P. Ltd. [2017] 249 Taxman 532 (Allahabad). The High Court had held that the amended law under section 201, which requires initiation of proceedings within six years for a resident, would also be applicable in the case of a non-resident. The law provides for non-discrimination between a non-resident and a resident and requires equal treatment of both under the DTAA.

Conclusion:

Based on the various terms and conditions of the agreement, the Tribunal held that the payment towards distribution rights is in the nature of royalty under the Act as well as under the DTAA because of the right to access not only to the technology but also to customer data and intellectual property rights.

1.5 Right Florist (P) Ltd. [2013] 32 taxmann.com 99 (Kolkata - Trib.)

Facts:

- The assessee company used online advertising on search engines, i.e., Google and Yahoo, but did not deduct tax at source on payments made for the service.

- The Assessing Officer disallowed the payments under section 40(a)(i) for non-deduction of tax at source, holding the amount as taxable in the hands of the search engine companies.

- On appeal, the Commissioner (Appeals) deleted the disallowance on the ground that Google and Yahoo did not have any permanent establishment in India and, therefore, the amounts were not taxable in view of the provisions of the DTAA with Ireland and USA respectively. Aggrieved, Revenue preferred an appeal.

Observations of the Kolkata Tribunal:

Nature of transaction:

- Google and Yahoo search engines are basically software codes that are designed to search for information on the World Wide Web. When an internet user needs information about a product or service, he visits the website of the search engine and keys in the search words. A large number of results, such as addresses of the related websites, are produced so that internet user can then visit those websites for further information on that product or service.

- There are sponsored search results also, which is de facto advertising, and these sponsored search results help those advertisers improve the visibility of their respective websites. The actual rendering of this service is a highly technical process. On one hand, a web search engine maintains real-time information by running an algorithm on a web crawler, and, on the other hand, produces, in the search results to the internet users, the sponsored advertisement. It is primarily for this service that the search engine is paid.

- An ad server, which is at the core of this form of online advertising, is a computer server, specifically a web server, that stores advertisements used in online marketing and delivers them to website visitors. Whatever be the form of advertising service, whether sponsored or as a web banner or in any other form, there can hardly be any dispute on the proposition that these search engines or ad servers, which are patented and provide valuable services, are essentially technical in nature. It is this kind of advertising service for which the payments were made by the assessee.

Observations and ruling of the Kolkata Tribunal:

- To examine the taxability of an income in the hands of a non-resident, these three aspects need to be examined – application of section 5(2)(a), application of section 5(2)(b), and application of section 9, which actually deals with the deeming fiction embedded in section 5(2)(b). In the present case, it is an admitted position that the payment was not received or deemed to have been received in India. Section 5(2)(a), therefore, has no application in the matter. Therefore, scope of section 5(2)(b), i.e., 'income accruing or arising in India' and 'income deemed to accrue or arise in India', needs to be considered.

- The Supreme Court, in the case of CIT v. Hyundai Heavy Industries Co. Ltd. [2007] 291 ITR 482/161 Taxman 191, inter alia, observed that, "……as far as the income accruing or arising in India, an income which accrues or arises to a foreign enterprise in India can be only such portion of income accruing or arising to such a foreign enterprise as is attributable to its business carried out in India. This business could be carried out through its branch(es) or through some other form of its presence in India such as office, project site, factory, sales outlet etc. (hereinafter called as "PE of foreign enterprise").

- A search engine's presence in a location, other than the location of its effective place of management, is only on the internet or by way of a website, which is not a form of physical presence. As to whether a website can be PE or not, guidance is found from the High Powered Committee Report[1] which, while recognising the need to make the form of presence tax neutral but realising the limitations of the scope of existing principles and rules, observed, "The Committee supports the view that the concept of PE should be abandoned and a serious attempt should be made within OECD or the UN to find an alternative to the concept of PE". Clearly, conventional PE tests fails in this virtual world even when a reasonable level of commercial activity is crossed by foreign enterprise.

- In the light of the above discussions, even as per the High Powered Committee, a website per se, which is the only form of Google's presence in India – as far as test of primary meaning, i.e., basic rule, of PE is concerned – cannot be a permanent establishment under domestic law. This view further finds support from the Commentary on the OECD Model Convention.

- The interpretation of the expression 'permanent establishment', even in the context of tax treaties, therefore, does not normally extend to websites unless the servers on which websites are hosted are also located in the same jurisdiction. While a website per se does not constitute a tangible property as it cannot have a location which constitutes place of business, a web server, on which the web site is stored and through which it is accessible, is a piece of equipment having a physical location and such location may, thus, constitute a "fixed place of business" of the

[1] Committee on 'Electronic Commerce and Taxation' constituted by the Central Board of Direct Taxes on December 16, 1999

enterprise that operates that server. A search engine, which has only its presence through its website, therefore, cannot be a permanent establishment unless its web servers are also located in the same jurisdiction. That is not the situation here and it is not the case of the revenue that servers are located in India.

- In the light of the discussions above, Google's presence in India through its website cannot be said to constitute permanent establishment in India under the basic rule and, thus, conditions of section 5(2)(b), read with the Supreme Court's judgment in the case of Hyundai Heavy Industries Co. Ltd. (supra), are not satisfied to the extent that no profits can be said to accrue or arise in India.

- Thus, the question remains whether the second limb of section 5(2)(b), i.e., income 'deemed to accrue or arise in India', can be invoked in this case. So far as this deeming fiction[2] is concerned, a complete code of this deeming fiction has been spelt out in section 9.Section 9(1), which specifies the incomes that shall be deemed to accrue or arise in India. Clause (i) of section 9(1) provides that all income accruing or arising, whether directly or indirectly, through or from any 'business connection' in India, or through or from any property in India or through or from any asset or source of income in India, etc., shall be deemed to have accrued or arisen in India. In the present case, the assessing officer has not made such a claim nor was it pointed out that how the receipts have arisen on account of any business connection in India. There was nothing on record to demonstrate or suggest that the online advertising revenues generated in India were supported by, serviced by or connected with any entity based in India. On these facts, the Tribunal held that section 9(1)(i) cannot have any application in the matter.

- Section 9(1)(ii), (iii), (iv) and (v) deal with incomes in the nature of salaries, dividend and interest etc., and therefore, these deeming fictions are not applicable to the facts of the case. As far as applicability of section 9(1)(vi) is concerned, co-ordinate benches, in the cases of Pinstorm Technologies (P.) Ltd. v. ITO [2012] 54 SOT 78/24 taxmann.com 345 (Mum.) and Yahoo India (P.) Ltd. (supra), have concluded that the provisions of section 9(1)(vi) cannot be invoked. That leaves out only section 9(1)(vii).

- In view of the provision of section 9(1)(vii), if services rendered by the foreign enterprise by way of online advertising services constitutes technical services, the income from providing these services can be taxed under section 9(1)(vii). It is also not necessary that services should be rendered in India. It is also relevant that the definition of 'fees for technical services' under the India-Ireland Double Taxation Avoidance Agreement (India-Irish tax treaty, in short) is on the same lines, as in the Income Tax Act, and does not have a 'make available' clause. The 'fees for technical service', which is also taxable in the source jurisdiction under the India-Irish tax treaty at a rate not exceeding 10 per cent, is defined, under Article 12(2)(b), as "payment of any kind in consideration for the rendering of any managerial,

[2] Deeming fiction means law considers a particular thing in a particular way, although in general parlance it is not understood in that sense.

technical or consultancy services including the provision of services by technical or other personnel …". The scope of fee for technical services ("FTS") in the tax treaty is, thus, not any narrower than the scope under domestic tax law. It is, therefore, essential to examine whether or not the online advertising services in question can be said to be technical services of a nature that can be covered by the scope of Explanation 2 to section 9(1)(vii).

- While there is no specific definition assigned to technical services, Explanation 2 to section 9(1)(vii), as also Article 12 (2)(b), merely states that 'fees for technical services' will include considering of "rendering of any managerial, technical or consultancy services". It is significant that the expression 'technical' appears along with expression 'managerial' and 'consultancy' and all the three words refer to various types of services, consideration for which is included in the scope of 'fees for technical services'. The significance of this company of words has been discussed by the co-ordinate bench of this Tribunal in the case of Kotak Securities Ltd. v. Dy. CIT[2012] 50 SOT 158/18 taxmann.com 48 (Mum.) and the Delhi High Court in the case of CIT v. Bharti Cellular Ltd.[2009] 319 ITR 139/[2008] 175 Taxman 573. As per this decision, both the words managerial and consultancy involve a human element. And, both, managerial services and consultancy services are provided by humans. Consequently, applying the rule of "noscitur a sociis",[3] the word technical as appearing in Explanation 2 to section 9 (1) (vii) would also have to be construed as involving a human element.

- The service rendered by Google is the generation of certain text on the search engine result page. This is a wholly automated process. In the light of the legal position that any services rendered without a human touch, even if it be a technical service, cannot be a technical service covered by the limited scope of section 9(1)(vii), the receipts for online advertisement by the search engines cannot be treated as fees for technical services taxable as income, under the provisions of the Income-Tax Act, in the hands of Google. The wordings of Explanation 2 to section 9(1)(vii) as also that of the definition of fees for technical services under Article 12(2)(b), being similar in material respects, the above legal proposition equally applies to the definition under Article 12(2)(b) of the India-Irish tax treaty. The income earned by Google, in respect of online advertising revenues discussed above and based on the facts on record, cannot be brought to tax as income deemed to accrue or arise under section 9(1)(vii), i.e., last limb of section 9(1), as well.

- The facts relating to Yahoo being similar in material aspects, the same conclusion holds good in respect to Yahoo as well. In addition, as Yahoo is a USA-based Delaware company, the benefit of "make available" clause under Indo-USA tax treaty may also apply.

- The connotations of the expression 'make available' were examined by the Tribunal in the case of Raymond Ltd. v. Dy. CIT[2003] 86 ITD 791 (Mum.). There are two

[3]The rule of noscitur a sociis implies that the meaning of an unclear word may be known from its accompanying words

High Court decisions – that of the Delhi High Court in the case of DIT v. Guy Carpenter & Co Ltd.[2012] 207 Taxman 121/20 taxmann.com 807 and of the Karnataka High Court in the case of CIT v. De Beers India Minerals (P.) Ltd. [2012] 208 Taxman 406/21 taxmann.com 214. These uphold the principle that unless services rendered by the service provider results in transfer of technology and enabled the recipient of service to make use of the technical knowledge by himself and without recourse to the service provider, mere rendition of such services cannot be brought to tax as fees for technical service.

- Clearly, as far as online advertising is concerned, there is no transfer of any technology of any kind, and as such, any payment for such service is outside the ambit of source taxation under Article 12. For this reason, the payments made to Yahoo could not be brought to tax in India.

- Therefore, the receipts in respect of online advertising on Google and Yahoo cannot be brought to tax in India under the provisions of the Income Tax Act, as also under the provisions of the India-US and the India-Ireland tax treaty. This observation is subject to the rider that as far as the PE issue is concerned, the existence of PE has been examined only on the basis of website simplicitor, and on no other additional basis, as no case was made out for the same. In any case, revenue has not brought anything on record, either at the assessment stage or even before the Hon'ble tribunal, to suggest that Google or Yahoo had a PE in India.

- In view of the above discussions and considering the entirety of the case, the Hon'ble tribunal held that there was no failure in deduction of tax at source by the assessee inasmuch as the assessee did not have any obligation to deduct tax at source under section 195 for the simple reason that income embedded in impugned payments was not chargeable to tax in India. Accordingly, the disallowance under section 40(a)(i) was uncalled for.

Conclusion:

The Kolkata Tribunal applied the basic rule to ascertain if a non-resident had a PE in India, which is based on the physical presence of the website/equipment and ruled that in the absence of a server/website in India, there cannot be a PE. As regards the issue of royalty, the Tribunal followed the co-ordinate bench ruling in the case of Pinstorm and Yahoo and held that Google's and Yahoo's online advertising services do not give rise to royalties. Finally, the Tribunal also held that such services are not fee for technical services due to the lack of human intervention in both Google's and Yahoo's cases and because the services do not satisfy the 'make available' clause in the case of Yahoo.

1.6 Western Union Financial Services Inc. v. ACIT [[2007] 104 ITD 34 (DELHI)]

Introduction:

This case examines the question of business connection and permanent establishment with respect to money transfer business. It specifically deals with dependent agents PE.

Facts:

- The assessee, a non-residential company, incorporated in the USA, was engaged in the business of rendering money transfer services worldwide. Under the arrangement, any resident of USA, desirous of transferring monies to his relatives in India, would approach the assessee's outlets in the USA with the money, together with charges for which a receipt with a computer generated unique number (MTCN), would be given to the remitter for onward transmission to his relative in India, who would take it to the assessee's representative/agent in India.

- The said agent, in turn, would feed the allotted MTCN into the computer with the help of software (Voyager), gaining access to the assessee's mainframe computer in the USA. Thereafter, he would make the payment to the claimant after ascertaining his bona fides through documentary evidence. On completion of the transaction, the agent was to be remunerated by the assessee by way of a commission at an agreed percentage for his services.

- For the purpose of carrying out business in India, the assessee entered into agreements appointing four types of agents in India, the department of posts, commercial banks, non-banking financial companies and tour operators. Generally, the appointments were for an initial period of five years, which could be extended any number of times for periods of one year at a time.

- In terms of agreement, the money so transferred by it was required to be first paid out by those agents, after which he would be reimbursed the amount together with the commission due to him, which was called the base commission in the agreement. The agents were given the power to appoint sub-agents at their own cost but their services could be terminated by the assessee if it was found that the appointed sub-agent was acting in a manner prejudicial to its interest.

- Pursuant thereto, after obtaining requisite permission from the RBI, the assessee set up its liaison office (LO) with its own stipulation that it would not represent any party other than the assessee. Thereafter, in accordance with legal requirements and the arrangements with the agents, the assessee kept the RBI posted on the activities of its LO and started remitting monies to India followed by commission payable thereon as remuneration. However, the assessee did not file its return on the ground that it was not taxable in India but ultimately filed the return declaring nil income pursuant to the notice issued under section 142(1).

- The Assessing Officer, holding that the income arising to the assessee in India from activities carried out in India was taxable both under the Act and the agreement (DTAA) between India and the USA, framed its assessment accordingly. On appeal, the Commissioner (Appeals) upheld the impugned order. Being aggrieved, the assessee filed an appeal before the Tribunal.

Arguments of the Revenue:

- The transaction of remitting monies to India from abroad is a single unified transaction and cannot be severed into two or more transactions, so as to say that at the Indian border, it assumes a different character. Both the receiving aspect and the payment aspect are a single integrated whole, incapable of being split.

- The assessee had a business connection in India, as it had a full-fledged office in India which conducted aggressive marketing activities together with negotiations with agents, providing software to them and imparting training about the product. The money is paid to the recipient in India on behalf of Western Union by its agents in India and thus, there was no difference between various branches of banks engaging in international transactions and the system adopted by the assessee. There is continuity of the transaction which gets completed only when the money is paid to the claimant in India through the agents. The software through which the agents access the mainframe computer in the USA is owned by the assessee. There is supervision of the transaction through the employees of the assessee. Thus, there is "business connection" in India and the assessee is liable under section 9(1) of the Income-tax Act to pay income-tax on the profits arising from its activities in India.

- The assessee has a PE in India in the form of various systems installed at the premises of various agents through which the business is carried on. There is a fixed place of business at the premises of each agent where the software is installed. The software ensures connectivity between the assessee and the premises of the agent. The agents are "dependent agents" within the meaning of Article 5.4(a) of the DTAA. For instance, the agreement between the assessee and a third party, Weizmann Ltd. prohibits the latter from carrying on a similar business during the term of the agreement and for six months after the expiry of the agreement, which shows that Weizmann is working wholly and exclusively for the assessee. The case of other agents is the same. Thus, they are all dependent agents of the assessee. Further, they have the authority to conclude contracts on behalf of the assessee in the sense that they carry out in India the commitment given by the assessee that the money will be paid.

The LO takes active part in the business of the assessee in the form of marketing, appointment of agents, brand building, providing software to the agents and imparting training to them in India. Therefore, the LO is a PE of the assessee in India.

- It was further submitted that so far as the Department of Posts is concerned, which was appointed as the agent of the assessee in India, though it was engaged in the money order business facilitating transfer of funds within India, the activity of paying out monies in India in the course of "trans-border money transfer business" was not in the ordinary course of its business, and hence, the primary condition of the article was not fulfilled. It was further pointed out that clause 3.1 of the agreement with the Department of Posts shows that it is a new business in which it had not so far engaged. Turning to the case of banks that were appointed as agents, the tax department pointed out that though under section 6(1)(a) of the Banking Regulation Act, 1949, banks are allowed to carry on the business of "collecting and transmitting, money", since the said Act extends only to India under section 1(2) thereof, the money transfer business involving trans-border transfer of funds cannot be said to be in the ordinary course of banking business. Hence, banks have had to seek the approval of the RBI under section 3(c) of the Foreign Exchange Management Act, 1999. A similar argument was advanced with regard to the non-banking financial companies (NBFCs) and tour operators appointed as the assessee's agents.

- The compensation paid to the agents is not adequate in comparison to the revenue received by the assessee for the work. The main part of the transaction – the payment of the money to the claimant – is carried out by agents in India and thus merits adequate compensation. Since the compensation paid is not adequate, the transaction is not at arm's length.

- The assessee had not submitted its global accounts or balance sheet or India-specific accounts. The only information given was the amount of transfer and commission paid. Considering the expenses to be incurred such as maintenance of the network, communication charges, mainframe expenses etc., the profit attributable to the Indian operations had been estimated at 10 per cent of the gross commission.

Arguments of the Assessee:

- The LO cannot be regarded as a PE since the RBI prohibits carrying on any business or commercial or trading activity under the conditions imposed for granting approval. The activities of the LO are continuously monitored by the RBI, which has not alleged any violations of the relevant conditions. It was pointed out that the LO is manned by only two employees at a junior level with a small staff.

- The Assessee relied on the case of IAC v. Mitsui & Co. Ltd. (39 ITD 59) (SB), wherein a Special Bench at Delhi has held that an LO cannot be regarded as a PE. A similar view has been taken by the Delhi Bench in BKI/HAM V.O.F. v. Addl. CIT (70 TTJ 480).

- The software alleged to be a PE cannot be so regarded since the agents used software only to gain access to the mainframe of the assessee located outside India so that they could match the MTCN number, without which the claimant would not be paid the money and, thus, it acted only as a tool for verification of the genuineness of the claim and nothing more. The intellectual property rights in the software remained with the assessee. The mere use thereof, it was argued, cannot lead to the result that the premises where it is being used can be regarded as the PE of the assessee. The assessee has no access as of right to the offices or premises of its agents or representatives in India.

- The terms of the agreement did not provide any authority to the agents to conclude contracts on behalf of the assessee and that there was not a single instance in which an agent or representative concluded any contract for the assessee. The assessee no doubt authorised the agents to appoint sub-agents but that was only for the purpose of enabling the agent to carry on his part of the transaction and the assessee had no say or control in the matter of appointing sub-agents. It was not the obligation of the assessee to remunerate the sub-agent, if one were to be appointed by the agent. Even the termination of the services of the sub-agent was not a matter within the control of the assessee. Thus, the agents were not dependent on the assessee in the matter of appointing, terminating or remunerating the sub-agents.

- The assessee argued that he agents were acting in the ordinary course of their business in undertaking the activity of disbursing the payments in India, this activity constituted a fraction of the overall activities of the agents, the activities of the agents were not devoted wholly or almost wholly for the foreign enterprise (the assessee), the compensation paid to them is uniform throughout the world and thus the dealings between the assessee and the agents were at arm's length. Hence, it cannot be said that the agents were not independent agents.

- The non-compete clause in the agreement of appointment of agent does not make the agent dependent on the foreign enterprise (assessee). It is the usual clause found in all such arrangements, mainly intended to protect the assessee. The training of the agents is an activity auxiliary or preparatory and therefore, by virtue of Article 5.3(e) of the DTAA, the LO cannot be deemed to be a PE.

- The words "ordinary course of their business" appearing in Article 5.5 of the treaty should be construed broadly and it must be accordingly held that the agents' activity constituted their regular business. There is no allegation that any of the conditions prescribed by any law were violated, nor is there any evidence to show that the transactions were not at arm's length. Therefore, the agents were all independent agents. It is only because the RBI has been constituted the ultimate controlling authority for transactions involving foreign remittances that its permission is required under section 3(c) of the FEMA. It does not necessarily mean that the activity is not in the ordinary course of the business of the assessee or representative.

- As regards attribution of profits under Article 7.1 of the DTAA, reference was made to the judgment of the Supreme Court in the case of Carborundum Co. (108 ITR 335), rendered with reference to section 42(3) of the 1922 Act, the provisions of which now find place in Explanation (a) to section 9(1) of the 1961 Act. It was contended that it was only those profits which can be reasonably attributed to the Indian operations of the foreign enterprise that can be taxed and if it can be shown, as explained in Board's circular dated 23-7-1969, that the agent's commission fully represents the value of the profit attributable to his service, it should prima facie extinguish the assessment. It was submitted that the compensation paid to the agents at the rate of 25 per cent to 30 per cent of the fees, received by the assessee is a reasonable attribution of the income to the PE (agents) and if the compensation so paid is allowed as a deduction, it will extinguish the assessment.

Decision of the Hon'ble Tribunal:

- The case has to be approached first from the point of view of the Act to see if any tax liability arises. In case no tax liability arises under the Act, nothing further requires to be done. But if there is a tax liability arising under the Act, it is open to the non-resident to claim that either there is no or less tax liability if the provisions of the DTAA are applied, in which case provisions of DTAA has to be given effect in preference to the provisions of the Act.
- In CIT v. R.D. Aggarwal & Co. [1965] 56 ITR 20, the Supreme Court held that the expression "business connection" means something more than a business, that it presupposes an element of continuity between the business of the non-resident and the activity in the taxable territory, although a stray or isolated transaction would not be taken into account, that the connection may take several forms, that it may include carrying on a part of the main business or activity incidental to the non-resident's business through an agent or it may merely be a relation between the business of the non-resident and the activity in the taxable territory that facilitates or assists the carrying on of that business.
- Applying these tests in the present case and taking into account the fact that the term "business connection" is broad in scope, the assessee would have a business connection. The business of the assessee is to transfer monies across countries. There is thus a receiving aspect and a paying aspect to the transaction. They cannot be segregated; to do so would be artificial. There is a seamless integration between the two. The transaction, as has been rightly noted by the income-tax authorities, is not complete unless the monies are paid in India to the claimant. Further, the agreements with the agents are initially for a term of 5 years, renewable for periods of one year at a time, but this could go on endlessly. The agents are bound to render services for the assessee as stipulated in the agreements. The agreement provides for security and confidentiality. The assessee has provided the software to the agents, although it retained the copyright, to enable them to access the assessee's mainframes in the USA. All these sufficiently justify the conclusion that there is a business connection within the meaning of section 9(1) of the Act.

- **Fixed place PE:**

A PE should project the foreign enterprise in India. The assessee has appointed different agents in India. These agents are the Department of Posts of the Government of India, commercial banks, non-banking financial companies and tour operators. These agents have their own or hired premises from which they operate. All that they have to show that they are agents of the assessee is to put up a display board claiming so. This cannot by any stretch of imagination amount to projection of the assessee in India. It cannot be postulated that the post offices of the Department of Posts, which functions under the concerned Ministry of the Government of India, would permit themselves to be looked upon as projecting the presence of Western Union Financial Services Inc., in India. The same would be the case of commercial banks such as the Karnataka Bank Ltd., Bank of Punjab Ltd., etc., and others which have been appointed agents. They have their own presence and business with which they are perhaps more concerned and may be surprised to find themselves characterised as projecting the assessee in Indian soil. There is no evidence to show that the assessee can, as a matter of right, enter and make use of the premises of these agents for its business. Therefore, there is no fixed place PE of the assessee in India.

- **Is LO a fixed place PE:**

The LO acted as a communication link between the agents and the assessee's head office, has trained and installed agents after obtaining approval from the RBI, has visited the agents and offered training and refresher courses in connection with the operations of the assessee, about the standards of service and security, accounting procedures, telecommunication systems and configuration, merchandising standards, etc. It has also helped agents to overcome the Y2K problem. It has organised local production of posters for display at the agents' locations. Further, the LO has facilitated the visit of the Director (Operations) of the assessee to the agents so that he could satisfy himself about quality standards. Finally, the LO has provided the management software (VOYAGER) to agents (free of cost) and trained their staff on its usage, These activities are in line with the activities mentioned in the annexure to the application to the RBI seeking permission to open the LO. The annexure also states what activities will not be undertaken by the LO. There is no allegation of any violation of the conditions of approval.

The LO cannot be considered to be the fixed place PE of the assessee as it carries out activities which are of a preparatory or auxiliary character. It has not carried on any trading activity for the assessee in India. It has only a small number of executives and a support staff. The LO has also filed status reports to the RBI listing out the activities which it actually carried on during the years. None of the activities can be described as anything other than of preparatory or auxiliary in character.

In the UAE Exchange Centre LLC, In re (supra), the AAR noticed that the applicant, who was engaged in money transfer business, had adopted the mode of remitting money to India through its liaison offices in India. The liaison offices downloaded the data about beneficiaries in India, printed cheques/drafts and dispatched them to the beneficiaries. On these facts, it was held that the LOs constituted PE in India.

The test laid down by the AAR was that the role of the LO should be nothing short of performing the contract of remitting the amounts at least in part, before it could be called a PE of the foreign enterprise. The performance of the contract of remitting the amounts, at least in part, was held to constitute an essential activity in the performance of the contractual obligation, and such activity was held not to constitute an auxiliary activity. In the present case, the LO performs no part of the contract of remitting the money into India. From the nature of the activities carried on by the LO, its activities can properly be called auxiliary or preparatory in nature. Therefore, the LO cannot be considered to be the PE of the assessee in India.

- **Software as the PE of the assessee:**

The premises of the agents are either owned or hired by them. There was no evidence to show that the assessee can as a matter of right enter and make use of the premises for the purpose of its business. The software is the property of the assessee and it has not parted with its copyright therein in favour of the agents. The agents have only been allowed the use of the software in order to gain access to the mainframe computers in the USA.

Mere use of the software for the purpose from the premises of the agents cannot lead to the decision that the premises-cum-software will be the PE of the assessee in India. Under Article 5, installation may amount to a PE provided it is used for the exploration of natural resources. Therefore, even if the software is to be considered as an installation, since it is not used for exploration or exploitation of natural resources, it cannot per se be treated as a PE.

- **Agency PE:**

Three conditions are required to be satisfied in order that an agent may be said to be an independent agent: (1) he should be acting in the ordinary course of his business; (2) his activities should not be devoted wholly or almost wholly on behalf of the foreign enterprise for whom he is acting as agent and (3) the transactions between the foreign enterprise and the agent should be at arm's length.

(1) He should be acting in the ordinary course of his business:

In the leading case of Narain Swadeshi Weaving Mills v.CEPT [1954] 26 ITR 772 the Supreme Court explained that business connotes some real, substantive and systematic course of activity or conduct with a set purpose. In Liquidators of Pursa Ltd. v. CIT [1954] 25 ITR 265, the Supreme Court held that underlying the expression "business" is the fundamental idea of continuous exercise of an activity. In Barendra Prasad Ray v.ITO [1981] 129 ITR 295, the Supreme Court again held that the word is of wide import and means an activity carried on continuously and systematically by a person by the application of his labour and skill with a view to earning income. Therefore, any activity which is being systematically and continuously carried on with the object of earning profits is a business activity. That way, the activity engaged in by the agents of paying the monies to the beneficiaries or claimants in India, after satisfying themselves about their identity and after accessing the MTCN number to verify the genuineness of the claim, amounts to carrying on of the business of money transfer. The agreement of agency is initially for a period of 5 years and can be renewed for successive periods of one year each. The agents could appoint sub-agents for carrying out the activity. They have to maintain records and measure up to the standards set by the assessee. They have received training from the assessee in the use of the software and communication systems. All these are activities which are carried on systematically and continuously with a set purpose and hence amount to business.

In the case of the Department of Posts, it is well-known that they accept money orders for transfer of funds within India. Engaging themselves in the same type of business with international ramifications is just an extension of their business. It cannot be said that it is not in the ordinary course of their business. The same is the case with commercial banks. Although it may not, strictly speaking, be part of their banking business as defined in the Banking Regulation Act, 1949, it is still nobody's case that it is not a lawful activity which they have embarked upon. In fact, they have obtained the approval for such activity from the RBI under section 3(c) of the FEMA. Although the approval is only for the purpose of FEMA, it would still amount to a business, though not banking business, because it has been carried on systematically and continuously to earn a commission. Having regard to the variegated services provided by the banks these days, which cannot be ignored, all with a business motive, it is difficult to say that the activity carried on by the assessee's agents in India is not a business activity in the ordinary course of their business. Non-banking financial companies deal with money belonging to others and the activity of paying out monies on behalf of the Western Union Financial Services Inc., must be viewed as part of their business activity. In the case of tour operators, acting as agents of an established firm engaged in international money transfers may be conducive to their business. A broad view of the matter has to be taken in these matters.

(2) Activities should not be devoted wholly or almost wholly on behalf of the foreign enterprise for which he is acting as agent:

The Department of Posts functions under the aegis of the concerned Ministry of the Government of India. Its main activity is to serve the public in India in the matter of sending/receiving letters, parcels, packets, etc., within or to/from outside India, money orders within India, maintaining small savings account in several forms such as savings certificates, time-deposit accounts, postal life insurance, etc. They have a vast network throughout the country. They are a service organisation for the benefit of the general public and it would be a misnomer to say that their activities are wholly or almost wholly devoted to Western Union Financial Services Inc. of the USA. There is no evidence that the Department of Posts are dependent on the assessee for their revenues. The position is the same in the case of commercial banks, non-banking financial companies and tour operators appointed as the agents of the assessee. There is no evidence to show that the extent of their activities for the assessee, compared to all their activities, is so large that it can be said that they are dependent on the assessee for their earnings or revenues. The agents in the present case have not been shown to be economically dependent on the assessee. They are not carrying on the activity for the assessee, as agents, in exclusion of their other businesses or activities. In this situation, it cannot be said that their activities are wholly or almost wholly devoted to the assessee just because they are not acting as agents for any other company in the money transfer business. Further, an agent will in no case be liable for damages for the delay, non-payment or underpayment of the money transfer. The agent is not, therefore, liable to any risk on this account.

(3) The transactions between the foreign enterprise and the agent should be at arm's length:

As per the agreement, "base compensation" is 30 per cent in the case of the Department of Posts and 25 per cent in the case of others. It may be reduced with the Department of Posts if the assessee were to assume responsibility for the advertising and promotion of the services or to establish a customer service centre to handle customer queries. The reduction shall not exceed 10 per cent of the gross revenues earned by the agent concerned from the money transfer business done by it in the relevant year. In the case of banks appointed as agents, the amount of reduction is left to the determination of the assessee. There is no material to show that the rates of compensation are higher in other cases so as to indicate that the agents were discriminated against. The higher rate of compensation in the case of the Department of Posts is probably because its reach is much wider compared to commercial banks, NBFCs or tour operators. The terms of appointment of sub-agents are uniform in all cases. Thus, there seems to be no basis for the charge that the compensation paid is not adequate for the services rendered by the agents. There is no finding contrary to the claim made by the assessee that the rates of compensation are uniform throughout the world. In these circumstances, there is no merit in the claim that the transactions between the assessee and the agents are not at arm's length.

There is no express authority given to them in the agreement. All that the income-tax authorities have stated is that (a) that the agents carry out in India the commitment given by the assessee to the remitter of the money abroad and (b) that the agents have the power to appoint sub-agents to do their work. From these facts, taken singly or together, it cannot be inferred that the agents either have the authority to conclude the contracts or have habitually exercised the authority without any protest from the assessee. The fact that the agents (in the present case) have the authority to appoint sub-agents does not mean that they (agents) have the authority to conclude contracts. Nowhere in the sub-agency agreement do agents have any authority to conclude contracts. In fact, when the agents themselves have no such authority under their agreement, they cannot delegate the same to their sub-agents.

The fact that the agents conclude in India the commitment of the assessee made abroad cannot be considered as an authority to conclude contracts. The contract is between the remitter abroad and the assessee. It is entered into outside India. The agents are not party thereto. The agents merely carry out the concluding step in the arrangement embodied in the contract. In other words, the assessee undertakes outside India to transfer the money to India. It is only the payment part of the undertaking that is executed by the agents in India. The contract is already concluded outside India. The agent has no say over the contract. He has to merely execute the payment part, after satisfying himself as to the genuineness of the transaction and the identity of the beneficiary in India. By executing the last leg of the contract that has already been concluded (outside India), he is not concluding the contract for the assessee. The appointment of sub-agents is merely to facilitate the work of the agent. That apart, what is considered to be a "duty" cannot be considered to be an "authority". By making a payment to the beneficiary, the agent in India is only performing his duty under the agreement of agency, for which he is remunerated; he is not exercising any "authority", certainly not an authority to conclude contracts on behalf of the assessee. The words "duty" and "authority" are incompatible with each other. The dictionary meaning of the word "duty" is "assignment/burden/commitment that one is obliged to do by law or by calling of one's business". It connotes an obligation, which a person is bound to perform. Per contra, "authority" in law belongs to the province of power. Judged by these tests, the fact that the agents in India pay out the money to the beneficiaries or claimants, which they are bound to under the agreement with the assessee for which they are remunerated, does not appear to be a case of exercise of any authority. Thus, the agents do not habitually exercise the authority to conclude the contracts on behalf of the assessee. Therefore, there is no agency PE of the assessee in India.

Thus, there is no PE in India. Since there is no PE in India under Article 5 of the DTAA between India and the USA, no profits can be attributed to the Indian operations of the assessee and taxed in India.

Conclusion:

The Hon'ble Tribunal analysed the facts both from the perspective of business connection and permanent establishment. As regards "business connection", the tests laid down by judicial precedence were noted and it was observed that the expression "business connection" was wide enough in scope to include the present situation and hence, it was held that the money transfer activity carried out in India by the agents constituted "business connection".

The Hon'ble Tribunal then analysed the question of existence of PE. With respect to fixed place PE, it was observed that the premises of the agents were not at the disposal of the assessee and the agents were carrying on their business. Further, it was observed that the LO was permitted to carry on limited activities for which it was set-up in India with the approval of RBI and it does not undertake the money transfer business. It was also observed that the software which gives agents access to the US mainframe computer was owned and belonged to the assessee and agents only had a right to use them for the limited purpose of agency work. Therefore, there is no fixed place PE of the assessee in India. Further, it was observed that the agents were independent agents as they were not economically dependent on the assessee. They neither had the authority to conclude contracts as per the agreement, nor did they habitually exercise authority to conclude contracts. Therefore, there is no PE of the assessee in India. As the provisions of the DTAA are more beneficial, the assessee would not be liable for tax in India.

1.7 Dell products [Resolution Number 00/2107/2007 dated 15.3.2012 (Central Economic Administrative Court, Spain]:

Introduction:

This case deals with a situation wherein a subsidiary, which was dealing directly with customers on its account under the direct sale model, was brought under the commissionaire model. Further, under the commissionaire arrangement, the subsidiary was performing the same work as was undertaken earlier. The Spanish Court has examined whether such an arrangement would lead to PE of the parent company.

Facts:

In the facts of the case, the multinational company Dell was engaged in the computer business. The computer products were manufactured in Ireland by the Irish company, Dell Europe and sold by the Irish company, Dell Products through local Dell subsidiaries in various European countries. Dell Products operated through a direct sales model whereby the purchase orders were placed in a web or call centre.

Dell Spain was responsible for the direct sale of the computer products in Spain. In charge of the commercialisation of these products, it operated as a full-fledged distributor. Dell Products had no employees or facilities in Spain.

In 1995, the sales operations of the Dell group were reorganised and the customer's profile (database) was transferred to the Irish company, Dell Products. Dell Products' function was the sale of computers and the management and control of their distribution in different markets through local distributor companies. These distributors were functionally characterised and remunerated as commissionaires but, from a business perspective, they actually performed substantive activities beyond a mere commissionaire function. Dell Products did not have its own human resources; these were subcontracted from Dell Europe.

In the new sales structure, Dell's computers were sold in Spain by Dell Spain in the capacity of a commissionaire (unlike the earlier scenario of direct sale between Dell Spain and customers) under a commission agreement with Dell Products in Ireland as the principal. Dell Spain sold and marketed the computers in the Spanish market in its own name but for the account of Dell Products. In particular, Dell Spain was directly and actively involved in the logistics, marketing, after-sales services and administration of Dell Products' Spanish online store. The Spanish market was segmented in two areas:

(i) large customers who required specialised and on-site attention were served by Dell Spain; and

(ii) small-sized customers were served by Dell France through a call centre and a website.

Issues raised before the Court:

Whether the way the sales operations in Spain were organised under the commissionaire agreement made Dell Spain a permanent establishment of Dell Products under Article 5(1) [fixed place of business] and/or Article 5(5) [dependent agent] of the tax treaty between Ireland and Spain (the treaty).If so, what is the proportion of its profits that could be attributed to the activities of such PE?

Court decision:

The issue of fixed place of business:

The Spanish Court held that Dell Products had a fixed place of business in Spain through the use of Dell Spain's facilities. The Court observed that according to Para. 4 of the OECD Commentary on Article 5, it is immaterial whether these facilities are owned or rented by or are otherwise at the disposal of Dell Products. A parent company can have a PE in the state where its subsidiary has a place of business, e.g., a space or premise belonging to the subsidiary that is at the disposal of the parent company.

The Court then dealt with the question of whether the online store could be characterised as an "online PE", even though the server was situated outside Spain and no activity was performed through human resources or assets located in Spain. The Court observed that the sales and deliveries in Spain by Dell Products through the server in France were economically significant and that employees of Dell Spain were involved in the maintenance of the online store. The Court did not follow the explanation of Paras. 42.1 to 42.10 OECD commentary on Article 5, where it is stated that a web site does not constitute a PE in a state, unless the server is physically located in that state. As the trading, selling and delivery carried out in Spain were economically significant activities, the Court was not prepared to accept these paragraphs of the OECD commentary as guidance in the pertinent case. The Court found support in Para. 45.6 of the OECD commentary on Article 5 in which Spain had included an observation on these paragraphs of the OECD Commentary, indicating that Spain would not necessarily take into consideration the aforementioned paragraphs until the OECD study of e-commerce taxation has been brought to a final conclusion. [This Spanish observation was withdrawn in the 2010 version of the OECD Model Convention.]

The issue of the agency PE:

Furthermore, the Court held that Dell Products had an agency PE in Spain because Dell Spain had the authority to conclude contracts in its name, and hence was acting as a dependent agent. These contracts were binding on Dell Products, even if those contracts were not actually concluded in its name. In this context, the Court took into consideration that Dell Spain acted under the comprehensive supervision and control of Dell Products and its activities were not limited to those of an auxiliary character.

Conclusion:

The Central Economic-Administrative Court (TEAC) held in favour of the tax authorities. The Court decided that Dell Spain constituted a Spanish PE of Dell Products, both under Article 5(1) and Article 5(4) of the treaty; the TEAC used the Commentaries to the OECD Model as an interpretative guideline. This conclusion was reached despite the fact Dell Products had no employees or facilities in Spain. The Court held that all the sales by Dell Products in Spain (less commission paid to Dell Spain and other related allocable expenses) should be attributed to Dell Product's Spanish PE. The Court also held that the sales to Spanish customers through the French subsidiary of the Dell group should be allocated to the Spanish PE of Dell Products inasmuch as the sales of the French subsidiary were carried out through or with substantial involvement of the human and material resources of Dell Spain. The Court observed that from a legal and economic perspective, the division of the functions between Dell France and Dell Spain was unclear. In the Court's opinion, tax authorities had sufficiently demonstrated that the most significant economic activities were carried out in Spain.

Having discussed the judicial precedents of various countries above in the context of the digital economy, the next chapter summarises the significant events or developments in the history of international taxation in relation to the digital economy and also India's position and its enactments in relation to taxation of the digital economy.

2. Taxation of the Digital Economy – Snapshot of developments and India position:

2.1 TAG report – OECD (2001):

The Technical Advisory Group (TAG) on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits was set up by the OECD Committee on Fiscal Affairs in January 1999 with the general mandate to "examine how the current treaty rules for the taxation of business profits apply in the context of electronic commerce and examine proposals for alternative rules".

The TAG analysed the current treaty rules for taxing business profits, which includes allocation of taxing rights, threshold for PE exemption, and attribution of profits. A critical evaluation of existing treaty rules was undertaken by the TAG with respect to the digital economy dealing with aspects such as consistency with the conceptual base for the sharing of taxing rights, neutrality, efficiency, certainty and simplicity, effectiveness and fairness, flexibility, compatibility with international trade rules and stress on the need to have universally agreed rules.

The TAG categorised various alternatives to the current treaty rules into two. One set of alternatives would not require fundamental modifications in existing rules whereas the other set of alternatives would require so.

The changes that would not require fundamental modification of existing rules include:

- Modification of the PE definition to exclude activities that do not involve human intervention by personnel, including dependent agents
- Modification of the PE definition to exclude functions attributable to software when applying the preparatory or auxiliary exception
- Modification of the PE definition to provide that software in itself cannot constitute PE
- Elimination of the existing exceptions in paragraph 4 of Article 5 or making these exceptions subject to the overall condition that they be preparatory or auxiliary
- Elimination of the exceptions for storage, display or delivery in paragraph 4 of Article 5
- Modification of the existing rules to add a force-of-attraction rule dealing with e-commerce
- Adopting supplementary nexus rules for purposes of taxing profits arising from the provision of services

The changes that would require fundamental modification of the existing rules include:

- Adopting rules similar to those concerning taxation of passive income to allow source taxation of payments related to some forms of e-commerce
- A new nexus: base eroding payments arising in a country
- Replacing separate entity accounting and arm's length by formulary apportionment of profits of a common group
- Adding a new nexus of "electronic (virtual) permanent establishment"

Based on its analysis of advantages and disadvantages of the current treaty rules for taxing business profits and of a number of possible alternatives, and after having considered the comments received on its first draft, the TAG reached the following conclusions:

- Changes requiring fundamental modification to existing rules would not be appropriate on the basis that e-commerce and other business models resulting from new communication technologies would not by themselves justify a dramatic departure from the current rules and there is no actual evidence that the communications efficiencies of the internet have caused any significant decrease to the tax revenues of capital importing countries.

- Further, unless such fundamental change appears to be superior to other possible alternatives and is broadly agreed upon, it is better to refrain from such change as it would create difficult transition rules given the fact that many countries are likely to disagree with such changes and that a long period of time would be required for the gradual adaptation of the existing network of tax treaties. However, the TAG recognised that there is need to keep close watch on the movements in the digital economy and how these affect tax revenues.

- Of the alternatives highlighted that do not require fundamental modification, the TAG concluded that the application of exceptions in paragraph 4 of Article 5 subject to the overall condition that they be preparatory or auxiliary and to eliminate the exceptions for storage, display or delivery in paragraph 4 of Article 5, should continue to be monitored to determine whether practical difficulties or concerns warrant any such changes, which could lead to further study of these alternatives or of combinations or variants thereof.

Further, the application of current rules to functions performed with the use of servers and software should also be monitored.

Regarding the option of adopting supplementary nexus rules for purposes of taxing profits arising from the provision of services, the TAG noted that this option would be examined in the context of the work that the OECD would undertake on the application of tax treaties to services. The conclusions from that work could lead to further study of the option or variants thereof.

During its work, the group had examined, as it was mandated to, characterisation issues that were relevant to the OECD Model Tax Convention as well as some issues that relate to alternative treaty provisions not found in the Model Tax Convention. Its recommendation covers both sets of issues. The TAG recommends that a document be issued clarifying how the various tax treaty characterisation issues arising from e-commerce should be resolved.

2.2 The HPC Report (2001):

The High Powered Committee on 'Electronic Commerce and Taxation' ("HPC") was constituted by the Central Board of Direct Taxes on December 16, 1999. The HPC was constituted to examine the projected overall growth in e-commerce business and technology transfer in and out of India; whether e-commerce and technology transfers, etc., should be subject to tax; the position on taxation of e-commerce transactions under existing law and the changes required, if any, in domestic law/treaty law for this purpose; and the implementation aspect of taxation of e-commerce besides examining the position adopted by the advanced countries and neighbouring countries such as China, Nepal, etc.

The HPC opined that there should be taxation of the income of content providers, service providers and all other persons engaged in e-commerce on the same principle that the traditional business world is subject to. At the broad policy level, the taxation perspective envisaged was neutrality of taxation of e-commerce with reference to traditional commerce; integrity of tax base through constant monitoring of trade flows, changes in technology and business practices; and international consensus while protecting national interest.

As part of its recommendations, the HPC recommended that "place of effective management" should be continued to determine residence and no revision was required on this account.

Conclusion on the concept of PE:

Conventional treaties provide for source based taxation of business income which is based on the physical presence in the form of a fixed place of business or a dependent agent in the source country and the characterisation of the income. In the digital world, the need for a physical presence virtually ceased, which has affected sharing of revenue between countries. The change in the mode of delivery from physical to online raises characterisation issues. Further, lack of physical presence also creates issues in the enforcement of tax laws. The HPC, therefore, supported the view that the existing PE concept should be replaced with an alternative one.

As an alternative, what could be considered is the "base erosion" approach in which:

- All transactions, whether traditional or through e-commerce, are subjected to tax based on chargeability rules
- The tax should be implemented through a low withholding tax on all tax deductible payments to a foreign enterprise
- Preferably, the withholding tax is final without the option of tax on net income being given to the tax payer or the tax administration.

Until an international consensus is reached, no revision should be made on this account. The HPC suggested that an immediate study be conducted on the impact of possible solutions before they are implemented.

The HPC also took note of the TAG report and analysed the categories that were analysed by the TAG, in the light of the provisions of the Income-tax Act, 1961, tax treaties and judicial precedents, if any. There were some categories where the views of the HPC matched with that of the OECD while it differed in the case of others. With respect to characterisation issues, the HPC opined that there is no rational basis to different characterisation of the particular income and a long term solution is necessitated specifically because the "base erosion" approach may also not provide equitable sharing of revenues. Accordingly, the HPC recommended that the CBDT should express its position on various categories analysed by the TAG - OECD.

As the growth of e-commerce could lead to a situation where end-to-end transactions are happening over a network, which leaves no audit trail, it was recommended that an appropriate system that mandates disclosures by business, effective monitoring and surveillance should be put in place with minimum compliance burden on business entities.

2.3 eComTaxpert Group report (convened by Nishith Desai Associates) (2002):

The objective of eComTaxpert Group ("eCTG") are to give constructive feedback on the HPC report to the government, taking into account the views of eminent academicians, tax professionals and industry experts across the globe. .

The eCTG was in agreement with certain segments of the HPC report that contended that there is no policy justification to exempt net income derived from ecommerce from all direct taxation and that technological neutrality is a fundamental policy point. Besides this, the eCTG agreed with the views of the HPC that e-commerce transactions do not lead to anonymity. It also concurred with the view of the HPC that the Indian government should participate in an international platform alongside international bodies like the OECD to reach a consensus on various enforcement issues.

However, eCTG did not agree with the "base erosion" approach suggested by the HPC as it felt this was not in consonance with the international consensus which states that withholding taxes are appropriate only in certain limited cases. The base erosion approach is a radical departure from this consensus. Considering this and the fact that e-commerce was expected to strengthen India's position in the digital economy, this approach was disapproved by the eCTG.

The eCTG concluded that the Indian government should work in conformity with the international consensus and formulate a policy that is clear and transparent and which is consistent with the international norm of characterisation of revenues. Further, the group was of the view that the government should honour the principle of neutrality as laid down by the OECD and endorsed by the HPC in its characterisation of income from e-commerce transactions.

2.4 India action –Amendment to domestic law (2012):

There were conflicting judicial decisions on whether consideration for the use of computer software was royalty or not; and whether the right, property or information has to be used directly by the payer or is to be located in India or control or possession of it has to be with the payer. Similarly, doubts have been raised regarding the meaning of the term 'process'.

The above taxation aspects had arisen due to the impact of e-commerce and the manner in which e-commerce can negate the literal reading of various provisions. To put such issues to rest and to clarify the intention of the legislation, the Finance Act, 2012, had brought in following clarificatory amendments under section 9(1)(vi).

- The consideration for use or right to use of computer software is royalty by clarifying that the transfer of all or any rights in respect of any right, property or information as mentioned in Explanation 2, 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.

- Royalty includes and has always included consideration in respect of any right, property or information, whether or not the possession or control of such right, property or information is with the payer; such right, property or information is used directly by the payer; and the location of such right, property or information is in India.

- The term "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.

Although intended to put ligation arising regarding these aspects to rest, the amendments had created a whole new set of interpretational issues with regard to other kind of payments, which were never intended to be treated as royalty.

2.5 BEPS Action 1 report (2015):

The Task Force on the Digital Economy ("TFDE"), a subsidiary body of the Committee on Fiscal Affairs (CFA) in which non-OECD G20 countries participate as associates on an equal footing with OECD countries, was established in September 2013 to develop a report identifying issues raised by the digital economy and detailed options to address these by September 2014. It issued an interim report in September 2014 and continued its work in 2015. The conclusions regarding the digital economy, the BEPS issues and the broader tax challenges it raises, and the recommended next steps are contained in this final report.

The BEPS Report recognises that the digital economy is becoming an economy itself. Therefore, treating it separately from the traditional economy is difficult. The BEPS Report had laid down certain recommendations after considering various aspects. These recommendations are as follows:

- To modify the list of exceptions to the definition of PE to ensure that each of the exceptions included therein is restricted to the activities that are actually "auxiliary or preparatory” in nature. Further, it is necessary to introduce anti-fragmentation rules so that it is not possible for closely related enterprises to benefit from these exceptions. As an example, the maintenance of a very large local warehouse in which a significant number of employees work for purposes of storing and delivering goods sold online to customers by an online seller of physical products (whose business model relies on the proximity to customers and the need for quick delivery to clients) would constitute a permanent establishment for that seller under the new standard.

- To modify the definition of PE to address circumstances in which artificial arrangements relating to the sales of goods or services of one company in a multinational group effectively result in the conclusion of contracts such that the sales should be treated as if they had been made by that company. For example, where the sales force of a local subsidiary of an online seller of tangible products or an online provider of advertising services habitually plays the principal role in the conclusion of contracts with prospective large clients for those products or services, and these contracts are routinely concluded without material modification by the parent company, this activity would result in a permanent establishment for the parent company.

These recommendations are expected to be implemented across the existing tax treaty network in a synchronised and efficient manner via the conclusion of the multilateral instrument that modifies bilateral tax treaties under Action 15.

- It was also recommended 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 assets, but that the group companies performing important functions, contributing important assets and controlling economically significant risks, as determined through the accurate delineation of the actual transaction, will be entitled to an appropriate return. This revised transfer pricing guidance should also ensure that the transfer pricing analysis is not weakened by information asymmetries between the tax administration and the taxpayer in relation to hard-to-value intangibles, or by using special contractual relationships, such as a cost contribution arrangement.

- To include definitions of controlled finance corporation (“CFC”) income that would subject income that is typically earned in the digital economy to taxation in the jurisdiction of the ultimate parent company.

- To apply the principles of international VAT/GST guidelines and consider the introduction of the collection mechanisms included therein.

- The other options discussed in the BEPS Report, namely (i) a new nexus in the form of a significant economic presence, (ii) a withholding tax on certain types of digital transactions, and (iii) an equalisation levy, had not been recommended from the tax treaty perspective; however, any of these three options could be introduced in domestic laws as additional safeguards against BEPS, provided they respect existing treaty obligations. The adaptation should ensure consistency with existing international legal commitments.

2.6 India action – Equalisation levy (2016):

The Committee on taxation of e-commerce took cognizance of the Report on Action 1 of the BEPS Project, which has been accepted by G-20 countries, including India and OECD, and provides a broad consensus view on issues relating to the digital economy and options suggested. After examining the three options identified in the BEPS Report, the Committee noted that compared to the first two options, i.e., a new nexus based on significant economic presence and the withholding tax on digital transactions, which would require changes in a number of tax treaties, the third option of 'Equalization Levy' provides a simpler option that can be adopted under domestic laws without requiring amendments to a large number of tax treaties. Accordingly, the Committee recommends the adoption of an 'equalisation levy' to address the tax challenges of the digital economy and provide greater certainty and predictability in its taxation. However, while the Committee recommended the 'equalisation levy', the Committee suggested that it should be imposed on the payment for specified digital transactions, which would not be a tax on income, and hence would not be covered by tax treaties. As an equalisation levy is not proposed as tax on income, it would need to be imposed outside the Income-tax Act, 1961.

The specified digital transactions could include online marketing and advertisements, cloud computing, website designing hosting and maintenance, digital space, digital platforms for sale of goods and services and online use or download of software and applications. However, to limit the impact of the equalisation levy, the Committee recommended that only payment exceeding Rs. one lakh made by a person resident in India or a permanent establishment of a non-resident person to a non-resident enterprise be covered by this levy, which may be charged at a rate of between 6 to 8 per cent of the gross payment made for specified services. Further, the Committee notes that income arising from payments subjected to equalisation levy should not be subjected to income-tax, and hence, transactions on which such levy is paid may be exempted from income-tax.

To ensure compliance, it was proposed to impose the obligation on payers to deduct the equalisation levy from the payment, but such obligation should be limited to only those payers who wish to claim that payment as a deductible expense for determining taxable profits in India. Therefore, allowability of expense was to be linked with the payment of equalisation levy on the line of the already existing one in Section 40. The payer's obligation on compliance has to be similar to TDS compliance such as filing of return. Further, the requirement of auditor's certificate may be mandated. The Committee also recommended that reporting obligations for a non-resident may be kept simple with the facility of filing return being made available online in case the total sum received in a year exceeds Rs.10 crore.

It was also stressed that the payer's obligations could be complemented/substituted with the help of payment gateways and authorised dealers and hence, immediate action should be initiated on this front. The other recommendations of the Committee was that the definition of "business connection" in Section 9 may be expanded to include the concept of 'significant economic presence'. The Committee also acknowledged the need for continuously monitoring further developments in the digital economy as well as further developments in international taxation rules.

In line with the above recommendations, India imposed an equalisation levy as part of the Finance Act, 2016, and made it effective from June 1, 2016 at 6 per cent on online advertisement, any provision for digital advertising space or any other facility or service for the purpose of online advertisement. Further developments are expected to take place in the near future.

2.7 Bloomberg BNA Report 2015:

It may be noted that the committee on taxation of e-commerce had recommended "significant economic presence" also among others in its other recommendations. In its report, the committee took note of a special report by Bloomberg BNA titled "Multistate Tax Report 2015 Survey of State Tax Departments". This was a survey analysis conducted in the USA to seek position of its states on nexus issues arising in a digital economy. Among others, the report states that 31 of the states in the United States now resort to "significant economic presence" criteria for establishing tax nexus, instead of 'physical presence", and thereby tax intangible digital goods and services provided through the digital or telecommunication networks.

To avoid potential revenue loss, an increasing number of states rejected the bright-line physical presence test and adjusted to the new economy by taxing out-of-state businesses based on their ''economic presence'' within their borders. They were also adopting new rules aimed at taxing out-of-state companies' receipts from services and intangibles that are attributable to in-state customers. Even in the sales tax arena, the physical presence standard appears to be eroded. More states are adopting click-through nexus laws and attributional nexus. By the date of the above report, 12 states had adopted click-through nexus provisions and several more have some sort of click-through nexus policy, even in the absence of specific statutory authority. After nexus has been established, most multistate corporations must take the analysis one step further. As a result, in addition to nexus issues, a new area emerged as a major hub of state tax activity – income sourcing. Income sourcing refers to the rules states use to determine whether business entities will attribute certain receipts to its jurisdiction after nexus has been established.

Most business entities will face income sourcing issues for receipts from intangibles and services when filing their tax returns, especially if they have nexus in several jurisdictions. While states have long-standing policies on sourcing income from tangible personal property and real property, there is little uniformity or guidance on sourcing income from services, intangibles, cloud computing and certain special industry receipts. One area in which states have made some progress is sourcing receipts from cloud computing transactions. For several years, generic ‘‘letter rulings’’ were the only guidance on cloud computing transactions. As indicated by survey responses, state policies in this area have changed dramatically as 19 states were able to characterise receipts from cloud computing as either receipts from the sale of tangible personal property, the lease, licence or rental or tangible personal property, the sale, lease, licence or rental or intangible personal property; or the sale of services.

2.8 Multi-lateral instrument:

There are measures suggested by BEPS Action report regarding the amendments to be made to tax treaties, however, negotiating and amending each and every tax treaty across globe appeared next to impossible. Therefore, the multilateral instrument (“MLI”) has emerged as a single convention to modify existing treaties [as changes to more than 3000 bilateral tax treaties will be burdensome and time consuming] to implement BEPS measures. The Convention also provides flexibility to exclude a specific tax treaty and to opt out of provisions or its parts by making reservations. The Convention implements two minimum standards relating to prevention of treaty abuse and dispute resolution through the mutual agreement procedure. It will be applied alongside existing tax treaties, modifying their application in order to implement the BEPS measures and not by way of amending the protocol in existing treaties. An ad hoc group of more than 100 jurisdictions from G20, OECD, BEPS associates and other interested countries have worked on the finalisation of the text of the Multilateral Convention, which along with explanatory statement was adopted by the ad hoc group on November 24, 2016.

On June 7, 2017, over 70 ministers and other high-level representatives participated in the signing ceremony of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS. Signatories include jurisdictions from all continents and all levels of development. Further, ministers and high-level officials from Barbados, Côte d’Ivoire, Jamaica, Malaysia, Panama and Tunisia signed the MLI on January 24, 2018, bringing the total number of signatories to 78. In addition to these, Algeria, Kazakhstan, Oman and Swaziland have expressed their intent to sign the Convention, and a number of other jurisdictions are actively working towards signature by June 2018. So far, four jurisdictions – Austria, the Isle of Man, Jersey and Poland – have ratified the Convention, which will enter into force three months after a fifth jurisdiction deposits its instrument of ratification.

India has signed the Convention on June 7, 2017. India has also made a provisional list of 93 tax treaties to be covered under MLI as covered tax agreements[4] and a provisional list of reservations. The final lists for both will be submitted by India at the time of submission of instrument of ratification.

[4] – Covered tax agreement refers to an existing tax treaty with respect to which each party to the tax treaty has made a notification for application of the MLI.

2.9 India action – amendment to domestic law (2018):

Alignment of "business connection" definition to give effect to MLI provision:

The BEPS Action 7 to Article 5 on the definition of a PE recommended that 'agent' would include not only a person who habitually concludes contracts on behalf of the non-resident, but also a person who habitually plays a principal role leading to the conclusion of contracts. It was further recommended to have in place anti-fragmentation rules that prevent a tax payer from resorting to fragmentation of functions which are otherwise a whole activity to avail of PE exemption.

The above recommendation was included in Article 12 of the MLI to which India is also a signatory. Consequently, these provisions will automatically modify India's bilateral tax treaties covered by MLI, where the treaty partner has also opted for Article 12. As a result, the definition of PE will become wider in scope compared to current provisions under the Income-tax Act, 1961. However, section 90(2) of the Act provides that the provisions of domestic law would prevail over corresponding provisions in the DTAAs, to the extent they are beneficial. Accordingly, the provisions of the domestic law being narrower in scope are more beneficial than the provisions in the DTAAs, as modified by MLI, rendering such wider provisions in the DTAAs ineffective.

In view of the above, the 2018 Finance Bill proposed an amendment to the provision of section 9 of the Act so as to align it with the provisions in the DTAA as modified by MLI to make the provisions in the treaty effective. With the enactment of these proposals, "business connection" will include any business activities carried through a person who, acting on behalf of the non-resident, habitually concludes contracts or habitually plays the principal role leading to conclusion of contracts by the non-resident. It is further proposed that the contracts should be (i) in the name of the non-resident; or (ii) for the transfer of the ownership of, or for the granting of the right to use, property owned by that non-resident or that the non-resident has the right to use; or (iii) for the provision of services by that non-resident.

Introduction of new nexus rule – "significant economic presence":

BEPS Action Plan 1 had discussed the new nexus rule based on "significant economic presence" as one of the options to tackle the challenges of a digital economy. As per this report, a non-resident enterprise would create a taxable presence in a country if it has a significant economic presence in that country based on whether it has a purposeful and sustained interaction with the economy through the use of technology and other automated tools. It further recommended that the revenue factor may be used in combination with others such as purposeful and sustained interaction with the economy to determine 'significance economic presence'.

The scope of the existing provision of Section 9 is restricted only to the nexus rule based on physical presence, which does not hold good anymore for taxation of business profits in the source country with the advent of digital economy. As a result, the rights of the source country to tax business profits that are derived from its economy is unfairly and unreasonably eroded. In view of the above, Section 9 is proposed to be amended to provide that 'significant economic presence' in India shall also constitute 'business connection'. The meaning attributed to 'significant economic presence' for this purpose is discussed below.

- any 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 the amount as may be prescribed; or
- systematic and continuous soliciting of its business activities or engaging in interaction with such number of users as may be prescribed, in India through digital means.

However, only so much of income as is attributable to such transactions or activities shall be deemed to accrue to or arise in India. It is further proposed to provide 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. Further, the above conditions are mutually exclusive. In this regard, the threshold of "revenue" and the "users" in India will be decided after consultation with the stakeholders. Further, it is also clarified that unless corresponding modifications to PE rules are made in the DTAAs, the cross border business profits will continue to be taxed as per existing treaty rules.

Practically, both the above amendments would be applicable only to non-treaty jurisdictions until the entry into effect of the MLI; even post-MLI applicability to treaty jurisdictions would depend on the extent to which the respective DTAA gets modified.

The above amendments proposed in the Finance budget 2018 were brought into force by the Finance Act, 2018.

In his 2018 budget speech, the Hon'ble Finance Minister, Shri. Arun Jaitley, commented on the power of digital economy and remarked that

"108. *Global economy is transforming into a digital economy thanks to development of cutting edge technologies in digital space – machine learning, artificial intelligence, internet of things, 3D printing and the like. Initiatives such as Digital India, Start Up India, Make in India would help India establish itself as a knowledge and digital society.*

109. Combining cyber and physical systems have great potential to transform not only innovation ecosystem but also our economies and the way we live."

It was also expressed that the block chain technology chain is useful as it allows the organisation of any chain of records or transactions without the need for intermediaries and the Government will explore the use of block chain technology proactively for ushering in the digital economy. While this was recognized, it was categorically announced that the Government does not consider crypto-currencies as legal tender or coin and will take all measures to eliminate use of these crypto-assets in financing illegitimate activities or as part of the payment system.

The concept of crypto currency is a new concept giving rise to new taxation issues. The next chapter deals with the most popular form of crypto currencies, namely, the Bitcoins. An attempt has been made to briefly discuss the taxation issues of Bitcoins.