CHAPTER 2

TAXATION OF ELECTRONIC COMMERCE

1. Should e-commerce be taxed?

E-commerce as generally defined covers transactions involving offer and acceptance on networks. Mode of delivery and payment may be in digitised form or in traditional manner.

The Committee considered the view that e-commerce should be exempt from direct taxation, even if for a period of time, on the ground that it will enable its unhindered growth. After due deliberations, the members of the Committee had no hesitation in coming to the conclusion that exempting e-commerce from direct taxation is a non-issue.

Exempting e-commerce creates horizontal inequity as an enterprise earning income from business carried on in traditional manner would be taxed while another earning the same income from same business carried on by using networks would pay no tax. For instance, a bookshop, which retains traditional style, will pay tax on its profits. But, another using a website to advertise inventory and taking orders online would not be paying any tax even if the mode of delivery of books and payment remains traditional. There is also vertical inequity in exempting e-commerce from tax. Generally, those better off are more likely to switch over to e-commerce. Also, the very rationale of change to e-commerce for any enterprise is greater efficiency through accessibility to wider markets and cutting of costs. Unlike previous technological breakthroughs, like electricity, information technology boosts efficiency in almost everything from design to

marketing to accounting and in every sector of the economy. It cuts cost of procurement, cost of processing transactions as also delivery costs for products and services delivered electronically, eg software, financial services and music. For the banks, the transaction cost reduces substantially with online banking. Increased efficiency through supply chain management and thus reduction in inventories, cutting down of intermediaries, etc also add to the profitability. Tax exemption for e-commerce would, therefore, result in those conducting business in traditional manner and earning less profit being taxed whereas those switching over to e-commerce and earning higher profit being exempt from tax.

The argument that tax exemption is justified to ensure unhindered growth of e-commerce lacks force as any economic activity, and not just e-commerce, would, in theory, grow faster if it is tax exempt. Tax exemption could perhaps be justified in case taxation is shown to be a constraint to the healthy growth of e-commerce. The discussion in the previous chapters clearly indicates that e-commerce has achieved unparalleled growth not only in the developed countries but also in a large number of developing countries including India. A Goldman Sach's study expects average annual growth in e-commerce in India at 246 percent, higher than any other Asian nation and Australia. A NASSCOM survey also expects e-commerce in India to grow from US$ 27.87 million in 1998-99 to US$ 255.3 million in 2000-2001 and be between US$ 5.7 and 13.4 billion by 2008. Clearly, the growth in e-commerce has been impressive and is expected to be even better in future. Taxation has not been a constraint in its growth in any of the countries.

The constraints identified for India in the Goldman Sach's study are:

- Weaknesses of distribution and payment systems;
- High telephone charges;
- High cost of Internet access; and
- High costs of leasing domestic and international lines.

There is no mention of taxation in this context.

The view that cries of 'no new tax on Internet', which may make sense have sometimes given way to demands for 'no tax on Internet' which generally do not have a sound basis. The three year ban on 'New internet taxes' by the Internet Tax Freedom Act (passed in 1998) in United States is sometimes misrepresented as no tax for three years and cited as a precedent to be followed in India to permit unhindered growth of e-commerce. Tax incentive based on 'infant industry argument' is not acceptable as e-commerce is 'up and running as fast as any other economic infant in history'. Also 'infant industries' granted preferential tax treatment typically never grow up. Temporary preferential treatments tend to become permanent. The Indian Income tax Act, 1961 ("the Act") has many such examples. The fiscal incentives for exports being one, which are now being rolled back in a phased manner. Also, tax exemption for e-commerce would be totally against the current reform process, as also the recommendations of Raja Chelliah Committee on Tax Reforms 1991, of reducing tax

shelters and the tax rates. It cannot, therefore, be supported.

In the 1997 International Fiscal Association ("IFA") Congress held at Delhi, David R Tillinghast, the then Chairman of the Permanent Scientific Committee of the IFA rejected the suggestion for tax exemption on the ground that in e-commerce 'the margins are high and base is big'. The same point is made by Charles Maclure of the United States while asserting that it is important to tax e-commerce like any other commerce as a significant and rapidly growing amount of revenue is at stake. Considering that e-commerce in India is expected to exceed US$ 5.7 billion in 2008, the country can ill afford to forego revenue on such a large base.

The Committee also notes that tax exemption for e-commerce can create administrative chaos. For any business can be converted to e-commerce by simply having offer and acceptance through a network without in any way affecting the mode of delivery and payment. In the example of the bookshop cited earlier, it will be possible to claim exemption by having a website and insisting that the customers place their orders through the website by using a PC which may be located in the shop itself. So the customer will browse the available stock and make a selection exactly as before. But, instead of asking the salesman to get him the book, he will be required to book the order through the website by using the PCs available in the shop itself. The action of going to the cash and delivery counters to make the payment and take delivery may remain unchanged. Clearly, this will provide an easy opportunity for tax avoidance.

It is also relevant that none of the countries have introduced legislation exempting e-commerce from direct taxation. In fact, the documents circulated by the OECD, as also the papers produced by the Revenue authorities of countries like UK, Canada and Australia highlight the need for ensuring neutrality of taxation between commerce carried on through networks and commerce carried on in traditional manner.

The Committee considered the argument that in case of Internet Service Providers ("ISPs") huge investments are required and there is a long period of gestation before profits start coming. Since growth of ISPs is crucial for development of e-commerce, tax incentives should be considered for ISPs. The Committee noted that income tax is levied only when profits are earned. In determination of taxable income, investments are tax deducted over a period. There is an overwhelming opinion against tax exemptions even in such cases. The Committee is, therefore, not in favor of any such tax incentives.

In view of the foregoing, the Committee is of the view that there is no case for exempting e-commerce, in any form, from direct taxation under the Act. The focus has to be on how to tax e-commerce efficiently keeping in view the basic principles of taxation.

2. Policy guidelines

The Committee on Fiscal Affairs set up by the OECD has recommended following five aspects as key to formulating tax policy relating to e-commerce:

- Neutrality;
- Efficiency;
- Certainty and simplicity;
- Effectiveness and fairness; and
- Flexibility.

It is accepted by all countries that **international consensus** is a must for evolving a coherent tax policy relating to e-commerce. A large number of countries, including some members of the OECD, also recognise the likely adverse effect on tax base of countries as a result of the advances in communication, technology and emergence of networks. There is, therefore, concern **that** the **integrity of the tax base must be protected** or the existing **equilibrium in revenue sharing** among countries of residence and countries of source must be maintained. UK and Canada, both members of the OECD, are amongst the countries whose Revenue authorities have expressed concern for the integrity of tax base with the emergence of e-commerce. These two aspects have been considered by the Committee along with the five principles enunciated by the Committee on Fiscal Affairs of the OECD as mentioned earlier.

(a) Neutrality

The focus is on neutrality of taxation of e-commerce with respect to commerce carried on in traditional manner. This is necessary in the context of equity as well as administrative simplicity. The Committee has no hesitation in endorsing this principle as an essential part of the policy relating to taxation of e-commerce.

(b) Efficiency

This is the basic principle of any taxation be it direct or indirect, levied on e-commerce or traditional commerce. The emphasis has to be to minimise distortions in business decisions and to ensure that compliance and administrative costs are minimum.

The complexity created in the manner of doing business though Internet or other networks may require new principles being put in place. These would certainly require new measures to take care of enforcement issues. The Committee is of the view that while formulating new principles or enforcement strategies to meet the new challenges the effect on compliance costs for the taxpayer and the cost of administration must be kept in view.

(c) Certainty and simplicity

Taxpayer should be able to anticipate the tax consequence of every transaction as it is crucial to business decisions. The Committee agrees that the approach to taxation of e-commerce should ensure such clarity even in the interim while the process of reaching international consensus on issues specific to e-commerce is being attempted.

(d) Effectiveness and fairness

Emphasis is on raising right amount of tax at right time and the need to minimise evasion and avoidance opportunities. E-commerce offers new avenues for evasion and avoidance. The Committee agrees that this has to be kept in view while formulating new rules and devising enforcement strategies.

(e) Flexibility

Clearly in a scenario of fast developing technologies and changing manner of doing business, the policies which are formulated have to be flexible and need to keep pace with changes in the manner of doing business as a result of advances in technology. The Committee also endorses this view.

In the context of tax policy making, specific to e-commerce in India, following issues need to be emphasised:

(a) Neutrality

As discussed earlier there is no case for exempting e-commerce from direct taxation. However, it will be important to ensure parity in the tax treatment with similar transactions conducted in traditional manner. Thus, if exports are exempt or subject to reduced tax for traditional commerce there will be a case for similar exemption for exports through e-commerce. The Committee, however, strongly recommends that the roll back of incentives as proposed should be strictly implemented.

(b) Equilibrium in revenue sharing

This is the most significant aspect of international taxation from the point of view of countries which are net importers of technology, goods and services. It is generally accepted that source taxation will become difficult in e-commerce. This aspect has been highlighted by Argentina's report to IFA while recommending non-exclusive source based taxation rules for both ISPs and content providers. The Department of Finance in Canada also recognises that e-commerce is likely to impact the current balance that exists between residence and source taxation. While participating in OECD work, it has undertaken to ensure that the integrity

of tax base is protected and that a fair sharing of tax revenue is achieved. The concern for shrinking tax base in importing countries is forcefully highlighted by Professor Chang Hee Lee of Seoul National University of Law, who is of the opinion that 'maintenance of existing rules and concepts benefits the countries that export goods and capital'. Most of the developed countries, however, favour retaining the existing rules with only some suggesting liberal interpretation to ensure that the existing equilibrium is maintained. OECD does not mention maintenance of equilibrium as one of the key considerations while formulating policy on taxation of e-commerce.

The Committee is firmly of the view that maintenance of existing equilibrium between residence and source taxation is crucial to prevent shrinking of the tax base in source countries and has to be an important component of the policy relating to taxation of e-commerce in India.

(c) International consensus

There is widespread concern at the possibility of countries, or states in federal setups, levying absurd taxes to make up for the loss in revenue both in direct and indirect taxes. Instances of stretching definitions to characterise incomes as 'royalty' or 'fees for technical services' liable to withholding tax under accepted international norms are noted in many countries. This creates uncertainty in tax treatment of cross border transactions. The need for international consensus is

obvious if broad uniformity is to be ensured. For India, also the tax policy making process will have to focus on securing international consensus with its point of view. In this connection, structured participation in the activities of organisations like IFA and OECD where most of the work on taxation of e-commerce is being done is crucial to protecting India's interest.

Having considered the broad policy requirements of taxation of e-commerce, the Committee proceeds to discuss specific issues involved.

3. Domestic e-commerce

Domestic e-commerce does not raise any conceptual issues. There are issues relating to enforcement in view of the additional evasion and avoidance opportunities available to a willing taxpayer. The discussion of enforcement issues, in the context of cross border trade, will cover these aspects.

4. Cross border e-commerce

In case of cross border commerce, income derived by a person may be taxed in the 'source country' having connection with generation of income or in the 'country of residence' having connection with the person earning the income who is its resident and

enjoys the public goods and services offered in that country. Most of the countries tax income on both the basis. Broadly, a resident is taxed on his worldwide income with credit for taxes paid in source countries and the non-resident is taxed on the income arising in the country. Double taxation of same income may arise due to residence and source conflict and sometimes even due to conflict about the country of residence. Double Tax Avoidance Agreements ("DTAs") between countries are aimed at avoiding such double taxation. OECD Model Tax Convention ("Convention") lays down the principles involved in taxation of cross border commerce. Most of the countries follow the Convention. Yet, a number of complicated issues arise, leading to conflicts between countries even in traditional cross border commerce.

The complexities of taxing cross border commerce increased originally with advances in communication technology in 1980s. Easy communication including tele-conferencing made personal presence in a country for decision making or for marketing unnecessary. Directors living in different tax jurisdictions could discuss issues without moving from their places of residence. This complicated determination of 'place of effective management' necessary for determining residence jurisdiction over an enterprise. Improved communication also removed the need for physical presence in the source country even for transacting business of substantial volumes. With the Internet revolution of the 90s, determination of **residence jurisdiction** becomes even more complicated. It also makes the traditional co-relation between the extent of physical presence in the source country and the volume of business non-existent. This is particularly so for services, entertainment, music and software industries as delivery can

be in digitised form. Absence of a permanent establishment ("PE") in the source country raises fears of revenue erosion in net importing countries and demand for **abandoning the concept of PE**. Delivery in digitised form makes **characterisation issues** complicated resulting in tendency among countries to characterise incomes in a manner so as to justify withholding of tax as permitted under the Convention or by common practice. The increasing tax competition, easy accessibility of tax havens and new evasion opportunities raise fears of shrinking tax base and **chaos in enforcement of tax laws.** The new technology makes national borders irrelevant. With access to worldwide markets available even to small businesses the problems arise for a large number of enterprises and involve significant and fast increasing volumes of cross border commerce. Each of these issues are discussed in the following paragraphs alongwith the views of the Committee.

4.1 Residence based taxation

Article 4 of the Convention deals with the concept of residence. In case of individuals, it is the personal attachment to a country, which gives it the right to tax. Most of the countries, including India, determine residence of a person on the basis of the period of stay in the country. Paragraph 3 of Article 4 of the Convention provides that in case there is a tie in determining the residence of a non-individual assessee, the non-individual shall be deemed to be a resident only of the state in which its 'place of effective management' is situated. Under the Act, a company is a resident in India in any previous year if it is an Indian

company, ie a company formed and registered under Companies Act, 1956 ("Co Act") or any other law earlier in force in any part of India or if during that year the control and management of its affairs is situated **wholly** in India (may include a company formed and registered under the law of any other country).

'Place of effective management' is not defined in the Convention. Paragraph 24 in the Commentary on Article 4 of the Convention, which was included in the year 2000 update to the Commentary, indicates that for determination of the effective place of management, no definite rule can be given and that all relevant facts and circumstances would need to be examined. It, however, clarifies that 'the effective place of management' would be where key management and commercial decisions necessary for conduct of the business of the enterprise are taken. The commentary rejects purely formal criteria like registration in deciding the conflict of residence between two nations. With the growth of e-commerce, place of registration of a company has become even more irrelevant than before. The advances in communication technology makes it possible for directors sitting in different countries to easily, and simultaneously, communicate with each other through video-conferencing. It is no longer necessary for the Boards to meet at a fixed place as was the practice in the past. This makes the determination of the 'place of effective management' extremely complicated.

A draft paper circulated by OECD in February, 2001 titled "The Impact of the

communications revolution on the application of 'place of effective management' as a 'tie-breaker rule' points out that even though the term 'place of effective management' is not defined in the Convention many commentators are influenced by the concepts used in domestic laws such as 'central management and control' used in the Australian Income Tax Act, 1936 and 'place of management' adopted by a number of treaty countries. Some countries like Switzerland use the concept of ' place of effective management' in their domestic laws. According to the draft paper, court decisions in Australia define the 'place of central management and control' as one where directors of the company exercise their power and authority. The factors taken into account include the place of incorporation, place of residence of shareholders and directors, place where business operations take place, place where financial dealings of the company occur and the place where the seal and the minute book of the company are kept. In Switzerland, 'place of effective management' is distinguished from the place where merely administrative decisions are taken. Under the German laws, the 'place of management' is not where the management directives take effect but the place where these are given. Where this can not be determined, the place of residence of top manager may determine the residence of the company. What is relevant is the place where high level decisions are taken. If persons other than the directors on the board of a company perform this function, the relevant place is where those other persons take their decisions. This paper points out that with the advance in technology and use of video-conferencing or the electronic discussion group applications available via the Internet, it is no longer necessary for directors or

other top managers to be located or meet at one place to take decisions. The decision-makers may, therefore, be located all over the world. Similarly, the top manager of the company may be taking the decisions while on move. Another possibility could be where the company is treated as resident in two countries and the place of effective management lies in a third country.

The draft paper suggests four alternatives to resolve the issue of a satisfactory tie- breaker rule, which gives unique solution in all the cases and not just for most of the cases. These are:

- Replace the 'place of effective management' concept;
- Refine the 'place of effective management' test;
- Establish a hierarchy of tests so that if one test does not provide a solution the next applies; or
- A combination of the second and third alternatives.

The Committee is of the view that there is no real alternative to the concept of 'place of effective management', which should continue to be used. It is not possible to set down a single rule. The 'place of effective management' has to be determined on the basis of facts and circumstance of each case. The existing concept gives an unique solution in most cases. Where in the case of a globally integrated enterprise, no unique solution is available through the concept of 'place of effective management', the solution could be 'source

based' taxation only. The provisions of the Act and the DTAs do not require any change.

4.2 Source based taxation

Source based taxation depends on the connection between a country and the generation of income. Thus, a business may be carried on in the country or income may be accruing from investments located in that country. Business income is taxable only if an enterprise maintains a PE in the country. Generally income from 'royalty' and 'fees for technical services' are subject to withholding tax in the source country under the treaties. Income from 'services' is taxed in the country where the service is provided and not where it is delivered or utilised. Taxation of income in the source country, therefore, depends on the existence of PE and characterisation of income. Both these aspects are seriously affected by growth of e-commerce.

With the emergence of Internet, the need for physical presence in the source country does not exist even where the volume of business is large. This has resulted in fears of shift in the existing equilibrium in revenue sharing between the residence and source countries, to the disadvantage of source countries. The concept of PE is, therefore, under challenge from such countries. E-commerce also creates problems in characterisation of income where the delivery is in digitised form. This again affects the revenue of the source countries. These

issues have been discussed in the following paragraphs.

4.2.1 PE

Article 7 of the Convention provides for taxation of profit of an enterprise of a contracting state only in that state unless the enterprise carries on business in the other contracting state through PE situated therein. This Article further lays down that there shall, in each contracting state, be attributed to that PE, the profits, which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly and independently with the enterprise of which it is a PE.

PE signifies a geographically 'fixed place of business' established with the intention of continuing for some period of time for conducting the 'core functions' of the enterprise and not just to perform ' preparatory' or 'auxiliary' activities defined in paragraph 4 of Article 5 of Convention. Provision of communication link like telephone lines between suppliers and customers, advertising, relaying information through mirror servers, gathering data, supplying information, etc are regarded as preparatory or auxiliary activities. When only such activities are performed and the 'core business functions' of the enterprise are not performed there is no PE. There are disagreements regarding what constitutes 'core functions'. For instance, sale functions by themselves are considered 'core functions' by some countries whereas others consider actual

selling of the product as 'core function'. PE is defined in DTAs but the domestic tax laws do not generally refer to PE.

The draft discussion paper issued by the OECD in October, 2000 conveys the belief of the Committee on Fiscal Affairs of the OECD that '*the principles which underline the OECD Model Tax Convention are capable of being applied to electronic commerce'*. At the same time, it mandated the TAG on "Monitoring the application of existing norms for the taxation of business profits" to, amongst other things, consider and comment on whether the concept of PE provides appropriate threshold for allocation of tax revenues between source and residence countries. It also required the TAG to consider whether there is need to have special rules for e-commerce and if so whether such rules would be a viable alternative to the existing international norms.

The views of the most of the developing countries are clearly in favour of a change. According to Professor Chang Hee Lee 'maintaining existing rules and concepts benefits the countries that export goods, services and capital'. Also, the rule that business profits are not taxable without PE in the source country pre-supposes that any massive sales are not possible without a PE. It is also implicitly presumed that without sales activity in a country no sales are possible. This is no longer the case with the advance in communication technology and emergence of Internet and other networks.

The views of the OECD on what may be regarded as PE in an e-commerce situation, are as follows:

- **Web site of the enterprise**

  Website by itself does not have any tangible property. Its exact location is also unknown. Accordingly, the website by itself cannot be treated as PE.

- **Server hosting the website of the enterprise**

  The server on which the website is hosted would be a PE provided it constitutes a 'fixed place'. Also, the activities carried on through the web site hosted on it relate to the 'core functions' of the business of the enterprise and are not merely preparatory or auxiliary in nature. The server must be 'at the disposal of the enterprise'. Server of an ISP hosting the website of the enterprise would not constitute a PE of the enterprise as it is not 'at the disposal of the enterprise'. It is the ISP, which controls and operates the server. If, however, the server is owned or leased by the enterprise owning the website then it is 'at the disposal' of the enterprise and would constitute a PE.

- **Computer equipment not requiring human intervention and which undertakes complete business transactions within the given framework**

  Such computer equipment constitutes a PE if the equipment is located at 'fixed place' and the functions performed are 'core functions' of the enterprise.

- **ISPs**

  ISPs generally provide services to a number of enterprises. These typically do not have authority to conclude contracts on behalf of the enterprise. ISPs can not be treated as either a PE or a 'dependent agent' of the enterprise.

- **Telecommunication company infrastructure or postal system or local exchange number**

  Mere use of telecommunication company infrastructure or postal system or local exchange number in the source country by an enterprise, which does not own or lease these facilities, does not make these a PE or a 'dependent agent' of the enterprise since the functions performed are only auxiliary in nature.

- **Software agent, which can conclude contracts within given parameters**

  This does not constitute a PE as it does not have any tangible property and is not a 'person'. Also, its location is not known. Where it can be downloaded on the computer of the customer and therefore the location is known, the position will not change as it still does not have any tangible property.

The Committee has carefully considered the views of the OECD. It is inclined to agree that the views taken are consistent with the existing rules and principles. However, the Committee is constrained to point out that treating the server which hosts the website, is at the disposal of the enterprise and performs 'core business functions' of the enterprise as PE will not address the crucial issues arising from growth of e-commerce. Treating the server as PE will not create certainty of tax burden or ensure maintenance of the existing equilibrium in revenue sharing between countries of residence and source.

More than one server may be used by the enterprise making the location of the server actually performing specific functions in the source country difficult to determine. The location of the server is easy to manipulate. There is nothing to

prevent it being located in a low tax jurisdiction or a tax haven and not in the source country. Even if the server is located in the source country, in e-commerce huge volume of transactions can be conducted without any requirement of office and staff in the source country. The attribution of income to the PE and taxation in the source country, in terms of Article 7 of the Convention, would be negligible. The paper titled 'Attribution of profit to a permanent establishment involved in electronic commerce transactions' circulated by the OECD, in February, 2001, concludes that, in the context of standalone computer servers, the analysis is likely to show that 'it is performing only the routine functions and is reliant on other parts of the enterprise to provide the intangible assets necessary for it to perform most, if not all, of those functions'. Accordingly, the activities of the PE are very unlikely to warrant it being attributed with a substantial share of the profit associated with the distribution activities of the enterprise conducted through the server. It is only where the server and the website are developed in the source country that a more substantial attribution of profits to the PE will result.

In light of the above, the Committee is of the view that applying the existing principles and rules to e-commerce situation does not ensure certainty and reasonable allocation of revenues between residence and source countries. The Committee is also firmly of the view that there is no possible liberal interpretation of the existing rules, which can take care of these issues, as suggested by some countries. The Committee, therefore, supports the view

that the concept of PE should be abandoned and a serious attempt needs to be made within the OECD or the United Nations to find an alternative to the concept of PE.

4.2.2 Alternative to PE

The concept of PE and the principles of taxation in the source country are given in Articles 5 and 7 of the Convention. These form the basis of most DTAs between countries. The domestic tax laws generally do not refer to PE. For instance, foreign enterprises are taxed in India on the basis of 'income accruing or arising or deemed to accrue or arise in India'. Income accruing directly or indirectly from any 'business connection' or through property or assets or source of income in India or through transfer of capital asset situated in India is 'deemed to accrue or arise in India'. 'Income accruing in or derived from the country', or, 'received in the country' from outside is taxable in Malaysia and Singapore. In Hong Kong, a corporation or individual is liable to tax if it carries on 'trade, profession or business' in Hong Kong. In USA, taxability arises if the foreign enterprise carries on 'trade or business' in the country.

The fundamental principle of taxation of foreign enterprises may be traced in the following observations in the case of **McCulloch vs. Maryland**, in USA:

"All subjects over which the sovereign power of a state extends, are, objects of

taxation; but those over which it does not extend, are upon the soundest principles, exempt from taxation. This proposition may almost be pronounced self-evident".

The US Supreme Court quoted this decision in the case of **Piedras Negras Broadcasting Co**. In the instant case a Mexican company had no office or business place in US. It broadcasted programs from Mexico for US listeners. The court held that 'collection of advertising proceeds within the US' did not determine the source of income and did not constitute conduct of 'trade or business in US'.

India is perhaps the only country to have court pronouncements on the direct tax issues arising out of cross border trade between independent states and British India. Before independence, the Allahabad High Court considered the scope of words 'business connection' in a case where cloth manufactured in an independent state was sold in a part of what was then the British India. The sale was through brokers who were not the employees of the enterprise and who were not canvassing only for the enterprise. The Court held that that there was no 'business connection' in British India. The Supreme Court defined the scope of 'business connection' in the case of a French textile company in following words:

'*When there is a continuity of business relationship between the person in British India who helps to make the profits and the person outside British India who*

receives or realises the profits, such relationship would constitute a 'business connection.'

The Act also provides for taxation of only on that part of income as is "reasonably attributable" to the operations carried on in India. Where such income from any 'business connection in India', cannot be ascertained, the rules permit estimation on the basis of a reasonable percentage of turnover or a part of profit 'in the ratio of receipts accruing in India to total receipts of business'.

Thus, most of the international commerce is taxed in the source countries only on the basis of existence of PE in terms of the Convention through the mechanism of DTAs. But, the domestic tax laws of countries do not refer to PE. The Act refers to income derived from 'business connection' and the US refers to income derived from 'trade and business carried out in US'. Also, the turnover accepted as the basis of estimation of profits 'accruing or arising in India'. The PE concept is, therefore, not the only concept invoked by countries across the world for taxation of income of foreign enterprises. It, however, remains the most widely accepted.

The PE concept emerged in traditional commerce as it was not possible to carry on business of any significant size without having physical presence in the source country. Where there was no physical presence the level of business was too low to be of concern for taxation purposes. The revolution in telecommunication

technology changed that. And now, with the Internet it is possible to transact huge business without moving out of the country of residence. The argument that in such a situation there is 'no PE' and therefore no value addition in the source country and hence no source taxation is being questioned. It can be argued that the supply side alone does not create value without there being demand. The existing rule which makes the right to tax, by the source state, dependent only on the existence of PE has, therefore, no rational basis in the era of e-commerce. Even though the turnover in the source country appears to be a possible alternative for determining the threshold for taxation of foreign enterprises the Committee has not come across any suggestion on these lines.

In a paper presented at the Asia Regional Conference on 'E-Commerce and International Taxation', organised by IFA in November, 2000, Professor Richard L Doernberg of the University School of Law, Atlanta took note of the concerns of the importing countries over erosion of tax base. According to him, the absence of consensus over what constitutes PE and characterisation of income, results in double taxation of income. In his paper, taxation of income streams in the source countries on the basis of the 'base erosion approach' is suggested, in case current efforts at achieving international consensus do not succeed. The suggested approach requires a low withholding tax on all remittances claimed as tax deductible by enterprises in the source country. The existing system of withholding tax, at the generally high rates of 10 to 20 percent on 'royalty' and 'fees for technical services' would be replaced by a

system of withholding tax at a low rate of, say, 3 percent on all tax deductible outflows including business incomes of foreign enterprise. Sales to individual customers and dividends will not be taxed in the source country. Enforcement will not be difficult as other incomes are being taxed on gross basis at present. Also, the importer in the source country would like to comply as otherwise he will have to pay tax by foregoing deduction. The paper suggests that the existing PE concept is preserved. In other words, if there is a PE the existing principles would continue to apply. Also, the foreign enterprise will have option of being taxed on its net income from operations in the source country.

The Committee is of the view that simultaneous application of the 'base erosion approach' and the existing principles would not be possible. As discussed earlier, the allocation of profits to PE in e-commerce situation will be negligible. The 'base erosion approach' will be easily avoided by the enterprises, if PE concept survives thus making it ineffective in achieving the objective for which it is recommended. The simultaneous existence of the PE concept also implies that the traditional commerce will get taxed differently as compared to e-commerce. This goes against the principle of neutrality.

The option of being taxed on the net basis if given to the foreign enterprises, as suggested in the paper, will also be difficult to implement. Attribution of profits to the business operations in the source country would be difficult. Conceptually, taxing the margin between wholesale value and the manufacturing and other costs

in the country of residence, and the balance in the source country, as suggested in the paper, makes good sense. But the actual working will involve complicated pricing issues. Also, collection of tax will have to be through withholding. Self-assessment and payment of advance tax will not work for an enterprise not having any physical presence in the source country. The only available basis for quantification and withholding of tax would be the turnover in the source country. It will be administratively simpler if withholding at low rates on turnover is final withholding, as in the case of incomes other than 'business income'.

The alternative to PE as discussed above will need international consensus before it can be implemented. For the country of residence, it may appear attractive as the present high tax rates will reduce substantially. The source country will have a much larger base to tax even though the tax rates will reduce. For the enterprise, it will provide certainty regarding the burden of taxation. Also, the dead weight loss in the taxpayer or the tax administration trying to color the nature of transaction to suit their respective interests would be avoided. Though not entirely equitable, it will be as good a trade-off between equity and administrative ease as any other presumptive tax.

The Committee is of the view that theoretically the 'base erosion approach' as discussed may offer an alternative provided:

- **The concept is applied to all commerce and not just e-commerce;**

- **The tax is implemented through a low withholding tax; and**
- **Preferably the withholding tax is final without the option of tax on net income being given to the taxpayer or the tax administration.**

Theoretically, it would seem that the erosion of tax base in an e-commerce situation, with the existing concept of PE, would be taken care of by accepting the 'base erosion' approach. However, a careful study of the trade data and the ground realities is required to see whether a real life tax based on 'base erosion approach' will actually ensure a more equitable sharing of revenues between countries of residence and source. In a real life tax based on this approach it may not be possible to tax all outflows eroding the tax base. Taxation of outflows, which even in traditional commerce, carried on long before the emergence of e-commerce, were not taxed, as no PE existed, would be difficult to justify or implement. In India, for instance, oil or fertilizer imports are so sensitive for the economy that it may be impossible to tax such goods. The tax may also be perceived as a transaction tax and therefore resisted. Exports will get taxed abroad thereby eroding the tax base within the country. The overall impact on the tax base in the event of change is, therefore, not all that clear. Before considering the 'base erosion approach' as a possible alternative to the PE concept, it is necessary to study the trade data carefully to ascertain if, and to what extent, there will be erosion or potential erosion, of tax base in India with growth of e-commerce and to what extent the 'base erosion approach' takes care of the problem. This Committee has neither time nor resources to undertake such a

study. **It is, therefore, of the view that such a study should be undertaken immediately.**

The Committee is also of the view that pending the new consensus it will be meaningless to amend the Act or the DTAs to provide for definition of what constitutes a PE in an e-commerce situation. There will be too many possibilities of manipulation and too many qualifications to be administratively feasible to implement. The attempts by countries to minimise the actual or perceived erosion of tax base by deeming the existence of PE or characterising the nature of income as one subject to withholding tax no doubt creates confusion. But, these will also create the required urgency to arrive at a consensus. **The Committee also recommends that interaction at the international level should be made regular and structured.**

5. Characterisation of e-commerce payments

Different countries usually justify their claims to tax income either by reference to personal links that the recipient has with the country or by reference to economic links that the income has with that country. The criteria most commonly used to determine whether a person has sufficient personal links with the country to justify imposition of tax is whether or not he is resident in that country. Most countries, in addition to levying tax on persons who have personal links with the country also levy tax on income which has

economic links with the country. Thus, countries not only levy tax on the worldwide income of their residents, but also levy tax on the income of non-residents who have a domestic source or situs. Taxation of income in the source country depends on its characterisation. Business income is taxed in the hands of a non-resident only if the non-resident were to have a PE in the source country. The income attributable to such PE alone is taxed. In case of royalty income, one view is that the country which provides the conditions for the research to be carried out should be entitled to tax the fruits of such research. On the other hand, the countries importing technology consider the source of royalties to be the place where the payer is resident. A third view taken by some is that royalties have their source where the technology is used.

Although the Convention provides for taxability of royalty income by the "Country of Residence" alone, most of the countries levy a withholding tax on royalty payments made by their residents. The DTAs between countries also generally accept the right of the source country to levy withholding tax on payment for 'royalty' and 'fees for technical services' by its residents. What constitutes 'royalty' or fees for technical services' liable to withholding tax in the source country is also a subject matter of conflict between nations. The definitions of 'royalty' and 'fees for technical services' in national laws do not always conform to the definition in the Convention. This justifies a contrary view being taken. Taxation of income through cross border trade depends on its characterisation. Taxpayers tend to colour the nature of income to minimise their tax burden whereas tax administrations tend to characterise it in a manner so as to maximise their revenues.

The TAG of OECD was asked to examine characterisation of various types of e-commerce payments under tax conventions with a view to providing necessary clarifications in the commentary. On March 24, 2000, the TAG released for comments a document describing 26 categories of e-commerce transactions and presenting the preliminary conclusions of the Group, their underlying analysis and classification for tax treaty purposes. After receiving comments from interested parties, the TAG released a revised document and included one more category of e-commerce transaction. After further analysis and considering comments received, the TAG finalised their report to Working Party No 1 of the OECD Committee on Fiscal Affairs, which has been released on February 1, 2001. The final report of the TAG includes 28 categories.

The Committee examined the view of TAG with reference to each of the 28 categories of income. The focus was to examine whether the views of the TAG were acceptable in terms of the Convention and whether these views are in line with the interpretation under the Act and two representative DTAs ie with the UK and USA, hereinafter referred to as India-UK DTA and India-US DTA respectively. While formulating its views the Committee has taken into account judicial pronouncements, wherever available.

Before proceeding with detailed discussion of each of the categories it will be appropriate to examine how 'royalty' and 'fees for technical services' are defined under the Act, DTAs and Revised Commentary on Article 12 of the Convention.

5.1 Definition of Royalty and Fees for technical services under the Act

5.1.1 Royalty

Explanation 2 to section 9(1)(vi) of the Act defines 'royalty' to be:

"Royalty" means consideration (including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head "Capital gains") for-

(i) the transfer of all or any rights (including the granting of a license) in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property;

(ii) the imparting of any information concerning the working of, or the use of, a patent, invention, model, design, secret formula or process or trade mark or similar property;

(iii) the use of any patent, invention, model, design, secret formula or process or trade mark or similar property;

(iv) the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill;

(v) the transfer of all or any rights, (including the granting of a licence) in respect of any copyright, literary, artistic or scientific work including films

or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films; or

(vi) the rendering of any services in connection with the activities referred to in sub-clauses (i) to (v).

5.1.2 <u>Fees for technical services</u>

"Fees for technical services" has been defined in explanation 2 to section 9(1)(vii) of the Act to be:

"Fees for technical services" means any consideration (including any lump sum consideration) for the rendering of any managerial, technical or consultancy services (including the provision of services of technical or other personnel) but does not include consideration for any construction, assembly, mining or like project undertaken by the recipient or consideration which would be income of the recipient chargeable under the head 'Salaries'.

5.2 Definition of Royalty and Fees for technical services under India-UK DTA:

5.2.1 Royalty

Paragraph 3 of Article 13 of the India-UK DTA defines "royalty" to be:

(a) *payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematograph films or work on films, tape or other means or reproduction for use in connection with radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience; and*

(b) *payments of any kind received as consideration for the use of, or the right to use, any industrial, commercial or scientific equipment, other than income derived by an enterprise of a Contracting State from the operation of ships or aircraft in international traffic.*

5.2.2 <u>Fees for technical services</u>

Paragraph 4 of Article 13 of the India-UK DTA defines "fees for technical services" to be:

The term "fees for technical services" means payments of any kind to any person in consideration for the rendering of any technical or consultancy services (including the provision of services of technical or other personnel) which:

(a) are ancillary and subsidiary to the application or enjoyment of the right, property or information for which a payment described in paragraph 3(a) of this Article is received; or

(b) are ancillary and subsidiary to the enjoyment of the property for which a payment described in paragraph 3(b) of this Article is received; or

(c) make available technical knowledge, experience, skill, know-how or processes, or consist of the development and transfer of a technical plan or technical design.

5.3 Definition of Royalty and Fees for included services under India-US Treaty:

5.3.1 Royalty

Paragraph 3 of Article 12 of the India US DTA defines the term "royalty" to be:

(a) payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic or a scientific work, including cinematograph films or work on films, tape or other means of reproduction for use in connection with radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience including gains derived from the alienation of any such right or property which are contingent on the productivity, use or disposition thereof; and

(b) payments of any kind received as consideration for the use of, or the right to use, any industrial, commercial or scientific equipment, other than payments derived by an enterprise described in paragraph 1 of article 8 (Shipping and Air Transport) from activities described in paragraph 2(c) or 3 of article 8.

5.3.2 <u>Fees for technical services</u>

Paragraph 4 of Article 12 of the India-US DTA defines "fees for included services" to be:

"Fees for included services" means payments of any kind to any person in consideration for the rendering of any technical or consultancy services (including through the provision of services of technical or other personnel) if such services:

(a) are ancillary and subsidiary to the application or enjoyment of the right, property or information for which a payment described in paragraph 3 is received; or

(b) make available technical knowledge, experience, skill, know-how or processes, or consist of the development and transfer of a technical plan or technical design.

5.4 Definition of Royalty under Convention

An extract of the definition of 'royalty as outlined in Paragraph 2 of Article 12 of the Convention is highlighted below:

The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematograph films, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

Th definition of 'royalty' in India-UK DTA and India-US DTA are similar to the definition of 'royalty' contained in Convention except that the Convention **does not include *payments for the use of or for the right to use industrial, commercial or scientific equipment*** as part of royalty.

In characterisation of income the main conflict being whether the payment consitutes business income of the foreign exporter or royalty paid to it, a detailed discussion of the views of the OECD would be in order before to discussing individual categories. Paras 12 to 17 of the Revised Commentary on Article 12 of the Convention have been outlined below:

12. Whether payments received as consideration for computer software may be classified as royalties poses difficult problems but is a matter of considerable importance in view of the rapid development of computer technology in recent years and the extent of transfers of such technology across national borders. In 1992, the Commentary was amended to describe the principles by which such classification should be made. Paragraphs 12 to 17 were further amended in 2000 to refine the analysis by which business profits are distinguished from royalties in computer software transactions. In most cases, the revised analysis will not result in a different outcome.

12.1 Software may be described as a program, or series of programs, containing instructions for a computer required either for the operational processes of the computer itself (operational software) or for the accomplishment of other tasks (application software). It can be transferred through a variety of media, for example in writing or electronically, on a magnetic tape or disk, or on a laser disk or CD-ROM. It may be standardised with a wide range of applications or be tailor-made for single users. It can be transferred as an integral part of computer hardware or in an independent form available for use on a variety of hardware.

12.2 The character of payments received in transactions involving the transfer of computer software depends on the nature of the rights that the transferee acquires under the particular arrangement regarding the use and exploitation of the program. The rights in computer programs are a form of intellectual property. Research into the practices of OECD member countries has established that all but one protects rights in computer programs either explicitly or implicitly under copyright law. Although the term "computer software" is commonly used to describe both the program – in which the intellectual property rights (copyright) subsist – and the medium on which it is embodied, the copyright law of most OECD member countries recognises a distinction between the copyright in the program and software which incorporates a copy of the copyrighted program. Transfer of rights in relation to software occur in many different ways ranging from the alienation of the entire rights in the copyright in a program to the sale of a product which is subject to restrictions on the use to which it is put. The consideration paid can also take numerous forms. These factors may make it difficult to determine where the boundary lies between software payments that are properly to be regarded as royalties and other types of payment. The difficulty of determination is compounded by the ease of reproduction of computer software, and by the fact that acquisition of software frequently entails the making of copy by the acquirer in order to make possible the operation of the software.

13. The transferee's right will in most cases consist of partial rights or complete rights in the underlying copyright (see paragraphs 13.1 and 15 below), or they may be (or be equivalent to) partial or complete rights in a copy of the program (the 'program copy'), whether or not such copy is embodied in a material medium or provided electronically (see paragraphs 14 to 14.2 below). In unusual cases, the transaction may represent a transfer of "know-how" or secret formula (paragraph 14.3).

13.1 Payments made for the acquisition of partial rights in the copyright (without the transferor fully alienating the copyright rights) will represent a royalty where the consideration is for granting of rights to use the program in a manner that would, without such license, constitute an infringement of copyright. Examples of such arrangements include licenses to reproduce and distribute to the public software incorporating the copyrighted program, or to modify and publicly display the program. In these circumstances, the payments are for the right to use the copyright in the program (ie to exploit the rights that would otherwise be the sole prerogative of the copyright holder). It should be noted that where a software payment is properly to be regarded as a royalty there may be difficulties in applying the copyright provisions of the Article to software payments since paragraph 2 requires that software be classified as a literary, artistic or scientific work. None of these categories seems

entirely apt. The copyright laws of many countries deal with this problem by specifically classifying software as a literary or scientific work. For other countries treatment as a scientific work might be the most realistic approach. Countries for which it is not possible to attach software to any of those categories might be justified in adopting in their bilateral treaties an amended version of paragraph 2 which either omits all references to the nature of the copyrights or refers specifically to software.

14. In other types of transactions, the rights acquired in relation to the copyright are limited to those necessary to enable the user to operate the program, for example where the transferee is granted limited rights to reproduce the program. This would be the common situation in transactions for the acquisition of a program copy. The rights transferred in these cases are specific to the nature of computer programs. They allow the user to copy the program, for example onto the user's computer hard drive or for archival purposes. In this context, it is important to note that the protection afforded in relation to computer programs under copyright law may differ from country to country. In some countries the act of copying the program onto the hard drive or random access memory of a computer would, without a license, constitute a breach of copyright. However, the copyright laws of many countries automatically grant this right to the owner of software which incorporates a computer program. Regardless of whether this right is granted under law or under a license

agreement with the copyright holder, copying the program onto the computer's hard drive or random access memory or making an archival copy is an essential step in utilising the program. Therefore, rights in relation to these acts of copying, where they do no more than enable the effective operation of the program by the user, should be disregarded in analysing the character of the transaction for tax purposes. Payments in these types of transactions would be dealt with as commercial income in accordance with Article 7.

14.1 The method of transferring the computer program to the transferee is not relevant. For example, it does not matter whether the transferee acquires a computer disk containing a copy of the program or directly receives a copy on the hard disk of her computer via a modern connection. It is also of no relevance that there may be restrictions on the use to which the transferee can put the software.

14.2 The ease of reproducing computer programs has resulted in distribution arrangements in which the transferee obtains rights to make multiple copies of the program for operation only within its own business. Such arrangements are commonly referred to as "site licenses", "enterprise licenses", or "network licenses". Although these arrangements permit the making of multiple copies of the program, such rights are generally limited to those necessary for the purpose of enabling the operation of the

program on the licensee's computers or network, and reproduction for any other purpose is not permitted under the license. Payments under such arrangements will in most cases be dealt with as business profits in accordance with Article 7.

14.3 Another type of transaction involving the transfer of computer software is the more unusual case where a software house or computer programmer agrees to supply information about the ideas and principles underlying the program, such as logic, algorithms or programming languages or techniques. In these cases, the payments may be characterised as royalties to the extent that they represent consideration for the use of, or the right to use, secret formulas or for information concerning industrial, commercial or scientific experience which cannot be separately copyrighted. This contrasts with the ordinary case in which a program copy is acquired for operation by the end user.

15. Where consideration is paid for the transfer of the full ownership of the rights in the copyright, the payment cannot represent a royalty and the provisions of the Article are not applicable.

Difficulties can arise where there are extensive but partial alienation of rights involving;

- *exclusive right of use during a specific period or in a limited geographical area;*
- *additional consideration related to usage;*
- *consideration in the form of a substantial lump sum payment.*

16. *Each case will depend on its particular facts but in general such payments are likely to be commercial income within Article 7 or a capital gains matter within Article 23 rather than royalties within Article 12. That follows from the fact that where the ownership of rights has been alienated in full or in part, the consideration cannot be for the use of the rights. The essential character of the transaction as an alienation cannot be altered by the form of the consideration, the payment of the consideration in installments or, in the view of most countries, by the fact that the payments are related to a contingency.*

17. *Software payments may be made under mixed contracts. Examples of such contracts include sales of computer hardware with built-in software and concessions of the right to use software combined with the provision of services. The methods set out in paragraph 11 above for dealing with similar problems in relation to patent royalties and know-how are equally*

applicable to computer software. Where necessary the total amount of the consideration payable under a contract should be broken down on the basis of the information contained in the contract or by means of a reasonable apportionment with the appropriate tax treatment being applied to each apportioned part.

5.5 Analysis of the categories of payments outlined by the TAG

Each of the 28 categories of income are discussed below alongwith the views of the Committee.

Category 1: Electronic order processing of tangible products

Definition

The customer selects an item from an online catalog of tangible goods and orders the item electronically directly from a commercial provider. There is no separate charge to the customer for using the online catalog. The product is physically delivered to the customer by a common carrier.

TAG View:

The consideration paid by the customer clearly falls within Article 7 (Business Profits) rather than Article 12 (Royalty), since the payment is not for use of copyright.

India-UK DTA:

The payment is covered within the provisions of Article 7 (Business Profits) of the India-UK DTA.

India-USA DTA:

The payment is covered within the provisions of Article 7 (Business Profits) of the India-US DTA.

Act:

The consideration arising under the transaction will be taxable under the head 'Profits and gains of business or profession' on a net income basis.

Category 2: Electronic ordering and downloading of digital products

Definition

The customer selects an item from an online catalog of software or other digital products and orders the product electronically directly from a commercial provider. There is no separate charge to the customer for using the online catalog. The digital product is downloaded onto the customer's hard disk or other non-temporary media.

TAG View:

This category raises a fundamental characterisation issue, ie the distinction between business profits and definition of royalties under the treaty, which deals with payments for the use of, or the right to use, a copyright. In order to determine the character of income, one needs to identify the consideration for the payment. Where the consideration is for something other than the rights in copyright and the use of copyright is restricted to enable downloading, storage and operation on a customer's network or computer, such use of copyright should be disregarded, as provided for in paragraphs 12 to 14 of the Commentary on Article 12 of the OECD Model. It concluded that in the case of transactions that permit the customer to electronically download digitised products (such as software, images, sounds or text) for the customer's own use or enjoyment, the payment is made to acquire data transmitted in the form of a digital signal. Since this

constitutes the essential consideration for the payment, that payment cannot be considered as royalties since the same is not a payment made for the use or the right to use a copyright so as to constitute a royalty. To the extent that the act of copying the digital signal onto the customer's hard disk or other non-temporary media (including transfers to other storage, performance or display devices) constitutes the use of a copyright under the relevant law and contractual arrangements, this is merely an incidental part of the process of capturing and storing the digital signal. This incidental part is not important for classification purposes because it does not correspond to the essential consideration for the payment (ie to acquire data transmitted in the form of a digital signal), which is the determining factor for the purposes of the treaty definition of royalties.

India-UK DTA:

Since downloading of software or any other digital product involves granting of use or right to use a copyright of literary, artistic, scientific work or secret process, the payment in question is covered within the purview of Para 3(a) of Article 13 (Royalty) of the India-UK DTA.

India-USA DTA:

Since the consideration is towards granting of use or right to use a copyright of literary, artistic, scientific work or secret process, the consideration shall be covered under the

definition of Article 12 (Royalty) of the India US DTA.

Act:

The payment in question is covered by clause (i), (iii) or (v) of explanation 2 to section 9(1)(vi) of the Act which defines "royalty" to be inter alia consideration for granting of license for use of secret process or granting of a license in respect of literary, artistic or scientific work.

Category 3: Electronic ordering and downloading of digital products for purposes of copyright exploitation

Definition

The customer selects an item from an online catalog of software or other digital products and orders the product electronically directly from a commercial provider. There is no separate charge to the customer for using the online catalog. The digital product is downloaded into the customer's hard disk or other non-temporary media. The customer acquires the right to commercially exploit the copyright in the digital product (eg a book publisher acquires a copyrighted picture to be included on the cover of a book that it is producing).

TAG View:

The unanimous view within the TAG is that the payment qualifies as 'royalty' since the payment is made as consideration for the right to use the copyright in the digital product (since in the given example, the use takes the form of reproduction and sale for commercial purpose of the copyrighted picture).

India-UK DTA:

The payment qualifies as 'royalty' since the payment is for a right to commercially exploit the copyright in the digital product which is covered under the provisions of Article 13(3)(a) of the India-UK DTA.

India-USA DTA:

The payment qualifies as 'royalty' as defined under Article 12(3)(a) of the India-US DTA.

Act:

The payment will be covered by the definition of the term 'royalty' as provided for in clause (i), (iii) or (v) of explanation 2 to section 9(1)(vi) of the Act.

Category 4: Updates and add-ons

Definition

The provider of software or other digital product agrees to provide the customer with updates and add-ons to the digital product. There is no agreement to produce updates or add-ons specifically for a given customer.

TAG View:

The Group agrees that this category of transaction should be treated akin to transactions described in category 1 above and the payment made by the customer would be covered by Article 7 (Business Profits) if the updates and add-ons are delivered on a tangible medium. If the updates and adds-on are delivered electronically it should be treated? like the transactions described in category 2 above. Since transactions under both categories give rise to classification under Article 7 (Business Profits), payments under this category would also be classified under Article 7 (Business Profits).

India-UK DTA:

Since the provider of software or other digital product provides the customer with updates and add-ons to the original digital product, which is simply an extension of the

original process, its characterisation will be same as that of the original software or digital product ie royalties under Para 3(a) of Article 13 of the India-UK DTA.

India-USA DTA:

The position is the same as under India-UK DTA.

Act:

The position with reference to updates and add-ons will be same as that of the original software or digital product and comments on category 2 will apply ie the payment in question is covered by clause (i), (iii) or (v) of explanation 2 to section 9(1)(vi) of the Act, which defines 'royalty'.

Category 5: Limited duration software and other digital information licenses

Definition

The customer receives the right to use software or other digital products for a period of time that is less than the useful life of the product. The product is either downloaded electronically or delivered on a tangible medium such as a CD. All copies of the digital product are deleted or become unusable upon termination of the license.

TAG View:

The TAG unanimously agreed that under the OECD Model as currently worded, transaction should be treated exactly as transactions falling under categories 1 or 2 so that the payment to the commercial provider of the limited duration digital product would fall under Article 7 (Business Profits).

Also, if a particular convention includes a definition of royalties that covers “payments for the use of, or the right to use, industrial, commercial or scientific equipment”, the Group concluded that such payments cannot be considered as payments "for the use of, or the right to use, industrial, commercial or scientific equipment".

India-UK DTA:

Limited duration use does not affect characterisation and the position will be same as discussed in category 2 ie royalties under Para 3(a) of Article 13 of the India-UK DTA.

India-USA DTA:

The position is same as under India-UK DTA.

Act:

Limited duration use does not affect characterisation and the position is same as discussed in category 2 ie the payment in question is covered by clause (i), (iii) or (v) of explanation 2 to section 9(1)(vi) of the Act which defines royalty.

Category 6: Single-use software or other digital product

Definition

The customer receives the right to use software or other digital products one time. The product may be either downloaded or used remotely (eg use of software stored on a remote server). The customer does not receive the right to make copies of the digital product other than as required to use the digital product for its intended use.

TAG View:

Whilst some members view this type of transaction as contracts for services and others view them as being similar to the transactions referred to in categories 2 and 5 above, the Group unanimously agreed that payments made in these transactions fall under Article 7 (Business Profits).

India-UK DTA:

The right to use software or other digital products one time does not affect treaty characterisation. The position would be as discussed in category 2 above and the payment in question will qualify as 'royalties' under Article 13(3)(a) of the India-UK DTA.

India-USA DTA:

The position is the same as under the India-UK DTA.

Act:

The right to use software or other digital products one time does not affect characterisation. The position would be as discussed in category 2 above and the payment in question will qualify as 'royalties' under clause (i), (iii) or (v) of explanation 2 to section 9(1)(vi) of the Act.

Category 7: Application Hosting - Separate License

Definition

A user has a perpetual license to use a software product. The user enters into a contract with a host entity whereby the host entity loads the software copy on servers owned and operated by the host. The host provides technical support to protect against failures of the system. The user can access, execute and operate the software application remotely. The application is executed either at a customer's computer after it is downloaded into RAM or remotely on the host's server. This type of arrangement could apply, for example, for financial management, inventory control, human resource management or other enterprise resource management software applications.

TAG View:

The Group agrees that, under the current wording of the OECD Model Tax convention, this type of transaction would give rise to 'business profits' as defined under Article 7. Where, however, a particular convention includes a definition of 'royalty' that includes "payments for the use of, or the right to use, industrial, commercial or scientific equipment", the issue arises whether these words can be applied to all or part of the payments arising from these transactions. The Group concluded that these transactions should generally give rise to services income as opposed to rental payments. In a typical transaction, the vendor uses computer equipment to provide data warehousing services to

customers, owns and maintains the equipment on which the data is stored, provides access to many customers to the same equipment, and has the right to remove and replace equipment at will. The customer will not have possession or control over the equipment and will utilize the equipment concurrently with other customers. The Group also discussed whether payments arising in this type of transaction could be treated as payments for services of a "technical nature" under alternative treaty provisions that allow source taxation of "technical fees". To the extent that main service being provided is merely that of storing the data and software of customers, this service is akin to mere warehousing and the performance of that function does not require the direct exercise of any special technical skill or knowledge.

India-UK DTA:

Article 13 of the India-UK treaty defines 'royalty' to include payments for the use of or for the right to use industrial, commercial or scientific equipment. Therefore, application hosting would be covered under 'royalty' as defined in Article 13(3)(b) of the India-UK DTA.

India-USA DTA:

The position is same as under India-UK DTA since Article 12(3)(b) of the India-USA DTA also defines 'royalty' to include payments for the use of or for the right to use industrial, commercial or scientific equipment. In fact, on similar facts, the AAR

has taken the above view in the case of American Express Bank, reported in 238 ITR 296 (AAR).

Act:

Since the definition of 'royalty' under the Act does not include payments for the use of or right to use industrial, commercial or scientific equipment as part of royalty, application hosting may not fall under 'royalty' and instead be treated as 'business income'. However, the Finance Act, 2001 has amended section 9 of the Act to include 'use or right to use any industrial, commercial or scientific equipment' within the definition of the term "royalty" with effect from April 1, 2001 and accordingly the payment in question will be characterised as 'royalty' under the Act. However, a view may be taken that it may fall under 'fees for technical services' as hosting of software product is akin to rendering of technical services and the host is also providing technical support to protect against failure of the system.

Category 8: Application Hosting - Bundled Contract

Definition

For a single, bundled fee, the user enters into a contract whereby the provider, who is also the copyright owner, allows access to one or more software applications, hosts the software applications on a server owned and operated by the host, and provides technical

support for the hardware and software. The user can access, execute and operate the software application remotely. The application is executed either at a customer's computer after it is downloaded into RAM or remotely on the host's server. The contract is renewable annually for an additional fee.

TAG View:

The Group agrees that, under the current wording of the OECD Model, there would be no need to separate the payment described in this example as all of it would constitute business profits falling under Article 7. The need to separate the payment into various components could arise, however, when applying bilateral conventions that include alternative provisions referred to in the previous category. This would be the case to the extent that part of the payment relates to the provision of technical support for the software that would constitute services of a technical nature. In that case, that part would be treated differently from the parts relating to allowing access to one or more software applications and hosting such software applications as such functions do not require the application of special skills or knowledge (they essentially require owning the relevant equipment and software rights that are made available).

India-UK DTA:

Since the payment in question is a single bundled fee and the host allows access to the user, it may be covered by Article 13(3)(b) of the India-UK DTA as payment for the use

of or for the right to use industrial, commercial or scientific equipment as part of 'royalty'. However, if a bifurcation could be made for the usage of software of which the host is the copyright owner, that part of payment would be covered by the discussion in category 2 above.

India-USA DTA:

The position is same as under India-UK DTA. Decision of the AAR in the case of American Express Bank as reported in 238 ITR 296 (AAR) also needs to be kept in perspective.

Act:

Since the definition of 'royalty' under the Act does not include payments for the use of or right to use industrial, commercial or scientific equipment as part of 'royalty', application hosting may not fall under 'royalty' and be treated as 'business income'. However, the Finance Act, 2001 has amended section 9 of the Act to include 'use or right to use any industrial, commercial or scientific equipment' within the definition of the term 'royalty' with effect from April 1, 2001 and accordingly the payment in question will be characterised as 'royalty' under the Act.

However, as stated in category 7 above, a view may be taken that it may fall under 'fees for technical services' as hosting of software product is akin to rendering of technical

services and the host is also providing technical support for hardware and software. Further, if the payment could be bifurcated for the usage of software of which the host is the copyright owner, that part of payment will be governed by the discussion in category 2 outlined above.

Category 9: Application Service Provider ("ASP")

Definition

The provider obtains a license to use a software application in the provider's business of being an ASP. The provider makes available to the customer access to a software application hosted on computer servers owned and operated by the provider. The software automates a particular back-office business function for the customer. For example, the software might automate sourcing, ordering, payments and delivery of goods or services used in the customer's business, such as office supplies or travel arrangements. The provider does not provide the goods or services. It merely provides the customer with the means to automate and manage its interaction with third-party providers of these goods and services. The customer has no right to copy the software or to use the software other than on the provider's server, and does not have possession or control of a software copy.

TAG View:

As regards the payment made by the customer, the Group agrees that the issues arising are similar to those discussed under the preceding category ie category 8.

India-UK DTA:

Comments made in category 8 will apply mutatis mutandis.

India-USA DTA:

The position is same as under India-UK DTA and comments made in category 8 will apply mutatis mutandis.

Act:

Comments made in category 8 will apply mutatis mutandis.

Category 10: ASP License Fees

Definition

In the example above, the ASP pays the provider of the software application a fee which is a percentage of the revenue collected from customers. The contract is for a one year term.

TAG View:

The Group agrees that this type of transaction, being essentially for the provision of a software product to be used in the business of the transferee, is covered within within Article 7 (Business Profits). The Group acknowledged the fact that the ASP's customer will have access to the software copy hosted on servers owned and operated by the provider which may technically involve the ASP displaying to the customers some copyrighted information (eg forms for data input). The Group agreed, however, that if providing such access constituted the use of a copyright right by the ASP (for example a display or other right), such use of copyright would be such a minimal part of the consideration for the payment made by the ASP to the software provider that it should not be relevant for the treaty characterisation of that payment.

India-UK DTA:

Payment made by ASP to the owner of software for hosting it on computer servers amounts to consideration for the use or right to use of a copyrighted scientific work or secret process and the payment in question will be royalties under Article 13(3)(a) of the India-UK DTA.

India-USA DTA:

The position is same as under India-UK DTA.

Act:

Since payment made by ASP to the owner of software for hosting the software on its computer servers amounts to consideration for granting license for use of secret process or granting of a license in respect of scientific work the payment in question would qualify as 'royalty' as defined in clause (i), (iii) or (v) of explanation 2 to section 9(1)(vi) of the Act.

Category 11: Web site hosting

Definition

The provider offers space on its server to host web sites. The provider obtains no rights in the copyrights created by the developer of the web site content. The owner of the copyrighted material on the site may remotely manipulate the site, including modifying the content on the site. The provider is compensated by a fee based on the passage of time.

TAG View:

The Group agrees that, under the current wording of the OECD Model, this type of transaction gives rise to 'business profits' as defined in Article 7. The Group also notes that where a particular convention includes a definition of royalties that covers "payments for the use of, or the right to use, industrial, commercial or scientific equipment" or alternative treaty provisions that allow source taxation of 'technical fees', this type of transaction would not give rise to issues that are discussed under category 7, which deals with application hosting.

India-UK DTA:

Article 13 of the India-UK DTA defines royalty to include payments for the use of or for

the right to use industrial, commercial or scientific equipment. Accordingly, web site hosting fees would be covered under the definition of 'royalty' as defined in Article 13(3)(b) of the India-UK DTA.

India-USA DTA:

The position is same as under India-UK treaty since Article 12(3)(b) of the India-USA DTA defines 'royalty' to include payments for the use of or for the right to use industrial, commercial or scientific equipment.

Act:

Since the definition of 'royalty' under the Act does not include payments for the use of or right to use industrial, commercial or scientific equipment as part of 'royalty', web site hosting fees would not fall under 'royalty' and it may be categorised as 'business income'. However, the Finance Act, 2001 has amended section 9 of the Act to include 'use or right to use any industrial, commercial or scientific equipment' within the definition of the term 'royalty' with effect from April 1, 2001 and accordingly the payment in question will be characterised as 'royalty' under the Act.

However, it may be noted that if the treatment under the domestic law works out to be more beneficial to the assessee as compared to the treatment under the DTA, the assessee may choose to be governed by the domestic law.

Category 12: Software maintenance

Definition

Software maintenance contracts typically bundle software updates together with technical support. A single annual fee is charged for both updates and technical support. In most cases, the principal object of the contract is the software updates.

TAG View:

The Group concluded that the principles set out in paragraph 11 of the Commentary on Article 12 which deals with mixed contracts would apply to such transactions. Where, under those principles, part of the payment is regarded to be for the provision of technical support, the issues described in category 14 below as regards alternative treaty provisions that allow source taxation of 'technical fees' will arise.

India-UK DTA:

Payment for updates of software will be treated at par with providing software and would be treated in the manner as discussed in category 2 above ie Article 7 (Business Profits). In so far as technical support is concerned, the same shall fall under Article 13(4)(a) of the India-UK DTA as 'fees for technical services'.

India-USA DTA:

The position is same as under India-UK DTA.

Act:

Since updates are extension of the original process, the part of the payment for updates will be treated in the same manner as discussed in category 2 above ie Article 7 (Business Profits). Payment for technical support is for rendering technical services and will be categorised as 'fees for technical services' as per explanation 2 to section 9(1)(vii) of the Act.

Category 13: Data warehousing

Definition

The customer stores its computer data on computer servers owned and operated by the provider. The customer can access, upload, retrieve and manipulate data remotely. No software is licensed to the customer under this transaction. An example would be a retailer who stores its inventory records on the provider's hardware and persons on the customer's order desk remotely access this information to allow them to determine whether orders could be filled from current stock.

TAG View:

The Group agrees that, under the current wording of the OECD Model, this type of transaction gives rise to 'business profits' falling under Article 7. The Group also notes that where a particular convention includes a definition of royalties that covers payments for the use of, or the right to use, industrial, commercial or scientific equipment or alternative treaty provisions that allow source taxation of 'technical fees', this type of transaction would not give rise to the issues that are discussed under category 7, which deals with application hosting.

India-UK DTA:

Article 13 of the India-UK DTA defines 'royalty' to include payments for the use of or for the right to use industrial, commercial or scientific equipment. Accordingly, data warehousing on computer servers of a provider is covered under 'royalty' as defined in Article 13(3)(b) of the India-UK DTA.

India-USA DTA:

The position is same as under India-UK DTA since Article 12(3)(b) of the India-USA DTA defines 'royalty' to include payments for the use of or for the right to use industrial, commercial or scientific equipment.

Act:

Since the definition of 'royalty' under the Act does not include payments for the use of or right to use industrial, commercial or scientific equipment as part of royalty, data warehousing on computer servers of a provider will not be covered under royalty and it may be categorised as 'business income'. However, the Finance Act, 2001 has amended section 9 of the Act to include 'use or right to use any industrial, commercial or scientific equipment' within the definition of the term 'royalty' with effect from April 1, 2001 and accordingly the payment in question will be characterised as 'royalty' under the Act.

It may be noted that if the treatment under the domestic law is more beneficial to the assessee as compared to the treatment under the DTA, the assessee may choose to be governed by the domestic law.

Category 14: Customer support over a computer network

Definition

The provider provides the customer with online technical support, including installation advice and trouble-shooting information. This support can take the form of online technical documentation, a trouble-shooting database, and communications (eg by

e-mail) with human technicians.

TAG View:

The Group agreed that, based on this description and under the wording of the OECD Model, the payment arising in this type of transaction would fall within Article 7 (Business Profits). In reaching its conclusion, the Group discussed the extent to which the payment could be considered as a payment for "information concerning industrial, commercial or scientific experience" (know-how) so as to constitute royalties.

The Group agrees that online advice, communications with technicians and using the trouble-shooting database, would clearly involve actual services being performed on demand rather than the provision of know-how. Whilst the provision of technical documentation could, depending on the circumstances, constitute the provision of know-how, this would require that the information be "undivulged technical information" as described in paragraph 11 of the Commentary on Article 12. Also, as mentioned in the same paragraph, know-how "is necessary for the industrial reproduction of a product or process". To the extent that know-how must be technical information relating to industrial reproduction of a product or process, the Group considers that information that merely relates to the operation or use of products as opposed to their development or production would not fall under the definition of know-how. The Group notes that the remarks which deal with mixed contracts, would be relevant if the contract were considered to cover the provision of both services and know-how. The Group finally

discussed how the payment arising in this type of transaction would be treated under alternative treaty provisions that allow source taxation of "technical fees". Whilst the provision of online advice through communications with technicians may require the application of special skill and knowledge and might therefore constitute services of a technical nature, the mere provision of access to a troubleshooting database would not require more than having available such a database and the necessary software to access it. The part of the payment relating to the provision of such access would not, therefore, relate to a service of a technical nature.

India-UK DTA:

Since India-UK DTA provides for source taxation of technical fees and the provider provides online technical support, including installation advice and trouble-shooting information in the form of online technical documentation ie a trouble-shooting database, etc, the payment in question will fall within the purview of Article 13(4) of the India-UK DTA and classified as ‘fees for technical services’.

India-USA DTA:

The payment would be covered under ‘fees for included services’ since the definition of ‘fees for included services’ under the Article 12(4) of the India-USA DTA is similar to that contained in Article 13(4) of the India-UK DTA.

Act:

The payment in question will classify as payment for rendering technical services and accordingly shall fall within the purview of explanation 2 to section 9(1)(vii) of the Act ie 'fees for technical services'.

Category 15: Data retrieval

Definition

The provider makes a repository of information available for customers to search and retrieve. The principal value to customers is the ability to search and extract a specific item of data from amongst a vast collection of widely available data.

TAG View:

All members of the Group consider that the payment arising from this type of transaction would fall under Article 7 (Business Profits). Some of them reach that conclusion because, given that the principal value of such a database would be the ability to search and extract the documents, these members view the contract as a contract for services. Others consider that, in this transaction, the customer pays in order to ultimately obtain the data that he will search for. They therefore view the transaction as being similar to those described in category 2 and will accordingly treat the payment as business profits.

The Group also addressed the issue of whether these could be considered as services "of a technical nature" under the alternative provisions on technical fees previously referred to. The Group agreed that providing a client with the use of search and retrieval software and with access to a database does not involve the exercise of special skill or knowledge when the software and database is delivered to the client. The fact that the development of the necessary software and database would itself require substantial technical skills was found to be irrelevant as the service provided to the client was not the development of the software and database (which may well be done by someone other than the supplier) but rather making the completed software and database available to that client.

India-UK DTA:

Since the information provided by the provider is out of a vast collection of widely available data and not any copyrighted article, simple data retrieval would amount to rendering of services and would be taxable as business income under Article 7 of the India-UK DTA.

India-USA DTA:

The position is same as under India-UK DTA.

Act:

For the reasons enunciated above, the payment in question will be taxable as 'Profits and gains of business or profession'.

Category 16: Delivery of exclusive or other high-value data

Definition

As in the previous example, the provider makes a repository of information available to customers. In this case, however, the data is of greater value to the customer than the means of finding and retrieving it. The provider adds significant value in terms of content (eg by adding analysis of raw data) but the resulting product is not prepared for a specific customer and no obligation to keep its contents confidential is imposed on customers. Examples of such products might include special industry or investment reports. Such reports are either sent electronically to subscribers or are made available for purchase and download from an online catalog or index.

TAG View:

The Group agrees that these transactions involve the same characterization issues as those described in category 15. The majority therefore believes that the payment arising under

this type of transaction would be covered under Article 7 (Business Profits) and is not technical fees for the same reason.

India-UK DTA:

Comments made in category 15 would be applicable in this situation also.

India-USA DTA:

Comments made in category 15 would be applicable in this situation also.

Act:

Comments made in category 15 would be applicable in this situation also.

Category 17: Advertising

Definition

Advertisers pay to have their advertisements disseminated to users of a given web site. So called "banner ads" are small graphic images embedded in a web page, which when clicked by the user will load the web page specified by the advertiser. Advertising rates are most commonly specified in terms of a cost per thousand "impressions" (number of

times the ad is displayed to a user), though rates might also be based on the number of "click-throughs" (number of times the ad is clicked by a user).

TAG View:

All members of the Group agreed that the payments arising under these transactions would constitute 'business profits' falling under Article 7 rather than royalties, even under alternative definitions of royalties that cover payments 'for the use, or the right to use, industrial, commercial or scientific equipment'.

India-UK DTA:

Payments arising under these transactions would constitute 'business profits' as defined in Article 7 of the India-UK DTA.

India-USA DTA:

The position is same as under India-UK DTA and payments arising from these transactions would constitute 'business profits' falling under Article 7 of the India-US DTA.

Act:

Under the provisions of the Act, the payment would constitute 'Profits and gains of business or profession'.

Category 18: Electronic access to professional advice (eg consultancy)

Definition

A consultant, lawyer, doctor or other professional service provider advises customers through email, video conferencing, or other remote means of communication.

TAG View:

Again, all members of the Group agreed that the payments arising from these transactions would constitute 'business profits' falling under Article 7, rather than royalties. As already stated, the provision of on-demand advice is a service and not the supply of know-how. As these transactions involve the provision of services, the Group also addressed the issue of whether these could be considered as services "of a technical nature" under the alternative provisions on technical fees that have been previously referred to. The Group concluded that to the extent that the services were rendered by someone acting as a consultant, they would constitute services of a consultancy nature so as to fall within the definition of 'technical fees'.

India-UK DTA:

Article 14 dealing with Independent Personal Services under the OECD Model has been deleted with effect from April 29, 2000 and now the income derived from professional services or other activities of an independent character is dealt with under Article 7 as 'business profits'. Since the India-UK DTA specifically provides for Article 15 which deals with Independent Personal Services, the payment in question will continue to be governed by the same.

India-USA DTA:

The position is same as in India-UK DTA.

Act:

Under the provisions of the Act, the payment in question would constitute 'fees for technical services' under explanation 2 to section 9(1)(vii) as is also the alternative view of TAG.

Category 19: Technical information

Definition

The customer is provided with undivulged technical information concerning a product or process (eg narrative description and diagrams of a secret manufacturing process).

TAG View:

The Group agrees that payments arising from this category of transactions constitute royalties as they are for the supply of know-how, ie "for information concerning industrial, commercial or scientific experience."

India-UK DTA:

As the payment is towards consideration for information concerning industrial, commercial or scientific experience, the same would constitute 'royalties' as defined in Article 13(3)(a) of the India-UK DTA.

India-USA DTA:

The payment would constitute 'royalty' as defined in Article 12(3)(a) of the India-US DTA since the same is towards information concerning industrial, commercial

or scientific experience.

Act:

The payment will be covered by the definition of the term 'royalty' as provided for in clause (iv) of explanation 2 to section 9(1)(vi) of the Act.

Category 20: Information delivery

Definition

The provider electronically delivers data to subscribers periodically in accordance with their personal preferences. The principal value to customers is the convenience of receiving widely available information in a custom-packaged format tailored to their specific needs.

TAG View:

The Group agrees that this type of transaction would raise the same issues as those that are described under category 15 above. The members of the Group therefore consider that the payments arising from these transactions constitute business profits falling under Article 7 and are not technical fees for the same reason.

India-UK DTA:

Comments made in category 15 will be applicable in this situation also.

India-USA DTA:

Comments made in category 15 will be applicable in this situation also.

Act:

Comments made in category 15 will be applicable in this situation also.

Category 21: Subscription-based interactive web site access

Definition

The provider makes available to subscribers a web site featuring digital content, including information, music, video, games, and activities (whether or not developed or owned by the provider). Subscribers pay a fixed periodic fee for access to the site. The principal value of the site to subscribers is interacting with the site while online as opposed to getting a product or services from the site.

TAG View:

The Group agrees that the subscription fee paid in this type of transaction would constitute a payment for services. As that payment is mainly for the interaction with the site for purposes of the personal enjoyment of the user and not for the provision of any service of a technical, managerial or consultancy nature, it would not, under the previously quoted definition of "technical fees", fall under the alternative provisions covering these types of payments. The Group also agreed that any payment to the owner of the copyright in the digital content made by the provider for the right to display that content to its subscribers would constitute royalties.

India-UK DTA:

Subscription fee paid for access to the web site would constitute a payment for services taxable within Article 7 (Business Profits) of the India-UK DTA. Payment by the provider to the owner of the copyright in the digital content would constitute 'royalty' under Article 13(3)(a) of the India-UK DTA.

India-USA DTA:

The position is same as in India-UK DTA.

Act:

Subscription fee paid for access to web site would be taxable as business income under the head "Profits and gains of business or profession". Payment by the provider to the owner of the copyright in the digital content will constitute 'royalties' as per the definition provided for in explanation 2 to section 9(1)(vi) of the Act.

Category 22: Online shopping portals

Definition

A web site operator hosts electronic catalogs of multiple merchants on its computer servers. Users of the web site can select products from these catalogs and place orders online. The web site operator has no contractual relationship with shoppers. It merely transmits orders to the merchants, who are responsible for accepting and fulfilling orders. The merchants pay the web site operator a commission equal to a percentage of the orders placed through the site.

TAG View:

The Group agrees that these payments are revenues from advertising or similar services which constitute business profits as defined in Article 7.

India-UK DTA:

Payments arising from these transactions would constitute business profits falling under Article 7 of the India-UK DTA.

India-USA DTA:

The position is same as in India-UK DTA.

Act:

Under the provisions of the Act, the payment in question would constitute 'Profits and gains of business or profession'.

Category 23: Online auctions

Definition

The provider displays many items for purchase by auction. The user purchases the items directly from the owner of the items, rather than from the enterprise operating the site. The vendor compensates the provider with a percentage of the sales price or a flat fee.

TAG View:

The Group agrees that these payments are revenues similar to those of an auction house and would constitute business profits as defined in Article 7.

India-UK DTA:

Payments arising from these transactions would constitute business profits falling under Article 7 of the India-UK DTA.

India-USA DTA:

The position is same as in India-UK DTA.

Act:

Under the provisions of the Act, the payment would constitute 'Profits and gains of business or profession'.

Category 24: Sales referral programs

Definition

An online provider pays a sales commission to the operator of a web site that refers sales leads to the provider. The web site operator will list one or more of the provider's products on the operator's web site. If a user clicks on one of these products, the user will retrieve a web page from the provider's site from which the product can be purchased. When the link on the operator's web page is used, the provider can identify the source of the sales lead and will pay the operator a percentage commission if the user buys the product.

TAG View:

The Group agrees that these payments constitute business profits as defined in Article 7.

India-UK DTA:

Payments arising from this transaction would constitute business profits as defined in Article 7 of the India-UK DTA.

India-USA DTA:

The position is same as in India-UK DTA and payments arising from these transactions would constitute business profits as defined in Article 7 of the India-US DTA.

Act:

Under the provisions of the Act, the payment in question would constitute 'Profits and gains of business or profession'.

Category 25: Content acquisition transactions

Definition

A web site operator pays various content providers for news stories, information, and other online content in order to attract users to the site. Alternatively, the web site operator might hire a content provider to create new content specifically for the web site.

TAG View:

The Group agrees that the two alternatives described above need to be distinguished. Where the site operator pays a content provider for the right to display copyrighted material, the payment would fall under the definition of 'royalty' to the extent that the

public display of the content constitutes a right covered by the copyright of the owner of the content.

Where, however, the operator pays for the creation of new content and, as a result of the relevant contractual arrangements, becomes the owner of the copyright in the content so created, the payment would constitute business profits as defined in Article 7.

India-UK DTA:

In the first situation, where the payment is made for right to display copyrighted material, the payment would constitute 'royalty' as defined in Article 13(3)(a) of the India-UK DTA. In the second situation, where the web site operator gets new content created and becomes the owner of the copyright in the content so created, the payment will be taxable as Business Profits (Article 7) or Independent Personal Services (Article 15) depending upon the status of the content provider.

India-USA DTA:

The position is same as in India-UK DTA.

Act:

Under the provisions of the Act, the payment would constitute 'royalties' under the first

situation and 'Profits and gains from business or profession' in second situation.

Category 26: Streamed (real time) web based broadcasting

Definition

The user accesses a content database of copyrighted audio and/ or visual material. The broadcaster receives subscription or advertising revenues.

TAG View:

The Group agrees that the subscription or advertising fees that would be received in such a transaction would constitute business profits as defined in Article 7.

India-UK DTA:

Assuming that the subscription allows only the real time enjoyment of web-broadcasted material and not the downloading of copyrighted material onto the customer's hard disk or other non-temporary media, the payment in question would constitute business profits as defined in Article 7 of the India-UK DTA.

India-USA DTA:

The position is same as in India-UK DTA.

Act:

With the same assumption, the payment in question would constitute 'Profits and gains of business or profession' under the provisions of the Act.

Category 27: Carriage fees

Definition

A content provider pays a particular web site or network operator in order to have its content displayed by the web site or network operator.

TAG View:

The Group agrees that in that type of transactions, the web site or network operator is providing a commercial service for a fee and its income should be characterized as business profits as defined in Article 7. In these transactions, unlike in those described in

category 25, it is the owner of the copyrighted material who makes the payment, which makes it clear that Article 12 is not applicable.

India-UK DTA:

The payment in question would constitute business profits falling under Article 7 of the India-UK DTA.

India-USA DTA:

The position is same as under the India-UK DTA.

Act:

The payment in question would constitute 'Profits and gains from business or profession' under the provisions of the Act.

Category 28: Subscription to a web site allowing the downloading of digital products

Definition

The provider makes available to subscribers a web site featuring copyrighted digital

content (eg music). Subscribers pay a fixed periodic fee for access to the site. Unlike category 21, the principal value of the site to subscribers is the possibility to download these digital products.

TAG View:

The Group agrees that the subscription fee paid in this type of transaction would fall under Article 7. Transactions that permit the customer to electronically download digitised products (*ie* music in this case) for the customer's own use or enjoyment do not give rise to royalties. The Group also agreed that this category of transaction is closer to category 2 than to category 21 since the essential consideration for the payment is not the temporary interaction with the site but, rather the acquisition of the music data transmitted in the form of a digital signal.

India-UK DTA:

Since the principal value of the site to subscribers is the possibility to download digital products, comments made in category 2 will apply mutatis mutandis.

India-USA DTA:

The position is same as under India-UK DTA and comments made in category 2 will apply mutatis mutandis.

Act:

Comments made in category 2 will apply mutatis mutandis.

To sum up, the views of this Committee match with those of the TAG in respect of 15 categories. In 1 category, the views of the TAG match in terms of the DTAs and not the Act. In the remaining 12 categories the views of this Committee differ from those of the TAG. A summary of the analysis of the Committee is contained in Annexure 2. The view of the TAG does not necessarily imply unanimity of view amongst all nations of the world. The Committee notes that where views differ there is legal and conceptual justification for both and it is not possible to dismiss either of the views as being absurd. A detailed analysis of characterisation of category 2 transactions will illustrate the point being made.

The view of the TAG that the category 2 transactions should be classified as 'business profits' follows the Revised Commentary on Article 12 of the Convention. The other view expressed before the OECD ie the transaction should be classified as 'royalty' is supported by a plain reading of the definition of royalty as contained in the Convention. The definition of royalty in explanation 2 to section 9(1)(vi) of the Act as well as the definition in the treaties signed with UK and USA follow the Convention. The payments in such cases are covered as 'consideration for use or right to use a copyrighted literary, artistic, scientific work or secret process'. These fall within the definition of royalty

under Article 13(3)(a) of the India-UK DTA and Article 12(3)(a) of the India-US DTA. These are also covered by the definition of royalty as contained in explanation 2 to section 9(1)(vi) of the Act. Under the Act even consideration for grant of license in such works is covered in the definition of royalty. The challenge to this view on the ground that it goes against the 'Framework conditions of neutrality between different forms of doing business' is not justified. Payments for software or other digital products bought 'off the shelf' with similar conditions relating to the right of transfer or copying would also be characterised as 'royalty' like the downloaded software or other digital products in terms of the Act and the two DTAs.

The Committee is of the view that the different positions taken by countries are in the background of concern for protecting the integrity of their respective tax bases. This concern makes it unlikely that an international consensus will be reached on the issues relating to characterisation of incomes. The possibility of some incomes getting taxed twice or remaining unintentionally untaxed, in both the country of residence and the country of source, cannot, therefore, be ruled out.

At the policy level, the Committee agrees with the view that the characterisation of payments should not change with the mode of delivery from physical to digitised form. The Committee also recommends that a clear position on each category of transaction should be taken by the Central Board of Direct Taxes ("CBDT"). This will ensure uniformity of approach among all the assessing officers. For the taxpayer, it will ensure certainty of the tax burden.

Since new categories of transactions are likely to emerge at a fast pace with advances in technology, it is also recommended that the CBDT should closely monitor the developments and issue guidelines to the assessing officers on new emerging categories of transactions as a continuing process. The monitoring should be through an expert advisory body on which the tax administration, the profession and the concerned industry is represented.

Having examined issues relating to characterisation, the Committee would like to place on record its view that there is no rational basis for having different tax treatment for different categories of incomes. Two transactions having same economic content may be categorised differently resulting in different tax burden. The Committee is also unable to accept that value-addition takes place only where manufacturing or marketing is done and that the customer base does not create any value addition. Customer base creates demand. Without demand, there will not be any value.

The Committee is of the view that the only long-term solution of the problems created by characterisation lies in making direct taxation identical for all streams of income in a manner aimed at ensuring equitable sharing of revenues between residence and source countries. The 'base erosion' approach suggested by Professor Doernberg and discussed earlier does not tax a transaction on the basis of income characterisation. It deserves to be evaluated to see if it also ensures equitable sharing of revenues.