Electronic Commerce Taxation Evolves in India

The authors trace the development of e-commerce policy in India, as well as put it in perspective with developing policies around the world and within multinational organizations.

Document Type: Special Reports

Tax Analysts Document Number: Doc 2000-27276 (11 original pages)

Citations: (October 13, 2000)

====== FULL TEXT ======

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The authors would like to acknowledge the contribution of ***Tushar Ajinkya****, a member of the technology law team at Nishith Desai Associates.*

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E-Commerce in India

The development of electronic commerce can be said to be the greatest event in the economic history of mankind, next only to the Industrial Revolution of the early 20th Century. Whereas Europe and United States were the main beneficiaries of the Industrial Revolution, there are clear indications that India, along with the United States and China, would be the major beneficiaries of the electronic commerce revolution. The huge pool of skilled technological manpower in India is at the basis of this indication. The Indian industry is attempting to harness technology to succeed in achieving its business objectives. In doing so, it has been focusing on balancing the benefits provided by new technology with the associated risks in having one's business depend on it.

Need for Legal Framework

Business conducted through the Internet caters to globally located customers. This raises cross-border legal issues. Transactions that may be legal and valid in one jurisdiction may not be enforceable in others. Issues relating to the conclusion and enforcement of contracts and choice of appropriate jurisdiction create interpretational issues. It is ultimately left to a court's discretion to decide whether it can try a particular matter brought before it. There are certain theories, such as "the minimum contact theory," that has been applied by several courts across the world to determine whether the particular court has jurisdiction to try a particular case. However, there are no defined principles for application of these theories yet. Therefore, there is a need for a uniform act governing transactions that are conducted over the Internet.

A series of legal issues need to be effectively addressed before e-commerce can be considered a safe and effective way of conducting business. Key legal issues arising out of e-commerce transactions include protection for authentication and nonrepudiation. This means that there needs to be a manner of authenticating the identity of the person entering into the transaction. Further, there needs to be some protection that the person entering the transaction cannot repudiate the same at a later stage.

E-commerce has also given rise to a new breed of crimes called "cyber crimes," "cyber squatting," and "virus attacks," among others. There is a strong need for cyber policing to reduce the Internet's abuse for carrying out crimes that are, at times, more harmful than physical destruction.

The regulatory environment in India, which broadly governs e-commerce, comprises of the following laws:

- Indian Contract Act, 1872;
- Copyright Act, 1957;
- Trademark Act, 1957;
- Patent Act, 1970;
- Information Technology Act, 2000; and
- Indian Penal Code, 1860 etc.

Steps in Development of Legal Framework

India has also recently enacted the Information Technology Act, 2000. Its salient features are as follows:

- addressing issues arising out of digital contracts, digital signatures, crimes, and formation of an appellate tribunal;
- authentication of electronic records by affixing electronic signatures, recognition of electronic records, and electronic signatures;

- retention of electronic records and submissions of electronic records to the government;
- attribution, acknowledgement, and dispatch of electronic records;
- provisions to appoint a controller to regulate the certifying authority, the duties of certifying authority, and the duties of the subscribers; and
- definition of offences and provisions for penalising the offenders.

In an important provision, the 2000 act also applies to an offence committed outside India by any person, irrespective of his nationality, so long as the computer system is located in India. Thus, mere presence of the computer system in India is sufficient for an offence to be committed in India. However, the 2000 act does not apply to negotiable instruments, powers of attorney, wills, trusts, and contracts for the sale or conveyance of immovable property.

Further, while the Information Technology Act, 2000 is the first step toward recognition of the need to protect and regulate e-commerce, it suffers from several lacunae in it. One such lacuna is that the act is "technology dependent," meaning it only recognises public key infrastructure as a form of digital signature, when other methods of authentication and identification (such as biometrics) are already developing across the world. Ideally, the 2000 act should have been technologically neutral, so that it could address all forms of technological advancements. Further, the 2000 act provides for definitions of certain terms that are ambiguous, while others include terms which may lead to interpretational issues. The Information Technology Act, 2000 also contains certain clauses that are contradictory to one another.

In a positive step, the government has invited comments and suggestions on the Information Technology Act, 2000. Once these issues are addressed, the act will be a major boost to e-commerce in India.

The Need for Special Tax Provisions

Some of the fundamental tax-related issues raised by the evolution of cross-border e-commerce transactions may be summarised as follows:

- Is there a need to develop new norms and tenets of interpretation to determine the nature and character of income from cross-border e-commerce transactions?
- Is there a need to create new definition and meaning of permanent establishment (PE)?
- Is there a need to change the basis of taxation (for example, residence-based taxation)?
- While considering taxation of e-commerce transactions, should principles of tax neutrality be adhered to?

Unless these issues are addressed, an erosion of the tax base may result, especially for developing and underdeveloped countries. Does this call for the need to evolve a global revenue sharing concept? If so, what should be the basis?

The growth of the e-commerce market, globally, is expected to reach as high as $3.2 trillion /1/ by the year 2003. In view of India's demonstrated capabilities in the infotech industry, it's expected that a fair share of this growth would be experienced in India. This certainly calls for an initiative on the part of the Indian government to develop appropriate policies in relation to the taxation of e-commerce transactions.

Neutrality is a fundamental tenet of taxation. It requires that taxation rules shouldn't affect economic choices and that, therefore, economically similar incomes should be taxed similarly. That is to say that the same taxation principles that apply to income from conventional ways of conducting business should also apply to income from e-commerce transactions.

In cases of cross-border e-commerce transactions, the tax issues are more complex because, according to the recognized principles of international taxation, when a resident of one country earns income from economic activity in another country, both countries have a right to tax the same income: the home state based on residence rule and the host state based on the source rule of taxation. While the principles of applying the source rule in the case of the conventional method of transactions have been fairly established, those for the e-commerce transactions pose considerable difficulties.

There are two main areas in which clarity needs to be established. One is the determination of the character of income that is generated by the e-commerce transaction: is it royalty, business profit, or fees for technical services? The other area is the determination of what constitutes a PE in the source country and attribution of income to the PE.

Global Initiative for Addressing Tax-Related Issues in E-Commerce

The Organization for Economic Cooperation and Development (OECD) has been developing proposals in pursuit of international consensus on e-commerce issues. The OECD has prescribed certain guidelines that they feel governments should adhere to while formulating new provisions regulating taxation of e-commerce transactions. It's helpful to revisit these guidelines, which are summarized as follows:

- governments should promote a pro-competitive environment to allow electronic commerce to flourish, work to reduce and eliminate unnecessary barriers to trade, and act when necessary to ensure adequate protection of key public interest objectives in the digital world, just as they do in the physical world;
- when required, government intervention should be proportionate, transparent, consistent, and predictable, as well as technologically neutral; and

- governments should recognize the importance of continued cooperation among businesses in standards setting, and in enhancing interoperability within an international, voluntary, and consensus-based environment.

Taxation of Cross-Border E-Commerce Transactions in India

In order to examine this area, we first need to analyze the concepts of taxation in India.

Indian Income Tax Law

In India, any person, whether resident or not, is chargeable to tax in respect of his income accruing, arising, or received, or deemed to accrue, arise, or to be received in India. Thus, even if the income was not actually received in India but is deemed to accrue or arise in India, it would be taxable in India. Residents are taxed on their worldwide income, whether it accrues, arises, or is received outside India. Nonresidents are taxed on their Indian-source income. The determination of a person's residential status becomes essential because taxability of a particular income and the rates at which it is taxed vary according to this status.

Residence

Any company incorporated in India is deemed to be resident in India even if its control and management are situated wholly or partly abroad. A non-Indian company is deemed to be resident in India only if its control and management are situated wholly in India. Thus, most foreign companies fall under the category of nonresident.

The expression "control and management" means, de facto, control and management, and not merely the right or power to control or manage. Even if a part of the management and control is outside India, the company won't be considered resident in India. Thus, in one year, a company may be "resident" in India and in another, it may be "nonresident."

Control and management is different from carrying on business operations of a company. It does not refer to control and management of the day-to-day affairs of the company's business, which is conducted by agents, employees, and servants. It's not situated where the shareholders meetings are held even if a single shareholder, by reason of his majority shareholding, has a decisive voice in matters relating to the company's affairs. It is situated where the central management and control actually resides. A company can have dual residence.

Partnerships, associations of persons, and bodies of individuals are treated as residents of India, even if a fraction of their control and management lies in India.

The Source Rule in India -- Section 9 of the Indian Income Tax Act

Section 9 of the Income Tax Act specifies various types of income that would be regarded as deemed to accrue or arise in India and, therefore, becomes taxable in India. The income is covered under this section when it isn't chargeable on the basis of its receipt. This principle is applicable to both residents and nonresidents. For nonresidents, unless the place of accrual or receipt of the income is within India, they cannot be subject to taxation in India.

Business Income

Section 9(1)(i) of the Income Tax Act deals with the source rules for business income in India. Any direct or indirect income is deemed to accrue or arise in India so long as it is derived through or from:

- any property in India;
- business connection in India;
- any asset or source of income in India; or
- transfer of a capital asset situate in India.

If not all operations of a business are carried out in India, then only the part of income that is attributable to Indian operations would be regarded as income accrued or arisen in India.

The expression "business connection" has a wide but uncertain meaning. The expression isn't defined under the Income Tax Act. The concept of "business connection" is similar to but much wider in meaning than the concept of PE. The meaning of this expression is also not restricted to the definition of "business." The judicial precedents on the subject have evolved a meaning for this term, which could be summarised as follows:

A business connection involves a relation between a business carried on by a nonresident that yields profits or gains and some activity in India, that contributes directly or indirectly to the earning of those profits or gains. Thus, to establish a business connection, an element of continuity should exist between the nonresident's business and the activity in India.

A business connection may exist even without any regular agency, branch, or other definite organization. The mere fact that a substantial part of the nonresident's output is sold in Indian markets, or is sold directly or through brokers to Indian consumers, or rendering of services outside India, per se, to a person carrying on business in India, would not amount to a business connection in India.

Thus, if it's established that a nonresident has a business connection in India, then its income would be subject to Indian taxation under section 9 of the Income Tax Act. However, the tax would apply only to the income that is attributable to its activity in India. The tax rate applicable to business income of a foreign entity in India would be 48 percent, subject to the applicable tax treaty.

Royalty and Fees for Technical Services

Section 9(1)(vi) of the Income Tax Act deals with the source rules in respect to royalty income. Royalty income is deemed to accrue or arise in India if it's paid either by a resident or a nonresident for any right, property, information, or services utilized for carrying on a business in India. For this purpose, "royalty" is defined to mean consideration for:

- the transfer of all or any rights in a patent, invention, model, design, secret formula, process, trademark, or similar property;
- the imparting of information concerning the workings of the intellectual property described above;
- the use of any of the intellectual property described above;
- the imparting of information concerning technical, industrial, commercial or scientific knowledge, experience, or skill;
- the transfer of all or any rights in any copyright, literary, artistic, or scientific work, including films or video tapes, for use in connection with television or tapes, for use in radio broadcasting (but not including consideration for the sale, distribution, or exhibition of cinematographic films); and
- the rendering of services in connection with the activities referred to above.

Similarly, section 9(1)(vii) lays down the source rules for fees for technical services. Once again, the fee is deemed to accrue or arise in India if it's paid either by a resident or a nonresident for any services utilized for carrying on a business in India. The definition of fees for technical services under the Income Tax Act is much wider than that under most double taxation avoidance agreements that India has entered into.

The rate of tax applicable to the income of a foreign company by way of royalties and fees for technical services is 20 percent, as set forth in section 115 A of the Income Tax Act. /2/

Withholding Tax Liability

When any person is responsible for making any payment to a nonresident of a sum chargeable under the provisions of the Income Tax Act (not being income chargeable under the head "salaries"), that person is required to deduct income tax thereon. This deduction must be done at the time of credit of the income to the account of the payee, or at the time of payment, whichever is earlier.

When the person responsible for paying any sum that is chargeable under the Income Tax Act (other than interest on securities and salary) to a nonresident considers that the whole of the sum wouldn't be income chargeable to tax in India for the recipient, he may make an application to the assessing officer under section 195(2) of the Income Tax Act to determine the appropriate proportion of the sum so chargeable.

Also, any person entitled to receive any interest or other sum on which income tax must be deducted under subsection (1) may make an application in the prescribed form to the assessing officer under section 195(3) for the grant of a certificate authorizing him to receive the interest or other sum without deduction of tax under that subsection. Under section 197, the assessee can apply to the assessing officer for deduction at a lower rate or for a remittance without any deduction under section 195.

Further, section 90(2) of the Income Tax Act provides that the provisions of the act will apply to an assessee only to the extent that they are more beneficial to the assessee as compared to the relevant double taxation avoidance agreement. The effect of section 90 is to incorporate treaty law into domestic tax law. In the case of a conflict between the two, the treaty would override the domestic tax law to the extent that it is more beneficial to the taxpayer. Hence, although the term "business connection" is much wider, in a situation when the nonresident comes from a treaty country, the definition and meaning of PE would be relevant in determining its tax liability in India. Similarly, the nonresident could also avail the benefit of the restrictive definitions in the applicable double taxation avoidance agreement of the terms "royalty" and "fees for technical services," respectively.

It's clear from the above that technology transfers are already subject to tax under the current provisions of the Income Tax Act. As we observed from the earlier discussion, e-commerce is merely a different form of doing business. There is, therefore, nothing sacrosanct about taxing e-commerce. It should be treated in the same manner as any other business, and the existing laws should be adopted and adapted to enable the taxation of e-commerce transactions while maintaining neutrality. The principle of neutrality requires that the e-commerce transactions be treated at par with the conventional way of doing business. This means that they should neither escape taxation all together, nor be subject to taxation if a similar transaction under conventional means would not have been taxed. Whether e-commerce should be taxed requires one to go back to the discussion where the e-commerce transaction is broken down into the various components, determine the characterisation of the relevant components, and examine whether the income is taxable in India.

Initiatives Taken by the Indian Government

The Income Tax Department in India had set up a working group to examine the tax implications of e-commerce transactions. The group submitted its report in 1999.

The report recognized the fact that in Internet transactions, figures (such as total profits of the enterprise, receipts accruing or arising in India, and the total receipts of the nonresident) would be unavailable. In these situations, the requirements of section 9(1) (i) and rule 10 of the Income Tax Rules (dealing with presumptive tax provisions) would be left unfulfilled, leading to a "dilemma of taxing of income arising due to Internet transactions." /3/ The report concluded that the existing tax laws were inadequate to cover e-commerce transactions. It suggested that the Tax Planing and

Legislation (TPL) section of the Central Board of Direct Taxes (CBDT) undertake a study on the issues arising out of taxation of e-commerce transactions. /4/

The report stated that a computer terminal, which is used to receive and send information across national boundaries, should be regarded as a PE. The same has been said of Web sites used in e-commerce. No reasons were given in support of this stand. /5/ The report also considered the imposition of a presumptive tax in the form of a fixed portion of billings, or a "bit tax." This approach was ultimately dismissed as being too simplistic. /6/

The report considered homepages on Web sites. It observed that homepages are analogous to magazine advertisements. No tax implications arise from placing advertisements on the Internet under the existing laws. A view could be taken, however, that when the seller's homepage is downloaded at the user's computer, a fixed place of business is created at that physical site. If the Web page is downloaded often enough, the activity may be considered regular enough for it to be treated as a fixed place of business. However, as article 5 stands today, requirements of a place of business in physical space at a particular geographical location wouldn't permit this interpretation. /7/

The report also considered Internet sales of software. In these cases, it noted, it would be necessary to examine whether supply of software was an isolated transaction or whether there is an element of continuity involved. This can be an indication of the presence of a business connection. However, to conform to the requirements of a business connection, there should be a real and intimate connection and commonness of interest between the trading activity carried on outside India and the trading activity carried on inside India. Mere purchases from abroad, on a principal to principal basis, don't establish a business connection. The report also examined the case of an Indian software vendor obtaining software on the Internet from a foreign software vendor, selling the same to Indian buyers and remitting a mutually agreed amount of the sale proceeds to the foreign vendor. In this case, since no activity is carried out by the foreign vendor in India, (apart from transmitting the software to India from abroad), no portion of the remittance can be brought to tax in India under section 9.

The report also suggested the formation of an international organization to detect any transaction on the Internet. The articles on "Mutual Agreement Procedures" and "Exchange of Information" can also form the basis of a system of dissemination of information on Internet transactions to competent authorities in various countries.

Another suggestion that was considered was the imposition of a tax on the person who gets the receipts that result in the creation of assets in the form of movable/ immovable property. The identification of the property could also be undertaken by the international organization to be set up, as suggested in the preceding paragraph. The jurisdiction to tax could be assigned to the country of the person receiving the payments. The sharing of tax proceeds could be covered by a new article in double taxation avoidance agreements.

Further Initiatives Taken by Indian Revenue Authorities

With a view to bringing balance between providing sufficient incentives to the growth of business in the e-commerce environment and getting a fair share of revenue, the ministry of finance, government of India, has recently set up a committee for e-commerce taxation. The committee is comprised of several commissioners of income tax, a few chartered accountants, and members representing the information technology industry. The committee's mandate is to submit a report of findings on whether there are adequate provisions in the present Income Tax Act to tax the transactions in the e-commerce environment. If not, the committee is required to suggest the changes that should be made. The committee is expected to submit its report by the end of the calendar year.

Decisions in India in Respect to Taxation of E-Commerce Transactions

Meanwhile, India has already taken a lead in taxing e-commerce transactions. It would be interesting to examine some of these cases which have been determined by the Indian tax authorities and the Authority for Advance Ruling (AAR) in the recent past.

When Payments Are Characterized as Royalties

The AAR has issued a ruling on the taxability of income of foreign companies engaged in the operation of credit cards and travellers cheques. The payment made by the Indian company for accessing the foreign company's computer system and data stored on the system in the U.S. has been held to be royalty income and is, therefore, taxable in India.

As an example, assume that Y is a company incorporated in the U.S. and belongs to "ABC" group of companies, which operates in the worldwide credit card and travel business. All of the transactions and related data in respect of each credit card holder and travellers cheques holders are stored in the central processing unit (CPU) maintained by Y in the United States. Y also maintains a computer set up in Hong Kong, called the Consolidated Data Network (CDN). Y has a worldwide information processing telecommunication centre (WPIT Centre) in the United States.

XT, an Indian company, provides customer services as a high technology centre for data management and information analysis and control. It provides these services to companies of ABC group and other companies situated in Asia, Europe, and elsewhere. Against payment, Y allows its customers, which includes XT, to use its CPU. Y's CPU is also accessed by various "ABC" entities located worldwide through a CDN maintained in Hong Kong. XT has a link up to CDN through dedicated international leased circuit lines of Videsh Sanchar Nigam Limited (VSNL), which is the gateway for international telephony in India.

The transaction is explained as follows:

Transactions executed by credit card holders and travellers cheques holders in India and the Asia Pacific region are reported to XT. XT accesses Y's CPU through the CDN in Hong Kong. It accesses the data on the CPU, updates it, and validates the credit card transactions. XT pays a certain fee to Y for accessing the data and for using the CPU.

The transaction is depicted above in the diagram.
[Diagram omitted]

The questions raised before the AAR were as follows:

1. Would the fees receivable by Y from XT for the use of its CPU in the United States and CDN at Hong Kong would be taxable in India?

2. If yes, would the payment due to Y be covered under article 12(3)(a) or article 12(3)(b) of the double taxation avoidance agreement between India and United States?

Observations and AAR's Ruling

The AAR observed that Y is a service provider, which, inter alia, allows XT to use its bandwidth and its networking infrastructure for a consideration. Y's CPU in the United States has its own software and is operated by its own personnel in the United States. XT is retrieving from the CPU the processed data of its customers and makes payments to Y only for having access to the data and the use of the computer system. This clearly establishes that the software used in the CPU is that of Y. XT is allowed to use the software developed and protected by Y. Therefore, the AAR concluded that the fees received by Y are in "consideration for the use of, or the right to use . . . design or model, plan, secret formula or process." The AAR held that the use by XT of the CPU and the CDN is not merely use of equipment as envisaged in article 12(3)(b) of the double taxation avoidance agreement relating to fees for technical services. AAR suggested that the following are the main ingredients for characterising any payment as a royalty payment:

1. It's a payment made in return for a right to exercise a beneficial privilege or right;

2. The payment is made to the person who owns the right; and

3. The consideration payable is determined on the basis of the amount of use.

The AAR held that the payment received by the U.S. company from the Indian company for the use of the computer systems situated abroad are taxable in India as "royalty" income under article 12(3)(a).

Comments in Light of Technical Advisory Group (TAG) Report on Characterisation of Income

The TAG on characterisation of income, set up by the OECD, considers and analyzes a situation similar to the one described above, under category 7 in their report dated September 1, 2000. This section is reproduced below:

Definition

The 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 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.

Analysis and Conclusions

The group arrived at a consensus that under the current wording of the OECD model, this type of transaction gives rise to business profits falling under article 7.

They also said that when 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 question is whether these words can be applied to all or part of the payments arising from a transaction like the one described above. In this situation, it was necessary to determine whether the payments were for "the use of, or the right to use, industrial, commercial, or scientific equipment." In order to make this determination, it would be necessary to consider the following factors:

- whether the user is in physical possession of the property;
- whether the customer controls the property;
- whether the customer has a significant economic or possessory interest in the property;
- whether the provider doesn't bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract;
- whether the provider doesn't use the property concurrently to provide significant services to entities unrelated to the service recipient; and
- whether the total payment does not substantially exceed the rental value of the computer equipment for the contract period.

In a typical transaction, the service provider uses the software to provide services to customers, maintains the software as needed, owns the equipment on which software is loaded, provides access to many customers to the same equipment, and has a right to update and replace the software at will. The customer may not have

possession or control over the software or the equipment, will access the software concurrently with other customers, and may pay a fee based on the volume of transactions processed by the software.

In light of the above discussion, the group concluded that these transactions should generally give rise to services income, as opposed to rental payments. In the transaction described above, the customer will not have possession or control over the equipment and he will utilise the equipment concurrently with other customers.

Applying the TAG Comments to the Indian Case

Applying the logic and conclusions arrived at by the TAG to the Indian case discussed above, the payment made by XT to Y may be characterised as fees for services. However, the AAR characterised this as payment of a royalty under paragraph 3(a) of article 12 of the double taxation avoidance treaty between India and United States.

While characterising a particular payment under "royalty" as described in the above definition of "royalty," the group is of the view that the "information concerning industrial, commercial, or scientific experience" must make the information useful for commercial exploitation by the payer. From the facts of the case under consideration by the AAR, it would appear that XT made payment to Y merely for the use of the application software embedded in XT's CPU and its data. XT did not commercially exploit the software. Hence, in view of this fact, it would be difficult to chracterise this payment as a "royalty."

Further, it needs to be examined whether the payment would be covered by the term "fees for included services" as described in paragraph 4 of article 12 of the double taxation avoidance agreement between India and the United States. The term is defined as a "payment 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 are "ancillary and subsidiary to the application or enjoyment of the right, property or information for which a payment of royalty under paragraph 3(a) of article 12 is received; or make available technical knowledge, experience, skill, know-how, or processes or consist of the development and transfer of a technical plan or technical design."

However, the services rendered by Y (in the case under consideration by the AAR above) don't fall within the scope of either criteria described above.

Analysing the transaction considered by AAR in light of the above discussion, it seems that the income may be neither royalties nor fees for technical services. It may be characterised as business income or other income under article 7 of the double taxation avoidance agreement and be taxed in India if Y had a PE in India. Indeed, a whole separate discussion would be required to determine whether Y had a PE in India.

Computer Reservation Services (CRS) Companies Have a PE in India

The Indian tax department has taken the view that the activities of Computerized Reservation System companies need to be understood in the light of the laws of physics. Accordingly, it has concluded that these companies have a "virtual" PE in India and, hence, the booking fees received by them from airlines for bookings originating in India are taxable as business income of the PE in India. The tax department has also treated the marketing companies as dependent agents, giving rise to a PE in India. A perusal of the CRS activities in India will prove to be a useful case study for the purpose of analysing some of the issues regarding the challenges posed to the prevalent definitions of PE by e-commerce.

The Stepwise Activities of CRS Companies

The business of the CRS companies is to make airline reservations on behalf of the participating airlines that enter into contractual relationships with the CRS company. For this purpose, the CRS company uses the "CRS host system" located in Country A, a country outside India, which may or may not be the country of residence of the CRS company. The participating airlines provide the necessary information, which is displayed on the CRS Host System. Travel agents throughout the world are able to access this information through the CRS system from their local computers so that they can guide their customers who make the necessary requests. The stepwise transaction is explained above:

Step 1

A travel agent in India either raises a query or requests a booking. The travel agent uses the equipment owned and provided by the Indian marketing company (IMC). /8/
[Diagram omitted]

Step 2

Generally, messages from travel agents may be transmitted through the Mahanagar Telephone Nigam Limited (MTNL) lines to the routers owned by the CRS company in the respective cities. In some cases, the messages are transmitted to the Societe Internationale Aeronautics Association (SITA) network.

Step 3

The message is then transmitted to the AT&T network in Country A via the VSNL network in India. From the AT&T network, this message is transmitted to the CRS owned router in Country A and from there it logs on to the host computer of the CRS company in Country A. Where the message is transmitted to the SITA network in India directly, it is transmitted to the SITA network in Country A. The messages going via SITA network directly log on to the host computer of the CRS company from the SITA network in Country A. The CRS host displays all the services and booking availability of the participating airlines.

Step 4

The CRS host is connected to the airline computer in Country B, which is consulted by the CRS host for the latest position on seat availability.

Step 5

If a seat is available, the booking is confirmed by the CRS host computer and is conveyed to the travel agent in India.

Step 6

The travel agent receives the message of confirmed booking from the CRS host, passing through the same communication channels, which were used for his outgoing message. He receives the ticket image from the host, which is printed by the printer in his office and the ticket is issued to the customer. If the travel agent doesn't have a printer, he would issue the ticket manually.

Position Adopted by Indian Tax Authorities

The Indian income tax authorities have sought to tax the booking fees, which have originated in India, as income of the CRS companies accruing and arising in India. This has been justified on the following grounds:

- Laws of physics are applied to interpret the conduct of this transaction. CRSs use electromagnetic waves for communication. This requires very high velocity of transmission. In such a situation, space collapses and time stops while the transaction is conducted. As a result, the CRS host located in another country becomes one with the travel agent's computer. Hence, the host attains virtual presence in India, resulting in PE of the CRS companies in India. Therefore, the entire booking fees received by the CRS companies are taxable as their business income in India. The IMC constitute the dependant agents of the CRS companies. On account of this reason, the CRS companies will have a PE in India.

Comments in Light of Technical Advisory Group (TAG) Report on Application of the Definition of a PE in the Context of E-Commerce

In their report submitted for comments, the working party of the TAG (which was set up to consider application of the existing definition of PEs) has examined and given their comments on transactions of a similar nature.

The working party noted that the draft dealt solely with the interpretation of the definition of permanent establishment as currently found in the OECD Model Tax Convention. It stated that while it cannot rule out that changes could eventually be made to the existing rules, it will await the report of the TAG set up to examine the need for such a change before considering any changes regarding e-commerce.

The working party considered issues relating to the fact that no permanent establishment may be considered to exist when the electronic commerce operations carried on through computer equipment located in a country are restricted to the preparatory or auxiliary activities covered by paragraph 4 of article 5. In their view, the question of whether particular activities performed through computer equipment fall within paragraph 4 needs to be examined on a case-by-case basis with regard to the various functions performed by the enterprise through that equipment. Examples of activities which, by themselves, would generally be regarded as preparatory or auxiliary include:

- providing a communications link -- much like a telephone line -- between suppliers and customers;
- advertising of goods or services;
- relaying information through a mirror server for security and efficiency purposes;
- gathering market data for the enterprise; and
- supplying information.

If the communication equipment situated at a given location in another country is owned by the user (who is not in the telecommunication business), there is no permanent establishment not because there is no fixed place of business, but rather because the activities performed there are preparatory and auxiliary.

Some of the members have drawn a parallel with the use of other communication facilities, such as the use of telephone lines to conclude a transaction. These members are of the opinion that the essential business activity of an enterprise that sells certain products -- physical or in the form of software -- is the selling of the product itself. The communication tools used in the selling process should make no difference, whether the transaction is concluded by mail order, by telephone, or through a server connecting the computer (Web site) of the selling enterprise with the computer of the customer. Thus, only in exceptional cases do these members see a possible permanent establishment for this category, for example, if the relevant transaction (the conclusion of a contract, the payment, and the delivery of the goods) is handled fully (automatically) by the server itself.

Analysis

The working group's comments suggest that in a situation similar to that of the CRS companies, equipment in India is providing channels of communication. They are, therefore, rendering preparatory and auxiliary services and, hence, even if the communication channels were to be regarded as being fixed places of business, they may not constitute a PE of the CRS companies in India. Importing the laws of physics to determine the existence of a PE in the present circumstance may be considered aggressive, because this would result in going beyond the scope of the present definition of a PE in the treaties.

Presumptive Tax

In a related situation, although not dealing with e-commerce transactions, the Indian tax authorities have addressed the issue of attribution of income in India when it's deemed that the income of the foreign company is taxable in India, even when it doesn't have a branch in India. In the case of foreign telecasting companies that do not have a fixed place of business in India, CBDT issued a circular in 1996 for determining the quantum of their income liable to tax in India. The issue considered in this circular is not whether these companies have a PE in India. According to the circular, when the foreign telecasting companies don't have a branch in India or when they don't maintain country-wide accounts, the taxable income is to be computed at 10 percent of the gross receipts from India, excluding the amounts paid by them as commission or charge to the advertising agents in India. /9/

Conclusion

Because conducting business through e-commerce is fast becoming the norm of the day, the pace at which international institutions and families of nations are evolving strategies to catch up with the challenges posed by e-commerce is too slow.
The existing tenets of income taxation based on source rules seem to be getting outdated. There is an immediate need for international institutions, such as the OECD and International Fiscal Association, to evolve more equitable tenets for cross-border e-commerce transactions so that there can be a more equitable distribution of tax revenues among nations. Countries that are feeling an erosion of their tax bases shouldn't be forced to adopt desperate measures that may be short term and, hence, likely to adversely affect the growth of their e-commerce economy. India, in particular, should adopt measures to ensure its position as the major beneficiary of the e-commerce revolution, along with the United States and China.

FOOTNOTES

/1/ Source: Stephen J. Korbin in his article "TAXING THE NET -- Governing the Digital World Economy."

/2/ Subject to annual revision by the provisions in the Finance Act, which is enacted every year after the presentation of the budget by the finance minister in Parliament.

/3/ Report of the working group, page 29.

/4/ Report of the working group, page 34.

/5/ Report of the working group, page 33.

/6/ Report of the working group, page 34.

/7/ Report of the working group, page 31.

/8/ There is an agreement between the CRS company and the IMC to market the CRS services in India.

/9/ Recently, certain income tax commissioners have expressed a view that this circular results in loss of revenue to the tax department. Judging by the rush of foreign telecasting companies in India, they feel that their profitability must be much higher than 10 percent and, hence, this circular should be replaced by another circular, prescribing a much higher rate of profitability.

END OF FOOTNOTES