Nishith Desai Associates
LEGAL AND TAX COUNSELING WORLDWIDE

MUMBAI SILICON VALLEY BANGALORE SINGAPORE MUMBAI BKC NEW DELHI MUNICH NEW YORK

Digital Economy in India

Direct and Indirect Taxation

March 2018

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ndaconnect@nishithdesai.com

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1. Introduction

This paper sets out a summary of the tax considerations, within the existing direct and indirect tax framework for those intending to operate a digital or digitalized business in India. This would include businesses that provide purely digital services or provision of services or goods that rely on technology predominantly in the delivery of such goods or services. The paper also looks at the different tax considerations that can arise over the lifecycle of a business in this area and from the perspective of the investors or the company undertaking such activities.

The Government of India has stated that it intends to support a positive collaboration amongst industry sectors, government bodies and businesses to encourage smarter investments, technologies and digital resources confident that growth in the digital economy will help make India a trillion-dollar digital economy by 2022.[1] India has also taken many positive steps to increase its ranking on the ease of doing business rankings and is also directing the greater expansion or availability of internet infrastructure in rural parts of the country. The Government is also increasingly digitalizing its operations and routine interactions with citizens are being transitioned to the internet.

As this space is at a nascent stage currently, the wide-scale adoption of newer digital technologies such as artificial intelligence or locationless bitcoin and blockchain networks are likely to bring about its own set of specific tax issues, risks and concerns for the investors and the company that is engaged in such activities. As business models are evolving rapidly along with the technology, it becomes important to understand the technology or business model and ensure it is taxed appropriately under the current rules, till laws catch up and appropriate modifications are made. It is therefore important to understand the various tax considerations and ensure that all precautions are undertaken to mitigate the possibility of triggering the following provisions.

I. What are Digital Economies or Digital Businesses?

Digital economies generally refer to economies based on digital technologies,[2] and not merely limited to e-commerce or buying, selling and facilitating sale of goods on Internet. In 2014, Organization of Economic Cooperation and Development (**"OECD"**), comprising of 34 countries observed the increasing and unparalleled reliance on intangible assets, the massive use of data (notably personal data) and the widespread adoption of multi-sided business models. It also acknowledged the difficulty of determining the jurisdiction in which value creation occurs.[3]

It also noted that it is *"difficult to ring fence the digital economy from the rest of the economy for tax purposes"* since the use of digital technologies has increased in traditional sectors as well.[4] Therefore the OECD has adopted a broad and inclusive definition for the digital economy consisting of a range of digital and tangible goods and services, including *inter alia* smartphones, tablets, computers, telecommunication digital content, availability of user data, cloud-based services, the Internet of Things, virtual currencies, advanced robotics, 3D printing, and peer to peer sharing of goods and services through the internet.[5] Contrarily, as per

1. Kiran Rathee, *India eyeing to become a trillion-dollar digital economy by 2022*, Business Standard (May 23, 2017, 20:44 IST), http://www.business-standard.com/article/economy-policy/india-eyeing-to-become-a-trillion-dollar-digital-economy-by-2022-117052301385_1.html.

2. Digital Economy, Chartered Institute of IT, available at https://policy.bcs.org/sites/policy.bcs.org/files/digital%20economy%20Final%20version_0.pdf.

3. OECD (2015), Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report, OECD / G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, Available at: http://dx.doi.org/10.1787/9789264241046-en.

4. Id. at page 11

5. OECD Action 1, supra note 2, pages 36-46

United States Census Bureau, digital economy primarily includes- (i) Supporting Infrastructure (Tangibles such as personal computing devices, routers, cables etc.) and intangibles including software and human capit al; (ii) Electronic Business Processes/ Internet based Business models and, (iii) E-Commerce transactions. [6]

India has not sought to make a distinction and continues to take a broad approach in line with the OECD.

6. Thomas L. Mesenbourg, Assistant Director for Economic Programs, U.S. Bureau of the Census, "Measuring the Digital Economy." Available at: https://www.census.gov/content/dam/Census/library/working-papers/2001/econ/umdigital.pdf.

2. Direct Taxation

I. Overview

The direct tax in India is the income tax levied on the taxpayer under the Income Tax Act, 1961 (**"ITA"**). While residents are taxed on their worldwide income, non-residents, are only taxed only on income sourced in India. Companies are treated as residents in India, if: (a) they are incorporated in India, or (b) their place of effective management (**"POEM"**) is in India. A company incorporated outside India may be taxable in India if considered as an Indian resident, having its POEM in India during the year.

Business profits (net of permissible deductions) in case of resident companies are taxed at 30 percent if the turnover is more than INR 250 Crores (approx USD 38.5 Million).[7] In order to make medium and small enterprises more viable and to encourage competition, such enterprises are taxed at reduced rate to 25 percent (as opposed to the current rate of 30 percent).

Ordinarily, non-resident companies are not taxable in India for their business profits, in the absence of the permanent establishment (**"PE"**) or a business connections in India. But, if there is a PE / Business Connection (**"BC"**), the profits are taxable at the rate of 40 percent on the net profits, unless such income qualify as royalties or fees for technical services (**"FTS"**) which are taxable at the rate of 10% on the gross amount recieved.[8] However, if a taxpayer is resident in a country with which India has a Double Taxation Avoidance Agreement (**"DTAA"** or **"tax treaty"**), the taxpayer has the option of being taxed under the provisions of the tax treaty or the ITA to the extent it is more beneficial to the taxpayer.[9] Withholding taxes may apply in a cross border scenario where payments made to a non-resident are taxable in India.[10]

Taxation of income generated by non-residents in the digital economy raises two primary issues for consideration: a) Characterization of Income, i.e., whether income earned with respect to the use or sale of goods (particularly items such as software and electronic databases), sale of advertising space etc. is royalty or business income or capital gains, etc and b) Classification as a PE, i.e., a taxpayer may have a taxable presence in India resulting in Indian tax liabilities due to the presence of a server / other electronic terminal, hosting of websites or other technical equipment, etc.

Characterization of income has an impact on the tax cost for the companies in doing business in India. Non-resident service provides in India are constantly posed with a huge risk for their business to be classified as a PE in India, resulting in all the income in India is deemed to be attributed to that PE. Taxpayers have been witnessing an increased risk of litigation costs as domestic tax authorities often take aggressive stand on these aspects, which leads to a lot of disputed tax liability being locked up during the pendency of the litigation (which could take 3 to 5 years).

7. All tax rates mentioned in this paper are exclusive of surcharge and cess; in case of residents, surcharge of 12% / 7% is applicable on the income-tax if their total taxable income is in excess of INR 10 crores / in excess of INR 1 crore but less than INR 10 crores respectively; in case of non-residents, the surcharge is 5% / 2% respectively for such taxable income; for both resident and non-residents, education and higher education cess of 3% (cumulative) is applicable on the total of the income-tax and surcharge.

8. After the amendment to the IT Act through the Finance Act, 2016 the tax rates for royalties and FTS has been reduced to 10% from the 25%. This is significant since most treaties provide for a 15% cap on the tax that can be imposed by India. In light of this change the availability of tax treaty benefits is not as import- ant as it was before.

9. Section 90(2) of ITA; India has entered into more than 88 DTAAs. In order to avail benefits under the DTAA, a non-resident is required to furnish a tax residency certificate ("TRC") from the government of which it is a resident in addition to satisfying the conditions prescribed under the DTAA for applicability of the DTAA. Further, the non-resident should also file tax returns in India and furnish certain prescribed particulars in Form 10F to the extent they are not contained in the TRC.

10. Section 195 of the ITA.

II. Characterization of Income

Most tech start-ups in India are required to transact globally which requires them to make payments overseas. The tax treatment of income earned by a nonresident would depend on the characterization of such income, and may be examined under the heads viz. business income, royalties or FTS. Where characterization by Indian tax authorities is not in consonance with international principles, non-residents could potentially face the risk of double taxation (arising from non-availability of credit for taxes paid in India).

Business profits earned by a non-resident are ordinarily taxable as follows:

property or rights for a business or profession carried out in India. This clearly deviates from the internationally accepted principles and arguably the non-resident should be entitled to the benefit of the more restricted definition of royalty as prescribed under the tax treaties.

Some key issues in relation to e-commerce transactions:

- **Copyright vs. copyrighted article in the treaty context:** Whether the payment made is for software purchases as a copyright or copyrighted article determines the taxability either as royalty or business income. The Indian courts have divergent views and a decision of the Supreme Court is still

	When the non-resident does not have a PE / business connection in India	**When the non-resident has a PE / business connection in India**
Business profits qualifying as royalties	Taxable on a gross basis at 10 percent (or at lesser rates prescribed under a tax treaty)	Taxable at 40 percent to the extent of profits attributable to the PE (net of permissible deductions)
Business profits qualifying as FTS		
Business profits not qualifying as royalties and FTS	Not taxable (unless there is a business connection in India)	

In determining whether a payment amounts to royalty, several issues arise in the Indian context as the definition of royalty under the ITA (particularly, after the clarificatory amendment introduced in 2012) is wider than the definition accepted internationally. For instance, the definition of royalty under ITA covers consideration received for license of computer software that does not involve the transfer of any underlying intellectual property; payments for access to or use of scientific / technical equipment even if no control / possession is granted over the equipment (for example, hosting website on third party servers without renting the server / obtaining any administrator rights over the server); payment of royalty between two non-residents is also considered to be sourced in India, if the payer utilizes the information,

awaited to settle the issue. In context of the applicability of sales tax, the Supreme Court[11] held that the copyright in a computer programme remains with the originator of the programme, but the moment copies are made and marketed, they become 'goods' qualifying for sales tax. This distinction is further bolstered by the approach of the OECD where 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.

11. *Tata Consultancy Services v. State of AP* AIR 2005 SC 371

It is relevant to note that on purchase of a copyrighted article, the purchaser does not necessarily get a "copyright licence". To be characterised as royalty, what is required is that there is transfer of some or all the rights which the copyright owner has such as the right to make copies or to adapt the work. Thus, payment for transfer of a non-exclusive and non-transferable licence enabling the use of a copyrighted product could not be construed as royalty.

With respect to taxation under tax treaties, most judgments[12] have upheld the view that purchase of software amounts to purchase of a copyrighted article. The reason that has been accepted is that a purchase of software as a product, (for e.g. Microsoft Office software which is used by the end users even though it is Microsoft which has the copyright over the software and not end users) is not the same as transferring or assigning rights relating to the copyright in the software itself.

On the basis of principles developed by case law, the current state of play may be summarized as below:

» Where the ITA applies/ where the non-resident is from a non-treaty jurisdiction, the Indian payer is under an obligation to withhold tax on payments for purchase of software. This is due to the wide definition of royalty brought under the charge to tax coupled with the narrow exception to it[13] in the ITA. Further, a large body of case law rejecting the distinction between copyrighted article and copyright means that there is little scope to establish that the payment is not in the nature of royalty;

» Where the definition of royalty in a tax treaty specifically addresses computer programmes, the same result as above should follow;[14]

» Where the definition of royalty in a tax treaty does not specifically address computer programmes, there may be scope for the taxpayer to pursue the argument based on 'copyrighted article'.

- **Embedded software:** Income generated by way of sale of embedded software is characterized as royalty income under the ITA. But, a different position may be taken in the context of tax treaties. In terms of the internationally accepted principles, the license of software is considered to be incidental to the sale of the product / hardware / device in which the software is embedded, and any consideration received for such license of software is clubbed with the consideration for sale of the product / hardware / device and is therefore not characterized separately.

An example of embedded software could be the setting up of an integrated GSM system for mobile phones that uses both hardware and software. It was viewed that software loaded on the hardware did not have any independent existence and formed an integral part of the GSM mobile telephone system and cannot be said that such software is used by the cellular operator for providing the cellular services to its customers.[15] However, in a case of an integrated product, it is viewed that consideration payable for the software is taxable as royalty as the hardware and software were sold under separate agreements; and license of software (even if made without license of underlying IP) amounts to transfer of a right in respect of a copyright contained in a copyrighted article.[16]

12. *Velankani Mauritius Ltd. and Bydesign Solutions Inc. v. DDIT;* [2010] 40 SOT 33 (ITAT Bangalore), *Novell Inc. v DIT* ITA No. 4368/Mum/2010 (ITAI Mumbai); *Black Duck Software Inc. v. DCITl* [2017] 86 taxmann.com 62 (Delhi – trib.);

13. Computer software supplied by a non-resident manufacturer along with a computer or computer based equipment under any scheme approved under a certain Government policy.

14. Eg. India's treaties with Russia, Namibia, Morocco.

15. Director Income Tax v. Ericsson AB, [2012] 343 ITR 470 (Delhi); Director Income Tax v. Nokia Networks OY (2012) 253 CTR (Del) 417.

16. DDIT vs. Reliance Infocomm Ltd/Lucent Technologies, 2013 (9) TMI 374

Even in case of e-commerce business models involving the use of or access to different kinds of scientific / industrial equipment (for example, in case of bandwidth services, medical diagnosis, etc.), where no control / possession is granted to the service recipient, the domestic law definition of 'royalty' (as retroactively amended in 2012) is wide enough to cover payments thereof. This is in deviation with international principles, where such payments are not treated as royalties unless the payer is also given control / possession over the equipment.[17]

- **Web hosting services / access to software or portal / bandwidth services:** Under the ITA, 'royalty' is defined to include any payments made for the *"use or right to use any industrial, commercial or scientific equipment"*. Majority courts in India have held that payment received for providing access to software / portal hosted on servers outside India or for bandwidth services and router management services is royalty, even though no control / possession was granted over the server. For the payment to be treated as royalty, the ITAT observed that the payer should be able to operate the scientific / industrial equipment on its own.
- **Other Issues:** In case of online auctioning websites, the marketing support services rendered by the Indian group companies to the foreign company is not considered as FTS.

Thus, as can be seen from above, characterization of income remains a major issue in India as far as digital economies are concerned. It is therefore recommended that domestic tax authorities must maintain a consistent and uniform approach in line with internationally accepted principles so as to prevent additional burden of unwarranted litigation and undue compliance costs.

Apart from the ones mentioned above, there are various other e-commerce transactions which have not yet been tested in the court of law yet, and the characterization of such transactions still remains uncertain. Examples being payments made for the maintenance of software, website hosting, data warehousing, data retrieval, delivery of high value data. In addition to software payments, e-commerce income arises from online shopping portals offering digital and tangible products, websites like snapdeal.com offering deals online and charging a commission for them, CRS websites, e-banking. In case of online platforms of tangible products, it is relatively simpler to characterize the income thereof as income from business profits. However in case of composite services like e-banking, access to paid databases, sale of digitized book issues, webhosting, bitcoin mining etc., issues arise with respect to characterization.

III. Classification as a Permanent Establishment (PE)

A non-resident company is taxed at the rate of 40 percent on its business income, if it has a PE / business connection in India. Due to the intangible nature of the transactions in online business models, it is difficult to determine the existence of a PE based on the existing tests of fixed place or service or agency PE laid down in tax treaties.[18] As a consequence, countries like India with consumer centric economies have looked to expand scope of PEs to include virtual PEs.

Considering the importance of certainty with respect to the criteria for determining presence / absence of a PE, issues concerning the digital economy and PE have formed part of the global BEPS initiative to adopt an interpretation which is mutually agreeable to all concerned tax treaty partners. Article 1 of the BEPS Action Plan tackles the issue of taxation of digital economy by bridging the gap between traditional tax systems and business models based on virtual PEs. The suggestions mentioned under BEPS Action Plan could be adopted within the

17. See, e.g., Para 9.1, OECD Model Commentary.

18. The existing tests for determination of PE are – Service PE, Fixed place of business PE, Agency PE, Warehouse PE, Construction, Installation and Supervisory PE.

domestic laws of the country/bilateral tax treaties keeping in mind the international collaborations of the domestic state.

While some of these options have already been implemented through the MLI,[19] three options in particular were put forward as suggestions that each country could adopt into their domestic laws or tax treaty framework keeping in mind their international obligations and collaboration with treaty partners. One of these options was for tax treaty partners to enter into bilateral negotiations with an aim to amend the current tax treaty framework to include the concept of a 'virtual PE'.[20] The threshold for such virtual PE would be based on the foreign company having a "significant economic presence" through internet-based activities in the taxing jurisdiction.[21]

A. Virtual PEs in India

The concept of virtual PE was first discussed around the year 2000 when e-commerce was on the rise and the existing PE rules were thought to be insufficient. However, business models and technologies have evolved since then and those changes have exacerbated the existing problems in the current PE definition. Over the last decade, the global response to base erosion has varied greatly from highly targeted measures such as transfer pricing, general anti avoidance rules to more general measures involving tax base expansion such as the introduction of the equalization levy.

As stated earlier, BEPS Action Plan 1 recognizes that tax on income of foreign entities may be imposed by implementing virtual PE mechanism. However, it emphasizes that such implementation should be through bilateral negotiations with treaty partners.[22]

In the absence of amendments to include virtual PE within the scope of PE, internationally, the mere existence of a website does not constitute a PE as a website does not have a physical location. However, Indian tax authorities have adopted a unilateral approach to virtual PEs and have contended that websites could in certain circumstances constitute a PE and have expressed their reservation to the OECD Commentary in this regard, which are not leased/ otherwise available to enterprise and lease automated equipment not operated and maintained by enterprise post set up would constitute a PE.[23] Some other important reservations made by India to the OECD commentary pertain to PE exposure from (i) websites hosted on a third-party server which are not leased or otherwise available at an enterprise's disposal; and (ii) leased automated equipment which is not operated and maintained by the lessor enterprise post set-up. Per contra, the OECD Commentary states that mere advertisement by an enterprise of its products and services through a website should not constitute a PE, irrespective of whether the website is hosted on a server in India (since mere advertisement is not business).[24] But, a third party website hosted on a computer server of an internet service provider should not result in the server being at the disposal of the enterprise owing the website and therefore, such hosting

19. Particularly, Article 13 of the MLI seeks to restrict exclusions from the definition of PE to activities which are purely of an auxiliary / ancillary nature. As a result, certain types of local presence / activities (for example, warehouses for delivery of goods sold online) which were used by online business models to supplement and complement their digital presence may now qualify as a PE if the presence / activity if not purely auxiliary / ancillary to the business model. Additionally, Article 14 of the MLI seeks to expand the scope of what activities could constitute an agency PE. It states that both - habitual conclusion of contracts on behalf of a non-resident and also habitually playing the principal role leading to the conclusion of contracts that are routinely concluded without material modification by a non-resident could lead to agency PE exposure. Further, it also covers contracts which are executed for provision of services by the non-resident or for transfer of the ownership of / for the granting of the right to use property owned by the non-resident or that the non-resident has the right to use. Prior to the MLI, only direct conclusion of contracts on behalf of a non-resident have been expressly covered within the definition of agency PE.

20. Paragraph 357 read with Paragraph 357 of Action Plan 1 of the 2015 BEPS Report.

21. Paragraphs 276-291 of Action Plan 1 of the 2015 BEPS Report.

22. BEPS Action Plan 1, Final Report, Page 148

23. For example, in the context of CRS for air tickets, the Delhi Tribunal concluded that booking fees received from Indian entities by non-resident companies providing CRS are liable to be taxed in India. *See Amadeus Global Travel v. Deputy Commissioner Income Tax*, [2008] 19 SOT 257 (Delhi).

24. OECD Model Tax Convention (2012).

should not create a server PE. This principle has been upheld by Indian courts in relation to advertisement revenue earned by Google and Yahoo from India.[25] Thus, a virtual PE can be implemented in India only when the business of a non-resident is carried out through the website hosted on a server in India and where the non-resident has the server at his disposal, in capacity of owner, lessee or otherwise. However, if the server is not located in India, a virtual PE cannot arise by virtue of website in itself.

In a few cases, the Indian judiciary has unilaterally digressed from the principles of PE towards application of "virtual PE". The Delhi Tribunal in the cases of *Galileo International*[26] and *Amadeus Global Travel v. Deputy Commissioner Income Tax*,[27] concluded that non-resident companies providing computerized reservation system providing real time access to airline fares and enabling bookings are liable to be taxed in India to the extent of booking fees received from Indian residents. The Tribunal came to such conclusion on the ground that these companies have a "virtual" presence in India which constitutes a "virtual" PE. More recently, the Bangalore Tribunal held that in order to determine whether a service PE under the UAE - India tax treaty has been established, it is not important to determine the number of days the employees of the non-resident company have been in India, but rather the number of days the non-resident company has been providing services in India on a continuous basis.[28] The Tribunal further went on to say that in this age of technology such services could be easily provided without having employees physically present in India.

Thus, courts in India have adopted a conflicting approach to determination of virtual PEs.[29] Additionally, the aggressive and contrary approach to tax adopted by domestic tax authorities in comparison to international principles may lead to double/excess taxation (arising from non-availability/partial availability of credit for taxes in India).

- Expansion of the scope of Business connection (**"BC"**): "Business connection" as a concept is based in the source theory of taxation to justify the source country's right to tax income arising from activities carried in that country, provided certain prescribed nexus thresholds are satisfied.[30] More specifically, the introduction of the new concept of significant economic presence (**"SEP"**), further expands the definition of business connection such that a non-resident would be deemed to have a SEP in India if it carries out any of the following:
  - » transaction in respect of any goods in India above a specified value, including digital goods; or[31]
  - » transaction in respect of any services in India above a specified value, including digital services; or[32]
  - » transaction in respect of any property in India above a specified value, including download of data or software; or[33]
  - » systematic and continuous solicitation of business from India from prescribed number of users through digital means; or[34]

25. ITO v. Right Florists Limited, I.T.A. No.: 1336/ Kol/ 2011
26. *Galileo International Inc. v. DCIT*, [2009] 116 ITD 1 (Delhi)
27. [2008] 19 SOT 257 (DELHI)
28. *ABB FZ - LLC v Deputy Commissioner of Income Tax (IT(TP) A.1103/Bang/2013 & 304/Bang/2015 (Bengaluru Tribunal))*

29. In *ITO v. Right Florists Limited*, ITA No. 1336/Kol/2011, the court upheld the OECD approach but in *ABB FZ - LLC v Deputy Commissioner of Income Tax* (IT(TP)A.1103/Bang/2013 & 304/Bang/2015 (Bengaluru Tribunal)), court have held that application of a virtual PE does not require the non-resident company to have physical presence in India.
30.
31. The Finance Bill, 2018, (1 Feb 2018), Bill No.4 of 2018
32. *Ibid.*
33. *Ibid.*
34. *Ibid.*

» systematic and continuous engagement with prescribed number of users through digital means.[35]

It is worth noting that the specified value would be on an aggregate basis and based on the value of a single transaction.

India adopted the MLI in 2017 as a consequence of which amendments to India's existing DTAA network with respect to the expansion of the definition of PE are expected to come into force in the near future. These expansions under the MLI target certain specific situations which take advantage of the preparatory or auxiliary activities exemption to avoid the creation of the PE in India. In the digital context these are understood internationally to encompass activities that are digitalised supply of goods or services but not inclusive of fully dematerialised digital services.[36]

Given that changes in the existing DTAA network due to the MLI may not guarantee effective source taxation of digital income,[37] changes in domestic law may be required to be able to tax such income.[38] The Budget proposes to introduce two changes to the ITA in this regard. The first is to expand the definition of "business connection" to harmonise it with prospective changes to existing DTAAs due to the MLI and include situations where a person plays a principal role in the conclusion of contracts in India.[39]

It is also important to note that despite the widening of the definition of PE under the MLI and business connection under domestic laws, without change in attribution rules globally, under the current regime this should not result in any significant income being taxed in India.[40]

IV. Equalization Levy

Equalisation Levy (**"EL"**) is an example of unilateral measures undertaken by the Government of India to tax multinational companies operating in the digital economy which do not have any physical presence in India. EL is a 6 percent tax *"on consideration received or receivable for any specified services".* These "specified services" has been defined to include *"online advertisement, any provision for digital advertising space or any other facility or service for the purpose of online advertisement."*[41] The Government, however, may expand the scope of "specified services" to include among others, online marketing and advertisement, cloud computing, website design hosting and maintenance, digital platforms for sale of goods and services and several other services.[42]

The considerations to levy the EL are:

- EL is levied on the resident payer[43] who also has to bear the administrative burden of payment of tax.
- Applicable on transactions which have an aggregate consideration of more than INR 100,000 (approximately USD 1,500) in a financial year.[44]
- The transactions must be between an Indian resident or a non-resident having a PE in India (Resident), and a non-resident service provider not having a PE in India (Non-Resident).[45]

The imposition of equalization levy poses great risk for businesses in digital sphere, especially when the market for online advertising is growing tremendously in India.[46] EL has been deliberately

35. *Ibid.*
36. Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report, *supra* n.5.
37. Daniel W. Blum, *'Permanent Establishments and Action 1 on the Digital Economy of the OECD Base Erosion and Profit Shifting Initiative- The Nexus Criterion Redefined?'*,69 Bulletin For International Taxation, 314,325 (2015).
38. *ibid.*
39. Memorandum of Objects and Reasons to the Finance Bill 2018 (1 Feb. 2018), Bill No.4 of 2018.
40. M. Wilde, *"Lowering the Permanent Establishment Threshold via the anti-BEPS Convention: Much Ado About Nothing?"*, 45 Intertax, (2017).
41. Section 162(i) of the Finance Act, 2016.
42. Section 162(i) of the Finance Act, 2016.
43. Section 162 of the Finance Act, 2016.
44. Section 163(1) of the Finance Act, 2016.
45. Section 162 of the Finance Act, 2016.
46. Online advertising constituted 12.7 of the total spending on advertisements in 2016. Also, India's digital advertisement market is expected to grow at a CAGR of 33.5%. See KPMG / Confederation of Indian Industry (CII), "Digital, the New Normal of Marketing" (January 2017), p. 8. Available at:

kept outside the purview of India's income tax regime and consequently, the government has taken the position that tax treaty relief should not be available. As a consequence, countries of residence of the foreign service providers could potentially refuse to grant tax credits against the EL paid in India thereby leading to double taxation.

V. Taxation of Share Premium on Investments

There exists a stark difference of opinion in valuation of companies operating within the digital sphere due to high weightage of intellectual property and other intangible assets in the books of such companies, valuation of which is dependent on a number of assumptions such as revenue earning capacity, projected cashflows etc. Taxation of the investments into such companies at high valuation may affect the growth of the industry significantly.

In terms of consideration in excess of the value of the shares issued is more than the fair market value (**"FMV"**), such excess is taxable as 'income from other sources'. The computation of such FMV considers the higher of the (a) FMV determined in the manner prescribed under the ITA (Rule 11UA provides the company the option to determine the FMV of its shares either as per (i) the book value of the shares; or (ii) the Discounted Cash Flow Method as determined by a merchant banker or an accountant); or (b) the value of the assets of the company, including intangible assets being goodwill, know-how, patents, copyrights, trademarks, licenses, franchis es or any other business or commercial rights of similar nature, as substantiated by the company to the satisfaction of the tax authority. However, registered venture capital company / venture capital fund by a venture capital undertaking and notified class of persons, like start-ups have been excluded from the levy of this tax.

Additionally, it is important to note that this is applicable only to Indian resident investors and not to non-resident investors.

https://assets.kpmg.com/content/dam/kpmg/in/pdf/2017/01/Digital-the-new-normal-marketing.pdf

3. Indirect Taxation

I. Overview

India's indirect taxation regime has been complex and cumbersome with Union and State Governments taxing different transactions and permitting overlap and ambiguity on certain transactions. The Constitution (One Hundred and First Amendment) Act, 2016 (**"Constitution Amendment Act"**) was both unprecedented and historical.

On July 1, 2017, India has introduced a dual GST, with multiple classification of goods and services which vary from state to state. Prior to the GST, India's indirect tax regime contemplated taxation of the following activities: manufacture of goods, by Central Government under the Central Excise Act, 1944; inter-state sale of goods, by Central Government under Central Sales Tax Act, 1956; provision of services, by Central Government under the Finance Act, 1994; intra-state sale of goods, by State Governments; sales of goods in one State, which have been brought in from another State; and sale of specific goods / services within a State.

GST would replace and subsumed:

Central Indirect Taxes	State Indirect Taxes
▪ Central Excise Duty	▪ State VAT / Sales Tax
▪ Additional Excise Duty	▪ Entertainment and Amusement Tax (except when levied by local bodies)
▪ Additional Customs Duty (CVD)	▪ Central Sales Tax (levied by Centre and collected by State)
▪ Excise Duty levied under the Medicinal and Toilet Preparations(Excise Duties) Act, 1955	▪ Luxury Tax
▪ Special Additional Duty of Customs	▪ Octroi and Entry Tax
▪ Service Tax	▪ Purchase Tax
▪ Central Surcharges and Cesses so far as they relate to supply of goods and services	▪ Taxes on lottery, betting and gambling
	▪ Taxes on advertisement
	▪ State surcharges and Cesses so far as they relate to supply of goods and services

India's new regime uses a dual GST structure.[47] The Constitution Amendment Act and the subsequent CGST Act have been passed by Indian parliament to integrate the indirect tax regime and streamline taxes and levies. GST is categorized as Central Goods and Services Tax (**"CGST"**) to tax intra-state sale of goods and services; Integrated Goods and Services Tax (**"IGST"**) to tax inter-state sale of goods and services; or State Goods and Services Tax (**"SGST"**) levied by the respective States /union territory and governed under the relevant state GST laws. An IGST is levied on every interstate supply of goods or services by the central government under the IGST Act, 2017 (**"IGST Act"**). Further, every intrastate supply is concurrently subject to a CGST by the central government under the CGST Act, 2017 (**"CGST Act"**) and a SGST by the relevant state government under the relevant SGST Act.

II. Basic GST Terms

Taxable events: Under GST laws, the levy of tax is on "supply" of goods or services and on imports. All intra-state[48] / inter-state[49] '*supply* of goods or services or both'[50] shall be liable to tax. The scope of 'supply' is wide in its scope to include all forms of supply of goods or services or both such as sale, transfer, barter, exchange, licence, rental, lease or disposal made or agreed to be made for a consideration by a person in the course or furtherance of business. It also includes import of services, and activities specified in Schedule I and Schedule II. Therefore, a transaction which is not a sale, may yet be counted as a taxable event on which GST is payable. The wide expressions and the inclusive definition provide for all transactions, including incidental and ancillary goods / services being provided as being amenable to GST.

The clarification issued by CBEC[51] (**"CBEC Clarification"**) reiterates the provision of the law and notes that following parameters may be considered:

1. Supply of goods or services. Supply of anything other than goods or services does not attract GST.
2. Supply should be made for a consideration, except in respect of supplies specified under Schedule I of the CGST Act, which are taxable even if made without a consideration.
3. Supply should be made in the course or furtherance of business.
4. Supply should be made by a taxable person.
5. Supply should be a taxable supply.
6. Supply should be made within the taxable territory.

While the CBEC Clarification places emphasis on consideration, the presence or absence of consideration would become a question of fact that may not, by itself, prevent tax authorities from scrutinising transactions in detail and characterising a transaction as 'with consideration'.

The term "supply" includes three elements:

- **Place of supply:** The governing law in relation to a transaction of supply of goods or services is to be determined on the basis of inter-state or intra-state supply of goods or services. If the supply is inter-state, then IGST law is to be applied. However, the supply is intra state, then CGST and SGST laws are to be applied. A cross-border supply of goods or service is subject to IGST, on crossing

47. See Stephanie Soong Johnston, "Modi Reviews New Goods and Services Tax Regime," Tax Notes Int'l, Jun. 12, 2017, p. 86 (describing the planned GST regime a few weeks before it took effect).

48. The intra-state supplies are supplies of goods or services where the location of the supplier and the place of supply are in the same state or same union territory.

49. The inter-state supplies include supplies of goods or services where the location of the supplier and the place of supply are in two different states, or two different Union territories, or a state and a Union territory; supplies of goods or services imported into India when the cross the customs frontiers of India; supplies of goods or services when the supplier is located in India and the place of supply is outside, to or by an developer in special economic zone or unit, or is a supply in the taxable territory and is not an intra-state supply nor covered elsewhere.

50. Except alcoholic liquor for human consumption.

51. The meaning and scope of supply, available at http://www.cbec.gov.in/resources//htdocs-cbec/gst/eflier-meaning-scopeofsupply14062017.pdf.

the Indian customs frontier. IGST is levied in addition to the basic custom duty levied on the value of the import transaction. In a cross-border supply of goods, the location of the importer (in case of imports) and location outside India (in case of exports) is considered. In a cross-border supply of services, the location of the service recipient or supplier depends on each transaction. Further, supply of services directly in relation to an immovable property, depends on the location of the immovable property. As the States formulate the applicable state laws, it is imperative for States to be coordinated and to ensure that different States do not apply different interpretation on 'place of supply of services' for the same transaction. This would otherwise expose a digital service provider to multiple litigations with the possibility of having to pay tax demands in each of the States.

- **Time of supply:** The element of time ascertains the rate of tax and when such tax is to be levied. Generally, the time of supply of goods is the earliest of the date of the invoice or last date of the prescribed period for issue of invoice, or date of receipt of payment. For a transaction on a reverse charge[52] basis, the time of supply of goods shall be earliest of the date of the receipt of goods, or date of payment as per the recipient's books of account or the date on which payment is debited in his account, or immediately after 30 days from issue of invoice, or date of entry in the recipient's books of account (where the above are not possible to determine).

- **Value of supply:** GST is computed on the value of the supply. The value of supply is the transaction value in case of unrelated transactions where the price is the sole consideration. For a transaction where the consideration is not wholly in money, or a transaction which is between distinct or related person (with or without agent), value of the supply is determined in a prescribed manner or on a recommendation of the GST Council. Further, a residuary method has also been prescribed to determine the value of supply of goods or services.

Further, certain activities or transactions are neither treated as a supply of goods nor services. These transactions are prescribed[53] or include transactions undertaken by the Central Government, or a State Government or any local authority (engaged as public authorities, as may be notified by the government on the recommendation of the GST Council).

Taxable person: A taxable person is a person who is either registered or liable to be registered under the provisions of the GST laws. The CGST Act requires that every supplier shall register from where he makes a taxable supply of goods or services only if the supplier has an aggregate turnover of INR 20 lakhs or more in a financial year.[54] The INR 20 lakhs threshold is a welcomed relief to most domestic Small and Medium Sized Enterprise's (**"SME"**) and start-ups which earlier had to pay VAT if their turnover exceeded INR 5 lakh (in most States) and Service Tax, if their turnover exceeded INR 10 lakhs. However, this threshold is not applicable to foreign companies supplying Online Information Database Access and Retrieval services (**"OIDAR services"**) from outside India to Indian consumers or to non-registered businesses in India.[55] Accordingly, such foreign companies are required to register under the GST regime regardless of their size or the value of the services being supplied in India in a financial year.

Certain persons required to obtain registration irrespective of turnover: a person making inter-state supply; a casual taxable person and non-resident taxable persons; a person required to pay tax under reverse charge; a person making supply on behalf of other registered taxable person,

52. "Reverse charge" means the liability to pay tax by the recipient of supply of goods or services or both instead of the supplier of such goods or services or both under sub-section (3) or sub-section (4) of section 9, or under sub-section (3) or subsection (4) of section 5 of the IGST Act.

53. Schedule III, CGST Act.

54. Section 22(1), CGST Act.

55. Section 24(xi), CGST Act.

whether as agent or otherwise; an input service distributors; a person making supply (except of branded services) through an e-commerce operator; an e-commerce operator; every person supplying OIDAR service from outside India to a person in India who is not a registered taxable person (B2C). A person exclusively supplying goods that are not liable to tax or exempt to tax, do not need registration. However, supplies with zero-rated tax requires a person to register in order to claim refund or credit.

Rates: Under the GST regime, there are separate notifications providing tax rates for goods and services, with separate IGST, CGST, as well as SGST notifications. These notifications have been amended multiple times since GST has become effective. For ease of reference, we shall only refer to the IGST rates for goods and services, and the rates notifications for goods shall be collectively referred to as "Rates Schedule for Goods" while those for services shall be collectively referred to as "Rates Schedule for Services". The Rates Schedules for Goods and Services provide a detailed list of all goods and services and their applicable tax rates under GST, and there is a residuary classification under both Schedule which is taxable at 18 percent. Further, there are separate exemption notifications for goods and services under CGST, IGST and each SGST Acts.

The rate structure for services under CGST falls within the range of 0 percent, 2.5 percent, 6 percent, 9 percent or 14 percent and under IGST falls within the range of 0 percent, 5 percent, 9 percent, 12 percent, 18 percent or 28 percent. Most of the rate in relation to digital services falls under 18 percent. Supply of certain goods and services have been designated as 'Zero rated supply' of goods and services meaning although it is taxable supply, zero rate of tax would be charged in respect to such supply and input tax credit or refund can be claimed. Such supplies relate to: (a) exports of goods or services (ii) supply of goods or services to a Special Economic Zone developer or a unit.

Refund of a zero rated supply can be claimed in either of two ways: (a) claiming unutilized ITC without payment of IGST by issuing a bond or a letter of undertaking; or (b) refund of the tax after having paid the IGST on the goods or services supplied.

III. Pre-GST classification of transactions in intangibles and corrections under GST

Taxation of transactions in intangibles, particularly intellectual property (**"IP"**) rights, has historically been a contentious issue in India due to differential taxation regimes for sale of "goods" and provision of "services" coupled with the obscurity surrounding the classification of such transactions. This has been one of the most litigated areas of indirect taxation in India. Due to continuous overlap between the definition of 'goods' under the Constitution of India and the state sales tax / VAT laws with the definition of 'taxable services' under the Service Tax Act, it was a question to ascertain a transaction in intangibles as a sale of goods or a provision of service.

A. Sale of "goods"

Article 366 (12) of the Constitution of India defines goods very broadly to include *"all materials, commodities, and articles"*. Prior to the introduction of the concept of 'deemed sale' under the Constitution, the Supreme Court in a series of decisions starting from *State of Madras v. Gannon Dunkerly & Co. (Madras) Ltd.*, AIR 1958 SC 560 found that various transactions resembling the sale of goods were not liable to sales tax.

The concept of deemed sales was introduced in 1982 upon recommendation of the Sixty First Law Commission Report as the position set out by the Supreme Court then had created scope for avoidance of tax in various ways. At that time, since there was no service tax in the horizon, it was considered necessary to classify these transactions as goods in order to bring them under the net of sales tax. Therefore, Article 366(29A) deems, inter alia, *transfer of right to use any goods for a valuable consideration,* as sale or purchase of 'goods'. Supreme Court decisions since 2000s have generally clarified the status of software and other intangibles and whether these constitute 'goods'.

B. Sale of "services"

With the introduction and gradual expansion of service tax under Finance Act, 1994 (**"Service Tax Act"**), transactions similar to deemed sales under the Constitution of India were identified as taxable services. These included any service in relation to *"intellectual property service"*, which was defined as a *"temporary transfer"* or *"permitting the use or enjoyment of"* an intellectual property right. With further expansion of service tax into the negative list regime from 2012, tax on IP services was continued by identifying *"temporary transfer or permitting the use or enjoyment of intellectual property right"* as a 'Declared Service'.[56]

This resulted in an ambiguity in respect of IP transactions on the question of an overlap between 'deemed sale' under the Constitution and 'service'. This is because the definition of 'deemed sales' did not specify whether such transfer should be permanent or temporary. The main point of debate has revolved around the question of whether 'transfer' of the right to use goods should be distinguished from a mere permission to use in the context of intellectual property.[57] As a result of this ambiguity, state Governments imposed VAT on transactions involving IP claiming that they were a sale of goods, while the Central Government levied service tax on the same transaction based on its claim that it's a service. Therefore, any tax paid by companies on these transactions was open to challenge by the other Government.[58] This was however contrary to judicial principles that service tax and VAT were in fact mutually exclusive.

Subject to mode of delivery and the type of software being licensed (for eg. packaged or customized), the Courts have a considered view to treat grant of an IP license as a provision of service unless it qualified as a 'transfer of right to use' the software.

C. Ambiguity in taxation of software license

The earlier regime had multiple parameters for taxation of software licenses which led to uncertainty on whether a particular form of software license was subject to VAT or service tax. Primarily, the determining factors were the mode of delivery of the software, and the nature of the software contract.

- *Pre-Packaged Software delivered on tangible media* - Packaged or canned software is a software which is sold off the shelf and it can be used by multiple customers. The copyright in a packaged software remains the property of the creator and only a right to use is sold to the customer. A software delivered on tangible media such as a floppy disk, CD or a DVD is considered a sale of goods, as the customer does not pay for the CD itself but for the intellectual property in the software.
- *Customized software delivered on tangible media* - There was lesser clarity in respect of customized software, which is developed specific to the needs of a particular user, and delivered on tangible media. Since the amendment to the Service Tax Act was introduced the legislative intent clearly appears to have been to treat customized software delivered on a tangible media as a service.[59] Pertinently, the service tax Education Guide published by the CBEC also stated that a customized software delivered

56. Section 66E, Service Tax Act. Specific categories of services which were no longer identified under the 'taxable services' category, and provides only a negative list of exempted services.

57. Parind Mehta, *Levy of Value Added Tax on Intellectual Property Rights*, available at http://ctconline.org/documents/service/Note_Parind-VAT_on_IPR-12Dec2015-PrintFinal-v3.pdf

58. Parind Mehta, *supra.*

59. Section 65(105)(zzze), Service Tax Act. Amendment in 2008, included services in relation to *"information technology software"* as a taxable service.

on tangible media under a contract for design and development of a software would be considered as a service because the contract is pre-dominantly a contract of service.[60]

Having stated the above, it is difficult to rule out situations where a customized software on tangible media could be considered as a deemed sale under Article 366(29A) of the Constitution. Since customized software is also a good,[61] the dominant nature of the contract would be relevant in determining whether it is a sale or a service. Where the dominant intention is to either assign the completed software to the customer or to transfer effective control to the customer, then it may be considered as a sale. However, where the software developer provides manpower and technical services for the development of the software, then the nature would be that of a service because the property in the software will never have belonged to the developer and would vest in the customer as and when and to the extent it is developed.[62]

- *Internet downloads / access* - Intangibles such as music files, movies, games, and even software downloaded over the internet are also in the nature of 'goods' as these are capable of abstraction, consumption and use and they can be transmitted, transferred, delivered, stored, possessed etc. Further, these intangibles can also be accessed over the internet without having to download them, such as in case of video streaming websites, music apps or even in case of SaaS. Therefore, there could be arguments to support their classification as either sale of goods or provision of services.

Hence, evidently, the earlier indirect tax regime was plagued with several overlaps with regard to taxation of IP transactions.

60. Tax Research Unit, Central Board of Excise and Customs, *Taxation of Services: An Education Guide*, June 20, 2012, para 6.4.5; available at http://www.cbec.gov.in/resources//htdocs-servicetax/EducationGuide.pdf

61. Supreme Court in the case of *Tata Consultancy Services (Supra note 3)* held that 'goods' includes intangible goods.

62. Parind Mehta, *supra.*

D. Corrections under GST

The Government of India has given incentives that required a boost in its early years, for instance, tax holidays for export earnings for information technology and software services, and certain units exemption from state and local taxes. However, the Thirteenth Finance Commission (**"13 FC Report"**) noted that no distinction should be made between goods and services, and consequently, Government of India should consider these factors and not treat the digital economy differently. Emphasis on a rationalised tax structure, cashless economy and inculcating entrepreneurial spirit calls for encouraging manufacturing and services activities in the digital economy and giving it the support it requires.

GST laws have therefore sought to start on a clean slate as the history of indirect taxation has multiple and complex litigation on issues relating to legislative competence and taxing machinery. While significant correction from the erstwhile measure has been undertaken, there continue to be ambiguities with regard to classification between a good and service, particularly with respect to the digital economy.

Under GST, the taxable event is the supply of goods or services. Therefore, the concepts of sale or deemed sale (as defined under the constitution) used under the VAT or central sales tax have become obsolete. The CGST Act defines goods as "every kind of movable property other than money and securities."[63] This definition is wide enough to include intangibles.[64] Services have also been defined broadly to include, among other things, "anything other than goods, money and securities but includes activities relating to the use of money."[65] Thus, the distinction between mere permission to use IP and a transfer of the right to use the IP is no longer relevant; both are considered a supply of service under GST.

63. Section 2(52), CGST Act.

64. The Model GST Law released by the Empowered Committee of State Finance Ministers in June 2016 specifically excluded intangibles from the definition of goods. This carveout was not been carried over into the final CGST Act.

65. Section 2(102), CGST Act.

Furthermore, the classification of customized software as a service has been retained under GST. The "development, design, programming, customization, adaptation, upgradation, enhancement, implementation of information technology software" is specifically deemed as a supply of service under Schedule II.

IV. Ambiguities under GST

A. Rates for Digital Goods and Digital Services

There are separate notifications providing tax rates for goods and services, with separate IGST, CGST, as well as SGST notifications, which have been amended multiple times since GST has become effective, including separate exemption notifications for goods and services under CGST, IGST and each SGST Acts. This results in uncertainty as to the applicable GST rate. For instance, IP assignment transactions should ideally be taxed according to the rate prescribed under the Goods Rates Notification.[66]

While there is an obvious and understandable distinction between the two entries regarding IT software, the incongruous presence of the language "in respect of goods" in the first entry and its corresponding absence in the second entry is unclear. This could lead to ambiguity in classification and resulting litigation. During the last GST Council meeting on November 10, the government identified this incongruity and amended the Goods Rates Notification to provide corresponding entries for permanent transfer of IP using the same language and the same rates quoted above.[67] This should bring needed clarity to IP assignment transactions (barring the dissonance with respect to the phrase "in respect of goods," noted above). Having said that, the government seems to have neglected deleting the words "permanent transfer" in the Services Rate Notification. We suspect a correction will only be a matter of time.

B. Regarding Trademark License Rate

The classification scheme contains two separate entries relating to trademarks: The first, titled "Licensing Services for the Right to Use Trademarks and Franchises," uses tariff code 997336 and appears under heading 9973; and the second, titled "Trademarks and Franchises," uses tariff code 998396 and appears under heading 9983 "Other Professional, Technical, and Business Services." These service descriptions fall into different rates categories under the Services Rate Notification with the former being subject to an IGST of 12 percent and the latter at 18 percent.[68]

Therefore, there is also an ambiguity surrounding the applicable rate for transactions involving license of trademarks and franchises because the two service descriptions are difficult to distinguish. This may lead to litigation in the future.

C. Regarding Import of Intangibles

Import of intangible goods appears to have been overlooked by the drafters of the GST, and there is an ambiguity regarding the taxation of such transactions.

Section 5 of the IGST Act provides that IGST is chargeable on all interstate supplies of goods and services based on the value determined under section 15 and at a notified rate that shall not exceed 40 percent. Section 5 of the IGST Act (which is the charging provision for IGST) further states *"[the] integrated tax on goods imported into India shall be levied and collected in accordance with the provisions of section 3 of*

66. MOF, "Integrated Tax (Rate)," Notification No. 1/2017 (June 28, 2017) (Goods Rates Notification).

67. MOF, "Central Tax (Rate)," Notification No. 41/2017 (Nov. 14, 2017).

68. See Services Rate Notification, *supra* note 25 (listing an ICST rate of 18 for services other than those relating to selling of advertisement space in print media that fall under heading 9983 titled, "Other Professional, Technical and Business Services").

the Customs Tariff Act, 1975 on the value as determined under the said Act at the point when duties of customs are levied on the said goods under section 12 of the Customs Act, 1962."

Therefore, determining when customs duty is levied is important to ascertaining whether IGST would be chargeable on a transaction involving the import of goods. Judicial precedents provide that customs duty is levied when goods are imported into India, that is, when they cross India's customs barriers. Decisions under the Central Sales Tax Act, 1956 (**"CST Act"**) have similarly equated the import of goods into India with the event of "crossing customs frontiers of India." While this phrase is not defined by the Customs Act, the CST Act defines "crossing the custom frontiers of India" as crossing the limits of the area of a customs station in which imported goods or export goods are ordinarily kept before clearance by custom authorities.

Because the point of taxation for imports under the Customs Act relates to the physical movement of goods across India's customs frontiers, it appears clear that no customs duty is due on the import of intangible goods. In turn, IGST is only applicable on import of tangible goods that physically cross the customs frontiers of India. It is not designed to apply to intangible goods that may be imported through a digital medium such as the internet. Intangibles could include IP such as software, copyrights, or trademarks assigned online by a person offshore to a person in India. They could also include online gambling or betting transactions, which involve the sale or purchase of actionable claims, when the website is owned by a person overseas and the player is in India.[69]

While these transactions would qualify as imports of goods, they have been (possibly inadvertently) overlooked by the charging section of IGST. Absent any conclusive judicial precedent on this point, it is unclear whether these transactions are subject to GST.

V. OIDAR Services

Similar to the service tax regime that preceded it, the GST regime captures digital services within the definition of OIDAR services,[70] which includes services *'whose delivery is mediated by information technology over the internet or an electronic network and the nature of which renders their supply essentially automated and involving minimal human intervention and impossible to ensure in the absence of information technology'*.[71] The definition further provides to include list of services within the definition of OIDAR services: advertising on the internet; providing cloud services; provision of e-books, movie, music, software and other intangibles through telecommunication networks or internet; providing data or information, retrievable or otherwise, to any person in electronic form through a computer network; online supplies of digital content (movies, television shows, music and the like); digital data storage; and online gaming.[72]

The distinction between OIDAR services and other types of services becomes particularly important when determining the place of supply of a service. Those transactions where the location of the supplier and place of supply of goods or services are in (i) two different States, (ii) two different Union territories; or (iii) a State and a Union territory are subject to IGST,[73] while those transactions where the two are in the same State or Union Territory are subject to CGST and SGST/UGST.[74] Further, imports of goods

69. "Actionable claim" is defined in section 3 of the Transfer of Property Act, 1882 as: *"a claim to any debt . . . or to any beneficial interest in movable property not in the possession, either actual or constructive, of the claimant . . . whether such debt or beneficial interest be existent, accruing, conditional or contingent."* Actionable claims are included in the definition of "goods" under section 2(17) of the CGST Act and Schedule II of the CGST Act treats actionable claims, other than lottery, betting, and gambling, as neither a supply of goods.

70. This definition has been transplanted from the earlier Service Tax regime.

71. Section 2(17), IGST Act.

72. Section 2(17), IGST Act.

73. Sections 7(1) and 7(2), IGST Act.

74. Section 8(1), IGST Act

and services are also subject to IGST, and the term 'import of services' is defined as a supply of services where (i) the supplier of service is locations outside India, (ii) the recipient of service is located in India; and (iii) *the place of supply is in India.*[75] Accordingly, it becomes important to determine the place of supply of a service[76] to determine whether IGST would be applicable. The place of supply of OIDAR services shall be the location of the recipient of services, and a service recipient shall be deemed to be located in India, if any two of the following non-contradictory conditions are met:

i. the location of address presented by the recipient of services through internet is in the taxable territory;

ii. the credit card or debit card or store value card or charge card or smart card or any other card by which the recipient of services settles payment has been issued in the taxable territory;

iii. the billing address of the recipient of services is in the taxable territory;

iv. the internet protocol address of the device used by the recipient of services is in the taxable territory;

v. the bank of the recipient of services in which the account used for payment is maintained is in the taxable territory;

vi. the country code of the subscriber identity module card used by the recipient of services is of taxable territory; and

vii.the location of the fixed land line through which the service is received by the recipient is in the taxable territory.

It could be argued that services provided through electronic means, specifically OIDAR services, should fall within the residuary category under the Rates Schedule for Services and be subject to tax at the rate of 18 percent. However, the Rates Schedule for Services does not make a distinction between services based on their mode of supply. The separate identification of OIDAR services with rate schedule may lead to litigation on classification.

75. Section 2(11), IGST Act.

76. Section 13, IGST Act.

VI. Tax Collection at Source ("TCS") obligation for E-Commerce operators

GST has brought in an additional challenge of TCS on e-commerce operators as the scope of definition of e-commerce operator is broader to include all forms e-commerce business models. An e-commerce operator has been defined to mean *"any person who owns, operates or manages digital or electronic facility or platform for electronic commerce"*.[77] Further, e-commerce has been defined as *"supply of goods or services or both, including digital products over digital or electronic network."*[78]

E-commerce operators are mandatorily required to collect and pay GST (by way of TCS) on behalf of the suppliers at the prescribed rate of the net value of taxable supplies of goods or services made through it, within 10 days from the end of the month and furnish a monthly statement of outward supplies.[79] The CGST Act further places significant compliance burden on e-commerce operators, which in most cases are start-ups. The Government has currently deferred the applicability of the TCS obligation on e-commerce operators indefinitely for a smooth GST roll out.[80] It will be a mammoth burden on e-commerce operators to claim a refund of TCS paid for the orders which have been returned or canceled. This problem will primarily arise when the return of the order takes place in the following month as it will

77. Section 2(45), CGST Act.

78. Section 2(44), CGST Act.

79. Section 52, CGST Act. Section 52 defines 'net value of taxable supplies' as the aggregate value of taxable supplies of goods or services or both, made during any month by a; registered persons through the operator, reduced by the aggregate value of taxable supplies returned to the suppliers during the said month.

80. *Deferment Of Tax Collection At Source Provision Under GST To Help Sellers: Amazon*, NDTV Profit, (June 26, 2017, 22:44 IST)

not have been accounted for while determining the 'net taxable supplies' and TCS would have accordingly been deducted and paid on it.

Imposing such a financial and administrative burden may be considered an unreasonable restriction on right of e-commerce operators to carry on business in India. While the TCS obligations on e-commerce operators are currently deferred, it is recommended that the same be repealed as these could be harmful to the development of e-commerce which is one of the cornerstones of the digital economy.

VII. Other ambiguities within GST Regime

While the GST has provided some improvement in clarity as to IP licenses, ambiguities do remain, some of which are being addressed by the government. While some of the flaws are inherited from the earlier system, there are also some issues that are newly created under GST.

A. Cumbersome Registration Requirements

Unlike the general provisions requiring the supplier to register in the State from where he is making the supply of services[81] there is no specific provision in relation to a non-resident supplier providing services outside India. This is not only a severely cumbersome requirement for foreign multinational enterprises (**"MNEs"**), but even more so for foreign small and medium enterprises (**"SMEs"**) and start-ups accessing the ever-growing Indian market through the internet.

Every registered supplier of the taxable services is required to issue an invoice.[82] The particulars for invoice[83] include name, address of the recipient and address of delivery along with State and its code only if the recipient is registered or if the recipient is un-registered and the value of taxable supply is INR 50,000 or more. However, if value of taxable supply is less than INR 50,000 and recipient is un-registered, then the recipient's details will be recorded only if the recipient requests such a record. This leaves a room for unregistered recipient to not register in every State as the registration is not mandatory.

For OIDAR services, or services being provided over a server, the GST provisions do not clarify as to what constitutes a location from where a taxable supply is made, and the same is likely to be understood based on the wide definition of 'location of supplier of service' under the CGST Act.[84] The definition recognizes a "fixed establishment" as the location of service supplier if the service is supplied from such a fixed establishment other than the supplier's registered place of business.[85] Accordingly, if a company located in Maharashtra provides OIDAR services from a server located in Gujarat, the provisions are unclear as to whether the place from which services are being supplied should be the company's location or the server's. For a lone server it is unclear as to whether the server would constitute a "fixed establishment", as the definition requires that the place have some human resources in addition to technical resources. Another point of significant concern is the registration requirements under the SGST Acts and CGST Act in relation to a supplier making a taxable supply of goods or services *in* that state, whereby service suppliers may be required to obtain an SGST registration in every state where their customers are located. A foreseeable hindrance which the absence of an SGST registration may cause is where a supplier seeks to claim input tax credit for SGST discharged in the state other than the state where such supplier is registered. This is because the SGST Acts only contemplate availment of input tax credit with respect to persons registered under the respective SGST Acts.[86]

81. Section 22(1), CGST Act.
82. Section 31, CGST Act.
83. Rules 46-48 of CGST Rules.
84. Section 2(71), CGST Act
85. Section 2(50), CGST Act defines *'fixed establishment'* as a place (other than the registered place of business) which is characterized with a sufficient degree of permanence and suitable structure in terms of human and technical resources to supply services, or to receive and use services for its own needs.
86. Section 2(62) of the SGST Acts (particularly, Maharashtra, Karnataka and Tamil Nadu) defines *'input tax'* "in relation

The registration requirement in every destination state is highly onerous to business and the Government should provide the necessary clarifications / amendments to address the above issues. Appropriate directions should be given by the GST Council to the states to correct contradiction in the SGST Acts with regard to registration and input tax credit and bring the same in line with the CGST Act. It would be advisable to have only a single simplified registration scheme for such businesses.

B. Residuary taxation powers

While the integration of taxation powers across States of India and Central Government and across sale of goods and provision of services is a remarkable feat, one dark lining to the silver cloud is the retention of residuary taxation powers by Central Government. Entry 97 of List 1 of Schedule 7 to the Constitution provides for '*Any other matter not enumerated in List II or List III including any tax not mentioned in either of those Lists.*'

The Constitution Amendment Act has deleted certain important legislative entries such as Entry 52 of List II (Entry Tax) and Entry 92C of List I (Service Tax) and amended others such as Entry 54 of List II (taxes on sale of petroleum, diesel, alcohol etc.). While the taxation powers of the State have been streamlined, it is imperative that for a GST to be successful, Central Government will have to resist levying taxes through its residuary legislative powers in Entry 97 of List I.[87] Legislative powers conferred by Entry 97 was relied on to justify imposition of equalisation levy as well.[88] States for their part, will also need to be mindful of the economic objectives of GST and refrain from imposing other taxes / exercising other taxation powers to raise revenue within that State.

Events after introduction of GST would show that these concerns are not unfounded and that certain States have in fact raised taxes outside scope of GST.[89] Therefore, to truly ensure harmonisation of taxes and reduce uncertainty on India's taxation regime, both Central Government and State Governments will have to refrain imposing taxes or similar levies through creative exercise of legislative powers under the Constitution.[90]

C. Inter-departmental / Intra-entity transactions

The pre-GST provisions did not subject to tax the transactions within an entity as it required a 'registered dealer'. While CGST Act defines 'person' to include a company, but the definition of 'person' and 'supplier' should not include a division or unit of a company. The CBEC Clarification provides that '*an unregistered person who is liable to be registered is a taxable person*', consequently, it is a moot point on how tax authorities would react to large entities which provide services within the entity or engage in branch transfers. This, coupled with the reiteration in the CBEC Clarification that '*a person making supplies from different States needs to take separate registration in each State*', thus, making compliance onerous. The need for multiple-registrations is reinforced when it is seen that registration is required to avail credit. However, a person who has obtained multiple registrations or is legally required to obtain multiple registrations, whether within a state or in different states, is treated as a 'distinct person' in respect of each such registration.[91] These provisions would be particularly burdensome when viewed in the context of the digital

to a *'registered person'* (i.e. a person registered under the concerned SGST Act) as CGST, SGST of the concerned state, IGST or UTGST charged on any goods or services supplied to him.

87. Levy of service tax was justified on the ground of Entry 97 of List 1 of Schedule 7.

88. Report of the Committee on Taxation of E-Commerce, February 2016.

89. Maharashtra, Tamil Nadu raise taxes outside GST, Centre says they can, Business Standard, July 5, 2017, available at http://www.business-standard.com/article/economy-policy/maharashtra-tamil-nadu-raise-taxes-outside-gst-centre-says-they-can-117070401228_1.html.

90. No Ghost in the GST Machine, Economic Times, August 27, 2016.

91. Section 25(4), CGST Act and Schedule 1, CGST Act.

economy where multiple jurisdictions would be involved, including, multiple points of transactions.

Under the final CGST Act, this has been expanded to also cover intra-entity supply of services, and also to supplies made between voluntarily registered establishments within a state. Therefore, even services such as back-office functions or Information Technology (**"IT"**) support services provided within the entity by a division or branch of the entity ould potentially be treated as a taxable supply. In order to escape the levy of GST on intra-entity support services, it could be argued that the services are not provided in the *'course or furtherance of business'*. Having said that, this is likely to result in litigation which could impact all enterprises having multiple branches in the country.

4. Conclusion

The Government of India expects that India's digital economy will grow from the current size of USD 270 billion to USD 1 trillion by 2022,[92] however, there is still a lot of ground work required to be done in order to realize that objective. The national tax policy on digital transactions does not seem to be completely aligned in this regard and in some respects there is no international consensus either on the taxation of the digital economy.

The introduction of the GST regime is envisaged to play a crucial role in integrating both the manufacturing and services sectors in the digital economy, which in turn, can help India achieve economic growth and social development. But the stability, reliability, and clear framework concerning digital economies depends on the resolution of issues and ambiguities present in the current tax system. It is imperative that such challenges are overcome if the 1 trillion USD goal is to be achieved.

92. Kiran Rathee, India eyeing to become a trillion-dollar digital economy by 2022, Business Standard (May 23, 2017, 20:44 IST), http://www.business-standard.com/article/economy-policy/india-eyeing-to-become-a-trillion-dollar-digital-economy-by-2022-117052301385_1.html.

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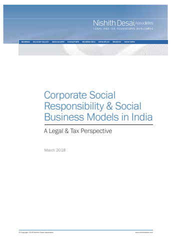

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Research is the DNA of NDA. In early 1980s, our firm emerged from an extensive, and then pioneering, research by Nishith M. Desai on the taxation of cross-border transactions. The research book written by him provided the foundation for our international tax practice. Since then, we have relied upon research to be the cornerstone of our practice development. Today, research is fully ingrained in the firm's culture.

Our dedication to research has been instrumental in creating thought leadership in various areas of law and public policy. Through research, we develop intellectual capital and leverage it actively for both our clients and the development of our associates. We use research to discover new thinking, approaches, skills and reflections on jurisprudence, and ultimately deliver superior value to our clients. Over time, we have embedded a culture and built processes of learning through research that give us a robust edge in providing best quality advices and services to our clients, to our fraternity and to the community at large.

Every member of the firm is required to participate in research activities. The seeds of research are typically sown in hour-long continuing education sessions conducted every day as the first thing in the morning. Free interactions in these sessions help associates identify new legal, regulatory, technological and business trends that require intellectual investigation from the legal and tax perspectives. Then, one or few associates take up an emerging trend or issue under the guidance of seniors and put it through our "Anticipate-Prepare-Deliver" research model.

As the first step, they would conduct a capsule research, which involves a quick analysis of readily available secondary data. Often such basic research provides valuable insights and creates broader understanding of the issue for the involved associates, who in turn would disseminate it to other associates through tacit and explicit knowledge exchange processes. For us, knowledge sharing is as important an attribute as knowledge acquisition.

When the issue requires further investigation, we develop an extensive research paper. Often we collect our own primary data when we feel the issue demands going deep to the root or when we find gaps in secondary data. In some cases, we have even taken up multi-year research projects to investigate every aspect of the topic and build unparallel mastery. Our TMT practice, IP practice, Pharma & Healthcare/Med-Tech and Medical Device, practice and energy sector practice have emerged from such projects. Research in essence graduates to Knowledge, and finally to *Intellectual Property*.

Over the years, we have produced some outstanding research papers, articles, webinars and talks. Almost on daily basis, we analyze and offer our perspective on latest legal developments through our regular "Hotlines", which go out to our clients and fraternity. These Hotlines provide immediate awareness and quick reference, and have been eagerly received. We also provide expanded commentary on issues through detailed articles for publication in newspapers and periodicals for dissemination to wider audience. Our Lab Reports dissect and analyze a published, distinctive legal transaction using multiple lenses and offer various perspectives, including some even overlooked by the executors of the transaction. We regularly write extensive research articles and disseminate them through our website. Our research has also contributed to public policy discourse, helped state and central governments in drafting statutes, and provided regulators with much needed comparative research for rule making. Our discourses on Taxation of eCommerce, Arbitration, and Direct Tax Code have been widely acknowledged. Although we invest heavily in terms of time and expenses in our research activities, we are happy to provide unlimited access to our research to our clients and the community for greater good.

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research@nishithdesai.com

Nishith Desai Associates

LEGAL AND TAX COUNSELING WORLDWIDE

MUMBAI

93 B, Mittal Court, Nariman Point
Mumbai 400 021, India

tel +91 22 6669 5000
fax +91 22 6669 5001

SILICON VALLEY

220 California Avenue, Suite 201
Palo Alto, CA 94306-1636, USA

tel +1 650 325 7100
fax +1 650 325 7300

BANGALORE

Prestige Loka, G01, 7/1 Brunton Rd
Bangalore 560 025, India

tel +91 80 6693 5000
fax +91 80 6693 5001

SINGAPORE

Level 30, Six Battery Road
Singapore 049 909

tel + 65 65509855

MUMBAI BKC

3, North Avenue, Maker Maxity
Bandra–Kurla Complex
Mumbai 400 051, India

tel +91 22 6159 5000
fax +91 22 6159 5001

NEW DELHI

C–5, Defence Colony
New Delhi 110 024, India

tel +91 11 4906 5000
fax +91 11 4906 5001

MUNICH

Maximilianstraße 13
80539 Munich, Germany

tel +49 89 203 006 268
fax +49 89 203 006 450

NEW YORK

375 Park Ave Suite 2607
New York, NY 10152

tel +1 212 763 0080