Taxation of a Global Corporation — E-Commerce

CA RashminSanghvi, CA NareshAjwani,
CA RutvikSanghvi

CA RashminSanghvi is practising in Mumbai since 1975. He has made presentations at several conferences organised by the Institute of Chartered Accountants of India (ICAI), Chamber of Tax Consultants (CTC), the Bombay Chartered Accountants' Society (BCAS) and various other institutions both within and outside India. He has also given lectures at Income-tax department's training Institute at Nagpur and UTI Institute of Management on tax treatment for foreign collaborations, e-commerce taxation, international economics, etc. He is presently spearheading a unique group on the study of International Economics under the auspices of BCAS.

CA NareshAjwani is a practising Chartered Accountant in Mumbai for the past 24 years. He has presented papers and given lectures on International Taxation, Foreign Exchange Management Act & Rules, structuring of foreign investment into India and investment abroad at conferences organised by various professional bodies including the ICAI, CTC, BCAS and other organisations. He is on International Tax Committees of Bombay Chartered Accountants' Society and The Chamber of Tax Consultants.

RutvikSanghvi qualified as a Chartered Accountant in 2005. He has authored articles in International Tax Journals and given presentations at ICAI's International-tax course & seminar, and at various professional forums. He is a Convenor of the CTC International Taxation Committee and its Intensive Study Group on International tax. He is also a member of the Direct Taxation & Journal Committees of the BCAS.

All three authors are partners of RashminSanghvi& Associates, Mumbai.

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Brief Contents

The **preface** presents a background of legal problems in taxing a Global Corporation doing business through E-Commerce.

Main Article is divided into following parts:

Part I	:	Mentions the **traditional legal concepts** which have already been discussed in the past at several forums. A look at how some concepts have developed in the past. This part specifies the principles accepted in the past; but now under challenge.
Part II	:	**Illustrations** of E-Commerce explaining why traditional legal principles of International Taxation cannot be applied to Global E-Commerce.
Part III	:	**Connecting Factors**& their inapplicability to E-Commerce. We observe that existing rules of international taxation are inadequate to deal with E-Commerce.
Part IV	:	We consider some **solutions** for taxation of business done through E-commerce. These contradict the principles of Neutrality. Overall solution. This will upset existing tax equilibrium.

Note : This is a long paper. We have given summaries for each part and summaries for the whole paper. Readers may see the summaries & decide which part may interest them.

Conclusion : Assessees doing their business through E-Commerce can avoid almost total tax. They can shift their operations to a tax haven and avoid COR tax. Their incomes may generally be categorised as "Business Income". They have no PE in most of the countries from which they earn their revenues. Hence they escape COS tax also.

Governments cannot sit idle and watch billions of dollars worth of incomes go tax free. It may be some time before Treaty models are effectively modified to cover E-Commerce. GOI has made amendments in Section 9 – which we feel are inadequate. GOI may need more comprehensive amendments to the Income-tax Act to tax these incomes. Part IV gives detailed suggestions.[1]

Important Note : All the company names used in this article are purely for illustration. Actual business activities and tax practices of the companies referred here may be totally different. We have used some names only to describe the kind of activities under E-Commerce.

SHORT FORMS

Ad	:	Advertisement.
BC	:	Business Connection.
BPO	:	Business Process Outsourcing.
CIT	:	Commissioner of Income-tax.
Compendium	:	"International Taxation–A Compendium" published by The Chamber of Tax Consultants.
COE	:	Country of Economic Base/Foot Print/PE
COM	:	Country of Market
COP	:	Country of Payment
COR	:	Country of Residence
COS	:	Country of Source
DTA	:	Double Tax Avoidance Agreement (Treaty).
E-Commerce	:	When a businessman conducts his business with customers in other countries by using electronic communication channels; without physically meeting the customers and without having a permanent establishment, it is called Electronic Commerce. In this article we are referring to only cross border E-Commerce.
EDT	:	Elimination of Double Taxation.
GC	:	Global Corporation which does business in many countries without having PE in those countries.
GDP	:	Gross Domestic Product.
GOI	:	Government of India. Mainly Income-tax department.
IPR	:	Intellectual Property Rights.
ITA	:	Indian Income-tax Act.
MNC	:	A multinational corporation which does business in many countries by **having PE** in most of the countries. Its focus is on traditional business & not E-Commerce.
NR	:	Non-Resident of India.
PE	:	Permanent Establishment.
TDS	:	Tax Deduction at Source.

TV : Television

USA : United States of America.

US : Something pertaining to USA. For example, US Government.

Preface

This is a Conceptual Paper. Hence it is lengthy paper. This paper may be complex for some readers. Some complex issues are first mentioned. Then in a separate part elaborated.Then repeated in conclusion. This is a style adopted in "Yoga Vashisthya" as well as in "Conservations with God". It helps many. Some experts may find repetition unnecessary. We are sorry. There are some radical thoughts.

1. In this compendium E-Commerce is **already covered** in (i) "Taxation of Electronic Commerce in India" by Mr. Vishal Gada& Mr. ZeelJambuwala; (ii) "PE issues in the context of Electronic Trade, Commerce & Services" by Dr. Amar Mehta; and (iii) "BPO Taxation" by Mr. PadamchandKhincha. International Taxation of Global Corporation involves similar issues. Hence there may be considerable overlap. Different authors may express different views.

2. **The issues** considered are: Scope of Total Income; Deeming provisions extending the scope; determination of COS & COR; Permanent Establishment, Attribution of profits to PE; Jurisdiction of a Government to tax; and so on. In this broad compendium, for each of these issues, there are one or more articles. Hence we are straight away going into the core issues. And in Part IV we present a new system of taxing E-Commerce.

3. Finance Ministry had appointed a **High Powered Committee** to make recommendations on **E-Commerce taxation.** The Committee presented its report in January, 2001. Committee made several important observations & suggestions. Many of these suggestions are already implemented by GOI. One of the authors to this article had the privilege of being a member of the Committee. Some issues discussed in the Committee report are discussed in this article.

4. **OECD** had appointed a committee (TAG) to study E-commerce Taxation and make recommendations. In the year 2005, the Committee presented its report. Committee concluded that "There is no alternative taxing rule (i) which is clearly superior to existing rules; and (ii) which is widely acceptable. Hence no changes may be made in existing tax treaty rules." We fully appreciate the difficulties faced by both the committees.

And yet we endeavour to present our views on possible solutions.

5. **Present situation is:** Everyone understands that there are problems in taxation of E-commerce. However, so far no clear solution has emerged. This may be largely because we want to apply the tax principles of Traditional Commerce to E-commerce.

6. We (authors) have presented in the past some papers on this subject submitting our views and proposals for solutions. Some issues have been discussed in depth in those

articles. Hence in this paper those issues are only briefly touched upon. Reference to earlier articles is given at appropriate places and in Annexure to Part I. In this paper we are going further. All these papers are available on our website.

7. In this paper we are discussing the international tax issues **focusing on India**. However, the principles discussed here may be applicable in other countries also.

8. Key Issues

8.1 One key Issue is: **"Sharing of tax"** by two or more Governments on the profits earned by a Global Corporation. The Global Corporation (GC) conducts its business in such a manner that it earns revenue from many countries and does not have a PE in most of the countries. Hence the countries from which the revenue flows, do not know how to tax the flows.

For the assessee, the issues are of (i) avoiding double taxation, (ii) having certainty and clarity of tax rules.

8.2 Can the Double Tax Avoidance Treaties be so amended that Double Tax as well as Double Non-Taxation of E-commerce is avoided? This may amount to **reworking some Treaty principles like Permanent Establishment and Attribution of Profits.** And even a fresh look at the Connecting Factors of "Residence" and "Source".

8.3 Can Government of India make fair provisions in the **Income-tax Act (ITA)** to avoid both – double taxation and double non-taxation?

9. An immediate issue comes in mind: **"What is so unique** about E-commerce taxation that one needs modification in Treaty Rules?"

Answer to this query is: Domestic tax laws and Treaty models have been drafted mainly considering (i) business in **goods;** and (ii) traditional methods of doing business.

Today (i) **services** business has become larger (in terms of turnover) than the commodities business; and (ii) technology has made **globalisation** of business easy. Methods of doing certain businesses have changed while for many businesses the traditional methods still continue. Old methods of tax sharing (avoiding double taxation) have not envisaged E-commerce. And Governments as well as OECD & UN are not yet ready to change the traditional methods of tax sharing.

This article at various places shows that the present system of international taxation has **serious weaknesses**. These weaknesses need to be removed. This is plain analysis of a legal system. No criticism is intended.

10. Any suggestion for taxing E-Commerce will necessitate a radical departure from the existing system. Legal minds may oppose departures from tradition. This opposition may become milder if we realise that the existing system is faulty.

10.1 In India & some other countries – Goods & Services are treated differently. Even amongst services, there is discrimination. Business income arising out of goods is taxable only in COR. While some services are taxable in COS, rest of the services are not taxable in COS.

OECD does not have any Article on Fees for Technical Services (FTS) and Independent Services (professional income) (Article 14). While there are Articles for Royalty, Capital Gains and Shipping & Airline incomes; maximum taxing rights are with COR.

It is a widespread understanding that OECD model favours COR at the cost of COS. There is a history to it. Professor Roy Rohatgi's book "Basic International Taxation" in Exhibits gives the model conventions by League of Nations. These models give an insight into the developments.

10.2 In essence it is assumed that all income accrues in COR. Only exception is Permanent Establishment. Country of Market is not considered as having any contribution towards the income.

11. While a globally acceptable solution for E-Commerce Taxation system has not emerged, **E-commerce Business is a reality.** People will do business. CITs will pass orders. In the absence of a clear law and clear treaty guidelines; CITs will try to work out a fair balance and pass assessment orders. There will be differences. Courts will try but Courts cannot come out with complete code on E-commerce Taxation. They will decide only on the limited issues before them.

Government of India (GOI) cannot wait for OECD or UN to come out with new Treaty rules. Some deeming provisions have already been made. However, a complete solution for taxing GCs has not emerged. Similarly several Governments will pass similar laws – protecting their own tax bases and probably hurting others' tax bases. This can mean a "Free for all." When the **"Tipping Point"** will be crossed, some new norms will have to be found out.

12. There are several companies like **Unilever**, Colgate, BASF which do business in several countries. However, their main focus is on commodities. So they have PE where they operate. It is useful to distinguish these companies from others like **Google** &facebook. Hence in this article, companies dealing with traditional PEs are called **MNCs or Multi National Corporations.** Global Companies dealing with E-Commerce are called **Global Corporations (GCs).**

In real life, there may not be a demarcation – except in some rare cases. Even Unilever uses E-Commerce to a great extent. And Google also needs PEs. Amazon uses both E-Commerce & physical logistics simultaneously for despatch of sold goods. Different companies use different methods to conduct business.

This probably means that **we cannot have different rules for taxing different kinds of businesses.** OECD has committed to **"neutrality"** in taxing E-Commerce & Traditional Commerce.

13. There is another issue. If any type of business is treated differently, then people will try to attribute maximum profits to that type of business – which gets more relief. This will lead to **litigation**. The vested interest in different kinds of treatment for business based on 'instruments used for business' must be avoided.

14. Normal tax issues are compounded by anti-avoidance provisions like "Transfer Pricing" and "GAAR".

15. In this paper we have discussed tax havens and how Global Corporations (GCs) can easily avoid taxes. However, such discussion is only to highlight the inadequacies of the present system of taxation. The theme of this paper is on a fair & proper system of international taxation.

16. This paper is on: "What should be the tax law of future". Hence there is no discussion on case law – which can only interpret existing law.

Main Article

In this paper, we submit in four parts (i) Legal problems in applying international tax treaty rules to a Global Corporation (GC); and (ii) make an humble attempt to present some alternative solutions.

In the first part we are discussing existing important principles of International Taxation. Let us try to apply these principles to E-Commerce. **Paragraph 7** in this part states the **core controversy in E-Commerce.**

Part I — International Taxation Existing Principles / Concepts

1. Scope of This Article

This paper does not discuss tax issues where the assessee (income – earner) and his source of income are within the same country – and the income wholly arises in the same country. Such income is called domestic income. This paper discusses **only Cross Border tax issues.**

2. There is traditional method of business. This paper does **notdiscuss traditional issues.** For example, in commodities manufacturing or trading business there will be Permanent Establishments. This business will constitute a significant part of GDP for a long time to come. The concept of PE will be a useful concept to determine taxability in such cases. In this paper we are only discussing the cross border issues arising out of E-Commerce & related matters.

3. Accepted International Taxation Principles

For International Taxation, following are the important principles which OECD has accepted and majority of the world is at present following. There have been discussions between developed & developing world. Developed world has succeeded in adopting **pro-residence** principles in the treaty model. Without any criticism let us discuss all the issues afresh.

3.1 How to determine the **jurisdiction** of a country? This is of course determined by the domestic law of each country. Treaty does not determine jurisdiction.

Connecting factors discussed in the next paragraph (4) determine jurisdiction as accepted in international taxation practices.

3.2 Next issue is: for which incomes the Country of Source (COS) should levy tax, levy full tax or lower tax, and which incomes should be exempted by COS? For this purpose, **categorisation of income** (Articles 6 to 22) have been provided.

3.3 Which country should tax **business income** – COS or COR? In these discussions, COS may be considered the **demand**/ utilisation/consumption side. COR may be considered as the **supply**/performance/production side.

History has so developed that OECD – had more finances and did more work. U.N. with limited finance did very little work. The OECD members had most of the companies exporting goods & technology to the developing world. So majority companies in international business had their "residence" in OECD member countries. Hence a clear bias towards supply side/ COR has been adopted by OECD. Most tax professionals have accepted this without questioning.

An illustration – till 1972 OECD model, global trade position was that the developed countries imported commodities at low prices and exported value-added goods at very high price. Hence majority of incomes were earned by the companies residing in the developed world. They also exported technical knowhow and gave licenses for use of the knowhow, patents, etc. OECD model provides that all these incomes may be taxed only in COR (subject to PE profits).

Under article 7 which covers goods, all rights to tax are given to COR. It has been assumed that the Country of Market – or consumption – has no right to levy any income-tax – except when there is a PE. Why so? This is a basic question. We will discuss further.

3.4 The Latin American countries protested the bias towards COR. In the model treaties prepared by the League of Nations, more taxing rights were distributed to COS. However, in OECD negotiations developed world has been successful in maintaining the bias towards COR.

4. Connecting Factors

Following principles of Jurisdiction in the matter of international taxation have been accepted by majority of Governments at present. This is where the **core legal controversy** lies.

A country gets its income-tax jurisdiction by any one or both of the following two Connecting Factors:

4.1 **Residential Status:** If the assessee is resident of a country, that country (COR) has jurisdiction to tax his global income – irrespective of the source of income.

4.2 **Source:** If the income is sourced in a particular country, that country (COS) has jurisdiction to tax the income – irrespective of residential status of the assessee.

4.3 In absence of any connecting factor, the country has no jurisdiction to tax. Thus a **Non-Resident's foreign sourced income** cannot be taxed. Problems arise when the non-resident assessee claims that his income is not sourced in India; and the GOI claims that the income is sourced in India. In controversial cases, GOI has made two kinds of amendments: (i) GOI has stated its position on the scope of total income. In such cases, if the DTA provision is more beneficial to the assessee, DTA provision applies. This is the normal case. (ii) Some provisions like GAAR – Chapter X-A & amendments to S. 90 are anti-avoidance provisions. These override the DTA provisions also.

4.4 Present International Taxation has emerged in a peculiar manner. When it comes to **business income**, a non-resident assessee claims that it has no physical presence and no agent in India. CIT claims that the NR assessee has a PE in India. Since E-Commerce does not require a PE in India, CIT claims a **Virtual PE** in India & then claims a jurisdiction to charge income-tax on such incomes. Different concepts have been tried for a virtual PE. **Footprint** of a Television Channel has been considered a Virtual PE. GOI's observations on OECD commentary on Articles 5 & 7 give **GOI position.**

4.5 In case of incomes categorised as **"Royalty"** or **"Fees for Technical Services"** (FTS) Governments see **no need to establish that the source of** income exists within their boundaries. These are considered **"passive incomes".** Just because **payment** for these categories is made from within their boundaries; or made by their resident assessees, it is considered adequate to tax such remittances. Hence CIT attempts to categorise E-Commerce payments made to non-residents as royalty or FTS. Assessee claims it as "Business Income" or FTS not "imparting knowledge".

4.6 On the other hand when a **Resident** earns income from within the country, both the connecting factors are applicable. Hence his income is considered "Domestic Income". The cross border tax issues do not arise in the case of domestic income. An Indian Resident assessee never raises the issue of "Jurisdiction to tax". In all cases, his income is liable to tax in India.

5. Country of Residence

5.1 The **Country of Residence** (COR) has a tax jurisdiction over the resident assessees'**global income. Why? Justification for jurisdiction** is discussed in paragraph 8 below.

5.2 A non-resident conducting business outside the country is not liable to tax in the country. In other words, a person doing business **with India** is not liable to tax in India. However, if he does business **within India** then he is liable to tax in India.

If the non-resident's business in India it too small, the cost of tax assessment and recovery may be more than the revenue. Hence the non-resident's income is considered for taxation only if his presence in India is beyond a threshold. **This threshold is a PE. PE is essentially a geographical term.**

5.3 If a non-resident has a PE in India, the profits attributable to the PE's activities are taxable in India. The country where the PE is situated can be referred to as: the **"Host country"** or the **COS.**

Paragraph 5.1 above states the Scope of Total Income for COR. Paragraphs 5.2 & 5.3 above state the Scope of Total Income for the Host Country/OS.

5.4 Residence – DTA Article 4

Treaty does not define residential status. If the domestic law of a country considers an assessee to be liable to tax in the country by the criteria like – residence, domicile, place of management or similar other criterion – then that person is considered to be resident of that country.

Thus the domestic law determines residential status of the assessee. Treaty does not determine residential status.

It is clarified in the treaty that if a country levies tax based on the connecting factor of "Source"; then such tax liability does not make the assessee "Resident". Countries like France, Singapore, Hong Kong, etc. adopt **"Territorial System"** of taxation. They tax only income sourced within the country. This is a different matter altogether. India, U.K., U.S.A., etc. have adopted **"Classical System"** of taxation. A non-resident of India is liable to tax in India only on income sourced in India. Because he is liable to tax on source basis, he does not become an Indian resident.

5.5 Resident – ITA Section 6

A company's residential status is determined by:

(i) Place of Incorporation; and

(ii) Place of Management.

Present definition is open to abuse. Hence Direct Taxes Code Bill proposes a better definition – and links the residence to "Place of Effective Management". This is a concept discussed at length by OECD.

Why place of incorporation? Normally, in the past, companies used to be registered in the country in which majority of share holders (ownership) and directors (management) were located. Major part of the company's business would be located in the country of incorporation. That company would benefit from the economy, stability, infrastructure, legal system of the country and would/should pay tax to the country of incorporation. It was legitimate to consider it to be a resident of the country where it is incorporated.

6. Source

This word has two different meanings. **"Source of Income"** may be – for illustration, a company — in case of dividends; employer — in case of salary income, a firm — in case of share of profit, etc.

Country of Source means the country from which an income has been earned. In this article when we refer to "Source"; we are referring to Country of Source (COS).

7. Permanent Establishment – Development of the concept

Until the development of internet, it was necessary for the buyer and seller of goods or services to physically meet and transact the business. The meeting could be through a branch or factory or any other establishment. The treaty draftsmen could not envisage a situation where business could be transacted without a physical place of business establishment or without personal meetings. Hence the concept of Permanent Establishment is largely **geographical.**

E-commerce by definition does not need a physical meeting place for business. **E-Commerce defies geography.** Hence the concept of PE cannot be applied to E-commerce.

The concept of PE will continue to be applicable for Traditional Commerce. But it fails in its application to E-Commerce. We may need to develop a new concept – **Virtual PE.** See Part IVA, Paragraphs 5 & 7. (Even more radical possibility – discard the concept of PE. See Paragraph 8.2 in Part IVA)

Country where the PE is situated is COS for the income attributable to the PE. In case of E-Commerce, a non-resident earns income from India without any PE in India. How do you tax him? Some non-resident FIIs doing business in India claim that they have no PE in India & hence are not liable to tax in India. They have succeeded even though all sales & purchases are transacted in India.

This problem does not arise in Traditional Commerce. (Traditional commerce needs a PE in the COS.) But it becomes the core issue in E-commerce. Existing **Treaty Models** and their commentaries are **inadequate to deal with** this problem. Hence special issues/ controversies

are arising in the matter of E-commerce. This paper discusses issues arising out of inadequacy of treaty model.

8. Justification for the Rules of Jurisdiction

8.1 Residence

There is a justification for a country to tax it'**sresident's global income.** When the resident conducts the business, he benefits from Indian economy, infrastructure, legal system & so on. India contributes to the value addition made by the resident. It is appropriate to expect the resident to contribute tax to the economy which has helped him earning the income. COR has a greater justification because the assessee owes his very home, his safety, his passport & all to the COR.

8.2 Source

There is a justification for a country to tax a **non-resident's Indian sourced income.** When the non-resident conducts the business within India, he benefits from Indian economy, infrastructure, legal system & so on. India contributes to that part of value addition which is made by the non-resident in India. It is appropriate to expect the NR to contribute tax to the economy which has helped him earning the income.

A further principle accepted under OECD model and accepted + elaborated by us in our E-Commerce presentation in year 2006 at FIT conference is as under:

Country of Source has a right to tax only that much income which is attributable to the **activities carried out by the assesseewithin** the COS. Assessee's activities outside COS do not give rise to any taxable income within COS. In other words, if the assessee has not carried out any activity within India; India has no right to tax his income. This is a simple summary of FAR analysis. This concept is extensively reviewed in the present article.

8.3 Country of Source

COS has not been defined either in Indian Income-tax Act or in the Treaty models. OECD and UN have left it to the Treaty countries to decide which income would be considered as sourced within their borders. A good **definition** can be:

When an assessee – by his own activities – within a particular country – makes value addition – that particular country is the Country of Source. The taxable profits earned out of the value addition are taxable in that country. This principle was accepted by us in our E-Commerce Presentation at the FIT Conference. In this article – Paragraph 9.2 in Part IVA - we are briefly reviewing this principle.

8.4 **Indian Income-tax Act** (ITA) has **not properly defined "Source".** Section 5 determines Scope of Total Income & section 9 makes deeming provisions extending the scope. This "Scope" includes even incomes which are simply **received** within India. Even if a non-resident receives his foreign income within India, he becomes liable to tax in India. Hence sections 5 & 9 cannot be said to be defining "Source".

DTA does not normally define "Source". Yet, in some cases, the DTA places restrictions on what can be termed as "Sourced" in COS and what cannot. In cases where domestic law and DTA provisions are at variance, DTA prevails. To this extent "Scope of Total Income" gets reduced.

8.5 Except for the contribution by the COR & COS to the assessee& to his income, there is no other fundamental reason why these countries should have jurisdiction to tax the income. If any other justification is found to change income-taxation principles that also should be fine. If necessary, the relevant laws can always be changed.

Tax legal systems have been set up considering these Connecting Factors. All other relevant issues have fallen in line with this basic structure.

9. Import of Goods

9.1 When goods are imported into India, it is a **presently accepted position** that India has no right to levy Income-tax on the income earned by the non-resident exporter. **The logic/justification** probably is that the exporter has made full value addition/ completed his manufacturing activity outside India. It is a Non-Resident's foreign income. Hence India has no jurisdiction to tax his income.

The facts that: (i) India is a market, (ii) goods are sold in India, and (iii) but for the sale, the non-resident would not have earned profits; are not considered relevant. (Here India is the Country of Market or COM. India is not a COS.)

Similarly when India exports goods to other countries, those countries do not charge any income-tax on the Indian exporters' incomes.

9.2 There is no doubt that **COM contributes** to the value of goods. For example, a product sold in India may command a price of ` 100. When the same product is sold in USA, it may command ` 200 net of all transport cost. This extra price is the contribution of value by US as an economy. Still USA has no right to levy income-tax on Indian exporter.

Its right to collect taxes is executed by indirect taxes like customs duty and octroi. This position is accepted by almost all countries and treaties.

9.3 Another concept may be discussed here. Many a times, payment may be made from one country. That country need not be where the assessee – income earner has any functions, assets or risks. Yet the country may choose to tax simply because payments have been made from the country. This is done mainly to "passive" incomes. Such a country is referred to in this article as **Country of Payments or COP.** Country of Source, Country of Market & Country of Payment – each term describes different characteristics. It is possible that one and the same country has all these three characteristics. It is also possible that different countries may have these characteristics.

10. Import of Services

10.1 OECD and UN Models of DTA do not have the Article pertaining to Fees for Technical Services. Hence FTS would be governed by Article 7 – business income. OECD Model does not have a separate clause for Service PE in Article 5 or for professional services. UN Model has Service PE clause in Article 5(3)(b).

Article 7 gives priority in taxing rights to the COR. Under OECD Model, COR gets priority for business, services & profession.

India has retained Service PE clause in Article 5 as well as FTS clause and separate article for professional services. (India–US DTA Article 5(2)(l) and Article 12.) **What is the logic for treating "services" different from "Goods"?**

There is absolutely no logical reason – except that it is a **tradition** followed for a long time. In the past, services constituted a small portion of total GDP. Hence law makers never bothered about services. For example, we have a "Sale of Goods Act" but no "Sale of Services Act". This, despite the fact that today, in Indian GDP, "Services" sector is the largest sector.

10.2 **Customs duty** on import of goods has been levied since long. There was no customs duty on import of services. This distinction is now reduced by the Service Tax provision of "Reverse Charge". An importer of service has to pay the service tax on the value of services imported. Under indirect taxes, India has reduced the distinction between "import of goods" & "import of services".

However, India has retained distinction in international- income taxation between "import of goods" & "import of services" in favour of COS. OECD has removed the distinction in favour of COR.

All these details are discussed here only to highlight that there is no fundamental logic/justification for this distinction. It is simply a tradition that India and some countries follow. This is an existing weakness in the international taxation practised in India.

The weakness in OECD model is that it gives disproportionately larger taxing rights to the COR.

10.3 Thus in India, services are treated differently. In case of import of services, it is possible that the non-resident exporter of services has completed all his value addition outside India. In other words, he has **"performed"** his services outside India. He has no activity and no PE in India. Still India claims and exercises a right to levy tax on "Fees for Technical Services" (FTS). [Explanation to Section 9, appears after section 9(2)]. GOI's claim is that the services are **"utilised"** in India. Modern technology has made it possible that the "Country of Performance of Service" can be different from the "Country of Utilisation of Service". Just as "Country of **Production** of Goods" can be different from the "Country of **Consumption** of Goods".

Similar position is accepted by many countries. This is an important **change** from the basic principles of international taxation.

Similarly under Indian DTAs royalties are taxed without examining whether India is the Country of Source. Just because an Indian resident has made the **payment**, the royalty is considered taxable in India. Under OECD Model royalties are taxable in COR.

11. E-commerce Definition

11.1 Literal meaning of E-commerce is "Commerce conducted through electronic instruments". Traditionally it is restricted to business transacted through **computers and internet.** Recently **mobile phones** are also included in the list of instruments used. Televisions are also electronic instruments and part of the business is conducted through TV.

Telephone landlines in India may be analogue instruments. However, if someone conducts commerce on these phones, it also should be included in E-Commerce. One can say that "Commerce conducted through electronic instruments" is only a **description. Not definition**. Having described a business, all similarly conducted commerce should be included in the term E-commerce. Thus E-Commerce may include commerce conducted without a PE or other physical presence in the COS. Instruments used may be: Internet & computers, television or radio, mobile phones or any other instruments.

11.2 E-Commerce is fast evolving. Ideas about what constitutes E-Commerce are also evolving. We may divide E-Commerce into two braod categories:

(i) Marketing, Order booking & payments are made by electronic means. However, actual service is provided physically. Like Airline & hotel bookings.

(ii) Even the service is provided online. Like Google &facebook.

Airlines & hotels can sell their spaces on the internet. A potential customer can visit their website, survey the opportunities available, book a seat or a room & make payment through internet. Contract is completed on internet. Hence it is considered E-Commerce. However, consider the fact that the real service to be rendered is – carrying the passenger or the cargo for the airline; and providing room for the hotel. Those services are physically, personally given. Contract is completed only when services are provided. In this paper we are focusing on the second category of E-Commerce.

11.3 **Instruments** used for communicating or for conducting business **cannot be a basis for any tax rules**. It is accepted by OECD & many others that there cannot be separate rules for E-commerce. **High Powered Committee** on E-commerce has discussed this issue and reported that under the concept of **neutrality**, all services should be taxed similarly. Hence there is no need to define E-commerce. A description of the concept is sufficient for discussion purposes.

11.4 Import of Goods

We have considered that import of services via E-Commerce should be liable to income-tax. This means that import of goods via E-commerce should not be liable to tax. One can place order on say, Amazon.com or similar companies through internet. Ordered goods will be supplied physically. They may be liable to customs duty. No income-tax will be chargeable. Main reason is that goods imported otherwise than through E-Commerce are not liable to income-tax. Neutrality may be maintained within the sector of goods.

12. Tax Avoidance

Some of the Tax Avoidance schemes that Global Corporations (GCs) use may be briefly considered.

12.1 In science there is a tremendous progress in **several technologies** – Computers, Mobile phones, Internet and Tele-communication. And all these technologies are **converging**. Today's latest mobile phone uses all the technologies together to provide the best solution to the user. And several companies are **competing** fiercely to come out with the best **products to do business – more efficiently.**

12.2 Similarly, on **tax planning** front, the consultants are using several "technologies"/ concepts together. They are competing with each other to present the **best tax avoidance** "products" for the tax payer. Following instruments/ circumstances help them:

(i) **Concepts** like – "company is a separate legal entity", "it is resident where it is registered" are used even where the facts are not applicable to the concept. With the help of these concepts, residence of a company is shifted to a tax haven to (i) pay zero or low tax; and (ii) do Treaty Shopping.

(ii) **Tax haven Governments** are competing with each other to present laws suitable for tax avoidance. Tax havens are used extensively by MNCs & GCs for (i) shifting their revenue profits and (ii) shifting capital gain transactions – outside COS. These tax avoidance methods are discussed briefly in paragraphs 4.9 to 4.15 and paragraph 5 in Part II; and in details in our article on Tax Havens available on our website.

(iii) Convergence of **technologies** discussed in Paragraph 12.1 above.

It is easy to incorporate a company in a tax haven, have the website, etc. in a tax haven; and then do a global business. The GC is resident of a tax haven. It earns from several countries around the world. But it has no PE in any source country. So it pays no tax on "Source" basis.

12.3 Now it is said in media reports that Google has set up corporate structure & tax planning schemes which are referred to as **"Double Irish"** and **"Dutch Sandwich"**. It earns substantial advertisement revenue from Great Britain but pays little tax in Great Britain. Members of British Parliament and tax experts are discussing: (i) Google's arrangements are legal; (ii) but evil & not acceptable (iii) and hence how to make Google pay a fair share of tax to the British Government.

Google's tax planning has added **two new dimensions:**

(i) In the software outsourcing business (that we considered earlier in our article on BPO Taxation), the services are provided in one country — India. Services are utilised in **another** country – USA. So there is **no confusion about COS or COR.**

In case of service providers like Google, You Tube, facebook, etc. the service is provided **all over the world;** service users are all over the world; the users pay smaller amounts; main revenue - advertisement - is earned globally. How do you tax these companies' net profits? Which countries are COS and which are COR? Who will check their accounts, who will calculate a fair net profit? How will the profits be attributed – based on users, footprints, advertisers or place of residence? Their taxation **defies geography**. And existing tax systems are based on Geography.

Further – all these companies do not really provide their own services. Google relies on millions of databases all over the world. facebook relies on the data given by the users themselves. You Tube relies on millions of people uploading video clips. In short, these three companies are providing merely communication services. Some free data available in some corner of the world is made accessible globally. And they earn billions of dollars in advertisement revenue. Fantastic business model. And almost tax free.

(ii) In the U.K. Google and other companies' tax avoidance has become a **public debate**. Members of Parliament seriously criticise tax avoidance. Media supports MPs and criticises tax avoidance. Common men stage processions against the companies & ask for boycotting these companies. This second development is a recent phenomenon. In the past common men did not criticise tax avoidance by tax planning. U.S. & European financial crisis has caused these phenomenon.

In India almost the whole of **media and profession praises tax avoidance schemes. Government seems to be confused and susceptible to lobbying. CBDT is on the defensive.** Similar trend was prevalent in Greece – until it went insolvent.

Note : Paragraphs 3 to 12 discuss two connecting factors. Now we discuss other principles.

13. Categorisation of Income

13.1 Within domestic taxation categorisation of income is essentially for computation of income. "Business income", "salary income", "capital gains" – each category needs and has been provided different rules for computation of income and different rules for granting reliefs. Once the income is computed, all incomes are added and then same rate of tax is applied to the Total Income.

In case of **treaty application,** the Categorisation of Income **should** have been to determine the COS. Thus for rent on immovable property – the COS will be where the property is situated. For business income, the COS should be where the value addition has

been made. However, in reality no attempt is made to determine the COS. Once payment for FTS, Royalty, etc. is made by a Resident of India, GOI acquires right to tax the same.

Whole scheme of DTA is: determining COR & COS and then sharing the revenue between them. And yet, in the treaties no attempt is made to determine COS. If a country claims right to tax a non-resident's income, it becomes COS. (Almost.) This is another serious **compromise** on the basic principles of international taxation.

Business income without PE gets total tax exemption from India. Other incomes become taxable in India irrespective of whether any value addition has been made by the assessee in India or not. Hence the non-resident assessee tries to claim that he has business income, he has no PE in India and hence India has no jurisdiction to tax his income. Department tries to claim that the NR earns royalty or FTS and hence is liable to tax in India irrespective of a PE.

13.2 "Categorisation of Income" is a significant cause for tax litigation. This is another existing weakness in International Taxation. Can we eliminate or reduce categorisation?

14. Elimination of Double Taxation (EDT)

The scheme of avoidance of double taxation is such that –The **COS** generally levies a lump sum flat tax on the gross receipt of the assessee. In cases of income from immovable property and the income attributable to a PE, full tax is levied on net profit.

Full income of the assessee is taxable in the **COR**. From the COR tax, a relief is given by the COR. It may totally exempt the income that has been taxed in COS. Alternatively COR may give set off for taxes paid/payable in the COS.

15. Company is a separate legal entity

This concept has been developed with a specific purpose. To allow people to collect small amounts from a large number of people and grow the business to a size which would otherwise be impractical. Separation of company's assets and liabilities from the shareholders' personal assets and liabilities and separation of management and ownership are some important characteristics of a company.

The status of a separate legal entity is granted to support these characteristics. Where the shareholders practise no separation and consider company's assets as their own assets; that company in reality does not exist as a separate legal entity. Yet, lawyers argue that once a company has been incorporated, irrespective of the fact that it is in a Tax Haven, it must be considered a separate legal entity. We will see below (i) how this assumption can be abused and (ii) how place of incorporation is becoming irrelevant. This matter has also been discussed at length in our articles on Vodafone available on our website.

16. Core Principle: Justification for Tax Jurisdiction

It is said that the core of every religion is “Love & Truth”. As long as this core lives, a thousand cobwebs hiding the core cannot affect the core. A religion propagating love & truth will always survive. In international taxation, can we find such a fundamental core?

Our submission on Tax Jurisdiction. A nation gets right to tax that part of income – which has been earned due to some contribution by the nation. No contribution to income, no jurisdiction to tax. It also means – when there is no income, there can be no tax. If two or more nations contribute an income, those nations share the tax revenue. And when a nation has contributed to a particular income; it must have a right to tax that income. No amount of tax planning can be permitted to take away that right. If a nation voluntarily forsakes a right to tax, that is its right to do so.

There will be several compromises and variations in calculating income and attributing profits to a particular nation. Difficulties in administration of law will force compromises to the core/fundamental principle. However, the system will continue to work if we do not stray too far away from the core principle. And every time we make a compromise, we recognise the compromise. A further compromise if it takes us away from core, should be avoided. At times it so happens that one compromise leads to another & yet another compromise. Ultimately one forgets the core. That is when serious risks start.

17. Summary

“Connecting Factors” determine whether a country has jurisdiction to tax or not. These principles are not given in Treaty. They are principles followed in International Tax Jurisprudence. “Categorisation of Income” determines how much tax will be collected by COS. The fact that COR has a basic jurisdiction to tax assessee’s global income is again a principle of International Taxation Jurisprudence. It is not stated in a Treaty.

Double taxation is eliminated by COR giving credit for taxes paid in COS; or by giving exemption for incomes taxed by COS.

Tax Havens & Tax Consultants keep coming out with new products for tax avoidance. E-Commerce makes it easy for GCs to avoid taxes.

Annexure I to Part I

A. Web Links for readers who want to read more:

1. Google and other Global corporations’ Tax Avoidance:

http://www.nytimes.com/interactive/2012/04/28/business/Double-Irish-With-A-Dutch-Sandwich.html

Please see New York Times link explaining tax planning resorted to by Global Corporations.

2. OECD 2005 report on E-commerce:

http://www.oecd.org/tax/taxtreaties/35869032.pdf

3. Indian High Powered Committee on E-commerce report:

http://www.rashminsanghvi.com/articles/taxation/electronic_commerce/finmin.html

B. **Authors' Articles:**

1. E-commerce paper at IFA Congress – USA: Year 2001 (Challenge to the concepts of PE, Residential status &Categorisation of Income.)

http://rashminsanghvi.com/articles/taxation/electronic_commerce/ecommerce_tax1.html

2. BPO Taxation: Year 2004: (Dual Entity Concept – Principal being liable to tax in India for BPO activities.)

http://www.rashminsanghvi.com/articles/taxation/international-taxation/bpo-taxation-in-india.html

Note: This article was also included in Chamber's Compendium 2008 edition – as Part B of 43rd article – "BPO Taxation in India" by ShriPadamchandKhincha.

3. FIT Conference presentation – Year 2006. (E-Commerce Taxation, Challenges & Possible solutions)

http://www.rashminsanghvi.com/articles/taxation/electronic_commerce/international_taxation_contents.html

4. Tax Havens article: Year 2012 (How tax havens abet tax avoidance.)

http://rashminsanghvi.com/articles/taxation/international-taxation/fundamentals-of-international-taxation.html

Annexure II to Part I

A. E-Commerce Committee Report summary

"6.1 Residence based taxation

The Committee is of the view that there is no real alternative to the concept of 'place of effective management', which should continue to be used. It is not possible to set down a single rule. The concept has to be applied considering the facts and circumstances of each case. Where in the case of a **globally integrated enterprise**, no unique solution is available through the concept of 'place of effective management, the solution could be **'source based' taxation only.** The provisions of the Act and the DTAs do not require any revision on this account.

"6.2 Source based taxation

The source based taxation of business income depends on physical presence in form of fixed place of business or a dependent agent in the source country. It also depends on the characterisation of income. With e-commerce, the need for physical presence virtually ceases. This affects sharing of revenue between countries. The change in mode of delivery from physical to online raises characterisation issues. Lack of physical presence also creates problems in enforcement of tax laws.

"6.2.1 Concept of permanent establishment ("PE")

"The OECD is of the view that in terms of Article 5 of the OECD Model Tax Convention, a server at the disposal of an enterprise and hosting its website could constitute a PE, if it is kept at a fixed place for a sufficient period of time and performs core business functions of the enterprise. The views of the OECD are consistent with the existing provisions of Article 5 of the OECD and UN Model Tax Conventions. However, within OECD some countries like UK, Spain and Portugal have different views.

"The Committee is of the view that applying the existing principles and rules to e-commerce does not ensure certainty of tax burden and maintenance of the existing equilibrium in sharing of tax revenues between countries of residence and source. The Committee is also firmly of the view that there is no possible liberal interpretation of the existing rules, which can take care of these issues, as suggested by some countries. The Committee, therefore, supports the view that the concept of PE should be abandoned and a serious attempt should be made within OECD or the UN to find an alternative to the concept of PE."

B. OECD report extract

The Ottawa OECD Ministerial Conference in 1998 "A Borderless World – Realising the Potential of Electronic Commerce", concluded the following as guiding principles for E-Commerce taxation.

Neutrality

i) Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.

Efficiency

ii) Compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible.

Certainty and simplicity

iii) The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted.

Effectiveness and fairness

iv) Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to the risks involved.

Flexibility

v) The systems for taxation should be flexible and dynamic to ensure that they keep pace with technological & commercial developments.

Part II — Illustrations of Global-Commerce

Why accepted principles cannot work.

1. **Business Process Outsourcing (BPO)** is a classic illustration of E-Commerce. A common illustration of BPO is: An American software developer company (let us say Microsoft) outsources some development work to an Indian software developer. (Let us say Infosys.) When Microsoft outsources software development work to a third party like Infosys; or to Microsoft's own subsidiary/branch in India; what Tax issues arise? Can it be said that Microsoft has a PE in India? What portion of Microsoft's profit can be attributed to the Indian PE?

When Infosys provides a service to a foreign Company, can the Government of that country tax the FTS earned by Infosys on 'Gross Basis'? Consider a DTA where the "Make Available" clause is not included.

This is simple. Our detailed article on BPO Taxation was included in the 2008 edition of Compendium. (Part B of article 43) It is available on our website. **"Dual Entity"** concept has been discussed elaborately in that article.

2. **Cricket**: Four country teams play a series of cricket matches in all the four countries - India, South Africa, West Indies & U.K. There are sports associations in all these countries that manage the cricket teams. The cricket players get **remuneration** from the organisers and they also get **advertisement fees** from different countries.

Four organisations share the **ticket revenue**. Tickets for all countries' matches are sold in all countries. There are different companies that "own" different teams. A group of companies gets right for **broadcasting** the cricket matches on television in several different countries. Let us say some of them are non-residents of India. They pay to the organisers& team owners. These TV broadcasting companies get their revenues from (i) cable operators; (ii) TV viewers – DTH, (iii) Indian advertisers & (iv) Foreign advertisers.

Cricket is played and broadcast globally. Many different entities earn different kinds of incomes globally. Which revenue can Government of India tax? On what basis?

Let us say, a European Company selling high fashion garments pays for advertisement to a foreign TV broadcasting company. The company is broadcasting cricket

matches in several countries. The advertisement is targeted to several countries. It has footprint all over.

Can Government of India tax this revenue on any grounds?

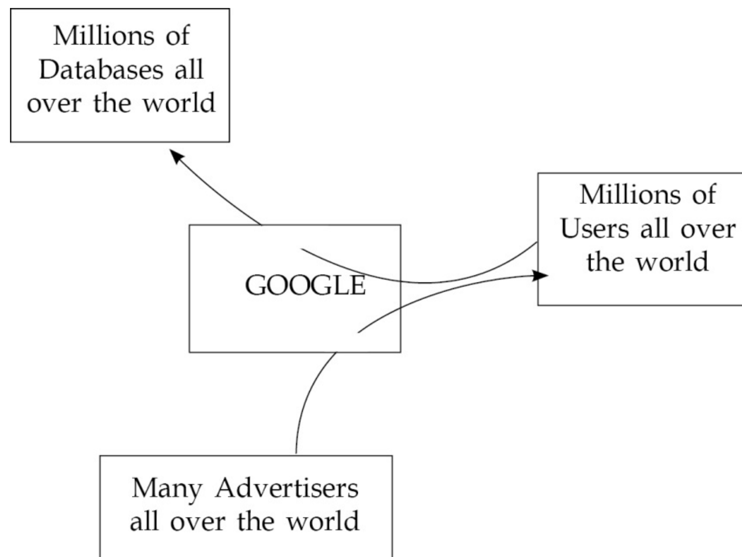
3. TV Footprint: In other cases of TV channels etc., Indian Income-tax department has claimed that it will tax advertisement revenue when the **TV footprint** is in India. Can Government of India tax (a) a non-resident company, (ii) doing broadcasting business outside India (iii) having no PE in India and (iv) earning advertisement revenue from other non-resident companies? If yes, on what grounds? Is it permitted by DTA?

Above illustrations are for starters.

Now let us move to a sumptuous illustration.

4. Global Corporation: Illustration of Google

4.1 Google's Business Model



Google helps internet users to access data base. Google provides the service to advertisers for being able to advertise. To attract more advertisement, Google attracts more users. To have more users, it provides more and more data in more efficient manner.

When we are considering the taxability of Google as an assessee, Google's value addition is — providing a base for advertisement. For providing this base, Google provides the data access services.

Google's revenue is (i) mainly from advertisers and (ii) from data users.

Since we are considering from the viewpoint of COS, following issues are relevant.

Value creation by assessee Google is by the provision of entire system whereby: (i) the advertisers can make their advertisements reach targeted users; and (ii) Internet Users can search the data. Everything else is a cost in that value creation.

Google has its massive server banks (hardware) at several countries. The connection amongst the data bases, user bases and advertisers are provided by innumerable internet service providers (ISPs).

Key instrument is the algorithm and software which makes all these accesses possible.

4.2 Where is the value addition made?

Is it where the server banks are situated? (Hardware)

Or Where the users are situated? (Part of the Market)

Or Where the data are situated?

Or Where the advertisers are situated? (Main Market)

Or Where the software is situated?

Where is the software situated?

Where does the software function?

Probably all these functions at all these places contribute to value addition. If that is true, there is no practical way to attribute profits to a specific country.

Experts in internet advise : Google has software which identifies every user, and his country; his choices based on past use of Google and such other information. It helps advertisers in targeting their advertisements to potential customers. Some advertisements may be open to all users.

Google's ad revenue comes from the "clicks" that particular advertisements get. Hence, it is possible to find out the country where the users are situated.

Now if the tax policy provides:

(i) Tax Google based on the users' location, then appropriate allocation of revenue can be made to India as COS.

Or

(ii) Tax Google based on the advertisers' location. Then also appropriate allocation of revenue can be made.

These allocations will refer to revenue. Then appropriate deduction of global costs may be made to arrive at net profits.

Or

A flat tax may be imposed on the Subscription and advertisement revenue paid from India.

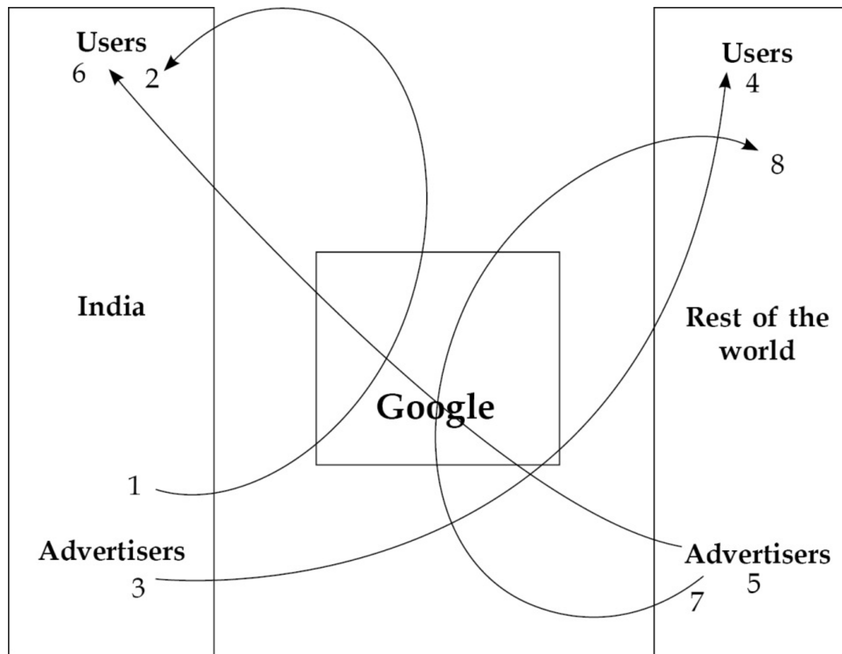
4.3 For India, Google is a non-resident. What is Google's **business?** It provides: (i) Data access service to internet surfers and (ii) advertisement service to advertisers.

Where is the **value addition** made by Google? (i) All over the world. (ii) Since advertisers pay based on clicks, the country where ad is 'seen' can be identified.

However, the tax should be on the basis of: (i) where advertiser is situated; or (ii) where user is situated? **Where is the service provided** by Google to the advertisers?

4.4 Google – Chart explaining its Business Model

Google provides service to advertisers.
Advertisers pay revenue to Google.



Notes on the Diagram

1 → 2 Indian Advertisers pay for Indian users.

3 → 4 Indian Advertisers pay for foreign users.

5 → 6 Foreign Advertisers pay for Indian users.

7 → 8 Foreign Advertisers pay for foreign users.

For which advertisement revenue can GOI tax Google?

If we consider the **internet user as a base,** GOI can tax Indian as well as foreign advertisers (1 & 5) for their advertisements targeted to Indian users (2 & 6). However, in such a case, GOI cannot tax the ad revenue paid by Indian advertisers (3) targeting foreign users (4).

If we consider **advertisers as a base,** GOI can tax only ad revenue from the Indian advertisers (1 & 3). GOI cannot tax Google's revenue from foreign advertisers targeting Indian users (5). Foreign advertisers targeting foreign users is out of reach for GOI.

4.5 If we consider both – **internet users as well as the advertisers** as the bases for taxing Google's advertisement revenue there can be different ways of considering tax base:

4.5.1 All charges paid to Google by Indian users as well as Indian advertisers. (Irrespective of targeted users).

4.5.2 Above plus foreign advertisers targeting Indian users.

What happens if other countries retaliate by making similar provisions in their domestic laws? On what grounds will different countries share tax on Google's income.

We have to note that most of the DTAs are bilateral DTAs. In Google's case, there may be **several countries simultaneously** being the **COS** for the same ad revenue. DTA system does not provide for sharing of tax revenue amongst several COS. If - Internet Users & Advertisers - both are considered as the base for COS jurisdiction, then an unsolvable tax problem may arise.

However, if each country claims only the **payments** made from within the country (by both – internet users and advertisers) as the tax base; then the tax base becomes simple to administer.

4.6 **"Simplicity in Administration"** is an attraction for any Government. And GOI also is taxing Google on this ground. However, what about the **source definition** – "Value addition by the assessee by performance within the boundaries of COS"? (**Note: no** such definition is made under domestic law or treaty. This is a principle adopted in International Taxation. Specific wordings for the definition have been used by the authors. There is no base for this definition except tradition.) (For the time being we continue with the tradition.)

Let us assume that Google has no hardware and no PE in India. Where does it provide its services? It is only exporting its service from a base country like Ireland. Google India's employees are in India only to collect the revenue. Value attributed to their work like a collecting agent may be only 2%. Can GOI tax 100% of Google's income?

4.7 ***Google – Indian Tax***

On what grounds can GOI tax Google's advertisement revenue? Let us examine.

4.7.1 Google is a Non-resident of India. Hence the connecting factor of COR does not apply.

4.7.2 For applying the COS connection, anyone of the following circumstances should exist:

(i) Google should have a PE in India and the PE should provide services. This is non-existent.

(ii) Google should be providing technical services and earning FTS. Then Section 9(1)(vii) can apply. Consider the fact that **Explanation to Section 9** (appearing after Section 9(2)) clarifies that FTS can be taxed in India even if the service provider has no PE in India; and the services are not "rendered" in India. Hence GOI has clarified that India wants to tax NR's income based on **"Utilisation" of services**& not just based on the "Performance" of services.

However the basic issue is: Are Google's services covered within the **definition of "Technical Services"?** Refer to Explanation 2 to Section 9(1)(vii). A service to be covered under S. 9(1)(vii) must be a technical, managerial or consultancy service.

4.7.3 Google provides two types of services.

(i) The service provided to **internet users** (people who search on internet) is comparable to any other communication service provider like telephone or internet companies. This is neither technical nor managerial nor consultancy. This service is not covered u/s. 9(1)(vii). It is true that Google uses high level complex technology. In the same manner, an airline uses complex machinery – aeroplane, and several high technologies. When the airline carries a passenger from one place to another; it is simply a carrier service. It is not considered "Technical Service". There can be several such illustrations. Google's service to its users is not a technical service.

From media reports it appears that Google has an establishment/subsidiary in India. Probably this establishment receives the subscription/advertisement revenue from Indian internet users & advertisers. Any revenue "received" or deemed to be received in India is taxable in India. Hence if Google receives the subscription revenue in India, it would be **taxable in India u/s. 5.** Entire discussion on Section 9 is unnecessary.

(**Note 1:** Conclusion in Paragraph II. 4.7.3 is different from the observation in Paragraph II. 4.6 above. Reason is: Paragraph 4.6 discusses principles. Paragraph 4.7.3 discusses Indian law. As seen earlier, (Paragraph I.8.4) provisions of section 5 of Indian Income-tax Act are at variance with international tax principles. **Note 2:** Even if an income is taxable u/s. 5, one will have to sill look at DTA. A non-resident's business income without a PE in India is not taxable in India. And DTA will override the domestic law. Under the existing domestic law & DTA, Google's income cannot be taxed in India.)

(ii) The service provided to **advertisers** is similar to the advertisement service provided by non-resident media like— Economist or any such magazine published abroad; or BBC/CNN or any such media company doing business outside India. They are doing

business "with" India and not "within" India. Their service is neither technical nor managerial nor consultancy. Hence even this service is not covered by Section 9. If the ad charges are received in India by a subsidiary or agent of India, they would be covered within the Scope of Taxable income u/s. 5. However, under DTA, they would not be taxable in India.

4.7.4 Observation

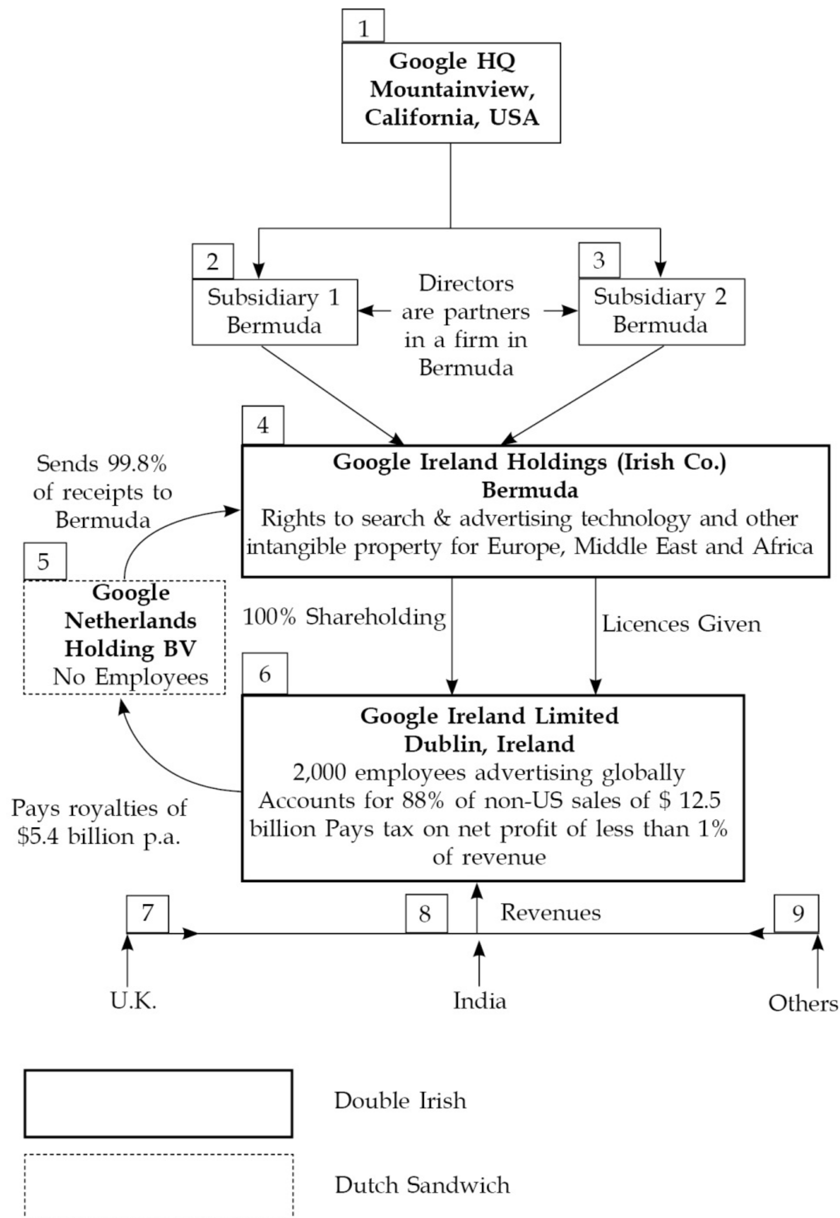
Even after the introduction of Explanation to Section 9 Google's revenue **cannot be taxed in India under Section 9.**

4.8 We have seen that taxation of Global Corporation is difficult even if they do not resort to tax avoidance. But E-commerce makes it eminently possible to avoid COS taxation ensuring that the GC has no PE/ no presence in the COS. When GC resorts to tax avoidance, tax administration becomes more difficult. This fact is compounded by the fact that existing rules and practice of International Taxation are inadequate. (This is simply an analysis of facts. No criticism is intended.)

4.9 Tax Avoidance by G.C.

This tax planning is explained by taking the illustration of one Global Corporation – Google. (The tax planning details are taken from media. Chart below and explanatory notes are prepared by us to explain the tax planning. It is possible that media reports are incorrect. We are interested in discussing tax planning that is possible for Global E-Commerce.)

Google Tax Structure



4.10 Google's Tax Planning

Explanations to the diagram — Explanatory notes on each entity.

(1) Google USA is a resident of USA. The public issue of Google shares was made by this company.

(2) & (3) are Bermuda companies ultimately beneficially owned by Google USA.

(4) Google Ireland Bermuda (GIB) is a company incorporated in Ireland. However, its central management & control is situated in Bermuda. Hence as per Irish law, it is a non-resident of Ireland. Hence no Irish tax.

Global revenues received through two Irish companies remain tax free. Since two Irish companies are used, it is called **"Double Irish".**

Since between the two Irish companies, a Dutch company is situated; it is called a **Dutch Sandwich**. Netherlands can be replaced by some other tax haven also.

Provision for treating the company as a non-resident of Ireland is **comparable but contrary** to section 6(3) (ii) of the Indian Income-tax Act. Under the Indian Income-tax Act, the attempt is to treat a foreign incorporated company as an Indian resident if its control management is situated in India. Objective is to prevent tax avoidance by incorporating companies abroad while the control and management remain in India.

Ireland treats a company incorporated in Ireland as a non-resident of Ireland based on the claim that its control & management is situated outside Ireland. Note the comparison of provisions and the contrary objectives.

This is how revenues from India, U.K. & other countries reach Bermuda without paying any substantial taxes anywhere.

(5) Google Ireland does not make payments directly to Google Ireland–Bermuda (GIB). It first makes payments to Google Netherlands (5). Because of a treaty between Ireland & Netherlands, no tax is deducted at Ireland. From Google Netherlands full payment goes to Google Ireland–Bermuda.

(6) Ireland levies a corporate tax of 12.5%. However, Google Ireland pays substantial expenditure to Google Ireland–Bermuda. From the balance it deducts expenses incurred for a large establishment within Ireland. On the net profits, it pays 12.5% tax to Irish Government.

(7) & (9) All advertisers pay their ad charges to Google Ireland (6).

(8) Google India gets advertisement revenue from Indian advertisers. This amount is fully paid to Google Ireland (6) without any TDS. (Please see paragraph II.4.7 for the possible reasons for non-deduction of tax at source.)

4.11 **Tax Planning explained:** Google's tax planning works on using all of the following principles/facts:

(1) It does not need a PE in any country where it provides services to the data users and advertisers.

(2) Google is a U.S. company.

(3) Google incorporates subsidiaries in tax havens. It claims these subsidiaries to be **separate legal entities.** Hence the subsidiaries' income is not taxable in Google's tax returns in USA. Since the subsidiaries are **"incorporated"** in tax havens, they are claimed to be **"residents"** in tax havens. Google avoids COR tax in USA.

(4) Tax Haven Governments provide legal systems which facilitate tax avoidance. And they work out elaborate Treaty (DTA) network. Google and other customers of tax havens can seek treaty protection against tax department of Governments like India, U.K., etc.

(5) All revenues from countries like India & UK are paid over to Tax Haven Company. Advertisement charges & data use charges are neither FTS nor Royalty. Hence no TDS/withholding tax in India/ U.K. Indian corporate tax rate of 30% (or 40% for foreign corporations) and TDS of 10% on gross – both are avoided.

(6) Ireland charges a corporate tax of 12.5%. Most of this tax is avoided by using schemes like "Double Irish" and "Dutch Sandwich".

(7) Revenue is accumulated in tax havens. Dividends are not declared to the ultimate parent company in USA. Hence no tax is paid in USA.

4.12 Tax planning explained by illustration.

Google's tax planning looks complex. Whole scheme may be easier to understand if we consider following purely hypothetical illustration.

Times of India (TOI) group has several publications which are printed & circulated. The group's revenue is mainly from advertisers. It attracts even foreign advertisers. When an ad is printed and circulated, it is traditional commerce.

Now TOI group has its own TV channel and website. Advertisements released on TV channel & website constitute E-Commerce.

Now consider a hypothesis: TOI group opens a subsidiary in a tax haven. The subsidiary then hosts the website. Subsidiary holds all foreign advertisement rights & IPR. That subsidiary will earn substantial revenue – which will be free from Indian Income-tax. The subsidiary can accumulate revenue and not declare dividends.

This subsidiary can get into a simple tax plan or an elaborate, complex tax plan – depending upon the reach of India's anti-avoidance provisions.

Like TOI, there are many Indian TV channels, websites like "Shadi.com" and "Make My Trip" which also attract foreign advertisements.

4.13 Comments

Theme of this article is not "Tax Havens". A highly complex tax planning is over simplified in this article. Objective of this discussion is to establish a hypothesis stated below.

(i) Global Corporations that conduct their business through E-Commerce can easily shift almost all their revenues to companies incorporated in tax havens. **They avoid COR tax.**

[Google is alleged to have avoided COR tax in USA by establishing truly business companies in tax haven. As per DTC draft CFC rules would not apply to "Business Income".

If GOI wants to avoid this kind of Tax Avoidance, it may have to review draft CFC provisions.]

(ii) They can **claim to have almost no COS.** They do not need factories for manufacturing, transport or crossing country borders because they are not dealing with tangible goods. Their only hardware is server banks and connecting cables, etc. Profits attributable to servers may not be more than the hire charges – if these servers were taken on lease.

(iii) The hypothesis that "COS is where the assessee makes value addition" – is easily avoided. Google will have no PE, no hardware & almost no men in the countries from where they get revenue. Hence under the existing international tax system, no country can claim taxation on the grounds of COS. If Connecting Factor cannot be applied for particular taxation, one cannot determine the tax base. It (Connecting Factor) has to be discarded and alternative Connecting Factor has to be considered.

Our submission: For a global Corporation, the **Connecting Factor of "Source" cannot be applied.** In our article on E-Commerce Taxation (Presented at FIT conference in the year 2006), we established that the traditional concept of PE is not applicable to E-commerce. Here we are going a significant step ahead. **Whole connecting factor of "Source" is not applicable to a Global Corporation conducting E-Commerce.**

4.14 There is some **similarity** between the U.S. bankers (who brought U.S. economy to a crisis) & the Global Corporations of USA.

(i) Both did everything legal and yet unethical.

(ii) Both earned substantial money.

(iii) Managers and consultants in both cases do not believe they have done anything wrong. They are doing "duty to their shareholders"–of minimising tax cost and maximising net revenues.

Differences are:

Banks have ultimately made huge losses. Sought bail out packages. Some of those who could not get bail-out went insolvent.

Still public at large has not understood the losses due to tax planning. CIT's simple answer to the issue of "Duty to Shareholders" may be:

"Okay. You do your duty to your shareholders. My duty to my nation asks me to stop you. And I will do everything possible to stop you. If existing principles are weak/ inadequate, I will create new principles/compromises by making deeming provisions."

4.15 Summary of Paragraph II.4

Paragraph 4.1 gives business model of Google.

Paragraph 4.4 analysis the business model in more depth.

Paragraphs 4.1 to 4.8 raise the difficulties in taxing Google.

Paragraphs 4.9 to 4.11 briefly explain the tax planning done by Google.

Note : We have no personal/ authentic information on Google & its activities. All information is taken from media. **One may assume that all the information discussed here does not pertain to Google.** This is only an illustration. Purpose of using the name is only to identify an activity under E-Commerce.

5. Tax Havens

Please see our detailed article on Tax Havens on our website.

5.1 Peter Principle: Anything that Can go wrong Will go wrong.

Tax Avoidance Principle: Any tax that can be evaded or avoided Will be evaded or avoided.

5.2 Oscar Wilde:

"I can resist anything but temptation."

Global Corporation: "I will pay anything but taxes."

Tax Haven : "Welcome. Our legal system is for you to avoid taxes of other countries".

5.3 There are almost 50 tax haven Governments - ready to make new laws & modify existing laws to help tax avoiders of the world.

5.4 **Our respectful submission:** The Courts make one error in treating all Governments as same. (AzadiBachaoAndolan 263 ITR 706)

Compare: All citizens are equal. All citizens have the right – of free movement, freedom of speech etc. And yet, when someone commits an offense, he is punished by the Courts. He may even be put behind the bars. His fundamental right of free movement will be gone.

Similarly, all Governments are equal. But when some Governments actively collude with tax avoiders of the world, can we ignore their crime? Can we afford to treat them equally?

5.5 **OECD & G20** are seriously concerned about Tax Avoidance. They all want to co-operate &minimise tax avoidance. At the same time, some of these countries/ politicians of these countries have vested interest in tax havens, treaty shopping & ultimate tax avoidance. Hence a good system is not emerging. For Global Corporations it is extremely easy to use tax havens, abuse tax treaties and avoid taxes. This makes it all the more necessary to have a new taxation system.

6. Other weaknesses of existing system

6.1 FTS

(i) Can we reflect on the term **"Fees for Technical Services"** (FTS) in Section 9(1)(vii)? When this clause was introduced in the year 1976; Indian industrialists were entering into "foreign collaborations" and importing technology. They were paying fees for such technologies. In some cases, GOI could not tax such fees. Hence this clause was introduced. Then the clause has been expanded to include managerial and consultancy services.

What is "technical" or "consultancy"?

Today cooks in five star hotels are paid very well. They are masters in their technology of cooking. If a cook in a five star hotel teaches his technology to a foreign visiting cook, can we say that he has provided technical service and imparted (made available) technical knowhow? Apparently yes. Mother or mother-in-law teaching cooking to daughter or daughter-in-law also amounts to imparting technical knowhow. But since no "fees" are paid, it is not "Commerce".

Point to be noted is the phrase – "Technical/managerial/ consultancy service" is too wide. And causes litigation. Either delete this clause and fall in line with OECD or drop the words "managerial, technical or consultancy" and tax all services. If the second alternative is adopted, then GOI will be able to tax E-commerce companies like Google, facebook, Yahoo, etc.

(ii) FIS – Fees for Included Services

Our suggestions discussed later in Part IV are that **all services** may be taxed by the COS/COM. Concept of "Included Services" is a relic of the past when our main import of services was technology. Today the scope of import of services has expanded widely. There seems to be no logic; why we should tax only certain kind of services and not others. Such a discrimination goes against the concept of neutrality. GOI rightly tries to avoid this concept in its treaty negotiations.

(iii) Shipping

People who know global shipping industry inform that – this industry is ultimately owned by a few holding companies. Ninety per cent of the revenue would flow to six countries in the world (ignoring tax havens). All other nations renounce their rights to tax a service and these six nations enjoy the tax revenue of global shipping industry. Airlines also have a similar story. There seems to be no logic for this anomaly. Article 8 of Model Treaty needs to be modified. Countries from where cargo and passengers originate should have a right to tax the revenue.

In administration it will be easier to ensure that the payer of fare/freight deducts tax at source.

6.2 Existing Treaty Rules

We have also seen that COM is also a major contributor of income.

Can we say that the Country of Purchase of Goods and Services is a contributor to the income? GOI tries to tax a NR buyer of services from Indian BPO service provider on dual entity concept basis. Here India is the country from which a NR is purchasing services, or India is the Country of Purchase.

It is said that Diamond Trading Corporation's income depends on (i) low cost purchase of rough diamonds from some countries; (ii) low cost of cutting & polishing of the rough diamonds in India; & (iii) undervalued currencies of mining countries & India. Microsoft earns major income by sourcing software development at low cost from several countries. The list of factors contributing to profits can be long. And all these may claim right to tax.

6.3 FAR analysis

We submit that the FAR analysis is highly subjective. Hence it is bound to create litigation. It would be best to avoid such litigious concepts in tax law. This subject has been debated at length. Many experts are against the concept. But we will not discuss the concept in details in this paper.

6.4 COR

Present Treaty Models assume only one COR for the assessee. Country of Incorporation is of course irrelevant for GC. Even when we consider Place of Effective Management, we realise that it is spread out over many countries. Ten years back, it was difficult to envisage. Today it is reality. **GC has several CORs.**

6.5 COS

It is understood that in a business, all functions of the assessee contribute to the value addition and not just sales or marketing. Similarly there are so many other forces/factors which contribute to the profits of the assessee and hence can have a claim to tax the profits. In case of Global Corporations, several functions are performed in several countries. Hence it is evident that **GC has several COS** – not just one.

Summary : In Part II we have seen how traditional principles of International Taxation cannot be applied to E-Commerce.

There are two separate but related matters:

(i) Since the existing system of international taxation relies on geography, it cannot be applied to E-Commerce.

(ii) Global Corporations are avoiding income-tax. It is reported in media that Google chairman called it as normal part of the capitalist system. Many GCs are proud of tax avoidance. E-Commerce helps them.

Part III – Connecting Factors not applicable to GCs

III. Connecting factors

All the difficulties discussed in Part II have long been anticipated. Experts have concluded that there is no solution better than the existing system. Now in Part III, we discuss difficulties that go to the core of International Taxation. Whole system is based on tax sharing by COR & COS. (Please see part I) In taxation of Global Corporation, can we apply the connecting factors of Residence & Source?

We discuss below in Paragraph III.1 "Residential Status" and III.2 "Source".

(We are saying in this paper that Google is spread out globally. But China has banned Google. And there may be some countries where Google has not reached. In a practical sense when a Company is spread out over scores of countries, we call it a Global Corporation.)

III.1 Residential Status

1.1 **Globalisation:** Imagine a position in the near future. A company like Google has shareholders & directors spread over many countries. Its shares are quoted in six different countries' stock exchanges. Board meetings are held over video conferences. Senior management is spread over several countries. Its business is transacted from several countries. Its customers are spread over several countries.

We have seen that the logic for COR getting the jurisdiction to tax global income is that the company has its ownership, management & business located in the COR (See paragraphs I.5 & I.8.1). When all these are spread out globally, which country can claim prerogative of a right to levy tax on global income? None. The place of incorporation loses its importance. No single country can claim that the corporation is its exclusive entity, or that it is the only COR for a GC.

This is a clear development from globalisation of business. It establishes our claim that "Place of Incorporation" has lost its significance as a "Connecting Factor". At least for Global Corporations.

1.2 **Tax Havens :** We have presented a paper on Tax Havens. It elaborates that a Tax Haven Government grants incorporation for any company that pays its fees. In some tax havens, pay just $ 500 per year and you have your company. It grants incorporation even when ALL the shareholders, all the directors (except the nominee directors) and entire business may be outside the country. In fact many tax havens simply prohibit the offshore companies from doing any business within their boundaries – except keeping bank balances. We have seen in paragraph II.4.9 to II.4.15 that Global Corporations can incorporate companies in tax havens & claim to be residents of tax havens. There is NO justification for those tax haven Governments to claim jurisdiction to levy tax on the global income of the Global Corporations. Tax havens do not levy any tax. They devise ways whereby in "Form"

a tax is levied. In substance the tax paid is "Nil" or "Insignificant". So the tax haven companies can claim DTA benefit & achieve Double Non-Taxation.

This position establishes the claim that **"Place of Incorporation"** has lost its significance as a Connecting Factor. At least for all entities incorporated in tax havens.

"Place of Incorporation" and "Country of Residence" **both concepts** have lost their meaning for GCs and for tax haven companies.

1.3 India published the draft **"Direct Taxes Code"**; specifying that a company that has no business in the country of incorporation will be considered a **Controlled Foreign Corporation (CFC)**. A tax haven went ahead and changed its laws. Earlier, offshore companies were prohibited from doing business in the tax haven. Now the prohibition has been removed. These countries will go to any extent to ensure that their clients can avoid regular tax; and that the "anti-avoidance provisions" don't apply to them. For these **tax havens, it is their business to help avoid regular taxes.**

There are dozens of tax haven countries that make specific laws separating substantial facts and legal form. The form is totally at variance from substance.

Our submission is: **"Form" must always state the "Substance".** When the "form" is at variance with "substance", "form" has to be rejected. Whole controversy about Substance vs. Form" is incorrect.

The very fact that **"Place of Incorporation"** can be easily manipulated is a strong factor to state that the place of incorporation should not be considered as a determinant for a company's residential status.

For practical and legal compulsions, a GC has to have a registered office. Many corporations register the main holding company in tax havens. Then subsidiaries may be registered in several countries. These corporations have to a large extent avoided income-tax on the basis of "Residence".

1.4 Traditional principles of International Taxation establish "residence" as one of the two connecting factors which grant tax jurisdiction to any Government. It will continue for a long time for many companies. But it will no longer be relevant for a truly global corporation.

(This issue was discussed in the year 2000 by the High Powered Committee on E-commerce. Today it has become a reality.)

An analogy: A Banyan tree spreads its branches in all directions. These branches spread their own roots. Some years after the branch roots have established themselves, the original trunk dies. Eventually one cannot find out which was the exact location of origin for the Banyan tree. "Kabirvad" in Gujarat is such a Banyan tree. A Global Corporation may

originate in one country. Then it spreads. It can dissolve original registration and decide that it is no longer incorporated in the Country of Origin.

There is nothing "Fundamental" or "Sacrosanct" about International Taxation. In fact, there is nothing fundamental about taxation. A hypothesis works as long as it works. And then it needs to be discarded. However, "discarding" an accepted principle/ hypothesis is anathema to **legal profession**. We love the past. We cling to the past.

Whereas technology loves demolishing the old and building the new. Scientists and technocrats will keep coming out with radically new ideas and instruments. Businessmen will eagerly jump for the latest instruments and methods of doing business.

The gap between (i) outdated laws and treaties and (ii) modern ways of doing business will keep widening ……… until ………. the law becomes impossible to administer/ comply with. Collapse of existing treaty models will bring about new treaty models --- unless someone bold enough drafts a new model before the collapse.

III.2 Connecting Factor – "Source":

We have seen that a good definition of "Country of Source" is:

"That country in which the assessee makes value addition by its own functions, assets and risk taking." Now consider Google and facebook. We have seen in Part II that these companies cannot be taxed on the connecting factor of COS. If GOI decides to tax Google, on what basis can it tax?

2.1 Data Base : What does Google do? The data that we see on Google is generally not provided/created by Google. (Now Google has started creating its own data base and providing the same to the users. Google Map is an illustration. However, Google's own data is a fraction of the global data being researched through Google.) The data exists all over the world. Much of it is free. Some of it is not free. But most of it is provided by different persons in many countries.

Google's main function is to make this data available to us. This data cannot be a tax base. If at all, the data may be a cost centre. If Google or the internet surfers pay any charges to the data provider, it is a separate issue. We are considering Google's taxable income here.

When Mr. M in Mumbai talks on telephone or through internet with Mr. U in USA and transacts a business; what is the importance/ value of the telephone or internet? Re. 1 per minute for MTNL land line; or no marginal cost for internet. Similarly, in internet search, Google's function seems to be insignificant. And yet it earns billions of dollars.

2.2 Users : Who constitutes the market for Google? There are millions of users of Google facility. They are spread out all over the world. But many of them don't pay anything to Google. They are not Google's primary market.

2.3 Advertisers : Most of us, users don't pay any charges to Google for using its e-mail facility, access to data and maps (and other services which will keep coming). Where does it gets its revenue of $ 34 billion (in the year 2011).

Google gets its major revenue from the advertisers. Businessmen all over the world pay advertisement charges to Google. These may be small businessmen in remote places. Or large corporations. Beauty of internet advertising is that even small businessmen can advertise themselves to the world. If the customer is on a look out, he will reach the businessman with a small budget.

For Google, the advertiser is the main customer and not the user of the website. User doesn't pay. Even if some users pay, it may be a small amount. Real market/ Real customers are advertisers. This is the case with most newspapers, magazines and TV channels. User/ reader/ viewer constitute a base to attract the advertiser.

2.4 We have discussed earlier that as per present principles of international taxation, the assessee's actions determine COS. Market or footprint do not determine COS. If this principle is accepted, both – users and advertisers – are not relevant for determining COS.

OECD has presented material on **FAR analysis.** Assume that we want to apply FAR analysis to the assets employed by Google, functions performed by Google and the risks taken by Google. How do we attribute profits based on these three factors to several COS?

While theoretically it may be possible; in practice it is a non-workable idea.

So the issue is: What constitutes the "Foot Print"? The users or the advertisers? The CIT should look at the assessee's market (advertiser) or the market of the market (users)? How far can the taxman stretch his reach and imagination?

In either case, both are spread all over the world.

2.5 Software & Hardware

Google owns software & hardware. These are the "assets" that may be considered for applying the FAR analysis. Software is intangible & hardware is tangible.

For determining the location of an intangible asset like software, let us consider similar intangibles like Intellectual Property Rights and Goodwill. It is a sound principle that intellectual property right cannot be said to be located where it is patented/ registered. Probably it is located where it is used.

Let us say a company has immense goodwill. Customers trust it for its fair trade practices and for the quality of the goods and services it provides. Where is the Goodwill located? It is where the customer, relying on the goodwill, makes a "buy" decision. Goodwill is where the market is.

Google needs massive infrastructure for providing the facility of accessing data and communicating via e-mails. It needs special algorithm for anticipating what a particular

regular user seeks. Then finding out data from a vast global database and arranging/ displaying on the user's computer in a particular order of priority. This operation goes on every second for numerous people all over the world.

Which asset has created the value?

Does data base add value?

Does the user base add value?

Does entire infrastructure consisting of hardware and software add the value?

In either case, where is it located? Which country can claim the right to tax its income based on the connecting factor of "Source"?

Google's server farms are located in some countries. Entire network of communication satellites and cables is situated in many countries and also outside the borders of all countries (in the oceans and in the sky). Where is the software located? Where are all the Intellectual Property Rights owned by Google located?

Intangibles have no fixed place. They defy geography.

If we say that Google adds value by its hardware and software; then it is spread all over the world. It defies the concept of "Country of Source". Hence we can't use the Connecting Factor of "Source" to tax Google's income.

2.6 Conclusion on "Source" as a Connecting Factor

FAR analysis or concept of **PE** (with present definition) cannot be applied to Global Corporations. If **any other base** is to be adopted, there can be diverse claims for taxation based on "Source". Any particular factor that may be adopted – will render an impractical method of attribution of profits. "Source" as a connecting factor for attribution of the profits of a truly global corporation is not workable.

Part III Conclusion

Both the Connecting Factors – "Residence" & "Source" will fail for determining tax jurisdiction for a Global Corporation. Existing rules of International Taxation will not work for E-Commerce.

Analogy : There was time when people used bullock carts and horse carriages. Kings would make rules for better traffic management. Today people drive cars and fly aeroplanes. Can we apply the bullock-cart rules to cars and aeroplanes? Bullock carts are still used in many parts of India. Completely different rules for aeroplanes have to co-exist with bullock cart rules.

Different principles for taxation of Traditional Commerce & E-Commerce existing simultaneously have become a necessity. Note: This statement is **contrary to the principle of neutrality** about which we have talked earlier. The arrangement of this article is: in the

beginning we have said the "Accepted Principles". Then we have stated difficulties in the application of "Accepted Principles". Then we will try to raise hypothesis on solutions to the difficulties. And also see whether we can still have neutrality & different rules together.

Part IV — Alternative Taxation Scheme

IV. Alternative Taxation Scheme

1. We have analysed the problems in taxing a Global Corporation conducting its business through E-Commerce. We have also seen that the existing system of International Taxation is inadequate. What is the alternative?

We have seen earlier that the system of Elimination of Double Taxation involves: (i) COS taxing the income of a NR at a lower rate; and (ii) COR granting credit or exemption. When we can design a system ensuring that the NR assessee gets credit in COR for the taxes paid in India; it will be a fair & proper system.

Summary of Part IV: In the following parts let us see the concepts, difficulties & solutions for:

(IV A) How GOI can modify the law to establish India as COS for GCs. (Paragraphs 3 to 17 below.)

(IV B) How the assessee can claim credit for taxes paid in India against the taxes payable in COR. (Elimination of Double Taxation.) (Paragraphs 18 to 21 below.)

And

(IV C) Macro Issues.(Paragraphs 22 onwards.)

Note: It would be interesting to consider how COR like USA can curb tax evasion by the GCs through tax havens. Today it is USA. Soon it will be Indian Global Companies that will avoid Indian taxes by setting up similar facilities abroad. However, let there be another paper to discuss that issue. In this paper we will not discuss anti-avoidance provisions that USA needs today & India will need tomorrow.

Note: We have presented some hypotheses. Then we have tried to anticipate objections to the hypotheses. And tried to respond to the objections. In the process, the paper has become lengthy & complex. This subject is complex in theory.

We are considering below several ways **to simplify**: (i) compliance by the assessee GCs; (ii) compliance of TDS by the payers to the GCs; and (iii) administration by the Department. A detailed conceptual discussion may help all in practice. Logistics for making a NR comply with Indian tax rules and logistics for tax payment as well as elimination of Double Taxation in the COR are discussed in this part IV.

2. Attitudes & Traditions

2.1 Even before looking at alternative, let us look at our attitude.

The scientists constantly keep asking questions: "What? Why? How?" They go to the root of roots and find new truths. With an open mind they embrace new ideas and new truths. Legal profession is rooted with the past. Precedents have tremendous value. We search for precedents even where none exists.

2.2 We, tax professionals are bound by traditions. Unless we are forced, we can't bring about new concepts. Very simple illustration:

Why is it that amongst tax professionals men wear trousers of black (or dark colour) and shirts of white (or light colour)? What is the logic behind it? There is no logic. It is just tradition. Why don't we wear white trousers and black shirt? The very idea seems to be revolting. Why? Because it is contrary to tradition.

Even when we realise that there is no fundamental merit in it, we will not change the tradition because it is a harmless tradition. However, when it comes to taxing a Global Corporation, clinging to tradition is harmful. We need to have a sharp look at the traditions and change them if a better system is available.

Harmful to whom? Traditional system saves tax cost for the Global Corporations. It is harmful to the nation, to the tax department. Profession argues in favour of continuing the tradition; and department goes ahead and breaks the tradition by amending the law, making anti-avoidance provisions.

IV A Modifying the existing system so that India can tax NR GCs providing E-Commerce facilities to Indian market.

3. Summary of Part IVA

GOI would like to tax a NR GC's revenues earned from India. Since the assessee is a NR, GOI can tax it only on the Connecting Factor of "Source". We have seen that both Connecting Factors fail for E-Commerce. Hence India needs to evolve new concepts to tax E-Commerce. Amend the ITA appropriately & canvass for amending the DTA. In this part we discuss following:

Conceptual Groundwork:

(i) India may tax the NR's business income by developing the concept of:

(a) Virtual PE or BC. The concept of PE is discussed from numerous different angles. Paragraphs 5 & 7 below.

OR

(b) Considering COM as COS (value addition by Country of Market). Paragraphs 6 & 10 below.

These concepts would mean modifying Article 7.

OR

(ii) India may tax the NR's revenue from India by equating it with Royalty. Paragraph 7.

OR

(iii) Developing a new system & combining the concepts of PE & Royalty. Paragraph 7.

ITA : To give effect to the concepts, Indian Income-tax Act has to be amended. Separate provisions are required for:

(i) Taxing E-Commerce Services – Paragraphs 13.2 & 14;

(ii) TDS provisions – Paragraph 5.6; and

(iii) Treaty Override – Paragraph 13.1.

Issues : These modifications in law will raise several issues & objections. Major issue will be of neutrality – Paragraph 9. Then there are other issues – Paragraphs 8, 12 & 17. Paragraph 8.7 explains the logic for a 4% TDS rate. **Paragraph 15 gives a summary** of the conceptual discussion as well as relevant amendments to ITA & DTA.

4. Justification for taxing NR

There can be different logics or justifications for taxing a NR:

4.1 He is **performing** services in India and hence he has a virtual PE or BC in India. This is **supply side** or assessee's side.

4.2 Irrespective of performance, we are taxing him because Indian Residents are **utilising** his services in India. This also amounts to saying that India is the **Country of Market**. COM has a right to tax because COM contributes to the NR assessee's profits. This is **demand side** or customer side. This approach is adopted by GOI by making a deeming provision – explanation after Section 9 (2).

4.3 India may be considered COM even though the service is neither performed nor utilised in India. This can be a situation when an Indian advertiser pays advertisement charges for a foreign viewer/ user. Indian Resident advertiser is **utilising** GC's services for **its business carried on in India.** Hence we say that for Google, the market is in India.

We examine all approaches and see their implications.

5. Permanent Establishment or Business Connection

Note: In this article we are not discussing the differences between PE & BC. Issue is: when do we consider the NR assessee as doing business **within** India?

5.1 **Facts**: Google, Facebook, Yahoo, You Tube, Star TV, CNN, BBC Radio & BBC TV are providing different kinds of services. Amazon.com provides even E-books. This is largely comparable to sale of books, CDs & DVDs. Can these non-residents providing E-Commerce services be treated as having a Virtual PE in India? If yes, on what grounds? What are the issues/difficulties in such a modification of the existing concept?

5.2 The Hypothesis of Virtual PE

It is accepted that E-Commerce defies geography. Concept of PE is a geographical threshold. Hence as far as E-Commerce is concerned, we have to find an alternative PE. **Virtual PE** may be an alternative for E-Commerce.

5.3 Google from USA/Ireland is service provider. Indian viewer is the service user. "Where" is the service performed? Google is the assessee. User is not the assessee. Has Google **performed** services in India?

It is difficult to construe that Google is providing services in India because: It has no human beings and no assets in India. In similar circumstances (Asia Satellite & B4U cases) Indian appellate authorities have ruled that there is no PE in India. No tax can be levied. Even the retrospective amendments to S. 9 (1) (vi) are to no avail as DTA overrides domestic law. In this article we are considering: "What should be the future law to tax E-Commerce?". Hence these decisions are not of much help. Except for a reminder that: Any amendments to the domestic law will be of no avail as long as we do not take care of the fact that DTA has no provision for E-Commerce taxation. And DTA will override ITA.

New law may be based on the consideration that: Geography is irrelevant for E-commerce. Google is providing services to Indian users. We are not able to see Google performing those services in India. However, Indian case law has considered that intangibles like Goodwill are present where they are used. Google's intangible services are "performed" where they are "used". If we accept this position, accepting taxability of Google's income will be in line with the principle that Google has a PE where it performs its functions.

5.4 Let us say

These assessees operate on the computers/TVs/Mobiles/ Radios or other instruments of the users of the services. Hence we can say that they are performing services on the instruments at the places where the instrument is situated.

It is difficult to accept this notion. Consider following illustrations. (Note: these illustrations raise many issues. We stick to the tax issues of **place of action & jurisdiction.)** As per media reports: (1) Chinese **Hackers** are stealing data from, and causing damages to the US media computers. (2) US hackers caused damage to Iranian Nuclear energy installations' software. (3) US **Drones** fly to Pakistan, drop bombs & kill people in Pakistan. In all these illustrations, no human beings travel. There are no permanent establishments. And yet functions are executed in different countries. In case of above three illustrations, the parties are acting in other countries without any physical presence in the country of action.

We have to come out of the mind-set that for taxing jurisdiction COS needs a PE as per the orthodox definition. A virtual PE may be good enough threshold for tax jurisdiction.

At the same time, we may consider the fact that there may be different situations. For illustration: An Indian user searches the US treasury website to look for US tax laws. He then

downloads certain data. In this case, it is the user who is acting on the computer of the US Treasury website. He could have directly gone to the database by using VSNL or any other Internet service provider. He has used **Google only as a search engine.** User is acting on database computer via the search engine. **Google is not acting on the Indian computer.**

Another illustration: Google places an advertisement on the user's computer, **Google is acting on the User's computer.**

When **Infosys** maintains software on its US customer's computer located in USA, Infosys is **acting in USA.** However, it is possible that the customer may be using "Cloud Computing" facilities. Its server hosting its software & database may be situated anywhere.

When **STAR TV** (assuming it to be a NR of India) broadcasts its programme with Indian footprint in mind, does it actually operate/function in India?

We can consider several illustrations. Each illustration will have its own different answer to the question: "where the assessee is functioning?"

Thus even if we accept the concept of Virtual PE, administering & complying with the tax law will be difficult.

5.5 Monetary Threshold – A substitute for traditional PE

We are not interested in tax administration for small assessees. Hence, we may provide a threshold: Only when the tax receivable from a NR is more than ` 1,00,000, the assessee will be deemed to be liable to tax in India. We are providing a TDS rate of 4%. Why 4%? Google & other Electronic service providers' net profit attributable to India may be assumed at 10%. This is higher than the net profit of 7.5% assumed under Section 172 for Shipping Companies. On this net profit, foreign company tax rate of 40% is considered. If the assessee's revenue from India crosses ` 25 lakhs in a year then we will consider that the assessee has a virtual PE in India and is liable to tax in India.

Under the suggested system, such assessee will be liable to file its Income-tax return in India, get its accounts audited, and pay advance tax. Claim credit for all TDS and pay net tax on self assessment. The assessee remains a NR of India and hence is not liable to comply with certain procedures like TDS on payments made by the assessee to NR persons.

For the concept of E-Commerce PE, all conditions in Article 5 are replaced by a single factor: Will the NR assessee earn annual revenue from India of ` 25,00,000 or more? In other words, will the NR assessee's annual tax liability cross ` 1,00,000? If yes, he has a PE in India.

5.6 Threshold for the Payer

Just as we have a threshold for the assessee, it is necessary to have a threshold for the payer also. Home consumers/users will find it extremely difficult to comply with TDS procedure. Hence we may consider another threshold. An individual or an HUF payer will not be liable to TDS procedure if both of the following conditions are satisfied:

(i) The payer is not liable to tax audit and is not claiming the payment as a tax deductible expenditure.

And

(ii) Pays less than ` 1 lakh per year; then he will not be required to deduct tax at source.

Such small payments will be taken care of by the bank/ payment gateway collecting funds on behalf of Google. When Google will file its own tax return in India, it would claim credit for the tax deducted by the bank/payment gateway.

6. COM is COS - Utilisation

In the concept of PE or BC (Paragraph 5 above) we consider whether the assessee is doing any function, etc. in India or not. In this paragraph we consider whether the Indian consumer is utilising services provided by Google.

6.1 Let us say, the concept of Virtual PE is not acceptable to us; or in any case, we want to consider alternatives. We do away with the criteria that the assessee should perform services in India. As long as the services are utilised in India and paid for by Indian residents, India has a right to tax the revenue. India is the Country of Market, it contributes to the value addition made by & profits earned by the NR assessee& hence it is treated as the Country of Source. GOI will tax only those GC assessees whose revenue from India is more than ` 25 lakhs.

6.2 Justifications

(i) Google and the TV channels are providing services to the users/ viewers AND to the Advertisers. Hence for them these people constitute the market. (ii) For the tax department, it is simple to administer (iii) For the assessee it is simple to comply with. There is no need to attribute any profits/revenue to any COS.

Here we are justifying India's jurisdiction to tax because India is the Country of Market. This involves (i) amending Income-tax Act and (ii) modifying Article 7 in the DTA.

7. Method of Taxing: "PE" or "Royalty"

7.1 Let us say, the suggestion to tax E-commerce services is accepted. How should the services be taxed? Some broad alternatives may be considered at this stage:

(a) Consider that Google is operating within India. It is providing services where the services are used. Hence it has a **Virtual Permanent Establishment** in India. Google's gross revenues minus expenses attributable to Indian operations give taxable net profits.

OR

(b) Consider Google's revenues as similar to "Royalty". Levy a tax @ 4% on gross revenues.

Details:

(a) First option (PE) requires Google to prepare separate books of account, consider FAR analysis & calculate net profit in India. Get the accounts audited + tax audited, maintain transfer pricing records and get TP audit done and comply with elaborate Indian legal procedures. Assessment, appeals & probable prosecution. Google may have to do this in a hundred countries. And defend itself from GAAR provisions in all countries where GAAR has been made a law.

(b) It seems, the second alternative of paying lumpsum tax will be better for administration as well as compliance. No application of FAR & no need to prepare separate profit & loss account, no audits. However, we examine all the aspects pertaining to both alternatives in paragraphs 7 & 8.

7.2 A solution can be: make a **combination of two concepts: Royalty & PE**. In other words, the tax system will have a flat tax on gross revenue like in Royalty. And yet, the tax liability will arise only if certain thresholds are crossed like in PE. Two separate thresholds are considered: number of days (paragraph 7.3) & amount (paragraphs 5.5 & 5.6).

7.3 A non-resident providing E-Commerce services in India will be liable to tax in India only if he regularly provides his services to Indian customers for a period of **60 days or more** within a financial year. Then casual service providers will not be liable to tax.

7.4 Combined Effect:

Non-Resident provider of E-Commerce services will be liable to tax in India only if all of the following conditions are satisfied:

(i) Services are provided to an Indian resident or to a person for his business conducted in India. (This will mean services for home consumption also will be covered.)

(ii) Indian resident (other than Individuals & HUFs who are not liable to tax audit) makes payment from India. (Also see paragraph 5.6 above)

(iii) Service provider provides services for more than 60 days in a financial year.

(iv) Service Provider – the GC earns gross annual revenue of ` 25,00,000 or more from India.

(v) If all these conditions are satisfied, the GC will be liable to tax in India & the payer shall deduct tax @ 4% fixed in the law. Payer will only look at his threshold of payment of ` 1,00,000 or more.

7.5 Avoidance of TDS

In this system **avoidance of** TDS procedure may be easy for some payers. Consider an illustration: There is a Global Advertiser – Corporation. It has subsidiaries in several countries including some tax havens. It places advertisements on a global TV channel for India as well as several other markets. Let us say, the ad charges payable for Indian market are ` 10 crore.

This advertiser will pay ` 2 crore from India and balance ` 8 crores from a tax haven company. It will comply with TDS procedure for ` 2 crore and save tax on ` 8 crore.

How does one deal with it? Advertiser and TV channel are not "Associated Enterprises" (AE). Hence the Transfer Pricing provisions (domestic or international) will not apply to this transaction.

Since comparable ad rates for other advertisers will be available; finding out market rates won't be difficult. And under invoicing/over invoicing can be enquired into under normal scrutiny assessment procedure also. One does not need the crutches of TP – deeming provisions for such matters.

Another way of looking at the tax avoidance by paying from tax haven is as under. When a Corporation pays from a tax haven, and does not pay from India, it cannot claim that payment as a tax deductible expenditure in its Indian tax returns. Hence it is not a big loss to Government of India.

8. Virtual PE: The concept of PE discussed above raises several issues. Some of these are discussed below.

8.1 FAR Analysis: Assets & functions

One view is: Google has its functions performed, assets situated and risks taken where its hardware and software are situated – Let us say, USA & Ireland. It has no functions and assets in India. It is like - a rose flower spreading its fragrance in all directions. Some passersby notice the smell, enjoy & appreciate the flowers. Many don't even notice it. Google's service is available to seven billion people (whole world). Not more than a fraction of the population may ever use it. How can we say that Google is performing where the user is using?

This discussion suggests that GCs are not having PE in India. In the next illustration we consider a different aspect (Paragraph 8.2).

Risk : Probably we can say that anyone who does business with/within India takes a business risk in India. Consider a TV channel broadcasts a programme with Indian footprint. Some Indian viewer files a case against the broadcaster for offending his religious views or for defamation. The risk has arisen in India. The risk is taken/ borne by the company outside India.

8.2 **Illustration:** A singer or a **performing artist** is performing on a stage in India. Viewers come, pay for tickets, listen to/watch the performance. Here we agree that the performer is physically present in India and is providing entertainment service in India. He/She is liable to tax in India even under the existing Treaty rules (OECD model – Article 17).

In this illustration, viewer/listener and performer are in the same room. Viewer, with his eyes watches. Listener with his ears listens. Performer performs.

In many cases, the audience is very large. The organisers put up large TV screens. Viewers actually see the performance on the TV screen. Actual performer would be so small in relation to the size of stage that if one were to watch only the performer, his facial expressions and subtle acting won't be seen by the viewer. It is also possible that the viewer and performer may be in **different rooms.**

Today, in almost all cases, the singer uses a microphone or such audio system. All listeners listen only through the sound system. What difference exists when some viewers/listeners are watching/listening from another country? The **space between** the performer and the viewer may be 10 feet or 100 feet or a thousand kilometres. They may be separated by a wall partition (another room) or by a country border.

Performer performs. Wherever he is. Listener listens. Wherever he is. Since we have accepted that in E-commerce **physical presence** and space are immaterial, anyone who receives revenue from India must pay tax to India. **Forget about the concept of virtual PE.** The fact that someone earns from India is sufficient to make him liable to tax in India. This argument favours**"Demand Side"** and places reliance on **"Utilisation"** of service.

Note : In this article in paragraph 9 we are discussing the issue of neutrality in some details. In paragraph IVB.4 we have discussed that there is considerable difficulty in achieving a consensus amongst treaty partner countries. Until a consensus is achieved & DTAs are modified, neutrality will not be achieved. Hence some difference will remain between the treatment of E-Commerce services & other services as well as goods. Until then all categories of incomes (including performing artists' remuneration) which are covered under different articles should be treated under those articles. E-Commerce taxation will apply only to E-Commerce services.

8.3 All Payments. (Traditional Services & Goods)

We say that the fact that E-commerce services are utilised in India; makes the service provider liable to tax in India. Irrespective of the time and place of provision of services.

Why not tax **other services?** Surely, the instrument used for communication/transmission of services cannot make a difference in taxation. Concept of **neutrality** requires that there should be no difference based on instrument or based on **services** and **goods.**

This leads to a view: "Tax all payments from India to all non-residents". (Excluding of course capital transfers & non-income type of revenue payments.)

8.4 Space

Performer & viewer are in two **different countries.** We hold performer liable to tax and payer liable to TDS. So what is the difference between **goods and services?** Producer produces goods in one country & consumer consumes in another country. Can we hold an exporter of goods (without PE) liable to tax in India? When we import crude oil and gold

into India, can we ask the importer to deduct tax at source? See paragraph 5 for further discussion on this issue.

8.5 Time

Performer performs today. Viewer watches after some time. May be after a day or after a year. He pays for watching. On payment tax liability arises. **Space and time of performance are irrelevant.** Place & time of payment are relevant.

8.6 Entity

Performer performs, takes his remuneration and goes out of the scene. **Producer** of the programme broadcasts the programme and earns revenue. Or producer may sell his IPR to someone else. Producer may still own the IPR but **You Tube** earns revenue because it permits the broadcasting of the programme. You Tube is the platform for advertising. Viewer may not pay anything. The **advertiser** pays because the viewer visits You Tube.

Who performs, who is the user, who owns IPR – all are irrelevant. Someone earns revenue. He is liable to tax. Someone pays. He is liable to deduct tax.

If we were to stop with TDS, things would be simple. At 4% TDS rate, the revenue earner may not mind it. He may not be bothered about claiming the TDS certificate from a million users and claiming set off in COR. Only when we insist on the system of Elimination of Double Tax (EDT) or claiming tax set off in COR; some problems arise.

8.7 Uniform Rate of Tax

For Royalty, FTS, interest etc. We would levy tax @ 10% (or such other rate). Tax will be irrespective of the amount of payment. However, in case of GC, we will levy tax only @ 4% and that too only if the payment exceeds ` 25 lakhs.

This is contrary to the concept of **neutrality**. Apart from it being an issue of **"fairness",** there are important issues:

(i) When different kinds of incomes are taxed at different rates, the assessee goes for lower rate and the CIT goes for higher rate. This causes litigation.

(ii) Even when both parties are honest, there will be honest differences of opinion. Compliance of law as well as administration of law will be difficult.

Hence the rate of tax should be uniform for all kinds of incomes. Consider following calculation:

Calculation of profits taxable in India may be as under:

(i) An assessee earns net profit of say, 20% on gross receipt.

(ii) Half the profit accrues in India. Hence 10% on gross receipt.

(iii) Corporate Income-tax @ 30% 3% on gross receipt.

(iv) Foreign company Income-tax @ 40% 4% on gross receipt.

Now consider following assumptions. There will be some businesses which earn more than 20% net profits. However, there will be some businesses that earn less than 20% net profits. When we are applying a uniform presumptive rate on all incomes, it would be fair to take 20% as a representative rate.

When GOI insists on TDS @ 10%, based on the above calculation, the presumed net profit is 10 X 20 ÷ 3 = 67%

When TDS rate is 15%, the presumed net profit is

15 X 20 ÷ 3 = 100%.

We would submit that a TDS rate of 3% on Indian companies and 4% on foreign companies is more reasonable.

Such a rate would also reduce considerable litigation. Most assessees would prefer to pay up the tax than to enter into litigation.

If this position is accepted, (tax all income payments to NR @ 4%), further discussion is not necessary. However, some readers may not accept this position. Then further details may be relevant.

9. Neutrality discussed from different angles

9.1 Neutrality within services

(i) We can raise an issue: If E-Commerce services are taxable and traditional services are not taxable; then there will be no neutrality between the two of services. And people will have a temptation to shift from E-Commerce to traditional services. We agree. All services imported into India should be liable to tax withholding.

We have also seen that the concept of FTS has become cumbersome. What is managerial/technical/consultancy; and what is not; is a matter of endless litigation. Ideally all services should be liable to tax @ 4%. Royalty, FTS and all services.

(ii) One can argue on the justification of reducing existing 10% TDS rate under S.115 A(b)(BB) to 4%. 10% TDS @ 40% tax rate means we are assuming 25% net profit rate. This 25% is the profit attributable to India. Assuming it is half of the total then the total profit is 50%. Is it fair to assume 50% net profit ratio?

(iii) Many of us (tax consultants) have clients abroad. They ask us advice on telephone & by e-mails. We also advise them through electronic means. This is E-Commerce. If Google can be taxed for providing E-Commerce services, all professionals & others providing goods or services through E-Commerce should also be taxed on the basis of COM. When a consultant advises on telephone and sends his opinion by e-mail, it is E-commerce. Hence under this proposal he will be liable to tax.

Issue: What if he sends the opinion by post? What if he personally meets the client and renders advice? System has to be neutral to the means of communication.

Response to the issue: As seen in paragraph 4A above, until complete system of International Taxation is revised, differences between E-Commerce services & other services will remain. It would be better to tax professional services under the existing article of "Independent Personal Services" – irrespective of whether the consultant provides services through E-Commerce or in traditional manner.

9.2 Neutrality with Goods

At present import of goods is not liable to income-tax. Why?

The argument runs as summarised below. In our article on E-Commerce Taxation (FIT Conference – year 2006) we have explained at length why the COS should have no right to tax the income arising on value addition completed outside COS. Income-tax is on assessee's income. Assessee earns his income by his own functions, assets & risk taking. When the assessee exports goods from COR, he has completed the value addition function in the COR. Hence COS may not tax the same. However, this argument is entirely favouring the **Supply side.**

Country of Market does add value and contributes to the profits of the seller. This is the **demand side** of argument. In fairness, there is no reason for not taxing import of goods. Repeat: In fairness, accepting the principle of neutrality; and accepting that the Country of Market also contributes to the profits of the seller of goods & services; COM should have a jurisdiction to insist on the TDS on the import of all goods & services – whether by traditional commerce or by E-Commerce. **This is where we are modifying our opinion expressed in the E-Commerce presentation.**

The practical issue is: India imports $ 100 billions worth of crude oil every year. Will the Saudi/Iraqi/Iranian Governments accept TDS of 4% from their bills? We are net importers of goods. If we tax the imports, in retaliation, our customer countries will tax our exports. If our exporters succeed in passing off the TDS burden to foreign buyers, fine. Otherwise we may end up with a situation: "Heads I lose, tails you win". There is a distance between the theory and the practice. This is where the Governments have to use "Vivek" (discretion) in the extent to which they can go.

In Part III we have concluded as under: bullock cart rules & air traffic rules have to co-exist. Similarly, we may need different rules of taxation of E-Commerce & Traditional Commerce. **There will be no neutrality.** We may draft new rules for E-Commerce & continue with the existing rules for Traditional Commerce.

9.3 Neutrality between R & NR assessees

For E-commerce, we are taking a stand that the appearance of data/picture, etc. on user's computer/TV amounts to the **performance** within India by the non-resident assessee.

This is clearly a grey area. If we apply the same principle, **Infosys or TCS** (Tata Consultancy Services) staff operating from India and providing services to their customers at USA/Europe can be considered to be operating within USA/Europe. They would be having a virtual PE and would attract taxes in every country where their client is being served.

Many Indian companies are providing **BPO services** to their foreign clients. Indian Income-tax department is making serious attempts to apply "Dual Entity Concept" and tax the Non-Resident principals for purchasing services from India. If the concept of Virtual PE is accepted countries where clients are being served, will demand tax from all these BPO companies. On elimination of Double tax (EDT) under Double Tax Avoidance Agreement, India as COR for the BPO companies will have to give credit for such taxes paid abroad. India will suffer substantial tax losses.

We must be ready that – any deeming provision that we make, will be retaliated by other Governments. Irrespective of retaliation, any taxation system that we suggest must be on sound basis, and fair to all parties.

If we do not claim that the NR GC (like Google or facebook) is operating/performing in India; and we still want to tax it; we have to rely on another concept: Country of Market also has a right to levy income-tax. Under this principle, NR GC can be taxed without any compromise about performance/utilisation.

In other words: **"Country of Market can tax the income of a foreign buyer of services."** Now apply the concept of neutrality – what applies to E-commerce, should also apply to other services. This means, all the countries buying our software & BPO services; and of course all other services – tax consultancy, medical consultancy & so on – can tax the **Indian exporter.**

10. Supply Side/ Assessee's performance

10.1 We have considered the concepts of Virtual PE and COM as COS. Google's provision of services in India contributes to its profits. However, which activities shall constitute Virtual PE or the "Source" of income? Service to "user" or "advertisers" or "both"?

10.2 FootPrint as Virtual PE/ Source

Using the language used by Indian Income-tax department - India is the FootPrint for all the television channels that broadcast their programmes for Indian viewers. Similarly India is the footprint for Google, facebook, etc. when they target the Indian market. For Google, what should be included for the footprint? The viewer base/ user base (Paragraph 10.3) or the advertiser base (Paragraph 11)?

10.3 Indian Viewer/User

When we consider the Indian viewer/ user as the tax base, there are two further issues:

(i) A person in India views TV programme in India or uses a Google service in India. And the **user pays for their services**. The user's payment is the revenue for NR GC and is sought to be taxed. This is further considered in paragraph 13.4 below.

(ii) An **advertiser** targets Indian viewer/user and pays ad revenue to the NR GC. The ad revenue is sought to be taxed. This is further considered in paragraph 14 below.

10.4 In case, we **adopt viewer base,** the concept of footprint is vague. A viewer may be in India today and he may be abroad tomorrow. We can say: "We are considering people who are viewing television when they are physically in India".

If we consider **Indian viewers** as the base, then any TV channel and any service provider like Google &facebook – irrespective of their residential status will be liable to income-tax in India. They will be liable to pay tax on ad revenue earned by them for broadcast to Indian viewers. This liability will arise even if the advertiser is a non-resident of India. In other words, **foreign advertisers paying ad charges to the TV channel** will be liable to comply with Indian Tax Deduction procedure (TDS). Advertiser himself will not be liable to income-tax in India. But the TV channel & internet search facility provider will be liable. Advertiser will deduct tax at source from the payments made to them. Do we have the jurisdiction to ask - the foreign advertiser paying to a foreign service provider - to comply with our law? How do we **enforce** such a jurisdiction?

Similarly an Indian advertiser paying charges to a British channel for the user base in Europe – will be liable to pay taxes. A further question arises – "To which Governments?" – British or the European Government? The channel's footprint may cover almost the whole of Europe; or another channel may cover almost the whole of the Middle East. None of these groups have a tax collecting agency – covering whole footprint.

When this assessee (Indian advertiser) files his return of income in India, he will claim 'elimination of double tax' by using the DTA with which country?

It seems quite impractical/ unworkable to consider the users as footprint. Because of the difficulty in administering such a tax system, it may not be acceptable.

10.5 To the extent that Indian TV viewers or internet users are themselves **paying charges** to the channel/ Google; it can be considered as a tax base for India. For Google, we may consider advertisers as tax base. However, there are many companies that provide E-Commerce services. Google is only an illustration. Other service providers may not have advertisers as revenue base. In future, many new services will come about. In all cases, the **user** as tax base will be a basic necessity.

How do you ask millions of viewers/ users from home to deduct tax at source before paying to Google? Probable logistics are discussed in the paragraph 14 below.

10.6 **Conclusion** on user/ viewer as Connecting Factor: Non-Residents providing internet or TV channels to users/ viewers from India may be taxed on the payments made by the

users/ viewers. However, (i) this base cannot be used to ask non-resident advertisers paying to non-resident service providers to comply with TDS procedure. (ii) ITA needs to be amended for taxing the E-Commerce service providers.

11. Advertisers as the base

11.1 Can we consider the **advertisers** as the tax base? This means, we are saying: Google is providing a service to the Indian advertiser and hence Google should be taxed. See chart in Paragraph II.4.4. Arrow 1-2 indicates **Indian advertisers** targeting **Indian users**. This seems acceptable. Next is Arrow 3-4 **Indian advertisers**targeting **foreign users**. This may be justified on the grounds that we are saying that Indian Resident advertisers are the market. They have been provided the advertisement service. **Indian advertisers** may be treated as the tax base & asked to deduct Income-tax. In such a case, **foreign advertisers** paying to Google, etc. will not be liable to comply with Indian TDS procedure.

Consider an **Indian advertiser** paying to a **foreign media** company for advertising in say, Europe. See the chart in Paragraph II.4, arrow 2:2. If advertisers are the base, this Indian advertiser should deduct tax from the ad revenue paid to non-resident media company. One may raise an issue: "The media company is providing advertising service outside India. Service has been provided as well as utilised outside India. No services are provided in India. Why should it be liable to Indian Income-tax?" Response would be: "For E-commerce we are no longer considering COS to be: Where the assessee has made Value Addition". We are saying that an Indian has received services – whether in India or outside India. Hence like Service tax, this also should be taxable in India.

The non-resident assesse – Google has neither performed, nor Indian advertiser hasutilised the services within India. So India is simply a country of payment and not COM. Unless we move to the concept of COP, we cannot tax this revenue. Base Erosion concept would permit COP to tax because the base shifts from service provider – Google to customer – the advertiser.

11.2 We have seen earlier that many **Indian TV channels and media websites** (like Time of India's website) attract foreign advertisements. If we accept Indian advertisers as the base, these foreign advertisers will not be liable to deduct tax at source from the payments to Indian media. Foreign advertisers will pay TDS to their country's tax department. Indian media companies will have to claim DTA relief in their Indian income-tax returns. On the other hand, we say that the advertisement service provided to the foreign advertiser has been provided (performed) as well as utilised in India. Can we tax it?

It may be noticed that the assessee to be taxed is Google and it is a non-resident of India. Advertiser is not to be taxed. Times of India is an Indian resident. In any case it is fully taxable in India.

11.3 Extend the illustration. Times of India provides advertisement service in India targeting Indian advertisers. However, Times of India opens an offshore subsidiary outside

India. All advertisement revenue from foreign advertisers is received abroad. Under Transfer Pricing rules, the offshore subsidiary of Times of India will have to pay to the Indian publishing company.

12. Country of Payment (COP)

12.1 Probably we can say that advertiser or user/viewer, anyone who makes payments from India for services must deduct tax at source for these services. This will be practical, enforceable & convenient in compliance also. However, it is unfair. Services utilised as well as performed outside India can be taxable under COP.

This solution raises the issue: Google & TV channels provide the service of "transporting" data & entertainment through electronic means. Shipping & Airline companies provide the service of transporting goods & passengers through ships/aeroplanes. If the former can be taxed, what is the logic for not taxing shipping & airline companies?

(i) Either tax all of them; or (ii) tax none of them; or (iii) clarify that we are making a distinction between E-Commerce & Traditional Commerce.

12.2 Let us distinguish between COM & COP

COM : If India claims jurisdiction as COM, it would tax following:

(i) Indian viewers/ users using GC services in India.

(ii) Indian advertisers using advertisement services which target Indian audience.

Above two will be practical & enforceable.

(iii) COM would also include NR advertiser paying to a NR GC for Indian audience. The advertisement service will be utilised in India. (It will appear on the computers, etc. located in India. However, this will be difficult to enforce.

COP : If India claims jurisdiction as COP, it would tax following:

(i) & (ii) above. It will not tax (iii) above.

(iv) Indian advertiser making payment to foreign media for foreign audience. COM is logical. COP is practical. However, in this case, the ad service is provided by a non-resident &utilised abroad. It would be unfair & illogical to tax such revenue.

Right balance/ compromise may be to tax only (i) & (ii) and not tax (iii) as long as efficient tax recovery system cannot be worked out.

12.3 We are considering here a system where India can tax a non-resident's income earned out of revenue earned from India. In other words, we are considering India as the country of market. And justifying a COM as COS. Normally, the COM will also be the Country of Payment (COP). However, justifying a Country of Payment as a COS is not fair.

Hence we may consider the fact that in principle COM has a jurisdiction of tax. There is a compromise for the sake of efficiency that COP will collect tax. This compromise is already practised under OECD as well as UN Models. Royalty is taxed by the Country of Payment.

13. Income-tax Act Amendments

GOI has already made some amendments to S. 9. See explanation inserted at the end of S.9 and explanations 5 & 6 to S. 9 (1) (vi).

13.1 Treaty Override : By these amendments, GOI has acquired right to tax a Non-Resident even if he has no PE/ BC and services are not rendered in India. These amendments were to cover the SC decision in the case of **Ishikawa Harijima and some other decisions.** This is an extended power under ITA. None of the DTAs grant such power. And for section 9, the DTA prevails over the ITA. So in all cases of NR doing business from a DTA country, **this amendment will be of no avail.**

GOI needs to make a provision that these amendments to Section 9 - will override DTA. **See Section 90 (2A).** It provides that the GAAR provisions under chapter XA will override DTA. Similarly anti-avoidance provisions in Section 9; and E-commerce taxation provisions need to be included in Section 90 (2A).

13.2 Amendment to **Section 9 – Explanation** at the end of the section is inadequate. It only covers (v) interest, (vi) royalty & (vii) fees for technical services. The subscription charges paid by viewers/ users and the ad charges paid by the advertisers to Google are not covered by any of these categories. Hence **unless the law is amended**, these E-Commerce charges won't be taxable in India.

13.3 The system of E-Commerce taxation under ITA may be summarised as under: Make a separate chapter/ section exclusively for E-commerce. It will make deeming provision to tax import of E-Commerce services and will provide for 4% tax rate. Section 195 will provide for TDS on E-Commerce payments. Disallow expenses u/s. 40 if no TDS is made by payer and hold him to be a defaulter u/s. 201.

14. Income-tax Act: How to make a NR GC comply with Indian law?

Google, facebook etc. may get revenues from millions of home users. It is not practical to ask them to comply with TDS. However, Governments may consider the following: Every company that asks for a licence/ permission to broadcast its TV channel or internet facility in India would be required to file Income-tax return in India. Today Yahoo, You Tube, Google, facebook, etc. may not need licence for providing the services in India. **Internet Law may be amended** to make provision requiring service providers to obtain requisite licence.

14.1 The company should in advance and as a consideration for the permission, agree on the following:

(i) It will file Indian Income-tax return;

(ii) It will agree to a withholding tax at the rates prescribed under the ITA; and

(iii) It will submit itself to income-tax in India considering India as the COS.

14.2 This will require co-operation of several agencies

(i) FIPB and Telecom/internet authorities that grant permission - to a TV channel/e-commerce service provider - to provide its services in India shall make a condition that the applicant agrees on conditions (i) to (iii) above. (Note: If FIPB and CBDT had collaborated more extensively, the Hutchison – Vodafone deal could have avoided the tax controversy.)

(ii) RBI asking **all banks and pay channels** to ensure that any remittance going abroad meets with the TDS requirement. In fact, the company can be asked to receive all remittances from India into a few specified bank accounts within India. These banks can be asked to specifically ensure compliance with TDS procedure.

(iii) For all the remittances where no TDS is made (home/ small remittances) the bank may deduct appropriate tax.

15. Observations & Summary of discussions so far in Part IV

It is fair & practical to say that all revenues paid by Indian viewers/users and Indian advertisers for E-Commerce services utilised in India, paid to the Global Corporations may be considered as liable to tax under the ITA. This is based on the ground that India as the COM is the COS.

Indian payers may comply with TDS procedures. Both – the GC & the payer – will be exempt from tax & TDS procedure if the revenue/payment are below the relevant thresholds.

Existing ITA does not make a NR GC liable to Indian tax. A separate deeming section may be made which will be a complete code by itself for taxation of E-Commerce. And a separate Article will be needed in the DTA. While the E-Commerce service charges will be taxed in a manner similar to "Royalty"; they are business income. It would be improper to stretch the definition of royalty beyond its true meaning.

The proposed system will combine three principles: (i) COM is COS, (ii) PE & (iii) Royalty.

This provision should be covered under the group of provisions where ITA will override DTA [Section 90 (2A)]. This is necessary because the DTA models may take several years before they get modified to cover E-Commerce.

16. Further Issues

16.1 Problems of Flat Rate:

4% flat TDS by COS may be attractive for many assessees who have good profit margins and for assessees for whom almost the whole receipt is taxable income. There may

be some businesses which have low profit margins. For them this rate may be stiff. The negotiating countries may consider important industries/businesses and may make two or three additional categories. COS may exempt some categories and may levy a higher tax for some categories.

16.2 **Base Erosion:** Professor Richard Doernberg's theory of "Base Erosion" may be summarised as under:

If any assessee claims as expenditure, any amount payable to a Non-Resident, he erodes the tax base of the paying country. Hence a tax @ 3% should be deducted by the payer. This is a good & efficient mechanism. However, Companies like Google, Facebook & Amazon.com may earn substantial incomes from ultimate home consumers. Most of it will not be claimed as expenditure by the payers. Hence it will be paid without any TDS.

Our suggestion is that even home service payments to Non–Residents should also be subject to TDS @ 4%.

16.3 Burden of Tax: Since this tax will work as a tax on market and not on income; quite likely, the tax burden will be passed on to the payer/ consumer. That would mean that ultimately the tax would be borne by the Indian consumer/ payer; Indian economy.

Since it will be a TDS of income-tax, the Global Corporation will be able to claim set off of income-tax in COR. If the GC claims credit at COR, then the tax will be borne by the foreign country/ foreign economy.

Wherever the Indian payer is able to shift the tax burden on to the receiver, the tax will be borne by the foreign economy.

17. Existing Tax Balance

Present position under ITA is: On import of goods, we do not tax the NR supplier. On import of services – except FTS, royalty & interest – we do not tax the NR provider of services/ earner of revenue. If we change this position, it would mean – we will tax on the basis of utilisation/import of goods and services.

Let us consider the position when other countries retaliate by taxing goods and services exported by us. Our Wipro, TCS & Infosys will be liable to tax in U.S., Europe, Japan, etc. We are net exporter of services - we will suffer.

We are net importer of goods. We can tax all non-resident suppliers of goods. Will they pay? Or will they ask Indian importer to pay & bear? If we assume that the Indian importer will be successful in deducting income-tax at source from the payments made to NR suppliers, on the whole; India will gain under this system. But the assumption does not seem to be practical at present.

In short, a net exporter benefits when the taxation is based almost wholly on supply side as it is today. Net importer would benefit if the taxation system was based almost

wholly on demand side. In our calculation for arriving TDS rate of 4%, we have seen that the taxing rights are fairly distributed between Supply side & Demand side.

We submit, the tax balance will be fairer on adoption of this system.

To clarify: This system may not be beneficial for India at present. But it will be fairer as a global tax system.

For striking a balance between (i) the concept of neutrality and (ii) maintaining present tax equilibrium, the proposed system of sharing International Taxation may be executed in following steps:

(i) TDS on import of all E-commerce services.

(ii) TDS on import of all services.

(iii) TDS on import of all goods and services.

(iv) World Government collecting taxes globally.

Part IV B Elimination of Double Taxation

18. Credit in COR

We have considered different systems for levying tax on Global Corporations carrying on E-commerce business. Let us say, we arrive at a conclusion that GOI shall levy a 4% flat tax on the gross revenue received from India. Will the GC get credit for the Indian tax in COR? Some thoughts on the issue:

(i) Earlier in arriving at 4% rate we have seen that we are assuming net profit of 20%. Out of that we assume the Indian share of net profit to be 10%. Hence the 4% tax is the fair share of Indian tax. How the GC claims credit for this tax in COR is GC's problem. We do not talk such language in International Taxation. We want a more responsible & fair method of taxation.

(ii) Article 23B for Elimination of Double Taxation reads as under: "Where a resident of a contracting state derives **income … which in accordance with the provisions of this convention,** may be taxed in the other contracting state, the first-mentioned state shall allow: …"In other words, the COR will give credit only for the tax paid in COS (India) according to the treaty. At present the treaties do not contain either the concept of a virtual PE or the concept of country of market having a right to tax income. Hence either way the tax imposed by GOI will not be available for credit in COR.

(iii) In our illustration, if Google Ireland, a tax haven company is collecting revenue from India, then in any case, the tax credit is irrelevant. However, if Google USA, a proper business company gets the revenue from India, then it should be entitled to tax credit in COR. How does GOI ensure such credit?

19. Voluntary PE

If GC itself admits that it has a permanent establishment in India, will the situation change? Under the current system, the GC's COR can insist that only the profits attributable to the PE are taxable in India. If GC pays tax on anything more than the profits attributable to its PE, the COR is not bound to give credit for such taxes.

20. COM as COS

Considering COM as COS is a significant departure from existing principles. If GOI taxes Google on the grounds of COS, it would not be "in accordance with the provisions" of DTA. Hence Google and similar companies will not be able to claim the tax credit in COR. We are aware of the current controversies. If a foreign investor does not get a fair tax treatment in India, then India loses a reputation as a destination country for foreign investment.

21. Consensus

Biggest hurdle in implementation of any new system is: a consensus by majority of treaty partners. Without a consensus, the DTA cannot be modified. Unless the DTA is modified, amendments in the ITA will not be helpful. Even in the year 2001, The High Powered Committee on E-Commerce could not suggest a definite proposal because of this difficulty.

In the circumstances, we may consider the implementation of the new tax system in the following manner: GOI may publish a **Draft Code of Taxation of E-Commerce** and invite comments from India as well as from treaty partner countries. CBDT may canvass the new code & try to achieve a consensus. As & when individual countries agree, relevant DTAs may be suitably modified.

In the meanwhile we may start with imposing a 4% tax on import of **E-commerce services from tax havens**. This action will be part of **anti-avoidance provisions & hence can override the treaties.**

At present several Governments are suffering huge budgetary deficits. G20, European Union and several other Governments are serious in tackling the issue of tax avoidance. This may be the right time to discuss these matters in forums like United Nations and G20 and work out a consensus for taxing E-commerce.

Part IV C. We have seen in part IVA that every proposal to tax NR GC's income raises its own issues. In this part we consider some totally different proposals.

22. Levy import duties on all – goods & services. It will be a flat rate on gross values without giving any deductions. **And then do not levy any income-tax at all.** Tax administration & compliance will be simple. Governments will get their revenues. Whether the revenue comes from income-tax or customs duty – what difference does it make?

Under this system television channels will be taxed on viewer subscriptions and advertisement revenue that they get from India. Companies like – Google & Facebook will

pay a Service Tax on all the advertisement charges that they receive from India. They will also pay service tax or entertainment tax on the subscription paid by users.

Having charged a service tax/import duty/entertainment tax; there will be no further income-tax. This will be in keeping with Article 7. For import of goods, we don't levy income-tax; but we do levy import duties. If the non-resident does business activity within India, we levy income-tax on the value addition made within India. This value escapes import duty.

If we levy a service tax on all advertisement and similar remittances from India; we avoid all complications of computation of net profit; and we are not worried – whether the remittance is going to a tax haven entity or a regular entity. All the compromises to the existing international taxation will not be necessary.

Objection to this alternative solution may be: This revenue going abroad escapes income-tax. While Indian advertisers will claim the payments as deductible expenditure; the earner – Google will not be liable to tax. This is base erosion.

Response to the objection can be: India imports goods worth almost $ 500 billion every year. The importers claim import expenditure as deductible expenditure. And we do not tax the foreigners exporting their goods. So why tax foreigners exporting services?

23. Ultimate Solutions

If even the solution in paragraph 1 is not acceptable, following options may be considered: Ultimately all these tax issues, transfer pricing and attribution of profits, etc. maybe resolved if any one of the following two modes are accepted:

23.1 **Globally**, only one authority to collect taxes. Until a **Global Government** is established, a Global body like United Nations may collect the income-tax from all Global corporations and from all companies and entities incorporated in all tax havens.

Let us say, a tax @ 25% is collected by the U.N. from Google and from lakhs of entities registered in diverse tax havens. If these companies have paid income-tax to any Government which is a member of the U.N., such tax may be deducted from the gross tax to be collected. To the extent of this tax revenue, UN will need less contribution from member Governments.

This leads to an altogether new discussion. Is UN honest? Or is it acting in the hands of some powerful Governments & lobbies? Unless & until an actually fair & honest global body is found, this alternative is academic.

23.2 All tax payers, consultants and administrators become **honest in substance & in spirit.**

Both these solutions are utopian. First solution of Global Tax Collector will be a compromise on the sovereignty of nations. Second hypothesis is utopian. Hence these are

not discussed further. However, mankind will have to evolve to utopian levels if we want peace & joy.

24. Summary of the Article: Parts I to IV

Existing system of International Taxation has several weakness and compromises even as applicable to Traditional commerce. E-Commerce by its very nature of conducting business challenges many principles and assumptions. It is easier for an E-Commerce company to avoid all income-taxes. GOI and other Governments may amend their domestic laws to tax E-Commerce. These amendments must override treaties – otherwise the outdated treaty will make the amendments redundant. Eventually new treaty model may have to be worked out.

The domestic law provision may be as under: A separate section or chapter exclusively to deal with E-Commerce which will levy a flat tax @ 4% on all payments made by Indian residents to GCs providing E-Commerce service. This tax shall be subject to threshold like virtual PE.

At least to start with, we may have to sacrifice the rule of neutrality and tax E-Commerce under its special rules. Eventually, if a consensus can be built, all incomes can be taxed on same principles & neutrality can be restored. Taxing import of other services will be the second step. Taxing import of goods may be a third step.

25. Notes

25.1 Normally, Government drafts tax provisions. Professionals analyse and criticise the same. In this article we are suggesting some solutions. We realise possible criticism of our suggestions. We have tried to answer some of the criticisms briefly. More detailed responses will make the paper too long. We also realise how many problems can arise for any particular course of action. We will be glad if the readers can examine this article and send their critical comments. We will try to improve the article.

25.2 No tax system is ideal or absolute. If it works fairly, fine. Keep evolving but don't wait for the ideal. "Perfection is the enemy of Good".

25.3 There has been a series of articles presented by us at several forums on the subject of E-Commerce taxation. Present article is one more step. Still, considerable work needs to be done.

25.4 Whatever taxation system one may work out; there will be people who will find out ways for not paying tax. Best brains in the world will help them. It is a constant drama that will continue. Honest people will have to be continuously vigilant to curb the play of Greed.

25.5 The best taxation system worked out today will be found to be inadequate after five years. Circumstances will always change. Taxation systems have to be regularly updated to take care of changing circumstances.