Revenue is garnered by most countries by imposing taxes on two key components of the economy i.e., income and consumption. As traditionally followed in most countries, determination of conditions for levy of consumption-based taxes is relatively simple compared to determination of levy of taxes on Income.

Consumption-based taxes operate as a levy on consumption of goods and services and are imposed at the time of incurring the expenditure on the transaction or, differently put, are levied at the place of destination. However, tax levied on income is generally due on the net income (gross income net of expenses for material, labour, capital, etc.,) realised by the taxpayer over an annual tax period.

Given this significant difference in nature of levy (i.e., the taxable event not being a transaction in form of exchange of goods), determination of place of levy or right to levy taxes on income is a vexed issue.

Over a period of time, economies have evolved two principles for determination of taxability of an income in a particular jurisdiction, one is the residence-based taxation, where income is taxed by virtue of a person’s domicile in a particular country, and the other being the concept of source-based taxation where a person is taxed in a country on the income sourced from that country.

Source versus residence – Evolution of the principle

In the early 1920s, with the increase in global trade, the League of Nations took upon itself the task of studying the issue of global double taxation which had shown signs of becoming an issue affecting businesses. The possibility of formulating general principles which would become the basis of an international tax framework and which would be capable of preventing double taxation was one of the foremost objectives of that study.

The outcome of the study conducted by the
League of Nations was the concept of “economic allegiance”. That became the basis to design an international tax framework. Economic allegiance is based on factors aimed at measuring the existence and extent of the economic relationships between a particular state and the income or person to be taxed. The study also identified four factors comprising economic allegiance, namely

(i) origin of wealth or income,
(ii) situs of wealth or income,
(iii) enforcement of the rights to wealth or income, and
(iv) place of residence or domicile of the person entitled to dispose of the wealth or income.

Among those factors, the study also concluded that in general, the greatest weight should be given to “the origin of the wealth [i.e., source] and the residence or domicile of the owner who consumes the wealth [i.e., residence]”.

In other words, the League of Nations advocated that tax jurisdiction should generally be allocated between the state of source and the state of residence depending on the nature of the income in question. This was one of the earliest principles of international taxation and continues to be valid till date.

**Evolution of treaties and distribution of rights**

The international tax framework developed around a vast network of bilateral tax treaties following the so-called “classification and assignment of sources” method, in which different types of income are subject to different distributive rules. Most of the tax treaties follow distributive rules for taxation of income which entail a preliminary step, whereby the income subject to conflicting claims is first classified into one of the categories of income defined by the treaty.

Where an item of income falls under more than one category of income, double tax treaties resolve the conflict through ordering rules. Once the income is characterised for treaty purposes, the treaty provides distributive rules that generally either grant one contracting state the exclusive right to exercise domestic taxing rights or grant one contracting state priority to exercise its domestic taxing right while reserving a residual taxing right for the other contracting state.

The choice between (or a combination of) source or residence based taxation alternatives has a number of macroeconomic ramifications apart from the mere avoidance of international juridical double taxation. This choice may be influenced by the state of a country’s economic development, the need for foreign investments and capital inflows, its international economic ties, the state of its tax
administrative and enforcement machinery, and other such factors. The challenge in making this choice, based on a State’s long-term economic policy, is evident when one considers some of the pros and cons of choosing an exclusive residence-based or source-based taxation regime.

Conflict in the Digital economy age

The continued globalization of world economies, and the related developments in information and communications technologies have brought into sharper focus the question whether maintaining the existing international tax principles provides an effective way of taxing international transactions. The modern day digital commerce poses a lot of complex issues as compared to traditional commerce, as the national borders of a country are no more relevant. Going forward, businesses may be carried out in a country with minimal presence in that particular country, making the tax authorities go haywire in determining their jurisdictional right to tax the income from such transactions.

In many respects, the debate of residence versus source-based taxation precedes the current debate in the context of electronic commerce transactions. The present international tax system, under which business profits are taxed only in the source country if a Permanent Establishment (‘PE’) exists, represents in many ways a balance or compromise between the two systems, despite recommendations by commentators at various times that tax systems adopt either the residence principle or the source principle exclusively.

The Organization for Economic Co-operation and Development (‘OECD’) in its final report on Action Plan 1 – Addressing the tax challenges of the Digital Economy has tried to address issues surrounding how the digital economy relates to the concepts of source and residence or the characterisation of income for tax purposes.

Exclusive residence-based tax system: May not get consensus

Continuing to apply source-based tax principles (including the PE concept) in an electronic commerce setting poses the question whether these difficulties can be overcome by adopting an exclusive residence-based tax system. Under such a system, source countries would not have jurisdiction to tax electronic commerce transactions, which would be taxed exclusively in the countries where the enterprises conducting the business are considered to be resident. While such an approach may, at first glance, appear to be too arbitrary and one-sided in favour of residence countries, many believe that, unless electronic commerce transactions are taxed in the country where the enterprises engaging in the transactions are resident, the transactions may escape taxation altogether.

Residence-based tax rules are generally easy to apply, and there is a relatively higher degree of certainty with respect to the trigger point for tax liability. It is simpler to determine the state of residence of an individual or a corporation, than to conclude on the source or situs of a specific income stream. For instance one does not have to determine whether a host of servers spread across the world and used in a complex e-commerce transaction, may be viewed as a PE in a particular contracting state. Under a residence based tax regime, the state of residence of the enterprise owning and operating the servers would exercise the right to tax any income from such a transaction. A state may lay down certain bright line tests for residence in terms of number of days’ presence, place of control or management, etc. In case of conflict of residence rules between two states, the relevant tax treaty may provide some sort of an objective ‘tie breaker’ test to determine the state of residence.

The US Treasury has been a prominent advocate
of residence-based taxation and has at different times indicated its preference for such a system. In 1996, and relevantly in the context of electronic commerce, the US Treasury hinted at the possible ascendancy of residence based taxation in the face of emerging technologies:

“The growth of new communications technologies and electronic commerce will likely require that principles of residence based taxation assume even greater importance. In the world of cyberspace, it is often difficult, if not impossible, to apply traditional source concepts to link an item of income with a specific geographical location. Therefore, source-based taxation could lose its rationale and be rendered obsolete by electronic commerce. By contrast, almost all taxpayers are resident somewhere.”

The above is not unheard of. There is a long history of shipping profits being exempt from source-country taxation and a more recent history of air navigation profits being similarly exempt. Both of these exemptions are now in Art. 8 of the OECD Model, which allocates exclusive taxing rights with respect to shipping and air transport profits to the country in which the enterprise’s place of effective management is situated.

While there are advantages to an exclusive residence-based system, the disadvantages of such a system are many. They include the presence of a robust residence definition which is universally accepted, the risk of capital flight, the potential unfairness to countries that are net importers of goods and services sold electronically. With most countries not willing to support this, the required international consensus would not be obtained to enable the successful implementation of such a system.
Exclusive source-based tax system: May not be agreeable to all

The logic behind exclusive source-based taxation is that states have a right to tax all income that is generated within its territory. A source or territorial based taxation system therefore seeks to compensate the source country for its contribution to sustenance of the economic activity.

Source-based taxation is also supported by the principle of economic allegiance which originated in the League of Nations era and was considered a guiding principle for determining the respective taxing rights of the State of source and residence. There have also been views that the source State should receive a larger share of the taxing rights since there is greater economic allegiance with the State of source, which also was more capable of enforcing these rights at the point of origin.

The obvious limitation of source based taxation is the difficulty in applying conventional source based rules in a modern day transactions involving intangibles and a fleeting presence in the territory of the source State. Unless there is some sort of consensus among States regarding the structure and exact threshold for taxation, and the scope for conflicting interpretations is reduced, source-based taxation may in several cases lead to double taxation.

International Tax principles for Digital taxation

With no specific provisions in the tax treaties (unlike those for shipping or air transport) nor specific provisions for taxation of e-commerce or digital economy in the domestic laws of India, the digital economy transactions would be subject to the same principles of taxation as have been governing the ‘brick and mortar’ industries!
Country of residence as per Double Tax Avoidance Agreement (‘DTAA’) and domestic law

Residence of Indian Companies

Worldwide income of the Indian residents is taxable in India, though section 91 of the Indian Income-tax Act, 1961 (‘the Act’), provides relief by way of credit in respect of the tax paid on their foreign income, if the source is in a country with which India has not entered into a tax treaty. Otherwise, the relief is provided according to the provisions of the treaty.

Residence of Foreign Companies

Foreign Companies as the name suggests are not prima-facie residents of India. As per Section 6 of the Act, a company is treated as a resident if it is incorporated in India or if the control and management of its affairs are wholly situated in India. However, Finance Act 2015 has brought in the concept of Place of Effective Management (‘PoEM’), to replace the concept of ‘control and management of affairs’. PoEM seeks to extend the residence rule to foreign companies. PoEM is defined to mean a place where key management and commercial decisions, that are necessary for the conduct of the business of an entity as a whole, are in substance made. Therefore, the concept of PoEM seeks to make a foreign company which is effectively controlled (i.e., place where the key decisions are taken) from India, a resident of India.

However, the definition of the term PoEM is not very clear and therefore the Central Board of Direct Taxes (‘CBDT’) has assured the taxpayers that it would shortly come out with guidelines for the applicability of PoEM. Therefore, one would need to wait for the related guidance to be provided by the CBDT on the interpretation and application of PoEM, to have some clarity and certainty.

In the context of its treaties, India has relied on both the OECD as well as the United Nations (‘UN’) model conventions. Section 90 of the Act allows India to enter into tax treaties not only for the purpose of providing relief against double taxation, but also to “promote mutual economic relations, trade and investment.”

The PoEM is a widely used test for the purpose of determining residency for MNEs under tax treaties that are based on the OECD Model Conventions and UN Model Conventions. The concept of PoEM has evolved over a period of time.

The OECD Commentary provides that PoEM is the place where key management and commercial decisions, that are necessary for the conduct of the entity’s business as a whole, are in substance made. An entity may have more than one place of management, but it can have only one PoEM at any one time. Most DTAAEs entered into by India with other countries have the concept of PoEM as a tie-breaker test. Therefore, in a scenario where the key decision-makers are sitting in India and have taken such decisions, it may expose the foreign company to the risk of being a resident in India.

In India, the term PoEM has been examined in the case of DLJMB Mauritius Investment Company (1997) 228 ITR 268 (AAR) and Integrated Container Feeder Service v JCIT (2005) 98 TTJ 69 (Mumbai) wherein it was observed that PoEM refers to the place from where factually and effectively, day to day affairs of the companies are carried on and not at the place in which the ultimate control of the company resides. This indicates that the place where the board of directors sit is not important, but it is important to determine the place where the executive management functions from.

Therefore, there could be a scenario where the key decision makers may be present in more than one place and a MNE may have a PoEM in more
than one country. In such scenarios, one may have to look at the Mutual Agreement Procedure (‘MAP’) between the two countries to determine a line of taxation.

Country of source as per DTAA and domestic law

Concept of doing business with India/ within India

There is a difference between doing business “with India” and doing business “within India”. When an oil company exports crude oil to India, it is doing business with India. However, if a foreign exporter establishes a factory/branch/office in India and then conducts business through such establishment in India, he is considered to be doing business within India.

When a businessman earns profits by doing business With India, his income is NOT taxable in India. When he does business Within India, the portion of profits made in India, is taxable in India. This is the key factor for the source concept to trigger, which would be discussed in detail in the ensuing paragraphs.

Business Connection

Business profits earned by non-resident MNEs are taxable in India, only to the extent they have arisen directly or indirectly through a business connection of the MNE in India. The expression, ‘business connection’ has been defined in the Act. It is slightly different from the definition of PE under various tax treaties signed by India. The term ‘business connection’ is defined to include the following activities carried-on on behalf of the non-resident:

- Habitual exercise in India of an authority to conclude contracts on behalf of the non-resident;
- Habitual maintenance in India of a stock of goods or merchandise from which he regularly makes deliveries;
- Habitual securing of orders in India, mainly or wholly for the non-resident or other related non-residents.

The proviso in the aforesaid definition of business connection exempts any business activity carried out through a broker, general commission agent
or any other agent having an independent status, if such broker, general commission agent or any other agent having an independent status is acting in the ordinary course of his business.

Prior to a statutory definition being inserted into the Act specifically defining the term ‘business connection’, the Supreme Court of India in the case of CIT vs. R.D. Aggarwal & Co. (1965) 56 ITR 20 (SC) had held that a business connection entails a relation between a business carried on by a non-resident which yields profits or gains, and some activity in the taxable territories which contributes directly or indirectly to the earning of those profits or gains. Further, the expression ‘business connection’ postulates a real and intimate relation between trading activity carried on outside the taxable territories and trading activity carried on within the taxable territories, the relation between the two contributing to the earning of income by the non-resident from his trading activity.

The term predicates an element of continuity between the business of the non-resident and the activity in the taxable territories. A stray or isolated transaction is normally not to be taken as a business connection.

The concept of ‘business connection’ is broader than that of PE, as envisaged in most of the tax treaties, where specific exclusions have been provided for a number of activities including those of a preparatory and an ancillary nature. Therefore, the term ‘business connection’ being wider under the act, this indicates India’s intention to bring a larger number of transactions within its tax ambit.

**Permanent Establishment**

As per Article 5(1) of the DTAAs, the term PE is defined to mean a fixed place of business, through which the business of an enterprise is wholly or partly carried on. The term PE generally refers to the business presence of an enterprise in another
country. Based on the definition of the term PE, the following conditions need to be satisfied in order to constitute a PE under the basic rule:

- There must be a place of business (“Place of business test”);
- The place of business must be located in a certain area (“Location test”);
- The use of place of business must last for a certain period of time (“Permanence test”);
- The foreign enterprise must have a certain right of use to the place of business (“Right of use test” or “Right of disposition test”); and
- The activities performed through the place of business must be a business activity for the foreign enterprise and such activities should constitute the “core activities” (“Business activity test”).

The activity performed through a place of business should be the “business of the foreign enterprise”. Accordingly, a PE can be said to have been constituted, only if the business of the foreign enterprise is carried out from the fixed place of business and operations must be carried out on a regular basis.

E-Commerce has left countries to overhaul their tax policies and examine as to how to bring these transactions within the ambit of taxation. The e-commerce industry would do business with minimum physical presence in the country of source. Therefore, it poses challenges for tax authorities to tax such transactions with their age-old principles.

A classic example of an E-Commerce transaction that confounds the taxpayer is a source-to-source conflict, wherein a server is placed in Country X and a person from India accesses such server. In such a scenario, if the person making a payment from India is an Indian resident, such payments are taxable in India, unless the payments are made
for a business carried on outside India. However, the tax authorities in Country X would want the payments to be taxable in their country, given that placing a server in Country X might create a PE for the Company in such country. Therefore, the same payment would be taxable in Country X as well as in India basis the source.

On the other hand, there are certain E-Commerce companies which escape from the ambit of taxation and do not pay tax in any country. OECD has also understood the challenges faced by countries because of Digital Economy, and has come with the Base Erosion and Profit Shifting (‘BEPS’) Action Plan 1 to address the tax challenges of the digital economy. The OECD while working on the plan would take cognizance of the following issues to ensure that the proposed solutions fully address BEPS challenges in the digital economy:

- Ensuring that core activities cannot inappropriately benefit from the exception from PE status, and that artificial arrangements relating to sales of goods and services cannot be used to avoid PE status;
- The importance of intangibles, the use of data, and the spread of global value chains, and their impact on transfer pricing;
- The possible need to adapt Controlled Foreign Corporation (‘CFC’) rules to the digital economy; and
- Addressing opportunities for tax planning by businesses engaged in VAT-exempt activities.

Judicial Precedence

There are no set principles for taxation of e-commerce transactions. However, there are certain judicial precedents in this regard from which support could be drawn/ safeguards could be applied:

- The Kolkata Tribunal in the case of ITO v Right Florist Pvt Ltd 154 TTJ 142 concluded that a website per se could not constitute a PE in India under the Income-tax Act for the search engine companies which was in concurrence with the view taken by the High Powered Committee (‘HPC’). In a tax treaty context, reliance was placed on the OECD Model Commentary to conclude that a search engine, which has a presence through its website, cannot be a PE under the treaty, unless its web servers are also located in the same jurisdiction which is in line with the physical presence test.
- In the context of computerized reservation system (“CRS”) for air tickets, the Delhi Tribunal in Amadeus Global Travel v. Deputy Commissioner Income Tax, [2008] 19 SOT 257 (DELHI) concluded that booking fees received from Indian entities by non-resident companies providing CRS are liable to be taxed in India. The Tribunal came to such a conclusion on the ground that these companies have a “virtual” presence in India which constitutes a “virtual” PE.
- In the case of E-bay International AG [ITA No 6784, 7046/Mum/2010], the Mumbai Tribunal held that income earned by eBay, from operating India-specific websites are not in the nature of “Fees for Technical Services”. The Tribunal on the issue of PE held that while the Indian Company was a dependent agent of E-bay, the Indian Company did not have an authority to conclude contracts, though they were legally and economically dependent on E-bay. Therefore, the Tribunal held that E-bay does not have a PE in India.
Concluding Remarks

Therefore, given that the e-commerce is a new concept for India which has evolved very recently, there are not many judicial precedence on the issue. Further, the issue is also too technical for the courts to understand leading to ambiguity.

However, in terms of a general policy trend, India seems to be quite aggressive in asserting as well as expanding its source-based taxation rights. This is quite typical of capital importing countries which fundamentally rely on taxation at source. India has also been increasingly ‘dynamic’ while enforcing its source tax rules, especially in the context of electronic commerce and cross-border movement of intangibles. Both, treaty as well as the domestic law practice, suggest that India is poised to defend itself against any sort of potential erosion of tax base.
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