
EMERGING ISSUES IN INTERNATIONAL TAXATION

**B. M. SINGH
MEMBER CBDT
NEW DELHI**

EMERGING ISSUES INTERNATIONAL TAXATION

- **ATTRIBUTION OF PROFITS TO THE DEPENDENT AGENT PERMANENT ESTABLISHMENT**
- **TAXATION OF SOFTWARE**
- **TAXATION OF FOREIGN INSTITUTIONAL INVESTORS (*FII*s)**
- **TAXATION ISSUES RELATING TO E-COMMERCE**

ATTRIBUTION OF PROFITS TO THE DEPENDENT AGENT PERMANENT ESTABLISHMENT (*PE*)

- **WHAT IS DEPENDENT AGENT PERMANENT ESTABLISHMENT ?**
 - **DEPENDENT AGENT *PE* ARISES THROUGH THE ACTIVITIES OF A THIRD PARTY**
 - **CONCEPT OF DEPENDENT AGENT *PE* ELABORATED IN ARTICLE 5(5) OF THE OECD MODEL. ALSO IN INDIAN TREATIES.**
 - **COMMENTARY TO ARTICLE 5(5) STIPULATES THE CONDITIONS UNDER WHICH AN ENTERPRISE IS DEEMED TO HAVE DEPENDENT AGENT *PE***

-
- **IN THE INCOME TAX ACT, THE ISSUE IS COVERED IN THE MEANING OF BUSINESS CONNECTION. EXPLANATION 2 TO SECTION 9(1) OF THE ACT, REFERS TO ACTIVITIES CARRIED OUT THROUGH A PERSON WHO, ACTING ON BEHALF OF NON RESIDENT, HAS EXERCISED AN AUTHORITY TO CONCLUDE CONTRACT ON HIS BEHALF.**
 - **WHETHER DEPENDENT AGENT *PE* IS CREATED OR NOT DEPENDS ON THE FACTUAL CIRCUMSTANCES OF THE CASE. SUBSTANCE OF THE TRANSACTION IS THE DECIDING FACTOR AND NOT THE FORM SHOWN IN THE AGREEMENT.**

▪ IN INDIA THE ACTIVITIES OF THE SUBSIDIARIES ENGAGED IN THE SERVICES OR MANUFACTURING ACTIVITIES INVOLVING OUTSOURCING OF HIGH END ACTIVITIES FOR THE ASSOCIATED FOREIGN ENTERPRISE, MAY CREATE DEPENDENT AGENT PERMANENT ESTABLISHMENT OF FOREIGN ENTERPRISE. SUCH ACTIVITIES INCLUDE:

- SOFTWARE DEVELOPMENT,**
- RESEARCH & DEVELOPMENT**
- BUSINESS PROCESS OUTSOURCING /KNOWLEDGE PROCESS OUTSOURCING**

-
- **WHETHER THE PAYMENT TO THE DEPENDENT AGENT OR SUBSIDIARY AT ARM'S LENGTH, EXTINGUISHES THE TAX LIABILITY OF THE FOREIGN COMPANY?**
 - **AS PER THE DECISION BY AUTHORITY FOR ADVANCE RULING IN INDIA YES**
 - **AS PER INTERNATIONAL PRACTICES.. NO**

-
- **DISCUSSION DRAFT OF OECD ON ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENT DEALING WITH *PE* OF ENTERPRISE CARRYING ON GLOBAL TRADING OF FINANCIAL INSTRUMENTS, SPECIFICALLY REFERS TO DEPENDENT AGENT *P.E.***
 - **PARA 257 OF DRAFT READS “IN CASES WHERE A PE ARISES FROM THE ACTIVITIES OF DEPENDENT AGENT, THE HOST JURISDICTION WILL HAVE TAXING RIGHTS OVER TWO DIFFERENT LEGAL ENTITIES – THE DEPENDENT AGENT ENTERPRISE (WHICH IS A RESIDENT OF THE *PE* JURISDICTION) AND THE DEPENDENT AGENT *PE* (WHICH IS A *PE* OF A NON-RESIDENT ENTERPRISE.”**
-

-
- **EXTRACT OF PARA 260 OF THIS REPORT ON GLOBAL TRADING READS “WHEN ATTRIBUTING PROFITS TO THE DEPENDENT AGENT PE, THERE ARE LIKELY TO BE PROFITS (OR LOSSES) OVER AND ABOVE THE ARM’S LENGTH SERVICE FEE PAID TO THE DEPENDENT AGENT ENTERPRISE.”**
 - **IN THE REVISED VERSION, OECD IS LIKELY TO CONFIRM THIS PRINCIPLE.**

-
- **AUSTRALIAN TAXATION OFFICE ALSO ISSUED GUIDELINES IN 2005 FOR TAXATION OF DEPENDENT AGENT PERMANENT ESTABLISHMENT AND PROVIDES FOR ASSESSMENT OF TWO TAXPAYERS IN THE HOST JURISDICTION, CONSISTING OF ...**
 - ❖ **FOREIGN COMPANY, THROUGH ITS DEPENDENT AGENT *PE* , AND**
 - ❖ **SUBSIDIARY COMPANY, THROUGH ITS AGENCY ACTIVITIES.**

-
- **APPROACH OF INDIAN TAX ADMINISTRATION NOT MANY CASES ASSESSED AS DEPENDENT AGENT PERMANENT ESTABLISHMENT.**
 - **IN FEW CASES ATTRIBUTION OF PROFIT TO DEPENDENT AGENT *PE* DONE ON THE BASIS OF RULE 10 OF I.T. RULES 1962 :**

THE RULE PROVIDES THAT IF THE INCOME OF NON RESIDENT CANNOT BE DEFINITELY ASCERTAINED, IT MAY BE CALCULATED BY ADOPTING THE TURNOVER, RECEIPTS ETC. AS THE KEY OF ALLOCATION.
-

-
- **HOWEVER, CORRECT AND SCIENTIFIC METHOD FOR ATTRIBUTING THE PROFITS TO THE DEPENDENT AGENT PE WOULD BE A TWO STEPS APPROACH BY APPLYING AN ARM'S LENGTH SEPARATE ENTERPRISE PRINCIPLE.**
 - ❖ **STEP 1: UNDERTAKE A FUNCTIONAL ANALYSIS, WHICH ATTRIBUTES TO THE PE THE FUNCTIONS PERFORMED, ASSETS USED AND RISKS ASSUMED (*FAR*) BY THE ENTERPRISE IN RESPECT OF THE BUSINESS IT CARRIES ON THROUGH THE PE.**
 - ❖ **STEP 2: UNDERTAKE A COMPARABILITY ANALYSIS, WHICH DETERMINES AN ARM'S LENGTH RETURN FOR THE *FAR* ATTRIBUTED TO THE *PE* THIS PROCESS APPLIES TO ALL *PE*s, INCLUDING DEPENDENT AGENT *PE*s.**
-

-
- **FOR BRINGING A CERTAINTY IN DETERMINING THE PROFITS OF DEPENDENT AGENT PERMANENT ESTABLISHMENT :**

FOLLOWING APPROACHES COULD BE ADOPTED

- ❖ **COMPREHENSIVE GUIDELINES, FOR FIRST IDENTIFYING WHETHER DEPENDENT *PE* EXISTS AND THEN APPLYING ARM'S LENGTH PRINCIPLE.**
- ❖ **MECHANISM OF ADVANCE PRICING AGREEMENTS**

TAXATION OF SOFTWARE

- **BIGGEST BENEFICIARY OF INTEGRATION OF INDIAN ECONOMY WITH GLOBAL ECONOMY HAVE BEEN SECTORS LIKE INFORMATION AND COMMUNICATION TECHNOLOGY PARTICULARLY THE SOFTWARE INDUSTRY, BUSINESS PROCESS OUTSOURCING AND OTHER IT ENABLED SERVICES.**
- **INDIA IS AN IMPORTER AS WELL AS EXPORTER OF SOFTWARE.**
- **TAXATION OF SOFTWARE - COMPLEX ISSUE FOR BOTH TAX ADMINISTRATION AND TAXPAYERS.**

SOFTWARE CATEGORIES

- **CANNED OR SHRINK WRAPPED SOFTWARE - THESE ARE PREWRITTEN SOFTWARE REQUIRING NO MODIFICATION FOR CUSTOMER USE.**
- **CUSTOM MADE SOFTWARE – DEVELOPED FOR SPECIFIC CUSTOMER NEEDS.**
- **SOFTWARE EMBEDDED WITH THE HARDWARE**

-
- **INDIAN PRACTICE IS TO TREAT PAYMENTS FOR IMPORT OF ALL TYPES OF SOFTWARE AS ROYALTY.**
 - **INCOME TAX TRIBUNAL DECISIONS –IMPORT OF SHRINK-WRAP SOFTWARE NOT A ROYALTY, AS PER *INDO - US DTAA*.**
 - **SUPREME COURT OF INDIA IN THE CASE OF TATA CONSULTANCY SERVICES HELD THAT COMPUTER SOFTWARE ARE GOODS AND CHARGEABLE TO SALES TAX.**
 - **FOR CUSTOMS DUTY PURPOSE, THE SOFTWARE IS BEING TREATED AS AN INTANGIBLE IN INDIA.**

-
- **AS A PRINCIPLE, INLAND REVENUE AUTHORITY OF SINGAPORE TREATS PAYMENT FOR PURCHASES OF SOFTWARE, WHETHER ONLINE, IN A BOX OR OTHERWISE AS A ROYALTY PAYMENT AND SUBJECTS IT TO WITHHOLDING TAX.**
 - **HOWEVER, SINGAPORE TAXATION AUTHORITIES GUIDELINES FOR TAXATION OF SOFTWARE ISSUED IN 2001, EXEMPTED SHRINK WRAP SOFTWARE AS WELL AS DOWNLOADABLE SOFTWARE AND SOFTWARE BUNDLED WITH COMPUTER HARDWARE FOR END USER, FROM WITHHOLDING TAX REQUIREMENT.**

-
- **MAJORITY OF THE OECD COUNTRIES, EXCEPT CANADA AND JAPAN DO NOT TREAT PAYMENTS FOR IMPORT OF SHRINK WRAPPED SOFTWARE AS ROYALTY.**
 - **THE GOVERNMENT MAY COME OUT WITH SUITABLE GUIDELINES FOR TAXATION OF IMPORT OF SOFTWARE, FOR THE PURPOSE OF**
 - **BRINGING CERTAINTY FOR THE TAXPAYERS AND TAX ADMINISTRATION**
 - **INDIA IS ALSO A MAJOR EXPORTER OF SOFTWARE. ON THE PRINCIPLE OF RECIPROCITY, IT WOULD BE HELPFUL IN SETTLING THE CROSS BORDER TAX DISPUTES.**
-

TAXATION OF FOREIGN INSTITUTIONAL INVESTORS (FIIS)

- **FOREIGN INSTITUTIONAL INVESTORS (*FII*s) WERE ALLOWED TO INVEST IN THE INDIAN CAPITAL MARKET FOR THE FIRST TIME IN 1992.**
- **THE CUMULATIVE NET INVESTMENT BY *FII*s AT THE END OF MARCH 2006 WAS US\$ 45.3 BILLION. 882 *FII*s REGISTERED WITH SEBI AS ON 31ST, MARCH 2006.**
- **MOST OF THE *FII*s ARE NOT PAYING TAX IN INDIA.**
- **ALL THE *FII*s ARE REQUIRED TO HAVE A LOCAL CUSTODIAN AND A BROKER IN INDIA, AS PER SEBI RULES.**

-
- **THE MODUS OPERANDI OF ALL THE *FII*s IN INDIA IS ALMOST THE SAME, BUT THE *FII*s, INVESTING THROUGH SOME COUNTRIES, WITH WHOM THE INDIAN *DTAA* PROVIDES FOR CAPITAL TAX EXEMPTION IN INDIA, TREAT THE INCOME FROM INVESTMENT AS CAPITAL GAIN.**

HOWEVER, THE INVESTMENTS MADE BY RESIDENT OF OTHER COUNTRIES TREAT THE INCOME AS BUSINESS INCOME AND IN ABSENCE OF PERMANENT ESTABLISHMENT IN INDIA, THEY CLAIM EXEMPTION.

-
- **EARLIER SEBI ALLOWED *FII*s TO MAKE INVESTMENTS ONLY, BUT NOW PERMITTED TO OPERATE IN DEBT MARKET AND TRADE IN DERIVATIVES MARKET.**
 - **WHETHER THE ACTIVITY OF A PARTICULAR FII WOULD LEAD TO A PERMANENT ESTABLISHMENT OR NOT IS A QUESTION OF FACT.**
 - **THE TAX DEPARTMENT MAY COME OUT WITH SUITABLE GUIDELINES FOR BRINGING A CERTAINTY IN CASE OF TAXATION OF *FII*s.**

TAXATION OF E-COMMERCE

- **FEATURES**

- **E-COMMERCE CAN BE BORDERLESS TRANSACTIONS REQUIRING LITTLE OR NO OBVIOUS PHYSICAL PRESENCE**
- **REQUIRING FEWER OR NO INTERMEDIARIES**
- **REDUCES MARGINAL COST DISTRIBUTION TO NEAR ZERO (INFORMATION GOODS)**
- **NO 'PAPER TRAIL',**
- **BUT COMPETES FAVOURABLY WITH TRADITIONAL PHYSICAL COMMERCE**

▪ **SCOPE OF E-COMMERCE**

- **SALE AND PURCHASE OF TANGIBLE PROPERTY OVER THE INTERNET**
 - **SALE AND PURCHASE OR LICENSING OF DIGITIZED INFORMATION OR PRODUCT (INCLUDING SOFTWARE, MUSIC, VIDEO OR OTHER DATA)**
 - **PUBLICATION AND SALE OF PERIODICALS (ELECTRONIC FORMAT)**
 - **E-MAIL SERVICES THROUGH SECURED NETWORK.**
 - **ONLINE AUCTIONS**
 - **CENTRALIZED RESERVATION SYSTEMS**
 - **CREDIT CARD TRANSACTIONS**
-

SOME INCOME TAX ISSUES RAISED BY E-COMMERCE

- **WHETHER E-COMMERCE ACTIVITIES AMOUNT TO TAXABLE PRESENCE IN A COUNTRY**
- **CHARACTERISATION OF E-COM. TRANSACTIONS - INCOME SHOULD BE TREATED AS SALES INCOME, RENTAL INCOME, ROYALTY INCOME, SERVICES INCOME, ETC.**
- **HOW TO APPLY TREATY SOURCE RULES**

-
- **CHALLENGES POSED BY E-COMMERCE TO INTERNATIONAL TAX ISSUES**
 - **JURISDICTION TO TAX QUESTION OF PHYSICAL OR ECONOMIC 'PRESENCE'**
 - **WHAT INCOME IS CONNECTED TO SUCH PRESENCE TAXING POWER OF A JURISDICTION (COUNTRY)**
 - **SOURCE RULES..... ALLOCATING TRANSACTIONS TO TERRITORIAL LOCATION OR ORIGIN**
 - **CHARACTERIZATION PROCESSES WHETHER TO TAX ON GROSS INCOME, NET INCOME OR APPLYING WITHHOLDING TAXES.**

-
- **QUESTION WHETHER THE TRADITIONAL RULES OF TAXATION APPLIES.**
 - **IN E-COMMERCE TRANSACTIONS, THE SOURCE COUNTRY OUGHT TO HAVE FAIR SHARE OF THE TAXES.**
 - **IS IT TIME FOR *DTAAs* TO BE MODIFIED TO TAKE IN TO ACCOUNT OF ADVANCEMENT OF TECHNOLOGY FOR CONDUCTING BUSINESS?**

THANK YOU

