

THE TAXATION OF ELECTRONIC COMMERCE

By

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DECLARATION

I, the undersigned here by declare that the work titled "THE TAXATION OF ELECTRONIC COMMERCE" is the outcome of the research carried out by me under the guidance and supervision of Justice R.Jayasimha Babu, Judge, High Court of Judicature, Madras. I also declare that this work is original, except for such help taken from such authorities, as have been referred to at the respective places for which necessary acknowledgements have been made. I further declare that this work has not been submitted either in part or in whole, for any degree or diploma at any other university.

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INTRODUCTION

¹The Internet is the world's fastest growing computer network which has touched and changed the lives of people, the world over, in myriad ways.

²It has been prophesied that every business one day will become an e-business, which is now being proved right. People have always known that companies succeed by creating value. What is new today however is how innovative business designs are delivering value. Essentially, that's what an electronic business is all about. ³Similar to the Industrial Revolution that took place at the turn of the last century we are today witnessing a revolution of a different sort. This is the information age and a new revolution is in the

¹ 'Electronic Commerce - From Vision to Fulfilment' - Elias M.Awad - Prentice Hall of India (2002)

² Andrew Grove, CEO, Intel Corporation as quoted in E-Commerce Management, Sandeep Krishnamurthy, University of Washington, Thomson - South Western (2003) at pg.37.

³ E-Commerce - the cutting edge of Business Kamlesh K.Bajaj, Debjani Nag.

making; ⁴One which is being referred to as the knowledge based Industrial Revolution. Information technology and business have never been so closely related. Together they not only define new organisations, products, services and means of delivery but also newer and more novel ways of servicing customers. Electronic commerce or, e-commerce is primarily associated with the buying and selling of services and products over the Internet. E- businesses today have leapfrogged over competition by delivering end-to-end service. As a corollary to the changing face of business the concept of taxation has to undergo a modification or change too. Before we go into the question of taxation of e-commerce transactions let us take a brief look at the evolution of e-commerce from what started as a promising prospect on the distant

⁴ ibid at Pg.6

horizon to the giant economic and commercial opportunity that it presents today.

⁵The Internet was not designed initially for commercial use. Its primary objective was to create a decentralized network for the United States Department of Defences' security concerns about a possible nuclear attack. Interestingly the Internet was envisaged as a closed network accessible only to employees of the defence organizations. Its growth therefore, to a worldwide, decentralised network was unforeseen and unprecedented.

⁶The most significant development in the history of Internet is perhaps the World Wide Web. This was developed by Tim Berners-Lee at the CERN lab in Europe. The key difference between efforts up to this point and the World Wide Web was

⁵ Cyber Law - Brian Fitzgerald & Anne Fitzgerald - Lexis Nexis - Butterworths (2002)

⁶ ibid

that all previous efforts were dominated by hierarchical ways of structuring information whereas the Web represents all information as being interconnected. Today the World Wide Web is being adapted for wireless communication. This represents unique challenges and the future is, obviously, still largely unwritten.

The importance of the Internet in today's business cannot be overstated. The application of the Internet to the sales process has advanced rapidly in leaps and bounds. Early and primitive websites were simple electronic billboards that provided product information and invited potential buyers to make purchases using conventional means such as placing orders over the telephone, faxing them or visiting a brick-and-mortar establishment. This evolved into the order-taking websites where the customer could place an order directly via the website itself. These early transactional

relationships, restricted though they were, still involved automated electronic execution of transactions between a buyer and seller such as purchase orders, invoices, confirmation orders, shipping notices, freight notices and payments. Since the transactions did not have the flexibility available today, it involved electronic transmission of documents with fixed format⁷ and predefined data and information fields. The most familiar example is EDI, or Electronic Data Interchange where established document formats were used by companies to transmit transactions over private Value Added Networks (VAN). The benefits of EDI were electronic administration without the necessity for human direction, greater employee productivity, accuracy in transactions, less paperwork, faster transactions, and significantly

⁷ Building an intelligent e-business- David Ferris and Larry Whipple - Prentice Hall of India, Delhi (2001) at Pg.87 onwards.

lower costs. On the flip side, it was inflexible, and did not further supply chain planning and collaboration. Internet-enabled electronic data interchange today offers all the benefits of EDI over VAN's with the addition of cost benefit, since the Internet as a vehicle, is free. These sites, over time, became more sophisticated with the addition of ease-of-use features such as the shopping carts. Inherent disadvantages in them were corrected and these websites paved the way for still more sophisticated ones which featured highly configured products hitherto not available online, and with very efficient back-end fulfilment systems which made the processing of orders, including their filing and despatch, efficient and prompt. Currently e-commerce technology aims at further streamlining of electronic commerce. The target areas for development have been identified as online configuration, capability to deliver

promptly, integrated fulfillment and targeted pricing handled by rules-based pricing engines linked to the ordering site.

What is e-commerce? E-commerce has been defined as follows:-

⁸International Fiscal Association

E-commerce comprises 'commercial transactions in which the order is placed electronically and goods or services are delivered in tangible or electronic form and there is an ongoing commercial relationship'.

⁹National Association of Software and Service Companies (NASSCOM)

E-commerce comprises 'transactions where both the offer for sale and the acceptance of offer are made electronically'.

⁸ [http:// www.ifa.org](http://www.ifa.org)-(the official website of the International Fiscal Association)

⁹ [http:// www.nasscom.org](http://www.nasscom.org)-(the official website of Nasscom)

¹⁰Organization for Economic Co-operation and
Development-OECD

Electronic commerce has been defined to be 'commercial transactions, involving both organizations and individuals that had based upon the procession and transmission of digitized data, including text, sound and visual images and that are carried out over open net works (like the internet) or closed net work'. These include electronically marketed products from business consumers, which are 'intangibles such as travel and ticketing services, software, entertainment, banking, insurance and brokerage services, information services, legal services, real estate services and increasingly health care, education and government services'.

¹⁰ [http:// www.oecd.org](http://www.oecd.org)(the official website of the Organisation for Economic Co-operation & Development.

For the purpose of this thesis, the definition put together by me which most comprehensively describes e-commerce from the taxation angle is :

E-Commerce comprises 'transaction involving both tangible as well as intangible goods and services, where both the offer and acceptance of offer are made electronically and payment, completion of contract and delivery could either be physical or digital.

What is driving e-commerce forward?

The answers are relatively simple. Like any revolutionary technology, electronic commerce is succeeding because it provides competitive advantages to those who choose to use it. World over, it is being increasingly recognized as having a positive impact in several ways. ¹¹The advantages

¹¹ 'Electronic Commerce - From Vision to Fulfilment-Elias M.Awad - Prentice Hall of India (2002)

that electronic commerce has over traditional businesses are many. We can broadly classify them as follows;

(i) It reduces cost.

Doing business on the Internet is very cost-effective. This is because every financial transaction on the net turns into an electronic process and the sooner this conversion is made the more cost-effective the transaction becomes; for instance, it has been proven that in a commercial bank, where a basic transaction would cost \$1.07, to process the same transaction over the Internet would cost about one penny.

(ii) Reduces operational inefficiencies

A net based business typically has virtual teams for various aspects of its business like customer service, sales, product development etc. Remote presentations are made to prospective clients over the net, client meetings are held online,

interoffice meetings are held in virtual space; thus saving enormous time and money.

IBM conducted a recent company-wide meeting completely online. 52,600 workers met virtually leading to over 6000 proposals, suggestions and comments. Consider the saving in terms of transportation costs, meeting costs including food and drink and the amount of time and effort; which is why conducting business over the Internet is looked upon as very good value for money.

(iii) Economy

Unlike a brick-and-mortar environment, in an e-commerce business there is no rental of physical store space, investment for infrastructure or warehousing facility required. All that is needed is a unique concept, a well-selling product, a well designed web- storefront and a partner for fulfilment.

(iv) Streamlining supply chains

One of the biggest positive effects of the Internet on businesses is to streamline the company's supply chains. Virtual companies can easily share information with their suppliers and customers across the globe allowing it the freedom to plan and forecast better.

(v) Significantly higher margins

E-commerce translates into higher margins since overheads and other costs inherent in a brick and mortar business are absent in this medium. For instance, in a virtual travel agency the cost of processing an e-ticket is only 1/8 of the cost of processing a conventional ticket. The resulting higher margin affords an e-business more control and flexibility.

(vi) Eliminates distance and helps in comparison shopping

The Internet has completely eliminated geographical boundaries and business can be conducted across barriers of time and space. The world is today a virtual global market with all the attendant advantages of a wider range of goods and services to choose from. Automated online hopping assistants called hopbots scour net shops and find the consumer the best deals on every product possible.

(vii) Enhances the value proposition to customers

Internet businesses have the potential to enhance the value provided to a customer. A wide product assortment is provided and technology is used to provide optimum service to the customer in terms of a product recommendation engine, e-mail alert technology customization, easier transactional capability and better value-added services.

The sheer convenience of avoiding traffic jams, jostling crowds and heavy shopping carts with all the advantages of technology available at one's fingertips makes the Internet a shoppers paradise. The control that the customer has over fulfilling their shopping needs including the fact that online shops work 24 hours a day and seven days a week without a break is another major factor pushing prospective customers towards virtual shopping.

Electronic commerce has also resulted in better and quicker customer service. Web-based customer service eliminates waiting time and gives the customer direct access to what he requires. It is therefore a win-win proposition.

The medium is however not without its disadvantages. Let's take a brief look at some of them;

(i) Security

Security concerns bog the biggest online businesses. For millions of potential cyber customers, the fear of credit card theft is very real and reluctance in revealing their credit card details via the Internet is one reason why one would avoid a cyber transaction. Naturally, customers will have to feel confident about the integrity of the process before they commit to the purchase.¹² Advances in areas like Biometrics have however allayed fears in this area to some extent.

(ii) Data and system integrity

The protection of the data used and the integrity of the system that handles it pose very real and serious concerns for the e-business world. Computer viruses are rampant and cause delays, file backups, and storage problems among others. Further, with

¹² a) [http:// precise biometrics.com](http://precise.biometrics.com)
b) Biometrics Resource Website [http: // www.nist.gov/biometrics](http://www.nist.gov/biometrics)

hackers finding newer and more innovative methods to enter systems, access files and corrupt accounts, an already complex system is further stressed.

(iii) System scalability

The scalability of a web site would have an effect on its optimum performance levels. To ensure that the performance of a site does not get degraded, slowed down and therefore lose customers, it must be scalable or upgradable on a routine and regular basis. To ensure constant scalability with respect to performance, speed and maintaining a sub-8-second response time takes substantial effort and cost.

(iv) Corporate Vulnerability

The free availability of details of products, catalogues and all other information about a business on its website make it extremely vulnerable to access by competition. This idea of

extracting business intelligence about a competitor from its own web pages is called Web Farming and is one valid reason why an entrepreneur would think twice about doing business on the net.

(v) Lack of a blueprint for handling electronic commerce

Being a nascent industry, the shortage of e-literate people, that is, managers with e-commerce skills, Internet experience and foresight is a serious handicap for those wanting to start an Internet business. Besides, the horror stories of the past two years about the dot-com downslide has further turned away potential entrepreneurs from the Internet.

(vi) Lack of defined legal structure

Business over the Internet is conducted mostly using electronic documents. The absence of paper documentation is felt the most when the business runs into troubled waters. Judicial forums, the

world over, are only now beginning to recognize documents in an electronic form, and that too only in a very limited sphere. Total dependence on electronic documents which can very easily be manipulated or even effaced renders a transaction risky.

The taxation issues surrounding transnational electronic commerce are also a grey area with no clearly defined rules or regulations. Though the absence of the same could have the effect of enticing some entrepreneurs to earn tax-free revenue, a majority of the world business community would address Internet business with more confidence and clarity if these were sorted out and cleared.

The term "net markets" broadly describes all online marketplaces where buyers and sellers meet to exchange goods and services for money. These markets are also called "butterfly markets" or

"butterfly hubs". If one wing of the butterfly is made up of buyers and the other is made up of sellers, then the body of the butterfly where they meet is the hub.

Net markets are of two types -horizontal and vertical. The horizontal market cuts across many industries typically providing a common service while a vertical market would concentrate on one specific industry and seek to provide all services pertaining to that industry under its umbrella.

There are three kinds of businesses that can be conducted over the Internet. They are

- (i) Business to business-B to B
- (ii) Business to consumer-B to C
- (iii) Consumer to consumer-C to C

While the first and second categories do not require explanation, a business in the third category is one which involves exchanges between

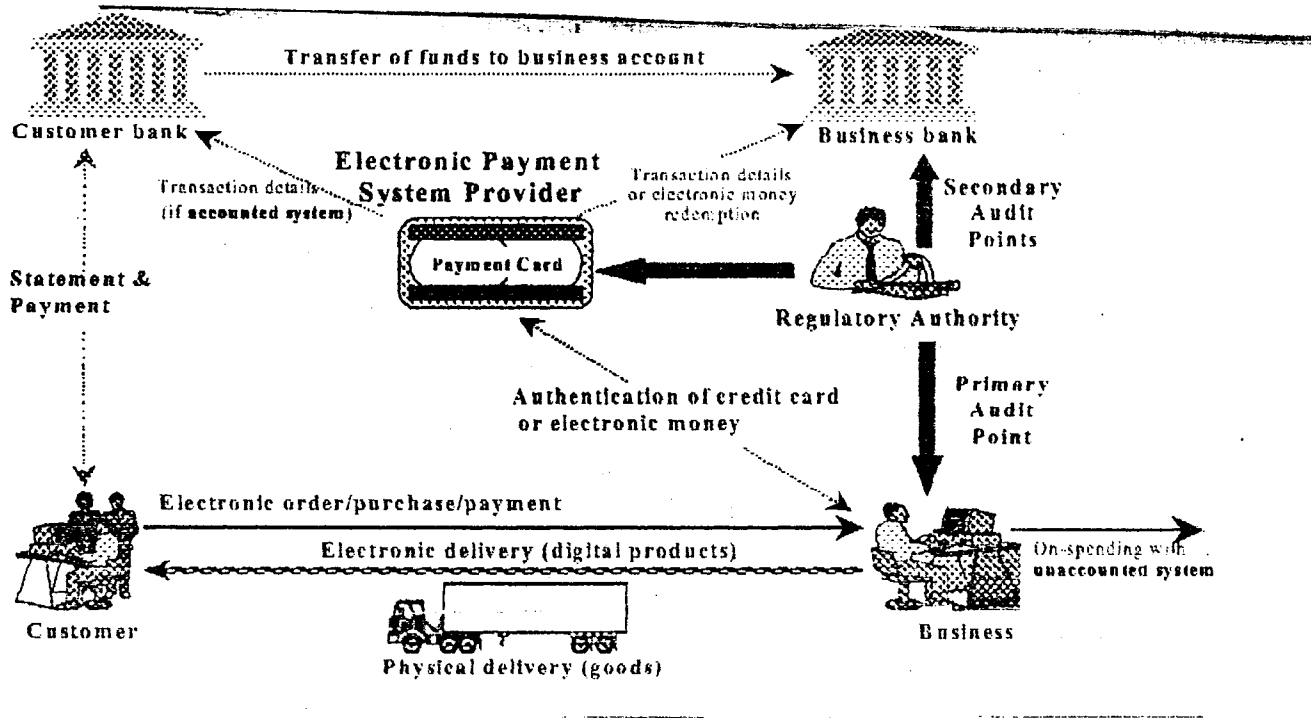
two consumers. A good example would be an ¹³online auction where the price of a product is determined by a system of bidding. The Internet has enabled global auctions with buyers and sellers from all corners of the globe participating in it.

One aspect of electronic commerce that has generated much controversy and discussion is how "payments" are made in an online transaction. Given below is a diagrammatic representation of a typical e-commerce transaction and its components.

¹³ E-Commerce Management - Sandeep Krishnamurthy, University of Washington, Thomson, South Western (2003) at pg.88 onwards

¹⁴DIAGRAM OF BUSINESS MODEL WITH ELECTRONIC PAYMENT

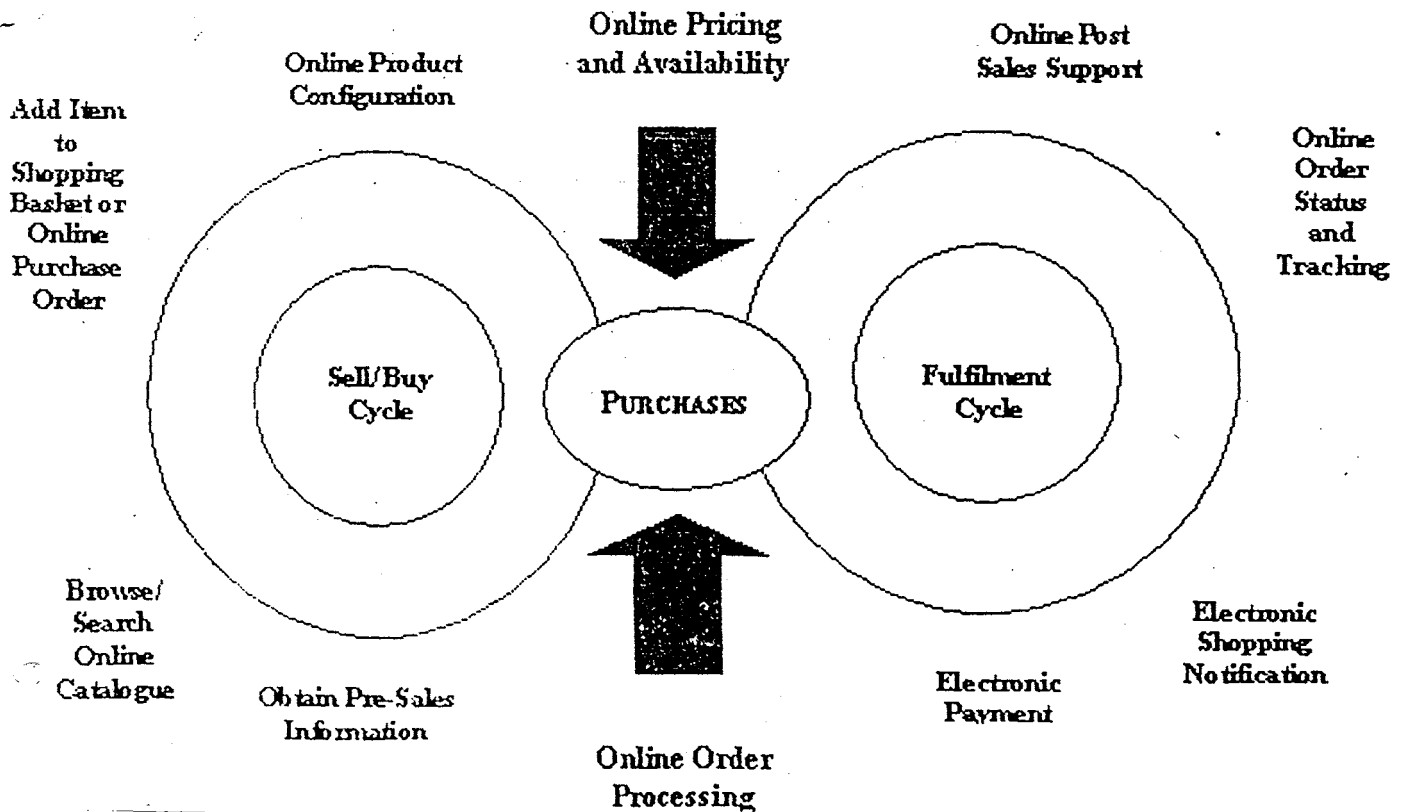
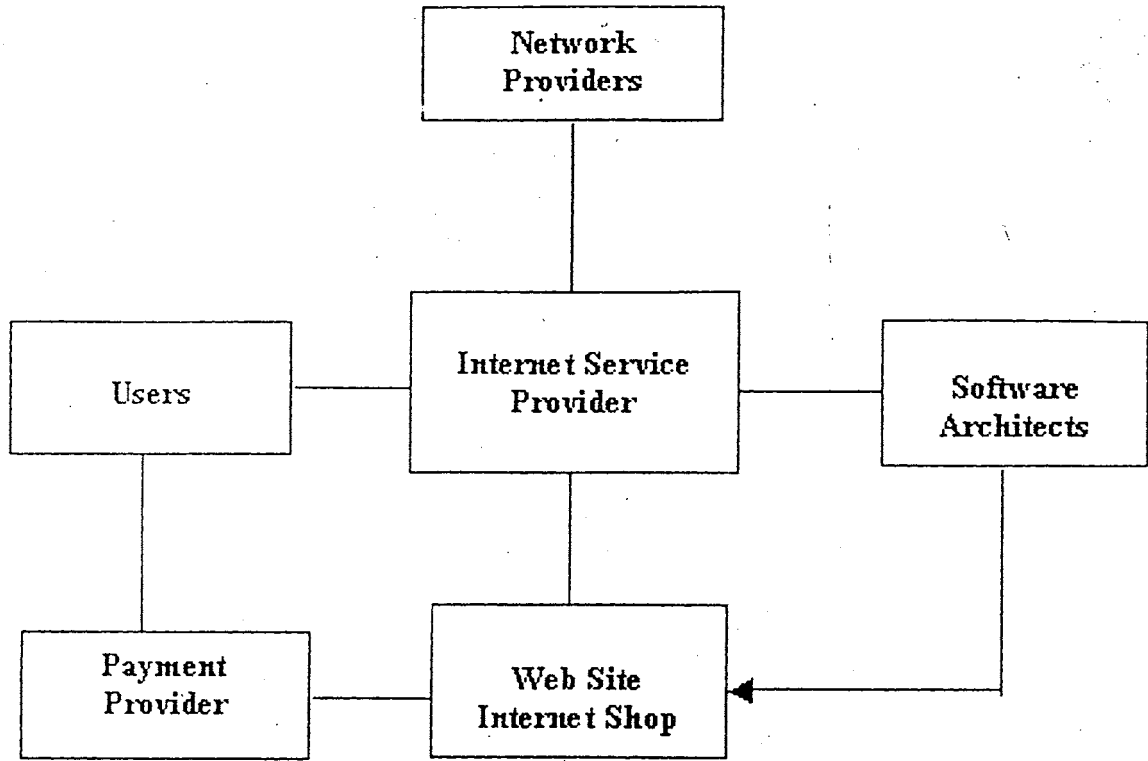
SYSTEM PROVIDER



¹⁴ Electronic Payment Systems- Accountability Guidance - prepared by OECD Committee of Fiscal Affairs Forum on Strategic Management Electronic Commerce Sub-group dated 16-04-2002 - See <http://www.oecd.org>

A DIAGRAM OF A TYPICAL E-COMMERCE TRANSACTION -

SOURCE: THE INTERNET



¹⁵Payments for electronic transactions are termed electronic payments. These are financial transactions made without the use of paper such as cash or cheques. In the Internet-based payment systems the following are the four major models of payment systems.

- ¹⁶(i) Electronic currency or e-cash
- (ii) Credit cards,
- (iii) Debit cards and
- (iv) Smart cards

Electronic currency or e-cash is the network equivalent of traditional cash. Electronic funds transfer (EFT) enables the transfer of cash from one account to another regardless of the type of the bank or the location. Credit cards and debit

¹⁵ [http:// www.digicash.com](http://www.digicash.com).

¹⁶ The Report of the High Powered Committee constituted by the Central Board of Direct Taxes contains a detailed analysis of the Modes of payment in an e-transaction as also electronic money or digital cash. See <http://www.Laws4India.com/Indian Tax Laws/notification/ecomcontent.asp>

cards are the electronic equivalent of checks. They require the purchaser or the user to have an account on the server or at the issuing bank equipped with the proper Internet network. Smart cards are cards which are equipped with a memory chip.

An electronic transaction system makes it possible for transactions to be processed over the Internet. The following guidelines are mandatory for the efficient and proper functioning of an electronic payment system;

(i) The system must be widely accepted by merchant bankers .The merchants themselves must have the technical ability and the required processes to expedite the sale or a transaction without delay.

(ii) The software that accommodates the user -the website interface -must be effective, efficient and well integrated into the total network

environment. It should also be independent of any other payment instrument.

(iii) The customer base must be significant with enough traffic to justify investment in the electronic payment mechanism.

(iv) The thumb rule of any payment system must be ease of use and of access.

Electronic money:

Electronic money would include credit cards, debit cards, electronic funds transfer and others automated clearing house systems (ACH). Every transaction is verified and approved by the issuing institution before the payment is made. Where the transaction is made off-line, validation or verification is not required.

Electronic money is of four types:

The first is identified and online electronic money, unique to a credit card or debit card transaction. There is clear identification of the

buyer and the transaction is verified and card validated against the issuing banks' computer before it is approved and payment made.

The second is an identified and offline transaction which is unique to purchasing by cheque or postal money order. The identity of the purchaser is verified but no account verification is done.

The anonymous and on-line payment is similar to a cash payment where the identity of the purchaser is not known and cash purchases are made on the spot. Transactions involving automated teller machines (ATM's) would be included here.

The fourth is anonymous and offline electronic money which is unique to electronic cash. This would include transactions like making deposits via an ATM, or making a purchase with a credit card from a merchant who is not connected online to the banker.

Generic Tenets of Taxation

According to Adam Smith ¹⁷"The Wealth of Nations," there are 4 basic maxims to be adhered to with regard to taxes in general.

1. Equality: Tax payees should be required to contribute towards governmental support in as close a proportion as possible to their respective abilities. The proportion referred to would be the revenue which they respectively enjoy under the protection of the State. The equality or otherwise of taxation would be the result of the observation or neglect of these very important maxims.

(ii) Certainty: It is vital that the tax payer knows exactly the amount that he is bound to pay towards taxes and to that end, the tax level ought to be certain and not arbitrary. The time of payment, the manner of payment, and the quantum of

¹⁷'The Wealth of Nations, Part V' - Adam Smith - Bantam Dell, a Division of Random House Inc. New York, March (2003)

tax to be paid are to be clear and unambiguous to the tax payer as well as to every other connected or concerned person. If this were not so, the tax payer being subject to the whims and fancies of the tax gatherer, would be in an unenviable position. This in turn would naturally encourage corruption.

(iii) Convenience of payment: The levy of tax ought to be timed when it would be the most convenient for the tax payer to pay, or when he is most likely to have the funds to pay.

(iv) Economy of Collection: The design and structure of taxes ought to be so contrived that the tax payer should be made to pay the minimum possible amount necessary over and above what comes into the public treasury of the state.

These Maxims, though over two centuries old, have stood the test of time, and are as applicable in the electronic commerce environment as they were in Adam Smith's times. They continue to be

applied to the levy of tax, whether domestic or international. In the framing of rules and regulations for the taxation of E.Commerce therefore, one cannot and should not deviate from these general maxims.

¹⁸There are divergent views on whether E.Commerce should be taxed at all. ¹⁹The statistics that I have set out in detail in the next Chapter would establish that E.Commerce is on the rise and is fast gaining acceptance worldwide as the best and easiest way to engage in trade and commerce. According to the classical theory internet transactions should be taxed just like any other

¹⁸ a) Cal-Tax Digest published by the California Tax Payers Association - May 2000. E-Commerce-Q & A, Interview with Dean Andal, Chairman, California Board of Equalization, Member of the U.S. Advisory Commission on Electronic Commerce (ACEC)

b) 'Establishing the Ground Rules' - Issued by the Working Group 2 - Customs & Taxation, Government of South Africa.

¹⁹ See Chapter Two for details of Statistics.

form of trade and commerce. ²⁰There are various reasons for this. ²¹The first is that the growth of E.Commerce will result in volumes of transactions that will be too large to ignore and the revenue loss from not subjecting them to the levy of taxes will be significant. This loss of revenue from taxes will impair in the long run the ability of the States to improve facilities and infrastructure available, in terms of Education, Public Services, Health and many other essential services. ²²Various studies have shown that the loss of revenues from not taxing E.Commerce will result in a situation where citizens will either have to learn to live

²⁰ E.Commerce: To Tax or not to Tax? That is the question . . . or is it? Annette Nellen, Computer & Technology Conference, Berkeley Centre for Law & Technology & The University of Texas School of Law, June 29th, 2001.

²¹ E.Commerce Taxation - EAS: 4/00-103:13-Centrede Recursox Informatives - Section Cultural Information - Remarks of Stewart Gizenstat, U.S. Deputy Secretary of the Treasury before the Tax Executives Institute Midyear Conference, Washington DC, March 20, 2000.

²² Internet Taxation which side are you on?
Isabel M. Isidro, Managing Editor E-Commerce Guide
<http://www.powerhomebiz.com>.

with low standards of essential public services or will have to fork out higher taxes in other sectors, like for example, property tax. There has been a proposal by the proponents of this theory to impose a BIT or BYTE tax on internet commerce.

²³The second argument put forth is the unfair advantage that internet will have as a medium of commerce over traditional retailers. An E.tailer would end up having a competitive advantage which does not have any basis or rationale. They argue that the mere choice of a medium of commerce cannot be a reason for gaining an unfair advantage over the rest of the commercial world. The levy of tax on internet commerce would protect the revenue bases of States as well as, main street, Brick and

²³ E-Commerce & Internet Taxation: Issues, Organizations & Findings - Laura Gordon Murnane, Knowledge Net Unlimited, Vol.8 No.6, June 2000.

Mortar business. ²⁴On the other side of the fence, it is argued that the imposition of taxes will impair and slow down the growth and opportunity of this nascent business which is fast gaining a foothold among consumers. The loss of revenue from E.Commerce transactions have been an area of survey. However, though ²⁵statistics project the growth of E.Commerce in all parts of the world at very high levels the ground reality today, is that E.Commerce represents less than 1% of retail sales globally. In acceptance of this theory the United States has passed a Moratorium in 1998 on the levy of new taxes on Electronic Commerce. The interests of revenue have however been protected in that the ban is only on the levy of new taxes and does not bar application of existing taxes to internet commerce.

²⁴ *ibid*; as above

²⁵ For Details, See Chapter Two.

The rationale behind the ITFA therefore could be to ensure that the amount spent on the setting up of a system to tax e-commerce, could possibly be more than what it could collect in terms of revenues.

²⁶The United States Advisory Commission on E.Commerce (ACEC) has issued ²⁷majority representations to United States Congress on the various recommendations made in this area. This Commission is a creature of the Interest Tax Freedom Act though it endeavours to present a balanced view of both Groups - those favouring Nil taxation and those in favour of taxation. It has been argued that it cannot possibly be a good idea to recommend a whole new set of taxes on what the commission calls "the great individual technology revolution" and consequently taxing E.Commerce may

²⁶ The Advisory Commission on Electronic commerce is created under Section 1102 of the Internet Tax Freedom Act, 1998.

²⁷ Report of the Advisory Commission on Electronic Commerce- See http://www.ecommercecommission.org/asec_report.pdf

not be neither politically nor technically possible.

²⁸Within the United States alone, an E. business model would have to collect taxes in 46 different States, complying with 7000 sales tax rates and 38,0000 tax jurisdictions. This is quite apart from the question of determining what would be deemed taxable and not taxable within a State. The introduction of a new tax now would seriously impair its development at such a critical stage. Accordingly, and also in view of the fact that there is no established system of taxation that is granted to work in the face of new challenges thrown up by E.Commerce, a haphazard tax structure could only result in the failure of the system to work and spoil any chances of growth that it might otherwise have. One School of Thought is that the internet is a medium, which, by its very

²⁸ ibid,

nature cannot be regulated, or controlled. It is unfettered by geography and should remain so. It has been proposed that the internet be developed as a global free trade zone unencumbered by overlapping, discriminatory taxes. A Bill called the Internet Tax Nondiscrimination Act was passed with a voice vote extending the legislation earlier passed till the 1st of November 2003. ²⁹In a Press release by President George Bush on the 13th January 2004, the stage appears to be set to make permanent "all the tax relief we have delivered to the American people and our Nation's small businesses". It appears therefore that the Moratorium would be not only extended, but made permanent and it remains to be seen what repercussions this will have on the rest of the global market as well as its response to the same.

²⁹ Bush calls for Tax Relief to be made Permanent - Mike Godfrey, Tax-News.com, Washington dated 13th Jan.2004 (<http://www.tax-news.com>)

Recognising the importance of Electronic Commerce on the growth of trade and business globally, international organizations have been engaged in pioneering and in-depth work to identify, analyse and formulate guidelines with respect to the tax issues affecting this medium. This would include a conglomeration of software companies the world over, The Global business Forum (GBF), The Global Industrial and Infrastructure Committee (GIIC), as well as the Organisation for Economic Cooperation and Development (OCED), World Trade Organisation (WTO), The European Union (EU), the United Nations (UN) and the Central Board of Direct Taxes (CBDT) in India. The CBDT had constituted a High Power committee to go into the issues relevant to and affecting E.Commerce. The High Power Committee submitted its report in 2000. The CBDT has now set up a committee to examine Emerging Issues in

International taxation. E.Commerce has been identified as one such area.

STATISTICS

¹Statistics show that E.Commerce is on its way to becoming the main medium of business for the future. This would indicate the reason why Governments the world over are making concerted efforts to harness tax revenues from this medium of business even though admittedly revenues from the same are not yet, very significant.

Statistics gathered by the ²Forrester Research Inc. indicate that information Technology Investment, the world over are on an upswing. ³The increasing trends in sectors of E.Commerce transactions as forecasted for the year 2004 in

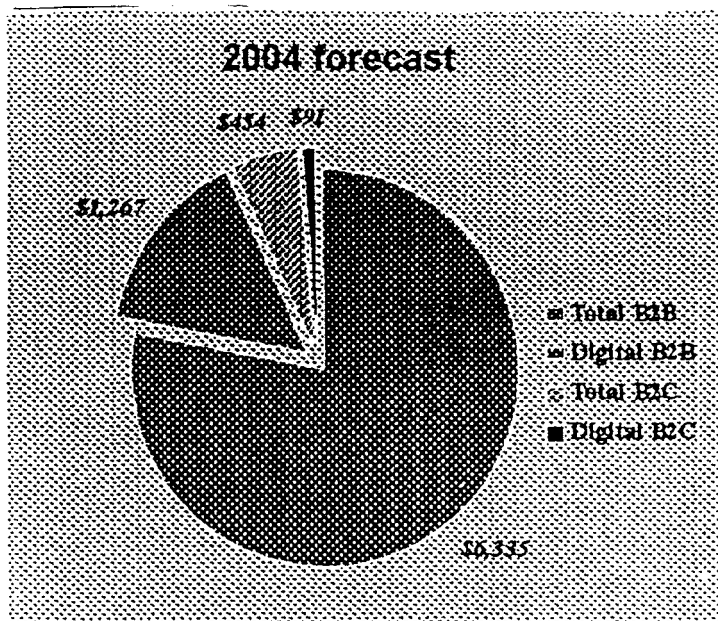
¹ For the purposes of this Chapter , statistics have been gathered from the following sources:

- a. Nasscom - <http://www.nasscom.org>
- b. <http://www.forrester.com>
- c. nature-und umweltschutz akademie des landes NRW (NUA-
<http://www,nua.com>
- d. <http://epaynews.com/statistics> for electronic transactions.
- e. [http:// Datamonitor..com](http://Datamonitor.com)
- f. Statistics from the Official websites of the OECD, EU,UN, Referred to in detail later in the Chapter
- g. <http://www.clickz.com/stats>

² <http://forrester.com/ER/Press> Release/0,1769,873,00,html

³ Source : <http://www.forrester.com>,

respect of Global transactions is indicated below
in millions:



In fact, the ⁴High Power Committee constituted by the Central Board of Direct Taxes in India, has cited the increasing usage of this medium in all sectors as one of the reasons why it was thought necessary to analyse and formulate a system of taxation with respect to E.Commerce.

⁵The U.K. Government has issued a Three year work plan for the years 2002-2003 to 2004-05. A brief over view of the various programmes includes among other things:

(i) Exploring, under the Data Collection Initiative Strategy, action for improved data collection, including collections made over the internet, to enable the strengthening of infrastructure systems which support data collection and keeping pace with advances and technology for the determination/dissemination of data. Periodical

⁴ Report of the High Power Committee constituted by the Central Board of Direct Taxes, India in Chapter II: The Taxation of Electronic commerce. See [http://www.laws4India.com/Indian taxlaws/notification/ecomcontent.asp](http://www.laws4India.com/Indian_taxlaws/notification/ecomcontent.asp)

⁵ For details of the work plan see [http://www.statistics.gov.uk/nsworkprogramme/downloads/04c_commerceEnergy &Industry pd/](http://www.statistics.gov.uk/nsworkprogramme/downloads/04c_commerceEnergy%20&Industry.pdf)

national statistics published since the ⁶"First National Statistics on E.Commerce" in May 2001 have been providing estimates of the value of E.Commerce sales and purchases in the U.K.

⁷The United Nations Economic and Social Council, Statistical Commission and Economic Commission for Europe had its Fifty first plenary session in Geneva between the 10th to 12th June 2003. An integrated presentation was made of programmes of Interanational Statistical work in the region for 2003-04 and 2004-05. Programme Activity No.2 deals with the managing of Technical Infrastructure and other cross-cutting issues and sets out as its goal "that the benefits of information and communication technology (ICT) be harnessed to the greatest extent possible in the collection, processing and dissemination of statistical data. Short and Medium term objectives

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⁷ Full details available in document Distr.generalCES/2003/4 dated 4thApril, 2003'E--see <http://www.unecce.org/stats/documents/ces/2003/4.e.pdf> at page 10 onwards

have been set out to be achieved and discussed in its next meet in 2004. The United Nations Statistical Commission has also cleared the publication of a new Manual on "Statistics on International Trade and Services".⁸ The Voorburg Group which works closely with the OECD and the U.N. and is an influential group of Experts, in Service Statistics has highlighted areas where there is maximum demand for data pursuant to which efforts are made to regulate and streamline the collection of the same. The Voorburg Group was created in 1987 subsequent to a request from the United Nations Statistical Office (UNSO), for rendering assistance in developing service statistics. It derives its name from the place Voorburg in Netherlands, where it had its first meeting hosted by the Netherlands Statitiscal office (NSO). Its main purpose is to be a informal

⁸ For Details see <http://www.statcan.ca/secure/english/citygrp/voorburg/template1/htm>

forum for the exchange of views on service statistics. The Bureau which consist of a core group of members elected every year, meets annually.

⁹The Commerce Energy and Industry system has published a Series of Statistics on the development of E.Commerce related areas. Some major heads where statistics have been collected:-

Cross-Border and Domestic Payment Transactions In The EU

Domestic Transactions

Others	1.7%
Direct debits	21.4%
Checks	15.5%
Credit transfers	28.1%
Cash withdrawals	13.7%
Card payments	19.5%

100% = 62.4 billion transactions

Cross-border transactions

Checks	0.3%
Credit transfers	16.5%
Card payments	83.2%

100% = 0.8 billion transactions

⁹ See http://www.statistics.gov.uk.nsworkprogramme/downloads/04C_commerceenergyandindustry.pdf

B2B Payments In The US, 2002 - 2010 (in USD billions)

Year	Checks	ACH/Wire	Commercial Cards
2002	21	12	0.5
2004	21	13	1
2006	20	16	1.5
2008	18	19	2
2010	16.5	23.5	2

Source: Celent Communications, February 2002

Total Worldwide eCommerce Revenues, 2004 (B2B & B2C)

Region	Total
North America	\$3.5 trillion
Asia Pacific	\$1.6 trillion
Western Europe	\$1.5 trillion
Latin America	\$81.8 billion
Rest of World	\$68.6 billion

Source: Forrester Research

Payment Systems In The US, 1999 - 2010

Volume (\$ trillion)	1999	2005	2010
Paper	\$3.3 (69%)	\$3.4 (50%)	\$3.6 (36%)
Cards	\$1.4 (28%)	\$2.7 (39%)	\$4.3 (49%)
Electronic	\$0.2 (3%)	\$0.7 (11%)	\$1.3 (15%)
Total	\$4.9 (100%)	\$6.8 (100%)	\$8.7 (100%)

Source: The Nilson Report

**Volume of B2B Transactions in Asia-Pacific 2000 - 2004
(exc Japan)**

Year	Total
1999	9.2 billion
2000	29.9 billion
2001	93.4 billion
2002	258.5 billion
2003	510.7 billion

Source: Gartner Group



Comparison of Research Firms' B2B Totals For 2004

Firm	Total (USD trillion)
IDC	2.2
Forrester	2.7
Yankee	2.78
Gartner	3.95
AMR	5.7

Source: epaynews.com



Electronification Of UK Business Payments, 2001 - 2011

Year (mill)	2001	2003	2005	2007	2009	2011
Checks	1042	926	837	776	719	671
Direct credits	1088	1491	2241	2313	2365	2413

Source: APACS Payments Market Report, July 2002

Costs Of Traditional Vs Online Purchasing Processes (in USD)

Process Step	Traditional Process	Purchase card + eCommerce
Buying	59.00	3.40
Paying	12.00	0.34
Reconciling/data integration	19.00	0.70
Average transaction cost	90.00	4.44

Source: American Express/Ernst & Young, June 2002

Consumer Comfort Levels Using Various Payment Methods

Method	Comfortable	Uncomfortable
Billed later	68%	18%
Credit card	55%	27%
Debit card	32%	49%
Checking account	25%	57%
Debit card with PIN	20%	66%

Source: Jupiter Research, March 2003

US Households Receiving And/Or Paying Bills Online

Year	View & pay bills online (millions)	Paper bills but pay online (millions)
2001	2	8
2002	7	11
2003	15	17
2004	26	21
2005	40	25

Source: Jupiter Media Metrix November 2001



Online Shopping Patterns In Terms of Internet Penetration

Category	Country average	Lowest	Highest
Internet users	27%	6% (Indonesia)	58% (USA)
Online shoppers	10%	1% ¹⁷⁰ (Thailand/Turkey)	27% (USA)
Online dropouts	15%	1% (India)	32% (Korea)
Offline shoppers (but browse online)	13%	1% (Portugal)	36% (Hong Kong)
Future online shoppers	14%	3% (Poland)	31% (Italy)

Source: Taylor Nelson Sofres Interactive

Read the TNS Interactive Global eCommerce Report Power Point
Taylor Nelson Sofres Interactive analysis of eCommerce in 27 countries

Forrester's Global eCommerce Predictions For 2004

Region	Total (USD)
North America	3.5 trillion
Asia Pacific	1.6 trillion
Western Europe	1.5 trillion
Latin America	81.8 billion
Rest of World	68.6 billion

Source: Forrester Research

Worldwide B2B eCommerce Market, 2000-2005

Year	Total (USD)
2000	\$433 billion
2001	\$919 billion
2002	\$1.9 trillion
2003	\$3.6 trillion
2004	\$6.0 trillion
2005	\$8.5 trillion

Source: Gartner Group

Total B2C Revenues For US, Europe & Asia, 1999 - 2003 (in USD billions)

Region	1999	2000	2001	2002	2003
US	75	150	250	400	750
Europe	25	30	40	50	60
Japan	25	30	50	75	250

Source: Fortune Magazine

Business-to-Business Transactions 1998 - 2004

Year	B2B Transactions	Total Web Sales
1998	30 bn	50 bn
1999	60 bn	80 bn
2000	100 bn	190 bn
2001	220 bn	330 bn
2002	420 bn	590 bn
2003	740 bn	900 bn
2004	1100 bn	1400 bn

Source: Keenan Vision

¹⁰The United States is engaged in detailed study and analysis of various areas of E.Commerce. The Statistics Bureau of the Department of Commerce which is engaged in the compilation of the statistics, made a recent announcement on the 23rd February 2004 that the estimate of United States retail E.Commerce sales for the 4th quarter of 2003, not adjusted for seasonal, holiday and trading differences was 17.2 billion dollars, an increase of 25.1% from the 4th quarter of 2002. The total retail sales for the 4th quarter of 2002 were estimated at 918.2 billion, an increase of 6.2% from the same period, in the previous year. The E.Commerce sales in the 4th quarter of 2003 accounted for 1.9% of total sales, while during the 4th quarter of 2002 E.Commerce sales were 1.6% of total sales. In comparison in the 3rd quarter of 2003 E.Commerce sales were 1.5% of total sales.

¹⁰ See http://www.census.gov/tos/www/papers/2002/2002final_text.pdf

Also See Release of the Economics and Statistics Administration, US Census Bureau dated April, 15, 2004 in <http://www.census.gov/estats>.

Total E.commerce sales for the year 2003 had increased by 26.3% from 2002 and were estimated at 54.9 billion dollars. The retail sales alone had increased by 5.4% from the year 2002 and the sales made over the internet in 2003 accounted for 1.6% of total sales as compared to 1.3% of total sales in the year 2002.

**Estimated Quarterly U.S. Retail Sales:
Total and E-commerce (in billions)**

Period	Retail Sales Total	E- Commerce	E- commerce's % of Total
Q4 1999	\$787,362	\$5,393	0.7%
Q1 2000	\$715,102	\$5,772	0.8%
Q2 2000	\$775,364	\$6,250	0.8%
Q3 2000	\$768,559	\$7,079	0.9%
Q4 2000	\$812,667	\$9,248	1.1%
Q1 2001	\$723,710	\$8,009	1.1%
Q1 2001	\$801,115	\$7,904	1.0%
Q3 2001	\$777,882	\$7,894	1.0%
Q4 2001	\$850,608	\$10,788	1.3%
Q1 2002	\$740,020	\$9,470	1.3%
Q2 2002	\$818,609	\$9,761	1.2%
Q3 2002	\$822,125	\$10,465	1.3%
Q4 2002	\$864,653	\$13,770	1.6%
Q1 2003	\$772,185	\$11,928	1.5%
Q2 2003	\$858,793	\$12,464	1.5%
Q3 2003 ^R	\$872,634	\$13,284	1.5%
Q4 2003 ^F	\$918,245	\$17,226	1.9%

Notes: Estimates are based on data from the Monthly

Statistics collected have also lead to the inference that a percentage of internet users and internet shoppers would stop shopping online if transactions were taxed in a way similar to that in a conventional retail setting. In a ¹¹study conducted by Austin Goolsbee, a Professor of Economics at the University of Chicago Group School of Business on Online shoppers, 25,000 purchasing units were examined and an important conclusion reached that, one in 4 shoppers, i.e. 25% would refrain from using the internet as a virtual market if there was a tax incidence included in the transaction. ¹²Identical conclusions have also been reached by Biz Rate DotCom's Flash Survey Study. Taxation, therefore, will clearly will have a great impact on revenues, if any, to be garnered from E.Commerce.

¹¹ Evaluating the Costs benefits of taxing internet commerce-Austin Goolsbee. in <http://www.gsbadg.uchicago.edu/internet.htm>

¹² See <http://bizrate.com> for details.

It is recognized internationally therefore that the collection of reliable and authentic data concerning various areas of Electronic commerce is vital in order to find answers to the various issues that the usage of the medium generates. ¹³To this end, the Directorate for Science, Technology and Industry, Committee for Information computer and communications Policy of the OECD had released a Model Questionnaire 'Measuring ICT usage and Electronic Commerce in households/by individuals/ by the Working Party on Indicators for the Information Society.

¹⁴The United Nations Conference on Trade and Development in its 7th session in Geneva on the 24th to 28th February 2003 discussed various issues relating to the development of major issues concerning e.commerce and ICT. It identified

¹³ For Text of Questionnaire See OECD document DSTI/ICCP/IIS(2002)1/REV2 dated 10th April 2003 available at <http://www.oecd.org/dataoecd/3/3/20630152.pdf>

¹⁴ United Nations Document TD of the UN Conference on Trade and Development, Distr. general, TD/B/CO3M/49 dated 19th December 2002 available at http://www.uncpad.org/en/docs//c3d49_en.pdf

broadly critical areas for further study by the Commission on Development and Business Facilitation. ¹⁵It emphasised the importance of this area of study on the ground that the Asia Pacific Region alone was adding close to 50 million new internet users every year and the potential for growth is therefore exponential. ¹⁶It had identified the satisfying of demand for reliable and internationally comparable data for informed decision making as one key area which it proposes to address.

¹⁵ ibid at Page 5.

¹⁶ ibid at Page 7.

INTERNATIONAL TAXATION UNDER THE INDIAN
CONSTITUTION

¹Article 253 of the Indian Constitution, gives Parliament the power to make any Law for India in order to implement any Treaty, Agreement or Convention with any other country or Countries or any decision made at an International conference, Association or any other body. This Article is to be read in conjunction with Art.51 in part IV - the Directive Principles of State Policy of the Indian Constitution which deals with the promotion of the International Peace. The Supreme Court considered the question of whether the powers under Art.253 would be wide enough for Parliament to invade items in list II as well. In ²S.Jagannath -vs- Union of

¹ Article 253 reads as follows: "Notwithstanding anything in the foregoing provisions of this Chapter, Parliament has power to make any law for the whole or any part of the territory of India for implementing any treaty, agreement or convention with any other country or countries or any decision made at any international conference, association or other body."

² The Supreme Court in S.Jagannath's case held that in view of the opening words of the article "Notwithstanding anything in the foregoing provisions", Union Parliament would be empowered to invade List II, and an entry under Entry 13, List I Schedule VII read with Article 253 to

India (AIR 1997 S.C. p.811) it was held that it empowered the Union Parliament to invade the State List as well in so far as that may be necessary to implement National Treaty Obligations. An inconsistency in the State Act therefore vis-à-vis an international Treaty could be corrected by Parliament under Art. 253.

³Art. 51 sets out the object of India's participation in the International arena. Though International Treaties entered into by India would have the force of Municipal Law only with the appropriate legislation having been passed by Parliament as laid down by the Supreme Court in Varghese Jolly George -vs- Bank of Cochin (AIR 1980 SC 470), and Civil Rights Vigilance Committee SLSRC College of Law, Bangalore vs- Union of India AIR

implement an international agreement would override an inconsistent State Act.

³ Article 51 reads as follows: "The State shall endeavour to- (a) promote international peace and security; (b) maintain just and honourable relations between nations; (c) foster respect for international law and treaty obligations in the dealings of organized peoples with one another and (d) encourage settlement of international disputes by arbitration."

1983 (Karn) 85 the restriction is only with respect to certain specified situations. They are: 1) ⁴Payment of Money to a foreign power out of the consolidated Fund of India. 2) ⁵Where the Treaty affects the justiciable rights of a citizen; 3) ⁶Where it requires the taking of property, life or liberty e.g: extradition or imposition of a tax; 4) ⁷Where it modifies the Laws of a State. Where the ⁸Treaty pertains to other matters, legislation or constitutional amendment would not be required. With respect to Tax Laws, and subsequent to the inclusion of ⁹Sec.90 in the Indian Income Tax Act,

⁴ Motilal -vs-UP AIR 1951 Allahabad 257 (Full Bench)

⁵ Maghanbhai -vs- Union of India AIR 1969 (SC) 783 & In Re: Berubari Union AIR 1960 (SC) 845.

⁶ Ali Akbar Kashami Mirza -vs- United Arab Republic AIR 1966 (SC) 230.

⁷ State of West Bengal -vs- Jugal Kishore More AIR 1969 (SC) 1171.

⁸ Maganbhai -vs- Union of India AIR 1969 (SC) 783.

⁹ Section 90 of the Act of 1961 corresponds with the Section 49A of the 1922 Act. The present section was substituted for the old section with effect from 1.4.1972. The significant changes was the inclusion of clauses for exchange of fiscal information between the States, recovery of taxes and of Section(2) which reads as follows: "Where the Central Government has entered into an agreement with the Government of any country outside India under sub-section (1) for granting relief of tax, or as the case may be, avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to that assessee."

¹⁰a plethora of decisions of the Supreme Court as well as the High Courts have laid down the proposition that in the event of a conflict between Treaty Law and Domestic Law, it is the former that will prevail. (Dealt with in detail in the Chapter on Judicial Interpretation of International Tax Principles).

Under the Indian Constitution, Taxation of Income is a Central subject which can be legislated on only by the Union Government. List I Entry 82 deals with Taxes on income. Powers have been conferred on the Union Government and the Legislature to legislate in the area of taxes and income, and courts have held that such legislative power should not be interpreted in a restricted sense. The Supreme Court, in Naveen Chandra Mafatlal -vs- CIT reported in AIR 1955 SC p.58, has held that "the rules which apply to the interpretation of other statutes apply equally to

¹⁰ Case Laws set out in later Chapters

the interpretation of a constitutional enactment subject to this reservation that their application is of necessity conditioned by the subject-matter of the enactment itself. None of the items in the Lists is to be read in a narrow or restricted sense and each general word should be held to extend to all ancillary or subsidiary matters which can fairly and reasonably be said to be comprehended in it. It is therefore, clear that in construing an entry in a List conferring legislative powers the widest possible construction according to their ordinary meaning must be put upon the words used therein."

Since the word "income" has not been defined in the Constitution, the interpretation would have to be according to the natural meaning which one would understand. Again, as interpreted by the Privy Council in Commissioner of Income-tax -vs- Shaw Wallace (AIR 1932 P.C.138) income has

been interpreted to mean any thing "that comes in" and is thus a word with wide amplitude and the broadest connotation. It takes within its fold all incidental and ancillary matters, as well as the implied authorization to make provisions to deal with all such matters including the prevention of evasion of tax, recovery, collection, enforcement of payments etc., as set out by the Supreme Court in Union of India -vs- A.Sanyasi Rao AIR 1996 SC 1219.

With reference to the topic on hand therefore, the Constitution of India and the Income Tax Act contain in-built provisions to make them applicable to any commercial transaction within their wide ambit. Safeguards have also been advocated by the Supreme Court as set out in Naveen Jawahar -vs- I.T.A.A. (Income Tax Appropriate Authority) Commissioner K.K.Sen (AIR 1965 SC 1375) wherein a rational connection has to be drawn by the Revenue between the addition sought to be made and the

assessee's income. ¹¹However, where it is a device engineered by the assessee to avoid legitimate taxation, the Supreme Court has held that a fiction is permissible and the veil can be pierced.

¹²Art.245 dealing with the distribution of legislative powers provides that any Act of Parliament formulated under the said Article will have territorial or extra-territorial operation and no such law shall be deemed to be invalid on the ground that its operation extends beyond the territory of India (Provident Fund Commissioner vs. Shillong City Base Syndicate [AIR 1996 Supreme Court 1546]). The question of the competence of Parliament to pass the Indian Income Tax Act, 1961 has been upheld by the Supreme Court in Union of India vs. M.V. Valliappan [AIR 1999 Supreme Court 2526]. The Supreme Court in that case examined the

¹¹ For a more detailed analysis of Tax Avoidance and Tax Planning, See later chapter on Judicial Interpretation of Tax Principles.

¹² Article 245 reads as follows:“(1) Subject to the provisions of this Constitution, Parliament may make laws for the whole or any part of the territory of India, and the Legislature of a State may make laws for the whole or any part of the State.

provisions of Sec.171 (9) of the Income Tax Act and held that the legislative competence to pass an Act would have to be decided on the basis of the Constitution which empowers it to levy taxes. Item 82 of List 1 of VII Schedule to the Constitution, empowers the Parliament in this regard and therefore the vires of the Section cannot be questioned. The Supreme Court further made an observation which would be very pertinent in the context of the taxation of Electronic Commerce. As stated elsewhere in this Thesis, the United States has passed a moratorium on the levy of new taxes on internet businesses on the ground that taxation of commerce conducted over the net would sound a death-knell for small businesses which transact over the internet. The Supreme Court in ¹³M.V. Valliappan's case, has held that hardship or equity have no place in determining the exigibility to

¹³ AIR 1999 (SC) Pg.2526.

tax. It has been ¹⁴reported in the media that President Bush intends to extend the moratorium on a permanent basis so that internet business remains free from and unencumbered by the levy of new taxes.

Under the Indian Constitution, taxes that are applicable to normal, commercial transactions would be applicable to trade and commerce transactions over the internet. However, the issue as we saw earlier would turn on the ¹⁵nexus that is established by the department on a "transaction to transaction" basis.

¹⁴ Article dated 13-2-2004 by Mike Godfrey in <http://tax-news.com> - 'Bush calls for Tax Relief to be made Permanent.'

¹⁵ For details, see Chapter on Permanent Establishment & the Nexus Rule.

THE HISTORY OF TAXATION OF INTERNATIONAL COMMERCE

The writings on this subject span nearly one and a half centuries and the earliest of them are of the year 1884. ¹David Hume, in the mid-18th century enunciated what possibly were the first faint and distant glimmerings of ideas and concepts consistent with, and akin to today's ideas of international commerce, international taxation and income distribution. David Hume had a clear vision of a country's interests being connected to, and dependent on the well-being of its neighbours. This is what he wrote :

²"I will venture to assert, that the increase of riches and commerce in any one nation, instead of hurting, commonly promotes the riches and commerce of all its neighbours; and that the state can scarcely carry its trade and industry very far,

¹ International Taxation - The Trajectory of an Idea from Lorimer to Brandt' - Myron Freankman - World Development, 24th May, 1996, 2000-Global Policy Forum.

² ibid at Pg.2.

where all the surrounding states are buried in ignorance, sloth and barbarism"

David Hume's assertion was the first and giant step of formulating a policy along lines that it adheres to even today. It was the primary recognition that internal trade and commerce could receive a great boost only with conducive and good global market conditions. It further advocated action intended to assist one's neighbours in matters of commerce, revenue collections, and in ensuring that there was no loss of revenue to either state.

Another early reference to international taxation was by James Lorimer in his "Ultimate problem of International Jurisprudence" published in the year 1884. In this work, Lorimer addressed and discussed various aspects of International Jurisprudence before identifying the problem mainly as ³"the problem of finding international

³ ibid.

equivalents for factors known to national law as legislation, jurisdiction and execution". The financial aspect was also discussed, and according to him, the levy of an international tax on the citizens by the government of each state would defray the expenses of the international authority, the setting up of which he advocated.

Later writings show that though international institutions, organizations and transnational taxation was on the agenda of economists, politicians and jurists, the emphasis was on social welfare. The Second World War and the early postwar experience resulted in much importance being given to the social welfare state. The Atlantic charter of August 1941 captured the spirit of the times when Churchill and Franklin Roosevelt declared that no effort would be spared in bringing about the fullest co-operation among all nations for bringing about improved labour standards, economic

development and Social Security. This led to the anticipation that some form of international organization or body would be conceived of that would head and regulate transnational conduct and behaviour in the field of economics and commerce, among others. This, in turn prompted discussion on the need for revenue, if this international organization was to have the extensive powers that it was intended to. It was at this juncture that the levy of an international tax came into play as a means of funding for the international authority. The intention was also the reduction of inequalities in the income of various member states as the member states with the highest per capita income would face the largest per capita burden by means of member state contributions or a system of progressive taxation.

Subsequent economists, ⁴C. Wilfred Jenks and T.A. Someberg considered the idea of taxation of activities which were all dependent on the existence of an international order. Jan Tinbergen advocated the "World Peace through World Economy" approach whereby only a distribution as just as possible would result in a more stable and prosperous social system.

One of the most prolific contributors to the entire discussion was John Maynard Keynes. His suggestions included an International Clearing moving Union as an authority monitoring the economic and commercial growth of all nations. Keynes himself had opined that ⁵"the union might become the pivot of the future economic government of the world". Where most other economic proposals suggested a levy of tax on transactions or the income of a nation, Keynes talked about an

⁴ ibid
⁵ ibid.

international tax to be levied on the balance of payments surpluses of nations. We see therefore that this was a stage when a consensus was being arrived at with respect to the levy of an international tax but the reasons for the same had not yet fructified into a common agenda acceptable to all nations.

The post-war period saw the growth of international organization as a concept. It also witnessed international cooperation in its myriad forms including collective security arrangements which imposed a collective financial burden as well. The sharing of the financial burden by national governments and the distribution of the same resulted in a series of comparisons drawn between the individual taxation policies of these nations. It was not a happy situation. An important anomaly was discovered, that is, where the state's contribution was based on its per

capita income, is this distribution consistent with progressive individual national taxation? The inability to provide an affirmative answer to this question resulted in the recognition that the levy of an individual, international tax necessarily has to be complemented with some degree of harmonisation of internal, national tax structures. While the social philosophy of taxation as a means of international aid was still strong and the guiding factor in international taxation, it had evolved to a point where the world community had realized that whatever the primary reason may be, the levy of an international tax has to complement the domestic tax structure. A happy marriage between the two therefore was established as a thumb rule and continues to be one of the guiding principles till date.

Till the 1960s there were other theories and schools of thought on this subject. Some suggested

alterations to the existing mass of thinking, others recommended modifications, mostly cosmetic, but very few resulted in concrete growth or codification. The work done during this time was mostly to extend the existing work and calculations of earlier economists and jurists and this continued till Albert Hirschman and Richard Bird formulated the proposal explicitly envisioning a link between personal income tax and the financing of International Aid. ⁶They proposed a system of tax credits to individuals for contributions made to foreign aid. Though this proposal would have involved a major and complete departure from the existing line of thinking, it was not to be, since, few countries at that time envisaged tax exemption for any personal charitable contribution. This proposal therefore, soon passed into intellectual limbo.

⁶ *ibid.*

Several other proposals and studies extended this idea and concept even further. A levy of tax on the beneficiaries of the existence of an international order was proposed and this gained intensity around the 1970's. One impetus to this was the principle of the "Common Heritage of Mankind" included by the United Nations general assembly in 1967 with respect to the Law of the Sea Conference. ⁷The 1974 United Nations Resolution calling for a New International Economic Order gave it further impetus. The global sharing of proceeds from economic exploitation of common regions that are not part of the territory of any sovereign state in particular (Res Nullius) was gaining in importance, both in theory and in practical application. The reasons were clear-it was being increasingly recognized that the entire world we

⁷ United Nations Development Programme, Human Development Report, 1994, Oxford University Press, New York, 1994.

live in today is based on a common heritage, including the food we eat, the thoughts we think, the technological building blocks and machines we use and international public goods, including peace. Under these circumstances and the atmosphere of open ended interpretation of the common heritage of mankind, a strong case was made out for the levy of an international tax to finance both global income redistribution and the maintenance of an international order. In fact a concrete proposal was made in 1970 in the ⁸Timbergen Report of a United Nations committee proposing a 0.5% tax on the value of selected consumer durables to source global development finance. This tax was to be referred to as a "world solidarity contribution". Again in 1976 Mahbub ul Huq and James Grant enumerated several taxes to aid automaticity of global funds. Some of these were taxes on non-renewable resources,

⁸ ibid at Pg:8.

international pollutants, the activities of transnational enterprises, on royalties from commercial activities arising out of international commons, as well as proposals for taxing international consumer spending etc. Of the two, Huq, expressed a preference for an international income tax. He admitted however that an international tax on personal income would be a great challenge to the States' national sovereignty and therefore reluctantly concluded that the levy of the same ought to be deferred.

There were several tangents and corollaries to this main idea of international income taxation. ⁹Edith Penrose had proposed an international corporate income tax to be levied on firms according them a newly created status of international incorporation. The resultant revenues were however to be allocated among the countries in which the company is operated

⁹ ibid

according to a formula, as a deviation from the existing line of thinking, where the revenues were to be pooled for global good.

¹⁰Steinberg, Yager, and Brannon, proposed a national "shadow tax" which is to be levied on the basis of estimated yields from nations as opposed to an actual levy proposed by the United Nations calculated on the gross national product of member states.

An interesting proposal was a tax on "brain drain" proposed in 1979. The ¹¹Tobin tax on foreign exchange transactions was formulated and developed around the 1970s. His proposal was however motivated by a desire to streamline, and if possible dampen speculative capital flows and restore greater autonomy to a nation's monetary policy. To this end, the question of disposition of the vast sums of money likely to be raised by a

¹⁰ *ibid* at Pg.9

¹¹ See <http://www.tobintax.org.uk/tobintax>

internationally uniform tax was not dealt with specifically by him. There was a mere suggestion that the proceeds collected be paid over to an international authority like the IMF or the World Bank.

Later studies had much in common with existing ones but the emphasis continued to be on raising funds for global economic integration, harmonisation and development. The 1980 ¹²Brandt Commission Report listed similar findings but chose to emphasise the importance of universality in any revenue-raising programme. The report received wide publicity and was the focus of discussions at many meetings and seminars.

The situation remains much the same today. The wheel, it appears, is reinvented daily, with routine calls for the levy of one type of international tax or another advocated by one

¹² Brandt Commission, Common Crisis North South: Co-operation for world Recovery, PanBooks, London, 1983.

grass-roots agency or another. The need however is more urgent today than it ever was.

Never before has the world been in such a state of flux. The existence today of significant negative externalities having a global impact is well-recognised and has profound ramifications. Never therefore, has the idea of an international tax levy been more relevant than today.

¹³It is felt that in the present economic and political contexts, it is unlikely that any State would make a concession in any area of revenue, particularly revenues from tax. Allowing for the fact that all Theories, concepts, guidelines and regulations that govern international law and which are discussed in detail in the later pages of my thesis, are purely advisory in nature, the only deterrent for a State to not comply with

¹³ The Formulary Approach to the taxation of Transnational Corporations : A Realistic Alternative? Lindsay C.Celestin - <http://setis.2.library.usyd.edu.au/adt/public/html/adt-Nil/uploads/approved/adt-NU20020917.133138/Public/02 Whole.pdf>.

international regulations is the fear of International sanctions and International opinion. Though political and criminal conflicts have seen international organizations like the U.N. using force and other pressure tactics, it is unlikely that any international organization will assume such power of enforcement in the area of fiscal concerns.

Developments in the areas of Commerce & business, however have made the world one big Global market It is time therefore that the suggestion and thinking of economists are applied to today's situations and conditions.

TAX TREATIES AND THE PERMANENT
ESTABLISHMENT RULE

¹The role of Tax treaties in the arena of international taxation cannot be emphasized enough. Tax Treaties are entered into between countries in order to ensure that there is no revenue loss to either country on account of a cross border transaction while at the same time there is no element of double taxation suffered by either party. On the domestic angle, relief is provided under the Treaty which can be enforced under International as well as domestic law. The agreements are governed by the rules and the framework of the ²Vienna Convention on the Law of Treaties 1969. Most Double Taxation Avoidance Agreements entered into by States are based either on the ³OECD Model Law on Treaties.

¹ Fundamentals for the negotiation of Tax Conventions between Developed and Developing countries -ST/SG/2001/L.10 5th April 2001 -United Nations Secretariat.

²www.un.org/law/i/e/texts/treaties.htm

³ www.oecd.org/document

⁴Historically, there are two ways of avoiding Double Taxation: either the foreign income can be exempted from domestic tax or a credit could be granted in respect of the foreign taxes. A great deal of discussion has gone into the question of which of the two methods would be superior.

⁵Richard & Peggy Musgrave in "Criteria for Foreign Tax Credit" had considered the distinction between the economic and the equity aspect of international taxation, and within the ambit of economic aspects, between "Capital Exports" and "Capital Import Neutrality".

An interesting point that was noted by them was that a third dimension would come into operation namely, while there could be equity in taxing the individual tax payer one cannot lose sight of equity in the distribution of tax revenues among

⁴ Should Europe adopt a uniform method for the avoidance of Double Taxation? Klaus Vogel - "International Taxation" - Global Policy Forum - Social and Economic Policy.

⁵ ibid at Pg.1.

the states involved. According to ⁶Klaus Vogel in his paper, "Should Europe adopt a uniform method in the avoidance of double taxation?" the natural conclusion would be that foreign tax credit was not introduced to preserve or protect Resident state taxation, nor was it introduced to attain capital export neutrality. In fact, the idea was to prevent double taxation. A simpler way of achieving the same objective would be by an exemption, in combination with a subject-to-tax clause.

⁷In interpreting Tax Treaties entered into by Nations to avoid Double Taxation, the Vienna Convention on the Law of Treaties enacted in 1969, provides guidance which is relevant, despite changes in situations and new situations that have occurred since then, till date. The Vienna

⁶ ibid.

⁷ Relevance of the Vienna Convention on the Interpretation of Treaties in Taxation' Rashmin Sanghvi - International Tax Planning Conference Dec. 5 & 6, 2003, Bombay, India.

Convention seeks to codify international customary law which would be applicable to Treaties and is therefore respected and followed by most countries regardless of whether they have been a signatory to the Convention or not. Some Articles of the Vienna Convention are relevant in the broad and general interpretation of a Treaty.

Article 3 (1) states that "a Treaty shall be interpreted in good faith" in accordance with the ordinary meaning to be given to the terms of the Treaty in their context and in the light of its objects and purpose.

(2) The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, its preamble and annexes:

(a) any agreement relating to the Treaty which was made between all the parties in connection with the conclusion of the treaty.

(b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.

(3) There shall be taken into account together with the context:

(a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;

(b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;

(c) any relevant rules of international law applicable in the relations between the parties.

In the interpretation of the above, recourse may also be had to any supplementary means of interpretation including preparatory work of the Treaty and the circumstances surrounding its completion in order to confirm the meaning

attributed to the application of Article 3(1) or to determine if the interpretation would obscure or lead to a result which is manifestly absurd or unreasonable."

⁸These Principles should be kept in mind while interpreting Treaties and DTAA'S in the light of the new challenges thrown up by Commerce conducted over the Electronic medium. The conclusions arrived at by the ⁹Organisation for Economic Cooperation and Development, ¹⁰the European Union, the ¹¹CBDT in India and other bodies engaged in Research in this area, have all been framed within the parameters laid down by the Vienna Convention. It should, however, be kept in mind that the new questions that the Taxation aspects of Electronic Commerce open up were not

⁸ Permanent Establishments & Internet enabled enterprises & the physical presence and contract concluding Dependent Agent Tests Feb. 27 & 28, 2003 - Gary D.Sprague, Rachel Hersey. Baker & Mckenzie.

⁹ For details on conclusions reached by the Organization For Economic Co-operation and Development and Text of Releases by Working Parties and Technical Advisory Group (TAG's) See <http://www.oecd.org>.

¹⁰ For details see <http://www.eu.org>.

¹¹ See Report of High Powered Committee at <http://www.Laws4India.com/indiantaxlaws/notifications/ecomcontent.asp>

envisaged at the time when the Convention took place. The general rules framed by the Vienna Convention for the interpretation of Treaties would however, still be applicable in view of Art. 3 (2) of the OECD model Treaty which contains an Umbrella clause reading as follows:-

OECD Model Treaty: Article 3 (2)

"As regards the application of the Convention at any time by a contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that state for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State."

The term Electronic Commerce, Internet, world wide web or other terms connected to, or concerned with the same will not find a place in either the

Convention or the Model Law Treaty. The application of the Convention would be governed by the sanction accorded to it by Article 3(2). For the purposes of the subject on hand therefore, one would adopt popular and commonly understood definitions of the terms relevant to E.Commerce in the interpretation of Tax Rules governing the same.¹² The application of the Convention itself gives rise to 2 basic issues concerning interpretation.

(i) Static Interpretation:

Static interpretation would result from interpretation of the issue with respect to domestic law.

(ii) Ambulatory interpretation:

This would refer to later commentaries for the purpose of interpreting a previously concluded Treaty.

¹² 'Double Taxation Conventions' - Klaus Vogel, Kluwer Law International, IIIrd Edition.

Static interpretation has its genesis in paragraph 3 of Article 2 as seen supra.

The Ambulatory rule reads as follows:

"Convention shall also apply to any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to or in place of the existing taxes".

¹³In respect of the tax treatment of electronic commerce, in the interests of international business one would suggest that ideally, it is a combination of the two theories of interpretation that should be applied. The larger issues in the Domestic law of individual Nations should be examined and harmonized into a commonly acceptable system of taxation and then the ambulatory approach should be utilized at the time of application of the same to issues that arise.

¹³ Are the current treaty rules for taxing business profits appropriate for e-commerce?- Public Discussion - <http://www.oecd.org>.

¹⁴At the Domestic level, we find that each State follows its own methodology of taxation which differs in content and practice in respect of the levy, enforcement, recovery etc. Tax systems are naturally, not harmonized and differ widely from one country to another. Varying Rules at the national levels have therefore to be juggled with rules at the international level. The combination of the two systems sometimes creates very complex interpretation issues when applied in practice. ¹⁵One of the most important of these is the apportionment of income. This has been sought to be addressed by the Permanent Establishment or the nexus rule. This is defined by Article 5 of the OECD model tax treaty which reads as follows:-

¹⁴ Draft Manual for the negotiation of bilateral Tax Treaties between Developed and Developing Countries - UN Publications ST/ESA/94 XVI.3 -UN Publications.

b) Manual for the negotiation of bilateral tax treaties between Developed and Developing Countries, United Nations, New York, 2003, <http://www.un.org>.

¹⁵ Taxation of Electronic Commerce - Prof.K.C.Gopalakrishnan & Ms. Aruna Kanthi - Snow White Publications - October 2001.

Article 5

PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "Permanent establishment" includes especially:

(a) a place of management;

(b) a branch;

(c) an office;

(d) a factory;

(e) a workshop;

(f) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources;

(g) a warehouse, in relation to a person providing storage facilities for others;

(h) a farm, plantation or other place where agriculture, forestry, plantation or related activities are carried on;

(i) a store or premises used as a sales outlet;

(j) an installation or structure used for the exploration or exploitation of natural resources, but only if so used for a period of more than 120 days in any twelve-month period;

(k) a building site or construction, installation or assembly project or supervisory activities in connection therewith, where such site, project or activities (together with other such sites, projects or activities, if any) continue for a period of more than 120 days in any twelve-month period;

(l) the furnishing of services, other than included services as defined in article 12 (royalties and fees for included services), within a Contracting State by an enterprise through employees or other personnel, but only if;

(i) activities of that nature continue within that State for a period or periods aggregating to

more than 90 days within any twelve-month period;
or

(ii) the services are performed within that State for a related enterprise (within the meaning of paragraph 1 of article 9 (associated enterprises))

3. Notwithstanding the preceding provisions of this article, the term "permanent establishment" shall be deemed not to include any one or more of the following:

(a) the use of facilities solely for the purpose of storage, display, or occasional delivery of goods or merchandise belonging to the enterprise;

(b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or occasional delivery;

(c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;

(e) the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information for scientific research or for other activities which have a preparatory or auxiliary character, for the enterprise.

4. Notwithstanding the provisions of paragraphs 1 and 2, where a person-other than an agent of an independent status to whom paragraph 5 applies-is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a

permanent establishment in the first-mentioned State, if:

(a) he has and habitually exercises in the first-mentioned State an authority to conclude contracts on behalf of the enterprise, unless his activities are limited to those mentioned in paragraph 3 which, if exercised through a fixed place of business, would not make that fixed place of business a permanent establishment under the provisions of that paragraph;

(b) he has no such authority but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise, and some additional activities conducted in that State on behalf of the enterprise have contributed to the sale of the goods or merchandise; or

(c) he habitually secures orders in the first-mentioned State, wholly or almost wholly for the enterprise.

5. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise and the transactions between the agent and the enterprise are not made under arm's-length conditions, he shall not be considered an agent of independent status within the meaning of the paragraph.

6. The fact that a company which is a resident of a Contracting State controls or is controlled by

a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not by itself constitute a permanent establishment of the other."

Before going on to the Nexus Rule as it exists today, it would be relevant to mention in brief, the history and the Development of this Rule over the last Century and a half.

¹⁶The first convention for the avoidance of double taxation was concluded more than a century ago between 2 States, not united in a Federation, viz; Austria and Prussia, on 21st June, 1899.

The earliest Treaty between States resulted in the distribution of taxable goods and services among the states so that each good or event was taxable only in one State, thus precluding the

¹⁶ Global Taxation - Extending the Fractal, DR, 2002.
Myron J. Frankman - Atclier, Fucalite mondiale it financemntdu developpement durable, Paris Novembre 7 & 8, 2002.

other from taxation. This method was unanimously applied among European States till the Second World War.

¹⁷Granting of credit for domestic taxes on the basis of foreign taxes paid was originally formulated by the U.K. and its applicability was restricted to the levy of taxes by the States of the British Empire, particularly India. At the international level a credit given for foreign taxes by the State of Residence was first introduced in 1918 by the United States. This was only by convention and was clearly subject to the reciprocity of the other States. The first appearance of the credit method as a Treaty provision was in 1928 by the League of Nations and subsequently by the OECD model convention.

¹⁷ Rethinking the concept of Permanent Establishment in the light of an E-Commerce Driven International Corporation - Pub. date 31.3.2001. Gowling Lafleur Henderson LLP.

¹⁸The brain behind the introduction of the credit scheme was, Thomas Sewall Adams, the Tax Advisor to the U.S. Treasury Department under President Wilson, who suggested that in view of the War, double taxation had become a very serious menace to Americans who were investing or engaging in business abroad. They had to be entitled to claim a credit against their domestic taxes for the taxes that they had paid to other countries. The seed of the foreign tax credit payment was sown. The basic goal appears to be the achievement of Equity for the tax payer as well as the nation concerned, the latter because according to Adams, "business ought to be taxed because it costs money to maintain a market and those costs should in some way be distributed all over the beneficiaries of that market". He was also of the opinion that "income must to some extent be taxed where it is earned at rates and by methods

¹⁸ ibid - foot note no.5

determined by the conditions under which it is earned . . . not by the conditions under which it is spent".

¹⁹The concept of a permanent establishment even then, extended to the economic conditions prevalent, as well as the physical connection between the nations involved. This definitely has set the trend for the broad view and interpretation of the permanent establishment concept that is being taken by judicial authorities to determine the nexus of a State to a transaction for purposes of its taxation.

²⁰An interesting point has been made about why a credit system was selected and not a total exemption of foreign income for the avoidance of double taxation. The logic was clear. A tax payer

¹⁹ Economic Integration & Tax Harmonization in Asia & Oceania - Speech by Haruhiko Kuroda, Vice Minister for International Affairs, The First AOTCA International Convention, November 6th, 2002.

²⁰ Ibid Footnote No.5 at Page 5.

should be taxed once - no more, no less. ²¹It is argued that this goal can be achieved by an exemption clause in combination with a subject-to-tax clause. This would also avoid a serious limitation of the foreign tax credit policy, which is the disparity in the rates of tax between the source States and the Resident States. This sometimes results in the advantage of a low rate of tax adopted by the source State or a reduction in the tax base, being nullified by a higher levy by the Resident State.

The latest thinking does not provide any answer as to which system is more relevant or desirable. ²²What is gaining foothold for sure is the concept of "Economic Allegiance". According to Nancy Kaufman, a Professor at St.Louis University Tax School, the economic allegiance to a Source State would justify taxation by it. She opines

²¹ Ibid

²² ibid footnote No.5

that it would be a mistake "to think of international equality in taxation only in terms of the entitlement theory" and that a "conception of international equity founded on the economic allegiance theory deserves greater attention than it has received".

²³The Permanent Establishment principle as it exists today has shown remarkable dexterity and flexibility in terms of interpretation and adaptation to changing and evolving situations and times. Courts, the world over, have often been engaged in the interpretation of what would constitute a permanent establishment and a business connection which would make the income eligible to tax. The dimension of Electronic Commerce and business conducted over the Internet has added yet another facet to this constantly evolving area. The Supreme Court of North Dakota in the U.S.A,

²³ "Permanent Establishment" & "Place of Supply" as Geographical Tax Nexi in E-commerce - Assessment Essay - Peter Rheinlaender.(source) The Internet

considered the issue of permanent establishment in a land mark judgement in ²⁴Quill Corporation -vs- North Dakota represented by and through its Tax Commissioner Heidi Heitkamp. The facts of the case are as follows: Quill was a Delaware Corporation with offices and warehouses in other States of the United States of America. None of its employees were stationed in North Dakota and its ownership of tangible property there was insignificant. However, it carried on the mail order business through fliers, advertisements, catalogues and telephone calls. The total national sales of Quill Corporation was in excess of 200,000 million dollars of which almost 1 million were made to 3,000 customers in North Dakota. It was the 6th largest supplier of office supplies to the State. All the deliveries made within North Dakota were by mail or common carrier. North Dakota

²⁴ Quil Corp Vs. North Dakota -504 US 298 (1992)

imposed a use tax on any property that was put to use within the State. It required every retailer who maintained a place of business in the State to collect the tax from the consumer and remit it to the State coffers. The statutory definition of the term "Retailer" was amended in 1987 to include "any person, who engaged in regular or systematic solicitation of consumer market within the State" and in turn State regulations define "a regular or systematic solicitation" to mean 3 or more advertisements within a period of one year. Quill took the stand that it was not liable to collect a use tax from its customers in North Dakota. However, the State Tax Commissioner ruled that after the amendment in 1987 Quill would be liable to collect use taxes. The Trial Court ruled in favour of Quill following the earlier decision of the Supreme Court in ²⁵Bellas Hess on the ground

²⁵ National Bellas Hess Inc. Vs. Dept. of Revenue of Illinois 386 US 756 (1967)

that no nexus had been established between Quill and North Dakota. The North Dakota Supreme Court however, declined to follow the earlier precedent concluding that there had been "whole-sale change in economic conditions as well as in the legal scenario which made it inappropriate to follow Bellas Hess". The Court noted that the Mail order business itself had grown from very small beginnings to becoming a huge business giant. The Supreme Court therefore took into account the economic conditions which would make Quill liable for the levy of use tax.

The changes in the legal landscape of the U.S. were also considered. ²⁶The physical presence rule that had been the norm till then, the court maintained, is no longer mandatory but had to be tailored and conditioned to suit the situation

²⁶ The physical presence rule had been laid down in a series of cases reiterating the commerce clause (Art 1 Sec. Clause 3) Miller Brothers C. Vs. Maryland 347 US 340, Complete Auto Transit Inc. Vs. Brady 430 US 274 (1997)

prevalent at that time. Applying the facts of the instant case, the court emphasized that North Dakota had created "an economic climate that had created demand for Quill's products", used 24 tonnes of catalogues and fliers mailed by Quill into the State every year and based on these facts concluded that Quill's presence in North Dakota depended substantially on the services and benefits provided by that State to it. This was, in the court's opinion, constitutionally sufficient nexus to justify the imposition of use tax.

In a ²⁷recent decision of the California Supreme Court, the court had examined the case of Scholastic Book Club Incorporated. Scholastic published books which were sold in retail outlets all over the country. It, however, maintained a list of all its titles on its website where online

²⁷ Scholastic Book clubs Inc Vs. State Board of Equalisation 207 cal app 3d 734, 255 Cal Rptr 77. Scholastic Book clubs Inc 920P. 2d947. See also Pledger vs Troll Book clubs Inc. 920P.2d 947. Pledger vs Troll Book clubs Inc 871 sw 2d 389 State of Michigan dept, of Treasury 567 NW2d 692

orders for purchase could be placed. Scholastic Club had appointed "helpers" to assist in the marketing of their books. The Helpers were teachers, employed by concerns totally unconnected to Scholastic and who popularised the books among their students thereby facilitating the sale of Scholastic Club's books. It was likely that the teachers suggested the books as recommended reading which in turn resulted in increased sales of books. However, all orders were made and taken only online over the website of the Tax payer. A commission was paid to the teachers on the sale of the books as a percentage of the total sales. Anticipating the stand of the Revenue Department that the teachers would be deemed to be agents and a possible business connection be drawn, a specific disclaimer had been issued by the tax payer on its website confirming that any arrangement or appointment made which resulted in the facilitating of the online sales of its books should not be deemed to be sales

through an agent constituting a business connection or a taxable nexus. As anticipated, the Revenue Department took the stand that the teachers constituted sufficient nexus in spite of the specific disclaimer in the website. This was in spite of the fact that all orders had been made online by persons from various parts of the Globe from their individual computers. The orders had been processed and despatched by Scholastic club and there was no official appointment of the teachers as agents to market its books. This decision indicates that the nexus rule is highly flexible and adaptable. Interpretations of the Permanent Establishment Rule rendered by courts the world over, evidence this.

In the light of this, and keeping in mind the ²⁸OECD recommendations, one might suggest the inclusion of an Internet Service provider (ISP) to Article 5 of the OECD model tax convention defining permanent establishment; however, judicial thinking as well as pronouncements have equipped the arm of the Revenue Department with enough muscle to respond and react to situations peculiar to E.Commerce in establishing nexus.

The stand of the ²⁹Inland Revenue Department of Singapore in its Income Tax Guide of E.Commerce proceeds along similar lines. Largely, the conclusions drawn are that a transaction will be liable for tax in Singapore, if there is a permanent establishment as defined under Section 2 of the Income Tax Act, Singapore. For this purpose

²⁸ Clarification on the application of the Permanent Establishment Definition in E-commerce-Changes to the Commentary on Article 5 - <http://www.oecd.org>. - 22-Dec-2000

²⁹ a) Income tax guide on e-commerce -3rd Edition dated 23rd February 2001 of the Internal Revenue Authority of Singapore.

b) See also U.S. -Singapore Joint statement on Electronic Commerce . Nov. 18, 2002.

a server alone would not constitute a permanent establishment. There has been no further elaboration on what exactly a server is or whether the need for human intervention would make a difference. This does not follow the ³⁰OECD's conclusions in entirety.

³⁰ Clarification on the application of the Permanent Establishment definition in e-commerce-changes to the commentary on Article 5-See <http://www.oecd.org>

JUDICIAL INTERPRETATION OF TAX PRINCIPLES

TAX PLANNING AND TAX AVOIDANCE:

¹International Law has always recognized and respected certain tax principles which are common to all States irrespective of geographical borders and Treaties. Courts the world over have always made a distinction between tax avoidance and tax planning and have allowed the latter while coming down heavily on the former. ²In 120 ITR 46 Justice Krishna Iyer had warned society that the concept of avoidance of tax against evasion of tax would one day have to be exposed. ³A Full Bench of the Supreme Court of India in McDowell & Co. Ltd., -vs- Commercial Tax officer, (154 ITR p.148) made a distinction between colourable devices which would not found part of tax planning and legitimate

¹ Tax Avoidance V.H.Patil - IncomeTax Review - July 2001 Pgs:25-32.

² C.I.T. AP Vs T.N.Aravinda Reddy

³Scope of McDowell's case & Tax Planning - Bal Krishna Bhargava Taxman - Magazine Vol.116(2000) Pgs. 69-77

methods provided within the frame work of Statute and Law in order to plan and minimise the payment of tax. Again a Full Bench of the Supreme Court in ⁴Sunil Sidharth's case (156 ITR 509) enunciated the principles laid down in the English Trilogy of cases and laid down that where there was a series of transactions quite apart from the genuineness of the same, the question of commercial and economical value would also have to be considered in order to determine whether the intention was to avoid tax liability without any commercial benefits attached to the same. However, in 173 ITR 479, CIT -vs- Arvind Narottam the Supreme Court held that where the documentation which is suspect is clear and unambiguous the question of tax avoidance would not arise.

The United States Supreme Court in a series of land mark decisions dealt with the same issue. In Gregory -vs- Helvering (293 US 465, 469) the United

⁴ Sunil Siddharthbhai Vs. CIT, Ahmedabad

States Supreme Court dealt with the following facts:

Mrs. Evelyn F. Gregory, Brooklyn was the sole owner of the United Mortgage Corporation which held the shares of a company known as Monitors Security Corporation; these shares were sold in the year 1928. In order to fasten Capital Gains Liability which was lower than the ordinary rate, a new Corporation, 'Averill' was created and the shares of Monitors Securities was transferred to Averill. Three days later Averill was liquidated and Mrs. Gregory sold the shares having received them as the sole asset of Averill. It was her defence that her action was only a ⁵reorganization under the provisions of Section 112 (g) of the Revenue Act of

⁵ Revenue Act of 1928 §112(g), Pub.L.No.562, 45Stat. 791, stated that if there is distributed, in pursuance of a plan or reorganization to a shareholder in a corporation a parry to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or securities shall be recognized. Section 112(1)(1)(B) defined "reorgnisation" as "a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or

1928. Judge Hand opined that the purpose of the reorganization provision was only to exempt reorganisations undertaken for "reasons germane to the conduct" of a business and not when the sole purpose of a transaction was to avoid tax. He therefore felt that the approach to tax law interpretations should be purposive.

In Shaffer -vs- Heitner 433 US 186 (1977) the U.S. Supreme Court considered the Due Process clause and dealt with the earlier ruling of the Supreme Court in International Shoe Company -vs- Washington. (326 U.S. 310). In the former case the court held that a tax avoidance motive is not inherently fatal to a transaction and citing the observation of the Supreme Court in Yosha (861 F.2d at 497) that "there is no rule against taking advantage of opportunities created by Congress or the Treasury Department for beating taxes. The

both are in control of the corporation to which the assets are transferred."

Supreme Court further held that what is important to make a distinction would be the Form which he desires for the conduct of his business.

The English Courts have dealt with a series of cases referred to as the Trilogy on this issue. - W.T. Ramsay Ltd., -vs- IRC (1981) (1 All England Reporter 865); IRC -vs- Burmah Oil Company Ltd., (1982 STC 30) (Burmah) and Furbuss (Inspector of Taxes) -vs- Dawson (1984) (1 All England Reporter 530) These cases together laid down the principles that if there is a tax planning device entered into with the sole object of tax avoidance notwithstanding that it is legally genuine, courts are empowered to ignore such transactions on the ground of artificiality in spite of they being legal. The Hon'ble House of Lords considered the question in Craven -vs- White 1988(3) All England Reporter 495. The approach hitherto followed was sought to be limited to those cases which were

part of the chain of transactions and which have no commercial value on their own. The test laid down the determination of whether "a series of transactions where pre ordained", had no other purpose other than the reduction of tax liability; that the impugned transactions were only part of a series or chain and did not have any independent existence and that the events did actually happen.

In Commissioner of Inland Revenue -vs- Duke of Westminster (1936 Appeals Cases 1), Lord Tomblin had opined thus: "Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Act is less than what it otherwise would be". The avoidance of the payment of tax becomes child's play in Electronic Commerce as it exists today and the application of Lord Tomlin's dictum would ring a warning bell to all tax collectors. As we have seen elsewhere in this Thesis, all aspects of E-commerce including the

markets, the transactions and the products themselves sometimes are purely virtual and not easy to get a grasp of. The substantial loss of public revenue, the economic imbalances caused by reason of illegal money are only some of the repercussions that the avoidance of tax brings. Add to it the complications caused by reason of the wiping out of geographical boundaries bringing in its wake, manifold legal complications and we have a situation which is the Revenue Department's nightmare. Courts have therefore to be extra vigilant in bringing to book individuals and businesses which have crossed the fine line between planning one's taxes and avoiding them altogether.

THE CONCEPT OF PERMANENT ESTABLISHMENT/BUSINESS CONNECTION

The Nexus rule referring to the nexus or connection between two concerns in order to determine whether one would constitute a permanent

establishment of the other for tax purposes has been the subject of judicial scrutiny worldwide.

A landmark decision of the ⁶U.S. Supreme Court in Quill Corporation has been set out in detail in the Chapter relating to the Permanent Establishment Rule. Again the California Supreme Court in the Scholastic Book Clubs Incorporated case set out in detail in the same Chapter has expanded the concept of nexus in the concept of Electronic Commerce.

Indian Law has always interpreted the nexus rule more liberally and has expanded the concept to a 'business connection' concept rather than a fixed place of business, as conceived by the OECD and other taxing jurisdictions. The term 'Business connection' has not been defined and it has been held to be not equivalent to carrying on a business. It is something more. The Supreme Court

⁶ Quill Corp Vs. North Dakota, 504 US 298(1992)
Scholastic Book Clubs.Inc Vs. State Board of Equilisation 207 Cal
App3d734

in Barendra Prasad Roy (91 ITR 82) summed it up by saying that a matter in which one has a right of interference would come within the ambit of the expression 'business connection'. The Supreme Court in CIT -vs- R.D. Aggarwal & Company (56 ITR 20) and a series of later cases have given various shades of meaning to the term 'Business connection'. (Dealt with more in detail in Chapter - The India Perspective). More recently the Authority for Advance Rulings in XYZ/ABC Equity Fund (250 ITR 194) considered the question of whether an Investment Advisor and Custodian of Shares and Securities in India would be a permanent establishment in the light of a Double Taxation Avoidance Agreement between India and Mauritius. The Authority held that since the Investment Advisor was not working exclusively for the applicant, whatever advice was rendered by it was done in the ordinary course of its business with

nearly 20 companies. It would, therefore not constitute a permanent establishment. It relied on observations rendered earlier in RE: Cyril Eugene Pereira (239 ITR 650) in coming to this conclusion.

The Andhra Pradesh High court in Elcom Technology -vs- Deputy Commissioner of Income Tax (250 ITR 164) broadened the scope of Sec.9 of the Income Tax Act with particular reference to clause (vii) pertaining to Fees for Technical services. Where an assessee, being a non-resident company, entered into a contract with an Indian Company and received a substantial amount towards fees for technical services rendered, the High court held that the expression used by the Section was "fees for services ⁷utilised in India" and not "Fees for services ⁸rendered in India" in the course of its business carried on by it in India. The deeming

⁷ emphasis mine.

⁸ emphasis mine

provision would come into play irrespective of the place where the services were rendered.

It has been consistently held by the various High Courts that where there is a DTAA between States, in the event of conflict between the provisions of the DTAA and Domestic law, it is the former that would prevail. This has been reiterated by the Calcutta High Court in Tomkin India Ltd -vs- CIT and others (256 ITR p.460) wherein the Calcutta High Court held as follows: "Whenever any specific arrangement or agreement has been made regarding the taxability of any income under the Agreement for Avoidance of Double Taxation, such agreement would necessarily prevail over the provisions of the Income Tax Act." The rationale has been that the law which is more beneficial to the assessee would govern. Observations of the Calcutta High Court in CIT -vs- Davy Ashmore India ltd., (190 ITR 626) were invoked for support. In CIT -vs-

Quantas Airways Ltd, (256 ITR 84) a Division Bench of the Delhi High court emphasized that in the taxation of a Non-Resident what is important is the presence of a business connection or an asset or a source in India. The issue pertained to whether profits and gains from the sale of Aircrafts outside India would be assessable in the hands of an Australian company carrying on Air Transport business. The Delhi High Court held that though the words "business connection in India" was wide enough to cover all transactions, including transactions involving sale or purchase of capital assets, since Parliament has referred expressly to the transfer of a capital asset situated in India in the deeming fiction of Sec. 9 of the Income Tax Act, the intention was clearly to exclude any transaction involving a capital asset outside India. Further in the event of slightest doubt or dispute as laid down time and time again by the

Supreme Court, the construction which would favour the assessee should be adopted, which was done in the instant case.

The Supreme Court had occasion to consider the scope of a business connection in Addl. Commissioner of Income Tax -vs- New Consolidated Gold Fields Ltd., (257 ITR 770) where the assessee was the Technical Advisor to an Indian company which was treated as Agent of the Assessee Foreign company.

The Department sought to tax amounts paid by the Indian Company to the foreign company in respect of technical advice received from it. The Supreme Court has emphasized that whether there would be a business connection or not would have to be determined on a case to case basis by assessing the extent of activity carried on by the foreign company in India as compared to that outside India. However, only that part of the income which could

be attributed to the operations carried on in India could be brought to tax which clearly involved a determination and computation. Another interesting question that arose before Bombay High Court in CIT -vs- Bombay Burma Trading Corporation Ltd., (259 ITR 423) was with respect to relief to be granted u/s 91 (1) of the Income Tax Act in respect of a Resident of India having paid income tax in another country in respect of his income earned therein, where there is no Double Taxation Avoidance Agreement between the two countries. In such a situation, credit has to be granted to the Resident under Explanation (iii) calculated on the income earned in each country separately and not on the basis of aggregation or amalgamation of income from all foreign countries. . The observations of the Supreme Court in Ramanathan Chettiar -vs- CIT (reported in 88 ITR p.169) were relied on in reaching this conclusion.

This decision would support the first ⁹Conclusion reached by me dealing with the setting up of an International Tax Authority/International Advance Rulings Authority which will demarcate the earnings of Indian Residents on a case to case basis with respect to their electronic commerce transaction with the nationals of other States .

In Union of India and another -vs- Azadi Bachao Andolan (263 ITR 716) the Supreme Court in a detailed judgement considered the DTAA between India and Mauritius. The Supreme Court again reiterated that where there is a conflict between the DTAA and domestic law, the provisions of the Agreement would prevail and can be enforced. A reference has been made to the decision of the Andhra Pradesh High Court in CIT -vs- Visakhapatnam Port Trust (144 ITR 146), CIT -vs- R.N.Muthiah (202 ITR 508) and Arabian Express Line Ltd of U.K. -vs- Union of India (212 ITR 31). With respect to

⁹ See Conclusion I in Chapter on CONCLUSIONS.

Treaty Shopping the Supreme Court has indirectly blessed the same holding that many "developed countries support or encourage Treaty Shopping, even if it is unintended, improper or unjustified for other non tax reasons unless it leads to significant loss of tax revenue". and "an Act which is otherwise valid in law cannot be treated as non est merely on the basis of some underlying motive supposedly resulting in some economic detriment or prejudice to national interests.

The Supreme Court has also considered the test of "place of effective management" as well as the concept of "fiscal residence". Both concepts are very relevant in the light of developments in Electronic Commerce. Both the OECD and U.N. model conventions define "Fiscal Residence" as a place where a person, amongst others a Corporation, is subjected to unlimited fiscal liability and

subjected to taxation on the world wide profits of the Resident company. The place of effective management on the other hand would require correct determination on a case by case basis of the fiscal residence of a company and of its various components in order to determine its taxable profit. While on the one hand, it is the status of Residence which fastens the levy of tax on the Corporations' world wide profits and where the company is subject to unlimited fiscal liability, the place of effective management in respect of the same company may change in respect of different transactions from one place to another depending on the intensity of its administrative activities and locales from where Directors and Managers meet and take decisions. Therefore, depending on the criterion adopted, the fiscal residence would be in one or the other country. This gives rise to a difficulty in pinpointing accurately for the

purpose of taxation, where the activities of a concern have been carried out.

With respect to Electronic Commerce, by their very nature these transactions are spread over the Globe in varying proportions. The application of my first conclusion therefore that the apportionment of the profits would have to be done by an International Tax Authority would be supported by this one factor alone. This Authority would be in a position to determine the place of effective management/place where maximum economic activity has been generated in order to apportion profits attributable to each State based on which Revenues with respect to a Global E.Commerce transaction can be determined. This is a gray area and can be adjudicated on only by one Supervening Global authority formed under a multilateral Treaty.

THE ORGANIZATION FOR ECONOMIC CO OPERATION AND
DEVELOPMENT

The Organisation for Economic Cooperation and Development, headquartered at Holland, started its research into the taxation of E.Commerce almost a decade ago. ¹In 1998, a High Level Ministerial conference was held at Ottawa to debate on the need for a Global strategy to tackle issues relating to E.Commerce taxation and to formulate a work plan. ²Subsequent to the 1998 Ministerial conference, an administrative structure was set up to address the various issues that concern E.Commerce taxation. ³A Committee for Fiscal Affairs (CFA) was set up with Technical Advisory Groups (TAGs) each dealing with specific aspects of e-commerce working under it. They are

¹ OECD: Electronic Commerce: Taxation Framework Conditions : A Report by the Committee on Fiscal Affairs as presented to Ministers at the OECD Ministerial

² OECD Global Forum on Taxation, Ottawa, 14-15 Oct, Closing Statement by the CO-Chairs - <http://www.oecd.org>.

³ See <http://www.oecd.org>

- (i) The Business Profits Tag
- (ii) The Consumption Tax Tag
- (iii) The Treaty characterization Tag
- (iv) The TAG on the Attribution of Profits
- (v) The TAG on the Application of current treaty norms.

Working groups or working parties were formed to engage in researching issues and issuing Drafts for Public Debate and comment. As the result of this hierarchy technical discussion papers have been issued which call for comments from the International community concerning different aspects of E.Commerce. Various recommendations have been made to deal with the issues at hand.

Working party No.9 works in tandem with a special group on E.Commerce which had a 3 year mandate, between 2001 - 2003 to focus on

- i) The practical application of the principles of taxation,

(ii) Analysis of different possible tax collection mechanisms,

(iii) Examination of the possibilities for tax payable and some identification access information and administrative simplification.

A Special Group also uses inputs from the Forum for Strategic Management, established within the sub group on E.Commerce.

The major issues considered by the OECD concern the permanent establishment and nexus rule in relation to broadening spheres of business and the applicability of the business connection rule to today's times. ⁴The OECD has considered the question in detail and has come to the conclusion that the Permanent Establishment rule has been a thumb rule of international taxation for several years and there does not seem to be any particular

⁴ a) OECD Paper on the attribution of Profits to a Permanent Establishment involved in Electronic Commerce (A Discussion Paper from the TAG on monitoring the Application of Existing Treaty norms for the taxation of Business Profits) dated Feb. 2001.

compulsion in doing away with it. ⁵Certain clarifications have however been given and the conclusions of the OECD in this regard are :

(i) a web site cannot, by itself, constitute a permanent establishment.

(ii) An Internet service provider hosting a web site is deemed to be a permanent establishment of a "Web Site", on the condition that it performs core functions - however, the terms "core" and "auxiliary" have not been defined vis-à-vis a web site or the functions of a server.

(iii) The performance of the functions could be with or without human intervention. On the satisfaction of these conditions, the OECD suggests that the server in certain situations be regarded as a permanent establishment for the purpose of international taxation.

⁵ Clarification on the application of the Permanent Establishment Definition in e-commerce - Changes to the Commentary on Article 5 - <http://www.oecd.org/dal/treaties/clari-e.polf>.

See also the Position Paper of the Banking Federation of the European Union on this clarification issued by the OECD - Doc K14a/S0036AES/19.06.2000

⁶The Organisation for Economic Cooperation and Development has set up a Technical Advisory Group working under the umbrella of the Committee for Fiscal Affairs for monitoring the application of existing Treaties for taxing business profits that arise from E.Commerce. This was set up in January 1999 and has, as a part of its mandate, the formation of proposals for alternative rules to the currently existing ones. Four Issues were on its Agenda.

1. The place of effective management.
2. The Concept of Permanent Establishment
3. The attribution of profits
4. Transfer Pricing.

I will not endeavour to go into much detail on the Fourth issue, Transfer Pricing, since that would be beyond the scope of my Thesis.

⁶ OECD Model Convention on Double Taxation - <http://www.oecd.org>.

See also a) the Public Discussion Draft issued by the OECD on 'Are the Current Treaty Rules for taxing Business Profits appropriate for e-Commerce?' dated 26 Nov. 2003.

With respect to the first and second, the Thumb rule that is followed is that any tax payer who is resident in a country may be taxed on his business profits wherever they arise. The concept of Permanent Establishment is considered in detail in a later chapter.

⁷The Rule concerning a non resident tax payer is that income can only be taxed to the extent that the income is attributable to a permanent establishment situated in that country. For Treaty purposes, Residence will be the basis for the liability to tax under that particular domestic law. Since one is considered to be a Resident of a State by reason of the operation of certain factors, the same entity may be deemed to be a Resident of more than one State. Treaties therefore include the "Tie Breaker" rule which provides that in the event of the same entity being

⁷'Uneasy application of Permanent Establishment Rule in a Digital Era: Comments on recent work undertaken by the OECD' - Chen Yanzhong, Xiamen University.

resident in more than one state, it would be considered to be a Resident only of the State in which it has its place of effective management. This ensures that for the purpose of application of the Treaty the tax payer has only a single country as his residence.

There could be situations where an income arising out of the commercial transaction is subjected to triple taxation. This occurs since current tax treaty rules allow certain categories of profits to be taxed in the State of source, in the State where the permanent establishment to which such profits are attributable is located and to the State of Residence of the tax payer to which that permanent establishment belongs. This issue is taken care of by Treaties providing for the elimination of such triple taxation, by subjecting the same first to source taxation, then to the

State where the entity is located and finally the residual taxation right to the State of Residence.

⁸A detailed study was undertaken by the Technical Advisory Groups, originating in the Study of the work of the International Chamber of Commerce and League of Nations in the year 1920. Specific reference has also been made to a Report of International Committee of Technical Experts in 1927 which was the genesis for the major rules on which international commercial law is today based. The arguments advanced against the taxation of income exclusively in the State of Residence was that the Residence of the tax payer is not necessarily the place where vital components of the commercial transaction take place or happen. In 1923 a Group of Economists working with the League of Nations opined that what is important was the place where significant economic activity had taken

⁸ OECD & Building Partnerships for Progress:

(1) Workplan of the WP 9 sub-group on Electronic commerce -2001-2003.

(ii) OECD Launches Project on improving the resolution of cross border tax disputes <http://www.oecd.org>.

place. ⁹This is particularly significant in today's commercial world where geographical barriers have become irrelevant or of not much importance. What is significant is where the tax payer is situated, not where the tax payer resides, and the examination of where the economic activity occurred that led to the happening of the particular commercial transaction. This indicates the place where significant contribution was made to the production and enjoyment of the income.

¹⁰The effective management concept has developed as an off shoot to the Permanent Establishment concept due to advances and changes in methods and medium of business. ¹¹There has been a trend world wide, to look beyond the mere definition of permanent establishment as set out in Article V of

⁹ Reforming the Permanent Establishment Principle through a Quantitative Economic Presence Test - Arthur J Cockfield - <http://www.innovationlaw.org/pages.doc>.

¹⁰ OECD Discussion Draft on 'Place of Effective Management Concept. Suggestions for changes to the OECD Model Tax Convention dated 27 May 2003 <http://www.oecd.org>.

¹¹ Taxation of e-commerce: The challenge of e-commerce to the definition of a Permanent Establishment. The OECD's Response - Dr. Jean Philippe Checutti@2002.

taxation discussed the issue in its Paper ¹²"The impact of the communications revolution on the application of 'place of effective management' as a tie breaker rule". ¹³In the virtual business it becomes especially important to ascertain the place where maximum economic activity has been carried out in order to determine the residence of a particular business. Paragraph 3 of Article 4 of the Model Convention is proposed to be amended to keep pace with the new challenges that E.Commerce throws up in fixing the nexus of the entity.

"3. Where by reason of the provisions of paragraph 1, a person other than an individual is a resident of both Contracting States, then its status shall be determined as follows:

a) it shall be deemed to be a resident only of the State in which its place of effective

¹² Discussion Draft of the OECD released in Feb. 2001.
<http://www.oecd.org>.

¹³ ICT and International Corporate Taxation: Tax Attributes & Scope of Taxation - Anne Schafer & Chrisloph Spengel - Centre for European Economic Research(ZEW) & University of Mannheim - Dec. 2002 at Pgs.11 & 12.

laws of which it derives its legal status cannot be determined, the competent authorities of the Contracting States settle the question by mutual agreement."

It is possible in view of the advances made in communication, for persons in good management positions who control and run the entity in question to themselves be scattered in various parts of the world and to communicate using modern communication technologies, instead of face-to-face. In such an event it would be extremely difficult to determine the place of effective management based on these considerations.

The viable alternative to the permanent establishment rule is therefore to determine the one place where maximum economic activity connected to the entity or transaction in question has happened. This would indicate the closeness that the entity has with that particular

place rather than with any other place where the volume of economic activities is less.

The Tie Breaker Rule therefore could turn on the question of economic relations and economic activity connected to the entity concerned, in keeping with changing times and changing modes of businesses.

The enforceability of rules of taxation to
E.Commerce.

Apart from the legal issues there is one issue which poses a very serious problem in the taxation of E.Commerce. ¹⁴This is the difficulty that is evident in monitoring transactions that take place over the net, determining the taxability and the place of taxation, and enforcing or recovering tax dues from the tax payer concerned. There is significant work going on all over the world in respect of the same. Recognizing the importance of

¹⁴ Overview to e-Commerce taxation - Guide to understanding the Current discussions & debates - Annette Nellen CPA, Esq., College of Business, San Jose State University July 2003 - http://www.cob.sjsu.edu/facstaff/neller_a

policing the internet for transactions that would otherwise go unnoticed and untaxed, nations are engaging in serious study to determine ways and means of tackling the same.

¹⁵Studies have shown that payments for online purchases and online business deals including services and other digital products disseminated in a form other than physical, are often either by debit cards, credit cards, or in a small proportion of cases, E.money or e-cash. The last is impossible to trace on account of anonymity of the transactions and the fact that the entire transaction happens virtually without leaving any trail that can be picked up and followed. In respect of the transactions that involve credit cards, debit cards or other forms of bank involvement, audit trails are left which are one way of monitoring the transaction and taxing the

¹⁵ DocNo:DST1/ICCP/REG (2002)6/FINAL dated 21 Jan 2003 -Implementation Plan for the OECD Guidelines for the security of Information Systems and Networks ; Towards a culture of security issued by the Directorate for Science Technology & Industry

same. To this end, the ¹⁶OECD after substantial study, published a report in 2000 dealing with improving access of countries world wide to banking information for tax purposes. ¹⁷The progress report published in 2003 has been made after the Committee for Fiscal affairs monitored progress made in the implementation of the earlier report and undertook a formal comprehensive review of all the steps that were initiated and undertaken by the Member countries. ¹⁸Countries had been encouraged to move towards standards that were required to achieve maximum results for access of bank information.

One of the important achievements of the 2000 Bank Report was to set an ideal standard of access to bank information, namely that "all Member countries should permit access to bank information, directly or indirectly, for all tax purposes so

¹⁶ Improving access to Bank Information for Tax Purposes - 2000 OECD Report; April 2000.<http://www.oecd.org>.

¹⁷ Improving Access to Bank Information for Tax Purposes -2003 OECD Progress Report -23/2003/06/3/pl/ISBN/0264018840 - Dec. 2003

¹⁸ Exposure draft of Electronic Payment systems - Accoutability Guidance -Prepared by the OECD CFA, Forum On strategic Management, Centre for Tax Policy &Administration dated 16.4.2002

that tax authorities can fully discharge their revenue raising responsibilities and engage in effective exchange of information with their treaty partners".

¹⁹Enforcement issues and possible solutions

(i) Prohibition of anonymous accounts.

Financial institutions have been required to identify their usual or occasional customers, as well as those persons in whose benefit a bank account is opened or a transaction carried out.

Prohibition of anonymous accounts will lead to a greater deal of transparency in banking transactions which in turn will result in easier monitoring and enforcement of business conducted over the internet. There are no longer any OECD countries where anonymous accounts can be opened. The Banking Act of Austria was amended on 22nd June

¹⁹ *ibid*, Foot Note 18 at Pgs. 6-15

2000 to prohibit anonymous bank accounts to be opened as on the 1st November 2000. Hungary did likewise as on 1st January 2002, as did the Czech Republic as on the 31st December 2002.

Much action and initiative has been taken by the Financial Action Task force on money laundering in order to reach such positive results. In Poland, which was the only country which did not have legislation in place setting down mandatory requirements, the Polish Money Laundering Act of 2000 was amended in 2002 to lay down stringent guidelines.

(ii) Review of any domestic tax interest requirement that prevents the tax authorities from obtaining information for a tax treaty partner, in the context of a specific request, is necessary with a view to ensuring that such information can be exchanged by making changes, if necessary, to their laws, regulations and administrative practices.

Domestic tax interest requirement can be an impediment for tax authorities to share information with the Treaty partner. A time frame of April 2003 was set encouraging countries to frame legislation or make necessary changes in this respect.

The U.K. in 2000 gave its assent for the introduction of legislation, invoking statutory information powers on behalf of a contracting State. Other countries such as Ireland, Luxembourg, Greece and Japan have also included provisions to this effect in their legislation.

Such acts, on the part of the States however are purely voluntary and are not mandated or compulsory. Nothing except political pressure could persuade the State to adhere to international obligations.

This obligation to obtain and furnish the information requested by a Treaty partner,

irrespective of domestic interests has been set out in paragraph 16 of the OECD commentary to Article 26, extracted below.

"This obligation is clearly evidenced by the practices of Member countries which show that, when collecting information requested by a treaty partner, Contracting States often use the special examining or investigative powers provided by their laws for purposes of the application of their domestic taxes even though they do not themselves need the information for applying these taxes"

(iii) The determination of the term 'Tax Fraud'. One significant step that has been initiated and which will go a long way in minimizing tax evasion activities at an international level, is a common understanding of the term 'tax fraud'. Tax fraud, as of now, is only an inclusive definition. It includes but is not restricted to:

"Failure to comply with legal record-keeping duties (including the preparation or use of false or incomplete records, the non-production of records, the destruction of records and the preparation and or use of forged documents.

Failure to comply with legal information reporting duties (including the failure to file an income tax return or any other official document upon which a tax liability is based).

The inclusion of false or misleading information (including the omission of information) in an official document that leads to an incorrect reduction in an amount of tax payable.

The arrangement of transactions or entities for the purpose of dishonestly reducing an amount of tax payable.

The organization of insolvency for the purpose of obstructing the collection of tax.

The deliberate making of incorrect claims to repayments or other entitlements. The deliberate failure to comply with tax obligations resulting or intended to result in an unlawful reduction of tax revenue."

This is particularly important in view of the fact that most countries apply "the double incrimination principle" when it comes to furnishing of bank information for criminal tax purposes. This would not be an impediment to exchange of information where the definitions of tax crimes are similar in both the States i.e. in the requesting and the requested States. It would, however, hamper proceedings where the definitions differ. For instance, Luxemburg and Switzerland are countries where narrow and dissimilar definitions of tax fraud, combined with the principles of double incrimination restricts the abilities of both States to exchange and

share information relating to criminal tax fraud cases.

One would see that the use of the advanced technology available would substantially help in this process. The '1997 OECD Standard Recommended Format' facilitates the automatic exchange of information. This is however, a delicate area since this information may also include bank information which naturally will be subject to data integrity and security concerns. These are sensitive issues, which cannot be compromised and will have to be dealt with cautiously and carefully. One way by which the process could be smoothed as well as streamlined, is by the addition of a clear stipulation in the Double Tax Avoidance Agreement between States, concerning the sharing of tax information which would include bank information pertaining to tax payers. There has also been talk of the allotment of a Tax

Identification Number (TIN) which would be very similar to the PAN Number issued by the Indian Income Tax Department. In the context of international trade and commerce, where tax payers the world over are participating in a global market, the issue of a TIN would facilitate transparency as well as bring order into the structure of international trade and commerce. Following the 1997 OECD recommendation along these lines, Sweden has passed legislation in May, 2002 making it mandatory for all financial institutions in Sweden to enter into transactions with non-residents only on production by them of their TIN. From the year 2005, all returns filed by Swedish institutions will have to contain the TIN number of non-residents with whom they have had commercial transactions. The use of these numbers will certainly speed up transactions as well as facilitate the verification of information in the return with that in their domestic records. A

possible further simplification of this scheme would be to use the domestic number allotted to the tax payer for all international transactions as well. For example, if an Indian enters into an agreement with a tax payer in a foreign State, the PAN number allotted to the Indian participant would have to be made available to the non-resident to be disclosed in his tax return and vice versa.

There will therefore, have to be a complete re-examination of policies and practices that do not permit tax authorities to have access to bank information, directly or indirectly, for purposes of exchanging such information in tax cases involving intentional conduct which is subject to criminal tax prosecution, with a view to making changes, if necessary, to their laws, regulations and administrative practices.

Appropriate initiatives will have to be taken to achieve access and verification of tax liabilities with a view to making changes, if

necessary, to their laws, regulations and administrative practices.

(vi) Improve the administrative feasibility and the capability of information systems.

It has become vital for all taxing jurisdictions to become technically and technologically savvy in order to meet the challenges that e-commerce poses. The designing of software to meet such ends and the use of state-of-the-art technology would help the revenue departments to stay abreast of the developments in the medium of online businesses. It is necessary, therefore, that officers of the tax departments are selected, based on their aptitude, and specially trained to handle issues relating to electronic commerce.

(v) Examine how to develop a voluntary compliance strategy to enable non-compliant taxpayers to declare income and wealth that they have in the

past concealed by means of taking advantage of strict bank secrecy laws in some jurisdictions.

The developing of a voluntary compliance strategy would also go a long way to enable an errant tax payer to declare income so far concealed, so that the slate can, so to say, be wiped clean and a fresh start made. The 2000 Report of the OECD had suggested that States make an effort to develop and popularize voluntary compliance strategies.

²⁰The Italian Government on the 25th September 2001 proposed a "Tax Shield Programme" in respect of capital and assets held off-shore by their Residents. There were 2 options provided, (i) to repatriate to Italy assets that were held abroad or (ii) report the assets for domestic tax purposes without repatriating them. 2.5% of the value of the assets would have to be paid as tax or in the alternative, Special State Bonds were issued to

²⁰ ibid

which the Tax payer could subscribe. A confidential return was to be filed setting out the disclosures made. The duration of the Scheme was between Nov. 2001 to 15th May 2002 and netted 54 billion Euros to Italy. A similar Scheme has been proposed by the Financial Act for the year 2003 as well, pertaining to income from income generating activities abroad received not later than the 31st December 2001 by the Italian Resident.

A similar scheme was also implemented by the United States Internal Revenue Service on the 11th of December 2003. This Scheme revised and updated a practice that has been long prevalent in the United States regarding recommendation of a case for criminal prosecution.

Where voluntary disclosure of an asset which has been unreported for long has been made, it would constitute an important factor in the ultimate decision regarding the referral of the case for

criminal prosecution. This practice has now been modernized with certain built in conditions regarding the "timeliness" aspect. However, it is to be noted that the practice is mainly customary and discretionary. It does not automatically grant any immunity from prosecution.'

²¹On the 16th of December, 2002 the then German Chancellor Gerhard Schroeder, announced an Amnesty Plan aimed at reclaiming funds invested abroad. A 25% withholding tax was proposed to be levied on the same. The Federal Govt. proposed a Draft legislation on the 18th June 2003 offering the tax payers a "bridge to tax honesty", which stipulated the following conditions:

"The tax payer must disclose after 31 December 2003 but before 1 January 2005 the total amount of all income subject to tax that has not been reported after 1992 and before 2002.

²¹ *ibid*, Foot Note.18

The taxpayer must pay within 10 days of disclosure 25% of the disclosed amount. If the unreported income is disclosed after 31 December 2004 but before 1 April 2005, the amount to be paid is 35%."

(vii) Encourage non-OECD economies to improve access to bank information for tax purposes.

Member countries with dependent or associated territories or which have special responsibilities or taxation prerogatives in respect of other territories, were encouraged to promote, within the framework of their constitutional arrangements, the implementation of the above measures in those dependent, associated or other territories in the same time frame.

On a general note, the OECD has also recommended that in order to streamline international tax, development of certain pockets of the world would not suffice. It has suggested

adoption of all these recommendations by all States. It is to be noted that the atmosphere internationally is leaning towards a harmonisation of guidelines adopted for international commerce, including E-Commerce. Subsequent to the ²²Harmful Tax Practices Project, 32 taxing jurisdictions made a firm political commitment to enact legislation for the effective sharing of information, commencing from the 1st of January 2004. A number of other countries are in the process of negotiating Tax Information Exchange Agreements based on the OECD model agreement on exchange of information in tax matters, developed by the OECD's global forum working group on Effective exchange of information.

The interesting feature to note in this working group is that Membership is open not only to OECD Member countries, but also to several other

²² Harmful Tax Practices Project aims at recommending and implementing various remedial measures to correct enforcement related issues. For more details see <http://www.oecd.org>.

committed jurisdictions which think along similar lines.

Software for the taxation of e-commerce.

An important development in the area of Enforcement is that the ²³Business Application Software Developers' Organisation (BASO) has, in its press release dated 16th December 2003, detailed the development of an international software for guidance in tax administration, which is a significant step forward in the development of a global standard for software called the "Standard Audit File".

The Software seeks to crystallize all the issues that arise for the business community as well tax authorities in dealing with E-Business accounting systems and the need to facilitate one's access to these systems to verify their compliance with tax laws. The Modus operandi would be to

²³ Press Release dated 16th December 2003, <http://www.basda.org/>
<http://www.oecd.org>

build in a Standard Audit File into a regular business accounting software which will be subject to approved and valid confidentiality provisions, making it possible for one to extract data from the accounting systems by tax authorities and other Government agencies.

The Report recognises the need to take into account the fact that the data requirements vary from one country to another and the recommended software will have to be conditioned to suit the tax systems of each country.

It however remains to be seen as to how willing, the assessee would be to make available, particularly to the tax authorities and Governmental agencies, the details of its business accounts as well as bank information. The lofty aims of this software could be made more practical by including in it a set of requirements that could be made mandatory by all tax jurisdictions

to aid the revenue department in determining the identity and source of taxable transactions.

The Indian Perspective

¹India has kept pace with the rest of the world in realising the potential of tax revenues in e-commerce. Since commercial transactions conducted over the internet are international transactions, though with the added dimension of taking place in the virtual world, the provisions of the Indian Income Tax 1961 would be, broadly speaking, applicable to it.

Sec. 5 of the Income-tax Act, 1961 deals with the charge of income which accrues or arises in India and contains a deeming provision as well, by which all income deemed to accrue or arise in India is also brought to charge. The provisions of Sec.9 are an indicator as to the type of incomes which though arising elsewhere, are deemed to accrue or arise in India for the purpose of levy of tax. The

The Report of the Hi Powered Committee on Taxation of Electronic Commerce constituted by the CBDT, Executive Summary-See

constitutional validity of this Section was tested before the Federal Court in the case of A.H.Wadia - vs- CIT (1949, 17 ITR p.63) and it has been held to be not ultra vires the constitution. The matter in question came under the purview of the 1922 Act and the Federal Court by a majority judgement held that the bringing in of money into British India within the knowledge of both the parties concerned would give rise to a real territorial connection and therefore would be liable to tax. Patanjali Sastry J. in his minority dissent, opined that the bringing in of money into India could not be deemed unless it had actually resulted in the accrual of income in India and therefore there would be no liability under the Indian Income-tax, Act 1922 since it did not constitute sufficient territorial connection.

²The applicability of Sec.9 is restricted to incomes under certain enumerated categories. The main plank on which income is deemed to accrue or arise in India is through the existence of a ³'business connection' in India.

The following Explanation 2 and Explanation 3 have been inserted after the renumbered Explanation 1 to clause (i) of sub-section (1) of section 9 by the Finance Act, 2003, w.e.f. 1-4-2004:

Explanation 2.- For the removal of doubts, it is hereby declared that "business connection" shall include any business activity carried out through a person who, acting on behalf of the non-resident,-

(a) has and habitually exercises in India, an authority to conclude contracts on behalf of the non-resident, unless his activities are limited to the purchase of goods or merchandise for the non-resident; or

² See Text of Sec.9 of Indian Income Tax Act 1961

³ See Text of Sec.9 of Indian Income Tax Act 1961

(b) has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident; or

(c) habitually secures orders in India, mainly or wholly for the non-resident or for that non-resident and other non-residents controlling, controlled by, or subject to the same common control, as that non-resident;

Provided that such business connection shall not include 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;

Provided further that where such broker, general commission agent or any other agent works mainly or wholly on behalf of a non-resident

(hereinafter in this proviso referred to as the principal non-resident) or on behalf of such non-resident and other non-residents which are controlled by the principal non-resident or have a controlling interest in the principal non-resident or are subject to the same common control as the principal non-resident, he shall be deemed to be a broker, general commission agent or an agent of an independent status.

Explanation 3.- Where a business is carried on in India through a person referred to in clause (a) or clause (b) or clause (c) of Explanation 2, only so much of income as is attributable to the operations carried out in India shall be deemed to accrue or arise in India.

The above insertions are in keeping with the advances made in business and commerce,

particularly, Electronic Commerce. ⁴It is being increasingly recognized that the nature of Trade and Commerce the world over is undergoing tremendous change. Electronic Commerce has given rise to newer methods of conducting business which include variations of conventional methods as well as the adapting of accepted methods to suit the new medium of commerce.

The Explanations extracted above would render India E-Commerce ready, in that, the definition of business connection has been broadened to include within its ambit activities which would facilitate commercial transactions conducted online in different corners of the world.

Double Taxation Avoidance Agreements give rise to various issues which are vital to determine the taxability of the International Transactions.

⁴ Congressional Research Service Report for Congress dated Feb 22, 2002
-Order Code RL 31293 issued by Rita Tehan, Information Research
Specialist Information Research Division.

Some of the issues concerning DTAA's and their interpretation came up for the consideration of the Supreme Court in a land mark judgement in Union of India vs. Azadi Bachao Andolan reported in 263 ITR p.706. The salient facts of the case necessary to appreciate the various conclusions are:

Double Taxation Avoidance Agreements are entered into by the Government of India with Governments of other countries to prevent fiscal evasion as well as avoid double taxation. The Union of India entered into a double taxation avoidance agreement with the Govt. of Mauritius and the Agreement was brought into force by the issue of a Notification dated 6th December 1983. Vide Circular dt. 30th March 1994, numbered 682/94 a clarification was issued by the CBDT that capital gains arising out of alienation of any shares of the Indian Government shall be taxable only in Mauritius and not in India. Subsequent to and

relying on the Circular, there was a great deal of investment by Foreign Institutional Investors (FIIS) in Mauritius, in shares of Indian companies. The obvious reason was the large profits that were expected to be made by sale of shares which would not be taxable in India.

This was questioned by the Department. The Corporate veil was sought to be lifted alleging that the FII's were mostly "shell companies" which, though incorporated and operating in Mauritius, had been set up with the main purpose of investing funds in India. Since the control and management of these companies was not in Mauritius, they were not resident in Mauritius, and therefore were not eligible for the benefits of the Double Taxation Avoidance Agreement between India and Mauritius. There was a flurry of withdrawal of funds resulting from the issue of the show cause notices by the Income Tax Department. The Finance Ministry

responded by issuing a Press Note clarifying that the action taken by the assessing officers was only in specific cases and was not representative or indicative of the policy of the Government with regard to the taxability or benefits accruing to the FII's. To further clarify the situation the CBDT issued Circular No.789 dated April 13th, 2000 as under:

"Circular No.789:

F.No.500/60/2000-FTD

Government of India, Ministry of Finance
(Department of Revenue),
Central Board of Direct Taxes, New Delhi,

Dated 13th April 2000

To,

All the Chief Commissioners/Directors-General of
Income-tax.

Sub: Clarification regarding taxation of
income from Dividends and capital
gains under the Ino-Mauritius
Double Tax Avoidance Convention
(DTAC) -Regarding.

The provisions of the Indo-Mauritius DTAA of 1983 apply to 'residents' of both India and Mauritius, Article 4 of the DTAC defines a resident of one State to mean any person who, under the laws of that State is liable to taxation therein by reason of his domicile, residence, place of management or any other criterion of a similar nature. Foreign Institutional Investors and other investment funds, etc., which are operating from Mauritius are invariably incorporated in that country. These entities are 'liable to tax' under the Mauritius tax law and are, therefore, to be considered as residents of Mauritius in accordance with the DTAC.

2. Prior to 1st June, 1997, dividends distributed by domestic companies were taxable in the hands of the shareholder and tax was deductible at source under the Income-tax Act, 1961. Under the DTAC, tax was deductible at source on the gross dividend

paid out at the rate of 5 per cent, or 15 per cent, depending upon the extent of shareholding of the Mauritius resident. Under the Income-tax Act, 1961, tax was deductible at source at the rates specified under section 115A etc. Doubts have been raised regarding the taxation of dividends in the hands of investors from Mauritius. It is hereby clarified that wherever a certificate of residence is issued by the Mauritian authorities, such certificate will constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the DTAC accordingly.

3. The test of residence mentioned above would also apply in respect of income from capital gains on sale of shares. Accordingly, Flls, etc., which are resident in Mauritius should not be taxable in India on income from capital gains arising in India on sale of shares as per paragraph 4 of article 13.

The aforesaid clarification shall apply to all proceedings which are pending at various levels."

A Public interest litigation was filed challenging the said Circular and seeking to quash it. The Delhi High Court quashed the Circular.

The matter was taken up on appeal by the Union of India before the Supreme Court. The questions that came up for the Supreme Court's consideration were,

(i) the effect of the Circular issued by the CBDT and its binding nature;

(ii) Was the impugned circular ultra vires Sec. 119?

(iii) is Treaty shopping illegal?

The Supreme court considered initially the purpose and consequence of states entering into Double Taxation Avoidance Conventions and the Treaty making powers of a State as part of its sovereign powers. An important question that was

considered by the Supreme Court was, what would prevail in the event of conflict between the provisions of the Income Tax Act and a Notification issued u/s 90. Sec. 90 deals with Agreements entered into with Foreign countries.

The question of which would prevail in the event of a conflict between the two has been considered by the Andhra Pradesh High Court in CIT -vs- Visakhapatnam Port Trust (144 IT 146). The Andhra Pradesh High Court after going into the provisions of the Double Taxation Avoidance Agreement held that the provisions of Sections 4 & 5 would be subject to the provisions of Sec.90. It was concluded that the impugned transactions would be subject to, and governed by the terms of the DTAA, if any. The Calcutta High Court in CIT -v- Davy Ashmore India Ltd. (190 ITR 626) reiterated this view, holding that in case of conflict between the terms of the agreement and the Statute, the

Agreement would prevail. The Calcutta High Court was dealing with a circular dt. April 2nd 1982 numbered 333 which provided as follows:

"The correct legal position is that where a specific provision is made in the Double Taxation Avoidance Agreement, that provision will prevail over the general provisions contained in the Income-Tax Act, 1961. In fact the Double Taxation Agreements which have been entered into by the Central Government under sec. 90 of the Income-tax Act, 1961, also provide that the laws in force in either country will continue to govern the assessment and taxation of income in the respective country except where provisions to the contrary have been made in the Agreement.

Thus, where a Double Taxation Avoidance Agreement provided for a particular method of computation of income, the same should be followed, irrespective of the provisions in the Income-tax

Act. Where there is no specific provision in the Agreement, it is the domestic law, i.e. the Income-tax Act, that will govern the taxation of income." The validity and the correctness of the Agreement was upheld by the Calcutta High Court.

The term, "Business connection" contains no fetters, since Section 2(13) of the Act deals with an enumerative definition of "business" which is not exhaustive. The term has been open to interpretation in a series of judgements from CIT - vs- R.D.Aggarwal & Company (56 ITR 20) which lays down the ground rule that a continuity between the business of the non-resident and the Indian activities is essential. The Privy Council has in CIT -vs- Currimbhoy Ebrahim & Sons Ltd., (3 ITR 395) stated that the term "business connection" is in fact much wider than the term "business" and cannot be precisely pinned down to one set of rules or regulations. This rationale has been reiterated

in various later decisions of the High Courts. The Bombay High Court, as early as 1969 stated that the term "Business connection" would have to be interpreted on the facts of each case (Blue Star Engineering Company (Bom) (P) Ltd. -vs- CIT (73 ITR 283) .

One challenge that Electronic Commerce throws up is the dissemination of services rendered over the net. Quite apart from the question of the trace ability of this service, whether it would amount to a business connection has been considered by the Supreme Court in Barendra Prasad Ray -vs- ITO (129 ITR 295) which laid down that the Section was wide enough to include the term "profession" under the umbrella of "Business connection". The clear principles that emerge from the ratio of decided cases are applicable to the taxation of Electronic Commerce in today's time and place.

The Supreme Court and the High Courts have consistently been holding in favour of the Double Taxation Avoidance Agreement, when it conflicts with the terms of domestic law. This is on the ground that Sec.90 has been introduced to specifically empower the Central Government to issue Notifications, for implementation of the provisions of DTAA's with countries. The implication clearly is in favour of the provisions of such an agreement operating even if it is inconsistent with the provisions of the Income Tax Act. The Supreme Court has noted that Sections 4 & 5, which deal with the charging of income to tax and ascertainment of total income have, expressly been made "subject to the provisions" of the Income-tax Act. The obvious reason would be to empower the Central Govt. to ensure that DTAAs would automatically override the provisions of the Income-tax Act to the extent to which the

provisions of the latter are inconsistent with the terms of the international agreements. The Revenue in ⁵Azadi Bachao Andolan's case also relied on the principles of stare decisis in coming to its conclusion that the provisions of the DTAA's will supercede the provisions in domestic law, but this was negated by the Apex Court on the ground that the proposition was one that had been consistently followed, and following the ratio of earlier Supreme Court Decisions, a rule laid down and followed for several years, should not be displaced lightly, even assuming that it was found to be incorrect later .

For the purpose of this Thesis, we would be concerned with the treatment of the concept of 'Treaty Shopping' by the Supreme Court. E.Commerce by its very nature, and being unfettered by geography, can be misused leading to significant

⁵ 263 ITR 701

tax evasion. It would be possible for an Entrepreneur to set up a web site or a company owning and running a web site, in a country or a State where the laws most favour reduced tax incidence. The resultant situation would be that though based in a place of one's choice where the levy of tax would be minimum, the Entrepreneur could still do business with the rest of the world, thus benefiting greatly by his chosen place of business, to the detriment of International as well as Domestic Commerce.

This is how the Supreme Court defines "Treaty Shopping". "Treaty Shopping" is an expression, used to describe an act of a resident of a third country taking advantage of a physical treaty between 2 contracting States. The Supreme court, quoting ⁶McNair observed thus," that any necessary implantation by Municipal law has been carried out,

⁶ Referred to by the Supreme Court in 263 ITR 701 at 747 extracted from 'The Law of Treaties', Lord McNair-Oxford, Clarendon Press, 1961.

there is nothing to prevent the nationals of "third States" in the absence of any express or implied provision to the contrary, from claiming the rights or becoming subject to the obligations, created by a Treaty".

There are instances where, if it was intended that a national of a third State should be precluded from the benefit of the Double Taxation Avoidance Agreement, a suitable clause setting out the term of limitation is incorporated in the Treaty itself. For instance, Art. 24 of the Treaty between India and United States on Avoidance of Double Taxation specifically sets out the limitation subject to which the benefits under the Treaty can be availed of.

In terms of E.Commerce therefore it becomes important that to prevent a situation such as the one examined by the Supreme Court in the Azadi Bachao Andolan case, it would become imperative for

Agreements between States to include such a clause setting out clearly the terms and situations to which the application of a Treaty would be limited. This would prevent misuse of the Treaty, by unscrupulous entrepreneurs intending to set base in a State where the rates of taxation are favourable, as a result of which the international community would be deprived of legitimate tax revenues.

One cannot but recognize the importance of enforcement issues in taxing E.Commerce. Assuming that a policy for taxation has been put in place, the practical application of the same gives rise to many issues which will have to be resolved before the system would commence to work satisfactorily. Though various Governments have been concerned with the study of enforcement issues, barring regional specifications that may vary, the rest are by and large common. They are :

- ⁷(i) The identity or location of parties to the transaction;
- (ii) The anonymity of transactions and accounts;
- (iii) Intermediation;
- (iv) Transfer Pricing Issues;
- (v) Online delivery and Net cash;
- (vi) Easy access to tax havens and low tax jurisdictions;
- (vii) Identification of taxing jurisdictions;
- (viii) New Evasion opportunities;
- (ix) Recovery of Taxes;
- (x) Exchange of Information;
- (xi) Tax payer service opportunities.

⁸Trade and Commerce in the virtual world, virtually means that one is not aware of who is doing what and where. Transactions take place in space and disintegrate there, without leaving any

⁷ Report of the 16 Powered Committee on the Taxation of Electronic Commerce, Chapter 3, Enforcement Issues in Electronic Commerce Pgs.148-170

⁸ Electronic Commerce - Taxation and Planning - David Hardesty - <http://e-commerce.tax.com/ectp-toc.pdf> © Copyright 2001 RIH

trail which can be picked up or followed. This is further complicated when payments are made using Electronic cash, since even data trails which will help in detection and monitoring of a transaction will not be available. Once the technical and technological problems concerning delivery, payment etc., are sorted out, there is further scope for online commerce to grow expeditiously. It becomes necessary, therefore for Tax administrators to have adequate responses ready to meet challenges as they arise. The following suggestions have been made by various international and national agencies to tackle the issues.

(i) With respect to the anonymity that parties to E.Commerce transaction have, it is being recognized that technology itself can be utilized to trace the identity and location of internet users. Governments will have to enforce special measures such as compulsory registration of names,

mailing addresses, telephone and fax numbers of all customers with whom they have dealings, on their website, itself. There is a crying need for revenue authorities to enforce, promote and popularise such initiatives.

⁹(ii) The recommendations of the High Power Committee of the CBDT include among others:

(a) The department should work in tandem with business organisations, and put in place mandatory systems which would minimise the risk of non compliance.

(b) Agencies like the Customs and Central Excise Departments, Exchange Control Departments, The Reserve Bank of India, CBI, RAW, Narcotics control Beureau etc., should be involved to devise a uniform system to restrict and control the anonymous nature of the internet. This common

⁹ ibid ,Foot Note -1

approach by various agencies in a sustained manner will soon yield results.

(c) The Department will have to create Committees and special cells at the administrative level to tackle administrative problems and work out and clearly specify the rules and regulations and penalties imposable for violation of the mandatory principles enunciated.

(d) The High Power Committee that was set up, admitted that concealment of amount is not new to the system. Concealment is rampant even in Brick and Mortar enterprises. The provisions in the Indian Income Tax Act therefore relating to concealment, penalties and prosecution could be applied even in an E.Commerce situation. However, the ingredients of Electronic commerce businesses and electronic commerce transaction should be included in the text of the Income Tax Act wherever applicable.

Based on the studies and research undertaken by me, the following measures are suggested:

i) The Central Government had till recently initiated the 1/6 scheme whereby persons who satisfied one of six conditions had to mandatorily file a return of income whether or not, they had taxable income to declare. Likewise, it could be made mandatory for any person engaged in an online commercial transaction to file an income tax return, irrespective of the income. Noncompliance shall be visited with appropriate Penalty. This would help in keeping a check on the commercial usage of the internet and ensure that maximum coverage of taxable transactions is achieved.

ii) The Income Tax Act has countered the laundering of black money by the inclusion of Sec. 269 SS and 269 T. These sections provide for the imposition of penalty where loans in excess of specified amounts are given or taken in cash. The

primary objective is to reduce cash transactions and prevent the circulation of unaccounted funds. Likewise, a provision could be introduced for the compulsory disclosure of internet transactions of a commercial venture irrespective of whether they attract liability to tax or not. The provision would be revenue neutral, but open to imposition of penalty in the event of noncompliance.

iii) Sections 131 and 132 of the Act dealing with production of evidence as well as search and seizure under the Income Tax Act should be amended to include a list of Electronic documents as well.

(iv) Though the High Power Committee constituted by the Central Board of Direct Taxes was of the opinion that it was not necessary to define the term "Electronic Commerce" in view of the fact that the general principles of commerce would include the same, it is suggested that in

view of certain peculiarities of this medium of commerce which have to be addressed differently than from conventional means of commerce, a comprehensive definition of what would constitute "Electronic Commerce" be included in the Act. Other Associated and allied terms should also be defined clearly for purposes of the levy of income-tax.

¹⁰Concept of a Gross Base Tax:

The 'Base Erosion' approach has been offered as one possible and viable alternative to the current concepts dealing with allocation of tax revenue. The basis of this approach is the permanent establishment principle which has the advantage of having withstood the test of time. Yet, application of the permanent establishment principle as it exists today may pose problems in

¹⁰Concept of a Gross Base Tax dealt with in 'Changing Income Tax Treaty Principles a Bit?' Richard L.Doernberg © 2001, Emory University School of Law, Atlanta, Georgia-Tax Notes International, 20th Nov. 2000, Pgs.2417 to 2430 (Special Reports)

that the States importing Electronic Commerce may be unable to share in the tax base generated and the expansion of it may not solve the issues and problems caused by the growth of Electronic Commerce. The base tax approach is currently used in International Tax Law, realizing the concern that administrative burdens have to be practical and achieved. The flip side is that a gross base tax could become exigible even on a loss. This, however, has become an accepted norm in International Taxation.

The arguments against the concept are that by its very nature, a gross base tax is not workable because more and more payments that are not currently subjected to taxation would be brought into the tax net. Though it has been suggested that on account of this factor, the tax rates may be pegged at a very low percentage, it remains to be seen as to how receptive the world

business community as well as taxing jurisdictions would be to this proposal. The arguments that can be put forward in its support are that it is a tried and tested concept and is therefore not new to the arena of International Taxation. It is, admittedly simple in contrast to the Permanent Establishment Rule which requires examination on a case to case basis. Though the levy of a gross base tax would be easier in terms of administration the trade off element which jurisdictions have accepted for the treatment of Royalties and other specified payments is what might tip the balance in its favour.

The question of what would be the appropriate rate has been considered at length, but the conclusion reached is that the answer would be largely political.

Since the Emerging Erosion Committee is now appraising international law concerns, it remains

to be seen as to how the various issues are tackled practically, as and when they arise.

¹¹At a policy level, the Committee agrees with the view that the characterization of payments should not change with the mode of delivery from physical to digitized form. The Committee also recommends that a clear position on each category of transaction should be taken by the Central Board of Direct Taxes ("CBDT"). This will ensure uniformity of approach among all the assessing officers. For the taxpayer, it will ensure certainty of the tax burden.

On an overall appraisal of the situation existing today, it appears that no specific or new law is required to be enacted for the taxation of E.Commerce and specific and peculiar situations created by Online delivery and payments made by

¹¹ Report of Hi Powered Committee on Taxation of Electronic Commerce, constituted by the CBDT - Chapter 2 Pgs. 49-147- See Foot Note 1.

electronic means. ¹²The High Power Committee has, however, recognised that developments in these areas are extremely fast phased and one would have to be very diligent to monitor and modify existing laws as it is deemed fit to keep pace with changes that take place.

¹³It has been recommended that, along the lines of legislation like the "Controlled Foreign Corporation" (CFC) Legislation in the United States, similar measures should be initiated and adopted in India. This legislation enables the taxation of specified incomes like those from deferred dividends from concerns in nil tax jurisdictions and therefore operates as a measure to control and regulate investments. However, it is possible to circumvent the same by a tax payer opting for the citizenship of the low or nil tax jurisdiction in order that they may reap

¹² ibid

¹³ ibid

the benefits available from the same. In the United States penalties are imposed on such deviations in the form of ceilings on their visits to the United States.

The High Power Committee has opined that the long term remedy for the prevention of evasion would be to phase out favoured tax treatment for export income. According to it, it is the export income angle which mainly facilitates the transfer of funds illegally. The withdrawal of incentives for the same would result in streamlining and controlling this area.

¹⁴CHARACTERISATION OF E-COMMERCE PAYMENTS:

Given below is a comparative table on the characterization of Electronic Commerce payments, vis-à-vis the OECD view, the Treaty view and the stand as per the Indian Income Tax Act.

¹⁴ ibid

Transaction	Suggested Characterization
1. Electronic Order processing of tangible products	Business profits
2. Electronic ordering and downloading of digital products	Majority-Business Profits Minority-Royalty for right to make a copy
3. Electronic ordering and downloading of digital products for purposes of copyright exploitation	Royalty
4. Update and Add-ons	Treat like (1) if delivered on a tangible medium Treat like (2) if delivered electronically
5. Limited duration software and other digital information licenses	Business profits if provided on a tangible medium. Downloaded projects: Majority-Business profits. Minority - Royalties
6. Single-Use, Software or a Digital product	Mixed View - Either contracts for services or treat similar (2) and (5)
7. Application Hosting- Separate License	Business profits.
8. Application Hosting - Bundled Contract	Business profits.
9. Application Service Provider (ASP)	Business profits.
10. ASP License Fees	Same as (2)
11. Web site hosting	Business profits.
12. Software maintenance	Principles for dealing with mixed contracts (11 of Article 12 commentary) applies.
13. Data warehousing	Business profits.
14. Customer support over a computer network.	Business profits.
15. Data retrieval	Majority- business profits. Minority - consider (2)
16. Delivery of exclusive or other high-value data	Same as (15)

17. Advertising	Business profits.
18. Electronic access to professional advice (e.g. consultancy)	Business profits.
19. Technical information	Royalties became received for supply of know-how.
20. Information delivery	Same as (15)
21. Subscription-based interactive web site access	Payment for services.
22. Online shopping portals.	Business profits.
23. Online auctions	Business profits.
24. Sales referral programs.	Business profits.
25. Content acquisition transactions.	Royalties, if site operator pays content provider for right to display copyrighted materials. Business profits if operator pays for creation of new content and becomes the owner of the copyright.
26. Streamed (real time) web based broadcasting	Business profits assuming customer not allowed to download copyrighted material permanently.

Tax Havens

¹A study on the taxability of Electronic Commerce will not be complete without a discussion on the impact of Low tax or Nil tax jurisdictions on E-trade and commerce. Many of the tax havens enjoy a major world status as places of investments in various sectors of trade and commerce. ²There are however concerted efforts being made by international organizations to minimize their negative impact with the OECD and the U.N. leading the way. Entrepreneurs engaged in E-Commerce have seen the potential for doing business from a base in a nil tax jurisdiction since these low/no tax regimes make ideal places for the setting up of a Service Hosting Web site.

Tax Havens are competing with each other to attract or retain businesses and financial resources that will add more to their economy, over what is

¹ See <http://www.offshorepress.com>

² See Harmful Tax Practices Project in <http://www.oecd.org>

consumed. It is a dream situation for any country in the world to have their resource base expanded in any way possible including E.Commerce, without depleting their lasting resources of land, labour and supplies.

For the past several years, strenuous efforts are on to try and break this cycle. The ethical issues involved have been brought to focus by International Organizations and are slowly being curbed. The result of all this international effort has culminated in a situation that is more controlled than what it was. Voluntary co-operation as well as political pressure has, to a large extent, been responsible for this.

The OECD has done pioneering work in identifying and carrying out negotiations with tax havens in order to control and regulate them. Low Tax Havens, like Newis and Barbados have recently

issued ³ letters agreeing to participate and cooperate in the area of taxation.

In accordance with Global thinking, the Internal revenue code of the U.S. has released a set of regulations concerning the disclosure of confidential transactions in February 2003. This requires tax payers to disclose participation in certain specified classes of transactions with Residents of Tax Havens. These are referred to as "Reportable Transactions". Any assessee, who participates in a Reported Transaction is required to attach a disclosure statement to his Tax return disclosing it and estimating the tax benefits therefrom. The list of Reportable Transactions includes among others confidential transactions in

³ The OED has issued a list of 31 co-operative Tax Havens on 18/4/2002 which is available on <http://www.oecd.org>, which have made commitments to transparency and effective exchange of information. The following have been listed as yet, unco-operative

1. Andorra
2. The Principality of Liechtenstein
3. Liberia
4. The Principality of Monaco
5. The Republic of the Marshall Islands
6. The Republic of Nauru'
7. The Republic of Vanuatu.

which the tax payer participated on condition of confidentiality. The ⁴revised final regulations issued by the Treasury Department of the United States on December 29, 2003 restricts the application of the Reportable Confidential Transactions clause to those in which (i) the Advisor restricted the disclosure of the transactions to the Tax structure and Tax treatment (ii) the Advisor is paid not less than 25,000 Dollars.

While these guidelines framed by the International community would go a long way in streamlining international commerce and the taxation aspects thereof, particularly with reference to E.Commerce, it is to be noted that they are clearly advisory in nature. There is yet no Global Agency or institution which can enforce the performance of these regulations or make

⁴ New and Improved Disclosure Regulations & Proposed Reporting Requirements for Foreign Disregarded Entities - Baker & Mckenie

them mandatory. It is therefore left to each country to realise the importance of adhering to an honourable standard with respect to the issues raised and conform to the same.

Transfer Pricing:

Tax Havens or Low tax jurisdictions assume importance in the light of developments in Transfer Pricing methodologies. ⁵By hiving off a big profit earning part of a Multi-national to a jurisdiction where the tax incidence on its income is very low/nil, the tax obligation is transferred by the multi-national to that jurisdiction. On ethical grounds this would amount to clear tax avoidance and operates against national interest, since the Government of that particular State spends considerable amounts on behalf of its citizens by providing infrastructure for their businesses as well as various facilities, including Education,

⁵ Transfer Pricing for Electronic Commerce - David Hardesty April 21, 2002, <http://www.e-commerce tax News.com/document/040702.htm>.

Health care etc. ⁶This is why the pricing of goods and services between associated businesses becomes critical. Under the OECD's Transfer Pricing guidelines for multi-national Enterprises and tax administrations it is defined as the process of settling the prices in respect of transfer of goods and services between Associated companies. What is to be determined is therefore is the "Arms length price" which is the price that any two concerns would have agreed on in respect of the same transactions, if they were not associated with each other. This is not a new problem and is not exclusive to Electronic commerce. What is new, however, is that E-Commerce results in greater integration of businesses at an international level which compounds the problem of Transfer Pricing. The problem becomes further compounded when income is earned through intangibles or by the digital

⁶ Transfer Pricing & Taxation, Manfred Davidmann, Community E.Commerce, Multinational Operations - source - The Internet

dissemination of services. The valuation and the allocation of profit to the various components of a transaction becomes vital. The delineation as well as the Indepth analysis of transfer pricing issues which impact Electronic commerce are beyond the scope of this Thesis and are therefore not considered in detail. Sections 92 to 92 (f) of the Indian Income Tax Act, 1961 deal with Transfer Pricing. These provisions set out in detail the various aspects of computation of income from international transactions. For the purpose of these provisions an Arms length price is defined as a Price which is applied or proposed to be applied in respect of a transaction between persons other than associated enterprises in uncontrolled conditions. Section 92 F(iii) (a) defines permanent establishment as a fixed place of business through which the business of the enterprise is wholly or partly carried on. The

details contained in Art. 5 of the OECD model convention do not figure here and neither does the reference to "Business connection". The application of Transfer Pricing guidelines is not new to India. In 60 ITR 28, M.C.P.M.Chidambaram Chettiar -vs- CIT, a Full Bench of the Supreme Court dealt with the transfer of assets in a HUF which was partitioned, the members constituting themselves into a firm to carry on money lending business. Businesses were started at Kuala Lumpur and subsequently a company was formed in Pudukkottai to acquire the foreign business. Later, the assets of the foreign company were transferred to the Indian company in consideration of which shares as well as bonus shares were allotted to the partners. It was held by the Supreme Court that in view of the fact that the

partners were acting in unison through out and had always had the power to enjoy all incomes from the company, the transfer was clearly made to avoid liability to taxation. The decision of the Madras High court was affirmed. The transfer pricing has therefore always been a concern in the domestic as well as international tax arena and has only become more complicated due to advances in technology as in the case of Parallel/Mirror sites, where the factor of traceability of the transaction would be compounded many times over.

CONSUMPTION TAXES, VAT AND A BRIEF NOTE ON THE
TAXABILITY OF INTANGIBLES

¹The levy of consumption and value added taxes on commercial transactions conducted over the internet is an issue that calls for resolution. The feature that has to be addressed is the fact that online services can either result in physical delivery of goods or in digital dissemination of goods or services. Consumption taxes on physical goods are levied at the place of consumption, but the dissemination of online services and digital goods can result from activities which happen simultaneously in many different corners of the globe. ²The allocation as well as assignment of the components of the sales to the various States therefore becomes extremely difficult. The levy of Consumption tax on

¹ Solving State & Local Use Tax collection Problems: A necessary First step before dealing with Use Tax Problems of Electronic Commerce -Kaye K.Caldwell, Software Industry Coalition, Santa Clara - <http://www.softwear Industry.org/Issues/docs-hum/usetaxwp.html>

² Online services & the Sales Factor in State Income Tax - David Hardesty Nov. 13, 2002 - <http://www.e-commerce-taxnews.com>.

E.Commerce transactions has been the subject matter of a great deal of research by the European Union. The Economic and Social Committee of the European Union, the Council, and the European Parliament, have been engaged in structuring the levy of value added tax and consumption taxes applicable to online sales, whether consisting of physical delivery or digital dissemination of goods and services. It has been observed, in the course of their research, that for the levy of consumption tax, the physical location of a business and management of its core activities and all allied and ancillary services, are generally losing significance. This is in direct contrast to the levy of direct taxes where a significant physical presence of the entity is mandatory in order to establish presence of activities that generate income. In view of the fact that E.Commerce has been seen to hold the promise of significant wealth

generation, it becomes important that taxation does not become a barrier to its growth , but should foster a climate whereby commerce can flourish and grow. ³The Lisbon European Council conducted on the 23rd and 24th March 2000 recognised the importance of "predictability" in the rules laid down for the levy of consumption taxes on E.Commerce.

Since 1997 the European Union has been working closely with representatives of 15 national tax administrations. It was found that the volumes of E.Commerce being what they are, existing legal provisions would be sufficient to monitor and police the same. A note of caution was, however, sounded in that, tax administrations should work keeping in mind changing market environments and anticipate increases in the volume of commercial transactions conducted over the internet. A set of

³ <http://www.eu.org>

guidelines to this effect were adopted in June, 1998.

This resulted in all supplies made within the European Union being subjected to Value Added Tax while supplies made to other jurisdictions were not. Another important conclusion that was reached was the need for evolving a new set of rules recognising and dealing with paperless invoicing - a prominent feature in e-commerce. The Economic and Financial Council (ECOFIN) highlighted the absence of control and enforcement of VAT payments on E.Commerce due to lack of trails, and to that end, voiced the need for the compilation of rules and regulations to monitor, trace and enforce the same. ⁴An extensive consultation process was initiated which culminated in a Round Table on the options for the European Union VAT System held in Brussels in January 1999. The work

⁴ Directive 2000/31/EC of the European Parliament and of the Council of 9th June 2000 - On certain legal aspects of Information Society services, in particular, Electronic Commerce, in the Internal market Official Journal L 178, 17/07/2000p.001-0016 <http://www.eu.org>

plan to be followed by the European Union was set out in phases. The first phase was enforcing the levy of VAT in the single market without really considering the long term commitments to a more definitive and globally accepted system of taxation and the degree of harmonisation that was required.

It was recognised that the compliance, control and enforcement models that were currently in place was likely to be inadequate to address the issue of online supply of digital products.

The proposal was that any modification should be based as closely as possible on the VAT system that operated currently. ⁵The use of the reverse charge system for transactions involving registered traders linked to the imposition of a registration obligation on non European Union operators supplying services to European Union non-taxable persons, was therefore proposed to be continued. However, this resulted in placing suppliers based

⁵ ibid

in the European Union on a comparative disadvantage as compared with operators who were outside the European Union. The remedy proposed the introduction of a new paragraph 2(f) to Art. 9 which transfers the taxation of services within the mischief of this proposal, to the place of supply of the same. Where the user is registered in a country other than where the supplier is established, liability for VAT will be assumed by him. Art. 9 (2) (f) stipulates that where supplies are made by taxable persons either within or outside the European Union, to Non Taxable persons within the EU, the place of supply will be the Member State where the supplier is registered.

It was also clarified that this proposal would not relate to any other services except the dissemination/delivery of service for a consideration. Free downloads or services

rendered free are not hit by it. These regulations were especially framed for transactions conducted over the Electronic medium-the dissemination of software, processing of data, which would include services like web designing, web hosting etc.

⁶All procedural aspects of the scheme were proposed to be concluded electronically, including, but not limited to, the registration of Member States, filing of tax returns etc. Another issue that was identified, but where no conclusion was reached was the rate of tax to be applied to different goods and services. The Commission has deferred the matter to be addressed in a future review of Annexe H of the 6th VAT Directive which enlists the rate of taxes to be applied to goods and services. ⁷This is inspite of concerns invoiced

⁶ Vat Information sheet 16/03 - which contains changes to VAT invoicing effective from 1/1/2004 <http://www.hmce.gov.uk/forms/notices/infol603.htm>

⁷ EU puts off action in harmonized VAT Rates - <http://EurActiv.com-News> nr 1506718 dated 26/1/2003

in the Media about a possibility of harmonized VAT Rates being put off for the time being.

A vital concern in the area of VAT proposals relates to the aspect of enforceability of the levies. It is one thing to formulate a scheme and systemize and prepare administrative aspects but quite another to enforce the scheme and recover taxes therefrom.

⁸Three factors were identified as being important in this aspect.

(i) The willingness of a non-European Union Trader to submit himself to voluntary registration;

(ii) The willingness of a non-European Tax administration to cooperate or be willing to accept the jurisdiction of the EU in enforcement procedures.

(iii) The Possibility of securing enforcement by any other means.

⁸ ibid Footnote No.4

The position as of now is that enforceability is largely dependent on the co-operation of the States and cannot be achieved by any other means.

A problem that is likely to arise in this context is the factor of "Member State shopping". There is a fear that revenue may be lost to those Member States with lower rates of VAT, since the proposal states that registration should take place in the Member State, where a taxable supply takes place. In view of the fact that the internet is an open medium without constraints or barriers of limitation, this is clearly open to manipulation. A "Clearing House System" was advocated to redistribute the total tax collected, but the question raised was how practically workable that would be. Thought was given to another measure that may be introduced to secure compliance in terms of payment of VAT. It was acknowledged, albeit reluctantly, that reliance cannot be placed

totally on voluntary compliance and that a basic change of the system by introducing a tool for directing enforcement will have to be developed, if the scale of evasion is to be controlled. It was suggested that credit cards could be the medium through which control could be exercised. But how?. Either the supplier from outside the EU should consent and cooperate or more drastically, the bank should be approached to levy VAT on all transactions which have been charged to the card. Apart from raising ethical issues and concerns of privacy, there can be no legal embargo on the bank to disclose such collections; further, credit cards are not the only medium of payment for E.Commerce transactions. The discussion continues and the question remains unresolved though hotly debated.

The new rules were given political assent on the 12th February 2002. ⁹Formal adoption happened however only on 7th May, 2002 when the Council directed the adoption of 2002/38/EC. Parallely, the Council adopted Rectified Regulation 792/2002, which temporarily amended Article 218 of 1992 dealing with administrative cooperation in the field of indirect taxation. It was now formalised under the new rules, that European Union suppliers will no longer be obliged to collect VAT while dealing with markets outside the European Union. This removed a significant competitive handicap.

¹⁰The Travel Industry has rallied together to protest against the proposed scheme. The Executive Director of the European Tour Operators organization, in a statement made recently stated that while transport in Britain per se is zero

⁹ For Text of Directive, See <http://www.eu.org>

¹⁰ EU Commission VAT Proposal will hit Travel Agents - Jason Goinge - <http://www.News.Com>, London. dated Monday, October 06, 2003

rated as far as value added tax is concerned, any change made in the European countries would override U.K. legislation.

There has, therefore, been some criticism of the scheme on the ground that some more time ought to have been allowed for the system to mature before an attempt was made to formalise rules for it.

One is left wondering whether the action taken by the EU, before the rest of the Globe deliberated and came to a conclusion on the issues concerned, was premature. However the efforts made by the EU in this regard are a big leap. Though its attention is focused primarily on the member states of the EU, it has provided the rest of the world with a blueprint of a probable scheme and at any rate, with much food for thought.

VALUATION OF INTANGIBLES

¹¹An Intangible is an asset that has value, which is independent and unconnected to the services of any individual and which derives its value not from physical attributes but from its intellectual contents or other inherent properties.

¹²This would include goodwill, rights in trade marks or trade names, technology which has patented or copy-righted materials, know-how etc. In Electronic Commerce, ¹³Intangible assets are of two kinds :

Marketing Intangibles which are used to market and sell products and services and Trade Intangibles which are used in the production of products or the dissemination of services. Since an intangible would have market worth that would be peculiar to itself and not comparable with or based on other

¹¹ OECD Transfer Pricing Guidelines for Multinational Enterprises & Tax Administrations (1995) <http://www.oecd.org>.

¹² See 'Cahiers de droit fiscal international' -Vol.LXXXIa-on Taxation of Income Derived from Electronic Commerce, International Fiscal Association, 2001. San Francisco Congress-KLUWER, The Netherlands.

¹³ Textbook on International Taxation -Prof.K.C.Gopalakrishna, Snow White Publishers, Bombay 2001.

See also Taxation of Software Licences, Prevention by Ajay Vohra for the International Fiscal Association, Southern Regional Chapter, Madras

intangibles in the market, the valuation of the same assumes importance. Market valuers would value the intangibles based on (1) the cost of acquisition of the same (2) income generating capacity of the asset and (3) the market perception or determination of the worth of the assets. Electronic Commerce enterprises are heavy users of intangibles and the rules for valuation of intangibles would therefore impact greatly on this medium of commerce. ¹⁴The Organisation for Economic Co-operation and Development has issued a set of guidelines and pricing rules concerning intangibles. Transfer pricing guidelines adopted for intangibles in international trade, particularly for Electronic Commerce are similar in many respects to those adopted for tangible property. The methods used would be (1) Comparable Uncontrolled Price Methods (CUP) (2) The Profit

¹⁴ OECD Guidelines on Transfer Pricing-See <http://www.oecd.org>

Split Method (PS) (3) The Comparable Profits Method and (4) other unspecified and indigenous methods.

A significant portion of Electronic Commerce also involves the dissemination of Software commercially. ¹⁵Software transactions can be either inbound or outbound and can be broadly classified into unbranded software and shrink wrapped software. The former refers to software which is specialized and custom made to cater to the needs of individual clients. Shrink wrapped software, also called branded software is that which is standardized and marketed. It consists of a programme or a series of programme consisting of instructions either for the operational processes of computer itself or for the accomplishment of other tasks and is usually accompanied by a shrink wrap licence. The transfer of software itself can be done in two ways. (1) Where the licence holder

¹⁵ Textbook on International Taxation -Prof.K.C.Gopalakrishna, Snow White Publishers, Bombay 2001.

of the software transfers only the right to use the software to the purchaser of the same and (2) where the licensee of the software transfers complete ownership in the software to the buyer pursuant to which he obtains all the rights to dispose of the software in any manner which he chooses without any interference from the seller. In the former instance, it is a transaction of simple sale which gives rise to taxable business profits, while in the latter instance where the copy right itself is transferred, a royalty is payable.

Article 12 (2) of the OECD Model Convention which deals with royalty makes the distinction between the characterization of software payment as royalty or business profit or in a third instance, to a mixed contract where there is a sale of computer hardware along with bundled software. In the third instance, the consideration should be broken down into the components and is treated

either as royalty or a business profit where nexus is established on the basis of the permanent establishment threshold.

CONCLUSIONS

As a result of the Study undertaken by me, I have reached three independent conclusions. The taxation of trade and commerce conducted over the internet is an evolving area and it will continue to develop as long as business continues to be conducted over the internet. ¹Statistics, as we saw earlier, indicate clearly that the figures are upwardly mobile. The broad issues and challenges that this medium throws up have been discussed in detail in the previous pages. The conclusions that I have reached are based on historical advances in the various concepts that are applicable to international taxation in general and E.Commerce in particular.

²The time may be ripe, for a foray into the past and a new look at the various proposals set

¹ For details See Chapter on STATISTICS

² For details See Chapter on History of Taxation of International Commerce

out by economists under new circumstances, and in today's times.

Conclusion I was discussed with³ representatives from the Organization for Economic Cooperation and Development, Paris at International Tax Conventions conducted by the International Fiscal Organisation at Bombay, India.

CONCLUSION 1

This Thesis suggests the establishment of a Global Tax Authority under a Multilateral Treaty to which a majority of States would be Signatories. Preliminary sessions would be required at regular intervals, to arrive at a common agenda and identify issues that need to be addressed in the Treaty. This Authority would require the adoption of harmonized International Accounting Standards for measuring the International income/Profits with respect to Electronic Commerce transactions.

³ See Acknowledgements

The Authority will facilitate the process of computing the share of revenues in respect of E-Commerce transactions attributable to a particular State. This necessarily implies that the Authority should adopt an ⁴International Tax Language that is truly Global. The minimilistic approach which characterizes this proposed system would be critical to its acceptance and success. The proposal only envisages an apportionment of the gross revenues from a transaction and does not require the participating countries to surrender the sovereign right to determine the tax liability. The Authority computes the income allocable to a state applying the parameters set by the Multilateral Treaty and the applicable International Accounting Standards.

⁴ As suggested by Janardhana Rao, J of the Andhra Pradesh High Court in CIT Vs. Visakhapatnam Port Trust (144 ITR 146)

The initiative for this would have to come from International Organizations like the OECD or the EU.

⁵The Concept of a TIN, referred to earlier -the Tax Identification Number-could be made mandatory, so that records pertaining to assesseees could be centralized and maintained. Cross references between the internationally granted TIN and a domestic Taxpayer Identification Number like the Indian PAN would then be possible.

The enforcement issues are automatically delegated, for reasons of simplification and effectiveness and also since it is beyond the scope of the Treaty, to the domestic recovery and enforcement Agencies of the particular nation.

This proposal can also envision a social angle. A percentage of the revenues collected from

⁵ See Enforcement Issues in Chapter on OECD

Electronic Commerce in proportion to the total tax revenues earned by a particular nation would go into an international fund to be used in times of acute global crisis.

Only the broad framework has been set out herein, and the nuts and bolts of the same will have to be examined by the various committees that will have to be set up.

Social welfare has so far been narrowly interpreted to mean furthering the interests of a particular State. In the context of a global market such as E.Commerce, the revenues should be applied in the international arena for the common good of the world community.

CONCLUSION-2

In the field of Direct taxation, the permanent establishment Principle has so far been a conclusive and decisive factor in determining the taxability of International transactions. The

Economic Allegiance Test has been gaining in popularity over the past several years and is today seen as a modification and extension of the PE concept. This has also found favour with courts and other judicial authorities, who have consistently been looking beyond the mere wording of the section to the substance. I draw inspiration from the writings of ⁶Klaus Vogel in reaching this Hypothesis.

The term economic allegiance is broad and does not stipulate any specific situation or set of conditions attributable to it. This flexibility of interpretation is exactly what is called for in the context of e-commerce.

As ⁷Klaus Vogel has opined, the stage is set for Economic Allegiance to "one day be the nucleus of a sophisticated international tax law".

⁶ Should Europe adopt a uniform method for the Avoidance of Double Taxation? Klaus Vogel

⁷ ibid at Pg.10

Just as the conflict of International Law would have to be resolved by determining the "Centre of Gravity of legal relations", the Centre of Gravity would, in this context, refer to a test as to whether ⁸"the State has provided some protection, opportunity or benefit for which it can expect a return".

In connection with the context of electronic commerce as we have seen, the physical has become irrelevant. All components of a commercial transaction are virtual and sometimes impossible to grasp. The most relevant factor to fix the taxability of Electronic transactions is therefore to examine and determine which State has sourced the maximum economic activity relating to the particular transaction. The connection and nexus are then established.

⁸ The United States Supreme Court in Quil Corp. Vs North Dekota, 504 US 298 (1992)

This Conclusion neither concurs with the⁹OECD's guidelines for the application of the currently existing permanent establishment theory to taxation of electronic commerce, nor with¹⁰India's "Base Erosion Approach"

It considers that the economic allegiance to which a State is entitled should be the more appropriate yardstick for determination of the taxability of an E.Commerce transaction. This is particularly applicable to a virtual transaction where, various components occur in different parts of the world. Traditional rules pertaining to a fixed permanent establishment might not serve the purpose in fixing Nexus. One should therefore determine where maximum economic activity has taken place in order to fix the nexus or the business connection.

⁹ OECD Clarification on the Application of the Permanent Establishment Definition in E-commerce-changes to the commentary on Article 5-
<http://www.oecd.org/dal/treaties/clari-e.pdf>

¹⁰ The Report of the High Powered Committee on Taxation of Electronic commerce constituted by the CBDT- http://www.laws-india.com/indiantax_laws/notification/econcontent.asp

This would necessitate appropriate amendments or inclusions to be made in the OECD Model Law on Treaties as well as the Double Taxation Avoidance Agreement between nations.

CONCLUSION 3

Incrementalism as an approach, would involve making a change by taking small steps to bring about the desired end results. ¹¹Charles.E Lindblom in his Article "The Science of Muddling Through" has described two approaches on how to deal with problems - The Root Method and the Branch method. The former was also called the Rational and Comprehensive method of decision making and even according to Lindblom, would be practically impossible to achieve. It would require evaluation of one's own values regarding a given situation as compared with values of others regarding the same situation. After this a decision would have to be

¹¹ See US Public Administration Review (1959)

made taking into account all the values and variables involved.

The latter involves putting into motion procedures such as clarifying the objective, and comprehension and classification of the values for a systematic analysis. This would be possible only in a problem of very small magnitude where all the variables would be known and limited. He, therefore, advocated the evaluation and empirical analysis of a system both of which are interlinked, where attention is focused on incremental values rather than approaching the entire issue at one time. Lindblom's suggested approach to problem solving therefore could well be the basis and approach for solving issues concerning the Taxation of Electronic Commerce.

In an analysis of his earlier Article, titled¹² "Still Muddling not yet Through" upgrades his ideas on problem solving in keeping with societal changes.

The Taxation of E.Commerce is most likely to raise newer problems and issues as advances in technology come about. It is best, therefore that we cross one bridge at a time and tackle each issue as it arises rather than attempt to solve the problem wholesale, at one go.

My first Conclusion would be an ideal one. The second, a practical approach using a tried and tested method. For both to succeed however, the approach required is the Incremental method as suggested by Charles E.Lindblom.

¹² See Us Public Administration Review Nov - Dec 1979.Vol 39 Issue 6
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