

TAXATION OF “*THE DIGITAL ECONOMY*”

Digital Goods and Digital Services – Pervasiveness in Digital Economy

India has rightly embarked on a path for “Digital India” in line with world economies in transforming to a digital economy. The move in 2015 budget towards a “near cashless” economy will further significantly contribute to the transformation in to Digital Economy.

Whereas Internet and Internet based online transactions have been there for some time now, the transformation at scale for a large country like India and other countries or continents like USA, Europe and Australia as a single “digital market” is being recognized now and has associated challenges. Apart from the tangible hardware, cables, networking and telecom equipment, the “Digital Economy” will be overwhelmed with “Intangibles” i.e. “Digital Goods” (Products with one or more of Software, Audio, Video and Data) and “Digital Services”.

The emergence of Digital Economy globally has a power to disturb and outmanoeuvre tax systems if not accommodated well in time. Hence, globally there are developments to address the taxation of Digital Economy. US is late on the track, but has a well drafted bill under consideration called “Digital goods and service fairness act”. EU since 2015 has already started taxing VAT on all Digital Goods and Services on consumption irrespective of the country of sale or origin. Consultation papers are under progress at OECD for taxation on digital economy and BEPS.

India too is a large country with 29 states and a single digital market has the potential to be a significant economic contributor. All these burning issues affect India as well. Hence, India cannot afford to overlook the taxation of “Digital Economy”, as “Digital India” emerges in to a single digital market. There is an urgent need to address these concerns and evolve a neutral, simple and fair tax system on “Digital Goods” and “Digital Services”.

Traditionally the taxation on intangible goods and services has been marred with double taxation, litigations and confusion in the industry. It is an opportune time, just as GST will be rolling out shortly in the country.

However, GST alone will not solve the problems of intangible goods and intangible services without clearly defining them. Software business is evolving as well as are the lines of differentiation between pure software and other digital goods.

Customised software is giving way to readymade products, large monolithic software products are being replaced by small mini and micro size products. In addition in large number of situations the software may not be standalone, it may work with either data, audio or video products. Similarly the Audio, video or data products may have a software product running them. Hence Software product, sounds, images, data, and facts or combinations of them may exist as a “Digital Product/Goods”.

A digital economy will be overwhelmed with trade of not only digital goods and digital services, but also the trade of “right to use” or “transfer of right to use” just as there is “deemed sales” or “transfer of right to use” of tangible goods.

Recognizing the tradability in “Digital Goods” is one the most important need of a “Digital Economy”. The current system creates a high level of resistance to trade e.g. Software in Income Tax Act is treated as “Royalty” and subject to TDS. A book is traded as a product (a tangible good), whereas the contents are copyrighted. So a buyer buys the book and not the copyright. Similarly in the case of a software product, the buyer buys the product and not the copyright. However the tax treatment is as if the buyer has purchased the copyright. If the dichotomy is addressed, it would help the fledgling industry unlock capital which unnecessarily gets blocked.

The volume of such trade will be huge in future as the digital economy is unleashed. Anderson said, “Software is eating the world”. Another quote from Eric Schmidt, “there will be so many sensors, so many devices, that you won't even sense it, it will be all around you”. Similarly, “Internet of Things” is a known concept globally. All these reflect the pervasiveness of “Digital” in future economies. The world has started recognizing it and moving along the idea.

Hence, the concerns of single Indian “digital market” can be addressed by clearly defining “Digital Goods” and “Digital Services” in the tax system.

A generally accepted principle across the ongoing discussions in world, on taxation of digital economy is that there **should not be any special tax regime** for digital companies and they should comply with the general rules.

Adapting existing and proposed (GST and Income tax Acts) with a clear definition of “Digital Goods” and “Digital Services” as proposed in this document can not only solve existing problems but also provide future proof solutions.

The emergence of a “Digital Economy”, therefore imposes an urgent need to:

- Introduce the concept of “intangible” goods and treat them as “Goods”
- Clearly demarcate “Digital Goods” and “Digital Services” and remove ambiguities.
- Bring in measures for ease of doing business in “Digital Goods”.
- Recognize that tradability of “Digital Goods” and unlock the industry in segments of Software Products and other Digital Goods.
- Bring in the concept of input credit to digital goods and digital services across the value chain of trade.
- To ensure neutrality and provide a level playing field for Indian companies
- Help India to emerge as a Single Digital Market
- Help India take early action to align with global development in the direction of taxation of Digital Economy

Definitions

DIGITAL GOOD - The term “digital good” means any software product or other good that is delivered or transferred electronically, including sounds, images, data, facts, or combinations thereof, stored and maintained in digital format, where such good is the true object of the transaction, rather than the activity or service performed to create such good.

DIGITAL SERVICE - The term “digital service” means any service that is provided electronically, including the provision of remote access to or use of a digital good.

For purpose of above definitions, the term

- (i) “Digital Goods” means “Goods” as defined in 366(12) of the Constitution
- (ii) “Digital service” means a “service” as per section 65B(44) in the Finance Act, 2012 and that which is not a “Digital Good”
- (iii) “Delivered or transferred electronically” means the delivery or transfer by means other than tangible storage media, and
- (iv) “Provided electronically” means the provision remotely via electronic means
- (v) “Software” is a representation of instructions, data, sound or image, including source code and object code, recorded in a machine readable form, and capable of being manipulated or providing interactivity to a user, by means of a computer or an automatic data processing machine or any other device or equipment. And, “Software Product” is a standardised set of such software bundled together as a single program or a Module that directs computer's processor to perform specific operations, exhibiting the properties of an intangible good that can be traded.

Explanatory Note:

The goods exhibit the following properties:

- a) Durability (perpetual or time bound)
- b) Countability – traded commodity can be counted as number of pieces, number of licenses used, number of users etc.
- c) Identifiability – identified as a standardised product
- d) Movability and storage. Can be delivered and stored and accounted as an inventory
- e) Ownership of the right to use
- f) Produced/Reproduced through a process
- g) Marketable/Tradable or can be marketed and sold using standard marked price (except when volume discounts, bid pricing and market promotion offers are applicable).

as distinguished from services that are consumed either instantly or within very short period of time or continually coinciding with the activity of provision of service.

Digital goods exhibit all these properties plus the property of being stored and maintained digitally.

This definition of “Digital Goods” will also imply that sales and purchase of “Digital Goods” will be governed by same laws as for “Goods” in the constitution and various acts thereof. Hence just as Goods are subject of “sales” under article 366(29A) so will be “Digital Goods”. It is important in the context of “ease of doing business” in trade of “Digital Goods” and removing the present confusion on taxation in trade of “Digital Goods”.

The “right to use” as a deemed sales of digital goods to be used or consumed at future instance(s) can also be delivered or transferred digitally. It can be a PIN or a Password or a combination of biometric and password to allow access to digital goods.

In digital economies, many a times “Digital Goods” are stored on a remote server or maintained digitally on a remote location by a producer or its agents/dealers/distributors for use or access by clients and users.

An act of use or remote access of “Digital Goods” by using the access PIN or password acquired in advance through a trade or commerce transaction in “right to use” of such “Digital Goods” shall be an act of trade or commerce in “Digital Goods” and not of “Digital Service”.

Recommendations to implement

It is recommended that:

- a) Definition be introduced through a finance act in proposed budget 2016-17 and also the following provisions be addressed.
- b) Also a clarity be inserted that “Digital Goods” will mean “Goods” for all purpose including “tax on the sale or purchase of goods” as defined in Article 366(29A) which also includes the “transfer of right to use digital goods”.
- c) Both GST and Income tax ACT to refer to the same definition for purpose of “Digital Goods” and “Digital Service”. Relevant clauses needing changes can be produced through a separate detailed document.
- d) Need for a Tariff code (HS Code) for Digital Goods.

The future lies with recognition of “Digital Goods” as an international standard and WTO involvement in the accepting these principles.

In the interim, India can adopt a workable solution.

At present, all that is not covered under HS Code classification as given below (mostly software/digital goods downloaded online or SaaS Software) is treated as a service, despite the fact that packaged software and SaaS is the same whether traded on a media or online as a medium.

HS Code	Item Description
4907 00 30	Documents of title conveying the right to use Information Technology software
4911 99 10	Hard copy (printed) of computer software (PUK Card)
8523 80 20	Information technology software on Media

Source: DGFT HS Code Database and CBEC

A HS code classification for following categories can be issued using the last 2 digits (first 6 Digits being defined under international system) Or Until a global harmonious classification emerges a codes may be defined under chapter 98/99.

Following category of definition will solve the issues of Digital Goods

- (i) Pre-packaged software (Software Product) downloads
- (ii) Software Product supplied as S-a-a-S model
- (iii) Sale of “Right to use” digital goods
- (iv) Digital Goods other than Pre-packaged Software

Some countries have created a HS code under 98/99 for Downloaded Software e.g. China has a code under 980300 for Computer software, not including software hardwired or integrated in products. Similarly some countries are using 9916 as a code for pre-packaged software.

- e) Both the Direct tax (Income tax act) and Indirect tax (Excise and Service Tax or GST) should take reference to same definition for purpose of “Digital Goods” and “Digital Services” as applicable.

The above proposal of definition and the measures in recommendations can solve the issues faced by the industry and also provide solutions when GST is rolled out. It shall also help in “ease of doing business”, lubricate trade, ensure neutrality and fair practices as well as provide the much needed level playing field.

The proposal does not create any loop holes in system as it does not recommend the change in the tax regime. It merely recommends the changes desired to accommodate the rise of digital economy.

References

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3. BEPS ACTION 1: ADDRESS THE TAX CHALLENGES OF THE DIGITAL ECONOMY 24 March 2014 – 14 April 2014 <http://www.oecd.org/ctp/tax-challenges-digital-economy-discussion-draft-march-2014.pdf>