White Paper:

History of Indirect Taxation in India and Principles of Indirect Taxation on Online Gaming

EXECUTIVE SUMMARY

Technology has been the driving force in defining the growth of nations over the past few decades. The digital economy has been a space of constant and rapid innovation. We have witnessed multiple new business models emerge in time frame and can expect business model disruptions to happen at a much faster pace with the advent of web 3.0. Naturally, this means that the government will have to consistently build new frameworks and apply existing precepts of law in a manner that balances regulation, economic growth and revenue generation goals of the government.

This note highlights how the concept of supply of services under taxation framework has developed in India wherein taxation authorities have consistently adopted and designed approaches that are based on a sound understanding of business models. To this end, the note highlights how the taxation of online services has developed overtime and in doing so the different models of taxation that have been framed by the government such as the OIDAR scheme. In all these models, the approach has been driven by established canons of taxation and a careful lens has been applied in distinguishing services from goods for the purposes of determining the taxable event.

These models have clearly laid out what constitutes the scope of service and taxable event as part of these services. To this end, the GST law has also incorporated this approach and adopted a unified framework for taxation of all forms of online services.

The note goes on to highlight that the case for taxation of online skill gaming is not different from other forms of online services. Based on the current reading of the GST law and allied policies and even the historical understanding of supply of service, it is amply clear that the platforms do not engage in any supply of goods and the only supply of service is the platform features that are offered for the benefit of the user. The deposits made by users on these platforms cannot be considered to be in the form of consideration offered to the platform. In fact the only consideration made to the platform in lieu of the services is the platform fee that is charged by the operator of such platforms. Importantly, the services offered by such platforms are not in the nature of betting and gambling and they have been recognised as legitimate businesses, the Supreme Court and different High Courts in the country and have been held to enjoy constitutional protection.

Therefore, the note argues that it would be unjustifiable for any taxation authority to deviate from existing standards and proceed to levy GST on the prize pool on these platforms especially when: The determination of the taxable event is clear i.e. the platform fee charged by the

operator of the online gaming platform ; Prize pool or deposits by users are not consideration paid to the platform and cannot be considered to be either a supply of good or service ;there is a clear lack of nexus between the prize pool and the actual supply of service ;There are no supply of goods or actionable claims as part of the transaction; and there is a clear distinction in law between online skill based games and betting and gambling, wherein the former enjoys constitutional protection like any other legitimate online service.

To this end, it is recommended that taxation authorities adopt a rational approach while evaluating the methodology for taxation of online skill games, which is in line with the innovative and principle based framework that they have followed for distinguishing online services from goods and maintaining a clear nexus between the supply of service and the taxable event. Any departure from this carefully designed approach will create the risk of altering the entire concept of supply of service and will be perceived as a retrograde step impacting India's digital economy.

1. HISTORY OF TAXATION IN SUPPLY OF SERVICES

a. Historically, the government of India introduced an indirect tax levied on the services offered by the service providers, effective from 1st July, 1994 vide chapter V of the Finance Act, 1994. Initially, under the service tax regime, 3 services namely Telephone Services, Non-Life Insurance Services and Stock Brokers' Services were subject to taxation, but gradually the tax was extended to 119 services.

b. The concept of taxation on services was changed from a Positive List of services approach to a 'Negative List regime' in July 2012 changing the entire taxation system of services.[1]

c. The question of what constitutes as a "supply of service" has been challenged on multiple occasions:-

i. Larsen & Toubro Ltd. v. State of Karnataka[2]: The Karnataka High Court held that software supplied electronically constitutes a supply of services and is taxable under Service Tax Act. The court also held that the transfer of the right to use the software is a supply of services and is taxable under the Service Tax Act.

ii. Maheshwari Mining Pvt. Ltd. v. Union of India[3]: The Court held that the activity of excavation of minerals from mines and their transportation from the mine site to the purchaser's premises is a supply of services and is taxable under the Service Tax Act.

iii. Bhayana Builders Pvt. Ltd. v. Union of India[4]: The Punjab and Haryana High Court held that the sale of developed plots by a builder to buyers is a supply of services and is taxable under the Service Tax Act.

[1] https://www.cbic.gov.in/htdocs-servicetax/ovw/ovw1-1_st-ataglance-19may16.pdf
[2] (2014) 1 SCC 708
[3] (2018) 9 GSTL 462 (Raj)
[4] (2018) 9 GSTL 153 (Del)

d. To simplify, bring clarity, and ensure ease of business, on 8th September, 2016, the Constitution (101st Amendment) Act, 2016 introduced a new indirect tax regime in India - Good & Services Tax ("GST"). GST is levied on all supply of goods and services except alcoholic liquor for human consumption w.e.f 1st July, 2017. Therefore, the taxable event under GST law is supply of goods or services or both.[5]

e. It is important to note that the concept of supply of service has not changed but has just been simplified under Section 2(102) of the Act to include services other than goods, money, and securities made for consideration. Further, Section 7(1)(a) of the Act defines "supply" as "any form of supply of goods or services or both for a consideration by a person in the course or furtherance of business".

2. HISTORY OF TAXATION OF ONLINE SERVICES

a. Historically, operators supplying online services have faced multiple issues and there was confusion about the nature of transaction and who is liable to pay tax.

b. For instance, the online marketplace was often misconstrued as seller and even if the online marketplace's involvement in the transaction is limited to packing, repacking and forwarding the consignment to the buyer, the authorities often insist that the e-commerce player is the 'dealer' and is supplying goods and hence is liable to pay VAT/CST and undertake all related compliance.

c. Further, it was confused with supply of service and taxed it under the Service Tax Act. Thus, online marketplace faced the issue of double taxation and ended up paying both VAT/CST as well as service tax.

d. For digital products, online marketplace companies were experiencing difficulty in categorizing the offerings as 'goods' or 'services' for charging VAT or service tax.

3. CASE STUDY- TAXATION OF SOFTWARE AS GOODS OR SERVICES

a. Since the service tax regime, Information technology computer software has been a litigious issue primarily because of lack of clarity as to what constitutes supply of service for the purpose of taxation. Especially the tax liability in case of pre-designed softwares i.e. off-the-shelf or the use of encryption keys and the specific software designed to address specific requirements of the user.

[5] Section 2(108)

b. The GST regime has brought in much needed clarity on the issue. CBIC vide its sectoral FAQs[6] on Information Technology ('IT') and IT enabled services had reiterated that in terms of Schedule II of the CGST Act, 2017 'upgradation and implementation of information technology software or permitting the use or enjoyment of any intellectual property right are treated as services. But, if a pre-developed or pre-designed software is supplied in any medium/storage (commonly bought off-the-shelf) or made available through the use of encryption keys, the same is treated as a supply of goods classifiable under heading 8523.' Further, even the Tax Research Unit has made a clear distinction between two different classes of softwares.[7]

c. The said case provides and sets a precedence of how important it is that a "taxable event" is clearly defined and identified for the purposes of tax.

d. With the introduction of the Goods and Service Tax Act, 2017, a lot of aformentioned issues were resolved for operators offering online service.. The definition of e-commerce, e-commerce transaction and online information database access or retrieval services was added to tax online services which brought in further clarity.

e. The tax authorities have been consistently working on introducing a simpler tax regime that avoids multiplicity of taxation and leads to simplification and uniformity. The introduction of GST was truly a game changer for the Indian economy that while keeping the core principle of taxation into consideration has eliminated cascading of taxes and enhanced ease of doing business in India.

4. INTRODUCTION OF INNOVATIVE POLICY FRAMEWORKS FOR ONLINE SERVICES

a. FORMULATION OF OIDAR

i. OIDAR was brought under indirect tax net in India in 2001 under the service tax laws. In 2001, 15 services were added within the service tax regime, one of which was online information data access or retrieval services. It was noticed by CBEC that there are certain services such as services provided by website operators, internet service providers who charge customers for providing their services. They are an integral part of the internet operations and without their service, the data or information can neither be accessed nor retrieved. They are, therefore, liable to pay service tax on the amount charged from the customers.[8]

ii. Initially, the scope of OIDAR services included online services, supply of software, supply of information in database, supply on music online via downloading, supply of

[6] www.cbic.gov.in/htdocs-cbec/gst/sectoral-faq-it-ites.pdf
[7] Ministry of Finance (Department of Revenue) Letter D.O.F No. 334/1/2008 – TRU dated 29.02.2008
[8] https://taxindiaonline.com/RC2/pdfnoti/pdfsertax/pdf2001/instruct.pdf

distance learning, etc. In 2016, the scope of OIDAR services was extended to include electronic services.

b. **IMPORT OF SERVICES AND REVERSE CHARGE MECHANISM**

i. Generally, the supplier of goods or services is liable to pay GST. However, in specified cases like imports and other notified supplies, the liability may be cast on the recipient under the reverse charge mechanism. Reverse Charge means the liability to pay tax is on the recipient of supply of goods or services instead of the supplier of such goods or services in respect of notified categories of supply. The intention of introducing the concept of reverse charge mechanism was to check tax evasion and expand tax the base through self-policing by taxpayers

ii. Under the GST regime, Article 269A constitutionally mandates that supply of goods, or of services, or both in the course of import into the territory of India shall be deemed to be supply of goods, or of services, or both in the course of inter-State trade or commerce.

iii. While IGST on import of services would be leviable under the IGST Act, 2017 the levy of the IGST on import of goods would be levied under the Customs Act, 1962 read with the Custom Tariff Act, 1975.

iv. The importer of services will have to pay tax on a reverse charge basis. However, in respect of import of online information and database access or retrieval services (OIDAR) by unregistered, non-taxable recipients, the supplier located outside India shall be responsible for payment of taxes (IGST). Either the supplier will have to take registration or will have to appoint a person in India for payment of taxes.

c. **INTRODUCTION OF EQUALISATION LEVY**

i. Law in respect of Equalisation levy was introduced pursuant to Base Erosion and Profit Shifting-Action Plan-1(BEPS Action Plan 1) on Digital Taxation.

ii. It was noted that a lot of profit was shifted outside India and the companies were eroding tax by undertaking activities like online advertisement offshore.

iii. The Indian residents procuring advertising services from Platforms outside India, who did not have a permanent establishment in India get deduction for advertising expenses while calculating their taxable income but advertising income arising to non resident digital platforms remain untaxed in India.

iv. To tax such digital advertising services by way of Equalisation levy, Section 165 was inserted with Finance Act, 2016.

d. Thus, it is clearly visible that the taxation regime for the new age digital economy is still developing, while keeping the core principles intact. Some of these principles have been as follows:

   i. **The measure of tax shall have a nexus with the charge of tax.**
   ii. **There shall be a clear taxable event that shall be identified and tax shall only be levied with respect to the said taxable event.**
   iii. **All taxation policies relating to this sector should be guided by the canons of taxation**

e. Keeping the above principles in mind, the following sections examine the application of these principles to the online gaming industry.

5. RATIONALISING THE SCOPE OF SUPPLY PROVIDED BY ONLINE GAMING COMPANIES

The questions that need to be rationally examined are what is the nature of transaction on an online gaming platform. Whether the same is to be considered as a supply of service or supply of goods.

WHETHER THE PLATFORM FEE CHARGED BY ONLINE GAMING COMPANIES CONSTITUTES AS SUPPLY OF SERVICE?

a. On an online gaming platform there is only supply of following services -

   i. Gaming software to participants of a game which provides the following features:

      - Creation of contests where the participants can compete with each other;
      - Payment services and wallets for deposit of prize pool money;
      - Tabulation of points for and on behalf of the participants;
      - Collation of data, information, statistics, scores etc. to enable the users to make informed choices for competing in contest;
      - Updating of the leader-board point system during the ongoing contests between the users to ensure transparency;
      - Providing information of winners amongst the users after completion of the contests;
      - Facilitating escrow mechanisms for secure transfer of winning amounts to users;
      - Services for withdrawal of winning amount by users ;

b. For the abovementioned services, the online gaming platform charges a commission in the form of a “platform fee” from the users. These fees enable the platforms to cover costs of providing the technology platform and ancillary services for users to participate

in the contest. The “platform fee” for a paid format on an online gaming platform constitutes approximately 15-20% (might vary depending on the type contest) of the predetermined contest entry amount collected from users. It is only the “platform fees” that gets retained by the gaming platforms as a “consideration” for the platform services provided to the users/players. The sum total of the “platform fees” collected by the online gaming platforms across the various contests offered on its platform is known as ‘Gross Gaming Revenue’ (GGR).

c. The remaining part of the users deposit goes towards contributing to the prize pool money which is held by the platform in trust via an escrow mechanism in a fiduciary capacity for a brief period of time (i.e., from commencement of the game till its completion).

d. Subsequently, the “prize pool” is distributed amongst the winners. The platform does not have any right over the prize-pool fund/amount, which it merely holds in trust on behalf of the winners for a certain period of time. Thus, as far as the amount in the prize pool is concerned, it is not “consideration” in return for any services provided by the platform. In other words, since no services are provided in return for the money held in the “prize pool”, the same is not, and cannot be, a supply of services. As such, the question of GST on the amount in the “prize pool” does not arise.

e. For example - If a gaming company is hosting a game with contest entry amount of Rs. 1000, and 10 gamers participate in the game, each paying “platform fees” of Rs. 100 to the online gaming platform, the total value of the “prize pool” of winnings can be computed as follows:

   Total amount deposited with gaming company as contest entry amount = Rs. 1000x10 = Rs. 10,000

   Total amount collected by the gaming company as “platform fees” = Rs. 100x10 = Rs. 1000

   Total value of “prize pool” of winnings = Rs.10,000 minus Rs. 1000 = Rs. 9,000

f. The gaming company has no rights over the amount of Rs. 9,000 which remains deposited in a separate independent account. This amount must be paid to the winner(s) of the game at the end of the contest.

g. The gaming company itself is not a participant in the game and stands no chance of “winning” the amount of Rs. 9000 or any part thereof, nor does it carry the risk of losing for the reason that it would recover the “platform fees” from the participants. This amount would necessarily be disbursed by the gaming company to one or more of the 10 participants, depending on the rules and outcome of the game. It is open to the winner(s) of the game to do as they wish with this amount; it can either be immediately withdrawn

from the user account into which it is released by the gaming company or the amount may be retained in the account to be used for future gaming activity.

h. In either event, these funds remain with and exclusively accessible to the user/player. The consideration received by the gaming company, in the example above, is only Rs. 100 collected by it as “platform fees” from each user, which is subject to GST.

i. Thus, while it is clear that there is a supply of service by online gaming platforms for which it charges platform fees, the other question that arose is whether the prize pool can qualify as an actionable claim and be considered as a supply of goods and hence taxable.

WHETHER THE PRIZE POOL IS AN ACTIONABLE CLAIM ON ACCOUNT OF IT BEING A SUPPLY OF GOODS?

j. Section 7 of the CGST Act, 2017 provides for the scope of supply. Section 7(2) of CGST Act, 2017 specifies that activities or transactions listed in Schedule III shall neither be treated as supply of goods nor supply of services.

k. As noted above, the prize pool that is collected by the OGI is merely held as deposit by the OGI as a custodian on behalf of the winning users. There is only one taxable event for the OGI i.e. the supply of platform services by the operator to the players. Further, there is no nexus between the prize pool contribution and the taxable event of supply of service by the OGIs.

l. It is pertinent to note that the deposit towards prize pool contribution by the players is not a consideration for any supply made by the online gaming operators to the players and hence has no nexus with the taxable event, which is the supply of platform services provided by the operator. There is no supplier-recipient relationship between any parties qua the prize pool contribution. Since there is no supply of actionable claim by the operator to the users, GST is not payable on such prize pool contribution by the operator.

m. Online skill gaming industry which has legitimate protection under Article 19(1)(g) of the Constitution of India needs to be treated distinctly and separately from gambling and betting which are *res extra commercium* in nature and have no constitutional protection. Thus, as a corollary, for online skill gaming, the prize pool can neither be considered as supply of goods nor supply of services and cannot be considered as a value of supply.

n. While the position in law appears to be abundantly clear on this issue, we must consider another issue when there is clear determination of transaction value and clear demarcation of what constitutes as supply of service, can there be a deeming fiction created by legislature for deeming a taxable value.

WHETHER DEEMING PROVISION FOR VALUATION UNDER SECTION 15(4) OF CGST ACT BE USED WHEN THERE IS CLEAR DEMARCATION OF SUPPLY OF SERVICE?

o. The GST regime under Section 15(4) of the CGST Act, 2017 provides that the value has to be determined as per rules only if the actual value of the transaction is not determinable.

p. Hon'ble Supreme Court in the case of **Gannon Dunkerley and Co. and Ors. vs. State of Rajasthan and Ors**[9] while dealing with the issue of measure of tax under Central Sales Tax Act held that when the contractor does not maintain proper accounts, then is is permissible for State legislation to prescribe a formula for determining labour charges, however such charges shall not differ appreciably from that what would be incurred in normal circumstances.

q. The Supreme Court in the case of **Wipro Ltd. vs. Assistant Collector of Customs and Ors.**[10] held that if the actual charges are ascertainable, then introducing a deeming fiction is arbitrary and irrational and violative of Article 14 of the Constitution of India.

r. In case of online gaming industry, the value of actual value of supply is clearly determinable since the user on the online gaming platform is clearly informed of all the payment related terms and conditions, including the bifurcation of the contest entry fee into platform fee i.e. the actual value of supply and the prize pool. Therefore, the deeming provision for valuation under Section 15(4) is not applicable in the case of the online gaming industry.

6. JURISPRUDENCE ON NEXUS BETWEEN SUPPLY OF SERVICES AND TAXABLE EVENT

a. The concept of nexus between the supply of services and taxable event underlies an important concept in the field of taxation. In the context of the supply of services, the nexus refers to the connection between the provision of services and the occurrence of a taxable event.

b. In **Commissioner of Service Tax v. M/s Bhayana Builders (P.) Ltd**[11]**,** the Court while deciding upon the value of supply under pre-GST regime held that any amount charged which can become the basis of value on which service tax becomes payable has to be necessarily a consideration for the service provided which is taxable under the Act. Any amount charged which has no nexus with the taxable service and is not a consideration

[9] (1993) 1 SCC 364
[10] (2015) 14 SCC 161
[11] 2018-TIOL-66-SC-ST

for the service provided does not become part of the value which is taxable under Section 67.

c. In ***State of Rajasthan v. Rajasthan Chemists Assn.***,[12], the question arose that whether a particular taxing event of sale be subjected to tax at the prescribed rate to be measured with such price which is not the component of the transaction of sale, which has attracted the sales tax. The Hon'ble Supreme Court held that every transaction of sale is independent and can be subject to levy of tax and the components and the measure which can make the tax levy effective must have nexus with the taxable event,

d. Hon'ble Gujarat High Court in the case of **Munjaal Manishbhai Bhatt vs. Union of India**[13] while deciding upon the tax liability under the GST on the consideration paid towards the purchase of land, ruled that the measure of tax shall have a nexus with the charge of tax.

e. Therefore, in the case of the online gaming industry, any tax on the quantum of prize money would be beyond the nexus with the essential character levy i.e. the actual supply of the service of providing gaming platforms by the OGI. As noted above, the role of OGI is limited and therefore, there is no nexus between the provisions of the platform services by the OGI and the prize pool contribution made by the users.

f. Further, the tax liability for the online games offered by the OGI has to be distinguished from the tax liability from gambling and betting since the latter are "actionable claims" and fall within the definition of goods under Section 2(52) of the CGST Act, 2017.

g. The judgment passed by Hon'ble Supreme Court in the matter of Sunrise Associates case[14] and Skill Lotto Solutions case[15] does not apply to online skill gaming as these cases pertains to lottery which is a *res extra commercium activity* distinct from online skill gaming which is held to be legitimate business activity protected under Article 19(1)(g) of the Constitution of India. **Further, it is important to highlight that supply of online gaming is a service and involves two transactions unlike lotteries where supply of lottery tickets is supply of goods.** In online skill gaming, the first transaction is regarding supply of platform service and the second transaction is the actual gameplay between the players involving skill and judgment. Unlike in a game of skill where the user does not play against the house, in lottery, betting and gambling activities, users play against the house. The gaming house in lottery, betting and gambling activities profits when the user loses and there is also a probability of the entire

[12] (2006) 6 SCC 773
[13] (06.05.2022-GUJHC): MANU/GJ/1379/2022
[14] The State of Madras v. Gannon Dunkerley & Co. (Madras) Limited [1959] SCR 379
[15] 2020 SCC OnLine SC 990

amount being won by a gaming house. Thus, the judgment of Skill Lotto and Sunrise Industry cannot be said to apply to the online skill gaming industry.

7. LEARNINGS AND WAY FORWARD

From the above, it is clear that the basic principles of taxation needs to be taken into consideration while levying tax on any transaction. For the purpose of determining the methodology for taxing online skill gaming platforms the following concepts must be borne in mind :

a. Given the nature of business operations conducted by online gaming intermediaries, there is no supply of goods that's taking place. The only supply occuring on these platforms is a supply of service where the platform is playing the role of provisioning access to the game and allied features for the benefit of the user.

b. Accordingly, the taxable event can only be the supply of various services as listed above against which platform charges platform fees.

c. The nexus is between supply of service and charging of platform fees and there is no nexus of supply of service with the contribution made by the user in the prize pool.

d. Online skill gaming industry which is a legitimate industry needs to be treated distinctly and separately from gambling and betting which are *res extra commercium* in nature and have no constitutional protection.

e. Prize pool for the online skill gaming industry can neither be considered as supply of goods nor supply of services.

Therefore, based on the aforementioned concepts, approach and business model, it would be unjustifiable for any taxation authority to deviate from existing standards and proceed to levy GST on the prize pool on online skill gaming platforms.

To this end, it is recommended that taxation authorities adopt a rational approach while evaluating the methodology for taxation of online skill games, which is in line with the innovative and principle based framework that they have followed for distinguishing online services from goods and maintaining a clear nexus between the supply of service and the taxable event. Any departure from this carefully designed approach will create the risk of altering the entire concept of supply of service and could prove to be a retrograde step and thereby negatively impacting India’s digital economy. Accordingly, in the case of online gaming, the only taxable event can be the platform fee charged by the operator of the online gaming platform which constitutes as the supply of service.