

EVOLUTION OF E-COMMERCE IN INDIA

Taxation of e-Commerce Transactions (Part 3)

M.M.K. Sardana*

[Abstract: In this concluding part of the series of the Discussion Note on Evolution of E-commerce in India, impact of e-commerce on the prevailing concepts of tax regimes in cross-border trade and trade within the country are highlighted. It also discusses how the existing laws and understandings are coping with such an impact in a dynamic situation created by continuous technological development and innovation.]

In the absence of boundaries and physical nature of e-commerce transactions relating to goods and services, taxation of such activities raises several issues. E-commerce transactions are conducted worldwide—between parties residing in different states as well as countries. There is tremendous increase in the magnitude of cross-boundary transactions. By significantly reducing the transaction costs of communication and selling without regard to geographic boundaries or the size of the company, the tool of internet permits companies—that were earlier confined to local markets—to sell goods, services and information internationally. While tax authorities may track those e-transactions where goods are delivered physically, tax evasion becomes a distinct possibility in direct e-commerce. The techniques employed in the transmission of digitized information create difficulties in identification of the source/origin and destination of both production and consumption locations. Also, the technical feature of online transactions creates various problems for the taxing authorities, for instance, in establishing audit trails, verifying parties involved in transactions, obtaining documents, and fixing convenient taxing points. Internet operations lend anonymity to the parties in various ways despite the availability of email addresses and domain particulars. Concerns have thus been expressed that e-commerce could result in the evasion of taxes. Consumption taxes are levied according to: i) the principle of taxation

* The author is a Visiting Fellow at the Institute.

followed at the place of consumption, and ii) the rates that are set in individual countries or individual states in the case of federal nations. E-commerce has the potential of undermining the application of both domestic and national tax rules.

Generally, the physical presence or permanent establishment determines the jurisdiction that shall have the right to tax the income generated. Using e-commerce, tax payers can conduct business and generate income in a country/state with little or no physical presence in that country. Though this mode represents a significant change from historic business models, it poses challenges for administration and enforcement of tax laws. Perhaps, new concepts need to be included and addressed; for instance, to determine whether information can be precisely defined from legal, economic and technical perspectives to be recognized as an “asset” and hence liable for taxation. An emerging tax regime should be recognized both at the domestic and international levels and should evolve out of existing tax laws. At the same time, it should also remain in harmony with other branches of law for a smooth transition. Importantly, due to the primary objective of revenue generation, unrealistic compliance burdens are placed on e-retailers whose main concern may be with markets, growth and profit and not necessarily towards paying taxes. If workable rules, keeping this objective in view, are not placed in position, then several players may simply choose to ignore indirect tax requirements. Therefore, in the interest of a healthy competition, a sustainable indirect tax regime is the need of the hour, which will help reduce direct taxation—income tax and corporate tax.

Both developments in internet technology and growth of e-commerce are undermining the exclusivity of the state as a taxing entity within its jurisdiction. Taxation authority is likely to be shared with international forums and institutions to help improve the design and administration of tax policy for a conflict free e-commerce environment. In any such designing it is evident that focusing on the inherent advantages of technology would help establish international coordination and collaborative infrastructure for data sharing and analysis. A common thread that would sustain such an international understanding would be that the emerging designs are placed in operating mode without damaging the growth of e-commerce.

It may not be out of place to be aware of and remember that a web page can be constructed using materials from across multiple locations around the world, that is, physical and logical locations need not necessarily match. Thus, what appears to be a single website may, in fact, be a set of servers distributed around the world. All this would have obvious implications for enacting laws, including taxation law, relating to the aspect of jurisdiction.

For tax purposes, it must be recognized that the “subject matter” dealt with during e-commerce transactions could be either intangible goods, data products or tangible goods. Further this module (i.e. through the internet) of business provides for not only the means of making contracts, but also for the analysis of the performance. In a very broad sense, e-commerce transactions may be seamless from the point of origin to the endpoint and along the entire value chain of the business process. And, the process for conducting an electronic transaction is designed such so as to enable the accomplishment of a business goal. The processes may be partial or complete and may encompass business to business, business to consumer as well as consumer to business transactions. Thus, e-commerce may encompass a full value chain.¹

The above description presents three types of challenges ranging from *feasibility* challenges (whether the current regime can be applied to e-commerce) to *normative* challenges (whether the current regime should be applied to e-commerce) and further *acceptability* challenges (whether countries will accept the application of the current regime to e-commerce). It goes without saying that until a new international regime or practice is firmed up, the e-commerce mode of business has to submit to the current regime and cope with the associated challenges. Such challenges are not unique to the international tax regime in respect of e-commerce. Tax challenges are only one aspect of the difficulties faced while regulating the internet and gaining jurisdiction to set rules, to judge, and to enforce laws. Therefore, the practitioners of international tax regime have much to learn from other areas of law where territorial law—which has its unique characteristics—has been adapted for

¹ Basu, Subhajit (2007), *Global Perspectives of E-Commerce Taxation Law*, Ashgate.

application in cyberspace². The tools for making decisions on such adaptations vary from the Rulings of the courts to the adoption of new legislations and also international treaties and understandings. As in other fields, a law for taxing e-commerce income has to evolve. In such an evolutionary model, guidelines will be laid through court's Rulings and guidelines for developing income classification rules and residency rules. And, for such purpose, lessons can be drawn from instruments that bear similar challenges of adaptation in the fields of judicial jurisdiction, criminal and copyright law. Understandings within international tax regime superimposed by the Rulings of the courts should introduce new source rules, based on the location of the parties involved in the transaction as well as physical components of income-production process. Towards this end, the international tax regime as also the courts will be guided by the way technology—following the internet code of conduct—is used in e-commerce transactions. As evolution takes place, it may prepare the ground for developing an international treaty that will comprehensively encompass e-commerce features. This is the road with defined milestones to address the feasibility, normative and acceptability challenges.

Feasibility challenges to the prevailing international tax regime, which has been governing the conduct of nations in tax matters since 1920, include those on core issues such as Income Classification Rules, Source Rules, Permanent Establishment, Residency and Enforcement. These have been brought about by the capacity of information technology revolution that is capable of generating endless new products, services and introducing varied methods of business that do not conform to the conventional way of conducting transactions. A wide range of tangible/intangible goods and services are being traded through technology-aided new and even multimodal methods. For example, a book can both be a part of a database which is accessible to users and can also be downloaded as an e-book with the possibility of receiving updates. Such features of the business/income blur the distinction between “trade income” and “service income”. E-commerce thus cannot be easily classified according to the conventional categories. Similarly, the current

² Cyberspace is a domain characterised by the presence of a “virtual space” that is created by interconnected computers and computer networks on the internet.

source rules—which are strongly territory based—are not applicable straight away. In e-commerce, it is not easy to identify the precise location of the transaction. Source rule challenge is thus unique to e-commerce and may require a new understanding. A similar difficulty is encountered in determining the existence of a permanent establishment for conducting business over the internet, both physically and conceptually. Residence-based taxation, too, faces challenges in e-commerce because technology allows e-commerce operators to locate their company offices in low tax areas, which helps minimize their tax burden³.

Enforcement of an international tax regime in e-commerce is not easy due to the limited physical presence or the virtual nature of the transactions. Besides, the anonymity of the transactions and transacting parties makes it hard for the enforcement agencies to identify the existence of transactions.

Thus, e-commerce touches inter-individual equity and presents the challenge of taxing both e-commerce players and non e-commerce players equally. Inter-nation equity is also affected by e-commerce; the logic of giving the source country the primary right to tax active income while the residence country has primary right to tax passive income cannot simply be applied to e-commerce income. And once such logic is distorted, the effectiveness of the tax regime to ensure economic efficiency through the instrument of taxation will become blurred.

From the perspective of taxation, there is an urgent need to give a fresh look at the international tax regime to tailor it for the e-commerce business to ensure that it brings about economic efficiency on the one hand, and maintains equity between nations on the other hand. However, the building of an international consensus may not come about as the exercise of consensus building cannot keep pace with the breakneck speed of technological advances.

OECD (Organization for Economic Cooperation and Development) has been taking a lead in addressing challenges posed by e-commerce in the international tax regime

³ Azam, Rifat (2007), "E-commerce Taxation and Cyberspace Law: The Integrative Adaptation Model," *Virginia Journal of Law and Technology*, Vol. 12, No. 5.

since 1997. In 1998, the Ottawa Taxation Framework was designed with the following leading principle:

“The taxation principles that guide governments in relation to conventional commerce should also guide them in relation to e-commerce.... Existing taxation rules can implement these principles. The application of these principles to e-commerce should be structured to maintain the fiscal sovereignty of countries, to achieve fair sharing of the tax base from e-commerce between countries and to avoid double and unintentional non-taxation.”

Intense deliberations were held among members of the technical advisory groups, particularly in relation to income-classification and permanent establishment resulting in incorporation of Article 5 to the OECD Model Tax Treaty. According to the Treaty, a server might constitute permanent establishment as long as it was ‘an essential and significant part of the business activity of the enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment’. This approach of OECD is based on territorial location of the server; an irrelevant factor which cannot be relied on for successful taxation of e-commerce income. There is no justification for giving tax jurisdiction to the country housing the server, because often there is no real economic allegiance between the location of the server and the production of income. This principle set by OECD does not have many takers.

There is a suggestion that e-commerce be subjected to a one-source rule by subjecting services, royalties, rents, and sales in electronic commerce to the same source rule. Apart from this, it should also include the imposition of a gross withholding tax on sales and services provided through electronic means into the demand jurisdiction. This principle obviously suffers from the infirmity of conferring the jurisdiction of collecting tax exclusively to the demand jurisdiction providing its market while excluding other jurisdictions; and, as a result, the principle of sharing the pie gets affected. Besides this, the mode of taxation disturbs the principle of

neutrality and introduces a distinct tax regime for e-commerce in comparison to non e-commerce module.

Another alternative is towards making an attempt to track places of e-commerce transactions and the contributions made (by each place) to the production of income—a task which presents enormous difficulties to plug in all the jurisdictions involved in the value chain because of the virtual and anonymous nature of e-commerce.

The US has been arguing since 1996 that the growth of new communication technologies and e-commerce will require that the principle of residence-based taxation assumes greater importance. In the world of cyberspace, it is often difficult, if not impossible, to apply traditional concepts to link an item of income with a specific geographical location. Therefore, source based taxation could lose its rationale and be rendered obsolete by e-commerce. By contrast, almost all taxpayers reside somewhere. This enunciation gives advantages and benefits to resident countries (developed countries) over source countries (developing countries). Besides, it not only introduces a distinct tax principle for e-commerce module, but also hits at equity and efficiency norms. However, the principle, even if implemented, will not be of advantage to the resident countries because the corporations tend to station themselves in tax-haven locations.

The process of locating cybercriminals in a particular country involves challenges similar to those facing judicial jurisdiction and e-commerce taxation issues. Criminal law has been coping with the challenges by applying the current criminal law to such crimes. And, while courts make interpretations as well as adaptations to the current cybercrime law, the legislature defines new laws and crimes as required when the current law is unable to handle a new challenge. On the same analogy, when court Rulings are unable to resolve the issue by adopting the existing legal instruments, the international community would be required to work out an understanding. Nation states have followed similar course in relation to the challenges posed by the internet on copyright issues, i.e. by taking to court Rulings and also by working out an international understanding at WIPO (World Intellectual Property organization).

Even in the application of existing tenets of e-commerce taxation, the challenges have many common features—with the challenges being addressed through court Rulings satisfactorily. As in other areas such as those pertaining to criminal law and copyright law, there may be need for generating laws, in a limited way, where altogether new issues that are being encountered are not resolved through mere court Rulings. Adaptation of the international tax regime in e-commerce will have to be in harmony with adaptations in other fields because e-commerce is subject to such laws as well; and further, while giving judicial verdicts in case of a reference, courts would read law as one “harmonic” composition.

Many challenges, if recalled, before the e-commerce regime are:

- (i) Borderless feature of internet and e-commerce;
- (ii) Virtual feature of e-commerce—leaving no signs of the transaction outside the internet; and,
- (iii) Anonymity associated with e-commerce.

These challenges have been created by technology and it is possible to meet such challenges with the help of technology itself. Technology is becoming fast available to specify the geographic locations of the parties involved in e-commerce transactions, thanks to the demand made by the advertising world that wishes to target consumers based on their location and preference for selling their products and also by administrators seeking to target families and groups on locational basis. The virtual feature can be overcome by making use of the “tracking” technology to reveal the details of a transaction to the tax authorities. In fact, regulations can mandate the disclosure of necessary information to the tax authorities to help track e-commerce transactions. Likewise, the challenge of anonymity of e-commerce can also be weakened, one, with the use of technology which will help trace the details of the parties (their location, name, credit card or bank information), and two, by setting regulations to facilitate the disclosure of the particulars needed as “inputs” for such technologies.

Until such technologies become readily accessible and those in charge of reporting, monitoring and enforcing tax regime become familiar with such technologies to an extent that they can derive information of relevance for tax administration purpose, the tax revenue accrued to nation states would continue to be uncertain and suboptimal. International community would have also to reckon with the fact that compliance cost borne by a business entity does not become excessive and also the cost of tax system administration does not become prohibitive while adapting such technologies.

Scholars have attempted to develop concepts such as Digital Permanent Establishment⁴ (Digital PE), a global e-commerce tax on e-commerce income and creation of global tax fund to finance global public goods⁵. Such concepts presuppose a high degree of international understanding across the countries and reorientation of the domestic laws concurrent with such an understanding—a scenario which would be difficult to arrive at unless the shoe starts pinching the developed world and is unbearably hurtful to the developing world.

Another aspect of cross-border e-commerce, which does not receive adequate focus, is that it has been operating in a tariff-free environment far too long. In 1998, WTO member states agreed to a two-year custom duty moratorium on electronic transmissions and the same has continued since with the latest extension of moratorium decided at the WTO Bali Ministerial Conference held in 2014⁶. Such a moratorium has continued despite the fact that e-commerce border trade continues to have an impressive growth at increasing rates. There seems to be no serious effort to put in place an international understanding on this aspect. There should be a legitimate concern among the developing countries, particularly over the continued evasion of their tax base from the burgeoning e-commerce cross-border trade. WTO bodies continue to squabble around the “classification” of the electronic

⁴ Wagh, Sagar (2013), “Digital Permanent Establishment: A Road Ahead for E-commerce Taxation,” academia.edu

⁵ Azam, Rifat (2012), “Global Taxation of Cross-border E-commerce Income,” *Virginia Tax Review*, Vol. 31, No. 4.

⁶ Shepherd, Jordan (2014), “A Successful Conclusion to the WTO Bali Ministerial,” King & Spalding: Trade and Manufacturing Alert.

transmission or the products shipped electronically (instead of physically) as to whether they should be characterized as goods, services, intellectual property or something else. The difficulty of finding an agreement on the question of classification continues to hold up the progress of e-commerce. If they are defined as goods, they would be subject to GATT rules and thus dutiable. If they are classified as services, they would be subject to GATS rules and application of custom duty would become questionable. Further, GATS continue to provide countries with substantially more leeway for national policy discretion in the services trade. Under GATS rules, national treatment is available on negotiated specific commitments and services and that, too, with the flexibility of limiting such commitment and services. Member states would thus have to take a call depending upon their own potential whether to categorize electronic transmissions as “goods” or “services”. For instance, if India perceives a potential as that of a net exporter in e-commerce in the long term, it would like to see electronic transmissions coming under GATS so that its exports are not subject to traditional tariffs and subsequently to additional taxes which are normally imposed by an importing country. There is no urgency being accorded for bringing such transmissions under a tax regime.

It may also be noted that there is no ambiguity at present regarding the status of the goods ordered and paid for over the internet but delivered physically in the conventional manner. Except for the order and payment, these transactions are treated as goods trade and the GATT discipline applied to them⁷.

Results from data on trade flows of digitizable goods demonstrate that a few developed countries largely dominate trade in digitizable products, particularly on export side. The share of developing countries, on export side, is small and that, too, limited to the lower end of technology know-how. In a study generated by UNCTAD, an estimate of potential revenue losses resulting as a result of digitalization of products has been attempted. The ten countries most affected by fiscal loss include India, China, Brazil, Russian Federation and also EU and Canada. As trade in digitized

⁷ Panagariya, Arvind (2000), “E-commerce, WTO and Developing Countries,” Policy Issues in International Trade and Commodities Study Series No. 2, UNCTAD, United Nations: New York and Geneva.

commodities increases, the downward trend in revenue collection in developing countries will have to be addressed. A continued moratorium within WTO on this aspect is not in the interest of the developing countries⁸.

Even in regard to domestic levies on e-commerce transactions taking place within the country, e-commerce is posing challenges for revenue collectors. The growing volume of e-commerce in India promises a good tax base. Business groups would argue on merits that if e-commerce is allowed to grow there will be a general reduction in transaction costs everywhere. Resulting output increases will widen the tax base. Therefore, an argument is made out not to tax e-commerce. However, the states, in the hunt for revenue earning avenue and also on the principles of neutrality and equity, cannot let this module of business go tax-free. Even within the country with federal structures where tax levying powers are distributed between centre and states, the traditional tax models, in case of e-commerce, break down. The question of jurisdiction crops up since the vendor and the customer may be located in different states. As in relation to cross-border trading, ambiguities may arise: whether the product is a “good” or a “service” and whether it should be subject to sales tax or service tax. The government, in 1998, even constituted a High Powered Committee (HPC) to examine the position of e-commerce transactions and to determine any changes to be made while taxing such transactions. HPC covered the gamut of only direct taxes and did not consider the aspect of indirect taxes on goods and services transmitted electronically.

Sales tax is the principle source of revenue for states and the practices of taxation as well as tax rates vary from state to state. In some states sale tax is levied on the first sale transaction while in some it is levied on the last sale transaction—such heterogeneity complicates the tasks of both tax collection and tax administration. Problem is further compounded by the fact that states are not generally allowed to levy service tax except in case of certain specified categories, and in rest of the services, the central government is the competent authority. This scenario leaves

⁸ Teltscher, Susanne (2000), “Tariffs, Taxes and Electronic Commerce: Revenue Implications for Developing Countries,” Policy Issues in International Trade and Commodities Study Series No. 5, UNCTAD, United Nations: New York and Geneva.

scope for disputes to arise, particularly when there is ambiguity in relation to categorization of a product as a “good” or a “service.”⁹

Rajat Talati examined in detail the implications of sales tax and e-commerce way back in January 2002¹⁰ and, taking the multifaceted aspects of e-commerce into account, concluded that local as well as central sales tax provisions were inadequate to respond to the peculiarities of these types of transactions. Nevertheless, e-commerce within the country and beyond its borders is surging ahead at a healthy rate of growth. Technology has enabled the generation of e-Waybill in respect of the states of the Indian Union and the consigner has to feed the required particulars in respect of the state. These particulars require details in respect of information relating to the applicable taxes, e.g., VAT, TIN, CST, Local Body Taxes (LBT) and particulars of ST-Forms/VAT. Generation of e-Waybill is a step forward in tax-administration¹¹. Occasionally, state governments have put online retailers and dealers under the tax scanner. For example, in September 2014, Amazon office in Karnataka came under scrutiny after tax authorities alleged that Amazon India—the domestic online market place owned Amazon.com Inc.—has been violating the current tax norms and also been evading value added tax in respect of a facilitation store created by it.¹²

A milestone reform will be achieved once GST sets in, bringing uniformity in tax rates across all states and standard procedures for maintenance of records. However, the categorization of products traded through the electronic mode would continue to be an issue.

⁹ Sridhar, Kala S., “Is taxing E-commerce Feasible?” *The Hindu Business Line*, June 25, 2004.

¹⁰ Talati, Rajat (2002), “E-commerce and Sales Tax Implications,” *BCA Journal*. Pp. 1181–1187.

¹¹ India Interstate Regulatory Requirements, TNT, <http://www.fedex.com/in/domestic/services/regulatoryguidelines.html>

¹² Abudheen, Sainul K. (2014), “Amazon Comes Under Tax Scanner in Karnataka,” VCCIRCLE, September 16.