

## **Impact of E-commerce on Taxation**

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### **Abstract**

In the wake of e-business and concerns over its impact due to impact of E-commerce on tax revenue, there is an urgent need for new IT security solutions/models. E-commerce is a new way of conducting commerce or development of contractual relationship between buyers and sellers without either of them coming into physical contact with each other. This new way of conducting commerce has revolutionized the business and is fast becoming the norm rather than the exception of conducting transaction worldwide. This has also challenged the taxing authorities across the world. Our focus is on the three main issues of E-commerce transaction.

This paper will first describe the phenomenal growth of E-commerce transactions in India and the general initiatives taken by the government to boost the E-Commerce transaction. The global initiative of E-Commerce taxation will be dealt with in detail. Then we will analyze the existing laws in India especially the Income Tax & VAT Act and link it to E-Commerce Transaction.

**Keywords:** EC (Electronic Commerce), OECD(Organization of Economic Co-Operation and Development), PE(Permanent Establishment).

### **1. Introduction**

E-Commerce is a new way of conducting commerce that has revolutionized the way in which business are being conducted worldwide. In e-commerce, neither physical presence nor physical delivery of goods and services is necessary. The new technology will transform creation of products and services, marketing of goods/services, business processes, organization structure of the enterprise and other functional areas of

business. E-Commerce has challenged the taxing regimes round the world, India being no exception.

E-commerce is a subset of e-business. It is a commerce or conducting transactions using network of computers and telecommunication i.e. internet. It is an exchange of goods/services and the financial consideration for them. Business includes a whole set of transaction that must be completed before the goods/services change hands for the financial consideration. E-business links employees and internal business processes through intranets, the business relations with suppliers, customers through extranets and finally exchanging goods/services for a value. Goods/services can be directly delivered on the net or by conventional mode and similarly payment can be effected through electronic means or by conventional mode.

## 2. Challenges of E-commerce for Taxation

The Challenges of E-Commerce are manifold. Some of the conceptual challenges thrown by E-Commerce are how to characterize income and the approach towards residence-based and source-based taxation approaches. The worldwide nature of e-commerce transaction muddles the issue of '**jurisdiction**' which is a principle tenet of taxation.

E-commerce also challenges traditional company tax rules because businesses can sometimes exist almost totally in cyberspace, with communication tools/ technology being used to carry out interactions with directors or shareholders. Basically e-commerce challenges when, where and how taxation can be applied in an era where local markets are being transformed into global markets.

## 3. Indian Scenario

The growth of e-commerce in India is rapid. In the report released by IMRB (Indian Market Research Bureau) & IMAI (Internet and Mobile Association of India) the growth of e-commerce in India over the years has been analyzed.

**Table 1:** The growth of e-commerce in India over the years.

Year/Market	2007	2008	2009	2010	2011	Growth % (2007-2011)
Total Market Size	8146	14030	19688	31598	46520	471.08
Online Travel Industry	6250	10500	14953	25258	37890	506.24
Online Non Travel Industry	1896	3530	4735	6340	8630	355.17
E-Tailing e.g. electronic, home & kitchen appliances, apparels and jewellery	978	1120	1550	2050	2700	176.07
Digital Downloads/ Paid Content Subscription	238	290	435	680	1100	362.18
Financial Services	NA	1200	1540	2000	2650	

Other Online Services e.g Online Classifieds	680	920	1210	1610	2180	220.59
All Figures are in Rs. Crore SOURCE: Report by IMRB (Indian Market Research Bureau) and IAMA(Internet and Mobile Association of India) 2011						

In the year 2007 the total market size of e-commerce in India was to the tune of Rs. 8146 Cr. This market has risen from Rs. 8146 Cr. in 2007 to nearly double a year later i.e Rs. 14030 Cr. in 2008 to Rs. 46520Cr in 2011 **which is 471.08% growth in just 4 years.** This shows the phenomenal growth of e-commerce in India and is indicative of the exponential rise in the years to come.

In this scenario there is a need for special tax provision to ensure that the transactions come within the ambit of the tax net and the leakages are minimal. E-Commerce has led to new ways of tax evasion by dealers. In an accounted electronic payment system, a record of the flow of the e-money is currently being maintained. But no such record exists in unaccounted for system or e-system. Tax administrators cannot match payments and receipts to specific taxpayers in this situation. Situations of non-reporting or under-reporting are common in such systems.

A major issue in E-Commerce transactions is “*identity verification*”. The identity of the transacting parties in cyberspace is difficult to determine. This could preclude the enforcement of tax with respect to business opportunities between residents/non-residents. Even if the ownership of a web site or IP is established, factors such as ‘*encryption, fragmented transmission, use of proxies, and diverting mechanism*’ are a great hindrance of tax administrators. Verification of the identity of counter-party is a challenge. A seller of electronic goods or service may claim to be a resident of a country with which India has treaty thereby being entitled to a reduced or zero rate of withholding tax on royalties but in fact he may not be so. Obtaining of necessary records or setting up of audit control requirements & trails are difficult in e-commerce transactions.

#### 4. International Scenario

The first and foremost approach towards dealing with such situations can be attributed to the Ottawa Conference on E-Commerce (1998) organized upon the behest of OECD. This conference was study the new emerging way of conducting business and to analyze, discuss and generalize some ways of dealing with the issues.

The next step in developing a model for e-commerce transactions was in 2000 when the O.E.C.D released a clarification to Commentary to Article 5 of the OECD Model Convention with respect to taxes on Income and Capital. This clarification related to the application of the principle of 'Permanent Establishment'.

In 2001 the O.E.C.D came out with a Discussion Paper on the aspect of applying the existing principles of double-tax treaties for taxation of business profits arising on account of e-commerce and based upon this discussion paper, the Committee of Fiscal

Affairs in 2002 adopted a 'Report on Treaty Characterization issues arising from e-commerce'.

Amongst the nations, the USA as well as the EU were amongst the first nations to legislate on e-commerce activities. The regulatory environment in India, which broadly governs e-commerce, comprises of the following laws: Indian Contract Act, 1872; Copyright Act, 1957; Trademark Act, 1957; Patent Act, 1970; Indian Penal Code, 1860 & Information Technology Act, 2000

The two legal internationally accepted bases of taxation are

- (i) Residence based tax system and
- (ii) Source based tax system

Generally, a resident of a country is liable for tax on its world income, while a non-resident is taxed only on income sourced in the country. As far as Indian Income Tax is concerned, as per section 6(3) of the ITA, a company is treated as a resident of India for Indian tax purposes and taxed in India in respect of its worldwide income only if it is either incorporated under the laws of India or wholly managed from India.

In the above scheme of taxation, source of income play crucial role since the country of source has a right to tax income and residence countries' relieve double taxation. Thus, when a resident of a country earns income from a source in another country, he is subject to double taxation i.e. both in the source country as well as in the country of residence.

Normally the double taxation is relieved either by exemption method or by tax credit method. Under exemption method, the income is not taxed again in the country of residence. Under tax credit method, the country of residence gives credit for the taxes paid in the source country.

## **5. Comparison of OECD and HPC'S View on Characterization of Income**

In the era of E-Commerce, many of the goods and services transacted may be 'intangible' in nature and hence, often becomes difficult to apply the source concepts to link an item of an income with a geographical entity. The intangible transactions blur many of existing distinction between domestic and foreign business, and also between on-shore and off shore transactions.

In India, in 1999 a High Powered Committee was constituted under Shri. Kanwaljeet Singh to study the various aspects of e-commerce and suggest measures to take there in. The HPC under Shri. Kanwaljeet Singh had suggested a low withholding tax as a possible e-commerce taxation to safeguard against base erosion. The intention was to avoid double taxation for the assessee. But suppose the assessee has imported goods from a foreign supplier and he legitimately claims this as deductible expenditure. If the government allows this, then this will lead to an erosion of tax base since the government has not got the tax for the imported goods or services in the first place.

When any person is responsible for making any payment to a non-resident of a sum chargeable under the provisions of the Income Tax Act, that person is required to deduct income tax thereon. The Assumption is that the payee will get benefit of this withholding tax in his own country as set-off and thus double taxation will be avoided for the payee. But this depends on the Double Taxation Avoidance (DTA) Agreements that India has with other countries & also whether these countries will allow set off for this withholding tax that the companies registered under them suffer in the foreign country.

Based on the above scenario, can a taxpayer who has suffered this withholding tax claim a foreign tax credit in his country of residence? Under the DTA that India has with Australia, Belgium, Netherland, Germany, Malaysia, Singapore, U.S.A and U.K there won't be any grant of foreign tax credits for any taxes withheld under the base erosion. Thus the recommendation of the HPC for taxation of e-commerce through a withholding tax is not feasible.

The issue of characterization is very important because different categories of transactions may have different tax consequences. When the transfer is of partial rights in the product then it will constitute a royalty. Consequently, such a payment can be taxed in the state where it arises. However, if the web-site owner has a Permanent Establishment in the source state, the payment will be classified as business profits. The country of source can tax royalty and also services which are of technical nature but it cannot tax business profits. As far as India is concerned, under Explanation 2 to section 9(1)(vi) of the Income Tax Act, 1961 the term royalty has been defined to mean the consideration arising on the transfer of all or any rights in respect of a copyright or a scientific work.

The broad definition of royalty allows for the taxation of payments arising from transfers of all kinds. In this context any payments made in India for transfer of software or other digitized products on the Internet will be classified as royalty under the Income Tax Act, 1961. Thus, any payments made by Internet users for transfer of software or other digitized products will be subject to Tax Deduction at Source under section 195 of the Income Tax Act, 1961.

Our recommendations based on our analysis covers the entire gamut of e-commerce issues. The servers in e-commerce transactions that the customer's access can be in any country or they can be mirror servers. Therefore these servers cannot be said to constitute a permanent establishment. It is because of this fact that many business enterprises are earning profits out of sale of goods or services in India but are not paying taxes because it is classified as business profits and the business concerns do not have a permanent establishment in India. Therefore what we are suggesting is that a possible solution is to define a threshold for revenue generation within a country. Anyone receiving more than the threshold will be liable to file his tax returns in India irrespective of whether the transaction is categorized as business profits or royalty & thus to pay the tax. The payers will deduct tax at source (T.D.S) and deposit it with the Indian Government.

As far as the withholding tax issue is concerned, the income tax TDS is available for set off to the non-resident seller against his income-tax liability in his country of residence. In case of VAT, the set off is borne by the Indian Government instead of the seller's Government. Therefore, the objection of base erosion against the proposed treatment of e-commerce is not proper. In the interest of convenience and efficiency we can levy a single indirect tax on the import of goods and services and not levy income tax on the non-residents income.

The points of difference between O.E.C.D and India on the issue of categorization of payment are apparent. Out of the 28 issues, there is difference of categorization in the case of 11 issues. In all these 11 categories shown above the O.E.C.D has classified the transactions as business profits meaning thereby that the country of payment has no right to tax these transactions. But as per the India Income Act, India-U.K. treaty, India-U.S.A treaty it is classified as Royalty; this gives India the right to tax these transactions as Tax Deducted at Source. Actually in the attempt to classify the transactions on the basis of category of income, the O.E.C.D has erred for each state has tried to make the definition of royalty so broad so as to be able to tax the transaction. Therefore our recommendation is that the source based tax principle should be based on the presence or absence of source & not upon the category of income.

## **6. Conclusions**

Currently there is no single agreed framework in place for the countries. Each country has its own independent and separate Legal and Taxation framework for e-commerce. While some states like E.U already have the G.S.T framework in place, others like India have V.A.T while still others like U.S.A have retail taxation structure. Therefore tax on e-commerce is only an extension of the current tax laws. A comprehensive framework for e-commerce transactions has to be evolved. The "I.T Act 2000" has to be revisited. Some of the loopholes in the I.T Act like ambiguity regarding the legal jurisdiction of contracts involving international parties, non provision for dual-key pairs for individuals and business and issues of protection of individual rights including domain names have to be addressed.

Along with the strengthening of the legal and statute framework, efficient and comprehensive infrastructure has to be built for monitoring of all e-commerce transactions. Better audit trails and authorization control has to be built along with the necessary skill up-gradation of officers of the commercial tax department. Better consumer education and co-operation between different states are imperative for efficient administration. The I.T infrastructure has to seamlessly cover the transactions spread across states and even across nations.

E-Commerce is not only changing day by day but also branching into ever newer forms and will do so in the days to come. Nowadays mobile commerce is also building into a big business. Building new statutes, amending existing laws, constant monitoring, amending and adapting are the need of the hour. This will ensure that our

State not only reaps the benefits of e-commerce technology but also generates increasing revenue for its socio-economic needs.

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