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A critical study on taxation of E-Commerce transactions

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Abstract
The quick development of e-commerce, especially the sale of merchandise and enterprises over the internet, has fuelled a debate about the tax assessment regimes to be used. The move from a physically oriented commercial environment to a knowledge-based electronic environment poses serious and considerable issues in relation to tax collection and tax assessment regimes. Duty organisations all through the world face the formidable assignment of protecting their revenue base without hindering either the development of new technologies or the involvement of the business group in the evolving and developing e-market place. Concerns of governments centre on the effect of e-commerce on the state and nearby revenue. Whereas states can impose a duty on residents purchases from out-of-state vendors, they can't impose a commitment on those vendors to collect the assessment unless the vendor has a significant presence, or nexus, in the state. This paper deals about the issues and problems in taxation, determination of economic attachment, the way business is transacted through E-commerce, permanent establishment of e-commerce situation and the determination of nature of income. These problems will be greater for developing countries. The shrinking of the tax base will have a disproportionate effect and further jeopardise the already fragile economy of the developing world. These problems will be greater for developing countries. The shrinking of the tax base will have a disproportionate effect and further jeopardise the already fragile economy of the developing world.

Keywords: e-commerce, tax assessment, permanent establishment, determination of nature of income

1. Introduction

E-commerce or electronic commerce, in its widest sense, means consumer and business transactions conducted over a network, using computers and telecommunications. In other words, e-commerce refers to the exchange of goods or services for value on the internet. It includes, inter alia, on-line shopping, on-line trading of goods and services, electronic fund transfers, electronic data exchanges and on-line trading of financial instruments.

The OECD documents on e-commerce in a somewhat more restricted manner as commercial transactions between individuals and organisations, based on the processing or transmissions of digitised data units, sound, and visual images, which are carried out over open networks (like internet) or over a closed network (like minitel) with a gateway to open networks. This more specific definition would therefore exclude electronic data interchange (EDI), carried out over closed networks, if such EDIS are being used by themselves, without access to an open network (e.g. credit cards used over a closed network, connecting specified merchants with a card organisation).

Whatever be the definition, this method of carrying on a business is widely different from the traditional practice of business. Whereas traditional businesses have rested squarely on the physical presence and delivery of goods, in doing business via the internet, as is the case in e-commerce transactions, physical presence of goods is not required at all. Consequently, geographical boundaries between nations hold no significance. Secondly, in such type of transactions, physical delivery of goods is not necessary. Where the goods and services are available in digital form, e.g. computer software, music, magazines, drawings etc. physical transactions are replaced by transfer of bytes. Thirdly, e-commerce transactions can be completed almost instantaneously across the world and irrespective of the time of the day.

2. Issues and Problems in Taxing E-Commerce Transactions

Due to absence of national boundaries, physical presence of goods and non-requirement of physical delivery, taxation of e-commerce transactions raises several issues. They have to be understood in the light of international taxation. International taxation arises from cross border transactions for the reason that the author of the transactions arises in one country (called the Home State) and the sites of the transactions is in the other country (Host State). Income arising out of such transaction is subject to tax in both countries by virtue of 'personal attachment' to the transfer (in the Home State) and again by virtue of 'economic attachment' to the income itself (in the Host State). Thus, this gives rise to double taxation of the same income. This problem is generally solved by a Double Taxation Avoidance Agreement (DTAA) between the two countries concerned. The problematic issues arising in respect of e-commerce transactions are as follows:

2.1 How to determine 'economic attachment'

In order to determine economic attachment, the situs of the transactions should be clearly determined. In a traditional commerce transaction, the situs of the transaction is clearly known, because of the physical presence and the physical delivery. Therefore the Source Rule as laid down in section 9 of the Income-tax Act, 1961 can be clearly applied to effect Host State taxation. Section 9 provides that income is deemed to accrue or arise in Indian taxable territory if there is a business connection. In E-commerce situations, with transactions being completed in cyberspace, it is often not clear as to the place where the -transaction is effected, giving rise thereby to difficulties in implementing Source Rule taxation.

2.2 How to determine existence of a permanent establishment

Under most bilateral double tax treaties, a country will seek to tax corporate business profits if they can be applied to a 'permanent establishment' in that country. The basic requirement is, therefore, that there must be a place of business and it must have some permanence.

The major taxation problem of e-commerce is that no establishment is necessary across the border to carry on business. With regard to tangible property, the source can be traced, as the delivery has to cross the other territory through the customs or postal barrier. The destination also will be known from the shipping address. Where the seller is located in a tax-haven country, it becomes difficult to enforce tax laws on the non-resident business. In such cases, the natural option should be to tax the resident as the agent, especially where the non-resident cannot be reached. The difficulty is not so much in taxing those who are assessed and who maintain accounts but in taxing others who do business and there is no record of their transactions, like the persons liable to pay the 'use tax' in US. With the development of WAP (Wireless Application Protocol) which integrates mobile telephony with the Internet, e-commerce will be taken over by M-commerce (Mobile Commerce). This makes the place of origin of business invisible thus adding complication to the existing scenario and is a real challenge to domestic jurisprudence.

Further, how such income is to be attributed to the permanent establishment is also a significant matter. This is relevant to determine whether income from sales can be taxed on host country soil. For instance, if a particular income is classified as royalties or fees for technical services, or dividends or interests, then irrespective of the existence of a permanent establishment, the income will be liable to host country taxation under section 115A of the Income-tax Act. On the other hand, if the income is classified as income from sales, then unless there is a permanent establishment, there can be no taxation in the host country, And if there is a permanent establishment, how much income is to be taxable will be determined by how much of the income is to be attributed to the permanent establishment.

2.3 Legal difficulty

Till now all cross-border commercial transactions have to cross the customs barrier or the postal barrier. All trade and commerce are operated in a physical world and in terms of tangible goods. Hence, there is a check on these transactions, though smuggling remains outside the scope of any control. Even in the present situation, the tax authorities are unable to fully grapple with the problem of myriad ways of tax evasion. In e-commerce transactions, the contracting parties are in two different states and, therefore, the question would arise as to which state law would be applied.

2.4 Nature of contract

A contract need not necessarily be in writing unless, the statute requires it to be so. It can be oral, This will create problems relating to the law that will be applicable in case of dispute. in a contract, generally the parties are free of choose the law applicable to the contract and the same can be expressed or implied in the terms of the contract. In some cases, the principal' place of business is relevant in deciding the law applicable. In some other case, the place where the buyer normally resides decides the law to be applied. Where there is a clause for retention of title until the buyer performs some act, then the matter of which lex situs will govern the validity clause is open to question. In answering this, the Rome Convention says that if the contract accords with the rules of anyone of the States, its validity cannot be questioned. This would be the most satisfactory solution and can be followed. All these problems arise mostly regarding transactions relating to movables and those relating to immovable properties are less difficult, There are. many areas where the present domestic laws including international. laws would be inadequate to deal with the emerging new field of e-commerce.

2.5 Taxable jurisdiction

The taxable jurisdiction of any country covers its national boundary. Besides this the. territorial jurisdiction includes territorial sea and airspace above as per the territorial waters, continental shelf, exclusive economic zone and other Maritime Zones Act,1976. Each one extends to specified nautical miles from the base line. The following are the limits indicated therein:

1. Territorial Water-12 nautical miles from the nearest point of appropriate base line.
2. Contiguous Zone - 24 nautical miles beyond and adjacent to the territorial waters from the base line.
3. Continental Shelf - 200 nautical miles from the base line.
4. Exclusive Economic zone is an area beyond and adjacent to the territorial waters
5. Extending to 200 nautical miles from the base line.

But electronic commerce takes place through satellite and the server can be in any part of the globe. It can in all probability be in a tax-haven country. Another condition for taxing the income arising or accruing beyond the taxable territories in the physical residence of the taxpayer for 182 days or more. This becomes meaningless with the Internet access. The information highway provides numerous visits to another jurisdiction outside the control of border mechanism.

3. How Business Transacted Through E-Commerce

E-commerce is but a method of conducting business transactions and not a business transaction by itself. Therefore, the contents of a business transaction done through e- commerce are no different from that of a business transaction carried out through traditional means. Divergence however arises in two dimensions - the business methods and

the business concepts. The first area, which is very different, viz. the means of doing business, is analysed. In e-commerce there are three distinct means of doing business: electronic advertising, electronic sales and electronic delivery. The presence of anyone or more of these is sufficient to characterise the business as e-commerce.
These are separately discussed below:

3.1 Electronic advertising
Advertising is done on the open networks, through websites. Potential customers access the websites and obtain the information they need which enables them thereafter to proceed with the transaction is suitable cases. If the e-commerce business is restricted to putting up a website alone, then the rest of the transaction is completed through traditional means; i.e. the placing of orders by telephone or mail, the making of payment by cheque and credit card and the delivery of goods through a carrier, the telephone etc. being referred to as intermediaries.

3.2 Electronic sales
This is done through 'smart' resources which enable the potential customer to place an order on the internet. The payment is effected through a closed network by means of credit cards.

3.3 Electronic delivery
This is of course possible only for goods and services that can be fully digitised, but this range is quite wide and ever expanding. Texts, visual materials, audio materials and computer software are digitised Therefore products like journals, books, music, plans, designs, drawings and games to mention a few, would be goods available in digitised form. Besides goods, services like diagnostic services, could also be available In digitised form. Therefore a whole host of goods and services could be delivered electronically.

3.4 The Committee of Fiscal Affairs of the OECD: has been actively working on taxation issues relating to e-commerce. The committee has developed the taxation framework conditions setting forth the governing principles in relation to e-commerce. The key conclusion was that the taxation principles that guide Governments in relation to conventional commerce, should also guide them in relation to e-commerce. It was postulated that this would be possible only by adapting and adopting the existing principles to e-commerce situations.
For adapting and adopting the existing principles, the following key areas in the context of international tax were identified

1. The extent to which a website or a server can constitute a permanent establishment and how income may be attributed to it; and
2. The manner in which payments for digitised products are to be characterised.

4. Permanent Establishment in E-Commerce Situations
We now discuss different situations which arise in an e-commerce environment and consider whether these situations would constitute a permanent establishment.

4.1 Situation 1 - Existence of a website on host country soil: A website may be defined as a set of web documents belonging to a particular organisation. It consists of data and programmes in digitised form which is stored on a server of the internet service provider. On the other hand, a permanent establishment, as the name itself suggests, is a fixed place of some permanence from where a business is carried on. Therefore, the existence of a website, by itself, would not constitute a permanent establishment.

4.2 Situation 2 - Server on host country soil: A server is a system which carries out activities initiated by an end-user's computer. The question whether a server can be considered whether a server can be considered as a permanent establishment is more complicated. It is possible that the enterprise that operates the server may be different from the enterprise that carries on business through the website. The use of a particular internet service provider (ISP) does not give website owner the right of control over the server's operation. The server's location is not at that enterprise's disposal. The server could easily be removed to other locations. In such a situation, the server's location cannot be considered to be the place of business.
On the other hand, if the enterprise itself owns or leases and operates the server, and the computer equipment is fixed, and business is carried on through the server, it could be construed to be a permanent establishment, Therefore what is essential to be considered in this issue, is not merely whether a server exists or host country soil, but also What the value as well as extent of its operations are. As the permanent concept deals not only with permanence and a geographical link with the host soil, but also the actual carrying on of the business, the values and extent of the operations carried out by the server becomes important. We now consider separately the above points.

Nature of operation
The nature of operations could have a very wide range. The range could profess from being a mere provider of information, to being a forwarding address to acting as a warehouse for digitised goods, to contributing directly to productivity and value creation, thereby realising profits. In a situation where the server acts as a mere provider of information it cannot be considered to be a permanent establishment. At the end where it contributes to productivity, the server will become a permanent establishment for distinctions which falls in between there two entrances, it would be necessary to go to the next step of examining the extent of operations.

Extent of operations
In the extent of operations, as well, there could be a wide range of activities. A server could be simply located on host country soil with skeletal support services, or it could be a server with multiple services, or it could be a server which carries on the complete set of operations. In the last situation, there would clearly be a permanent establishment.

4.3 Situation 3 - Server functioning as agent: It is possible that a server on host country soil could be construed to be a dependent agent of the foreign enterprise. Such a situation will apply in the case of 'Smart' servers. 'Smart' servers are programmed to not only provide information but also to take and process orders from persons who make a 'hit' 'n the website. Such a server has the power to contract on behalf of the foreign enterprise and habitually exercises this power. It is possible to argue that since such a server is a dependent agent of the foreign enterprise, it may be considered to be a permanent establishment, However, a contrary and more logical view would be that the website together with the server that hosts it can only constitute the medium through which orders are placed. The time acceptance of the order is not done by the machine itself but by the person or corporation which inserted into the machine a programme capable of performing these tasks. Therefore, the website and the server would not constitute a permanent establishment.

According to the principles of international taxation, business income cannot be taxed on Host State soil, unless there is a permanent establishment in the Host State. If there is such a permanent establishment, then the only income which the Host State is entitled to tax is the income attributable to the permanent establishment. Such attributable income is determined by imagining the permanent establishment to be an entity independent of the foreign enterprise, and dealing with the foreign enterprise at arm's length price. The issue therefore translates to one of determining the transfer price between the foreign enterprise and permanent establishment, and rewriting the transaction between the two.

5. Determination of the Nature of Income

The manner of taxation in income arising from e-commerce transactions, as it also the case in conventional commercial transactions, depends on the characterisation of the income. The characterisation of income is relevant because different types of income are taxed differently. Once this is identified, the existing rules may be adopted and adapted to the e-commerce transactions.

In conventional commerce, when all rights in a property are transferred it would amount to a sale giving rise therefore to business income. On the other hand, when only limited rights in a property are transferred, the transferor retaining substantial rights therein, the income therefrom would be classified either as a royalty in the case of intellectual properties, or a lease rent in the case of tangible properties. Thirdly, if the ultimate results of the transaction is the rendering of services, the income would have to be characterised either as fees for professional services.

Similarly, in an e-commerce situation, if licensing of a know-how is done, the payment for this would clearly be characterised as a royalty income in terms of most double taxation avoidance agreements and this would be so irrespective of whether this is done by physical transfer of information or by transfer of digitised information. If on the other hand, practically all rights in a design are transferred, whether physically or through electronic transfer of digitised information, with no rights being retained by the transferor, under most double taxation avoidance agreements, the transaction would be considered to be one which is more in the nature of outright sale of the design rather than a licence thereof. The payment for this would then be characterised as a sale consideration rather than as a royalty.

The principles of adopting and adapting postulated by the OECD and the US treasury unable a proper determination of the character of income in most cases. However, the problem arises in the case of transactions involving software. This is discussed below:

Transactions involving software

The process of adopting and adapting existing rules to e-commerce transactions becomes complicated in the case of transactions involving software. For instance, where a packaged product like Windows 98 is sold, we normally refer to it as buying a product. Moreover, this sale in reality, not a sale but an agreement or a licence to use the software. The product comes in a transparent shrink wrap packaging through which the licence agreement can be read.

When the buyer tears open the packaging, this act is tantamount to his signing the agreement or licence. By doing so, the buyer (licensee) accepts the terms of the licence he agrees to use the software only at that one work station, to not make copies except for archival purposes, to not alter the contents, etc, other than a licence. When it comes to taxation of such transactions the characterisation of the income would become extremely relevant. If for instance the transactions were to be treated as a sale transaction, and the title is transferred outside the buyer's country, the transaction would not be subject to host country taxation in the buyer's State; this is because there would be no permanent establishment of the 'seller' of the software in the buyer's State, and therefore no subjection to Host State taxation. If on the other than the transactions were to be treated as one of licensing, irrespective of the fact that there might be no permanent establishment in the buyer's State, the amount paid by the buyer would, (according to most double taxation avoidance agreements and most domestic tax laws), be considered not as a sale consideration, but as a licence fee constituting a royalty and this would therefore be subject to Host State taxation on the basis of the Source Rule, the payer of the consideration being a resident of the Host State.

Let us now examine this issue in the context of Indian law. Section 14 of the Copyright Act, 1957, as amended by the Copyright (Amendment) Act, 1999, defines "copyright" to mean the exclusive right to do or authorise the doing of any of the following acts, in respect of a work or any substantial part thereof

a) In the case of a literary, dramatic or musical work, not being a computer programme,-
- To reproduce the work in any material from including the storing of it in any
- Medium by electronic means:
- To issue copies of the work to the public not being copies already in circulation:
- To perform the work in public; or communicate it to the public;
- To make any cinematograph film or sound recording in respect of the work;
- To make any translation of the work;
- To make any adaptation of the work;
- To in relation to a translation or an adaptation of the work, any of the acts

- specified in relation to the work in sub-clause (i) to (vi);

b) In the case of a computer programme

- To do any of the acts specified in clause (a);
- To sell or give on commercial rental or offer for sale or for commercial rental any copy of the computer programme.

Provided that such commercial rental does not apply in respect of computer programme where the programme itself is not the essential object of the rental.

It is therefore abundantly clear that computer programmes, including software would clearly be considered to be covered by copyright. Therefore if software is licensed or its use is permitted in any manner, in accordance with Explanation 2 to section 9(1) (vi) of the Income-tax Act, the income would be royalty in nature. The income would therefore be deemed to arise in India in accordance with section 9(1) (vi)(b) when the payer of the same is an Indian resident, unless it could be established that the software is used in a business outside India. When therefore purchase consideration in respect of any software to be use&in India is paid to a non resident who has exported software, the payment will be construed as income deemed to arise or accrue within India, in terms of section 9(1) (vi); it would become income of the non resident subject to Indian tax in terms of section 5(2); and consequently tax would require to be deducted by the buyer of the software in terms of section 195. In terms of most double taxations agreements entered into by India with other countries, again the amount would be considered royalty income accruing or arising within India, and therefore subject to Indian withholding tax. Therefore, what is most important in this context is the underlying concept of copyright.

US Revenue Regulations Approach

The US Revenue Regulations clearly use a two stage approach. It the first stage, the distinguishing done is whether the transfer is of a copyright article or of a copyright right. Thereafter, at the second stage, two different parameters are used for copyright articles and for copyright rights, but these parameters are rational and not arbitrary.

In the case of a copyrighted article, the source code is generally not given, which means that it is only use of the copyrighted article, that is possible. Nothing beyond the use of the copyrighted article would be possible, if the only transfer effected is on the copyrighted article. On the other hand, if there is a transfer of the copyright right (as contrasted to transfer of right merely in the copyright article) all the underlying rights in the intellectual property are also transferred. The source code is most available, with the result that it would be possible to delete, add, modify, adopt and use in all possible manners, the software in which the rights are transferred.

If the transfer in a copyright article is that of significant benefits and burdens of ownership, then the income imbedded in the transaction is considered to be sales income. If on the other hand, only insignificant benefits and burdens of ownership have been transferred, then this is treated as a rental income.

When it comes to copyright rights a different parameter is used viz. Whether all substantial rights are transferred or not. If the transfer is of all substantial rights, the transaction is considered to be one of sales, and the income therefrom is therefore business profits. On the other hand, if there is no transfer of all substantial rights, the transaction is one of licensing and the income therefrom is royalty income.

Therefore, according to the guidelines set out in the US Revenue Regulations for the income to constitute sales income, significant benefits and burdens of ownership in a copyright article or transfer of all substantial right in copy right rights should be effected. If this is not done, then the income arising from a copyright right is considered to be royalty and that from a copyright article to be rental income.

The OECD has sought to distinguish a software product transaction, from a software copyright transaction. Therefore they have sought to distinguish the transfer of a programme copy on the one hand (which is a software product transaction), from the transfer of copyright right on the other hand (which is a software copyright transaction). When the transfer is only of a programme copy, then this being only a software product transaction, the nature of the receipt would be a sale consideration received for a product, and therefore the income embedded therein would be a business profit. This therefore overcomes the hyper technicality of considering the transaction as one of a licence, and accepts it for the commercial reality of what is actually is, namely a sale transaction. The income therefrom will then be considered business profits.

On the other hand, when it comes to the transfer of a copyright right, this is then recognised as a software copyright transaction, and it is only at the next phase, that this approach requires determination of whether what is transferred is a complete right or a partial right. If what is transferred is a complete right, then the transaction is one of a sale and income imbedded therein is business profit.If on the other hand, the transfer is only of partial right, then the transaction is one of licensing and not of sale, and the income imbedded therein is clearly a royalty. Therefore, in essence both the approaches are along similar lines.

6. Conclusion

Despite the divergence of method between traditional commercial transaction and commerce transactions, it is essential to conform to the tenets of neutrality of taxation. On account of the characteristics of e-commerce namely that transactions are completed in cyberspace, thereby making national boundaries meaningless, and considering the level of dis-intermediation and untraceability of the path of the transactions, traditional source rules of taxation become increasingly difficult to apply. As techniques of e-commerce progress, the situations become more complex with increasing dis-intermediation. Instances of these could be where traditional transfer pricing rules cannot be applied to multiple servers which switch signals depending on their work loads. This could give rise to increasing emphasis on Residence Rule taxation whenever Source Rule taxation becomes difficult to apply. Such a situation could spell diminishing revenues for developing countries, particularly in situations of technology transfers, where Host States are generally developing countries.

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