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Taxing the E-Commerce Transaction - A Long Road to Go

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by
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Abstract

E-Commerce is defined as the conduct of commerce in goods and services, with the assistance of telecommunications and telecommunications-based tools. E-commerce occurs in various forms and between various entities in the market. The question is how to tax it. According to the current international income tax principles on business profits, a taxpayer is taxable in a source country only if it has a permanent establishment such as a branch in a source country, which is a fixed place of business through which the business of an enterprise is wholly or partly carried on. Otherwise, those incomes are exempted from taxation in a source country. However, different from conventional types of transactions, E-commerce transactions need no physical presence to do business continuously in the source country since the core activities of a business can be conducted online. Therefore the permanent establishment no longer functions as an effective criterion to measure the nexus of the taxpayer with the source country. The article identifies the key challenges before the authorities in taxing the authorities and proposing an alternative for the traditional P.E Concept.

INTRODUCTION

The internet has changed many of the fundamental and long-standing principles of direct and indirect taxation. Governments all over the world are grappling with the various issues of taxation raised by the e-commerce sector which are the result of the lack of comprehensive understanding of the communication technologies. The multifaceted nature of business existing through internet and computer networks etc. and the modus operandi of internet business have made the operation and enforceability of tax legislation more difficult. A substantial amount of state revenue which is generated through direct and indirect taxes is lost when internet transactions remain untaxed. An effective solution is needed to tackle this.

Several basic principles form the base of taxation policy of a country. The most important of these principles are efficiency, equality, certainty, and positive economic effect.[1] If the tax system disdains these principles, it proves to be fatally defective for a country's revenue generation. The efficiency principle encompasses notions of both fiscal efficiency and economic efficiency. The argument for this is that an economically efficient tax system should be neutral and should not influence one's economic behaviour simply because of the method by which the tax is levied or imposed. An ideal tax system should be equitable in its use and must be able to put into practice without disturbing the economy. Not only does it treat taxpayers in similar economic circumstances[2] similarly but also makes suitable distinctions in its treatment of those in different economic situations. It necessarily raises questions of 'similar economic circumstances'. Certainty in tax laws is a fundamental principle in the establishment of an ideal tax structure because the predictability of tax consequences is an essential component of other basic tax principles. Finally, taxation has always been a mechanism for stabilisation and regulation of the economy. Recognising this fact, the legislature has emphasised the economic effects of the principle of taxation, with a particular focus on encouraging economic growth.

HOW THE INTERNET WORKS

For the growth of rational tax policy one should understand the nature of e-commerce industry or in other words, one should understand how the internet works, and what all transactions can be carried with the aid of the internet. The peculiarity of internet is, that it is a 'network of networks' and it cannot be controlled or owned by one person. This 'network of networks' is capable of rapidly transmitting packets from one computer to another without any human involvement which actually makes them independent in their transactions. The internet can re-route itself if one computer is connected to the net. The world-wide-web environment provides a user-friendly graphical interface which can procure sufficient information from anywhere in the world for the user.

Primarily, internet activities are divided into two parts namely, 'access service' and 'content service'. In the former, access to the internet is provided to the individuals, whereas, in latter, content consisting of information is delivered electronically. To distinguish further an internet service provider is one which provides the service of accessing internet whereas, an online service provider[3] (hereinafter 'OSP') is one which provides service through

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the internet. This service, rendered by them in return for the payment of subscription and usage fees, are subjected to tax. The internet as discussed earlier encompasses content or material service, which contains traditional retail transaction to an electronic medium, electronic commerce involving digital products. This would eventually create so many intellectual property issues like the infringement of copyright, trademark abuses[4] etc.

The transactions through the internet are classified into two categories namely, online and offline transactions. 'Offline transactions' include any transaction where goods and services are ordered and possibly paid through an electronic mechanism, but delivered by other means like courier or postal services. The bulk of e-commerce is currently rooted in offline transactions[5]. In contrast to the normal transactions, these offline transactions came by disintermediation. The practicalities of enforcing sales tax, customs duty differ between online and offline transactions. The tax authorities will need to re-think their current methods of tax collection, simplifying or streamlining procedure without threatening any revenue or other cross-frontier controls.[6]

The term 'online transaction' refers to any transaction, which is delivered online. These transactions are very difficult to handle, for tax-collecting authorities. The problems with online transactions, as perceived by tax collecting authorities[7] include:

- Inability to identify a transaction
- Encryption of transaction
- Collecting the tax from millions of end-users rather than a small number of intermediaries
- Difficulties in determining where a product is produced or consumed
- Definition of goods and services and
- Distinctions between types of services

The online transaction renders the tax collecting authorities virtually powerless in identifying transaction between the consumers and overseas suppliers,

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where all of the transaction has been performed electronically including paying the money through electronic currency like Bitcoins and Credit Cards. We shall now discuss some of the important issues faced by the tax authorities in detail.

Establishing an Identity for a Transaction

In order to properly carry out taxation laws, the authority needs to not only identify whether a transaction has occurred, but also ascertain where it has taken place and by whom (i.e., to ascertain the place of transaction and the person who was involved in the transaction). Verifying the identities of parties to a business transaction may be difficult in the world of 'e-commerce' as the parties are always under an invisible cloak. For example, it may be impossible to identify the true owner of a web site conducting internet business. The problem here is that the mechanisms for tracing identity are weak, considering that it is a relatively simple matter to arrange for the untraceable use of an internet web site. The correspondence, furthermore, between the Internet address (the computer domain name) and the location where the activity is supplied, carried out or consumed is feeble. Although the address will reveal the person responsible for maintaining that site, it may not reveal anything about the computer that corresponds to the actual internet address, or even where that machine is located.[8] Authorities will need to think carefully before responding to this problem by instituting identification and registration requirements as it is likely that such requirements will have limited success due to the growing ease with which web sites can be located in an offshore place.

The Committee for Fiscal Affairs of the Organisation for Economic Co-operation and Development (hereinafter 'OECD') has responded to this issue by recommending that, "*Revenue authorities may consider requiring that business engaged in electronic commerce identify themselves to Revenue authorities in a manner that is comparable to the prevailing requirements for businesses engaged in conventional commerce in a country*".[9] However, this is possible for those countries having a strong ICT network like those of the developed countries.

This recommendation, adhering to the desired quality of trying to achieve neutrality between physical business enterprises and virtual business enterprises operating via internet, is essentially advocating voluntary compliance. Indeed, the OECD believes that many businesses will provide information on their web sites that can be used to accurately identify the business and its physical location, but also believes that it would be helpful if the information is provided as a matter of 'common business practice'. Nonetheless, as is the

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case in the physical world, any voluntary compliance regime that may be contemplated for the electronic world, will need to be reinforced with other methods to enable the taxing authorities to trace businesses that do not provide this information as a 'matter of course'. An example of a supplementary measure could be authorising the access, for the taxing authorities, to Internet Protocol number allocation records to validate identity.

Establishing a Location

Assuming a transaction can be identified and the identity of the parties is ascertained, the next problem is to determine whether a taxable transaction arises, and if so, under which jurisdiction that transaction should be taxed. Individuals and entities engaging in electronic commerce will be able to easily create an internet address in almost any taxing jurisdiction irrespective of the location of their residence or the source of their activities.

This could easily be exploited in manipulating a location to obtain a reduced or zero rate of withholding tax on royalties. While the problem of establishing a physical presence and withholding tax entitlements is not necessarily a new one, it does take on a different dimension in an electronic commerce world. Presently, a payer might be able to rely on the postal address of the payee to verify the right to any treaty benefit but in a world of electronic commerce, there is no necessary relationship between an internet address and a physical location.

As an example, a taxpayer may download a digitised photograph from an electronic stock agency and obtain the right to reproduce that image in a magazine or book. The payment for this right would presumably be characterised as a royalty. The seller of this electronic information may claim to be a resident of a treaty country by establishing an internet address in that jurisdiction in order to claim an entitlement to a reduced or zero rate of withholding tax on royalties.

Therefore, if withholding taxes are to be imposed on e-commerce, it will be necessary to establish procedures and standards for verifying the identity of electronic counter-parties to confirm claimed entitlements to a zero or reduced rate of withholding tax on royalties. Consideration would also need to be given to the management of withholding taxes, if they were necessary.

The challenge presented here is that traditional taxation concepts rely on physical presence or economic connection to a physical location; e-commerce, however, has little dependence on physical location. Thus, as physical location becomes less important in an electronic commerce world, it will become more difficult to determine the location where the activity has been carried out.

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Also, it will become easier to exploit rules based on location by establishing an internet presence in jurisdictions to claim treaty or other benefits. On the contrary, as an internet presence can easily be relocated, one can expect that manipulation and distortion could occur to avoid potential and undesirable tax consequences that may result from having an internet presence in a particular jurisdiction.

Encryption of Transaction

Powerful encryption technologies are now available to everyday internet user and are expected to become commonly used in the upcoming years. These technologies allow users to encrypt the whole transaction so that only the parties involved can decrypt the information. This means that if the income tax officer or other tax authority intercepts a transaction, he or she will not be able to read or understand its content in order to identify whether the transaction involves accessible goods or not. The use of encryption technologies will not only be conducted by tax evaders but also by the most honest citizens for a secure transaction.

Collection of Tax

Another major problem in e-taxation is collection of taxes from millions of individuals rather than intermediaries. This will increase the burden on the authorities as it leads to an increased rate for cost of tax collection. Internet makes the physical location of the seller's business irrelevant. Whereas, the conventional notions of the sales tax law are based on the location of seller's business itself. Making use of the unique feature of the internet, the seller may operate his market in a state effectively from far beyond the state's borders where it may be immune to the states taxing jurisdiction there by evading tax. The VAT system currently is place in 30 OECD countries used credit invoice tax systems. This method has a base that relies on a number of rules and one of these rules is the 'place of supply rule'[10]. This rule tries to ensure that appropriate goods and services are subject to taxation only once. The OECD has recommended that the place of supply rule be called the place of taxation rules, so as to minimise any prospect of misunderstanding about the extent and implication for countries arising from any consensus reached on the place of taxation[11].

The tax administrations throughout the world face the formidable task of protecting their revenue bases without hindering the development of new technologies. The challenges posed to tax systems worldwide by Electronic Commerce (hereinafter 'EC') are real. Numerous governments and financial

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organisations and institutions (e.g., the OECD) are focusing on addressing them in a spirit of collective co-operation. The allocation of taxing rights must be based on mutually agreed principles and a common understanding of the application of the principles. In addition to the need for consensus between governments, a need for co-operation between governments and business has also been identified[12].

A change in business practice due to the advent of EC has affected the taxation in the following ways:

- Lack of any user control forbids the access to the location of activity: As the physical location of an activity becomes less important, it becomes more difficult to determine the location of the activity, and hence to determine the source of income.

- No means of identification of users: In general, proof of identity requirements for internet use is very weak. The pieces of an internet address (or 'domain-name') only indicate who is responsible for maintaining that name. It has no relationship to the computer or the user corresponding to that address.
- Reduced use of information reporting and withholding institutions: Traditionally taxing statutes have imposed reporting and withholding requirements on financial institutions, which are easy to identify. In contrast, one of the greatest commercial advantages of EC is that it often eliminates the need for intermediary institutions. The potential loss of these intermediary functions poses a problem for the tax administration.[13]

GENERAL PRINCIPLES ON INTERNET TAXATION: SOME OF THE CHALLENGES

The International tax issues in the area of e-commerce are manifold and include the nexus of the vendor and the enforcement. Taxing authorities may face great difficulty in collecting revenue from the vendors who indulge in e-commerce transactions through their foreign internet address. The vendor operating through the internet is not identifiable as there is no physical presence of him. This is actually the prime challenge before the authorities for taxation.

There are certain principles in International Taxation which are as follows. The principle of tax neutrality requires that any equitable tax system should

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treat economically similar income equally.[14] For electronic commerce to flourish, the principle of tax neutrality would require that income earned through electronic means should be taxed similarly to the income earned through one or more conventional channels of commerce.[15] Doing otherwise would place e-commerce at a competitively disadvantaged position in relation to other modes of commerce, defeating one of the purposes of an equitable tax system. The practical application of tax neutrality, then, would be in a position that no new taxes would be placed on e-commerce transactions.

The principle that a country has the right to tax the business profits of a resident of another country, only if that person has a permanent establishment in that country, is one of the primary legal principles in international tax law and is a vital provision in international tax treaties[16]. The establishment of this conventional principle helps to alleviate the double tax[17] and base erosion of profit. The concept of permanent establishment is essentially a trade-off between source and residence state's jurisdictional power to tax. It determines whether an enterprise carried on in more than one country is subject to tax on its business profits only in the country of residence; or if that enterprise is also subject to tax on the same business profits in one or more of the countries in which the business is carried on.

A taxpayer is generally taxed on its worldwide income in the country of its residence ('residence based taxation'). In the case of a company, this is usually the place where the company is incorporated, registered, or has its place of central management and control. A company may also be taxed in another country if it has a recognised source of income there ('source based taxation'). Generally tax treaties[18] restrict the use of domestic source rules by requiring a certain minimum nexus to allow taxation in that jurisdiction. Thus, taxation of business income on the basis of the source rule requires the presence, in the country of source, of a Permanent Establishment of the enterprise sought to be taxed.

But when it comes to e-commerce a number of questions are raised. For instance, whether international trading by an enterprise through Electronic Commerce result in that enterprise creating a taxable Permanent Establishment (hereinafter 'PE') in the other countries in which its customers are located. The most important aspect here will typically be whether the existence of a web

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site and server in a country where no employees are located is sufficient to create a taxable PE. This actually leads to the arousal of the following questions. a) Whether an Internet Service Provider (hereinafter 'ISP') can be considered to be a dependent agent?

b) Similarly, if an enterprise provides excess server capacity to another business to operate a web site, is the equipment (the web-server) considered to have been leased?

If it is determined that an enterprise does have a PE in another country, another important issue then arises: how to attribute profits to the PE? Secondly, EC gives rise to new issues concerning the characterisation of payments under double tax treaties. It is often difficult to distinguish whether payments for activities such as searching a computer database and downloading a document represent payment for the sale or lease of property, payment for the provision of services, or royalty payments. If double tax treaties strictly follow the OECD model tax convention, the distinction may have little importance as taxing rights will be allocated to the country of residence of the enterprise unless it has a PE in the other country[19].

The concept of permanent establishment was originally developed under a Prussian domestic legislation and developed a narrower meaning as the necessity of prevention of double taxation grew among the German States[20]. Between 1927 and 1946, a number of draft tax treaties, which included variations of the permanent establishment principle, were introduced by the League of Nations but no commonly accepted definition of permanent establishment was established. In 1958, the Fiscal Committee of the OECD published its first report with a draft definition of permanent establishment. This draft definition formed the basis for Article 5 of the OECD Model Convention and, with some modification, was also used in Article 5 of the UN Model Convention of 1980[21].

There are generally three circumstances in which a 'permanent establishment' will be found to exist for treaty purposes. The primary rule provides that a permanent establishment exists if there is a fixed place of business through which the business of the enterprise is wholly or partly carried. The

term 'fixed' here is oriented towards a determinable place or geographical location. The term 'business' means any profit generating activity done by the enterprise and finally the 'wholly or partly' denotes the time essence of such enterprise. The essence of time is one of the pre-requisite for tax liability and it varies from treaty to treaty. There are a number of implied conditions that must be satisfied in order to constitute a permanent establishment. If one of those conditions is not met, there is no permanent establishment under the primary rule. Where the conditions of the primary rule are not met, a permanent establishment may be deemed to exist under either a 'construction clause' or the 'agency clause' in the relevant bilateral tax treaty.

The notion of a 'permanent establishment', as embodied in tax treaties, is a crucial one as it alone would be considered for the interpretation. Where the concept is applicable, one treaty partner relinquishes its jurisdiction to tax the business profits of residents of the other treaty partner unless local activities rise to a certain threshold, i.e., unless they amount to a permanent establishment. Thus, the purpose of the permanent establishment concept is to define when a non-resident has established sufficient presence in a jurisdiction so as to warrant direct taxation of his business profits there. When a taxpayer's presence is not sufficient (i.e., when no permanent establishment exists), source-based taxation is given up in favour of residence-based taxation.

The development of electronic commerce (hereinafter 'EC') has revolutionised the way businesses operate. It has also challenged the adequacy and fundamental validity of principles of international taxation such as physical presence, place of establishment etc., that have formed the basis for assessing tax liability.

With the advent of EC, even smaller corporations and individuals can aspire to have a global presence. Correspondingly EC has also bridged the gap between developed and developing countries. It has therefore become extremely essential to provide a legal and tax environment that is conducive to the growth and development of these technologies. The implications of the growth of EC on domestic and international tax systems has already been felt and considerable work on this subject has already been done by countries like U.S., U.K., Singapore and South Africa. They have identified the issues arising out of EC and have attempted to lay down the fundamental principles of taxation of EC. Most countries have advocated principles of neutrality, certainty, avoidance of double taxation and low compliance cost and they also incorporate them in their DTAA. The upcoming chapters will examine the position taken by these countries and other multilateral agencies like the OECD on the issue. It will furthermore identify the options available for Indian tax authorities.

Apart from this, a substantive issue raised by these technologies is identifying the country or countries, which have the jurisdiction to tax such

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income. Whether a web server and an Internet Service Provider will constitute a 'permanent establishment' or not are questions which have been haunting policymakers. The traditional concept of source-based taxation may lead to a global migration to low tax or tax haven countries. Any attempt to artificially tax e-commerce will also accelerate such migration. Therefore residence-based taxation is being advocated by many countries, with the U.S. being one of its main proponents. However, determining residence itself is likely to be problematic.

Classification of income arising from transactions in digitised information, such as computer programs, books, music, or images is also an issue that requires consideration. The distinction between royalty, sale of goods, and services income must be refined in the light of the ease of transmitting and reproducing digitised information. While electronic commerce may not necessarily present any unique problems for transfer pricing, the growth of electronic commerce may make some of the transfer pricing problems more common. Some of the issues that need thought include: possible difficulties in applying the 1995 OECD Transfer Pricing Guidelines[22], the likely difficulties in determining profits of enterprises where a high level of 'integration' within businesses (especially multinational enterprises) will be possible consequent upon electronic commerce; and the likely difficulties in identifying, tracing, verifying and quantifying transactions in highly integrated enterprises.

CONCLUSION

Firstly, there is a suggestion that e-commerce should 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.

Secondly, the existing definition of Permanent Establishment is obsolete and cannot be applied in the e-commerce sector. In section 8 of the Report, the work of reputed authors Peter Hongler and Pasquale Pistone have proposed the following amendment to the definition of the PE to base it on Significant Economic Presence, "*If an enterprise in one contracting state provides access to (or offers) an electronic, database, online market place or storage room or*

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offers advertising services on a website or in an electronic application used by more than 1000 individual users per month domiciled in the other contracting state, such enterprise shall be deemed to have a permanent establishment in the other contracting state if the total amount of *revenue of the enterprise due to the aforementioned services in the other contracting state exceeds XXX (EUR, USD, GBP, CNY, CHF etc.) per annum*".[23]

Thirdly, the scholars suggest the use of IP address as notion for physical presence or identification of the person who has done the transaction through the IP address, as every computer connected to internet uses the IP address. These IP addresses will be located in a country and through this one can attribute tax liability and infer jurisdiction to tax on it.

Fourthly, some potential options have been proposed as the alternative to PE thresholds. The three broad alternatives considered by the Business Profits Technical Advisory Groups (hereinafter, 'TAG') in the term PE to Virtual PE are as follows.

- A 'virtual fixed place of business PE': When a foreign enterprise maintains a website on a server of another enterprise located in a jurisdiction of State and carries on business through that website, the website should be considered as PE;
- A 'virtual agency PE': This is the extension of the existing concept of dependent agent PE when contracts are habitually concluded on behalf of a foreign enterprise through technological means located in the jurisdiction, rather than through a person; and
- An 'on-site business presence PE': The economic presence of a foreign enterprise within a jurisdiction should be recognised if it provides on-site services or other business interface at the buyer's location.
- Even if the challenges outlined above only erode the borders of the tax system, the impact could be considerable, because the public sector is inherently inflexible and dependent on taxes to fund political commitments given by governments.

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