



E-commerce – International approach

I. DEFINITION

Electronic commerce, commonly known as **e-commerce**, consists of the buying and selling of products or services over electronic systems such as the Internet and other computer networks.

The World Trade Organization defines e-commerce as, "e-commerce is the production, distribution, marketing, sales or delivery of goods and services by electronic means."

The Organization for Economic Co-operation and Development (OECD) defines e-commerce as commercial transactions, involving both organizations and individuals, that are based upon the processing and transmission of digitized data, including text, sound and visual images and that are carried out over open networks (like, the internet) or closed networks (like, AOL or Mintel) that have gateway onto an open network.

The meaning of electronic commerce has changed over the last 30 years. Originally, electronic commerce meant the facilitation of commercial transactions electronically, using technology such as EDI and EFT. These were both introduced in the late 1970s, allowing businesses to send commercial documents like purchase orders or invoices electronically.

The growth and acceptance of credit cards, automated teller machines (ATM) and telephone banking in the 1980s were also forms of electronic commerce. From the 1990s onwards, electronic commerce would additionally include enterprise resource planning systems (ERP), data mining and data warehousing.

A wide variety of commerce is now conducted in this way, such as, Electronic funds transfer (EFT), supply chain management, Internet marketing, online transaction processing, electronic data interchange (EDI), inventory management systems.

E-commerce now a days operates in all four of the major market segments: business to business, business to consumer, consumer to consumer and consumer to business.



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E-commerce may thus be defined as those commercial transactions carried out using electronic means, in which goods or services are delivered either electronically or in their intangible or tangible form.

KINDS OF E-COMMERCE

E-commerce is basically of two kinds:

- **Indirect e-commerce (electronic ordering of goods both intangible and tangible); and**
- **Direct e-commerce (exchange of goods online or using electronic means)**

Indirect e-commerce involves ordering of goods. Delivery of such goods cannot be done online. Thus, only soliciting the customers and orders through electronic mediums does not mean doing business within a country and there should not be any question of profit arising in that country in such a case.

EFFECTS OF E-COMMERCE ON BUSINESS

Electronic commerce is progressively and irreversibly changing the face of many businesses because of three dominant phenomena:

- (1) Disintermediation, whereby intermediaries in the transaction are eliminated (e.g., on-line trading);
- (2) Re-intermediation, whereby a new electronic intermediary comes between the seller and the buyer (e.g., electronic booksellers that take orders and farm them out to providers that have the book in stock); and
- (3) Cannibalization, whereby businesses progressively give up their traditional ventures system for the superior electronic model (e.g., traditional pharmacies opening on-line drug stores).

An e-commerce transaction may travel through series of applications and systems from the stage of initiation to its completion.

For example, a customer may enter a transaction using organization's websites. The transaction may then be passed to an application system by the web server. Finally, the application systems may pass the transaction to the accounting system.

All serious business & service providers now needs to have an E-identity, an E-address and an E-communication channel to communicate. Receiving post for business has become a rarity.

E-commerce also brings with it unfair, illegal and fraudulent practices which, also makes nations frame laws to check cyber crimes and develop web-based systems to check illegal practices.

II. Taxing E-commerce Transaction

- ***The Committee on Fiscal Affairs set up by the OECD*** has recommended following five aspects as key to formulating tax policy relating to e-commerce: Neutrality; Efficiency; Certainty and simplicity; Effectiveness and fairness; and Flexibility.
- ***Each country must focus to develop its own detailed system of tax, based on these indicative guidelines.***
- ***The various policy formulating organizations of the world, aim to develop some laws to deal with this new-era commerce. At the forefront is the OECD helped by various member countries, who lend their own experience to develop a comprehensive framework.***

III. Taxation of e-commerce

The e-commerce juggernaut is not without its dangers and shortcomings. It is drastically affecting traditional firms that cannot continue to do business according to the traditional economic model. This sometimes may lead to an elaborate and often untraceable form of tax avoidance. Transactions that may be legal and valid in one jurisdiction may not be enforceable in others. This is not only a threat to civil society but also overrides traditional principles of taxation.

Physical presence to perform the traditional commercial activities is no longer required; technological invention has replaced the physical transaction with bytes of data. Due to non existence of geographical boundaries in the e-commerce, the question where the profits should be taxed becomes crucial. The task of taxing e-commerce is frightening, since the data flowing through the internet is intangible and the network on which it is built is spread all around the world and caters the

to globally located customers. This raises cross border issues. It has also challenges the fundamental principal and assumptions of the International Taxation such as physical presence, place of residence of a person etc. that is the very basis of ascertaining a tax liability is under serious challenge.

In cases of cross-border e-commerce transactions, the tax issues are more complex. According to the well recognized traditional principles of international taxation, when a resident of one country earns income from economic activity in another country, both countries have a right to tax the same income: the home state based on residence rule and the host state based on the source of income rule.

A few important problems which are faced in International taxation of e-commerce are:-

1. There are no separate rules for taxation of electronic transactions.
2. Due to the absence of physical activity, it may be difficult to determine the place of the transaction and the source of income.
3. It may be difficult to trace the person who is responsible for entering into the transaction.
4. E-commerce may result in avoiding the "**withholding tax**", due to payment being made by electronic means eg. Credit card etc.
5. Whether a website, server, telecommunication equipment, local access numbers, etc. constitute a permanent establishment or not, or should the source based taxation or the residency based taxation be applied to an E-transaction?

Now a day's an electronic payment system clouds the identity of the parties to each transaction and sets aside the normal banking channels, it results in more difficulties to trace the e-transactions than traditional transactions.

Web - based companies are selling digitized photos, videos, various intangibles and software etc. and are usually located in one of the many offshore tax havens with a aim to minimize taxes. These tax havens have strict banking privacy laws and strong debtor protection laws. By using the internet, they have the ability to keep their income producing activities more secret than if they were engaging in traditional economy commerce.

The myriad problems in the taxation of e-commerce have brought the world to the cross-roads of moving ahead from traditional to new-age taxation. It is for us now, to be able to

develop tools and rules for this new technological environment and also deal with the problems.

IV. Basis of Taxation in India

There are three pillars of International taxation in India, namely:-

Jurisdictional Nexus - The prime principal which determines whether tax can be levied on the commerce or not within territorial jurisdiction of India as defined.

Source of Income - The Source based taxation rule provides authority to tax the income in the source country, i.e. the profit from e-commerce transactions shall be taxed in the country of origin. Taxing the income of an assessee by grouping the income, under the five heads provided by the Indian Income-tax Act 1961, which are Income from Salary, House Property, Business or Profession, Capital Gain and From Other Sources, and taxing each of them separately.

Status Principle – Resident, Non-resident or Not ordinary resident principle determines whether the person is exigible for taxation in India on its global income or Indian income only.

In India, in view of the recent judicial precedents, there are two main areas in which clarity needs to be established. One is the determination of the character of the income that is generated by the e-commerce transaction: is it royalty, business profit, or fees for technical services? The other more tricky area is the determination of income liable for tax. This necessitates the establishment of the existence of a Permanent Establishment (PE). Further, the determination of attribution of income, if any, to the PE needs to be determined.

This would also bring us to the critical area of the transfer pricing and determination of arm's length price for transfer of goods and services. A lot of Multi National Companies have Business Process Outsourcing Units (BPOs) in India. Normally, the whole operation is conducted electronically. Huge amount of litigation is ensuing in India on function thereof. In the following part of the analysis, we have summed up the various types of e-commerce transactions and the position by the International and Indian policy makers.

A. Taxation Digital Goods

Digital goods means, a product which could be translated into the language of e-commerce i.e.

zeros and ones, bits and bytes.

Examples of these are: Software, data and information product, audio and video composition etc. The "source" concept would still be relevant.

In India, "**Goods**" have been defined in the Sales Tax Act of States to mean all kinds of moveable property except actionable claim, stocks, shares and securities. It includes all materials, articles and commodities, which have been used in the same sense as used in **Article 366(12)** of the **Constitution of India**.

The case of, "Tata Consultancy Services V. State of Andhra Pradesh" [271 ITR 401 (2004)], throws some light on, whether the sale or purchase of goods "can cover intangible goods" or not? It was held by the Supreme Court, that branded software which is an intangible intellectual property where it is in the form of 'information' and 'Knowledge' once it is transformed into physical existence and recorded in physical form, it is no longer in an intangible form but a corporeal property and hence taxable as goods under definition of goods under the Sales Tax Act.

Various views have been expressed world over, some of which are described below:-

US Treasury department has divided software transactions into four categories, namely:

- 1 Transfer of copyright in the computer software*
- 2 Transfer of a copy of the computer software programme*
- 3 Provision of services for the development and modification of computer software programme*
- 4 Provision of know-how or the development and modification of the software programme*

In the first category, the transfer of copyright in the computer software is license and these license are viewed as Royalty. It is Indian sourced, if royalties are paid by the Government or the Indian resident or the non-resident Permanent Establishment (PE) in India.

Software is normally licensed out for use and not for sold. This means that a software vendor retains a proprietary interest in the software that it supplies and therefore it is Royalties or Fee for technical services (FTS). In India also, a similar issue was decided by the **Authority for Advance Ruling** in the case of **Airports Authority of India (AAI) Vs DIT in favour of revenue. 218 CTR 321 (AAR)**, which held that the seller has not transferred ownership in the documents and software supplied to AAI which has only been given the right to use the software, so it is not the case of outright sale and

the payment in respect of such software shall be taxed as Royalty and Fee for Technical Services as defined in the Indian Income Tax Act., 1961.

Further, this view was also supported by **Commissioner of Income Tax (Appeal)** in the case of **Microsoft Corporation** in which it was held that, "the appellant had sold software under the scheme 'full packaged product' and 'volume purchase product' to an Indian customer. This was a factual incorrect statement, the correct fact is that appellant had licensed these software to its customers in India to copy the same on a specified machine and to use it, in lieu there of a consideration." Here also, the appellant authority has held the payment to be that of Royalty and Fee for Technical Services as per Indian laws.

Further, the OECD committee on Technical Advisory Group (TAG), also states in its report, that the payment made as consideration for the right to use the copyright in the digital product should be classified as Royalty.

In the second category, if it is outright an alienation of rights in a software, it is considered to be a sale of copyright, as a sale of intangible property. It is sourced under the same rule as other property rights.

Further, **para 15 of OECD model tax convention commentary** states that, "Where consideration is paid for the transfer of the full ownership of the rights in the copyright, the payment cannot represent a royalty and the provisions of the Article are not applicable. Difficulties can arise where there is a transfer of rights involving:

- exclusive right of use of the copyright during a specific period or in a limited geographical area;
- additional consideration related to usage;
- Consideration in the form of a substantial lump sum payment."

Each case will depend on its particular facts and will need to be examined in the light of the national intellectual property law applicable to the relevant property and the national law rules as regards what constitutes alienation.

The third category consists of writing programme codes for the recipient where the recipient would own the substantive copyrights and assume the risk that the resulting code would serve its purpose. This transaction will be classified as "provision of services". In such a case, the payment is made in consideration for the services that will result in the development of the software. In such a case, taxation rights are where the source of the income is i.e. the place of performance of the services.

As for the fourth category, it involves the transfer of trade secrets, where the know-how providers assume the risk that they have provided the user with something that will achieve the desired result. In such case, the taxation rights are where the place is located where the know-how is utilized.

Further, it has to be analyzed, whether electronic delivery of software makes any difference comparative to physical delivery. In this regards Article 12 of the OECD Model tax convention addresses the issue of treatment of electronic delivery of computer software programme. It provides that such delivery should be treated as the physical delivery of the programme because the method of delivery is not relevant.

This view is not consistent with the view taken by the Indian judiciary as can be seen in the case of the **Authority for Advance Ruling (AAR) in AAR No. 390 of 1997**.

B. Whether e-commerce leads to creation of a Permanent Establishment (PE)?

The importance of determining the presence of PE in a country is crucial only because, an enterprise of a contracting state is generally exempt from tax on its profits derived from business carried on in the other contracting state unless these profits are attributable to a PE located in that other contracting State.

Taxation of business income on the basis of source rule requires the presence of a PE of the enterprise sought to be taxed, in the source country. Therefore, existence of a PE is crucial to verify the existence of tax liability in the source country (the other contracting state).

As per International Tax treaty convention there are three main criterions to determine the presence of a PE in a country; namely:-

1. **Assets test** – The enterprise owns tangible or intangible assets in a country.
2. **Agency test** – The enterprise employs a dependent agent having authority to conclude the contracts on behalf of non-resident.
3. **Activity test** – The enterprise perform activities in the other country that contribute to the productivity of the enterprise and involve actual realization of profit in that other country.

The basic rule of PE is given in **Article 5 of OECD Model tax convention** i.e., the fixed place of business and the agency rule.

A PE signifies a geographically 'fixed place of business' established with the intention of continuing for some period of time for conducting the 'core functions' of the enterprise and not just to perform 'preparatory' or 'auxiliary' activities. However, globally there are disagreements regarding what constitutes 'core functions'.

Whether e-commerce transactions leads to creation of PE or not, can be answered by applying the above mentioned basic tests on specific situations.

There has been some discussion as to whether the mere use in e-commerce operations of computer equipment in a country could constitute a PE. That question raises a number of issues in relation to the provisions of bilateral treaties.

Here we are discussing the presence of a PE in a country in probable specific situations of e-commerce.

(i) Whether a server constitute a PE

The basic criterion for the establishment of a PE is the totality of economic activities. The activities carried out through a server e.g. offering and accepting orders, management and administration, will constitute a PE but mere gathering of market information will not constitute a PE. The basic principal of server can constitute a PE is that, it performs some functions and the income is attributable to such functions performed through the server.

This issue has also been opined on by the Bangalore bench of the Tribunal in the case of ***Wipro Limited Vs ITO [2005 278 ITR 57]*** in which it is held that, "The data server is undisputedly located outside India, consequently the provision of services of offering the database to its customers is an event outside the taxable territories of India." Thus, the server did not constitute the PE in India. Here the inference is that the server was performing core functions outside India.

Further, Para 42.5 of the OECD commentary elucidates, "Another issue is whether the business of an enterprise may be said to be wholly or partly carried on at a location where the enterprise has equipment such as server at its disposal. The question of whether the business of an enterprise is wholly or partly carried on through such equipment needs to be examined on a case by case basis, having regards to whether it can be said that, because of such equipment, the enterprise has a facilities at its disposal where business function of the enterprise are performed."

Therefore, a server can constitute a PE depending on the facts of each case. If the server performs some core functions that are revenue generating for the enterprise, it may be regarded as a PE of that enterprise in the country.

(ii) **Whether a computer constitutes a PE**

Normally, a question arises in International Taxation, whether merely the use of a computer can constitute the computer to be a PE. One school of thought is of the view is that the location of a computer which initiates the contract, would constitute a PE for the non-resident, since it is carrying out revenue generating activities.

Thus, a location where automated equipment is operated by an enterprise may constitute its PE in the country where it is situated. In the case of *Galileo Intl. Vs DCIT [2008] 19 SOT 257*, the Delhi Tribunal held that the assessee has a fixed place of business on the grounds that the computer was installed in the premises of a subscriber to the CRS system through which its business (partly) is being carried on and therefore it constitutes a PE under article 5(1) of the DTAA between India and USA. Here the view was the computer terminal was performing a core revenue generating function.

The same view is observed by Klaus Vogel (3rd Edition page 286) in which he states, "In the same vein, para 4 OECD MC Comm. Article 5 states that it was immaterial whether the premises, facilities of installations were owned or rented by, or were otherwise at the disposal of, the enterprise. A similar view was held earlier by FC Munster which stated that it was not necessary for the power of disposition to be legally confirmed by ownership or a lease. All that was required to satisfy the power of disposition test was actual disposition which did not need to go any further than necessary for allowing the permanent establishment to function."

In the case of Galileo, the business was partly carried out through the computers, and thus they were held to be PE of the foreign enterprise in India.

However, as per para 42.4 of the OECD commentary, "Computer equipment at a given location may only constitute a PE if it meets the requirement of being fixed."

This leads to various issues like, would business carried on through Laptop computers and Blackberry mobile phones would constitute a PE or not?

Also, Where an enterprise operates computer equipment at a particular location in a country, not requiring any human intervention and the computer itself undertakes complete business transactions within the given framework. Such computer equipment may also constitutes a PE if such equipment is located at a 'fixed place' and the functions performed by it are the 'core functions' of the

enterprise. (para 42.6 of OECD commentary)

This should be read in conjunction with para 42.8 of OECD commentary which states, "Computer equipment is to be taken as a permanent establishment if it performs the activities which are the core function of the enterprise where sales functions are performed through the computer equipment. Whether the product is delivered online or by traditional method, the equipment would constitute a "place of business" and may a permanent establishment."

However, Klaus Vogel has observed that (Pg 205), "A place of business means all the intangible assets used for carrying on the business; in marginal cases, one such tangible assets would be sufficient. The term covers both premises and other tangible assets used by the enterprise."

It seems to us that, the opinion of the Dr. Vogel is more practical as compared to the OECD.

It was decided in the case of **Rolls Royce Plc Vs. Deputy Director of Income tax [2008] 19 SOT 42 (DELHI)**, "A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal." Thus, having legal ownership of the fixed place has been held to be immaterial for the establishment of a PE in a country.

(iii) Whether an Internet service provider (ISP) constitutes a PE?

An ISP is a company that provides access to the internet. Usually, the website of a business enterprise carries on its business and is hosted on the server of an ISP. These are hosted based on an agreement made between the owner and the ISP, but this does not constitute a physical presence of the enterprise at that location since a website is not tangible. Further, the ISP merely acts as an intermediary between the seller and the buyer in the two different tax jurisdictions. The ISP cannot ever qualify as an agent of the non-resident seller on the following grounds: An ISP hosts on several websites on its server; it would be an independent agent; does not have authority to conclude contracts on behalf of website owners.

In our view ISP providers only provides an E-address and E-transaction platform. More like a modern day post office. Taxing the Postman is like shooting the messenger.

In view of the above discussion it can be concluded that the service provided by an ISP does not constitute him to be the PE of the Non-resident. Since this specific issue has not been yet interpreted by the judicial authority or by the revenue department in India, it is still a grey area.

(iv) Accessibility of websites in a particular jurisdiction whether it amounts to taxation in that jurisdiction?

A website is a mere combination of software and electronic data. It is not a place of business therefore it may usually not be a PE. If an enterprise carries on business through a website, it also owns the server on which the website is stored and used, the server could constitute a PE. But where a mere hosting arrangement exists; such a server cannot be said to be a PE. Homepages are analogous to magazine advertisements; therefore, no tax implications should arise from placing advertisements on the Internet under the existing laws of International Taxation.

The **OECD commentary** also clarifies that, mere existence of a website cannot create a PE and that a person may not have a '**place of business**' merely by hosting a website on a particular server situated at a particular location.

As an observer on the OECD, India does not agree with this interpretation, it is of the view that a website may constitute a permanent establishment in certain circumstances. An enterprise can be considered to have acquired a place of business by virtue of hosting its website on a particular server at a particular location. Each case needs to be examined based on the facts and looking at global judicial precedents.

(v) Whether Computer Reservation Services (CRS) Companies have a PE in India

CRS refers to many of the several proprietary computer systems allowing real-time access to airline fares, schedules, and seating availability and offering the capability of booking reservations and generating tickets. Such a system is also known as Global Distribution System (GDS).

In the recent decision of the Delhi Tribunals in the case of ***Galileo Intl. Vs DCIT [2008] 19 SOT 257 and Amadeus Global Travel Vs DCIT [13 TTJ 767 (Delhi)]***, it has been held that, the CRS companies are liable to tax in India, to the extent of the income reasonably allocated to the revenue generating activities performed in India. It has been concluded that these companies have a "virtual" PE in India and, hence, the booking fees received by them from airlines for bookings originating in India are taxable as business income of the PE in India.

What percentage of income can be reasonably allocated to the PE is still a gray area in International Taxation and requires judicial clarity in the times to come. In the two cases cited above the attribution of 15% of profits of the US based Company was done to an Indian PE, however as these companies had paid more than these sums to their dependant agents, which were held to have been paid at an Arm's Length Price. The net tax was NIL.

(vi) Taxability of electronic access to professional advice (e.g. consultancy)



A consultant, lawyer, doctor, or other professional service providers advise customers through e-mails, video conferencing, or other remote means of communication. The OECD committee on Technical Advisory Group (TAG), suggests that these transactions would constitute business profits falling under Article – 7 rather than royalty.

Further, para 11.4 of the **OECD commentary 2008 (revised)** addressed the issue and clarified that such payments are not be considered to be received as consideration for the provision of know-how but, rather, for the provision of services.

Conclusion

The allocation of taxing rights must be based on mutually agreed principles. In conclusion, the area of International Taxation in India is full of controversies at every step. India is a developing economy and is drawing guidance from the various others more developed economies, which have well established judicial precedents in the matter of International Taxation. However, as the new age technologies step into the world arena all the countries and tax experts of the world, will have to come together, to resolve jurisdictional discrepancies of thought and form. As the boundaries of the world shrink and slowly dissipative to allow full movement of goods, services and people, tax administration should be facilitating this process and not hampering it with complex laws.

We look forward to a free world with simplified barriers to free flow of thoughts, ideas and laws.

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