SOME TAX ASPECTS OF ELECTRONIC COMMERCE

K. R. GIRISH

FORUM OF FREE ENTERPRISE
PENINSULA HOUSE, 235 DR. D. N. ROAD,
MUMBAI 400 001.

"Free Enterprise was born with man and shall survive as long as man survives".

— A. D. Shroff
1899-1965
Founder-President
Forum of Free Enterprise

SOME TAX ASPECTS OF ELECTRONIC COMMERCE

K. R. GIRISH*

Electronic Commerce (EC) refers to the buying and selling of goods electronically. Any transaction of exchange done electronically could be classified as EC. The U.S. Department of Treasury defines EC as "the ability to perform transactions involving the exchange of goods and services between two or more parties using electronic tools and techniques." Hence, even a payment to a cab driver using a pre-paid card could be termed as an EC transaction.

EC is all around us today. Pick up the morning newspapers, switch to a business channel or speak to associates at cocktail circuits and there are good chances that one would hear about companies around the globe taking new initiatives in this area. A niche in the EC business segment is the final destination in the value chain for any information technology company today. This is fortified by one look at the financial press and stock market highlights that the commercial aspects of EC are creating, seemingly overnight, multi-billion dollar valuations in business areas, which were inconceivable to think about a short while ago. Investors in the U.S. and other developed countries are grabbing the IPOs of information technology companies, having anything remotely to do with "Internet Solutions",

* The author is a Chartered Accountant and a Partner of M/s. Bharat S. Raut & Co. The text is based on a presentation made at a programme under the auspices of Forum of Free Entreprise in Mumbai on 4th October, 1999.

notwithstanding their hefty pricing. No wonder why certain e-commerce companies have stratropheric market capitalisation even though the companies have yet to commence generating profits!

It is not that EC is a new phenomenon, which happened overnight. The electronic interchange of data has been in existence for almost around 30 years. In fact, the Internet recently celebrated its 30th birthday. However, most of this period was characterised by prohibitive costs of technology which resulted in this technology being used only by Government departments or large corporations, and that too, mainly in the developed countries. It is only the recent rapid progress made in communications technology that has made it possible for people to be "networked" together and hence, the emergence of Internet, Intranets, Extranet, etc.

The Business-to-business (B2B) segment is driven by the Electronic Data Interchange (EDI) technology for functions such as purchase orders, shipping documents, invoices, etc. The Business-to-consumer (B2C) segment is characterised by the popularisation of Internet. The falling costs of communications technology has enabled people to host virtual malls and storefronts on the Internet to conduct business electronically. Add to that the progress made by the credit card industry, emergence of payment gateway providers, efficient mechanisms and we have all the components of an electronic business model.

The potential reach of the Internet presents itself with tremendous business opportunities at reduced costs. In an all India E-Commerce Survey Report carried out by KPMG last year, only 4% of the respondents felt the potential benefits of EC was of no importance to the organisation's

strategy. Further, 83% of the respondents cited improved customer service and 78% of the respondents cited improved productivity as the top two potential benefits of EC. A study conducted concludes that the value of goods and services traded on the Internet by the Year 2000 would be US$ 10 billion. A recent survey in the U.S. has estimated that worldwide EC will reach between US$ 1.4 and US$ 3.2 trillion by the year 2003. This represents 5 percent of the global sales. The above statistics prove that EC is on the priopríty list of boardroom agendas and reflects a shift in the thinking of the traditional "brick and mortar" business models.

Taxation issues at a glance

When new technologies evolve, can taxation issues be far behind? If EC is being billed as one of the greatest economic developments of the 21st century, the taxation issues arising therefrom poses the single biggest challenge of the century to both — the businesses and the taxman.

The EC business model has the potential to render redundant the fundamental basis of "source" and "residence" on which taxation systems have evolved around the world. The significance of "geography is history" in context of EC transactions has the taxman worried about collecting his taxes and the businesses worried about the uncertainty arising as to the right manner and mode of collection of taxes.

Briefly, the following issues arise for consideration:

1. Traditional "source" concepts were based on a strong connection between economic activity and a specific location. Traditional "residency" concepts were based on parameters such as personal and economic relations, physical presence and place of effective control. These

concepts were used as effective tools in allocating taxing rights between various countries. As technological changes weaken the physical nexus of business with a specific geographical point, what are the implications for the above concepts? With whom lies the jurisdiction to tax?

2. A related issue to the above is about the constitution of a Permanent Establishment (PE) in a world where business is carried on in bits and bytes. Are the traditional principles of PE valid in the determination of the jurisdiction to tax? Can a server or a server space constitute a PE for tax purposes?
3. How can income from transfers of technology over the Internet be characterised? Does it constitute business profits or royalties? Is there an erosion of source taxation?
4. How can new technologies be used to improve the administration of taxes by checking problems of tax evasion, identifications and audit trails of the transactions and providing better services to tax payers?
5. What would be the transfer pricing issues arising out of EC transactions?
6. What are the issues arising in relation to Value Added Tax (VAT)?

I would like to discuss the global initiatives that have taken place in relation to the taxation of EC transactions so that the issues are appreciated in the correct perspective.

Global initiatives

Initiatives by the Organisation for Economic Co-operation and Development (OECD)

The OECD had done some pioneering work in highlighting

not only taxation issues connected with EC, but on the overall industry as well. The following gives a chronology of the key tax initiatives undertaken by the OECD:

In 1992, the OECD revised its commentary on Article 12 of its model convention to incorporate the income characterisation relating of software transactions. It was the first attempt at issuing specific guidelines for software transactions. The guidelines focussed on the nature of rights transferred in a software program for characterising the income under the model treaty. It stated that software purchased for 'business or personal use' of the user should be considered commercial income taxable as business profits and not subject to source country withholding unless a PE exists. On the other hand, revenue from transfer of software for commercial exploitation only should be characterised as 'royalty' income subject to source country withholding on gross basis. The practical analysis represented an important "substance over form" approach.

The OECD convened its first informal discussion of EC tax issues with the business community in Turku, Finland in November 1997. Several preliminary tax issues were highlighted at the conference. Briefly, the issues related to:

- the need for further analysis of the PE concepts;
- characterisation of online transactions;
- possibility of increased tax avoidance;
- point of consumption should be taxing jurisdiction for Value Added Tax (VAT);
- neutrality between EC and non-EC transactions should be maintained, although it is not always clear what is a relevent comparision for this purpose;

- tax administrators must have equal access to secure information in the online and offline worlds; and
- greater levels of cross border mutual assistance amongst the tax authorities.

The Conference was one of the first initiatives taken on a collective basis by the member countries to identify the key tax issues involved in EC. The Turku Conference, after highlighting the issues involved in EC taxation, initiated work on developing taxation framework conditions for EC.

Pursuant to the above, the Committee on Fiscal Affairs (CFA) of the OECD developed Taxation Framework Conditions setting forth the governing principles, and has specified a detailed work programme that is intended to lead to a fiscal climate where electronic commerce can flourish. The Framework Conditions were adopted in June 1998 and were welcomed by the ministers of the member countries at the Ottawa meet in October 1998. The Framework Conditions identify general tax principles that should be applied to EC and identify the principal areas for further work. The document also lays the broad taxation principles which should apply to EC. They are:

Neutrality

Taxation should seek to be neutral and equitable between forms of EC and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar activities should be subject to similar levels of taxation.

Efficiency

Compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible.

Certainty and simplicity

The tax rules should be clear and simple to understand so that the taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how tax is to be accounted.

Effectiveness and Fairness

Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counter-acting measures proportionate to the risks involved.

Flexibility

The systems for the taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.

The Framework Conditions identified the following four areas of taxation :

1. *Tax Treaty:* It provides that the present international norms are capable of being applied to EC, but some clarifications should apply in EC transactions. By doing this, it seems that the OECD has ruled out any possibility of drastically altering the model tax treaty. At best, it may come out with the additional clarifications such as constitution of a server as a PE, etc.
2. *Consumption Taxes:* It advocated that the taxation should occur in the jurisdiction where consumption takes place, and that the supply of digitised products should not be treated as supply of goods. The place of consumption as the taxing jurisdiction for VAT purposes follows the U.S. model for sales tax, which are imposed in the states where sales are made or where the products and services are consumed. It seems to differ

from the VAT model where both goods and services are usually taxed at the vendor's location.

3. *Tax Administration:* In this area, it is proposed that the information reporting requirements and tax collection procedures being developed must be neutral and fair in order that the level and standard is comparable to what is required for traditional commerce.
4. *Taxpayer Service:* A number of options have been identified for using the new technologies to improve taxpayer service.

The Framework Conditions state that in future, the OECD proposes to work in the above areas. There is particular emphasis on working with business and with countries outside the OECD in order to ensure truly global solutions. The work would be carried out by establishment of small Technical Advisory Groups (TAGs).

One of the principle concerns on taxing EC transactions is the potential loss of tax base to source jurisdiction. It is apprehended that once countries start levying taxes on EC transactions, organisations would start relocating to various tax havens where no taxes or minimal taxes exist resulting in significant tax revenues. The potential impact of these developments is significant. It is estimated for example, that foreign direct investment by G7 countries in a number of jurisdictions in the Caribbean and in the South Pacific Island states, which are generally considered to be low-tax jurisdictions, increased more than 5 fold over the period 1985-1994, to more than US$ 200 billion, a rate of increase well in excess of the growth of total outbound foreign direct investments.

If nothing is done, governments may increasingly be forced to engage in competitive tax bidding to attract or retain

mobile activities. That "race to the bottom" where location and financing decisions become primarily tax driven, will mean that capital and financial flows will be distorted and it will become more difficult to achieve fair competition for real economic activities.

To address the above concerns, The OECD has issued in May 1998, a report on Harmful Tax Competition. The report created a Forum on Harmful Tax Practices, set forth guidelines for dealing with Harmful Preferential Tax Regimes in member and non-member countries and adopted a series of recommendations for combating harmful tax practices. The Forum is responsible for undertaking an ongoing evaluation of existing and proposed preferential tax regimes. The guidelines on harmful tax practices incorporate a standstill provision and a roll-back provision.

Under the standstill provision, member countries are to refrain from adopting new measures, extending scope that constitute harmful tax practices. Under the rollback provision, the harmful features of preferential regimes must be eliminated before the end of five years.

The report would certainly have bearing on the work currently being done by the OECD on EC taxation. The increasingly mobile nature of EC transactions could give philip to the harmful tax practices. However, it remains to be seen the extent of effectiveness of the above guidelines. Moreover, there is the issue of the non-member tax havens.

Initiatives by the USA

The USA has also been very active at highlighting the tax issues arising out of EC transactions. In late 1996, the U.S. treasury department issued proposed regulations on the characterisation of income arising out of software transactions. The regulations were formally issued in

December 1998. The final regulations retain substantially all of the provisions in the 1996 proposed regulations, while adding additional explanations and clarifications requested by the taxpayers. The announcement of the regulations is a step closer to drive out the uncertainty relating to EC transactions. The USA is the only country in the world presently, to come out with a detailed guidelines for the characterisation of software revenues. The regulations classify computer program related revenue into one of the following four categories:

1. Transfer of copyright rights
2. Transfer of copyrighted article
3. Rendering of services; and
4. Transfer of know-how.

The regulations use four rights in the U.S. copyright law to provide guidance on classification :

- The right to reproduce for distribution to the public by sale, etc.
- The right to make derivative computer programs
- The right to make a public performance of the computer program
- The right to publicly display the computer program.

The transfer of a copyright is classified as either a capital asset sale or a licence generating royalty income depending upon the extent of rights transferred. Copyrighted article transfers are classified as either product sales or rentals depending on which party retains the benefits and burdens of the ownership.

Though the regulations relate only to software transactions, it represents an important step forward to achieve clarity

relating to EC transactions. A significant observation made in the preamble of the regulations is that the form of transfer of the software does not matter. It is thus consistent with the principle of neutrality advocated by the OECD for EC transactions. The Internal Revenue Service (IRS) specifically declined to extend these regulations to other digital products. The IRS would continue to study the issue of extending these rules to other digital products. It is widely believed that the rules for electronically transferred music, videos and books will take a position similar to that taken in relation to the software.

Based on the above regulations, the OECD has proposed to revise Article 12 of the model tax treaty by incorporating most of the provisions of the regulations.

Soon after issuing the draft regulations in 1996, the Department of U.S. treasury, Office of Tax Policy came out with a discussion paper on Selected Tax Policy Implications of Global Electronic Commerce. The discussion represents the U.S. thinking with regard to EC transactions. Again the guiding principle enunciated by the discussion paper was neutrality. It highlighted various areas of concern for tax administrators such as :

- Effective elimination of national borders;
- Inconsistent treatment of cross-border transactions by taxing jurisdiction, taxpayers being subjected to quixotic taxation; and
- Tax rules should provide certainty and prevent double taxation.

In October 1998, the Internet Tax Freedom Act (IFTA) was passed. The IFTA imposes a moratorium beginning from

October 1, 1998, and ending three years after the date of enactment on :

- Taxes on Internet access, unless such tax was generally imposed and actually enforced prior to October 1, 1998; and
- Multiple or discriminatory taxes on EC.

The ITFA also establishes an Advisory Commission of EC to study issues related to international, national and sub-national taxation of remote commerce and to make recommendations to Congress. It is not clear whether the bill seeks a moratorium only on state sales tax or whether the same apply to income taxes also. The original draft of the Act contained a specific provision that the bill would not be applicable to Income taxes but the same was dropped in the final bill.

In addition to the above, various initiatives at different levels are currently being undertaken. The National Tax Administration (NTA) has also released its report on EC tax policy, dealing mainly with the state and local tax issues. The advisory Commission has just commenced its series of meetings to debate over the taxability of EC transactions.

Initiatives by the United Kingdom

The UK has published its tax policy on EC, titled 'Electronic Commerce: UK Policy on Taxation Issues". The paper sets out the guiding principles in administrations of the taxation of EC. These include the potential for tax avoidance and tax evasion; cross-border transactions; VAT and other issues.

The principles that the UK believes should guide the future tax laws relating to EC include certainty in tax law, neutrality, prevention of double taxation, low compliance costs and no

new taxes on Internet-based commerce. These principles are similar to those adopted by the OECD and the USA. The paper recognizes the need for co-ordinated multinational approach to EC to avoid the possibility of double tax, or worse - no tax. According to the paper, the UK does not believe that it is necessary, at this stage, to make any major amendments to existing tax legislation and regulations, or to introduce any new taxes. This is in consonance with the view of the OECD in its Framework Conditions that the existing laws are adequate to support the EC transactions.

Initiatives by Australia

In August 1997, the Australian Tax Office (ATO) has published a detailed report on Internet taxation titled 'Tax and the Internet', containing detailed recommendations relating to the tax environment affecting electronic commerce. These recommendations were based on the principle of achieving neutrality between the traditional and electronic forms of transactions. The ATO estimated that the potential impact on the tax base will vary according to industry, tax and income type but there will be no immediate appreciable impact on tax collections. It also concluded that tax revenues are likely to be affected as EC develops and to the degree that Australian business suffers adverse impacts due to EC, the tax base will be reduced. The following is the broad outline of the report :

- Many digital products can be expected to fall within the current broad definition of royalties;
- The possible use of middlemen such as Internet Service Providers and Online Service Providers as tax reporting and collection agents;

- EC would lead to increased difficulty in applying traditional transfer pricing transactions methods and result in a greater use of profit split and profit comparison methods;
- Popular websites such as Netscape Navigator or Microsoft Explorer to be embedded with specialised codes to enable reporting of financial transactions;
- Tax return forms should be amended to require furnishing of information such as the universal resource locators (URLs) and email addresses together with limited information indicating Internet trading;
- Websites should be licensed;
- Negotiations should be had with major international credit card and electronic payment system providers to seek international agreement to allow revenue authorities to obtain access to transaction details.

Europe

In April 1997, the Commission of the European Communities (CEC) released its EC plan titled 'A European Initiative in Electronic Commerce'. The purpose of the plan was to provide a coherent policy framework for future European Union (EU) action, to consolidate a common European position, and to establish the ground for global consensus. The document examined, made recommendations and provided an implementation timetable in three broad policy areas: ensuring access to the global electronic marketplace infrastructure, technology and services; creating a favourable regulatory framework and promoting a favourable business environment.

Canada

In April 1998, Canada issued a significant report titled 'Electronic Commerce and Canada's Tax Administration' in

the potential impact of EC on Canada's tax administration. The report concludes that countries and businesses have much more to gain by stimulating EC than by inhibiting it and recommends that Canada should foster a favourable business and regulatory environment.

The report concludes with numerous recommendations, significant of which are as follows :

- The private sector should lead in the management, promotion and development of EC while the aim of the Government involvement should be to support and enforce a predictable, consistent and simple legal environment for EC;
- The overall EC environment and specific business practices need to be understood before any new taxes or policies are introduced;
- The taxation of EC transactions should be neutral and equitable and the taxes should be easy to administer and collect; and
- Multiplicity of taxation should be avoided.

It was earlier suggested in Canada that it should impose a 'bit tax' for transactions entered into over the Internet. The tax would be a flat rate per unit tax, which would not attempt to evaluate the use or value of the information, but would merely tax all bits uniformly. The above report specifically addresses this issue and concludes that the imposition of a 'bit tax' would adversely affect the EC industry as the tax does not take into account the value of data transmitted but its volume. It observed that it may be possible that valuable data may be transmitted in less bits whereas applications such as films, etc. would require large volumes of bits for transmission. The report concluded that a flat rate without taking into account the value and function

of the data results in inequitable taxation and hence is not recommended.

From a study of the various initiatives adopted by various countries and international organisations such as the OECD relating to the taxation of EC transactions, it can be seen that there is a consensus amongst the tax administrators that the tax issues of EC is global in nature and the solutions could be appropriately addressed at the global level. Again, countries have agreed that the taxation of EC should be neutral and there should be no discrimination amongst the electronic and non-electronic transactions. The countries also seem to converge on the view point that the Government should provide an encouraging regulatory and fiscal climate in order that the growth of EC is not stifled.

However, beyond such consensus, raging issues such as the determination and verifications of the identity and location of parties to EC transactions, applying the territorial concepts such as income source and taxpayer residence to EC activities and accessing and verifying encrypted records, remain to be resolved.

The views expressed in this booklet are not necessarily those of the Forum of Free Enterprise.

"People must come to accept private enterprise not as a necessary evil, but as an affirmative good".

— Eugene Black

HAVE YOU JOINED THE FORUM ?

The Forum of Free Enterprise is a non-political and non-partisan organisation started in 1956 to educate public opinion in India on free enterprise and its close relationship with the democratic way of life. The Forum seeks to stimulate public thinking on vital economic problems of the day through booklets, meetings, essay competitions, and other means as befit a democratic society.

Membership is open to all who agree with the Manifesto of the Forum. Annual membership fee is Rs.100 (entrance fee Rs.100) and Associate Membership fee Rs.40 (entrance fee Rs.20). Students (Graduate and Master's degree courses, full-time Management students, students pursuing Chartered Accountancy, Company Secretaries, Cost and Works Accountants and Banking courses) may enrol as Student Associates on payment of Rs.10 per year (no entrance fee).

Please write for further particulars to : *The Secretary,* Forum of Free Enterprise, Peninsula House (formerly Piramal Mansion), 2nd floor, 235 Dr. D. N. Road, Mumbai 400 001.

Published by M. R. Pai for the Forum of Free Enterprise, Peninsula House (formerly Piramal Mansion), 235, Dr. D. N. Road, Mumbai 400 001, and Printed by S. V. Limaye at India Printing Works, India Printing House, 42 G. D. Ambekar Marg, Wadala, Mumbai 400 031.

18 Dec. 99-Jan. 2000