

Legal and Taxation Issues in Online Marketing in India- A Case Study

Dr Dibakar Panigrahi , Mr Susil Kumar Sarangi

Professor Department of MBA,

Berhampur University, Bhanja Vihar

(Asst. Prof Dept. of MBA, KIT, Berhampur)

The rapid pace of growth of the e-commerce industry is not only indicative of the increasing receptiveness of the public but has also brought to the fore the issues that the legal system of the country has been faced with. From the initial years when internet was a new phenomenon to recent times where internet has become a basic necessity for every household in most metropolitan cities, the e-commerce industry has come a long way. The legal system has constantly tried to catch up especially with the enactment of the various rules under the IT Act to deal with a host of issues emerging from the use of internet. Moreover the IP issues in e-commerce transactions have taken a new form with users finding loopholes to not only easily duplicate material but also mislead other users. Hence, much more is needed to effectively regulate the tangled web. Therefore an in-depth understanding of the legal regime and the possible issues that an e-commerce business would face coupled with effective risk management strategies has been the need of the hour for e-commerce businesses to thrive in this industry. E-Commerce is not only changing day by day but also branching into ever newer forms and will do so in the days to come. Nowadays mobile commerce is also building into a big business. Building new statutes, amending existing laws, constant monitoring, amending and adapting are the need of the hour. This will ensure that our state not only reaps the benefits of e-commerce technology but also generates increasing revenue for its socio-economic needs.

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

Key Point: E-Commerce, IT infrastructure, IT Act, Mobile Commerce. Legal and Statute framework

Introduction

The growth of e-commerce in India is rapid. In the report released by IMRB (Indian Market Research Bureau) & IMAI (Internet and Mobile Association of India) the growth of e-commerce in India over the years has been analyzed. In the year 2007 the total market size of e-commerce in India was to the tune of Rs. 8146 Cr. This market has risen from Rs. 8146 Cr. in 2007 to nearly double a year later i.e. Rs. 14030 Cr. in 2008 to Rs. 46520Cr in 2011 which is 471.08% growth in just 4 years. This shows the phenomenal growth of e-commerce in India and is indicative of the exponential rise in the years to come. In this scenario there is a need for special tax provision to ensure that the transactions come within the ambit of the tax net and the leakages are minimal. E-Commerce has led to new ways of tax evasion by dealers. In an accounted electronic payment system, a record of the flow of the e-money is currently being maintained. But no such record exists in unaccounted for system or e-system. Tax administrators cannot match payments and receipts to specific taxpayers in this situation. Situations of non-reporting or under-reporting are common in such systems

Indian tax authorities have been seeking to tax e-commerce and internet-based business models in a manner that conflict with international approaches. Global enterprises catering to Indian customers have faced difficulties as a consequence and there has been significant litigation in this respect, especially in relation to characterization of income and withholding taxes. Therefore, it becomes important to carefully structure e-commerce business models so as to mitigate tax risks, especially risk of taxation in more than one country (without availability of with respect to taxation of income generated by non- residents from e-commerce transactions, primarily, there are two main issues: a) Characterization of income i.e. whether income earned with respect to the use or sale of goods (particularly items such as software and electronic databases), sale of advertising space etc is royalty or business income or capital gains, and b) permanent establishment (PE) issues.

From the perspective of an e-commerce transaction, the issue of characterization of income becomes relevant in various circumstances, For example, payments received from residents making online purchase of digital products such as podcasts, online subscriptions, shrink-wrap software, etc., could fall within the ambit of royalty, notwithstanding that they are merely a sale of a good in electronic form. Similarly, income derived from granting rights to use a copyrighted article, for example, by way of an online copy of a book, could also be characterized as royalty income in the hands of the recipient of income under the current domestic provisions. However, with respect to the characterization of income earned in connection with a copyrighted article versus a copyright, the position is yet not Further, even in case of e-commerce business models involving the use of or access to different kinds of scientific / industrial equipment (for example, in case of bandwidth services, medical diagnosis, etc.), where no control / possession is granted

to the service recipient, the domestic law definition of ‘royalty’ (as retroactively amended in 2012) is wide enough to cover payments thereof. Internationally, such payments are not construed as ‘royalty’ unless some element of control / possession is also granted over the equipment. Therefore, while interpreting tax treaties (which override domestic law), courts have held in cases like Dell that such payments do not constitute ‘royalty’. Further, in the context of online banner hosting / advertisements, in cases like Yahoo, it has been held that the payer should be able to operate the scientific / industrial equipment on its own. As the payer was not able to operate the website on its own, but was only benefitting from the advertisement being hosted by the payee on its website, it was held that the payment did not constitute royalty. Another popular cross border e-transaction is data warehousing, which involves the storage of computer data by the customers on servers owned and operated by the providers. In this context, the Delhi Tribunal has held that where the taxpayer availed of data processing services performed by a company based out of India, for its Indian operations, then in the absence of any right to secret process that was made available by the foreign company to the taxpayer coupled with the fact that the foreign company performed support functions using its own intellect, there can be no income in the nature of royalty.

Sales tax Issues :- In the context of e-commerce transactions, sales tax is relevant with respect to sale of intangible goods. In this regard, the Supreme Court has held that intangible goods such as software put in a tangible media, technical knowhow and other IPRs are goods for the purpose of sales tax. It has also been held that the IP that has been incorporated on a media for the purpose of transfer and media cannot be split up. Therefore, sale of computer software falls within the scope of sale of goods and is taxable. Thus, CST as well as VAT may be applicable on the transfer of IP. According to tax experts, it might be difficult to fault companies like Facebook, Google, Yahoo! and Twitter, or accuse them of evading taxes, under the current laws. Such internet companies - which do not operate as permanent establishments here - might not be taxable under the present Indian legal system, the experts say.

If an advertiser puts an advertisement on social networking site Facebook, for instance, the fees for it are paid to Facebook Ireland. The invoices (some of which have been reviewed by Business Standard) come from Facebook Ireland, even if the payments eventually are made in the Indian currency. This model is followed by Google, Yahoo! (routed through their respective US entities), and almost all other internet companies. Though all of them also have their Indian subsidiaries, these arms provide specific services, and some operate as marketing arms. Facebook, Google, Yahoo!, LinkedIn and Twitter did not respond to a Business Standard's queries on the issue. The chief of the Central Board of Excise and Customs (CBEC) had recently said at an open forum that there was a need for better understanding on taxing internet and e-commerce companies. The government, meanwhile, does not seem to have a ready estimate of the notional loss to the exchequer on account of non-taxation of these companies.

Most of our laws are addressed in terms of companies' office presence or distribution centres in India. So, these taxation laws cannot be applied to internet companies, even if they have a sizeable customer base in India. The country's tax authorities seem to be trying to address this issue by experimenting with some of the provisions in law. They contend these companies' profits should be taxable here, as their business is carried out of India. The income-tax authorities have in certain cases considered running a website out of the country equivalent to a company's presence in India, while in some others they have held that a running server in India should be seen as amounting to permanent establishment here.

Tax Evasion Issues : There seems to be no clear answer to whether these companies could be said to be evading taxes. In simple terms, they might indeed be evading taxes. But they cannot be held liable, legally. There is a flaw in the law. Technically, these companies are not doing anything wrong; the legal system allows them to do so. But there could be a way to ask these companies to disclose details of advertising revenue they generate in India, if the government so wants. The business is generated here, so they should ideally be taxed here," he opines.

The loopholes are there in the law. Geography-focused source rules are a major reason why there is no clear way to tax global e-commerce companies. This is not an issue unique to India. It is a problem faced by authorities the world over. The Base Erosion and Profit Sharing (BEPS) initiatives are aimed at finding a solution to this issue. In April 2013, the Income-Tax Appellate tribunal (ITAT) in Kolkata held that payments to websites like Google and Yahoo! for online advertisements were not liable to be taxed in India. The order was passed by George Mathan and Pramod Kumar in an appeal filed by Right Florist Pvt Ltd, which had paid about Rs 35 lakh for its advertisements on the Yahoo! and Google websites in 2005-06. The tribunal held that the websites could not be construed as permanent establishments or as taxable presence of foreign enterprises owned and maintained in India. Also, since the web servers are located outside of India, no permanent-establishment risk to India exists. So, these incomes should be taxable in countries where the servers are located - there is no clarity where the servers for India are located.

Electronic Contracts Laws: Electronic contracts are governed by the basic principles provided in the Indian Contract Act, 1872 (ICA) which mandates that a valid contract should have been entered with a free consent and for a lawful consideration between two adults. Section 10A of the Information Technology Act, 2000 (IT Act) provides validity to e-contracts. So, both ICA and IT Act needs to be read in conjunction to understand and provide legal validity to e-contracts. Further, section 3 of the Evidence Act provides that the evidence may be in electronic form. The Supreme Court in Trimex International FZE Ltd. Dubai v. Vedanta Aluminum Ltd.1

has held that e-mails exchanges between parties regarding mutual obligations constitute a contract.

Taxation Issues : The Challenges of E-Commerce are manifold. Some of the conceptual challenges thrown by E-Commerce are how to characterize income and the approach towards residence-based and source-based taxation approaches. The worldwide nature of ecommerce transaction muddles the issue of ‘jurisdiction’ which is a principle tenet of taxation. E-commerce also challenges traditional company tax rules because businesses can sometimes exist almost totally in cyberspace, with communication tools/ technology being used to carry out interactions with directors or shareholders. Basically ecommerce challenges when, where and how taxation can be applied in an era where local markets are being transformed into global markets.

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

International Approach : The first and foremost approach towards dealing with such situations can be attributed to the Ottawa Conference on E-Commerce (1998) organized upon the behest of OECD. This conference was study the new emerging way of conducting business and to analyze, discuss and generalize some ways of dealing with the issues. The next step in developing a model for e-commerce transactions was in 2000 when the O.E.C.D released a clarification to Commentary to Article 5 of the OECD Model Convention with respect to taxes on Income and Capital. This clarification related to the application of the principle of 'Permanent Establishment'. In 2001 the O.E.C.D came out with a Discussion Paper on the aspect of applying the existing principles of double-tax treaties for taxation of business profits arising on account of e-commerce and based upon this discussion paper, the Committee of Fiscal Affairs in 2002 adopted a 'Report on Treaty Characterization issues arising from ecommerce'. Amongst the nations, the USA as well as the EU was amongst the first nations to legislate on e-commerce activities. The regulatory environment in India, which broadly governs e-commerce, comprises of the following laws: Indian Contract Act, 1872; Copyright Act, 1957; Trademark Act, 1957; Patent Act, 1970; Indian Penal Code, 1860 & Information Technology Act, 2000. The two legal internationally accepted bases of taxation are

- (i) Residence based tax system and

(ii) Source based tax system

Generally, a resident of a country is liable for tax on its world income, while a nonresident is taxed only on income sourced in the country. As far as Indian Income Tax is concerned, as per section 6(3) of the ITA, a company is treated as a resident of India for Indian tax purposes and taxed in India in respect of its worldwide income only if it is either incorporated under the laws of India or wholly managed from India. In the above scheme of taxation, source of income play crucial role since the country of source has a right to tax income and residence countries' relieve double taxation. Thus, when a resident of a country earns income from a source in another country, he is subject to double taxation i.e. both in the source country as well as in the country of residence. Normally the double taxation is relieved either by exemption method or by tax credit method. Under exemption method, the income is not taxed again in the country of residence. Under tax credit method, the country of residence gives credit for the taxes paid in the source country.

High Power Committee Report on Online Taxation: In the era of E-Commerce, many of the goods and services transacted may be intangible in nature and hence, often becomes difficult to apply the source concepts to link an item of an income with a geographical entity. The intangible transactions blur many of existing distinction between domestic and foreign business, and also between on-shore and off shore transactions. In India, in 1999 a High Powered Committee was constituted under Shri. Kanwaljeet Singh to study the various aspects of e-commerce and suggest many measures. It suggested a low withholding tax as a possible e-commerce taxation to safeguard against base erosion. The intention was to avoid double taxation for the assesses. But suppose the assessed has imported goods from a foreign supplier and he legitimately claims this as deductible expenditure. If the government allows this, then this will lead to an erosion of tax base since the government has not got the tax for the imported goods or services in the first place.

Impact of E-commerce on Taxation

When any person is responsible for making any payment to a non-resident of a sum chargeable under the provisions of the Income Tax Act, that person is required to deduct income tax thereon. The Assumption is that the payee will get benefit of this withholding tax in his own country as set-off and thus double taxation will be avoided for the payee. But this depends on the Double Taxation Avoidance (DTA) Agreements that India has with other countries & also whether these countries will allow set off for this withholding tax that the companies registered under them suffer in the foreign country. Based on the above scenario a question may be asked whether a taxpayer who has suffered this withholding tax claim a foreign tax credit in his country of residence? Under the DTA that India has with Australia, Belgium, Netherland, Germany, Malaysia, Singapore, U.S.A and U.K there won't be any grant of foreign tax credits for any taxes withheld under the base erosion. Thus the recommendation of the HPC for taxation of e-commerce through a withholding tax is not feasible.

The issue of characterization is very important because different categories of transactions may have different tax consequences. When the transfer is of partial rights in the product then it will constitute a royalty. Consequently, such a payment can be taxed in the state where it arises. However, if the web-site owner has a Permanent Establishment in the source state, the payment will be classified as business profits. The country of source can tax royalty and also services which are of technical nature but it cannot tax business profits. As far as India is concerned, under Explanation 2 to section 9(1)(vi) of the Income Tax Act, 1961 the term royalty has been defined to mean the consideration arising on the transfer of all or any rights in respect of a copyright or a scientific work. The broad definition of royalty allows for the taxation of payments arising from transfers of all kinds. In this context any payments made in India for transfer of software or other digitized products on the Internet will be classified as royalty under the Income Tax Act, 1961. Thus, any payments made by Internet users for transfer of software or other digitized products will be subject to Tax Deduction at Source under section 195 of the Income Tax Act, 1961.

As far as the withholding tax issue is concerned, the income tax TDS is available for set off to the non-resident seller against his income-tax liability in his country of residence. In case of VAT, the set off is borne by the Indian Government instead of the seller's Government. Therefore, the objection of base erosion against the proposed treatment of e-commerce is not proper. In the interest of convenience and efficiency we can levy a single indirect tax on the import of goods and services and not levy income tax on the non-residents income. The points of difference between O.E.C.D and India on the issue of categorization of payment are apparent. Out of the 28 issues, there is difference of categorization in the case of 11 issues. In all these 11 categories shown above the O.E.C.D has classified the transactions as business profits meaning thereby that the country of payment has no right to tax these transactions. But as per the India Income Act, India-U.K. treaty. India-U.S.A treaty it is classified as Royalty; this gives India the right to tax these transactions as Tax Deducted at Source.

Jurisdiction Issues: In any dispute, one of the primary issues that a court determines is whether or not they said court has jurisdiction to try the dispute. A court must have both subject-matter jurisdiction (i.e. jurisdiction over the parties involved in the dispute) and territorial jurisdiction. The increased use of the internet has led to a virtual world which is not possible to be restricted in terms of traditional concepts of territory; this has led to complications in determining jurisdiction. According to the traditional rules of jurisdiction determination, the courts in a country have jurisdiction over individuals who are within the country and/or to the transactions and events that occur within the natural borders of the nation. Therefore in e-commerce transactions, if a business derives customers from a particular country as a result of their website, it may be required to defend any litigation that may result in that country. As a result, any content placed on an e-commerce platform should be reviewed for compliance with the laws of

any jurisdiction where an organization wishes to market, promote or sell its products or services as it may run the risk of being sued in any jurisdiction where the goods are bought or where the services are availed of.

Conclusions and Suggestions:

1. Jurisprudence in India with respect to issues relating to jurisdiction and enforcement issues in e-commerce is still nascent. In general a lot of local statutes provide for a 'long arm jurisdiction' whereby the operation of such local laws have extra-territorial application if an act or omission has resulted in some illegal or prejudicial effect within the territory of the country.
2. Below we set out certain provisions of Indian laws which provide for such long arm jurisdiction. Our recommendations based on our analysis covers the entire gamut of ecommerce issues. The servers in e-commerce transactions that the customer's access can be in any country or they can be mirror servers. Therefore these servers cannot be said to constitute a permanent establishment. It is because of this fact that many business enterprises are earning profits out of sale of goods or services in India but are not paying taxes because it is classified as business profits and the business concerns do not have a permanent establishment in India. Therefore what we are suggesting is that a possible solution is to define a threshold for revenue generation within a country. Anyone receiving more than the threshold will be liable to file his tax returns in India irrespective of whether the transaction is categorized as business profits or royalty & thus to pay the tax. The payers will deduct tax at source (T.D.S) and deposit it with the Indian Government.
3. Currently there is no single agreed framework in place for the countries. Each county has its own independent and separate Legal and Taxation framework for e-commerce. While some states like E.U already have the G.S.T framework in place, others like India have V.A.T while still others like U.S.A have retail taxation structure. Therefore tax on e-commerce is only an extension of the current tax laws. A comprehensive framework for e-commerce transactions has to be evolved. The "I.T Act 2000" has to be revisited.
4. Actually in the attempt to classify the transactions on the basis of category of income, the O.E.C.D has erred for each state has tried to make the definition of royalty so broad so as to be able to tax the transaction. Therefore our recommendation is that the source based tax principle should be based on the presence or absence of source & not upon the category of income.
5. Some of the loopholes in the I.T Act like ambiguity regarding the legal jurisdiction of contracts involving international parties, non provision for dual-key pairs for individuals and business and issues of protection of individual rights including domain names have to be addressed.

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