E-commerce taxation: Direct tax issues
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The e-commerce industry in India has witnessed exponential growth in terms of volumes and revenue and is expected to grow to over USD 15 billion by the end of 2015. Reports suggest India is on its way to becoming the world's fastest growing e-commerce market.

Despite the unprecedented growth in recent years, the tax framework governing the industry has not managed to keep pace with the rapidly changing business environment. The advent of online marketplaces has enabled businesses to function in a virtual environment, which has rendered traditional taxation concepts redundant in some cases. Some typical problems include:

- Difficulty in characterisation of income;
- Difficulty in applying traditional PE concepts; and
- Enforcement issues.

These issues largely arise on account of the following aspects unique to e-commerce businesses:

- A lack of proper understanding of certain technologies used in conducting business online;
- The complex nature of business models used by e-commerce companies;
- Existing taxation laws and principles were laid down keeping in mind the traditional brick-and-mortar business model.

All these issues have made the implementation of tax legislations extremely difficult in case of e-commerce businesses.

In this article, we discuss some popular types of e-commerce businesses and the tax issues associated with them:

**Online marketplace/auction**

In an online marketplace model, a website operator typically hosts electronic catalogues of multiple merchants on its computer servers. Users of the website can select products from these catalogues and place orders online.

Normally, the website operator has no contractual relationship with shoppers but merely transmits orders to the merchants, who are responsible for accepting and fulfilling orders. In turn, the merchants pay the website operator a user fee/listing fee/commission based on orders placed through the site.

The main issue surrounding this business model is the characterisation of income earned by such entities for tax purposes. It has been debated whether the commission earned by such entities is in the nature of business income or Fees for Technical Services (FTS).

The revenue authorities in India argue that such payments should be treated as FTS on the presumption that services provided by the website operator are *managerial* in nature since a platform is provided where users can manage their orders. Also, another argument put forth is that services are *technical* in nature since the sale of products is routed through the entity's website, which came into existence through necessary technical inputs and by employing technical experts.

However, the Technical Advisory Group (TAG)\(^1\), in its report analysing taxation issues with respect to e-commerce, has classified such fees as *business income*. The TAG has opined that usage of technology for providing a service does not amount to rendition of technical services. Similarly, the delivery of a service via technological means does not imply that the service is technical in nature. The TAG further stated that provision of a platform for buying and selling does not qualify as providing managerial services.

The High Powered Committee (HPC)\(^2\) set up by the Indian government also concurred with the TAG's view and is of the opinion that such fee is in the nature of business income and not FTS.

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\(^1\) TAG: Technical Advisory Group on Treaty Characterisation Issues Arising from E-commerce was set up by the OECD Committee on Fiscal Affairs in January 1999

\(^2\) HPC: The High Powered Committee was constituted by the Indian government in 1999 to examine the position of e-commerce transactions under existing taxation laws and recommend changes
Furthermore, the Mumbai Tax Tribunal in the case of eBay International AG (which is involved in providing an online marketplace) held that the user fee charged by eBay is in the nature of business income. The Tribunal was of the opinion that services rendered by eBay are not managerial services as the portal had no role in the process of acquiring or completing successful sales; eBay merely allows buyers and sellers to interact with each other. Accordingly, it was held that the services offered by the portal were not in the nature of managerial services.

Similar to the view of the TAG and HPC, the Tribunal also held that simply because the transactions are routed though eBay's website, which came into existence through necessary technical input, this should not be construed as rendering of technical services. The Tribunal was of the opinion that eBay provided a standard facility that was available to all. A similar view was taken by the Madras High Court in the case of Skycell Communications Ltd.

**Subscription-based web services**

Under this business model, the business provides subscribers digital content such as information, music, videos, games and other activities. Subscribers pay a fixed periodical fee for access to the website. The issue surrounding this model is whether the classification of income earned is ‘business income’ or ‘royalty’.

The TAG, is of the opinion that income earned by web-based digital content providers is business income. The TAG has stated that services offered by such entities do not amount to ‘payments for the use of, or the right to use, industrial, commercial or scientific equipment’. The TAG stated that digital products do not qualify as equipment and also that none of the digital products can be termed as ‘industrial, commercial and scientific’ in nature. Accordingly, income of web-based digital content providers do not fall under the meaning of royalty.

Reiterating the TAG's view, the HPC also recommended that income earned by web-based digital content providers should be in the nature of business income and not royalty.

However, under this model, the Indian judicial authorities have taken differing views on the taxability of such entities. In the case of Dun & Bradstreet España, the Authority for Advance Rulings (AAR) held that making available reports compiled using information that was publicly available does not result in royalty income for the service provider. Such services were accessible to any subscriber on payment of the requisite subscription fee. A similar view was also taken by the AAR in the case of Factset Research Systems Inc.

However, the Karnataka High Court in the case of Wipro Ltd held that the payment made by Wipro to a content provider for providing access to its database is in the nature of royalty. The High Court stated that since a licence was granted to Wipro for access to a database maintained by the content provider, there is rendition of technical services and also a transfer of copyright. A similar view was adopted by the Mumbai bench of the Tribunal in the case of Gartner Ireland Ltd. Furthermore, in the case of Cargo Community Network Pte Ltd, AAR took a view that use of the portal was not possible without a server; thus, the portal and server together constituted integrated commercial-cum-scientific equipment and hence, considered it taxable as royalty.

There is a fierce controversy with regard to the nature of payment for ‘use of copyright’ and for ‘copyrighted article’. In the former case, it would be in the nature of ‘royalty’, whereas, in the latter, it would not be. However, the AAR in the case of Citrix Systems Asia Pacific Pte Ltd has held that the distinction between copyright and copyrighted article was ‘illusory’. A similar view was adopted by the AAR in the very recent decision of Skillsoft Ireland Ltd.

Thus, one would have to be extremely cautious while adopting a particular view and should consider facts vis-à-vis the judicial precedents very carefully before reaching a conclusion.

**Online advertising**

Advertisers pay to have their advertisements disseminated to users of a given website. A fee is normally charged by the website operator based on the number of times the advertisement is seen by a user or based on the number of times the advertisement is clicked on by a user.

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3 The AAR is a quasi judicial body which provides binding rulings to taxpayers before the transaction in question is entered into.
Similar to the abovementioned models, the main issue surrounding this business model is whether the income earned by such entities is in the nature of business income or FTS.

As discussed previously, the fact that technology is used in providing a service is not indicative of whether the service is of a technical nature or not. The TAG has also stated that services offered by web-based advertising service providers do not amount to ‘payments for the use of, or the right to use, industrial, commercial or scientific equipment’.

Even the Indian judicial authorities have taken a similar view. The Kolkata Tax Tribunal in the case of Right Florists Pvt Ltd, held that payments for advertising on search engines such as Yahoo and Google should not be characterised as either FTS or royalty income. The Tribunal held that the service of advertisement banner hosting did not result in the use of or right to use any industrial, commercial or scientific equipment. A similar view was taken by the Mumbai Tax Tribunal in the cases of Pinstorm Technologies and Yahoo as well.

Further, the Kolkata Tax Tribunal went on to further hold that a human element is required to characterise a payment as FTS. Since the services rendered by Google and Yahoo were without any human intervention, such payments could not be considered as FTS.

**Conclusion**

These are only a few of the issues faced by e-commerce entities as well as tax authorities worldwide. With a rapidly expanding and evolving marketplace, it is difficult to gauge the future of online businesses and the various unforeseen issues that may emerge.

As a starting point, the TAG has recommended various changes to the OECD Model Tax Convention so as to remove ambiguity with respect to the characterisation of income earned by e-commerce entities. We are of the opinion that further steps need to be taken by the OECD and local tax authorities to clarify the tax treatment of such organisations so as to ensure that income earned by e-commerce entities is characterised on a pragmatic and unbiased basis.

Based on the recommendations of various committees set up by international tax authorities as well as numerous tax experts, it is clear that issues surrounding the taxation of e-commerce entities can be dealt with only by gradually building a stable legal framework and bringing more clarity. Along with strengthening the legal framework, an efficient and comprehensive infrastructure must be built to monitor e-commerce transactions to prevent tax avoidance and detect dubious tax structures.

Lastly, tax authorities should take a long-term perspective when it comes to framing laws for the taxation of e-commerce transactions. Any hasty steps taken to increase tax inflows in the short term may dampen the growth of the e-commerce industry in India, which can have an exponentially negative effect on the economy as a whole, particularly in today's scenario.
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