

EXECUTIVE SUMMARY

The conclusions and recommendations of the Committee, on each of the issues arising in direct taxation of e-commerce are presented. The detailed discussion follows in the main report.

1. Definition of Electronic Commerce (“e-commerce”)

The needs for neutrality of taxation between e-commerce and business carried on in traditional manner, as also administrative simplicity, make it necessary that changes in law, if any considered necessary, should apply to all transactions - traditional as well as e-commerce. There is, therefore, no need to define e-commerce for the purpose of inclusion in the Income tax Act, 1961 (“the Act”).

2. Growth of e-commerce

2.1 Internet penetration

The number of Internet users in India is expected to grow from 0.5 million in 1998 to 9 million in 2003, with one study estimating the number of actual Internet users to be 32 million in 2003. The use of cable television to facilitate access to the Internet may

result in faster growth. Currently, US and Canada are dominant in Internet penetration (56%) followed by Europe (21%), Asia-Pacific (18%) and South American regions (3%).

2.2 E-commerce

E-commerce transactions in India are expected to grow from US\$ 27.87 million (Rs 131 crore) in 1998-99 to US\$ 255.3 million (Rs 1,200 crore) in 2001, ie 0.05% of the then expected GDP and between US\$ 5.7 billion and US\$ 13.4 billion in the year 2008. The B2B segment is expected to account for 90 percent of the total e-commerce in India. The IT enabled service exports to North America alone are expected to increase from the existing level of US\$ 264 million to about US\$ 4 billion by 2005.

Amongst the Asian nations, the growth of e-commerce in India between 1997 and 2003 is expected to be the highest with CAGR of 246 percent as against the CAGR of Australia (84 percent), South Korea (145 percent), China (243 percent) and Hong Kong (110 percent). However, the expected volume of e-commerce in India in 2001 (US\$ 255.3 million) is below the levels expected to be achieved in

Australia (US\$ 3 billion), China (US\$ 586 million), South Korea (US\$ 876 million) and Hong Kong (US\$ 685 million)..

Internet trade in shares and securities accounts for only 0.36 percent of the total trade, while in value terms the share of Internet trading is merely 0.19 percent. However, as per a study, worldwide more than US\$ 1.5 trillion of assets are expected to be managed online by end of 2002. In banking, electronic ordering and processing with a fully integrated online payment system, whereby payment shall be made online, is likely to be in place within the next few years. Online sale of insurance products is yet to take off. Net cash is yet to make an appearance in India. Development of net cash in USA has not taken place at the pace at which it was originally expected and is not likely to grow significantly in the near future.

In future, a transition from “right to use with possession” to “right to use without possession” is expected with downloading and temporary use of software and data becoming common. Fundamental business systems are expected to change blurring the distinction between B2B and B2C transactions. In Asia, mobile technology is expected to be a critical factor in enabling quick network infrastructure building.

The available data does not give separate estimates for domestic and cross border e-commerce in India. Data regarding likely trade outflows and trade inflows through cross border e-commerce, in India, is also not available. Separate data for e-commerce involving digitized delivery, which affects both direct and indirect taxation in a crucial manner, is not available for India or any other country.

The Committee also notes that the nature of transactions included in e-commerce in various studies may vary on account of difference in assumptions. The methodology of compilation of data is also not known. The figures should, therefore, be considered only as indicative of expected growth of e-commerce in India and abroad.

3. Should e-commerce be taxed?

Equity requires neutrality between taxation of e-commerce and the commerce carried on in traditional manner. A differential tax treatment would also offer an easy avoidance mechanism and create administrative complexity. What is crucial, is that e-commerce represents a fast growing base, which the country cannot afford to exclude from the direct tax net.

The Committee is of the view that there is no case for exempting e-commerce from direct taxation. The income of content providers, service providers and all other persons engaged in e-commerce should be subject to same taxation as traditional commerce.

4. How should e-commerce be taxed?

At the policy level, following aspects need to be kept in perspective:

- Neutrality of taxation of e-commerce with reference to traditional commerce;
- Integrity of tax base through constant monitoring of trade flows, changes in technology and business practices; and
- International consensus while protecting national interest.

5. Tax issues in domestic e-commerce

The Committee is of the view that domestic e-commerce does not raise any new issues for direct taxation. There may be new evasion opportunities due to anonymity of parties and transactions. There may also be difficulty in making recoveries from virtual organisations. The Committee's

views on these issues are discussed with reference to cross border e-commerce. The same conclusions and recommendations would also be valid for domestic e-commerce.

6. Tax issues in cross border e-commerce

6.1 Residence based taxation

The Committee is of the view that there is no real alternative to the concept of ‘place of effective management’, which should continue to be used. It is not possible to set down a single rule. The concept has to be applied considering the facts and circumstances of each case. Where in the case of a globally integrated enterprise, no unique solution is available through the concept of ‘place of effective management, the solution could be ‘source based’ taxation only. The provisions of the Act and the DTAs do not require any revision on this account.

6.2 Source based taxation

The source based taxation of business income depends on physical presence in form of fixed place of business or a dependent agent in the source country. It also depends on the

characterisation of income. With e-commerce, the need for physical presence virtually ceases. This affects sharing of revenue between countries. The change in mode of delivery from physical to online raises characterisation issues. Lack of physical presence also creates problems in enforcement of tax laws.

6.2.1 Concept of permanent establishment (“PE”)

The OECD is of the view that in terms of Article 5 of the OECD Model Tax Convention, a server at the disposal of an enterprise and hosting its website could constitute a PE, if it is kept at a fixed place for a sufficient period of time and performs core business functions of the enterprise. The views of the OECD are consistent with the existing provisions of Article 5 of the OECD and UN Model Tax Conventions. However, within OECD some countries like UK, Spain and Portugal have different views.

The Committee is of the view that applying the existing principles and rules to e-commerce does not ensure certainty of tax burden and maintenance of the existing equilibrium in sharing of tax revenues between countries of residence and source. The Committee is also firmly of the view that there is no possible liberal interpretation of the existing rules, which can take care of these issues, as suggested by some countries. The Committee, therefore, supports the view that the concept of

PE should be abandoned and a serious attempt should be made within OECD or the UN to find an alternative to the concept of PE.

6.2.2 Alternative to the concept of PE

The concept of PE evolved because in traditional commerce physical presence was required in the source country if any significant level of business was to be carried on. Absence of a PE implied only insignificant business activity, which could be overlooked for tax purposes. This concept lost relevance with the technological advance in communication and development of teleconferencing. With that and the development of the Internet in the 1990s, the correlation between the size of business and the extent of physical presence in the source country ceased to exist. In all transactions undertaken through the Internet, even where delivery is in the traditional manner, the tax base in the source country would be nominal.

At the IFA Asia Regional Conference on “E-Commerce and International Taxation” held at Mumbai in November, 2000, Professor Richard L Doernberg presented a paper suggesting ‘base erosion’ approach in taxation of income streams in source countries. The proposal requires taxation of any payment to a foreign enterprise, if it is tax deductible in the hands of a taxpayer in the source country. The implementation of the tax would be in

the form of a low withholding tax, with the option for being taxed on net income. According to Professor Doernberg, this proposal would imply that the concept of PE remains.

The Committee is of the view that the ‘base erosion’ approach suggested by Professor Doernberg offers a possible solution for equitable tax sharing between residence and source countries provided:

- The concept is applied to all commerce and not just e-commerce.
- The tax is implemented through a low withholding tax on all tax-deductible payments to the foreign enterprise.
- Preferably, the withholding tax is final without option of tax on net income being given to the taxpayer or the tax administration.

Before considering a solution on these lines, trade data needs to be studied carefully to ascertain if, and to what extent, there will be erosion, or potential erosion, of tax base in India. The study will have to keep in view the practicality of taxing all imports including crude, gold, fertilizers, etc. It will also have to assess the erosion of tax base as a result of credit for taxes levied by other countries on exports. The effect on the volume of exports, particularly software exports, will also have to be kept in view. The Committee

recommends that such a study should be undertaken immediately. The Committee also recommends that interaction at the international level should be made regular and structured. No changes in the Act or the DTAs are required till international consensus on abandoning the concept of PE is reached.

7. Characterisation of e-commerce payments

The Technical Advisory Group set up by the OECD (“TAG”) has examined 28 categories of transactions in its final report. The Committee examined each of these categories of transactions in light of the provisions of the Act as also the DTAs entered into by India with UK and US, as an illustration. The judicial pronouncements, wherever available, were also considered. In 15 categories, the characterisation by the OECD and the views of the Committee match. In 1 category, the views match in terms of the DTAs and not the Act. In the remaining 12 categories the views of the Committee differ from the views of the OECD.

The Committee is of the view that the different positions taken by countries are in the background of concern for protecting the integrity of their respective tax bases. This concern makes it unlikely that an international consensus will be reached on the issues relating to characterisation of incomes.

At the policy level, the Committee agrees with the view that the characterisation of incomes should not change with the mode of delivery from physical to digitized form. The Committee also recommends that a clear position on each category of transactions should be taken by the Central Board of Direct Taxes (“CBDT”). This will ensure uniformity of approach among all the assessing officers. For the taxpayer, it will ensure certainty of the tax burden.

It is also recommended that the CBDT should closely monitor the developments and issue guidelines to the assessing officers on new emerging categories of transactions as a continuing process. The monitoring should be through an expert advisory body on which the tax administration, the profession and the concerned industry is represented.

Having examined issues relating to characterisation, the Committee would like to place on record its view that there is no rational basis for having differential tax treatment for different categories of incomes.

The Committee is of the view that the only long-term solution of the problems created by characterisation lies in making direct taxation identical for all streams of income, in a manner aimed at ensuring equitable sharing of revenues between residence and source countries. The ‘base erosion’ approach suggested by Professor Doernberg and discussed earlier does not tax a

transaction on the basis of income characterisation. It deserves to be evaluated to see if it also ensures equitable sharing of revenues.

8. Enforcement issues

The expected challenges for enforcement, from e-commerce are anonymity of identity and location of parties; anonymity of transactions and accounts; dis-intermediation; transfer pricing issues; online delivery and net cash; easy access to tax havens and low tax jurisdictions; identification of taxing jurisdiction; new evasion opportunities; recovery of tax; and exchange of information.

The Committee considered each of the above issues. It was noted that large volumes of business are not done between strangers. Also, in majority of the e-commerce transactions, the mode of delivery and payment remain traditional. These leave audit trails and are not anonymous. The real challenge for enforcement arises only where delivery and payment are through Internet or any other network. This is limited in scope with little chance of acquiring significant levels in immediate future. However, once the problems with delivery mechanism and net cash are sorted out, e-commerce with delivery and payments through networks will grow exponentially.

It is, therefore, necessary for the tax administrations to have appropriate responses ready well before that happens. This essentially requires setting up of systems of disclosure by the enterprises- voluntary as well as when required; third party information requirements for intermediaries like ISPs and banks; monitoring and surveillance and improving taxpayer service. The systems must be setup in consultation with responsible businesses, other enforcement agencies, the central bank and the professional bodies. The focus would be to meet the requirements of healthy business practices and enforcement with minimum compliance burden on enterprises and intermediaries.