Tax Implications in the Information Technology Act, 2000

G. Selva Kumar
Legal Officer

As stated in the Preamble of the Information Technology Act, 2000 (the 'Act') that came into force on 18th October, 2000, the Act aims at giving legal recognition for transactions carried out by means of electronic data interchange and other means of electronic communication, commonly known as "electronic commerce", which involve the use of alternative methods to paper based or other similar modes of communication. It is therefore necessary to understand the principles involved in electronic commerce. The focus of this article is on the implications of the Act for direct taxes.

The electronic data interchange and particularly the Internet have opened vast possibilities for electronic commerce. The internet has not only succeeded in creating a world not fragmented by national frontiers in the sphere of communication but also has made it possible to transmit and transfer a product (whether goods or services) so long as the same can be digitized, both within and across the national frontiers. The buyer may be located in one country, the seller in another and the product may be supplied from a third country. Even the Internet addresses of both the buyer and the seller may be located in countries other than the country of their physical location.

But ascertaining the value of the transactions for tax purposes may pose additional problem if the payment details are transmitted through the Internet in the form of digitized data, or in other words as 'electronic money'.

Electronic Commerce ("e-commerce") involves using the Internet for the sale, license, offer or delivery of property, goods, services or information (collectively "purchase and sale transaction"). Because e-commerce involves numerous computers communicating at the speed of light, purchase and sale transactions are instantaneous but at the same time may very often be anonymous with respect to the identity of the buyer or the seller.
E-commerce differs from traditional forms of business and commercial transactions by way of mail or telephonic communication, between remote parties to the transaction (sellers or buyers in another state or country), because these involve the delivery of goods by carrier to and from a specific physical location.

Features of E-Commerce Transaction

E-commerce has some or all of the following features, which make it difficult to tax under traditional concepts :

∗ Computer-to-computer transactions rarely leave a paper trail.

∗ Because computers are communicating with each other, the purchase and sale transactions may often be anonymous, particularly the new forms of exchange, such as electronic cash are used.

∗ With anonymous transactions, there is a lack of information regarding the locations of seller and purchaser; Tax Laws are dependent on this information.

* E-commerce makes possible the electronic transmission and transfer of property and goods (books, CDs and movies in electronic form), and services (brokerage or legal or accounting services or any other consultancy services) so there is no physical delivery by a carrier. Also, the form of the goods is converted from tangible (a physical CD) to intangible (a downloaded computer program of the music) which does not exist as an object. Sales-tax regimes exempt intangibles from taxation.

* E-commerce makes possible the bundling of taxable and non-taxable items, such as taxable goods with tax-exempt services, such as a software package with e-mail technical support.

Absence of Paper Based Transaction

Unless a common or other carrier delivers a tangible product, it is impossible for a taxing jurisdiction to determine that an e-commerce transaction occurred. But if a consumer downloaded a computer game from a computer located in a foreign country for Rs. 1,000/-, paying by credit card, how would taxing authorities discover that such a transaction occurred?

How would it determine the physical location of the seller? What if the purchaser had an Internet Service Provider (ISP) in a foreign country as well?

Transmuting Property from Tangible to Intangible

Consider the following issues : Would the receipt of a computer game in electronic form convert the game into a non-taxable intangible item, whereas the purchase of the same game at a local computer store would be taxable because it is a tangible product?

Also, if a newspaper has an exemption from sales tax (as in India), will a newspaper that is downloaded in electronic form receive the same exemption? But if the same is downloaded in and from a country where newspaper is not tax free, the question of discrimination may arise.

Taxes Are Territorial Based

Taxation is based on territoriality. In international taxation, a government's authority to tax has always been premised on territory and jurisdiction. Jurisdictional nexus in the matters of taxation proceeds on the basis of two factors : (a) source (geographical location), and/or(b) status (residence). For instance, in India, the Government imposes taxes on its residents on their worldwide income because they are connected with India through residence. The Indian Government also imposes taxes on foreign individuals and business firms when they receive their income from India.
But the Indian Government cannot tax a U.S. citizen, resident there, who earns income outside India, because the Indian Government has no jurisdiction over the person either by way of status or by way of the source of income.

E-Commerce Defies Traditional Tax Jurisdictions

Using the Internet, a company can, in theory, move its e-commerce business to a tax-haven country (a country which levies no income tax or less percentage of tax or no sales taxes or lesser percentage of sales tax) and conduct e-commerce outside the jurisdiction of any country that would otherwise tax the transaction.

Also, because of the speed at which transactions occur and the frequent absence of a traditional paper trail, it will be very difficult, if not impossible, to apply traditional notions of tax jurisdiction. This is especially true with intangible property transmitted by computer such as software, digital music or electronic books and services.

While the Central Government, which depend on income tax, might have difficulty taxing e-commerce, States and Local jurisdictions that rely on taxes on sales could be in deeper trouble.

Permanent Establishment (PE)

The concept of PE is important in determining a company's business profits and tax liability in a particular country. However, business via Internet challenges the whole concept of a PE and therefore the question of how the business income of an enterprise is determined could become a debatable issue.

E-Commerce is undoubtedly going to pose challenges to countries as their present tax system is based on tangible information reporting and paper trail. Countries will be forced to rethink the method of taxation and adopt means to recognise transactions in an equitable manner keeping in mind the existing guidelines issued by some western countries for taxing e-Commerce transactions.

A PE requires a fixed place of business, through which business is wholly or partly carried on. Article 5 of the Organisation for Economic Cooperation and Development (OECD) Model Treaty defines PE to include a place of business, a branch, an office, a factory or a workshop. It generally will not include place, which consists of facilities solely for the purpose of storage, advertising or information provision, servicing a new patent or know-how contract, display, or for the maintenance of a stock of goods, or for the purpose of collecting information.

It seems difficult to argue that the mere right to put computer programs on someone else's computer, which is connected to the Internet, and the making of arrangements for facilitating the purchase would constitute a place of business. A web server can be considered for PE but not a web site, as a web site may be situated on a server anywhere in the world. However, if the website has the ability to automatically accept orders, generate shipment instructions, accept payment and provide electronic receipts, the arguments in favour of treating it as a place of business seem stronger.

An Indian permanent establishment generally requires a fixed place of business in India, although permanent establishment can also arise by imputation from the activities of an agent.

Telecommunications or computer equipment owned or used by a foreign person engaged in electronic commerce raises a question as to where this equipment could constitute a fixed place of business of the foreign person in India, taking into account that there would not necessarily be any employees present. It will be necessary to consider whether a foreign person who owns or utilises a computer server located in India should be deemed to have an Indian permanent establishment? Digitized information may also further complicate existing difficulties in defining income from services, as distinguished from income from sales of goods or from royalties. This distinction is important for the purposes of determining the source of income.

Often, commercial transactions involve elements of both goods and the performance of services. These transactions are generally classified in accordance with their predominant characteristic. However, a distinction between income from sale of goods and income from services may still be appropriate in this area taking into account the frequency at which the on-line service will be updated and the fact that the user of the online service must continue to make periodic payments, as contrasted with the fact that the purchaser of the CD may acquire the right to use the disk in perpetuity for a single payment.

For income tax purposes, if the business is owned by an Indian company or individual, the fact that the transaction has been concluded via the internet, possibly with a non-Indian purchaser, is irrelevant. The proceeds of sale will still be subject to Indian income tax. Liability to Indian income tax is not affected by, for example;

* physically locating the web site in a foreign jurisdiction, like a place which could be a tax haven.
* the fact that both offer and acceptance may have occurred outside India.
* the fact that the purchaser may be a Nonresident Indian.
* the fact that the proceeds may be received and held in a foreign bank account.

Although all of these things may make it much, more difficult for the Revenue Officials (Department) to audit the business's compliance, the usual record keeping requirements therefore will continue to apply.

Unlike US Internet Taxation Freedom Act ("ITFA"), 1988, the Indian Information Technology Act doesn't define what is an electronic commerce. In US IFTA, e-commerce is defined as : "any transaction conducted over the Internet or through Internet access, comprising the sale, lease, license, offer or delivery of property, goods, services or information, whether or not for consideration, and includes the provision of Internet access."

Section 12[1] of the Information Technology Act refers to acknowledgment in the form of electronic record by the originator from the addressee, where the originator and the addressee have rightly concluded the contract. Once, such a contract is concluded, then one needs to see whether the originator, or the addressee, as the case may be, is a resident as required under Section 6 of the Income Tax Act, 1961 or if the person has a permanent establishment then the treaty provisions entered into shall be applicable (in cases where India is a party to the treaty) or else the the Income tax Act will be applicable (as per the provisions of Section 91 of the Income Tax Act, where a a relief is given to a resident Indian who will be taxed in the other country). Section 92 of the Income Act would be applicable when, (a) it is restricted to business only, (b) only manipulation of resident income, (c) close connection is not defined under the Act, e.g. 'common control, 'holding companies', 'associated connections or persons', and (d) business connection need not be apparent, it can be indirect also, on the basis of facts.

Section 13[2] of the Information Technology Act is quite clear as to the time and place where the contract is concluded or the time or place which will be taken into account for the purpose of deciding when and where the contract is concluded. In such a case, the jurisdiction is quite clear for the purposes of treatment of tax, as it is clearly identifiable as a result of contract formation.

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1. **Section 12 of the Information Technology Act, 2000** dealing with acknowledgment of receipt, states as follows :

(1) Where the originator has not agreed with the addressee that the acknowledgment of receipt of electronic record be given in a particular form or by a particular method, an acknowledgment may be given by —

(a) any communication by the addressee, automated or otherwise; or

(b) any conduct of the addressee, sufficient to indicate to the originator that the electronic record has been received.

(2) Where the originator has stipulated that the electronic record shall be binding only on receipt of an acknowledgment has been so received, the electronic record shall be deemed to have been never sent by the originator.

(3) Where the originator has not stipulated that the electronic record shall be binding only on receipt of such acknowledgment, and the acknowledgment has not been received by the originator within the time specified or agreed or, if no time has been specified or agreed to within a reasonable time, then the originator may give notice to the addressee stating that no acknowledgment has been received by him and specifying a reasonable time by which the acknowledgment must be received by him and if no acknowledgement is received within the aforesaid time limit he may after giving notice to the addressee, treat the electronic record as though it has never been sent.

2. Section 13 of the Information Technology Act 2000, dealing with time and place of dispatch and receipt of electronic record, states as follows :

(1) Save as otherwise agreed to between the originator and the addressee, the despatch of an electronic record occurs when it enters a computer resource outside the control of the originator.

(2) Save as otherwise agreed between the originator and the addressee, the time of receipt of an electronic record shall be determined as follows, namely :

(a) if the addressee has designated a computer resource for the purpose of receiving the electronic records, —

(i) receipt occurs at the time when the electronic record enters the designated computer resource; or

(ii) if the electronic record is sent to a computer resource of the addressee that is not the designed computer resource, receipt occurs at the time when the electronic record is retrieved by the addressee;

(b) if the addressee has not designated a computer resource along with specified timings, if any, receipt occurs when the electronic record enters the computer resource of the addressee.

(3) Save as otherwise agreed to between the originator and the addressee, an electronic record is deemed to be despatched at the place where the originator has his place of business, and is deemed to be received at the place where the addressee has his place of business.

(4) The provisions of sub-section (2) shall apply notwithstanding that the place where the computer resource is located may be different from the place where the electronic record is deemed to have been received under sub-section (3).

(5) For the purposes of this section, —

(a) if the originator or the addressee has more than one place of business, the principal place of business, shall be the place of business;

(b) if the originator or the addressee does not have a place of business, his usual place of residence shall be deemed to be the place of business;

(c) “usual place of residence”, in relation to a body corporate, means the place where it is registered.