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Taxing the Internet: Analyzing the Implications and Solutions for E-Commerce

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Taxation is a basic feature of the fiscal system of any country since it imposes levies on individuals and corporations to raise revenue. Taxation has become more complicated due to the increase in e-commerce where there are virtual markets that are real revenues. Global sales of both tangible and intangible items can be carried out through electronic commerce, hence necessitating new tax rules. This paper examines the problems and legal concerns concerning taxation in e-commerce such as jurisdictional ambiguities, identification of parties, and administration of taxes. Traditional tax principles like minimum contacts theory, source and residency rules as well as permanent establishments have been invalidated by the digital environment. The judicial position regarding e-commerce taxation can be seen from cases such as Quill Corp. v North Dakota[1] and South Dakota v Wayfair Inc[2]. The research underscores the importance of international cooperation among other factors to be key elements in ensuring that tax erosion is handled suitably, especially in light of taxation issues pertinent to a digital economy. It also suggests solutions such as BIT-tax included in the Goods and Service Tax (GST) framework aimed at simplifying the process for collecting taxes on transactions related to Internet commerce so that taxpayers do not try to evade them while providing equal treatment within this area too.

[1] *Quill Corporation v North Dakota* [1992] 504 U.S. 298

[2] *South Dakota v Wayfair Inc* [2018] 138 S. Ct. 2080

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INTRODUCTION

Taxation is the backbone of any country's financial system. Every individual who is a part of the state or the government is subject to taxes, and they also have to pay taxes on the goods and services they provide. Taxes are a kind of charges that are raised by the government over businesses and persons as a source of income. So, in layman's terms, it is what generates income for the govt to administer public expenditure.

The online marketplace is a market shop, though it is virtual, however, there is actual money to be made, sales to be made, and customers to be served luxuriously and enjoyably. It has the potential to be a very effective tax that would allow for more commercial activity and, consequently, more opportunities for the state to collect taxes.

The current scenario, involving cyberspace, makes that a matter of debate. The e-commerce field is becoming an indispensable part of the modern world, along with various problems: regarding taxation, the issue of e-commerce presents the most serious challenges to the international tax system based on territorial and personal bases of tax jurisdiction.

E-COMMERCE

E-commerce stands for electronic commerce and refers to the buying and selling of goods and services online.[3] It lets individuals and companies purchase and get physical and digital goods and services electronically. Other companies only sell online or provide these mechanisms as an additional channel for existing distributors. Whatever you do, you should investigate e-commerce, which is booming in the market and maybe a more profitable venture than others.

E-commerce allows people to purchase from their computers, phones, tablets, and other devices. They scroll through websites, social media, and other online portals to get the information they

[3] 'E-Commerce - Business Models' (*Tutorial*, 17 June 2024) <https://www.tutorialspoint.com/e_commerce/e_commerce_business_models.htm> accessed 17 June 2024

need. This allows entrepreneurs, startups, small to medium businesses, and even large retailers to sell to customers anywhere in the world. A business may sell exclusively online, or online sales may complement sales in physical stores. For instance, a major physical store could start using an internet platform for selling products, or a small business owner could decide to sell a limited quantity of unique handmade items on a social networking site such as Facebook, Instagram, or Pinterest.

Another instance of e-commerce is known as social media commerce. Certain websites, such as Facebook, facilitate online transactions. A business or entrepreneurs that use social media to make money through revenue or by increasing income are participating in social media commerce.

SCOPE OF E-COMMERCE

E-commerce is one of the most recent advancements in technological development. E-commerce includes the purchasing, selling, promoting, and maintenance of goods or services online. Revenue earned by individuals in the e-commerce industry is subject to income tax regulations outlined in the Income Tax Act.[4] Developing software may be subject to taxation according to the excise law. Software can be created and set up for remote access to share the computer/server. Taxation of rights transferred during e-commerce transactions can occur through use or consumption tax or sales and value-added tax, whether through lease or sale. The service provider must pay taxes on the revenue generated from the services provided in cyberspace under the service tax system. The continuous advancements in technology make it easier to buy and sell products and services online through secure servers, specifically made to safeguard customer information for confidential ordering, using e-shopping cards, and electronic payment methods such as credit and debit cards.

Any item that can be converted into digital form can be sold and delivered through electronic means. This would involve items like books, newspapers, CDs, movies, photos, airline and cinema tickets, and video and audio recordings. Items that are easy to sell, such as patents, designs, and trademarks, can be traded in electronic commerce either through complete or

[4] Income Tax Act 1961, s 29

partial transfer of rights. E-commerce plays a crucial role in the entertainment industry. An acclaimed movie with global fame can be purchased and streamed on websites for a fee. Globally popular books are available for online reading for a fee by users worldwide. Fans worldwide can browse and download a newly released song by a popular pop singer. While enjoying a movie, book, or song, information is exchanged, whether through purchase or consumption.

TAXATION ISSUES IN CYBERSPACE

Just like all other legal systems, challenges are unavoidable in the realm of cyberspace taxation. Tax challenges in cyberspace are distinct globally, especially when it comes to establishing authority to create, interpret, and implement local tax regulations. Other areas that can create legal issues across borders include disputes involving the application of various legal principles. Income derived from economic activity by a resident of one country in another country's territory may be taxed in both countries in international taxation. The domicile state can justify taxing based on residency, while the destination state can tax based on the source of income.

1. JURISDICTIONAL ISSUES

Unavoidable ambiguity arises regarding jurisdiction and tax laws when e-commerce facilitates cross-border transactions of sale and services. Parties involved in an online contract may be situated in various regions, leading to significant consequences in the understanding and application of legal regulations. Does the field fall under the municipal law of the country or the law of another party with foreign jurisdiction? The jurisdiction of a country under the traditional rules of private international law is limited to people within its borders or to events and transactions occurring within its natural boundaries.[5] Certain crucial principles regulate the matters:

Theory of Minimum Contacts: The concept of minimum contacts implies that a person can be subject to a foreign court's jurisdiction, even if they are not physically in the country, as long as

[5] Pradeep K. P 'Key Issues on Cyber Space Taxation' (*Lawyer's Club India*, 16 June 2024) <https://www.lawyersclubindia.com/articles/key-issues-on-cyberspace-taxation-3542.asp> accessed 16 June 2024

their website has minimum connections to that country. This law applies universally in all cases. Typically, service providers can include a choice of law in online contracts, specifying the jurisdiction to which the contract parties will be subject, and these clauses are legally enforceable.

Source and Resident Principles: The rules of origin or domicile determine the jurisdiction of taxing individuals, specifically in the context of direct taxation. According to this principle, income is taxed based on where it is earned or where the individual resides. Nevertheless, when it comes to taxing E-commerce, the implementation of these principles could disturb regional equilibriums, especially if a significant number of products are obtained from one area but mostly used in another area. When countries have a significant monopoly on software and other digital exports, using source principles in E-commerce sales without attributing the sales to a permanent establishment in another country can lead to regional imbalance. The principle of residency does not apply to some areas of taxation, such as taxes on E-commerce sales, because most e-commerce service providers only operate online. Certainly, in these instances, the sellers' residency may be linked to the server location hosting their website.

Permanent Establishment: The idea of 'Permanent Establishment' implies that if the operation exceeds the permanent establishment in the source country, that country would have the main authority to tax the operation. The OECD Model Tax Convention defines a permanent establishment as a fixed place of business where the enterprise conducts all or part of its operations.[6] It could be a location for overseeing operations, a division, a workspace, a manufacturing plant, or a place for hands-on projects. If an individual consistently acts on behalf of a business to make contracts in the business's name, then that business is considered to have a permanent presence in that location. Nevertheless, if a broker, general commission agent, or any other independent agent is conducting business as usual, it cannot be concluded that the enterprise has a permanent establishment in that location solely because of transactions carried out by those individuals. If a non-citizen entrusts their local stock portfolio to a broker in a different country, it will not be considered a lasting presence. This means that if a website is hosted on a server owned by a domestic independent agent such as an ISP, it would not be

[6] Model Tax Convention on Income and on Capital: Condensed Version 2017, art 5

considered a permanent establishment. The internet home page of a vendor and the internet access granted to that page do not result in a fixed place of business, as the vendor lacks control over the equipment used for data transmission in a specific country. Another interpretation suggests that a webpage may be considered a fixed place of business in the country where the hosting server is located. A web page's physical form comes from being created with binary or digital code and stored on a magnetic surface, typically a disk. This binary code can be seen on a computer and communication device.

Theory of Physical Presence: The key factor that is most important and commonly recognized in determining whether taxes are owed on online or e-commerce transactions is the actual location of the seller or service provider in the state of the customer. To establish if a seller or service provider has a physical presence or level of activity, key indicators include owning or renting property, operating a warehouse, employing staff, or participating in trade shows in a specific state.[7] The United States Courts uphold a practical legal perspective on this matter. According to their viewpoint, if the seller or service provider is only present online and not physically in the location, the state does not have jurisdiction to take legal action against them. The U.S. Supreme Court's decision in the case of National Bellas Hess, Inc.[8] determined that sellers may only be obligated to pay sales taxes in states where they have established a specific physical presence. This significantly impacted the state's ability to levy taxes on mail orders or catalog sales between states. The U.S. Supreme Court in the case of Quill[9] later ruled that it is up to Congress to determine the extent of the nexus theory to safeguard the State's revenue.

2. IDENTIFICATION OF PARTIES

Determining the identity of the parties involved in an e-contract is a crucial issue that needs to be addressed during its execution. In Internet communications, unlike postal communications, the exact location of the parties cannot be determined initially. Deciphering protocol addresses and other technical solutions are necessary, but they are time-consuming and require high levels

[7] 'Explanatory Notes to the Scheme of Classification of Services' *(GST Council,* 15 July 2024) <https://gstcouncil.gov.in/sites/default/files/Explanatory_notes.pdf> accessed 15 July 2024
[8] *National Bellas Hess, Inc v Illinois* [1967] 386 US 753
[9] *Quill Corporation v North Dakota* [1992] 504 US 298

of technical expertise to achieve. Internet transactions, especially those involving consumers, frequently involve parties with no prior relationship, leading to questions about the person's identity in terms of their ability, authorization, and credibility to make a contract.

3. RELATIVE ISSUES IN TAXATION

Monitoring the transportation of products or services is a key issue when it comes to taxing online businesses. In e-commerce, most transactions involve intangible goods that do not require physical items to be provided to the customer; sales and services can be completed by transferring intangible properties.

Administration of Tax: In the conventional trading system, tax management is simpler for Main Street retailers. It is the responsibility of traders or service providers to collect and submit the tax on sales or services, which is considered an indirect tax, to the State treasury. Nevertheless, the e-commerce entrepreneur might not be required to adhere to those legal obligations if his business is not regularly monitored. Consumption tax plays a crucial role when it comes to tangible properties in such circumstances. The responsibility in these situations can be attributed to either the importer or the individual who uses the products. When intangible goods are supplied electronically within a country, there is not a significant difference because the local seller must still collect the tax and these transactions can also be audited for tax purposes. However, a problem may occur if the trader deletes his backup. In situations where intangible goods are electronically provided by a foreign vendor, these supplies fulfill the import transaction condition and the consumer who purchases and uses these goods may be subject to taxation. This type of use tax is common when the seller cannot charge sales tax because they do not have a connection to the state where the product is being delivered. There is no denying that E-commerce is significantly affecting nearly every aspect of business. It has created an international market with suppliers from around the world. While regulations have been implemented to oversee and safeguard intellectual property rights in the cyberspace sector, the taxation administration law remains underdeveloped. The outcome is that the affluent society, which is technologically advanced and establishes e-commerce as an alternative market, avoids paying taxes. Either the sales tax concept needs to be revised to include more areas, or the taxation laws need to progress by creating new methods to address the issue. If an e-commerce company displays information on its website, accepts payment via credit cards, and customers only view or write down the information without making a purchase, can it be considered a transaction of goods between the website owners and customers? Additionally, a simple download could result in the formation of a digital trash bin containing unwanted downloads in temporary internet files or cookies, a temporary storage that was not originally intended by the individual. The question is whether the tax authorities can impose taxes on these downloads, classifying them as either a sale or a service, or through the perception of income generated from them. The software appears to be running on a client's computer remotely from a programming terminal situated in a distant location to facilitate the exchange of intangible assets via communication devices. Even if it is not documented on physical material, when the property is transferred through an authorized individual, it is still subject to sales tax as per the law. The temporary transfer of information, seen as a valuable intangible asset, can be classified as a transaction subject to taxation. The tax authorities are considering ways to address the issue of tax avoidance in similar transactions. When imposing a tax on a product that is being sold, there needs to be a taxable event, which is the actual sale. The commodity itself is not taxed, but the act of selling it is what is taxed. When implementing the sales tax, one challenge for the Taxman is deciding when the tax should be applied and become payable. During a typical retail sale where products are purchased in person with cash at a store, the agreement, allocation of goods, handing over of items, payment, and ownership transfer all happen at the same time.[10] On the flip side, it is challenging to identify these stages individually in complex transactions such as E-commerce.

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[10] *King v Dominion Engineering Co. Ltd* [1951] 2 STC 67 (PC)
[11] *State of Bombay v The United Motors (India) Ltd* (1953) 4 STC 133 (SC)

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CULMINATION OF CONTRACTS

Accepting an offer forms a legally binding agreement. The seller needs to receive the acceptance when the contract is finalized. Throughout the process of electronic offer and acceptance, several inquiries will emerge. Is it possible for the act of downloading to be seen as acceptance? The user can get rid of any surfed content, whether it be images, videos, or text. Clicking on the options on the website does not constitute complete acceptance of the information, even though the seller expects to make an offer through the website. Without encryption technology, ensuring the trustworthiness and approval of email becomes more challenging. Someone can send an email or acceptance using electronic messages over networks, making it seem like it was sent by someone else. When it is uncertain if the messages are truly generated authentically, it becomes challenging to tax mail orders based on that.

CASE LAWS

Quill v North Dakotta:[12] Quill Corporation, registered in Delaware, did not have a presence in North Dakota. There were no employees based in that location. Quill marketed office supplies and stationery in North Dakota through catalogs, flyers, national magazine ads, and phone calls. Shipments were sent via mail and standard transportation services from locations outside the state. If the State of North Dakota had won the case, Quill would have had to refund taxes for three years. The Supreme Court determined that a company needs a tangible presence in a state for that state to mandate the collection of sales taxes. Nevertheless, the Court made it clear that

[12] *Quill Corporation v North Dakota* [1992] 504 US 298

Congress has the power to overturn the ruling with new laws. Politicians have made numerous efforts to alter this ruling with legislative action. No legislation has been passed due to the contentious nature of the issue.

National Bellas Hess v Illinois:[13] National Bellas Hess was a retailer that sold a variety of consumer products through mail order. The main location of its headquarters was in Missouri. It did not possess any physical assets in Illinois and did not have any sales locations, agents, phone numbers, or salespeople in that state. It refrained from promoting itself on radio, television, billboards, or newspapers. Catalogues were sent to customers across the United States, which included Illinois. Appellant's Missouri plant received orders for merchandise, which were then mailed to customers or shipped by common carrier. Illinois tried to make National Bellas Hess collect a use tax from customers. The Supreme Court said a mail-order seller didn't have to collect sales tax without a physical presence in the state.

South Dakota v Wayfair, Inc:[14] In the case of South Dakota v Wayfair, Inc., the US Supreme Court ruled by a slim majority of 5-4 that states have the authority to impose taxes on purchases from sellers located outside their borders, even if the seller does not have a physical presence in that state. The ruling overturned Quill Corp. v North Dakota (1992), which stated that states couldn't require retailers to collect sales or use taxes for mail or online sales to their residents unless the retailers had a physical presence in the state. Since Quill in 1992, the amount of interstate sales through online platforms, especially from Internet sellers, has increased quickly, and the Government Accountability Office calculated that in 2017, states missed out on more than $13 billion in taxes they were unable to gather. After Justice Anthony Kennedy's comment in a concurrence opinion in 2015 proposing a re-evaluation of the Quill decision due to advances in technology, over 20 states enacted laws known as 'kill Quill' to collect sales tax from vendors outside their state, to create a legal challenge to bring before the Supreme Court. South Dakota was the first state to present its argument in lower courts and reach the Supreme Court. The Supreme Court accepted a writ of certiorari in January 2018, deliberated on the case on April 17, 2018, and announced its ruling on June 21, 2018. A majority of five justices nullified Quill by

[13] *National Bellas Hess, Inc v Illinois* [1967] 386 US 753
[14] *South Dakota v Wayfair Inc* [2018] 138 S. Ct. 2080

deciding that the physical presence rule established by Quill was 'unsound and incorrect' in today's era of Internet services.

CONCLUSION

Because e-commerce is a technology-focused form of business, there are limited opportunities for overseeing transactions and services. The complexity of the subject is heightened by the cross-border aspects of E-commerce. Taxation in the physical world is a sovereign responsibility bound by territorial constraints and the country's Constitution. The fiscal policy of a country may be influenced by its revenue interests. In e-commerce, where there is no territory under any sovereignty, it is not possible to establish a standard formula without an International Charter. An international agreement can help a nation share information it already has or can obtain when necessary for tax authorities in other countries. Ensuring coordination among countries can be achieved through agreements for exchanging information, as seen in the example of the Organization for Economic Co-operation and Development (OECD). The OECD has released a model agreement for exchanging information that is comparable to the tax information exchange agreement made by the United States and other developed countries. In developing and third-world nations, a consistent global agreement is necessary to address the problem. The concept of being physically present may help address the issue of tax evasion online. In the country where the seller or service provider is located, they are required to pay taxes on their sale, service, or income because it is considered to have been completed or earned in their possession. This could be implemented as a general principle. However, the idea of defining physical presence poses additional challenges, as a one-size-fits-all approach is not feasible when countries have differing laws that consider physical presence to include virtual presence, requiring any type of presence to be considered physical presence for tax purposes. BIT-Tax is an innovative idea created by tax authorities to address concerns about tax erosion. This consists of a method of taxing the amount of Internet usage and implementing a turnover tax on interactive digital traffic.[15] The bit tax would be based on the amount of data transferred and would not differentiate between different types of content like telephony, data, voice, or images.

[15] Arthur J. Cordell, 'Taxing the Internet: The Proposal for a Bit Tax' (1997) 2(2) Journal of Internet Banking and Commerce <https://www.icommercecentral.com/open-access/taxing-the-internet-the-proposal-for-a-bit-tax.php?aid=38808> accessed 28 June 2024

The implementation of a bit tax or byte tax through internet service providers is more convenient for tax collection. Regarding the imposition of direct taxes on income, the tax may be levied on the individual receiving income that leads to the acquisition of assets such as movable or immovable properties. It is now time for countries like India, with intricate tax systems and multiple taxes, to adopt Goods and Service Tax (GST). When the GST takes over the old tax system with various types of taxes like excise duty, sales tax, use tax, luxury tax, service tax, etc., there should be no doubt about the importance of the BIT tax, as it will be included in the GST and will be charged for providing internet service. Under the GST system, the components of sale and services will combine under the taxable occurrence of supply, eliminating any concerns about the separability of sale and service for tax purposes. To what extent will tax authorities examine the generation of income, e-services, or e-commerce sales for tax purposes? What is the key aspect of online transactions in cyberspace? Previously, the tax authorities did not focus on the potential tax erosion caused by the significant expansion of e-commerce. Tax authorities are currently exploring how to tax e-commerce transactions to collect potential tax revenue from this market. Tax erosion in e-commerce is a significant issue in both developed and developing nations. Without taxing e-commerce, there is a possibility of tax evasion by wealthy individuals who have access to online shopping. This could lead to discrimination in taxation, with regular customers being taxed while the high-income group avoids taxation. It could be accurate that there is no immediate solution in any tax law or policy for the challenges presented by the online world. A tax-free cyberspace that lasts forever is only a dream, not a reality. In multiple nations, such as India, the Government has struggled to find a definitive resolution for addressing tax problems in the online realm. Current tax laws are not suitable for addressing the problem of tax erosion in the online environment.