VISION: Journal of Indian Taxation
Vol. 9(2), Jun-Dec 2022, pp. 57-69
DOI: 10.17492/jpi.vision.v9i2.922204
www.journalpressindia.com/vjit
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Taxation of E-commerce: Overcoming Challenges to Traditional Tax Regimes

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Abstract

Given the phenomenal rate of growth of e-commerce in India, the taxability of e-commerce transactions is a pertinent issue in terms of its revenue implications for the government. It is well recognized that e-commerce presents some formidable challenges for the tax administration. With the physical location of both the buyer and the seller of the commodity in question irrelevant for the transaction, assigning tax liability would be hard. In addition, many goods (such as software) sold through e-commerce are directly downloaded and do not necessarily have a physical presence. The paper discusses the taxation of e-commerce transactions in the post-GST era. With the TCS provisions coming into force, tax authorities are empowered to monitor e-commerce transactions and ensure that suppliers selling their goods through e-commerce platforms do not get away with under-reporting their turnover.

Keywords: E-commerce; Goods and Services Tax (GST); Tax collection at source (TCS).

1.0 Introduction

Taxation acts as a tool of good governance, allowing economies to grow while helping to improve society as a whole. Electronic commerce and globalization are challenges to traditional tax regimes. Historically, goods were physical, and hence the production, distribution and consumption of these goods was easily taxable. Physical goods were produced at a manufacturing plant, shipped off to wholesalers and boxed on retailers' shelves, with the final consumer walking away with a paid for and taxed product. Tax collection was in the hands of retailers. The retailer charged consumers VAT or sales tax, and then remitted it to the government.

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2.0 Theoretical Aspects of Taxing E-commerce

Taxation of any economic transaction requires that it can be legally verified that a transaction between the buyer and the seller has taken place, implying that the administrative procedures needed to generate the required verification are important. Verification can either be direct, for example, through observation of the transaction by a representative of the tax authorities or indirect, for example, through auditing of the parties involved in the transaction. In most cases, direct verification would be prohibitively costly making indirect verification through auditing the commonly used method in modern societies. Since auditing of firms takes place for other reasons thanfor raising tax revenue from commodity taxation, the marginal cost of generating the sufficient information for levying commodity taxes through auditing of firms is negligible.

Auditing of households for tax purposes may be effective in establishing how much income is earned, but ineffective in establishing the consumption levels of specific goods. In some cases, however, verification must take place through registration of the actions of the buyer. To what extent this is practically possible or economically feasible, very much depends on the type of good being traded, in particular whether it is a digitalized or a physical good. In any case, some form of direct verification will be needed.

Since e-commerce transcends national boundaries, it will often be the case that seller and buyer belong to different tax jurisdictions in which case it must be considered which tax principle applies. For commodity taxation, two main inter-tax jurisdictional principles exist: the destination principle and the origin principle. According to the destination principle, it is the destination of the final consumption of the good that determines the size of the tax so that all consumption taking place within the tax jurisdiction is taxed at the same rate. Hence, under the destination principle, exports of goods are untaxed while imports are taxed at the same rate as goods produced and sold domestically.

Under the origin (or the source) principle, it is the origin of the commodity, i.e. the location of the seller, that determines the size of the tax so that all goods produced within the tax jurisdiction are taxed at the same rate irrespective of the final destination of the good. Hence, according to the origin principle, exports are taxed at the same rate as goods produced and sold domestically while imports are untaxed. Of course, for transactions between sellers and buyers belonging to the same tax jurisdiction, the tax liability will be independent of the tax principle.

The choice of tax principle will affect the administrative procedures needed to generate the required verification. Since the tax authorities can only audit entities within

their own jurisdiction application of the origin principle, it implies that auditing of firms will generate the required verification. However, when the destination principle applies, the seller will be located outside the jurisdiction of the tax authorities levying the tax and alternative methods for obtaining verification are needed. To describe these methods in detail, it is convenient to treat the cases of digitalized goods and physical goods separately.

3.0 The Case of Digitized Goods

For digitalized goods, the verification of a transaction is particularly difficult due tothe anonymity provided by the internet. If the origin principle applies or when the seller and buyer belong to the same tax jurisdiction, verification should be obtained through auditing of the seller. The problem here is that due to digital goods being non-rival goods where the sale of one unit of a digital good (e.g. a computer program) does not reduce the potential for selling the same good to another customer, the same good can be sold unlimited number of times and the problem of the tax authorities becomes one of establishing how many transactions have taken place.

Auditing of the cost side of the selling firm will not yield the required information whereas auditing of the financial transactions of the seller, that is going through all payments made into the accounts of the seller, could provide the required information. That could prove to be quite a big task and even though the required verification could be provided but this way the costs to the tax authorities might be very high. In this case, origin taxationof e-commerce in digitized goods will not generate a lot of revenue as firms will expect the tax authorities to be unwilling to devote the resources required for effective auditing.

Under the destination principle, the tax authorities will have to establish verification through information gathered from the buyers. Two options could be possible: either by verifying the transaction through establishing that the digitalized good (computer program, mp3-file etc.) has been transferred onto the computer of the buyer through the internet or by verifying that a payment has taken place e.g., through a credit card payment. Regarding the first option, it could be argued that from a technical point of view, such evidence could be extracted from the computers or the networks involved in the transaction.

Specialist computer forensics firms are capable of establishing the history of a computer even if the user of the computer should attempt to erase any evidence of the transaction having taken place. The relevant observation is, however, that such verification would be extremely costly and given the likely size of the tax burden to be

imposed on the transaction through this verification, the costs would be considered prohibitively high. The second option could be viable, provided the tax authorities can get the information needed from the credit card companies.

Hence, transactions involving purely digitized goods should be expected to generate very little tax revenue no matter what tax principle is applied. Thus, e-commerce in digitized goods should for all practical purposes be considered untaxable implying that if e-commerce in digital goods substitutes for trade in commodities that are subject to taxation, the revenue of the tax authorities may be in jeopardy.

4.0 The Case of Physical Goods

Since physical goods either can be sold through the conventional retail trade channel or through the internet, a comparison of the tax aspects for the two types of trade may be informative. A typical aspect of conventional retail trade is that the seller and buyer belong to the same tax jurisdiction, implying that the tax principle employed is unimportant. As it is argued earlier, auditing of firms is much more effective than auditing of households implying that it will be most efficient to obtain the verification needed for tax purposes through auditing of firms. As a practical matter, the seller is usually required to collect the tax on behalf of the tax authorities.

For e-commerce, the seller and the buyer may typically reside in different tax jurisdictions, implying that the choice of tax principle becomes important.

For e-commerce in physical goods under origin taxation, nothing is really different from the case of conventional trade. Of course, an explicit definition of what determines the location of the seller needs to be stated in this case. It could either be the physical location of the server servicing the website of the seller or the physical location of the storage and shipping facilities actually handling the shipments of the goods sold to the final customers.

To make verification of location as easy as possible, it would probably be preferable to use the physical location of the storage and shipping facilities as defining the location of the seller. Just as with ordinary retail trade, auditing of the cost side of firms will be effective in establishing the required verification. Physical goods are rival goods where the sale of one unit of the good prevents the seller from selling the same good to another customer. Hence, effective auditing of the resource use of firms will make it possible for the tax authorities to tax the transaction no matter whether the good is sold through a bricks and mortar retail store or through an internet-based store.

Therefore, it is the effective auditing of firms selling physical goods that make such goods taxable. It does not matter for the taxability how the good is delivered to the

buyer e.g., whether the buyer collects it in the store or the good is delivered by a courier. In neither case, representative of the tax authorities is present to verify that the transaction has taken place. Verification is obtained indirectly through effective auditing. Collection of the tax will in both cases be taken care of by the seller.

Use of the destination principle for e-commerce requires that the transaction be verified in relation to the acquisition of the good by the buyer.

The important property of physical goods compared to digitized goods is that they have to be delivered physically to the buyer making the point of delivery an obvious possibility for the verification of transaction. How the verification should take place would depend on whether or not the tax jurisdiction of the buyer has customs control. With an effective customs control, direct verification is possible as the good passes through the customs control. Without customs control, indirect verification is still possible since the physical good has to be handed over to the buyer by a courier.

By auditing the courier firm, the required verification can be established implying that it should be possible to use destination taxation of e-commerce in physical goods. There are, however, some more practical matters that have to be considered mainly with respect to the administrative procedures used to make sure that the right tax liability is levied on and collected from a given transaction.

These administrative procedures are important as they affect the incentives of both firms and households to participate in the e-commerce market. For firms it is important how much of the tax collection (on behalf of "foreign" tax authorities) is required to be involved with since unduly complicated administrative procedures will be considered an additional cost for firms participating in e-commerce. For households, the administrative procedures may affect the degree of uncertainty related to trading with (more or less) anonymous sellers on the internet, and if some procedures increase the perceived level of uncertainty this will discourage households from using e-commerce.

For the administrative procedures for taxation of e-commerce, at least three options are available. They are as under:

- The selling firm could calculate, collect and forward the tax on a given transaction based on the tax rate prevailing in the tax jurisdiction of the buyer for that kind of commodity. This would create full certainty for the consumer regarding the total price of the good purchased, including tax and shipping costs, at the point in time when the purchase is made. Such a procedure would, on the other hand, impose substantial administrative burdens on firms by effectively requiring them to register with the tax authorities in all the tax jurisdictions (countries) they do trade with.
- A second possibility be still to have the selling firm calculating the tax but to have the courier handling the shipment of the good collecting the tax revenue from the

consumer when the good is delivered. This would still require extensive knowledge on part of the selling firm about the commodity tax systems in "foreign" tax jurisdictions, and also provide the consumer with full information about the total price of the good at the point of sale. The tax collection would be moved entirely into the tax jurisdiction of the buyer but would, of course, impose some handling costs on the courier. Given that the selling firm still needs extensive knowledge of (many) "foreign" commodity tax systems, it is not obvious that this procedure would be more efficient than when the seller also collects the tax.

- For both procedures, it must be considered how likely non-compliance with the tax collection will be, and what can be done to prevent non-compliance. Obviously, the selling firm has no direct economic incentive to become registered with the tax authorities in other tax jurisdictions. Of course, if the tax jurisdiction is a country with customs control, it is possible to exclude non-registered foreign firms by simply stopping any goods passing through the customs control that are not shipped from a registered firm. To what extent this will solve the problem of non-compliance depends on the efficiency of the customs control. Considering the efficiency of these tax collection procedures, the costs of having an effective customs control should be taken into account. When the commodity tax jurisdictions belong to the same country (or a customs union) with no customs control for inter-tax jurisdictional trade, non-compliance may be much harder to prevent. The obvious case here is the US where a requirement of registration with out-of-state tax authorities is likely to be unconstitutional.
- A third option would be to remove all responsibilities regarding tax calculation and tax collection from the seller and delegate that to the courier firm handling the shipment of the good. For the consumers that would certainly add some uncertainty about the total price of the good at the point of sale. For the courier firms additional handling costs are imposed (which obviously must be passed on to the consumers as higher shipping costs). How to deal with the compliance issue again depends on whether the tax jurisdictions have their own customs control. In case effective customs control is possible, it would be natural to let the customs office calculate the tax payment and just let the courier collect the tax. Without a customs authority, the tax authorities could induce compliance by performing effective tax auditing of the courier firms.

Which of these procedures should be preferred, all have their pros and cons. Requiring the seller to handle all the tax administration will presumably reduce the number of firms selling through the internet, thereby effectively reducing the degree of competition on that market leading to higher consumer prices. Similarly, letting the

courier firms handling the tax administration would lead to increased uncertainty about the final consumer price, leading to reduced demand from (risk averse) consumers. Of course, the selling firms could try to resolve that uncertainty by informing their customers about relevant tax regulations but that advice would be merely informative and not legally binding.

Taking these administrative aspects into account, reveals that although there is nothingformally hindering destination taxation of e-commerce in physical goods, it is not necessarily straightforward to set up proper administrative procedures that will be conducive to a well-functioning e-commerce market. Using the origin principle is somewhat less problematic as tax calculation and tax collection is done within the tax jurisdiction of the seller, and the buyers will enjoy full certainty regarding the tax and shipping included price of the good.

5.0 Commodity Taxation in India Prior to the Introduction of GST

Prior to the introduction of GST on July 1, 2017, the indirect tax system of India suffered from various disabilities. There was a burden of *tax-on-tax* in the pre-GST system of Central excise duty and the sales tax system of the States. The introduction of Central VAT (CENVAT) did remove the cascading burden of taxes to a good extent by providing a mechanism of set-offs for tax paid on inputs and services up to the stage of production, and was an improvement over the pre-CENVAT Central excise duty. Similarly, the introduction of VAT by the States removed the cascading effect by giving set-off for tax paid on inputs as well as tax paid on previous purchases and again was an improvement over the previous sales tax regime.

However, both the CENVAT and the State VAT had certain deficiencies. CENVAT was deficient because it did not extend to include chain of value additions in the distributive trade below the stage of production. Further, it did not include several Central taxes (such as additional excise duties, additional customs duties, surcharges etc.) in its overall framework. Hence, the benefits of a comprehensive input tax set-offs was not available to manufacturers/dealers under CENVAT.

Likewise, in the State-level VAT scheme, CENVAT load on the goods was not removed and the cascading effect of that part of tax burden had remained unrelieved. Moreover, there were several taxes in the States (such as luxury tax, entertainment tax, etc.) which had not been subsumed under the VAT. In addition, although the burden of Central sales tax (CST) on inter-State movement of goods had been lessened with reduction of CST rate from 4 percent to 2 percent, this burden had also not been fully phased out.

6.0 Introduction of Goods and Services Tax (GST)

GST became operative on July 1, 2017. GST is a tax on goods and services with comprehensive and continuous chain of set-off benefits up to the retailer level. It is essentially a tax only on value addition at each stage, and a supplier at each stage is permitted to set-off, through a tax credit mechanism, the GST paid on the purchase of goods and services. Ultimately, the burden of GST is borne by the end-user (i.e. final consumer) of the commodity/service.

The basic objective of tax reforms in any country should be to establish a tax system that is economically efficient, distributionally acceptable, and simple to administer. GST is India's most ambitious and remarkable indirect tax reform. Its objective is to levy a single uniform tax across India on all goods and services. Implementing a new tax, encompassing both goods and services, by the Centre and the States in a large and complex federal system, is perhaps unprecedented in modern global tax history.

Signifying the spirit of co-operative federalism, GST is a historic and game-changing tax reform. Domestically, it will help improve governance, strengthen tax institutions, facilitate *make-in-India* by *making-one-India*, and impart buoyancy to the tax base. The Indian GST is 21st century's global standard for VAT in large federal systems.

As the world economy slows, and increasing financial volatility and turbulence become the *newest normal*, only a few economies have the resilience to be a refuge of stability and the potential to be an outpost of opportunity. India is one of those few. As oil and commodity prices continue to be soft, macroeconomic stability seems reasonably assured for India. This bedrock of stability coupled with reforms can propel the economy to a high growth trajectory. Key amongst these reforms is the national level GST.

Implementation of GST leaves behind an inefficient, complicated and fragmented indirect tax system. Switch over to GST is fraught with many problems—administrative and technical. However, such problems are endemic of any change of revolutionary proportions. Many of the problems will be transitory in nature. No one should expect a foolproof GST from day one. GST Council has successfully sorted out political, administrative and implementation differences among the stakeholders and it is competent enough to grapple with any future challenges and rectifications

GST requires a very high level of compliance. The age of hand-written ledgers, account books, balance sheets and manual record-keeping is gone. Everything will now be online and need to be updated regularly.

Since major Central and State indirect taxes have got subsumed under GST, the multiplicity of taxes has been substantially reduced which, in turn, would decrease the

operating costs of the country's tax system. With GST in place, the burden of Central sales tax (CST) has also been removed. The uniformity in tax rates and procedures across the country will go a long way in reducing compliance costs.

7.0 Salient Features of GST

GST has subsumed a profusion of Central and State indirect taxes to create a single unified market. GST will make India a seamless national market, boosting trade and industry and hence growth rate.

As against the erstwhile system of tax on the manufacture of goods or on sale of goods or on provision of services, GST is applicable on *supply* of goods or services or both.

7.1 Destination-based consumption tax

GST is a destination-based consumption tax as against the erstwhile origin-based tax system. This implies that all SGST collected will ordinarily accrue to the State where the consumer of the goods and/or services sold resides. In other words, the tax would accrue to the taxing authority which has jurisdiction over the place of consumption which is also termed as place of supply.

In the case of inter-State trade, the inter-State seller pays IGST on the sale of his goods to the Central Government after adjusting credit of IGST, CGST and SGST on his purchases (in that order). The exporting State transfers to the Centre the credit of SGST used in payment of IGST. The importing dealer claims credit of IGST while discharging his output tax liability (both CGST and SGST) in his own State. The Centre transfers to the importing State the credit of IGST used in payment of SGST. Since GST is a destination-based tax, all SGST on the final product ordinarily accrues to the consuming State.

7.2 Dual GST model

It is a dual GST with the Centre and the States simultaneously levying it on a common base. GST levied by the Centre on intra-State supply of goods and services is called Central GST (CGST) and that levied by the States (including Union territories with legislature) is called State GST (SGST). Union territories without legislature levy Union Territory GST (UT-GST).

CGST and SGST are levied simultaneously on every transaction of supply of goods and services. Further, both CGST and SGST are levied on the same price or value unlike the erstwhile State VAT which was levied on the value of the goods inclusive of Central Value Added Tax (CENVAT).

While the location of the supplier and the recipient within the country is immaterial for the purpose of CGST, SGST is chargeable only when the supplier and the recipient are both located within the same State.

This dual GST model is implemented through multiple statutes (one for CGST and one each SGST statute for every State). To the extent feasible, uniform procedures for collection of both CGST and SGST are prescribed in the respective legislations for CGST and SGST. The basic features of law such as chargeability, definition of taxable event and taxable person, measure of levy including valuation provisions, basis of classification etc. are uniform across these statutes as far as practicable.

CGST and SGST are paid electronically into the accounts of the Centre and the States separately. Centre levies and administers CGST and IGST while respective States levy and administer SGST.

7.3 Integrated GST (IGST) on Inter-State transactions and imports

IGST mechanism has been designed to ensure seamless flow of input tax credit from one State to another. Centre levies IGST which is CGST plus SGST on all inter-State transactions of taxable goods and services.

7.4 Input tax credit (ITC)

According to Section 16(1) of the Central Goods and Services Tax Act, 2017, “Every registered person shall, subject to such conditions and restrictions as may be prescribed and in the manner specified in Section 49, be entitled to take credit of input tax charged on any supply of goods or services or both to him which are used or intended to be used in the course or furtherance of his business and the said amount shall be credited to the electronic credit ledger of such person”.

ITC is an important feature of GST. There are well-defined rules for availing ITC.

7.5 GST and foreign trade

Exports are zero-rated supplies under GST law. Supplies made to SEZs are zero-rated and considered as physical exports. As per explanation to clause (1) of Article 269A of the Constitution, IGST (CGST plus SGST) will be levied on all imports into the territory of India. Thus, import of goods is treated as inter-state supplies and hence subject to IGST in addition to the applicable customs duties. Import of services is treated as inter-state supplies and hence subject to IGST.

8.0 Electronic Commerce, Electronic Commerce Operators and GST

Electronic commerce means the supply of goods or services or both, including digital products over digital or electronic network [Section 2(44) of the CGST Act, 2017]. Electronic commerce operator means any person who owns, operates or manages digital or electronic facility or platform for electronic commerce [Section 2(45) of the CGST Act, 2017].

As per Section 9(5) of the CGST Act, 2017, "The Government may, on the recommendations of the Council, by notification, specify categories of services the tax on intra-State supplies of which shall be paid by the electronic commerce operator if such services are supplied through it, and all the provisions of this Act shall apply to such electronic commerce operator as if he is the supplier liable for paying the tax in relation to the supply of such services:

Provided that where an electronic commerce operator does not have a physical presence in the taxable territory, any person representing such electronic commerce operator for any purpose in the taxable territory shall be liable to pay tax:

Provided further that where an electronic commerce operator does not have a physical presence in the taxable territory and also he does not have a representative in the said territory, such electronic commerce operator shall appoint a person in the taxable territory for the purpose of paying tax and such person shall be liable to pay tax".

It may be recalled that during pre-GST era supplying goods through e-commerce platform was not well-defined. E-commerce operators (like Amazon and Flipkart) were treated as facilitators by some states (like West Bengal and Kerala) and hence not required to register themselves for VAT. Contrarily, in some states (e.g. Uttar Pradesh) they were required to file a VAT declaration and other documents. Due to differential practices of states in this regard, there was lot of confusion and ambiguity. Under GST, there are clear-cut provisions applicable to e-commerce sector on all-India basis. There is no complication regarding inter-state movement of goods.

8.1 Tax Collection at Source (TCS)

TCS means that any dealer selling through e-commerce will receive payment after deduction of tax at specified rate. Since TCS is mainly for e-commerce aggregators, it is necessary to understand what is e-commerce and who is an electronic commerce operator.

8.2 Legal Provisions for TCS

With regard to tax collection at source (TCS), sub-sections (1) and (3) of Section 52 of CGST Act, 2017 read as follows,

> "(1) Notwithstanding anything to the contrary contained in this Act, every electronic commerce operator (hereafter in this section referred to as the "operator"), not being an agent, shall collect an amount calculated at such rate not exceeding one percent, as may be notified by the Government on the recommendations of the Council, of the net value of taxable supplies made through it by other suppliers where the consideration with respect to such supplies is to be collected by the operator…(3) The amount collected under sub-section (1) shall be paid to the Government by the operator within ten days after the end of the month in which such collection is made, in such manner as may be prescribed".

Benefit of threshold exemption is not available to e-commerce operators and they are liable to be registered irrespective of the value of supply made by them. Thus, Amazon is e-commerce operator because it is facilitating actual suppliers to supply goods through its platform.

If a person is supplying own products through his own hosting website then tax collection at source (TCS) will not take place because TCS is required when taxable supply is made through e-commerce operator by other supplier and consideration is collected by e-commerce operator. When someone is selling own product through own website there is no need for TCS. Here normal GST rate will be applicable.

If someone is purchasing goods from different vendors and selling such goods on his own website under his own billing, then TCS is not needed because supply is not made by other supplier. Again, Amazon is e-commerce operator because it is facilitating suppliers to supply goods through its platform (popularly called market place model or fulfilment model). However, Amazon will not be treated as e-commerce operators in relation to those supplies which it makes on its own account (popularly called inventory model).

Twenty-sixth Meeting of the GST Council held on March 10, 2018 decided to postpone the applicability of TCS until June 30, 2018. Provisions relating to TCS were again deferred for another 3 months till September-end, 2018.

On September 13, 2018, Government notified the provision part of Section 52 of the CGST Act, 2017 which had been kept in abeyance since the rollout of GST on July 1, 2017. As per the notification, TCS provisions under GST regime took effect from October 1, 2018. Rate of TCS for intra-state supplies is 1 percent of net taxable supplies (0.5 percent CGST plus 0.5 percent SGST). Rate of TCS for inter-state supplies (IGST) is 1 percent of net taxable supplies.

Thus, e-commerce firms have to collect tax at the specified rate before making the payment to the supplier for proceeds of sale. E-commerce operators had opposed TCS arguing that it would add to their compliance burden due to the cumbersome reporting provisions. E-commerce firms have to furnish a monthly statement and an annual statement containing details of the outward supplies. In addition, they have to deposit tax collected at source by 10th of the next month in which the tax was collected.

With the TCS provisions coming into force, tax authorities are empowered to monitor e-commerce transactions and ensure that suppliers selling their goods through e-commerce platforms do not get away with under-reporting their turnover.

TCS implementation as a tool to check tax evasion comes at a time when GST revenues are lagging behind budgeted targets and the tax authorities are struggling to stabilize revenues at higher level. Government is hoping that TCS along with e-way bill implementation will prevent non-reporting and under-reporting of transactions thereby enlarging the taxpayer base.