UNIT 3 ADVERTISING AND TAXATION VIS-À-VIS E-COMMERCE

Structure

3.1 INTRODUCTION

Commercial transactions do not occur in vacuum. They require all kind of support services in the form of advertising, marketing, sales, logistics, insurance and banking. If these support functions are considered essential for offline commercial transactions, then these can also be taken as essential for online commercial transactions.

3.2 OBJECTIVES

After reading this unit, you should be able to:

- explain the concept of online advertising and taxation and make a comparison between traditional media and online media;
- describe the different forms of online advertising and the way it works;

- explain the merits and demerits of online advertising;
- explain the relationship between e-commerce and taxation; and
- discuss the tax issues emerging from online transaction.

3.3 ONLINE ADVERTISING

It is important to note that online advertising is still in its nascent stage of development. It is still evolving and is often considered to be complementary of offline marketing efforts. Any comparison of online advertising with offline advertising would be an unequal comparison but nevertheless should be made.

Table 1: Comparison[1] between traditional media and online media

	Traditional Media	Online
Advertising space	Expensive and limited	Cheap and unlimited
Advertising time	Expensive commodity for marketers	Expensive commodity for users
Image creation	Image is everything Information is secondary	Information is everything Image is secondary
Communication	Push, one-way	Pull, interactive
Audience	Mass	Targeted
Links to further information	Indirect	Direct/embedded
Investment in design	High	Low, allows change
Interactivity	Low	Low to two-way dialogue

Online advertising is specifically meant for online consumers. It is technology driven promotion of products, people, businesses and events in a digital medium, which primarily includes Internet, but of late even mobile telephones are also being included. As compared to traditional media, online media is still new and its audience (e-consumers) base is extremely low.

Please answer the following Self Assessment Question.

Self Assessment Question 1	*Spend 1 Min.*
Online advertising is meant for	

3.4 FORMS OF ONLINE ADVERTISING

Online advertising is a part of e-commerce ecosystem. To begin with, the Internet user population was extremely small, but with the passage of time, it has grown exponentially. If the earliest version of e-commerce happened on proprietary networks in the form of EDI, it is now happening at a public networks and these networks have brought more and more consumers closer to businesses than ever before. Online advertising has played an important role in bringing the consumer and the businesses closer and like e-commerce it has also grown exponentially.

3.4.1 Banner Advertisements and Payment Models

A banner advertisement is a small graphics link, sometimes called a 'hot link', placed on a Web page. The banner is linked to the advertiser's Web pages, so that clicking it will transport the browser into the advertiser's site.

A banner advertisement can be placed anywhere on a Web page. They look deceptively similar to 'real-world' magazine advertisements. The effect of such ads is precisely measurable, as the advertiser collating 'click-throughs' can easily count the users who click on the banner.

The earliest banner advertisement payment model was based on a simple, flat rate fee with little or no co-relation between the actual, or even the expected number of visitors to the site and the cost. Later, this unrealistic model was replaced by payment model based on the CPM model (cost per thousand impressions or page views), whereby advertisers pay on the basis of impressions of an advertisement. That is, advertising rates were calculated on the number of Web users accessing the Web page holding the banner.

In most cases, the publishers owning and operating the sites selling the advertisement space will guarantee a number of impressions per month, and either price on the CPM basis, or provide a fixed monthly price with a quotation for the equivalent CPM. For example, some of the most visited sites on the web would normally yield around 2.25 million impressions per month, with CPMs around Rs. 1000.00 to Rs. 1500.00 only depending on the location of web pages. If it is on a home page of a popular site, the cost per month may even exceed Rs. 20,000.00.

The problem with CPM is that it is difficult to assess the impact of impressions in terms of cost-benefit analysis. Moreover, technologically speaking, impressions are difficult to assess because site visits – the nearest Web has an impression not readily recorded by the Web servers themselves. Web servers receive requests to transfer page contents – that is, they receive 'hits' – and each page might require several hits to be satisfied, as different text or graphics elements are transferred. Now which of these hits is to be recorded as the impression? Does an impression occur when the first part of the page is copied to the browser, or when all of it is copied? What if the user chooses to interrupt a transfer, having already received part of the page – Does this count as an impression or not? And if unique impressions are required – i.e., a count of unduplicated visits – how is this to be achieved[2]?

A calculation based on impressions alone is not a good parameter and would be unwise of an advertiser to rely on such a measure without an independent audit of the numbers involved.

Proctor & Gamble, a global Fast Moving Consumer Goods (FMCG) company set a precedent in April 1996 when they agreed with search-provider Yahoo! that they would pay advertising fees based not on CPMs but on click-throughs themselves. It is based on, Cost per click (CPC) – the amount an advertiser pays for each visitor who clicks on his or her online advertisement. **Click rate** is the percentage of visitors who click on a banner ad. **Click through** is the number of people who click on a banner ad and get to the advertiser's Web site. The idea of paying for results, as it were, rather than promises is today gaining wider credence among the advertisers. In other words, inserting an advertisement on a well-focused Web page – one that is attracting the audience appropriate for the advertisement – is clearly worth buying, even at higher advertising rates.

3.4.2 Looking Beyond the Banner Ads

One of the simplest approaches to extend the value of a simple banner is to create an interactive ad. It requires the 'programmability' of the computer on which the advertisement is displayed, so as to create new and interesting shapes, images or messages whenever the banner is seen – by using the facilities of Sun's Java or Microsoft's 'ActiveX' applets.

An Applet is a small program or set of instructions copied from a web server on to the local browser, just like the graphics and textual content fold. With these applets, however, instead of merely fulfilling a simple display role, the browser can execute the program logically. It allows several concurrent parts of the program to be executed simultaneously; each part is called thread and can be used to gather information, animate pictures or to perform the most complicated of software functions.

Web applets are used within the banners to provide engaging computer games – banner games. The use of Java applets in the 'live' banner allows images to move and evolve as the mouse is moved around the screen.

3.4.3 Cookies as an Advertising Tool

When the online shopper does shopping it is necessary to maintain a record of these shopping details. Holding this record on the server is problematic, hence the data is stored on the browser or client end, available to the server for update as subsequent shopping choices are made. When the shopping session is complete, the server needs simply to examine the collected records and use this to place the order and invoice. The data stored on the local browser is referred to as a 'cookie'. In other words, a "cookie" is a block of text (digital identification tags) which the website (accessed) places in a file on a computer hard disk of a person to track his activity. While a code in the cookie file enables the site to label the person as a particular user, it doesn't identify the person by name or address unless the person has registered himself and provided the site with such information or set up preferences in his browser to do so automatically.

From the point of online advertisement, cookies can be used to record the location of the browser, so that only advertisements for a specific country, city, or even individual user are displayed. Also, cookies can be used to track the path through a series of Web pages or shopping choices (known as 'click trail'). Cookies help in creating a profile of the user so that only those advertisements for a particular web page or site those are relevant to the user are displayed before him. For example, international online advertising companies insert ads on web pages with cookies tagged on them. Once clicked, they start building up the user's profile as he moves from one site to another. This is how the advertising companies, known as *profilers* build a comprehensive profile of the user's surfing habits and use it to put ads targeting him on their partner sites. Also there has been an increasing use of *profiling software tool(s) that reads the user's on-line activity and recommends other similar products.*

3.4.4 Google AdWords: Pay Per Click

Credit should be given to the search engines to translate the search results into ads. In 2000, Google introduced its first advertising programme called AdWords, which allowed advertisers to place their ads alongside search results. These were not called advertisements, but "sponsored links" and appeared separately on the right side of the search page, demarcated by a vertical line. Initially, AdWords advertisers paid Google based on the number of times their ads showed up alongside the search results. By 2002, it started charging advertisers per click.

It is an innovation from Google, which has pioneered pay-per-click text advertisement, which appear alongside search results, triggered by keywords in the search query. In this case, the advertiser will bid for keywords that he thinks would be used by people to search the services and products he is providing. When a user searches using these keywords then they will see a listing and brief description of the advertiser's site, known as 'Google AdWords' which would appear to the right of its search result. The advertiser will only pay if that user decides to click on the description and follow the link to the advertiser's actual site. These keywords cost not much for relatively not-so-popular words but may cost on the high side if they relate to popular products and services. The advertisement is displayed for free with the site owner paying for those click throughs within a daily budget they have stipulated in advance. The rank of AdWords displayed on the right of the Google screen is decided by multiplying the maximum cost-per-click by the click through rate. Interestingly, majority of AdWord advertisers are small and medium enterprises. Only a minimum of Rs. 250.00 is needed to sign up for the service and money gets deducted from the account based on the number of clicks.

In 2005, Google started AdSense, which extended Google and the advertiser's reach to other (but specified) sites, which are using Google search. Suppose a visitor on a share and stock investment site runs a search (using Google search on the site's webpage) for a tax advisor. The tax advising firms whose ads show up as sponsored links will pay Google, which in turn will split some revenue with the website.

3.4.5 Other Advertising Tools

Blogger, Blogs and Forums

Blogger allows anyone to publish onto web instantly. It is like publishing one's own diary. Blogging has grown with web users publishing what are called webblogs or Blogs. This is a web page made up of usually short, frequently updated posts that are arranged chronologically. The blog posts are like instant messages to the web. These are being increasingly used to influence the viewers and many times these blogs are used to promote products and services in a clandestine manner.

Micro sites

These are like magazine inserts and usually associated with infotainment sites. They are placed in such a manner that they create interest to the visitor. These Microsites have sometimes also been called 'brand modulus' or even 'cuckoos', since they are 'eggs' placed in another bird's nest.

Messenger Services

Search engines, like Yahoo!, MSN, Google, Talk etc. help users to connect to other users instantly via messages or voice chat or webcam. These messenger alerts appear like Pop-ups (term given to when a new browser window which opens up while the user is viewing a website) on users display. These days they are one of the most popular ways to advertise on the Internet.

Short Messaging Service (SMS)

Short Messaging Text is used in sending advertisements to mobile phone users. This is commonly known as text messaging and usually involves a short message quite often using shortened or abbreviated form of words. This is an example of intrusive form of advertising.

Spyware

Spyware are malicious programs often hides insecurity holes in Windows, collecting data for market research, and will sometimes announce it by parasitically attaching an ad to the computer screen. This is known as adware. Sometimes spyware is part of mainstream software and it is the price a gullible Net user pays for that free download. Spywares are capable of not only generating annoying pop-up advertisements but also collect passwords and credit card numbers.

Web casting

It is a push technology that delivers personalised information to the individual's computer (even to his mobile number). For effective personalisation, web casting needs to build a profile of the user's interests. It comes in the form of NewsAlerts, MessageAlerts, and StockAlerts etc.

Please answer the following Self Assessment Questions.

Self Assessment Question 2 *Spend 3 Min.*

Google is a ....

The full form of SMS is ....

3.5 ONLINE ADVERTISING: BOON OR BANE?

From the Net advertiser perspective, online advertising is a boon for the advertisers. It is low cost, fast and has the widest of the wide reach. It is a good investment of money. From the Net user perspective, online advertising may become a nuisance. He may not want it and yet he cannot do without it. It is intrusive and yet useful and informative. It is the cost a Net user is paying for availing many services free of cost over the Internet. Nevertheless, it eats into Net users' Internet usage time and slackens the speed of Internet. Also, the most disturbing aspect of online advertising is that it could violate privacy of the Net user.

3.6 E-COMMERCE AND TAXATION

Tax revenues are a major source of income to the governments – whether Central or state. There have been numerous statutory provisions giving powers to the governments to levy both direct and indirect taxes. Over a period of time, numerous tax procedures and tax authorities have been created to streamline the tax collections. The advent of e-commerce has opened up a Pandora's Box – how to tax online transactions? Is it possible to tax such transactions in view of nature of Internet? Should e-commerce be taxed on lines of offline commercial activities? There are more questions than answers.

The broad consensus that has emerged is: (i) Online transactions should not be immune from taxation solely because the sale is conducted through a medium distinct from that of traditional offline businesses, and (ii) It is not prudent to tax these online transactions purely on the basis of traditional taxation approach applicable to offline businesses.

3.7 TAX ISSUES EMERGING FROM ONLINE TRANSACTIONS

As e-commerce represent online transactions involving consumer(s) and business(es) – it is occurring instantaneously, which makes it difficult to determine who the buyer and seller are and where they are respectively located. Question is how to tax such online transactions? From a point of electronic taxation following issues may emerge[3]:

- Who is the customer?
- Where does the customer live?
- Did the transaction constitute sale of tangible property, the performance of a service, or the transfer of intangible property?
- Which jurisdiction has the authority to tax the sale?
- What online activities constitute sales for sales tax purposes?
- What constitutes a business connection/substantial nexus within a taxing jurisdiction?
- Can Central and/or state Government(s) technologically capable to monitor all online transactions?
- What kind of record retention requirements is necessary for tax purposes?

Answers to these questions would lay down the ground rules of electronic taxation vis-à-vis e-commerce. Until then, traditional tax rules must be utilized to address these complex issues. Moreover, it is a myth that electronic tax is an 'additional' tax burden – the fact is, it is a new tax which is applicable *in lieu* of other indirect taxes.

3.8 E-TAXATION: PROBLEM AREAS

Apart from the above-mentioned tax issues there are certain problem areas as well. The problems are because of the very nature of Internet technology, which is seamless and unobtrusive. It may lead to[4]:

a) the lack of 'physical' connection between a consumer in one state and a seller in another state;

b) absence of permanent establishment (PE) – "place of business";

c) ever changing location of web servers hosting the website, meant for online transactions;

d) relocation of businesses in tax havens, like Bahamas, Monaco, etc.

e) general confusion regarding which country has the right to tax the transaction, and at what rate;

f) non-taxation of digital (intangible) goods, like software, music and data (or information);

g) export and import of digital (intangible) goods across international borders without paying customs duty (or tariffs), thereby bypassing the existing export-import policies, regulations and tax system;

h) a parallel channel of transactions, ignoring the traditional documents based on banking practices;

i) the general lowering down of 'barriers to trade' for the smaller and medium business entities; and

j) complete disregard to accounting and audit procedures.

These problem areas constitute real threat to the establishment of an extensive platform dealing with electronic taxation. It is thus imperative that in order to construct an effective e-taxation regime the problem areas should be addressed and proper guidelines must be framed to deal with such issues. But care should be taken not to impose an overly strong regulation and tax regime as this could lessen the financial attractiveness of conducting electronic commerce.

3.9 AN OVERVIEW OF DEVELOPING E-TAXATION PRACTICES

World over the nation states are in the process of introducing e-taxation in a selective manner. There have been legislative and treaty provisions unfolding the e-taxation practices.

3.9.1 The Internet Tax Freedom Act (ITFA)

The Internet Tax Freedom Act was introduced in March 1997 in the US Senate and was enacted into law on October 21, 1998. Its objective was to ensure the continued growth of the Internet as well as to prevent multiple or discriminatory taxes which could potentially stifle the growth of e-commerce. It further articulated[5]:

- Jurisdictions are free to impose taxes on all "e-business sales provided that the tax rate is the same as that which would have been imposed, had the transactions been conducted in a traditional manner, such as by mail-order.

- States may impose taxes on sales of "tangible personal property over the Internet, just as if those sales were conducted" in person.

- A three year moratorium on multiple or discriminatory taxes on e-commerce.

The ITFA moratorium expired on October 22, 2001, and was retroactively extended until November 1, 2003.[6] On December 3, 2004, Congress made the moratorium on taxes on Internet access and multiple and discriminatory taxes on electronic commerce imposed by Internet Tax Freedom Act permanent.[7] Even though the IFTA imposes a moratorium on taxes, it still allows the imposition of a single nondiscriminatory tax on goods and services sold on the Internet. In order to collect a sales tax on Internet transactions, a State in the US must show that it has sufficient jurisdiction over a company doing business over the Internet. Today many pure play e-commerce companies (e-tailers), like Amazon.com and eToys, are paying sales taxes as if their tax exposure is similar to catalogue businesses.

3.9.2 OECD Model Treaty

The Organization for Economic Co-operation and Development (OECD), a 30 member organization has proposed that the basis of any online taxation system should be equitable, simple, certain, effective, distortions free, flexible and dynamic. The idea is to create a uniform mode of taxation whether offline or online. That is, any online taxation system should completely harmonize with existing offline taxation system. Broadly speaking, electronic commerce should be taxed neither more nor less heavily than other commerce, and online sales should, to the extent possible, be taxed at the state of destination of sales, *irrespective* of the fact whether the vendor (seller) has a physical presence in the state or not.

The OECD Commentary, on the "OECD Model Treaty" issued on January 28, 2003, clarified from an e-commerce perspective.

Whether a website constitutes a "place of business"?

The OECD Commentary mentions that a website, which is a combination of software and electronic data, does not in itself constitute tangible property and hence cannot be referred to as a "place of business".

Whether location of a server constitutes a permanent establishment (PE)?

The OECD Commentary provides that if an enterprise owns (or leases) and operates the server on which the website is stored and used, the place where that server is located could constitute a permanent establishment of the enterprise.

It is evident that the OECD countries place a lot of emphasis on permanent establishment from e-taxation perspective.

3.9.3 India: E-taxation Practice

With the growth of e-commerce in India, it was felt that India should also adopt the concept of PE in view of rapid globalisation of commerce. The Finance Act, 2002 has introduced the definition of Permanent Establishment (PE) in the Income Tax Act, 1961. It shall mean to include a fixed place of business through which the business of an enterprise is wholly or partly carried on [S.92F (iii (a)]. It may include a wide variety of arrangements, like a place of management, a branch, an office, a factory, a workshop or a warehouse etc. The definition is similar to that of the OECD model. Apart from statutory provisions defining PE, e-taxation in India is still a developing area. In fact, online taxation regime is presently confined to development of IT infrastructure facilitating online filing of tax returns. Once it is achieved, e-taxation rollout would be the next logical step.

Further, it is obligatory to note that in *Tata Consultancy Services* v. *State of Andhra Pradesh*[AIR 2005 SC.371], the issue before the Hon'ble Supreme Court was whether the canned software which were available off the shelf in the form of software packages sold by the appellants can be termed to be "goods" and as such assessable to sales tax. The Constitutional Bench of five judges opined that for the purpose of sales tax, the term "goods" cannot be given a narrow meaning. In India, the test to determine whether a property is "goods", for purposes of sales tax, is not whether the property is tangible or intangible or incorporeal. The test is whether the concerned item is capable of abstraction, consumption and use and whether it can be transmitted, transferred, delivered, stored, possessed etc. Admittedly in the case of software, both canned and uncanned, all of these are possible.

It is important to note that under the Sale of Goods Act, 1930 "goods" means every kind of movable property other than actionable claims and money; and includes stock and shares, growing crops, grass, and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale [S. 2(7)].

The Hon'ble Supreme Court's decision has further widened the tax regime to include intangible property as well.

Please answer the following Self Assessment Question.

Self Assessment Question 3	*Spend 1 Min.*
The full form of OECD is	

Let us now summarize the points covered in this unit.

3.10 SUMMARY

- Online advertising is aiding online marketing initiatives.
- It has moved from a flat fee payment model to a more dynamic 'pay per click' model.
- Over a period of time, online advertising has become intrusive and bane for the Net users' and it is thus imperative that online service providers should now opt for self-regulation.
- It is a myth that electronic tax is an additional tax burden. The fact is that it is not! It is meant to tax e-commerce transactions but the process is not easy because of the very nature of Internet technology, which is seamless and unobtrusive.
- Nevertheless, world over, the governments are coming to terms with the e-taxation reality.

3.11 TERMINAL QUESTIONS

1. Online advertising is a necessary evil. Justify the statement with the help of examples.
2. What is so difficult about taxing e-commerce transactions?
3. Explain the different forms of online advertising?

3.12 ANSWERS AND HINTS

Self Assessment Questions

1. Online consumers
2. (a) Search Engine

   (b) Short Messaging Service
3. Organization for economic co-operation and development

Terminal Questions

1. Refer to section 3.2 of the unit.
2. Refer to section 3.7 of the unit.
3. Refer to section 3.4 of the unit.

3.13 REFERENCES AND SUGGESTED READINGS

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3. Rustad L. Michael and Cyrus Daftary, "E-business Legal Handbook. Aspen Law & Business". 2002.
4. Sharma Vakul . "Information Technology – Law and Practice". Universal Law Publishing Co.. 2004.
5. The Internet Tax Freedom Act. Pub. L. 105-277. S 1101.a, Oct. 21. 1998.
6. On November 28. 2001. President Bush signed H.R. 1552. the "Internet Tax Non-discrimination Act" which simply amended the IFTA so that the moratorium would not expire until Nov. 1. 2003.
7. Public Law 108-435. 108th Congress. Dec. 3. 2004.