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LEGAL FRAMEWORKS FOR TAXATION OF ONLINE MARKET PLAYERS IN INDIA

~ Naaz Ishrat

ABSTRACT

The rapid expansion of digital platforms has exposed fundamental weaknesses in traditional tax laws built around physical presence and territorial nexus. Online market players generate substantial economic value in user jurisdictions while often remaining outside effective tax reach, resulting in significant revenue losses and regulatory imbalance. This article critically examines the evolving legal frameworks governing the taxation of digital businesses, with a focus on international initiatives such as the OECD's Two-Pillar Solution, regional responses like the European Union's Digital Services Tax, and national approaches under India's GST regime and U.S. marketplace facilitator laws. It analyses judicial developments that have restrained aggressive administrative practices while underscoring the need for legislative clarity. The article argues that fragmented unilateral measures risk legal uncertainty, trade conflicts, and innovation slowdowns, and contends that coherent, technology-enabled, and harmonised tax frameworks are essential to ensure fairness, enforceability, and long-term sustainability in the digital economy.

INTRODUCTION

India's digital economy is expanding rapidly and is expected to reach the \$1 trillion mark by 2025. The e-commerce sector alone is projected to grow to USD 136.43 billion in 2025, up from USD 125.5 billion in 2024, with a steady growth rate of 15.2 percent annually until 2032. This growth has been led by platforms such as Amazon, Flipkart, and new quick-commerce companies, which have made buying and selling easier and more accessible. However, this rapid expansion has also highlighted serious gaps in taxation. Online market players, including e-commerce operators, sellers and digital service providers, operate across borders without physical locations. This creates difficulties for tax systems that are based on physical presence. Although India's e-retail gross merchandise value is expected to reach \$60 billion in 2025, tax revenue from this sector remains low. It contributes less than

5 percent of total GST collections, even though it accounts for nearly 8 percent of total retail sales. India's current tax structure built around the Goods and Services Tax, provisions of the Income Tax Act, and the now-changing Equalization Levy tries to address this gap but faces challenges related to enforcement, high compliance costs for small sellers, and international tax disputes linked to OECD reforms. This article examines how India taxes online market players, tracing the evolution of its legal framework, explaining its working, identifying weaknesses, and suggesting improvements. Using judicial decisions and recent data, it argues for a tax system that collects revenue fairly without discouraging digital growth. With nearly 500 million online shoppers driving annual growth of over 17 percent, fair taxation is not just a revenue issue but a requirement for long-term digital stability.

EVOLUTION OF TAXATION IN THE DIGITAL ECONOMY

The taxation of online businesses in India has changed gradually from outdated systems to more digital-focused laws. Before GST, multiple indirect taxes such as VAT, CST, and Service Tax applied, making compliance complicated and often unclear for e-commerce businesses. The introduction of GST in 2017 under the Constitution (101st Amendment) created a unified tax system based on consumption, which suited digital transactions better. One of the earliest steps was the Equalization Levy introduced in 2016. It imposed a 6 percent tax on online advertisements provided by non-resident companies, mainly targeting global digital firms earning income from India without a physical presence. In 2020, this levy was expanded to include a 2 percent tax on e-commerce supplies. This was India's unilateral response to digital tax challenges and came even before the OECD's global solutions under the BEPS framework. By 2025, however, India began aligning with international consensus. Amendments under the Finance Act removed both the 6 percent advertising levy and the 2 percent e-commerce levy to support OECD Pillar One, which reallocates taxing rights to user countries for large multinational companies. This shift reflects India's move from unilateral taxation to global coordination. At the domestic level, the Income Tax Department clarified the definition of e-commerce in 2016, and Section 194O was introduced in 2020 to require platforms to deduct tax at source on payments made to sellers. While these changes improved coverage, they were largely reactive. New rules often increased compliance costs, especially for small sellers. For example, GST 2.0 changes in 2025 introduced complex rules for bundled supplies and discount structures, which may discourage small sellers who already form the majority of transactions but contribute little to tax filings. Overall, India's approach shows progress but also highlights a lack of coordination between tax systems like GST and income tax. As e-commerce continues to grow rapidly, the focus must shift from correcting past gaps to preparing for future digital business models.

THE GST REGIME AND ONLINE MARKETPLACES

GST forms the core of India's taxation of online marketplaces. Under the CGST Act, an e-commerce operator is defined broadly as any person supplying goods or services through digital platforms. Such operators must register under GST regardless of turnover. They are required to collect 1 percent Tax Collected at Source on net taxable supplies and deposit it monthly. For sellers, GST applies based on whether the supply is within a state or across states. Digital services such as streaming and cloud computing attract 18 percent GST. Foreign service providers supplying digital services to Indian consumers must comply under the OIDAR provisions by appointing Indian representatives. The system allows Input Tax Credit to reduce cascading taxes, but the high volume of online transactions makes reconciliation difficult. In FY 2024, nearly 25 percent of ITC claims faced mismatches. Amendments in 2025 expanded GST liability for local delivery services, targeting quick-commerce platforms. While this helps prevent tax avoidance, it may raise prices for users, especially in rural areas where online penetration is still low. Although TCS collection increased significantly in FY 2025, small businesses bear a heavy compliance burden. Many sellers report that compliance costs exceed 5 percent of turnover. Delays in IGST refunds for cross-border transactions further strain liquidity. To remain effective, GST needs better technological integration, such as real-time reporting systems, to reduce disputes and costs.

INCOME TAX AND TDS IN PLATFORM-BASED TRANSACTIONS

Under the Income Tax Act, Section 194O requires e-commerce platforms to deduct tax at source on payments made to sellers once annual transactions exceed ₹5 lakh. The rate was reduced for smaller transactions after Budget 2024. Platforms must file regular statements reporting these deductions. Income earned through platforms is taxed as business income, with presumptive taxation available for small sellers. Transfer pricing rules apply to large multinational platforms, ensuring that transactions between related entities are priced fairly. While TDS collections have grown, under-reporting remains an issue. Many platforms face scrutiny for algorithm-based discrepancies. Budget 2025 introduced exemptions for very small sellers, reducing entry barriers. However, the lack of coordination between GST and income tax systems creates risks of double taxation and confusion. As gig work grows, integrating tax deductions with social security contributions could provide better coverage without increasing administrative burden.

EQUALIZATION LEVY AND CROSS-BORDER ISSUES

The Equalization Levy played a key role in taxing foreign digital companies without a permanent establishment in India. However, it was withdrawn in 2025 to align with OECD's global minimum tax and profit reallocation rules. This helped reduce trade tensions, particularly with the United States, but also reduced tax revenue. India now relies more on treaty-based taxation, supported by its adoption of the Multilateral Instrument and rules on significant economic presence. Still, as cross-border digital

trade grows, the absence of a direct levy raises concerns about under-taxation unless global reforms are fully implemented.

CHALLENGES IN ENFORCEMENT

Despite strong laws, enforcement remains difficult. Differences between GST and income tax databases result in frequent mismatches and disputed credits. Cross-border digital transactions using VPNs and crypto tools often escape taxation. Many small sellers avoid registration due to thin profit margins and high tax rates. The delay in global reforms may lead to revenue losses, while gig economy platforms often avoid withholding obligations by treating workers as independent contractors. These gaps increase inequality, as large companies manage compliance better than small businesses. Technological solutions such as blockchain-based tracking could improve transparency, but they must balance privacy concerns under India's data protection laws.

JUDICIAL INTERPRETATION AND THE ROLE OF COURTS IN DIGITAL TAXATION

Indian courts have played a crucial role in shaping digital taxation, particularly where legislation has lagged behind technological developments. Judicial scrutiny has primarily focused on tax nexus, characterization of digital income, and the limits of extra-territorial taxation, especially for foreign digital companies operating without physical presence in India.

A significant intervention came in *Engineering Analysis Centre of Excellence Pvt. Ltd. v. Commissioner of Income Tax (2021)*, where the Supreme Court held that payments for copyrighted software do not automatically qualify as "royalty" under the Income Tax Act or applicable Double Taxation Avoidance Agreements. This judgment curtailed expansive withholding tax demands on cross-border digital transactions and reinforced the principle that statutory interpretation cannot be stretched to fill legislative gaps in digital taxation. High Courts have also addressed GST-related disputes involving e-commerce platforms. In *Amazon Seller Services Pvt. Ltd. v. State of Karnataka*, the Karnataka High Court clarified that e-commerce operators function primarily as facilitators rather than suppliers, while upholding the validity of tax collection at source provisions. Courts have further restrained tax authorities from initiating recovery proceedings based solely on GST return mismatches, acknowledging technological limitations within the GST Network. Judicial review has extended to the retrospective application of digital tax measures, including challenges to the Equalization Levy. Although most petitions were dismissed on procedural grounds, courts consistently emphasized the need for tax certainty and alignment with international treaty obligations. These judicial concerns contributed to India's decision to withdraw the Equalization Levy in 2025 in favour of OECD-led multilateral solutions.

RECOMMENDATIONS FOR A COHERENT DIGITAL TAX REGIME

Digital taxation must move toward greater legal certainty and coordination. India should prioritise full alignment with the OECD Two-Pillar framework to reduce conflicts arising from unilateral measures and ensure taxation rights are exercised where economic value is generated. Swift implementation of Pillar One is essential to prevent renewed trade disputes and overlapping tax claims.

Domestic laws must be simplified to ease compliance burdens on platforms and small sellers. Rationalising GST obligations for e-commerce operators, especially tax collection at source mechanisms, would improve cash flow efficiency without undermining revenue interests. Introducing differentiated thresholds for startups and small digital enterprises can prevent regulatory overreach and support innovation.

Technology should be embedded within enforcement mechanisms. AI-enabled audits, real-time data reconciliation, and secure digital ledgers can improve transparency while reducing disputes caused by system mismatches. At the same time, clear statutory safeguards must be introduced to limit arbitrary assessments and protect taxpayer rights.

Finally, sustained judicial-executive dialogue is necessary. Courts have consistently signalled the need for precise legislative drafting, and policymakers must internalise these signals to build a stable, fair, and future-ready digital tax framework.

CONCLUSION

India's framework for taxing online market players has evolved significantly, combining GST, TDS, and international cooperation. While it shows strength, enforcement gaps and complexity remain. As the digital economy grows further, simplifying rules and using technology will be key to ensuring fair taxation. A balanced system can support growth while ensuring that digital platforms contribute their fair share to India's economy.

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