DIGITAL TAXATION

ICAI

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Background

OECD/G20 BEPS Action Plan- 1 : Digital Taxation

What is Digital Taxation?

- ✓ Tax levied by the Country of Market on profits earned from digitalized business is Digital Taxation

- ✓ The name of this tax has changed several times. In 1990s it was called E-commerce Taxation. Then Digital Taxation and now, Tax on Digitalized Economy.

<u>Source:</u> *https://www.oecd.org/tax/beps/beps-actions/*

Action Plan- 1 : Digital Taxation

- Is there a need for change in International Tax System?

Yes, there is a need for change in system of taxation due to the following main reasons

✓ Inadequacy of old law to deal with modern business models

✓ Residence Vs. Source Conflict

Action Plan- 1 : Digital Taxation

- Inadequacy of old law to deal with modern business models

Existing rules of international taxation for establishing Nexus (Permanent Establishment) and for Attribution of Profits are not adequate to deal with digitalized business (E-commerce).

In absence of a PE (due to non physical presence) which can be applied to E-commerce, the non-resident Digital Corporation cannot be taxed by the Country of Market (COM) irrespective of the revenue earned by the entity from COM.

Action Plan- 1 : Digital Taxation

Residence Vs. Source Conflict

Residence Vs. Source conflict for attribution of profits (or distribution of tax base) is an old controversy.

Major part of International Tax base goes to Residence countries. We may broadly consider following countries as "favoring Residence based taxation"– U.S., U.K., Germany, France & a few other developed countries.

Interestingly, E-commerce business has so developed that for E-commerce Tax Base, now mainly U.S. may be considered to be favoring the Country Of Residence (COR). China is indifferent. Rest of the world is favoring Country Of Source (COS).

Global Scenario

Action Plan- 1 : Global Scenario

- Unilateral Actions by different tax jurisdictions on digital taxation.

Italy's Web Tax	Australia's Multinational Anti-Avoidance Law (MAAL)
Austria's Online Advertisement Tax	New Zealand's Digital Services Tax
Slovakia's Intermediation Tax	Israel's New Nexus and Significant Economic Presence Test
France's YouTube Tax, GAFA Tax	India's New Nexus, Equalization Levy as extended
Belgium's Fairness Tax	Saudi Arabia and Kuwait's Virtual PE
Hungary's Advertisement Tax	Taiwan's New Nexus
UK's Diverted Profits Tax	Turkey's Withholding Tax on E-payments

Action Plan- 1 : Global Scenario

US response to France

- The US government then proposed the imposition of 100 % tariffs on up to US $2.4 billion of French goods, such as champagne, cheese and handbags
- Ultimately, a de-escalation seems to have occurred, at least temporarily, during the 2020 World Economic Forum in Davos, where both sides agreed to work on a global solution, with the aim of reaching agreement by the end of 2020.

Action Plan- 1 : Global Scenario

European Parliament's Report on digital taxation.

- The digital economy is growing exponentially while the whole economy is going digital.

- Digital businesses have a tendency towards <u>monopolization</u> due to network effects, scale effects, restrictions of use, potential to differentiate and multi-sided platforms. Yet, they are volatile and easily <u>contestable</u> by disruptive newcomers, as barriers of entry and exit are low.

- The main tax challenges of the digital economy include lack of <u>nexus</u>, reliance on <u>intangibles,</u> data and <u>user-generated</u> content, <u>income characterization</u>, spread of new business models, in which the buyer and seller are in different jurisdictions and the expansion of e-commerce

Action Plan- 1 : Global Scenario

European Parliament's Report on digital taxation.

- With digitalization allowing businesses activities to spread across the globe, it is more and more **complex to identify the location of value creation** and to decide on how to allocate profits.
- It remains unclear whether there is **consensus** at the OECD level whether the digital economy should and can be ring-fenced or not.
- The lack of consensus on **value creation** leads to a multitude of profit allocation methods, which somewhat diverge from the arm's length principle.

Action Plan- 1 : Global Scenario

- European Parliament's Report on digital taxation.
  - **Possible scenarios for taxing the digital economy** include specific taxes for the digital sector, to continue work on BEPS measures, especially regarding transfer pricing and value creation by amending the PE concept, granting more power to source countries via withholding taxes, radically changing the tax system by adopting a destination-based tax and integrating the digital sector in a formula-based transfer pricing regime, a formulary apportionment regime such as profit-splitting method or robust VAT measures to ensure compliance and collection.

Source: *http://www.europarl.europa.eu/RegData/etudes/STUD/2019/626078/IPOL_STU(2019)626078_EN.pdf*

Action Plan- 1 : Global Scenario

- European Parliament's Report summary on digital taxation- March 2020

  - The assets and activities of digital businesses can easily be moved across jurisdictions to avoid a taxable presence in those where taxes are higher. Furthermore, there is a risk that vendors on online platforms skip registration in third countries where they effectively conduct transactions. Companies may create value, or parts of it, in a different jurisdiction to that where they are physically present.

  - Difficulty arises due to the increasing reliance of digital or transnational businesses on intangible assets, such as software and algorithms, which are crucial to many new business models. These assets are easy to move around the world, which facilitates the process of structuring companies in such a way that their tax liabilities are minimized.

Action Plan- 1 : Global Scenario

- European Parliament's Report summary on digital taxation- March 2020

  - Tax authorities subsequently find it increasingly difficult to determine correctly how to identify income generated by intangibles and how such income is allocated amongst different entities forming the multinational groups.

  - highly digitalized businesses rely heavily on the use of data and user-generated content. This leads to a situation where it is difficult to determine to what extent the users, who allow platforms to use their data in exchange for free access, contribute to value creation.

Action Plan- 1 : Global Scenario

European Parliament's Report summary on digital taxation- March 2020

- The digital economy has increased the complexity of characterizing income for tax purposes. The main issue is whether certain rather novel payments and transactions (for example, infrastructure as a service business models), should be treated as business profits or classified as royalties or technical services.

- The sheer diversity of the digital businesses and digital businesses using multiple business lines are further tax challenges, which shall be addressed by robust measures that would last in face of rapid digital evolution'.

Action Plan- 1 : Global Scenario

- European Parliament's Report summary on digital taxation- March 2020

  - During the 2020 World Economic Forum in Davos, US representatives maintained that any international digital taxes must follow 'safe harbour' rules; however, these rules would be reformulated to avoid declaring the taxes 'optional'. Many observers see this as a unilateral approach, without genuine support for finding a global solution.

  - In January 2020, the OECD/G20 Inclusive Framework on BEPS issued a statement underlining that many of its members are concerned about implementing pillar one on a 'safe harbour' basis, as this may lead to new difficulties, heighten uncertainty, and risk failing to meet overall policy objectives. Resolving this issue remains crucial to reaching consensus.

Source: *https://www.europarl.europa.eu/RegData/etudes/BRIE/2020/649340/EPRS_BRI(2020)649340_EN.pdf*

Action Plan- 1 : Global Scenario

- OECD's interim report on tax challenges arising from digitalization – March 2018.

- Addressing the Tax Challenges of the Digitalization of the Economy - Policy Note – January 2019.

- OECD's Program of Work ("POW") – May 2019

Source: *https://www.oecd.org/tax/beps/beps-actions/action1/*

Action Plan- 1 : Unified Approach

- OECD - Secretariat Proposal for a "Unified Approach" under Pillar One. – October 2019

  - Three proposals presented are
    1. User participation
    2. Marketing Intangibles
    3. Significant Economic Presence ("SEP")

  - These proposals would entail solutions that go beyond ALP

Pillar two published in November 2019 on anti-avoidance

Action Plan- 1 : Unified Approach

- These 3 alternatives have significant commonalities

  - Though there is some variation in how the proposals address the digitalization issue, to the extent that highly digitalized businesses are able to operate remotely, and/or are highly profitable, all proposals would reallocate taxing rights in favor of the user/market jurisdiction;

  - All the proposals envisage a new nexus rule that would not depend on physical presence in the user/market jurisdiction;

  - They all go beyond the arm's length principle and depart from the separate entity principle; and

  - They all search for simplicity, stabilization of the tax system, and increased tax certainty in implementation.

Action Plan- 1 : Unified Approach

- Reallocation of Taxing rights to market jurisdictions
  - Marketing intangibles
  - User participation

  } **portion of non routine profit**

  - Significant Economic Presence — **portion of all profits (routine & non routine)**

Action Plan- 1 : Unified Approach

Summary of the Proposal

- Amount A – a share of deemed residual profit out of MNEs consolidated profits allocated to market jurisdictions using a formulaic approach, i.e. the new taxing right;

- Amount B – a fixed remuneration for baseline marketing and distribution functions that take place in the market jurisdiction; and

- Amount C – binding and effective dispute prevention and resolution mechanisms relating to all elements of the proposal, including any additional profit where in-country functions exceed the baseline activity compensated under Amount B.

The above approach is called Three- Tier profit allocation mechanism.

Source: *https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf*

Action Plan- 1 : Unified Approach

OECD/G20 IF on BEPS on the Two Pillar Approach Statement to address tax challenges arising from the digitalization of economy – January 31, 2020

- It is an updated Programme of Work ("POW") of Inclusive Framework ("IF") setting out the timeline for the work on Pillar One and the remaining technical challenges to be addressed.

- This statement is accompanied by an outline of the architecture of a "Unified Approach" to Pillar One, which will serve as the basis for negotiations by the Inclusive Framework.

Action Plan- 1 : Unified Approach

Summary of the Statement – January 31, 2020

- While the original Unified Approach identified "consumer-facing" businesses, the new version of the Unified Approach identifies two categories of businesses such as
  - Automated Digital Services; and
  - Consumer-facing businesses

Action Plan- 1 : Unified Approach

➢ Summary of the Statement – January 31, 2020

- Extractive industries and other producers and sellers of raw materials and commodities will not be considered "consumer-facing" even if they are incorporated further down the supply chain into consumer products.

- Most activities of the financial services sector (including insurance) take place with commercial customers and would not be in scope, and that there is a "compelling case" for excluding consumer-facing business lines based on the impact of regulation that ensures that residual profits are largely realized in local customer markets.

Action Plan- 1 : Unified Approach

Summary of the Statement – January 31, 2020

- It would be inappropriate to subject airline and shipping businesses to the new taxing right.

- Number of Revenue thresholds which includes following three to reduce compliance and administrative burden:
  - Gross Revenue Threshold - The new tax would apply only to MNE groups exceeding a gross revenue threshold (e.g., €750 million).
  - In-scope Revenue threshold - further carve-out is being considered for MNE groups with in-scope revenue below a certain threshold.
  - De-Minimis carveout - A carve-out could also be considered where profit to be allocated under the new taxing right would be minimal

Action Plan- 1 : Unified Approach

➢ Summary of the Statement – January 31, 2020

- As Amount A will feature a formula-based allocation mechanism – looking at a portion of deemed residual profits – there are many technical issues to resolve, including
  - The use of business line/regional segmentation,
  - The notion of digital differentiation, and
  - Specific revenue-sourcing rules for different business models.

- The outline identifies profit before tax as the most favorable profit level indicator and stressed the need for loss carryforward rules to apply.

- Work to determine **how to avoid double counting** among Amounts A, B, and C, as well as mechanisms for double taxation relief, will continue.

Action Plan- 1 : Unified Approach

Summary of the Statement – January 31, 2020

- Regarding Amount B, the outline notes that the fixed return for baseline marketing and distribution activities is ‘based on’ the arm’s length principle, but will <u>need to account for regional, industry, and functionality differences</u>.

- A definition of baseline activities will need to be developed but likely will include no/low risk, lack of intangibles, and <u>routine levels of functionality</u>.

- Further technical work is envisioned on profit level indicator, fixed percentage at an agreed profit, benchmarking studies, and <u>regional/industry differentiation</u>. The stated goal is for Amount B <u>to operate within the existing treaty network.</u>

Action Plan- 1 : Unified Approach

Summary of the Statement – January 31, 2020

- In addition to enhancing traditional dispute prevention and resolution tools, a review panel is also being considered to help make determinations regarding Amount A aspects (such as scope). Subject to consensus, <u>mandatory binding dispute resolution tools will be developed</u>

- The outline emphasizes that commitment to implementing Pillar One will require countries <u>to withdraw relevant unilateral measures.</u>

- In aid of this goal, the IF announced its intent to reach agreement on the key policy features of the two-pillar solution by its <u>next meeting in early July 2020.</u>

Source: *https://www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf*

Action Plan- 1 : Unified Approach

- Appropriate method for taxing Digital Businesses 'Net or Gross Basis'?
  - ✓ A tax on net income would need to identify allowable deductions, and for digital service companies, most of those deductions will not be in market countries. The distinctions the OECD is trying to make to justify the new income tax are not sound — or at least not sufficiently clear and persuasive to justify dismissing long-standing principles of international income tax administration.
  - ✓ The better approach is to use gross-basis taxes such as those that have been adopted by countries imposing unilateral interim measures.

Action Plan- 1 : Unified Approach - Challenges

Potentially Discriminatory	Deductibility requires profitability (or deferral)	Potential economic incidence of taxation on business – loss making businesses?	Different margins for different business / parts of the business life cycle
Defining location of users/possible to comply with?	No reward to IP developer/reward to investor/value on non-user contributions	Double and over taxation	Interim measure may prove to become permanent
No concept of differing value-per user	Unconsolidated joint ventures?	Unintended consequences?	May actually encourage unilateral moves

Action Plan- 1 : Unified Approach

- Applicability to certain business models.
  - Example: Facebook. Much of the content posted on Facebook is generated by customers, who are in countries where Facebook may have little or no physical presence. Without customer-generated content, Facebook's successful business model might not exist.
  - Facebook could not sell ads or gather user data that has value to it and to data purchasers. That single fact seems to serve to justify a demand by market countries to impose income tax on Facebook.
  - Not all companies have similar business models. Hence, methodology of Digital Taxation for them to be analyzed.

Action Plan- 1 : Unified Approach

- Whether concept of Digital Taxation applicable to Pharma Companies?
  - IP is a cornerstone of the pharmaceutical industry and manufacturing pills is a prominent example of a business that can achieve scale without mass.
  - Drug prices differ dramatically from country to country. Indeed, because of the high price of drugs in the United States and price controls in other countries, a fair cost accounting would conclude that almost all those companies' profits are from U.S. sales.
  - Under the OECD proposal, would that be ignored, with a portion of a drug company's global profits allocated to countries where price controls effectively eliminate most, if not all, net income?

Action Plan- 1 : Unified Approach

- Whether concept of Digital Taxation applicable to Pharma Companies?
  - ✓ Under the OECD proposal, revenue and net income from high-margin countries will likely be reallocated, at least in part, to lower-margin countries. High-margin countries will resist that reallocation, of course, while lower-margin countries will push for equality under the guise of simplicity.
  - ✓ That same problem arises in transfer pricing. The global rules require that country-specific markups and profit margins be respected. Why would we take a different approach in taxing digital companies?

Action Plan- 1 : Unified Approach

US – Update

- **The U.S. Treasury Secretary's letter (3 December 2019)** stated that the United States opposes digital services taxes because of their "discriminatory" implications for U.S. businesses, and recommended that taxpayer concerns could be addressed and the goals of Pillar One could be substantially achieved by making Pillar One a safe-harbor regime.

- **The OECD letter (dated 4 December 2019)** agrees with the position of the United States "that a global solution is needed to stop a proliferation of unilateral measures" and that the goal would be to arrive at an international tax system that avoids double taxation and taxes net income, and not gross income.

- The OECD letter further states:

  Throughout the extensive consultation process, however, we had so far not come across the notion that Pillar 1 could be a safe-harbor regime. We raise this concern, as it may impact the ability of the 135 countries that are now participating in this process, to move forward within the tight deadlines we established....

Action Plan- 1 : Global Scenario

- The key features to be identified for arriving at a solution are as under

  - **Scope**
    - – Consumer facing businesses.
  - **New Nexus**
    - – non physical presence based on sales.
  - **New Profit Allocation Rule going beyond the ALP**
    - – complimented by formulae based solutions
  - **Increased Tax Certainty delivered via a Three Tier Mechanism**

Indian Scenario

Digital Taxation – Indian Scenario

- ✓ Introduction of 'Equalization Levy' on online advertising(2016) and extended Equalization Levy (2020)
- ✓ New nexus rule - 'Significant Economic Presence' ('SEP')-(2018)
- ✓ Introduction of withholding tax on E-commerce transactions (2020)
- ✓ Proposed Rule 10 – Attribution.

Digital Taxation – Indian Scenario - Equalization Levy

Background

Finance Act 2016 – Equalization Levy

- Currently, an Equalization Levy is levied at the rate of **6%** on specified services received from a non-resident
- Currently the term specified services includes online advertisement, any provision for digital advertising space or any other facility or service for the purpose of online advertisement.
- The levy is to be collected and deposited by the payer who is receiving the specified service.

Digital Taxation – Indian Scenario - Equalization Levy

Background

Finance Act 2020 - Extended Equalization Levy

- FA 2020 has now introduced a new provision (Section 165A) to enhance the scope of the Equalization Levy. Equalization Levy will now be extended to an e-commerce operator on 'e-commerce supply and services' undertaken on or after 1st April, 2020.
- An "e-commerce operator" has been defined to mean a nonresident who owns, operates or manages digital or electronic facility or platform for online sale of goods or online provision of services or both.
- It mandates equalization levy @ 2% on the sum received or receivable by an e-commerce operator from e-commerce supply of goods or services made or provided.

Digital Taxation – Indian Scenario - Equalization Levy

Finance Act 2020 – Extended Equalization Levy

- However in the following cases Equalization levy of 2% will not be applicable
  - Having a PE in India
  - Equalization levy u/s 165 of the Act @6% is applicable
  - if the sale, turnover or gross receipts is less than 2 Crores during the previous year.

- Similar to liabilities of the equalization levy as previously imposed, this expanded levy would not be part of the Income-tax Act and, thus, **would not be subject to provisions of India's Income tax treaties**.

Digital Taxation – Indian Scenario - Equalization Levy

- Liability to pay Equalization Levy cast on the non-resident 'e-commerce operator'
  - No obligation on a resident payer to deduct and pay Equalization levy (unlike in the case of online advertisements etc.)
  - Payment to be made on Quarterly basis

- Interest @1% per month payable for delay in payment
- Penalty equal to amount of levy payable for default in payment

Digital Taxation – Indian Scenario - SEP

- Expanding the scope of Business Connection to include SEP

  SEP to cover the following:

  - Transaction in respect of goods, services, property by NR in India including provision of download of data or software in India, if aggregate of payments during the year exceed the prescribed amount.
  - Systematic and continuous soliciting of business in India through digital means.
  - Engaging in interaction with prescribed number of users in India.

- To come into effect from AY 2022 - 2023

Digital Taxation – Indian Scenario - SEP

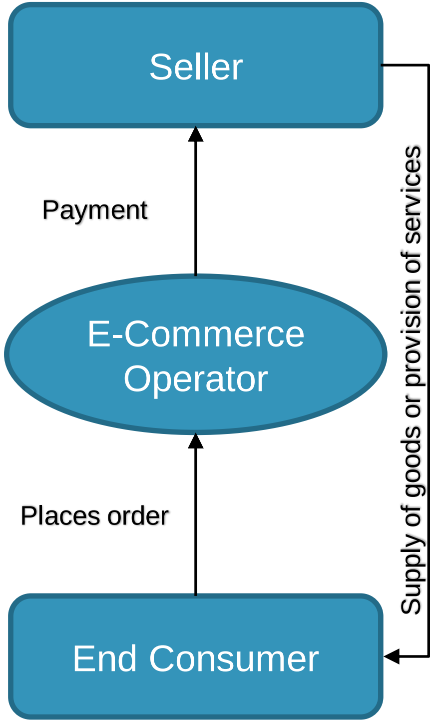
- A new Explanation 3A to Sec. 9(1(i)) introduced by FA 2020

  Income attributable to operations carried out in India shall include

  - Advertisements which targets customers in India.
  - Sale of data collected from a person who resides in India or who is using IP address located in India
  - Sale of goods using the above data that collected from a person who resides in India or who is using IP address located in India.

- To come into effect from AY 2021- 2022

TDS on E-Commerce Transactions – Sec.194O



- TDS @ 1% on sale of goods / services through e-commerce commerce operator (5 % if PAN not available)
- TDS obligation on e-commerce operator as 'deemed payer'
- TDS not to apply where:
  - Gross Proceeds are less than Rs. 5Lakhs (Ind/HUF)
  - Payment made for hosting advertisements

Issues/challenges in application of Sec. 194O

Difficulties in collection of TDS

- Some contracts will be made in such a way that the seller directly receive amounts from the buyer for the goods sold. In such a case it will be difficult from the end of E-Commerce Operators (ECO) to deduct the tax and pay the same to the Government.

Service and cancellation charges

- Whether cancelation charges also attracts TDS?

Sales Returns and discounts

- Whether credit notes will be accepted in situations like sales returns and thereby reducing the tax liability?
- Whether payments made by ECO to suppliers or sellers for giving discounts to the buyers will also be liable for TDS?

CBDT Draft Report- Proposed Rule 10

- CBDT Draft Report on Profit Attribution to market jurisdictions – proposal to amend Rule 10
  - Existing Profit Attribution Rule to PE under IT Act and DTAAs
  - Problems faced under existing Rule 10 and Court Decisions.
  - Need for clarity in India's approach on PE attribution.
  - Significant Economic Presence as a Nexus for Profit Attribution in case of New Business Models.
  - Demand recognized as requirement for income generation
  - Covers digital as well as remote business

CBDT Draft Report- Proposed Rule 10

Final Conclusions and Recommendations

Approach of the Committee and Proposals

- Emphasized that business profits are contributed by both demand and supply side, hence, profits should be allocated to market jurisdiction as well.

- Discusses different approaches to profit attribution – (1) 'supply based approach'; (2) 'demand based approach'; and (3) 'mixed or balanced approach' (based on both demand / supply);

- Rejects functional, asset and risk ("FAR") approach by underlining India's reservation on OECD Model Convention as amended in 2010, and commentary.

- Prescribes Fractional apportionment method (rejects formulary) (refer next slide for recommendations)

- Considers that the fractional apportionment method can be applied in treaty cases since Indian Tax Treaties do not follow FAR based approach and permit use of an apportionment based approach

CBDT Draft Report- Proposed Rule 10

Final Conclusions and Recommendations

Profits attributable to PE proposed to be determined based on the following formula#

$$= Profits\ derived\ from\ India\ \times \left\{ \left(\frac{SI}{3 \times ST} \right) + \left(\frac{NI}{6 \times NT} \right) + \left(\frac{WI}{6 \times WT} \right) + \left(\frac{AI}{3 \times AT} \right) \right\}$$

where,

'Profits derived from India' = Revenue derived from India x Global operating profit margin

SI = sales revenue derived by Indian operations from sales in India

ST = total sales revenue derived by Indian operations from sales in India and outside India

NI =number of employees employed with respect to Indian operations and located in India

NT = total number of employees employed with respect to Indian operations and located in India and outside India

WI= wages paid to employees employed with respect to Indian operations and located in India

WT = total wages paid to employees employed with respect to Indian operations and located in India and outside India

AI = assets deployed for Indian operations and located in India

AT = total assets deployed for Indian operations and located in India and outside India

CBDT Draft Report- Proposed Rule 10

Final Conclusions Recommendations

For digital businesses, a variant formula (with weightage to users) has been prescribed as follows

Profits attributable to operations in India in cases of **low and medium user intensity** business models=

'Profits derived from India' x [0.3 x SI/ST + (0.15 x NI/NT) +(0.15 x WI/WT) + (0.3 x AI/3xAT)] + 0.1]

In case of digital models with high user intensity, the users should be assigned a weight of 20%, while the share of assets and employees be reduced to 25% each after keeping the weight of sales as 30%, as under:

Profits attributable to operations in India in cases of **high user intensity** business models =

'Profits derived from India' x [0.3 x SI/ST + (0.125 x NI/NT) +(0.125 x WI/WT) + (0.25 AI/3xAT)] + 0.2]

Source: *https://itatonline.org/info/wp-content/uploads/2019/04/CBDT-Report-Profit-Attribution-Permanent-Establishment.pdf*

Thank You