Source : www.livemint.com Date : 2018-12-31

OPINION: THE CHALLENGE OF TAXING VALUE-CREATION IN INDIA

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Public Finance, Taxation & Black Money incl. Government Budgeting

Last week, French finance minister Bruno Le Maire announced the introduction of a GAFA tax—named after Google, Apple, Facebook, Amazon—on large technology and internet companies in France from 1 January 2019. Similar proposals had surfaced in both the UK and the European Union (EU) earlier. The French proposal is set to target only those profitable companies that have heavy annual global revenue.

The rationale behind devising a separate framework to tax online service providers is this: existing tax norms that are framed envisaging brick and mortar business models are not suitable to regulate online services. This is because the digital economy is characterized by a unique system of value creation resulting from a combination of factors such as sales functions, algorithms and personal information of users. What distinguishes technology companies from traditional businesses is user participation in creating value, which, in turn, translates into revenue. Although using consumer data to improve businesses is not exclusive to the digital economy, the unique ability of digital businesses lies in their power to analyse big data collected via constant user interaction and data mining.

In this piece, we highlight the need for India to consider the adoption of an accurate methodology to assess value created in India through user contributions so that digital service providers in India can be taxed more effectively.

To develop a simple, approximate tax rule, the Finance Act, 2016, accommodated a 6% equalisation levy (EL) in lieu of specified digital services provided to residents in India. However, EL can only be imposed on advertising services. Thereafter, through the Finance Act, 2018, the Income Tax Act was amended to expand the meaning of business connection to “significant economic presence”, which includes digital services. As a result, any income attributable to significant economic presence is taxable in India. An entity can have significant economic presence in India if it (i) provides data or software in India exceeding a payment threshold (yet to be notified) or (ii) engages in systematic and continuous solicitation of business activities to a prescribed number of users digitally. While this comes close to taxing value created by Indian users of foreign digital service providers, it is not clear whether the assessment of attributability is based on value creation per se.

As the basis of attributability to Indian services/activities is not clear, this can raise a serious problem at the time of assessing income tax. For instance, ride-for-hire companies such as Uber use data of users as inputs to develop their surge pricing algorithm. This algorithm enables these companies to assess the maximum fare a user would be willing to pay based on passenger demand and driver supply in real time. The difference in revenue generated between what Uber would have ended up charging a user in the absence of personal information (of users in a source country) and what it ends up charging the user is the “value” attributable to the user in the source country (say, India). In most jurisdictions at this point, entities are not taxed in the source country for the revenue generated with the help of this created value.

The Organisation for Economic Co-operation and Development (OECD) acknowledges the need to tax value at its source and has identified different ways in which companies operating in the digital economy create this value. Yet, it has been unable to devise a definite method of assessing the value that users generate in a source country. Due to this anomaly, the GAFA tax and other proposals floated in the EU, UK and France impose an approximate digital tax of 3% on the revenue generated by entities that operate in the digital economy above a certain threshold.

This resulted mostly from the slow ongoing process of quantifying user contribution and political pressure to resist further delay of taxing these entities. The lack of consensus is exacerbated due to a difference in the interests of developed (residence) countries and developing (source) countries.

The imposition of an EL instead of a more precise assessment of user contribution poses several questions regarding its enforceability. For example, countries like France have suggested imposing such an interim tax only on high profit big-tech businesses like Google and Amazon, making net valuation the metric for determining threshold. Moreover, these unilateral measures are all interim policies attempting to get some taxes while trying to reach a consensus. People have argued such steps are disruptive of the international taxation framework.

An even bigger challenge that the OECD highlights, however, is that the assessment of value of user contribution in the source country is subjective. So the government of the source country would always try to argue that the value of user contribution that has translated into the entity's revenue is far more than what the state where the entity is established would claim it to be. This could, in turn, create greater friction and undermine the efficacy of double taxation agreements.

It is imperative, therefore, that policymakers deliberate upon the possibility and feasibility of adopting a methodology to assess value creation objectively to tax digital players more effectively in the source country.

Siddharth Sonkar & Sayan Bhattacharya are students of the NUJS and Nalsar University of Law, respectively

END