

# TAXING NEW SPACES

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

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The proliferation of technology has challenged the conventional notions of economic activity. This is now a serious challenge for policy, particularly for taxation. The challenges of taxing digital companies are twofold. First, the existing laws tax business profits based on its physical presence in a country.

Such a pre-condition, conceived in 1920s, is dated since digital businesses no longer have to be physically present to operate in and interact with an economy. Second, these platforms use hard to value intangibles. They are often registered in low tax jurisdictions which further frustrate the efforts to appropriately tax digital companies.

In the early versions of the Base Erosion and Profit Sharing (BEPS) report on the issue, the Task Force on Digital Economy at the Organisation for Economic Co-operation and Development (OECD) mentioned three measures — an equalisation levy, withholding taxes and a new nexus rule. The first two are taxes on the gross turnover whereas the new nexus rule was to modify the taxable nexus beyond the physical presence in a country. While in principle it was agreed that data and user participation are critical for a platform, no consensus emerged on their economic contribution. Disparate views derailed the talk of a uniform solution while the OECD continued to work on value-creation by various business models. Revenue authorities around the world grew anxious since large tech companies were paying very low effective tax rates.

In 2016, India was the first to apply an equalisation levy. The levy was introduced outside the scope of the Income Tax Act and is applicable to a small set of companies operating in digital advertising. Globally too, there have been efforts to move past the OECD's call for consensus and to apply unilateral measures. For example, France and Hungary have implemented digital taxes, while Belgium, Italy, UK and Spain have proposed similar taxes. These would apply to a wide range of digital services. The potential ramifications of these taxes could be over-taxation or a pass through of costs to consumers. While it remains to be seen how tenable these are under the EU's state aid or WTO rules, such measures can give market jurisdictions greater power to tax.

Then in 2018, India proposed its long term solution to the problem — test for significant economic presence. The amendment, broadly similar to EU's proposal, was based firmly on the understanding that if a digital platform reported sales from a country or had significant number of users it should be considered as having taxable presence in that jurisdiction. Though it is a stride in the direction of reform, it is far from final. First, for the law to be applicable, treaties would have to be suitably amended. Second, the more fundamental issue of what size of operations would qualify as economic presence needs to be answered. Third, even if a business qualifies as having economic presence in India, how much of its profits should be taxable in India.

At the heart of the discussion is a more fundamental political issue of the redistribution of taxing rights.

An example of this tension is the US President Donald Trump's response to the French digital tax applicable to big tech companies that are predominantly residents of the US. Although, the agenda of taxing rights was strictly off the table, revisiting the age-old question of economic allegiance of a business made it impossible to ignore the elephant in the room. The OECD finally came around in 2019 when it published a policy note wherein its work plan was split into two pillars. Pillar one would examine the allocation of taxing rights whereas all anti-avoidance measures would be considered under the second pillar.

India has been extremely instrumental in driving this conversation. This is visible in the Programme of Work published in May 2019 which incorporates India's key proposals — significant economic presence and fractional apportionment, and among others the Modified Residual Profit Split, supported by the US, and the distribution approach. In an effort to garner consensus, the OECD released its draft for a unified approach earlier this month. While the report stresses on simplicity, it is far from it. The three proposals in the earlier draft have been tied together to present a complicated compromise. Proposed therein is splitting up of global profits of a corporation into routine and non-routine. Then a fraction of non-routine profits would be allocated to the qualifying market jurisdictions and if there is any dispute arising from such taxation it would be resolved through mandatory or binding dispute resolution.

This would require serious effort and harder consensus on issues such as what constitutes routine profit. Seemingly, the promise of an overhaul is over-sold, especially since carve-outs are anticipated for sectors such as mining and financial services. A unified approach backing the new nexus rule is only a partial win for India. The reliance placed on conventional transfer pricing could make taxation of digital companies more messy. India is in a unique position as it offers a wide user-base and thus a large market for digital companies. The idea of consensus, though critical for international relations, must also be evaluated in light of the misalignment of economic interests between developing and developed countries. A good tax system is often evaluated along the axes of certainty, simplicity and neutrality. The suggested measures in some ways undermine these principles. A possible alternative may perhaps be to switch to a simpler withholding tax architecture.

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