Challenges of taxing digital companies

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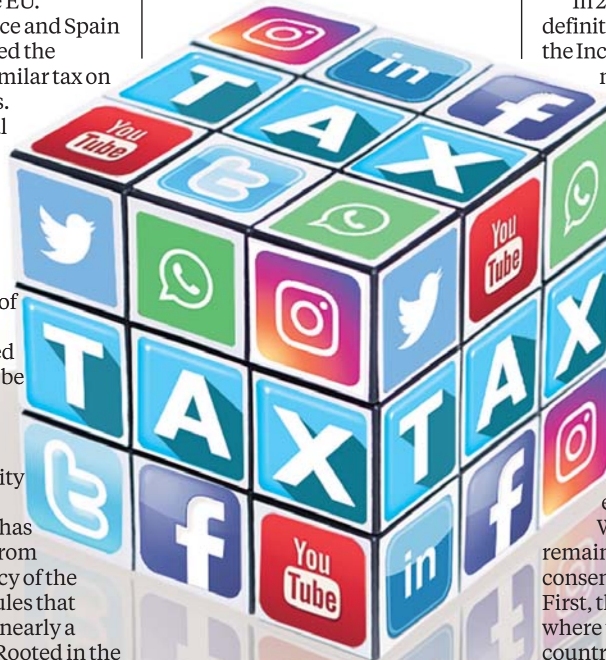
What do Google, Facebook and Apple have in common? Other than that these are large corporations with a digital presence globally, they have all been criticised for paying relatively low rates of corporate tax. It is increasingly evident now that digital companies present a special challenge to tax since they intensively employ intangibles registered in low tax jurisdictions and can operate in the market without necessarily being physically present.

Recognising these challenges to tax the digital economy, Task Force on Digital Economy at the Organisation for Economic Co-operation and Development (OECD) suggested three measures — equalisation levy, withholding tax and a test for significant economic presence. Despite such suggestions, no preferred alternative emerged.

Frustrated by futile efforts to tax digital companies and in fear that they may cede their tax base, countries began adopting measures unilaterally. In 2016, India was among the first to adopt the equalisation levy. This gross tax is levied on payments made for online advertising to a non-resident service provider in India. In 2018, the European Commission proposed a digital services tax. The proposal received a tepid response among members of the EU. Countries such as France and Spain independently proposed the implementation of a similar tax on specific digital services. Although the unilateral imposition of equalisation levy or a digital tax can help tax incomes that have escaped taxation in a jurisdiction, this may result in over-taxation of global profits. For this reason, these are viewed as interim measures to be replaced by a long-term solution.

Making users a significant basis for taxing digital companies may be met with resistance from developed countries



The inability to tax digital corporations has in part risen from the inadequacy of the existing tax rules that were devised nearly a century ago. Rooted in the notion that a corporation has economic nexus and, therefore, is taxable where it has a fixed place of business, these rules no longer suffice. In fact, revisions such as the location of the server as nexus have also proven inadequate. The economic ties of most digital businesses with a jurisdiction are most evidently manifest in user participation. It is seen that user participation is an indispensable element for a digital platform to thrive. Though in many cases, these platforms allow participation for free, businesses profits are derived either through transactions between users, such as in the case of e-commerce or by monetising user data in case of search advertising. The test for significant economic presence establishes the taxable presence of a digital platform on the basis of revenue or user participation. Therefore, among the recommendations, this is a plausible long-term solution to tax companies that have substantial operations, yet are not taxed in that jurisdiction.

In 2018, India amended the definition of business connection in the Income Tax Act. The CBDT is now in the process of operationalising the (Significant Economic Presence) SEP through the setting of such thresholds. These thresholds must be designed taking into consideration the demographic and economic structure of India. For a threshold of 100,000, as is proposed in the EU or less than 300,000, it is expected that some of the major digital companies will be considered as having an economic presence in India.

While a bold move, there remain issues that require further consensus for its applicability. First, the test will not be applicable where the company is located in a country with which India has a treaty. For the SEP to be applicable, the treaties will have to be suitably modified.

Second, if a company does qualify as taxable in India, the next major challenge will be the attribution of profit to Indian operations. That is, the revenues will have to be apportioned for user participation in India. A possible solution to this problem is a formulary apportionment of profits to users. While an apportionment eases taxation, an agreement will still be necessary on the weight assigned to users. Fixing such weights may not be an easy task, given that such incentives are not aligned across countries and greater weight to users can potentially reallocate taxing rights.

For one, developing countries have a large share of the user base. In 2018, India accounted for more than a tenth of the global digital users, whereas the share of revenue reported by digital platforms was only a per cent. On the other hand, the US accounted for close to a third of global revenues with only a tenth of users. As a result, any agreement to make users a significant basis for taxing digital companies may be met with resistance from developed countries, where such companies are headquartered. It is in response to such apprehensions that the US has proposed a relatively tedious approach to the attribution of non-routine profits to marketing intangibles, consisting of users.

The taxation of the digital economy has opened up the possibility to revise the old international tax architecture. Proposals such as the SEP are an opportunity for developing countries to assert their taxing rights. Yet more clarity is required on attribution and if agreeable a new multilateral convention may be necessary to revise existing conventions.

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