Taxing new spaces

The OECD's draft report on digital taxation is a complicated compromise

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HE PROLIFERATION OF technology has
allenged the conventional notions of eco-
omic activity. This is now a serious chal-
nge for policy, particularly for taxation. The
allenges of taxing digital companies are
vofold. First, the existing laws tax business
rofits based on its physical presence in a
ountry.

Such a pre-condition, conceived in 1920s,
dated since digital businesses no longer
ave to be physically present to operate in
nd interact with an economy. Second, these
latforms use hard to value intangibles. They
e often registered in low tax jurisdictions
hich further frustrate the efforts to appro-
riately tax digital companies.

In the early versions of the Base Erosion
nd Profit Sharing (BEPS) report on the issue,
e Task Force on Digital Economy at the
rganisation for Economic Co-operation and
evelopment (OECD) mentioned three
easures — an equalisation levy, withhold-
g taxes and a new nexus rule. The first two
e taxes on the gross turnover whereas the
ew nexus rule was to modify the taxable
exus beyond the physical presence in a
ountry. While in principle it was agreed that
ata and user participation are critical for a
latform, no consensus emerged on their
onomic contribution. Disparate views de-
iled the talk of a uniform solution while the
ECD continued to work on value-creation
y various business models. Revenue author-
ies 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 overtaxation 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 compromi
Proposed therein is splitting up of glo
profits of a corporation into routine and n
routine. Then a fraction of non-routine pr
its would be allocated to the qualifying m
ket jurisdictions and if there is any disp
arising from such taxation it would be
solved through mandatory or binding d
pute resolution.

This would require serious effort a
harder consensus on issues such as w
constitutes routine profit. Seemingly,
promise of an overhaul is over-sold, es
cially since carve-outs are anticipated for s
tors such as mining and financial service
unified approach backing the new nexus r
is only a partial win for India. The relia
placed on conventional transfer pricing co
make taxation of digital companies m
messy. India is in a unique position as it of
a wide user-base and thus a large market
digital companies. The idea of consens
though critical for international relatio
must also be evaluated in light of the m
alignment of economic interests betwe
developing and developed countries. A g
tax system is often evaluated along the a
of certainty, simplicity and neutrality. T
suggested measures in some ways und
mine these principles. A possible alterna
may perhaps be to switch to a simpler wi
holding tax architecture.

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