The Cyber Tax Conundrum

Digital Service Tax (DST) could offer an interim solution

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THE TAXATION OF digital companies has been a key concern for G20 countries. The agenda to reform international tax law so that digital companies are taxed where economic activities are carried out was formally framed within the OECD's base erosion and profit shifting programme. Seven years since its inception, it is still work in progress. Worried they might cede their right to tax incomes, many countries have either proposed or implemented a digital services tax. India is amongst the first to have implemented an equalisation levy in 2016, which sought to tax payments made for online advertising services to a non-resident business by residents. In March 2020, it expanded the scope of the existing equalisation levy to a range of digital services that includes e-commerce platforms. Any payment made by non-residents in connection with an Indian user will now attract a 2 per cent levy. Such an approach is often viewed as contrary to the ethos of international agreements. However, the proliferation of digital service taxes (DSTs) is a symptom of the changing international economic order. Countries such as India which provide large markets for digital corporations seek a greater right to tax incomes.

Apprehensive that DSTs could become the norm, in June 2020, the US initiated USTR investigations under section 301 of the Trade Act 1974 against 10 jurisdictions, including India. This inquiry intends to find out if DSTs discriminate against US corporations. The report released in January 2021 confirmed that India's equalisation levy is unreasonable for its sudden implementation and retrospective application, and is discriminatory since of the 119 companies to which it is likely applicable, 72 per cent are US-based. It cannot be dismissed that the tax can result in overtaxation since the company will not be able to claim any credit for tax paid on Indian sales. Further, the clarifications have not been made available. However, it is predominantly applicable to US companies since the market for digital services is dominated by US-based firms. The law itself in no way discriminates based on size of operations or nationality, and has no retrospective element.

The core problem that the international tax reform seeks to address is that digital corporations, unlike their brick-and-mortar counterparts, can operate in a market without a physical presence. The current basis for taxing in a particular jurisdiction is a notion of fixed place of business. To overcome this challenge, countries suggested that a new basis to tax, say, the number of users in a country, could address the challenge to some extent. The EU and India were among the advocates of this approach.

Any company that has a permanent residence in India is excluded since it is already subject to tax in India. For example, if company A that has a local subsidiary or is a registered entity, no levy is payable. If firm B operates services in India, but its billing address is registered in Ireland, then the levy will be charged on payments to this entity from India. Experts suggest that such taxes can be passed on to consumers. While the Indian customer may not pay this as a tax, this could mean higher prices, contrary to the claim that it taxes the company. The USTR investigations pose a threat of retaliatory tariffs. In a similar investigation for France's DST, the US responded with the threat to levy tariffs on select French exports, implemented in January 2021. However, these were suspended in light of other ongoing investigations. It seems trade is a new collateral of tax negotiations.

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Meanwhile, the OECD continued to work to find commonalities among a range of solutions. In October 2020, it released a blueprint of the solution that it seeks to finalise by June 2021. But consultations held with stakeholders this month do not inspire confidence. In its current form, the solution is too complex to administer and proposes to allocate residual profit — a term that has no economic definition — thus calling into question the gains. It would also require political consensus on multiple issues, including sensitive matters such as setting up of an alternative dispute resolution process comparable to arbitration. This can increase the compliance burden. The US has expressed its preference to apply this measure on a safe harbour basis, which can limit the companies to which it may be applicable.

As countries calibrate their response to competing demands for sovereignty to tax, DST is an interim alternative outside tax treaties. It possesses the advantage of taxing incomes that currently escape tax and creates space to negotiate a final, overarching solution to this conundrum.

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