THE DIGITAL TAX CHALLENGE

India must calibrate response to OECD formula, assess compromises it must make

SURANJALI TANDON

OVER THE PAST four years, 137 countries have engaged intensively with the OECD to find a solution to the tax challenges arising from digitalisation. Like any international agreement, finding a middle ground has been difficult and a series of compromises have been made. It was agreed initially that the unique features of the digital economy — firms can operate seamlessly across borders and users and their data contribute to their profits — made it harder to tax such an economy. It was not clear how profits were to be pinned down to any jurisdiction. This became a political issue because the largest technology firms are tax residents of developed countries and redefining digital presence as the basis of taxation would potentially allow large markets like India more right to tax.

The OECD's work reflected the divergence in expectations among countries about the ideal solution. Developing countries wanted that profits from digital operations should be fractionally apportioned to markets while developed countries believe that a fraction of residual profit, mainly arising from marketing functions, should be taxed in markets. Such divergence compelled countries to implement unilateral measures. India was the first country to implement a gross equalisation levy on turnover. This is not covered by tax treaties. So, while the income tax act does not apply to the levy, credit is available for the tax paid by the company in its home country. Similarly, several other countries have announced or implemented a digital services tax (DST).

In 2021, India expanded the scope of the equalisation levy. This pressured the US and OECD to respond. The US initiated the US Trade Representative investigations which found DST to be discriminatory, and then announced retaliatory tariffs. While the tariffs were to be levied on less significant items of the US-India trade, the DSTs encouraged the US to actively participate in finding a consensus-based solution. As talks progressed, the OECD announced that the issue of allocation of taxing rights would be actively considered and adopted a two-pillar approach.

The collections of the equalisation levy are now close to Rs 4,000 crore. One way to assess the relative gain is to compare the revenue from equalisation levy with the receipts under Pillar One. I estimate that India may gain only Rs 1,000 crore in the best case scenario. In fact, the EL may apply to companies that are not covered by the OECD proposal, leaving one to wonder whether it will truly address the tax challenges from digitalisation.

The first pillar was to define the rules for taxing digital companies. After a change in the administration, the US agreed to back the proposal. However, Pillar One was to go beyond digital companies and apply to large companies with annual revenue over €20 billion. To ensure certainty to taxpayers, the solution will require excessive global coordination. For this, an entirely different process of dispute resolution panels is being created. Whether this will undermine sovereignty, remains to be seen.

Therefore, it is important to consider if the consensus approach is worth pursuing. The collections of the equalisation levy are now close to Rs 4,000 crore. One way to assess the relative gain is to compare the revenue from equalisation levy with the receipts under Pillar One. My estimate is that India may gain only Rs 1,000 crore in the best case scenario. In fact, the EL may apply to companies that are not covered by the OECD proposal, leaving one to wonder whether it will truly address the tax challenges from digitalisation. In such a case, India's stance on OECD's approach must be calibrated. Current tax collections indicate that the EL can level the playing field between digital and brick and mortar firms through behavioural change or higher taxes. Corporations that argue in favour of simplicity must also consider the potential benefits from an EL like tax that sets aside the complications of attributing profits to complex functions.

As per an estimate of the US Treasury, 72 per cent of the companies covered by EL in India are US companies. Therefore, unless countries negotiate with the US, tax challenges will persist. There is no unanimous support for the Pillar One proposal in the US as well. A reason for this may be that the US could lose about 0.1 per cent of its tax revenues. To compensate for that, the global minimum tax is being proposed as a package deal. In effect, the OECD approach creates a fiction of reallocation, where the profits reallocated through Pillar One could in fact be compensated for by taxing back global profits taxed below 15 per cent. As per Pillar One proposal, DSTs will be removed once the OECD approach is ratified in 2023. It is imperative therefore that countries assess the price of compromise.

The writer is assistant professor, NIPFP