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Digital Economy and Indian Taxation Law - An Analysis

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ABSTRACT

The world today is driven by digital transformation which causes changes to take place at a rapid pace and which has impacted the businesses also as they have no physical whereabouts. Now, the main issue which arises from the point of view of the Income Tax authorities is to oversee the taxpayer with respect to the compliances of these companies in order to determine which tax regulations they ought to pay and to make sure they pay their taxes and do not avoid paying it by virtue of operating out of different countries online. This paper seeks to delve into the aspect of imposing taxes on the companies operating in the digital economy from the global perspective followed by the implementation of it in the Indian context along with its benefits, challenges and solutions to it. Further concluding with the way forward for India with respect to taxing these companies in comparison to the international trends.

Keywords: *Mistake; Apparent; Record; Argument; Plea; Sub-ground; Non-consideration; Rectificatory jurisdiction.*

1.0 Introduction

The world is continuously changing and developing with digital transformation being the most influential drivers driving this change to take place at a rapid pace. Digital transformation is about using the latest technology to do the same tasks/ work but better and more efficiently.[1]

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It about using digital technology to transform businesses and services in the 21st Century. Digital transformation takes places by two ways by replacing conventional manual processes with digital processes and/or replacing outdated processes with improved and modernized technology.

The digital economy is replacing traditional methods of conducting business with new and evolved ways by which firms interact, conduct their operations: how consumers obtain their goods, services and information. As Professor Brenner of St. Gallen University expressed his opinion with respect to the digital economy as, "*The aggressive use of data is transforming business models, facilitating new products and services, creating new processes, generating greater utility, and ushering in a new culture of management.*"[2]

As Tom Godwin rightly observed which was published on TechCrunch- a digital economy news "*Uber, the world's biggest taxi firm, owns no vehicles. Facebook, the world's most popular media owner, creates no content. Alibaba, the most valuable retailer, has no inventory. And Airbnb, the world's largest accommodation provider, owns no real estate… Something interesting is happening*."[3]

Previously a large portion of people would work and run their business out of an office, chambers having a permanent establishment at a particular place. With changing times- technological advancement and even more so because of the pandemic people have started working remotely and no longer restricting themselves to a brick-and-mortar permanent work place. Emergence of this new flexible method organisations are required to manage a dynamic and every evolving eco-system of talent which would next generation digital business processes to be more effective even though they are distributed across the world and located in different time zones.

The main issue arising with these digital businesses operating in the digital economy who have no physical whereabouts of places to work from the point of view of the Income Tax authorities is that it makes making it difficult for tax authorities to oversee taxpayer compliances according to tax regulations and collect taxes. Thereby, making it a perplexing issue of taxing international digital transactions.

Previously before the evolution and development of the Digital Economy International tax rules prescribe that if an enterprise is a resident in one state while earning income which is originating from another state (source country). In such a case, taxing rights over the income would be with the source country only on the condition that the enterprise has a permanent establishment (PE) in the source country. In other words, for the source country to be able to tax profits arising out of the digital economy, physical presence of the non-resident enterprise in the source state is crucial.

Due to digitalization a non- residents can carry out a large amount of internet transactions in the source state without having any presence there. Businesses working digitally can operate simply by launching a website from anywhere and make their goods and services available to users' cross borders anywhere in the world. Hence, no need of any central point, physical location for such a transaction to take place hence not falling within any country's jurisdiction for the purpose of taxation. The expected Permanent Establishment has become a grey area with the growth of digital economic activity. Thereby these corporations earn economic benefits from all over the world without owning a single inventory/ asset from which they earn profits. One of the most accurate examples to explain this would be Alibaba, which is a company which act as a merchant selling goods of other manufacturers/ retailers thereby having no inventory of its own.

The problem of the taxing corporations operating in the digital economy is that either they are double taxed or not taxed at all. These businesses often misuse the law by setting up online businesses at one place where none of their founders or promoters are present making it difficult to tax them as they form part of different jurisdictions and undertake cross border transactions without establishing a place of business or a physical presence. Hence, it is important that tax authorities in different countries to adopt a uniform acceptable method for allocating taxing rights among various jurisdictions involved in digital transaction.[4]

This paper seeks to do an in-depth study into the Digital Economy, corporations operating in this new digitally transformed economy which works out of different jurisdictions undertaking cross-border transactions without having any physical presence in any country. With specific emphasis and a narrowed study into how these corporations will be taxed specifically from the Indian perspective. Further researching into the need, implementation, benefits of this system and on the contrary challenges in taxing these corporations and concluding with solutions and key rulings by the courts in that respect.

2.0 OECD and Its Influence on Indian Law-making

Recognizing this as an issue the Organization for Economic Corporation and Development (OECD) came up with regulations to tax electronic activities which were getting away with not paying taxes through Base Erosion and Profit Shifting (BEPS) which is a tax planning strategy which is used by the Multinationals to exploit the loopholes and gaps in the tax rules in the state(s) out which they work in order to avoid paying taxes.[5] To counter this issue which causes a $100-240 billion (USD) OECD and G20 Inclusive Framework of 15 measures to tackle the problem of tax avoidance, improve coherence of international tax rules and ensure a transparent tax environment.[6] India being

a signatory to this implemented the "*Equalization Levy*" on the recommendation of the Committee on E- Commerce Taxation[7] constituted by the Central Board of Direct Taxes (CBDT), Department of Revenue and the Indian Ministry of Finance in it Finance Act of 2016. Equalization Levy is a direct tax which is withheld by the service recipient at the time of payment.[8] Section 164(d) of the Finance Act, 2016 defines it to mean the tax which is liveable on consideration received or receivable for a specified service including online advertising, digital advertising. Even though it was recommended to be applicable on a range of services the Government only levied it on online advertisements and not any other services in 2016. It provided a tax rate of 6% for items worth exceeding 1 lakh rupees provided by non-resident Indians doing business with Indian. Further providing that no income tax would be applicable on income on which equalisation levy is chargeable.[9] The Government extended the application of the Equalization Levy in 2020 thereby making it applicable to all digital e-commerce transactions and those business transactions done by Non-Indians with Indians would be subject to a charge of 2% on the amount of consideration received by them via e-commerce transaction.

The implementation of Digital Tax has resulted in changes to the revenue or business income earned by transnational firms who sell their products or services over the internet. The aim of Digital tax is to impose taxes on consumers and users based on the place they are located on one hand and on tax the company based on the where its headquarters is located. Though the problem lies here that a Multinational's headquarter may be located in a country which has lower tax slabs hence getting the benefit of paying less taxes.

To avoid concerns of tax credit of Equalization levy without beneficiary obligation, tax neutrality which was not addressed by the Income Tax Act the Finance of 2018 was amended to add the provision of Special Economic Presence (SEP). SEP entails the taxes on the revenue generated by a non-resident through a "business tie" he has in India. The income that can be traced back to the SEP would be liable to be taxed by the Indian Govt.

3.0 Need for Digital Taxation

With the advent of technology and digitalization, the need for digital taxation has been realised by various economies across the world as the current laws were made keeping in mind the earlier economic systems and traditional approaches towards taxation. These traditional laws and old approaches towards taxation have become obsolete owing to the increase in the number of digital businesses have increased, so has the need to formulate new laws for their taxation. The businesses that operate across nations, known

as transnational business always found ways to reduce taxes and pay taxes in a jurisdiction where the rates of tax are low, thus relocating their profits for other purposes and evading taxes. This was done as there were no laws in place to tax these corporations as they were working on the digital spectrum. The businesses across the world are taking advantages of these loopholes that are present in the current legal system for digital taxation. The corporations are taxed wherever headquarter of the corporation is located and obviously, in order to reduce the tax liability, they would always be located in a jurisdiction where the taxes to be paid are lower as tax reduces profit. Hence, the digital tax has been implemented at the rate of 2% on the revenues of such corporations, the tax is calculated on the revenue and not on the profits of the company. This would be beneficial for the local economy as these transnational corporations would not take benefit of the local economy to carry out their transactions abroad which is what was happening before the implementation of digital taxation and thus it was needed. Let's take the example of Amazon and Facebook in India which provide certain services that are not available in India[10], now when the digital tax is implemented, it would maximize the taxes based on revenue on such digital businesses operating in local boundaries. Hence, any income that is generated through these nations by the global digital businesses will be subjected to the Digital Service Tax.

4.0 Evolution of Unilateral Measures

With the changing sphere of the economy, it was deliberated by the G-20 countries in the G-20 summit that there was a need to devise laws on digital taxation. The economy was changing from the traditional brick and mortal model of business to the world of digitalization and digitalized economy. In furtherance of this, the G-20 countries directed the OECD (Organisation for Economic Co-operation and Development) to deliberate on laws for the same and to counter the loopholes posed by the current taxation laws of the various countries with respect to digital businesses and around July, 2013, the OECD came up with an action plan on BEPS (Base Erosion Profit Sharing) and 15 further action plans were submitted by it up till 2015. BEPS is a type of strategy that is used by transnational corporations to shift the tax from high tax jurisdiction countries to low-tax jurisdiction countries, this is done by shifting intangibles to these countries so that the tax liability is minimum or no tax liability.

The action plans as submitted by the OECD provided for the following three alternatives that the countries could be adopted by the countries in order to tackle the issue of digital taxation however, the same was supposed to be incorporated in the bilateral treaty obligations as adopted by the said countries. The alternatives proposed were:

- Equalization Levy
- Withholding tax on certain digital transactions
- Nexus based approach

Equalization Levy: This is what was adopted by India by virtue of revising the Finance Act of 2016 and finally on 1st April 2020, equalization levy was implemented and it was announced that all the commercial digital transactions would be taxed at the rate of 2% on the amount received as consideration for these e-commerce digital transactions.

In accordance with the Finance Act of 2016, in case a resident or a non-resident in India who has a permanent establishment in India makes any sort of payment in pursuance with a specified service such as digital advertisement or online advertisement, to a non-resident who does not have a permanent establishment in India, and in aggregate, this payment exceeds Rs. 10,00,000 in a given financial year, then in such a case this transaction and payment would be subjected to a tax rate of 6%. This is equalization levy and for transactions that have been subjected to this will not be considered as taxable income. In case, the equalization levy is not paid to the Government of India, then there are certain penalties also in the form of additional tax such as monthly simple interest at the rate of 1%. Any aggrieved person can approach the CTI (Commissioner of Income Tax) within 30 days of the order passed by Assessing Officer.

Nexus Based Approach: Significant Economic Presence (SEP) was introduced by India in its domestic tax regime in furtherance of digital taxation and nexus-based approach on the same. It was one of the first countries in the world to incorporate SEP in its taxation law system. Section 9 of the Income Tax Act, 1961 deals with the income deemed to accrue and arise in India and in pursuance of this income provides for business connection in India. The Finance Act of 2018[11] expanded the said interpretation of business connection in India to include Significant economic Presence thus widening its scope as it would now also include a non-resident's business that has a significant amount of economic presence in the Indian market and economy. Under this, digital goods and services, download of data or software, solicitation of business through digital means, engagement with users on the net through digital means, all of this was included under the purview of Section 9. However, the amount generated through these transactions have to exceed a certain specified value to be considered as significant economic presence and be subject to tax in India

5.0 Implementation of the Digital Taxation Regime in India

As discussed above, by way of these unilateral measures, India has adopted digital taxation for the taxation of digital income. This was, for the very first time done in 2016

on online advertising and digital advertising and was to include the income generated by the non-resident also through these means and then in 2019, Significant Economic Presence (SEP) came into picture by way of an amendment and again non-resident's income beyond a certain specified value would be subjected to taxation in India. All of these provisions were included in the Finance Act of 2020; however, the implementation of the said act was delayed by the government owing to lack of effective measures with respect of international tax agreements. However, it is to be noted that this plan of implementing the equalization levy that came into effect on 1st April, 2020 did not form part of the recommendations under the Union Budget 2020-21. Many types of expenses were covered under this such as digital goods and services, download of data or software, solicitation of business through digital means, engagement with users on the net through digital means, etc.

The implementation of these digital taxation measures has its own pros and cons for the Indian economy[12] as it would come with a lot of advantages and benefits, however at the same time, it would also impose challenges for the future. Let us look into these benefits and challenges in detail.

6.0 Benefits of Digital Taxation for the Indian Economy

Among the many benefits of digital taxation, one of the primary benefits of the same is that both the international and domestic enterprises would be placed at the same footing in respect of taxation. The international enterprises would no longer have an edge in relation to less tax payable by them in comparison of the domestic enterprises. Both of them would be subjected to the same amount of taxes and thus, the foreign companies would not have an unfair competitive advantage over the micro, small and medium enterprises including start-ups.

As earlier, the corporations operating in different jurisdictions took advantage of the low tax jurisdiction countries, this would no longer be the case as even though they do not have a physical presence, their digital presence in the country would be enough to make them subject to Indian taxation laws. Thus, they would no longer indulge in the practice of relocating their headquarters in low tax jurisdictions and tax haven countries. If they are generating income from the Indian population, even if through digital means, they are still liable for taxation under Indian law, thus benefiting the Indian economy in respect of more tax receivable by the government for the income generated through Indian population by these foreign overseas companies.[13]

With the improvement in technology, the Indian government would be benefitted in the form of better services for taxpayers with the increase in digitalization and the way

towards digital economy. The tax system would have a smoother functioning and increased efficiency and even the non-resident e-commerce operators would be included under the purview of digital taxation.

7.0 Challenges of Digital Taxation

Characterisation of Income which is generated through Digital Economy: Income tax that is to be applicable on non-residents have been entailed in section 9 of the Income Tax Act, 29161. Which provides for three categories of income which include business income, royalty and fee for technical services.[14] Income characterisation is important for determination of tax due to the fact that consequence of tax is different based on the head the income has been classified under. As the Income Tax Act applies for different rates of taxes on different categories of income. For instance, Income which is characterised as royalty of fees for technical services is charged at 10% while business income of non-resident is charged at a base rate of 40% for corporate entities and 30% in case of non-corporate entities. While if the income of the non-resident is in the nature of royalties, fees for technical services, capital gains or interest, specific rates of gross basis tax will be applicable.[15] Hence, in the case of digital economy it is difficult to characterise income generated by various businesses and corporations under one of the three categories mentioned under section 9 of the act as the pre-requisite of the income being classified under business income is the establishment of permanent establishment is difficult in a digital economy[16] as the country where the promoter/ founder resides in is not the same as where the good or services are rendered, hence making it difficult to categories the income under one of the three heads. The other issue which arises on the determination of profits earned over the digital marketplace under business income or fees for technical services.

7.1 The problem of permanent establishment

For the purpose of taxing a non-resident entity in India it is required to establish that the entity maintains a Permanent Establishment or a business connection in India. Since the digital model is completely different from the traditional business model due to the reliance on the use of intangibles poses as a difficulty in determining whether a foreign entity has sufficient business connection or a place of permanent establishment in another country. Owing to the business model of businesses and corporations in the digital economy it is a difficult task to establish a permanent establishment as they place reliance on intangibles like algorithms and patents[17] and thereby conduct business while residing in a foreign jurisdiction while providing services and goods all around the world. Hence,

it becomes a task to tax these entities as even though they conduct business and generate revenue in India without having any physical presence or establishment in the territory.

7.2 The Double Taxation Avoidance Agreement Treaties (DTAA)

Due to the fact that corporations and businesses in the digital economy operate from one jurisdiction and render goods and services to customers located in different states across the world the instances of double taxation increase as companies are subject to be taxed in multiple jurisdictions. By increasing the ambit of "business connection" in the concept of SEP, undue hardships of double taxation is caused to these companies operating in the digital economy as its PE is set up in one or no country and SEP in different countries. Thereby, subjecting these companies to double taxation. Further this would defeat the sole purpose and objective behind DTAA treaties signed between India and other countries where these companies are based.

8.0 Solutions to Deal with the Challenges

The OECD in October 2020 issued its Final Report on all 15 aspects of the BEPS Action Plan along with its recommendations of OECD's Action 1 on Tax Challenges in the Digital Economy were presented. Due to the global reach of digital business in the digital economy it is difficult to tax these corporations and businesses in the same manner as individuals are taxed. Hence in order to prevent non-taxing of these corporations' unique laws are to be implemented in order to tax the digital economy and further alleviate the digital economy's tax difficulties[18] the OCED has recommended two pillars that will help an economy to deal with their challenges related to Digital Taxation:

8.1 Re-allocation of tax rights

For corporations and businesses operating in the digital economy Pillar One provides an equitable division of their revenues and taxation rights worldwide. Through reassigning taxation rights of these corporations from their home nations to markets where they conduct their commercial operations and earn profits irrespective of the fact that the enterprise has a physical establishment in that nation. It is estimated that a total profit of USD 100 dollars would be transferred each year to the jurisdiction of the state where the corporation's market is situated under Pillar 1 of the OECD recommendations.

8.2 Global anti-base erosion mechanism

Pillar 2 of the OECD recommendation provides for the adoption of a minimum tax rate adopted worldwide to be paid by corporations and enterprises operating in the

digital economy which nations may adopt in order to preserve their tax bases. An estimate of 15% uniform minimum corporate income tax is anticipated to yield USD 150 billion as global tax collection per year. This would provide for stabilization of the international tax system with enhanced tax certainty for tax payers and the government.

9.0 Judicial Journey

With the fast-paced growth of corporations involved in the digital economy, the jurisprudence with respect to regulating and governing these corporations in the digital economy are also growing. Regulators such as the Income Tax Authorities are also more aware and have started scrutinizing transactions done by them over the digital space with a keen eye thereby increasing the number of litigation and courts discussing the problems associated with the digital economy in current times. Some key decisions delivered by the courts with respect to Corporations operating in the Digital Economy are as follows:

9.1 MasterCard Asia Pacific Pte Ltd v Union of India[19] (June 2018)

In this case the taxpayer was MasterCard Asia Pvt. Ltd. (hereinafter "MAPL") which was incorporated in Singapore and was involved in transaction processing and payment related services. It entered into various agreements with various customer banks and financial institutions situated in India with an aim to provide services- electronic authorization, clearing and settlement of payment of transactions which were made through cards. The processing of these transactions would take place over MasterCard Worldwide Network. Which could only be accessed through a MasterCard Interface Processor (hereinafter "M.I.P.") which was installed in India at the customers location were owned by the Indian Subsidiary MAPL. The issue before the Authority for Advance Rulings (hereinafter "A.A.R") arose that whether MAPL had a Permanent Establishment in India with respect to paying of taxes.

The Delhi High Court held that the automatic equipment MasterCard Worldwide Network. Which could only be accessed through a MasterCard Interface Processor (hereinafter "M.I.P.") which was installed in the customer's premises was in the nature of Permanent Establishment (hereinafter P.E.) and hence, MAPL was liable to be taxed as per the Indian laws as a link was established between MAPL and the revenue generated in India through the use of MAPL's equipment. Further holding that it was not necessary to establish that the equipment should be attached/ fixed to the ground in order for it to constitute as a fixed place of Permanent Establishment while relying on O.E.C.D. Commentary on Article 5 ("Permanent Establishment"). The fact is irrelevant that MIPs was permanently located in India and that neither the sites nor the MIPs were owned by

MAPL so long as it has a certain space which is at its disposal it is sufficient to constitute a permanent establishment.

Hence, MAPL was liable to pay taxes as the payment processing activities undertaken by it by personnel's in India were the core activities which generated revenue and were not merely preparatory or auxiliary activities.

9.2 Google India Pvt Ltd v Dy. DIT Bangalore[20] (October 2017)

Google India Pvt Ltd (hereinafter "Google India") was a tax resident of India by virtue of being an Indian Company granted the rights of marketing and distributing of AdWords program in India by the principal agreement holder Google Ireland. Google India made payments to Google Ireland for the use of advertising space under the said agreement without the collection of withholding taxes.[21] Upon assessment the Indian Income Tax Authority held that Google India was withholding from paying taxes as the payments were in the nature of royalties.

The second level appellate authority noted that the contract between Google Ireland and Google India was more than just a deal to sell advertising space. As payments were made by Google India as compensation for using a patented algorithm developed by Google Ireland in order to choose which advertisement would be displayed to a specific user who conducted a search on the Google website. With the aid of licenced technology, Google India was able to run a targeted marketing campaign for the goods and services of Google's clients. Intellectual property belonged to Google Ireland and included the search engine technology, related software, and other elements. As a result, the payments made by Google India was in the nature/form of royalty in return for the use of tools for accepting tools of Google Ireland.

10.0 Conclusion and Way Forward

In the present scenario, the provisions of Section 90(2) would be applicable. However, the tax payer can choose whether he wants to pay tax under the provisions of the act or the DTAA (Double Tax Avoidance Agreement). Whichever has a lesser tax burden would be ultimately chosen by the taxpayer. However, it is pertinent to note that the implementation of the unilateral measures in the form of equalization levy and Significant Economic Presence would not have an effective operation until and unless the bilateral treaties are amended in this respect or new treaties are formulated in light of the same. This poses the need of a MLI (Multilateral Instrument) as provided by the 15th BEPS Action Plan and the countries need to urgently discuss and take actions for the

implementation of these digital tax instruments keeping in mind the increase in the digital businesses with the advent of technology in the developing and developed world.

However, a Multilateral Instrument would lead to a further issue of Double Taxation and the Equalization levy as implemented by the countries would require a reconsideration and amendments in the domestic laws as well. The Personal Data Protection Bill of 2018, RBI Guidelines and the e-commerce draft national policy that the government came up with deals with the protection of personal data. As per the bill, one copy of the personal data has to be stored on a server or data centre in India by the data fiduciary. This would lead to very high operational costs for the data fiduciary and also increase the compliance burden on the companies.

In addition to this, the draft national e-commerce draft policy states that all the social media firms and the e-commerce website would be required to store their data in India. This has already imposed a burden on the Multinational Corporations to comply with the strict norms[22].

With respect to the permanent establishments and place of effective management, the existence of local servers in India would lead to these establishments to be subject to Indian taxes. This position has been reiterated in various judgments also.[23] This would in turn, lead to increased revenue for the Indian government owing to the creation of new avenues for taxation in the form of digital taxation. The government should formulate an inclusive, comprehensive, impartial policy for digital taxation, keeping in mind the domestic needs till the time a uniform global taxation policy is accepted by the countries.

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