The Impact of Digitalization on Broadening Income Tax Foundations

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ABSTRACT

This research article systematically examines the taxation challenges arising from the digitalization of the economy and proposes corresponding measures for mitigation. Initially, it delineates the distinctive features of the digital economy and delineates the tax challenges inherent in these features, particularly concerning major digital-tech entities exploiting base erosion and profit-shifting mechanisms to relocate profits from high-tax to low-tax jurisdictions. Subsequently, the article assesses the principal measures targeted at reshaping the international tax framework, encompassing the OECD's Pillar One, unilateral digital services taxes, and a U.N. proposal. It suggests the adoption of a novel nexus based on market thresholds, subject to a global de minimis amount, devoid of reliance on physical presence. Additionally, the article cautions against the adoption of global revenue thresholds and an overall international perspective as to how income tax base can be widened with the recent technological advancements.

Keywords: Digital taxation, Base erosion, Pillar One, Nexus, Global de minimis.

1.0 Introduction

The adoption of digital technologies for information processing and data exchange is reshaping traditional economic activities. This includes the buying and selling of goods and services, altering their nature, transmission channels, and the physical locations of buyers and sellers. Additionally, it impacts the production process, financing methods, and market analysis or advertising approaches. Simultaneously, these technologies give rise to entirely new realms of activity, previously non-existent or of much smaller scale. This results in the creation of new businesses, such as free services like social media, search engines, and information storage, which can be leveraged for demand analysis, advertising, and marketing.

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Other examples include platforms facilitating service exchange between individuals (e.g., leases, transportation services, and professional activities) and computer services in the "cloud." The digitalization of the economy, involving the transformation of traditional activities, coupled with the emergence of new digital economic models, presents numerous consequences—social, competitive, and labour-related. Importantly, this digital shift poses a challenge for traditional taxation. It requires the adaptation of classic tax concepts and mechanisms, along with the exploration of new alternatives to effectively address the evolving landscape. In the Indian economic landscape, the significance of direct tax, particularly income tax, is relatively diminished compared to indirect taxes. This discrepancy arises from the nature of income tax, which is imposed based on individuals' earnings, with a defined income limit. Given that a substantial majority of the population in India falls below this stipulated income limit, their earnings remain exempt from income tax. Only a small segment of the population surpasses this threshold, and income tax is applicable solely to their earnings. India employs a progressive income tax system, imposing higher rates on the affluent and lower rates on the less affluent. However, due to the limited number of individuals in the higher income brackets, the contribution of direct tax or income tax to the Indian economy remains minimal.

2.0 A Look at the Current Developments in Digitalization across many Industries

A significant and swiftly growing proportion of retail sales, reaching up to 9% in the USA and 15% in China, as well as a substantial portion of overall company sales, accounting for 18% in Europe and up to 33% in Ireland, are conducted through electronic commerce. The platforms of the collaborative economy, particularly in accommodation, traveller's transportation, banking, and professional services sectors, are expanding their reach. While their global impact on GDP or employment remains limited, their influence and growth within specific sectors are noteworthy.(OECD, 2017)

Certain sectors are rapidly transitioning to the digital realm, exemplified by online gaming capturing 17.5% of the European gaming market and, notably, advertising, where digital activities already constitute 35.2% of expenditures, expected to reach around 50% by 2021. This trend is accompanied by a concentration of market shares among a few key companies, with estimates suggesting that Google and Facebook collectively represent 62% of the online advertising market and 25% of the global advertising market. Although electronic money constitutes a small percentage of total payments (not exceeding 1%), it plays a crucial role as an accessible instrument for financial inclusion in less developed countries. In 2015, the number of mobile money accounts equalled or exceeded traditional bank accounts in 21 African countries. (Yusuf, 2021) Concerning cryptocurrencies, estimates in 2017 suggested 2.9 to 5.8 million users, with a market capitalization of 219 billion dollars in October 2018, where 52% constituted Bitcoins among over 2,000 existing cryptocurrencies.

Establishing tax nexus involves criteria such as residence or the existence of a permanent establishment, determined by physical presence, decision-making, and risk-taking. This approach applies source-based taxation to corporate income, incorporating territorial, worldwide, or mixed criteria. The process also encompasses mechanisms addressing double taxation relief (OECD, 2015). In cross-border operations, customs act as a checkpoint for applying consumption taxes (general and specific) and customs duties for tangible goods. For services purchased by companies, the reverse charge mechanism is often prioritized. In many instances, low-cost services or goods destined for final consumers were effectively exempt from taxation (Harpaz, 2021). Personal income, stemming from various sources, triggers the tax liability of the recipient. This is usually managed through self-assessment, with employers and financial institutions having withholding obligations. Employers also collect social contributions. If subject to taxation, property ownership entails a self-assessment obligation, with the tax administration overseeing values from public records.

A growing portion of consumption occurs digitally, presenting challenges for both suppliers and buyers. Suppliers may operate in another jurisdiction for tax purposes or informally through platforms, without a physical presence in the market country. New business models may generate significant product value using user data. Consumers can receive low-value or digital products and services directly from a foreign-based company or an individual through an intermediary platform not registered for tax purposes in their country. Ownership of assets may also pose issues, affecting various taxes in different cases (OECD, 2018).

Exploration of income-tax automation remains in its early stages, particularly in comparison to the more developed Goods and Services Tax (GST) automation. The full potential of corporate income-tax automation is yet to be realized, requiring both impetus from tax administrations and proactive engagement from companies recognizing the advantages of automation and technology utilization. Presently, organizations are directing their attention to tax-sensitive Enterprise Resource Planning (ERPs) to automate compliance tasks such as Form 3CD preparation, assessment responses, and TDS compliance, thereby streamlining these processes. Additionally, large Indian-headquartered groups are exploring the adoption of global tools to manage compliance on an international scale, with one example being the implementation of tools for global tax provisioning.

Beyond compliance, there is a growing recognition of the broader role of technology in tax. Companies are increasingly embracing cutting-edge data analytics and integrating Artificial Intelligence (AI) and Machine Learning (ML) in tax processes to derive strategic insights for business development (Gale & Samwick, 2014). The goal of reforms is to make India's tax regulation system competitive with the best in the world. The tax regulations should become stable after a simpler regime is adopted for at least five years. In the case of CWT v. Arvind Narottam ([1988] 173 ITR 479/39 Taxman 368 (SC)) , the Hon. Justice Sabyasachi Mukherjee made the observation that Taxpayers feel that whatever is contributed by way of

tax to the exchequer is mostly wasted away (in various scams), and the social responsibilities the government is expected to fulfil get neglected. The statement made by US Supreme Court Justice Homes that "the tax is paid for buying civilization" is completely absent.

3.0 Importance of using Digital Tools to Administer Taxes Effectively

The global tax landscape has undergone significant transformations, prompting both tax authorities and taxpayers to seek innovative methods of tax management. Recognizing that tax laws drafted in the 20th century are no longer aligned with the 21st-century business environment driven by advanced technology, tax authorities are swiftly adopting new strategies. Initiatives such as Base Erosion and Profit Shifting (BEPS) action plans are being implemented to secure taxes due and enhance reporting requirements (Rosario & Chavali, 2020). With the rise of digitization and e-governance, tax regulatory authorities globally are intensifying their focus on tax compliance and expanding their tax base. Utilizing advanced technologies and analytical tools, tax collection and monitoring mechanisms are being professionalized to ensure effectiveness and relevance. According to a report by PWC & Microsoft, digital transformation in tax administration can address key areas, including transparency, taxpayer-centric solutions, connected tax stakeholders, and data-driven decisions with automated processes. Transparency, facilitated by structured and visually supported data, increases taxpayer satisfaction and encourages voluntary compliance. Country-by-country reporting under BEPS initiatives encourages the sharing of data internationally and locally (Rosario & Chavali, 2020).

Countries are increasingly adopting cooperative compliance models, engaging taxpayers in revenue management, and shifting from traditional methods to risk-based cooperative compliance. As of mid-2017, 32 tax administrations transitioned to risk-based cooperative compliance relying heavily on analytics. The UK's HM Revenue and Customs (HMRC) is cited as a leading example, showcasing improvements in risk management, cost reduction, and enhanced taxpayer satisfaction (Pollack, 1999). The challenge of the tax gap persists globally, particularly in developing countries facing illicit financial flows resulting in a loss of around US\$ 1 trillion annually. To address this, there is a growing need for digitization of taxation to bring more taxpayers into the system, reduce tax evasion, and curb the flight of capital. Digitization allows for greater engagement of taxpayers, a deeper understanding of citizens, voluntary income declarations, online tax payment, and comprehensive online interactions for a 360-degree view of taxpayers.

4.0 Using Online Platforms to Comply with Tax Law

In the pursuit of common goals, governments face intricate challenges in harmonizing data submissions at the national level. Disparities in the scope and frequency of data

requirements for electronic auditing programs create variations among countries. While one nation may mandate a certain number of fields, another may necessitate additional fields, altering the dynamics of data submissions. Temporal variations in data submission frequency further complicate the landscape, with some countries opting for quarterly submissions, others monthly, and yet others allowing data on demand (Mpofu & Moloi, 2022).

Tax authorities are undergoing a paradigm shift, transitioning from historical data concepts to transaction-centric approaches. Digital reforms in the UK mandate quarterly submissions followed by year-end reconciliation, mirroring trends observed in various Latin American countries. Real-time or near-real-time data submissions have given rise to a dynamic approach where tax authorities rapidly layer new submission requirements. Latin American nations, in particular, have embraced a "layering" strategy, segmenting tax and accounting data into distinct "slices," each with its unique submission schedule, scope, and format. Notably, Brazil has witnessed a substantial surge in regular data submissions, with companies now obligated to fulfill 29 distinct submission requirements, a significant portion of them on a monthly basis (Li *et al.*, 2020).

The integration of data analytics marks a transformative phase for tax authorities, circumventing human intervention in data analysis. While data analytics has been utilized by tax authorities for over two decades, its applications were predominantly limited to case selection. The advent of advanced analytics, characterized by intricate techniques like pattern recognition, outlier detection, cluster analysis, experimental design, network analysis, and text mining, unlocks new avenues to harness intelligence across all facets of tax administration (Lipniewicz, 2017). This shift signifies a departure from traditional practices, offering unprecedented opportunities for leveraging sophisticated analytical methodologies in shaping the future of tax administration.

5.0 Utilizing Data Analytics to Expand the Income Tax Base

Tax evasion poses a significant threat to the fiscal health and societal well-being of numerous nations. As per the International Monetary Fund, the annual tax gap, denoting the variance between owed and paid taxes, is approximated at $500 billion for advanced economies and $200 billion for developing nations. This illicit practice not only diminishes public funds earmarked for social and economic development but also undermines the equity and credibility of the tax system (BusinessToday, 2018).

The multifaceted nature of tax regulations and transactions poses a central challenge in thwarting tax evasion, rendering it arduous for tax authorities to identify and prevent fraudulent activities. Additionally, tax evaders frequently employ intricate schemes and tactics to obfuscate their income and assets, incorporating offshore accounts, shell companies, transfer pricing, and money laundering.

Data analytics emerges as a potent instrument for tax authorities to pinpoint and address potential tax evaders with heightened efficacy and efficiency. Defined as the process of collecting, processing, analyzing, and interpreting extensive and varied datasets to derive insights and facilitate decision-making, data analytics finds application across diverse data sources, encompassing tax returns, financial statements, invoices, bank records, social media posts, and geospatial information (CXOToday, 2020).

The merits of employing data analytics for detecting tax evasion are manifold:

- Enhanced risk assessment and audit selection through data classification, clustering, and pattern recognition to stratify and prioritize taxpayers based on risk profiles and compliance behavior.
- Improved detection of anomalies, outliers, and inconsistencies in tax data using statistical methods, machine learning algorithms, and artificial intelligence to discern deviations from normal patterns.
- Streamlined prosecution of tax evaders employing data visualization, text mining, and network analysis to present complex data in a lucid manner, unveiling concealed relationships and connections among taxpayers, intermediaries, and entities.

6.0 Evaluating How Data-driven Insights affect Expanding the Income-tax Base

There is no one-size-fits-all solution for the digitization of tax administration, as experiences are often not universally applicable. It is crucial to recognize two key points: first, digital tax administration is inevitable and not a matter of choice; second, digitization requires more than a mere surge in implementation, as fundamental changes in social frameworks come with serious consequences. While complete solutions to digitization may not exist, certain strategically important steps are unavoidable on the path to fundamental digitization.

The initial step involves raising awareness of the desired outcomes. This requires conscious effort, clear political will, thorough work, and professional preparation. Questions such as the goals of digitization, the approach, and allocated resources need to be addressed. Identifying tax jurisdiction, controlling the flow of commercial services on the Internet, and identifying entities providing online services are critical considerations.

Digitization encompasses five key elements: technologies, people, management of tax risks, financial resources, and communication. Establishing a unified IT database connected with various government entities is a fundamental requirement for digitizing tax administration, enabling online control and tax collection. This integration helps prevent the uncontrolled accumulation of debt and reduces administrative costs. While technology is a primary element, the human factor is equally significant. Digitizing this segment involves educating tax officials, recruitment, determining their regular or special status, and implementing performance measurement and compensation systems (Latta & Singh, 2021).

To enhance the efficiency of tax administration and combat the shadow economy, a strategic approach involves re-qualifying and redirecting employees from paperwork-intensive tasks to the provision of services and taxpayer control, including cross-checking assets. This reallocation of human resources aligns with the broader aim of embracing digital disruptions within tax administration Tax jurisdiction, controlling the flow of commercial services on the Internet, and identifying entities providing online services are critical considerations. Digitization encompasses five key elements: technologies, people, management of tax risks, financial resources, and communication. Establishing a unified IT database connected with various government entities is a fundamental requirement for digitizing tax administration, enabling online control and tax collection. This integration helps prevent the uncontrolled (ICAEW, 2019).

In navigating the digital landscape, the flexibility of tax administration should address two key areas of action. Firstly, there is a need to harmonize the model of electronic (digital) business with the tax control model applied by tax administrations, ensuring adaptability to traditional business activities. Secondly, efforts should focus on amending international rules governing the exchange of information between tax authorities. This necessitates intensive cooperation among tax authorities globally to effectively prevent tax payment avoidance. The swift exchange of tax information is crucial for determining the tax base in cross-border income scenarios, serving as a vital measure to uphold state tax bases' sovereignty and ensuring the proper implementation of subjective tax law under international agreements.

In tandem with these administrative actions, adjustments to tax law are imperative to address technological challenges. Specifically, this pertains to provisions in international tax law that deal with delineating tax jurisdiction between states. Existing regulations, grounded in the territoriality paradigm, grant states the right to tax income based on its source or the taxpayer's residence. However, the influence of this paradigm diminishes in transactions conducted over the Internet, necessitating a re-evaluation of international tax law frameworks (Stojanović, 2020).

7.0 Processes for Automating and Simplifying Tax Collection

In order to increase the efficacy and efficiency of tax-related activities, processes for automating and streamlining tax collection make use of technology and streamlined procedures. Data input and processing, compliance monitoring, and enforcement are only a few of the parts of the tax process that are covered by automation in tax collection. These procedures' main objectives are to decrease manual labor, reduce mistakes, increase transparency, and quicken revenue collection. Digital platforms for filing tax information, online forms, electronic invoicing systems, and the use of data analytics to find prospective tax evaders may be important elements of such procedures (Selerity, 2019).

8.0 Online Platforms for Tax Filings

Submitting tax information, particularly for corporate taxes, is commonly facilitated through online forms or connections, often referred to as 'portals.' These portals encompass various websites, data connections, and online forms. While some implementations merely digitize existing tax processes by hosting PDF versions of traditional forms, more advanced portal leverage live data connections, collecting structured tax data, such as XBRL, from corporate taxpayer.

9.0 Electronic Invoicing for Efficiency

Governments may encourage the use of electronic methods, such as e-invoicing, as part of their tax policy. This not only benefits the tax system but also incentivizes private enterprises to adopt more efficient practices. Standard electronic invoice formats can significantly reduce administrative costs for businesses. However, finding a universally accepted format poses a challenge, requiring government involvement to establish momentum behind a specific format. Governments can implement automated prompts to remind taxpayers of filing or payment obligations. These reminders serve not only to enhance taxpayer satisfaction by helping them avoid unintentional breaches and subsequent penalties but also contribute to improving overall compliance rates. Automated prompting becomes a proactive measure to foster adherence to tax obligations.

10.0 Examining Government Attempts to Support Digital Tax Administration

Tax collection serves as a critical function for governments, acting as the primary source of funds for public services and development initiatives. However, numerous countries encounter challenges in generating sufficient tax revenue, especially amid rapid economic and social transformations. In response to these challenges, several nations have adopted automated systems to fortify and enhance their tax administration processes. The implementation of such automated systems offers diverse advantages, including cost reduction, efficiency improvement, accuracy enhancement, and bolstered compliance. This research journal delves into an examination of best practices and insights gleaned from the implementation of automated systems to optimize tax collection (Akitoby, 2018).

A pivotal facet of automated systems implementation revolves around the judicious selection and configuration of suitable tax software. Numerous third-party providers offer solutions catering to various tax categories such as income tax, value-added tax, corporate tax, and customs duties. These software solutions empower tax authorities to efficiently gather, process, analyze, and report tax data with precision and timeliness. However, the selection and

integration of new tax software necessitate a meticulous approach, encompassing a thorough analysis of specific tax requisites, adept software design and configuration aligned with industry best practices, rigorous testing and validation of tax outputs, and comprehensive training and support for end-users. Thus, the involvement of seasoned tax technology professionals becomes imperative to aid in the evaluation, selection, implementation, and optimization of tax software.

Furthermore, automation elevates the efficiency, productivity, quality, consistency, transparency, and accountability of tax processes. Noteworthy examples include Georgia's comprehensive automation of processes, encompassing e-filing, information sharing among tax entities, taxpayers, and banks, along with a consolidated internet portal for tax services. Similarly, Indonesia witnessed significant productivity gains and audit-related collections following the deployment of specific audit tools automating portions of the audit process.

A third dimension involves the development and deployment of a core tax system, a technological solution offering support, automation, workflow management, and authorization management across diverse tax administration functions. This system aids tax authorities in overseeing the entire tax cycle, from registration to collection to enforcement, while facilitating seamless data integration and exchange within and outside the tax administration. A core tax system contributes to informed decision-making and planning by furnishing timely and reliable data and analytics on tax performance indicators. Moreover, it enhances taxpayer service and satisfaction by providing secure online platforms for filing, payment, communication, feedback, and dispute resolution (Hendriyetty *et al.*, 2023).

The implementation of automated systems emerges as a potent strategy for augmenting tax collection and bolstering tax revenue. However, its success hinges on meticulous planning, execution, monitoring, evaluation, and adaptability. Key takeaways from the implementation of automated systems include the selection and configuration of appropriate tax software solutions, integration and automation of diverse tax processes, deployment and utilization of a core tax system, engagement of experienced tax technology professionals, stakeholder collaboration, ensuring data quality and security, providing comprehensive training and support, measuring performance and impact, and fostering a culture of continuous improvement and innovation.

11.0 Examining the Role that Digital Tools Play in Promoting Tax System Transparency

The utilization of digital tools is becoming increasingly prevalent among tax authorities and taxpayers, serving to enhance transparency and efficiency within the realm of taxation. Efficiency, on the other hand, denotes the optimal allocation of resources and time to attain objectives related to tax compliance and collection, all while minimizing administrative costs and burdens. This legal analysis delves into the manner in which digitalization

contributes to transparency and efficiency in taxation, exploring recent developments and associated challenges (Dosi & Virgillito, 2019).

A primary advantage of digitalization lies in its capacity to mitigate opportunities for corruption and fraud in taxation through the limitation of human interactions, heightened accountability, and facilitation of data analysis. In Kenya, for instance, the digitization of the tax system has curtailed direct interactions between taxpayers and tax officials, acting as a deterrent against bribery. In the UK, HMRC's Connect system employs data analytics on taxpayers' data and social networks to pinpoint potential tax evaders. Its predictive algorithm identifies individuals with a higher likelihood of engaging in tax fraud, facilitating the design of preventive measures. Over the period from 2008 to 2014, it yielded an additional £3 billion in tax revenue, surpassing the initial £80 million start-up costs of the Connect system, representing a notable return on investment of £37.5 to 1 within its initial five years.

12.0 Conclusion

With its variety of opportunities for streamlining procedures and enhancing revenue collection, the advent of digitalization has emerged as a fundamentally altering factor in the landscape of income-tax administration. A new era marked by greater transparency, enhanced efficiency, and the opportunity for wider tax bases has arrived as a result of the convergence of technical breakthroughs and tax policy. Tax authorities can tackle the complex issues brought on by the dynamic nature of company transactions and tax laws by embracing digital tools and automated systems (Bittker, 1967).

The use of tax automation, which has been emphasized in a number of talks, highlights the transition to a more sophisticated and responsive tax administration. Digitalization has been crucial in boosting risk assessment and audit selection, speeding data submissions and compliance processes, and strengthening tax authorities' capacities. By strategically combining data analytics, electronic filing, and real-time monitoring, tax administrations are better equipped to not only spot possible tax evasion but also quickly adjust to shifting economic conditions (Devos, 2015).

Countries are increasingly relying on digital solutions to rethink their tax structures, as was made clear in the investigation of international practices and projects. The world community is experiencing a paradigm shift in how taxation is administered and enforced, whether it be the complete Inclusive Framework on BEPS, real-time data submissions in Latin American countries, or the use of predictive technologies to combat tax evasion.

Along with higher revenue collection, other advantages include decreased corruption, better transparency, and higher taxpayer satisfaction. Initiatives like BEPS show how important it is for countries to take a harmonized and cooperative global strategy as they traverse the complex convergence of technology and taxation. The successful integration and

development of digital technologies will determine the future of income-tax administration and help to create a world where efficiency and compliance go hand in hand.

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