



Himachal Pradesh National Law University, Shimla (India)

HPNLU JOURNAL OF TAX LAW (HPNLU JTL)

JOURNAL ARTICLES

ISSN: 2584-0428

HPNLU JTL

Volume II (2023)

TAXING THE DIGITAL BUSINESS MODELS: REALIGNING OR REPLACING THE OLD NEXUS NORMS

Preeti Lakhera

This article can be downloaded from: <https://hpnlu.ac.in/journal-level-3.aspx?ref-id=39>

Recommended Citation:

Preeti Lakhera, *Taxing the Digital Business Models: Realigning or Replacing the Old Nexus Norms*, II HPNLU JTL 25 (2023).

This article is published and brought to you for free and open access by Himachal Pradesh National Law University, Shimla. For more information, please contact jtl@hpnlu.ac.in.

CONTENTS

<i>S. No.</i>	<i>Articles</i>	<i>Page No.</i>
1	TAXATION OF INDIVIDUAL INCOME WITH SPECIAL REFERENCE TO CITIZENSHIP BASIS: A COMPARATIVE OVERVIEW OF INDIAN AND USA SYSTEM OF TAXATION <i>Rakesh Kumar & Sonakshi Kashyap</i>	1
2	TAXING THE DIGITAL BUSINESS MODELS: REALIGNING OR REPLACING THE OLD NEXUS NORMS <i>Preeti Lakhera</i>	25
3	PROBLEMS ASSOCIATED WITH DOUBLE TAXATION AVOIDANCE AGREEMENTS: A GENERAL PERSPECTIVE <i>Manoj Kumar & Arpit Vihan</i>	33
4	ROLE OF GST IN INDIAN ECONOMY: AN ANALYSIS <i>Manjit Singh & Sahibpreet Singh</i>	49
5	CROSS-BORDER TAXATION IN PURSUIT OF GLOBAL CLIMATE EQUITY – COMPATIBILITY WITH THE CONCEPT OF FREE TRADE <i>Arunbaby Stephen & Ashima PA</i>	66
6	ANGEL TAX ON NON-RESIDENTS: DEVILISH ACT ON STARTUPS? <i>Ribhava Raj</i>	79
7	THE DIGITAL ERA: CRYPTOCURRENCY AND ITS (IN)EFFICIENT TAXATION AND REGULATION POLICY <i>Kumar Rishav & Divya Venugopalan</i>	91
8	DEMYSTIFYING CAPITAL GAINS: ANALYSING SECTIONS 45, 48, AND 55 FOR TAX COMPLIANCE <i>Kritin Sardana & Anurag Jaiswal</i>	116
9	IMPACT OF PRIORITIZING TAX CLAIMS IN CORPORATE INSOLVENCY: ANALYSING THE RAINBOW JUDGMENT <i>Aditi Dehal & Shubham Singh Bagla</i>	136
10	ROLE OF INDIAN JUDICIARY IN PREVENTING INTERNATIONAL TAX EVASION - AN ANALYSIS <i>Deepak B. D.</i>	155

TAXING THE DIGITAL BUSINESS MODELS: REALIGNING OR REPLACING THE OLD NEXUS NORMS

Preeti Lakhera*

[Abstract: The transactions to access, purchase, and consume digital technologies have been embedded in the contemporary economy. These services can be search engines, online advertising, online marketplace, etc. The efficiency and scale they offer make them an integral part of any new-age business model. A quick glance at the series of private equity funding diverted to these digital model businesses gives an insight into the future of wealth generation. But as physical presence is not required to access new markets such businesses can transact in an economy but not come under its tax base. This burdens the honest taxpayer and creates distrust over the tax system's fairness. The G20 and the OECD spearheaded an international project called the Base Erosion and Profit Shifting Project to streamline the international taxation framework and guarantee its relevance for contemporary times. It came up with fifteen Action Plans in July 2015 where the first action plan was on taxation of the digital economy.

The article wants to examine whether the tech business models create taxable events in market countries like India within the existing international taxation framework. It begins with an exploratory review of the existing literature on the taxation of the digital economy. It then analyses the solutions proposed by the OECD in its Action Plan 1 report and the Secretariat's twin pillar proposal. It examines whether the OECD is moving towards changing the norms in a fundamental way or realigning them to the new digital reality. It then proposes that a fair taxation model for developing countries will be where the current tax regime is fundamentally replaced to allow taxation of businesses in jurisdictions where they don't have any physical presence.]

The new-age digital economy is fast, scalable, and efficient. It is the use of digital business models which makes many conventional enterprises more efficient.¹ Or in the alternative in some cases, digital technologies

* Assistant Professor (Law) and Research Scholar, National Law University Delhi.

¹ See, The Growing Trend of Digital Economy: A Review Article, International Journal of Computing Sciences Research, June 2022, Pongsakorn Limna, Tanpat Kraiwanit, Supaprawat Siripipatthanakul; Dr. K. Kishore Kumar Reddy & Dr. Siddarapu Haribabu, "Digital Economy-Opportunities and Challenges in India, International Journal of Research and Analytical Reviews (IJRAR), July 2022, Volume 9, Issue 3, 2022; available at: <https://www.ijrar.org/papers/IJRAR1CQP010.pdf> Last Visited 2.08.2023; Also see generally, Alec Ross, "The Industries of the Future", Simon & Schuster UK Ltd, 2016

are the business model.² Though it's good for the economy and the consumer it becomes a nightmare for the taxman chasing the business profits of the multinational corporations.³

Before the advent of the digital era, the only thing worrisome for international tax policymakers in a globalized world was the issue of double taxation. In other words, as capital went mobile for enhancing development and earning interest in the Post World War II era a more significant concern was how the income should not be subject to double taxation. A solution was the emergence of a plethora of double tax treaties detailing how nations will be sharing the tax base amongst themselves.⁴ Apart from making the rules for sharing of different incomes and their rates, the compacts had detailed provisions for defining nexus, and dispute resolutions.⁵ Notably, as taxation is a sovereign issue the nation chooses its tax policy in view of its revenue needs. And this may involve choosing the tax rate, the type of income

² For instance, in the case of business models of Uber, Amazon etc the use of digital technologies makes the system efficient.

³ See, generally, "Tax Challenges of Digitalization" OECD, October 2017, *available at*: <https://www.oecd.org/tax/beps/tax-challenges-digitalisation-part-2-comments-on-request-for-input-2017.pdf>, Last visited: 22.07.2023; "Tax Challenges in the Digital Economy", Director General For Internal Policies, European Parliament; "Taxation in the Digital Economy: New Models in Asia and the Pacific", Edited by Nella Hendriyetty, Chris Evans, Chul Ju Kim, and Farhad Taghizadeh-Hesary, Routledge Studies in Development Economics, *available at*: <https://www.adb.org/sites/default/files/publication/822701/taxation-digital-economy.pdf> Last Visited: 10.07.2023

⁴ See, Thomas Rixen, Peter Schwarz, "Bargaining over the Avoidance of Double Taxation: Evidence from German Tax Treaties", *Public Finance Analysis*, Vol 65, No.4 (December 2009), pp. 442-471, *available at*: <https://www.jstor.org/stable/40913238> visited 16.07.2023; Steven A. Bank, "The Origins of Double Taxation", *From Sword to Shield: The Transformation of the Corporate Income Tax, 1861 to Present*, pgs. 145-190; Julia Kagan, What Double Taxation is and how it works, Investopedia, June 9, 2022, *available at*: https://www.investopedia.com/terms/d/double_taxation.asp Last visited 6.07.2023; Michael Lang, Ekkehart Reimer, "The History of Double Taxation Conventions in the Pre-BEPS Era", *WU Institute for Austrian and International Tax Law, European and International Tax Law and Policy Series*, IBFD, April 2021; W.H. Coates, "Double Taxation and Tax Evasion", *Journal of the Royal Statistical Society*, Vol 92, No.4 (1929), pp 585-593, *available at*: <https://www.jstor.org/stable/2342218> Last Visited: 1.07.2023; Andrey Savitkiy, "Tax in History: The First Tax Treaties: In Search of Origins", *Intertax*, Volume 49, Issue 6/7 (2021) pp. 569-585

⁵ See, OECD Model Tax Convention on Income and on Capital, Most treaties which resemble the OECD document in form have income characterized as royalty, fees for technical services, salary etc.

which may attract more tax, and what part of expenses to be allowed as deductions. A nation with abundant resources may have fewer revenue needs and may choose to have no or nil rate of taxation.⁶ This difference in tax policy and different tax rates creates arbitrage between nations.⁷ Multinationals or corporate entities who desire to minimize their tax bill take advantage of jurisdictions where the tax rate will be low. By choosing tax avoidance strategies, a multinational may choose to place its income in a place where it attracts no tax at all and shows its expenses where the tax rate is high.⁸ But these are the issues that were coming across when most of the business models needed to have a physical presence in a foreign territory to generate economic activity therein.

The Digital Business Models are different from the ones which have been used in the industrial era in which economies of scale were being used by using machines and division of labour.⁹ Interestingly, the business models have many unique features which create enormous value for them. They rely on network effects to create economies of scale.¹⁰ For instance, Facebook offers its services free but charges money from online advertisers on its platform. The greater number of users it attracts the more advertisers come into the space. The same is the case with business models like Uber. If more customers subscribe and exclusively use the app to find rides more drivers will use the app to find the customers. Apart from this customer not even use digital services but also create value in the business model. A customer using Amazon will also review products which will then lead to more sales for the products

⁶ See, Lucy Barnes “ The Politics of Domestic Taxation “, May 2018, 24 May 2018, *available at* <https://oxfordre.com/politics/display/10.1093/acrefore/9780190228637-.001.0001/acrefore-9780190228637-e-613;jsessionid=994554575010C1B1BEC329DDB-1B43013> Last Visited 03.08.2023; Richard Blundell and Ian Preston, “ Principles of Tax Design, Public Policy, and Beyond The Ideas of James Mirrles, 1936-2018, 21 February 2019, *available at*: <https://onlinelibrary.wiley.com/doi/full/10.1111/1475-5890.12183> Last Visited: January 2019

⁷ See, Tulio Rosebuj, “International Tax Arbitrage”, *Intertax*, Volume 39, Issue 4(2011) pp. 158-168

⁸ See, Maggi Cooper and Quyen T.K. Nguyen, “Multinational enterprises and corporate tax planning: A review of literature and suggestions for a future research agenda”, *International Business Review*, Volume 29, Issue 3, June 2020.

⁹ David Ingram, “The Evolution of Business Models, *available at* <https://smallbusiness.chron.com/evolution-business-models-77617.html>, Last Visited: 04.08.2023.

¹⁰ See, Shoshana Zuboff, “The Age of Surveillance Capitalism”, Profile Books, 2019

brought. The businesses that thrive on the digital economy are multidimensional where the services are being enhanced by constant feedback and input by the customers engaging with the business. This constant flow of information from the users of these models gives the digital companies valuable data which can then be used to give better services to the customers. ¹¹This data is the contemporary economy is most useful asset and is used by most business to create value. Also it can help the companies give them more efficient targeted advertising which in other ways leads to more expansion of the business model. Also, unlike the physical business models the marginal cost of enhancing the business is very less. Because of this efficient delivery of services these companies hold great potential and keep attracting a lot of private equity investors. It seems reasonable then economies where they have a business presence as they have customers there should have the right to tax their business models. ¹²This ability to tax depends on whether the nations can tax in the existing norms for taxation of the profits of foreign companies' income.

The existing international taxation framework is built on the idea of two founding principles which are called the source and residence principle. ¹³An income is taxed if it is earned or accrued in a particular jurisdiction. Alternatively, an income earned by the resident of a nation is taxed by that country. It is these two nexus factors that lead to the creation of a connecting factor that justifies the taxation of income. In essence, taxation is a very sovereign exercise. Countries may devise their tax policy depending on their revenue requirements. Having less population and a robust foreign reserve does not lead to the creation of a high tax rate. At times this revenue requirement is met by the abundant natural resources of the country. But as different countries have different tax rates it leads to the problem of double taxation. In this, an income can be taxed twice by two different jurisdictions. They may justify this

¹¹ See, Timandra Harkness, "Big Data, Does Size matter?", Bloomsbury, 2016

¹² See generally, David S. Evans and Richard Schmalensee, "Matchmakers: The New Economics of Multi-sided Platforms", Harvard Business Review Press; Thales s.Teirxeira, "Unlocking the Customer Value Chain", Currency New York, First Edition, 2019; Sangeet Paul Chaudary, "Platform Scale: For a Post-Pandemic World", Portfolio Penguin, Penguin Random House India, 2021

¹³ See, Liu Hern Kuan, "Income Tax-Source Principle Refined, Singapore Journal of Legal Studies, Vol 1992, Issue 2(1992), pp. 566-578

based on either source or residence principle. As tax is perceived as a cost of doing business by any company it is important that double taxation should not happen in an economy. It was in this context the international taxation architecture of model tax conventions evolved.¹⁴The object was to prevent double taxation and give a fillip to economic globalization. This 1920s evolved structure has the OECD model tax convention¹⁵and the United Nations model tax convention for developed and developing countries¹⁶.

The Organisation of Economic Cooperation and Development (OECD) has been working on the international taxation policy framework for decades. The OECD had diligently worked across decades to create better tax transparency and to make sure there is a normative structure that can facilitate information exchange for tax transparency.¹⁷Though companies had been doing creative tax planning to reduce their taxes the countries used to ignore it as it made their companies more competitive in the international market. But the 2008 financial crisis created widespread panic in the world and this tax dodging came to focus.¹⁸ The OECD launched its Base Erosion and Profit Shifting Project

¹⁴ See, Reuven S. Avi-Yonah, "The Structure of International Taxation: A Proposal for Simplification", University of Michigan Law School Scholarship Repository, the University of Michigan Law School, 1996

¹⁵ Called the OECD Model Tax Convention on Income and on Capital 2017

¹⁶ Called the United Nations Model Double Taxation Convention between Developed and Developing Countries 2017

¹⁷ See, "Putting an end to offshore tax evasion" Global Forum on Transparency and Exchange of Information for Tax Purposes, *available at*: <https://www.oecd.org/tax/transparency/> Last Visited 2.08.2023; Automatic Exchange of Information, "What it is, How it works, Benefits, What remains to be done", *available at*: <https://www.oecd.org/ctp/exchange-of-tax-information/automatic-exchange-of-information-report.pdf> Last Visited 2.08.2023; Tax Information Exchange Agreements (TIEAs) *available at*: <https://www.oecd.org/ctp/exchange-of-tax-information/taxinformationexchangeagreementstieas.htm> Last Visited 1.08.2023; Model Manual on Exchange of Information for Tax Purposes, Global Forum on Transparency and Exchange of Information for Tax Purposes, *available at*: <https://www.oecd.org/tax/transparency/documents/EOI-manual.pdf>, Last Visited: 1.08.2023

¹⁸ Thomas Hemmelgarn, "The 2008 Financial Crisis and the Taxation Policy", European Commission, Universite Libre de Bruxelles, CEPR and CESifo, *available at*: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1546973 Last Visited: 30.07.2023.

in 2013 in support of the G20.¹⁹ It came up with a 15 Action plan to address different sections of the international tax policy. It was Action Plan One which focussed on the digital economy and suggested an equalization levy and significant economic presence to tax the digital economy.²⁰ India set up a committee to discuss these tax developments in the context of the digital economy. Its committee on Addressing the tax challenges for E-commerce also suggested that an equalization levy can be introduced to tax the provision of digital services by some offshore companies till the multilateral framework under the BEPS project can be worked out.²¹ Though there were many issues to be resolved by the OECD it came up with a twin-pillar approach to tackle the tax challenges of the digital economy.²² Pillar one is about the reallocation of taxing rights between nations²³ and Pillar two is about fixing a minimum tax rate for the corporations.²⁴ It was recently in the

¹⁹ What is BEPS? Inclusive Framework on Base Erosion and Profit Shifting, *available at*: [https://www.oecd.org/tax/beps/about/#:~:text=Base%20erosion%20and%20profit%20shifting%20\(BEPS\)%20refers%20to%20tax%20planning,they%20suffer%20from%20BEPS%20disproportionately.](https://www.oecd.org/tax/beps/about/#:~:text=Base%20erosion%20and%20profit%20shifting%20(BEPS)%20refers%20to%20tax%20planning,they%20suffer%20from%20BEPS%20disproportionately.) Last Visited: 2.08.2023; Addressing Base Erosion and Profit Shifting, published on February 12, 2013, *available at*: <https://www.oecd.org/tax/addressing-base-erosion-and-profit-shifting-9789264192744-en.htm> Last visited 30.07.2023; OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing. <http://dx.doi.org/10.1787/9789264202719-en>.

²⁰ See, Action 1, Tax Challenges Arising from Digitalisation, *available at*: <https://www.oecd.org/tax/beps/beps-actions/action1/#:~:text=%C2%BB%20BEPS%20Action%201%20Report%20identified,mechanisms%20included%20in%20these%20Guidelines.>, Last Visited 2.08.2023.

²¹ Proposal for Equalization Levy on Specified Transactions, Report of the Committee on Taxation of E-Commerce, February 2016, Committee on Taxation of E-Commerce, Central Board of Direct Taxes, Department of Revenue, Ministry of Finance, Government of India.

²² See, Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, OECD/G20 Base Erosion and Profit Shifting Project, 1 July 2021, *available at*: <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf> Last Visited: 6.07.2023.

²³ See, Secretariat Proposal for a “Unified Approach” under Pillar One, 9 October 2019- 12 November 2019, *available at*: <https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf> Last visited 6.07.2023

²⁴ Tax Challenges Arising from Digitalisation of the Economy-Global Anti-Base Erosion Model Rules (Pillar Two), 20 December 2021, *available at*: <https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.htm> Last Visited: 26.07.2023

Post Covid world led by the U.S. government that the OECD adopted the Pillar Two approach.²⁵

On its own India has been involved in the processes of the OECD tax policymaking as an Observer. And the organization wants to give it more importance seeing its strategic importance in the world geopolitics²⁶ India, like any developing country, is participating in the process from a position of preserving its tax base. In the OECD commentary, India maintains a position that a website can also be considered to be a Permanent establishment. India also has amended section 9 of the Income Tax Act, 1961 which basically talks about the role of taxation at the source level. Within that, it has introduced the concept of significant economic presence.²⁷ In its draft on the allocation of business profits to the Permanent Establishment, it talks about the role of value creation within the source economy. The idea is that the consumer side of the economy also adds value to the business so profit should be allocated to the market jurisdictions.²⁸ Recently India decided to tax the earnings of Netflix in India. The tax department order claimed that to further its business model it has employees and infrastructure in India.²⁹

The taxation of digital business models is an area of conflict where many vested interests can be hurt. This paper proposes a two-pronged alternative. We can either talk about replacing the current rules framed for the physical economy. On the alternative one can reform and realign the rules to tax the digital economy. The paper will seek to study whether India should be realigning the International taxation concepts in its Double tax avoidance agreements to tax the business models. Or

²⁵ See, Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, October 2021, OECD/G20 Base Erosion and Profit Shifting Project.

²⁶ OECD invites India to participate in its committee of Fiscal Affairs, OECD, Centre for Tax Policy and Administration, *available at*: <https://www.oecd.org/ctp/oecdinvitesindiatoparticipateinitscommitteefiscalaffairs.htm> Last seen 05.08.2023.

²⁷ Indian added An Explanation 2A to Section 9(1)(i) of the Income Tax Act 1961. The Finance Act of 2018 introduced the amendment.

²⁸ See, Proposal for Amendment of Rules for Profit Attribution to Permanent Establishment, Central Board of Direct Taxes, Department of Revenue, Ministry of Finance, Government of India.

²⁹ See, IT department looking to tax Netflix's India operations: Reports, 12.05.2023, Live mint, *available at*: <https://www.livemint.com/news/india/it-department-looking-to-tax-netflixs-india-operations-reports-11683860282576.html> Last Visited: 2.08.2023

the better way is to replace these concepts with solutions that are better suited for the digital economy. The paper concludes by providing two solutions. First India should be engaged and in a cooperative mode as to the proposals which come through the OECD so that it does not lose any of the revenue generated in the new age tax model. Also, realignment of the age-old concepts will be a better idea as renegotiating the entire DTAs to include new concepts in a unilateral manner will be tough for India. Working out the consensus and the details of new proposals to replace the new order will create distrust towards India's economic interests. But realignment is necessary so that it gets its rightful share from the business models which generate a lot of revenue.

There have been reactions about the OECD's role in international tax policymaking. One of the reasons is that it leads to a scenario where the rich countries dictate and make the normative framework in a manner that suits them. It is important that the United Nations should be at the forefront of International tax policymaking. The UN recently came up with a proposal for mapping digital presence and creating a nexus for the digital economy.³⁰ The provision talks about the taxation of automated digital services by creating a withholding tax for the source country where the foreign company is providing services.

It is the cooperation and coordination between the nations to preserve the tax base which will lead to tapping into the revenue generated by the tech giants. And the cooperation should not be an agreement on general guidelines on how the taxation is to be done. But more than how we work out the details to make the whole process workable. India's position can be best served by falling behind the United Nations' position conceptualized under Article 12 B.³¹

³⁰ See, Article 12B of the UN Model Tax Convention, as agreed by the UN Committee at its 22nd Session, *available at*: <https://financing.desa.un.org/document/article-12b-un-model-tax-convention-agreed-committee-its-22nd-session> Last Visited 30.07.2023

³¹ Article 12 B of the UN Model Tax Convention, as agreed by the Committee at its 22nd Session; An active UN adopts new UN Model treaty provision regarding income from automated digital services, 14.05.2021, *available at*: <https://wts.com/global/publishing-article/20210512-un-income-from-automated-digital-services~publishing-article>