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THE CHALLENGE OF CREATING TAXABLE EVENTS IN THE DIGITAL ECONOMY

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[***Abstract***: *The digital way of life has forced the digitization of the business model of the most profitable enterprises. This creates problems for the government relying on revenue from direct taxation of income. The taxation framework is structured for the old physical economy and does not capture the taxable event where economic activity occurs in the digital landscape. This article studies the challenges in creating taxable events for the digital economy in a developing country like India. It studies this issue in the context of India and highlights the Organization for Economic Cooperation and Development's work in reforming the international tax architecture for the current digital economy. It argues that the solution can be found by engaging with the multilateral process and resisting unilateral solutions.*]

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I

INTRODUCTION

The digital economy has changed our life in a revolutionary way. The way we interact, socialize, and transact is defined within the interface of the digital space. Though the advancement of science and technology has led to significant progress and facilitated massive development this has not benefited all sections of society. [1] Inequality has become a high-level priority for governments as it may harm the country's social fabric and create a lack of confidence in democratic institutions. The institutions and civil society mapping inequality have been studying the country's social fabric and income is getting concentrated in the hands of a few people. [2] The World Economic Forum report assessing countries for Inclusive growth and development ranks India 62nd among 74 developing countries.[3] Though the report claims that poverty has reduced in India, most citizens are surviving on less than $3.20 per day. [4] A United Nations study has pointed out that the living conditions are not the same for all and there is variation in terms of accessing opportunities to excel. [5]

The concept of a welfare state mandates working towards the betterment of its citizens which entails providing basic education and health facilities for all.[6] Reducing inequality and operationalizing social security plans requires a

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[1] OECD, INCLUSIVE GROWTH IS ECONOMIC GROWTH THAT IS DISTRIBUTED FAIRLY ACROSS SOCIETY AND CREATES OPPORTUNITIES FOR ALL. *Available at-* https://www.oecd.org/inclusive-growth/#inequality-puts-our-world-at-risk (last visited 25 Aug., 2022).

[2] S. Irudaya Rajan and Udaya S. Mishra, *What rising inequality means* (Dec., 2021 THE HINDU). *Available at-*https://www.thehindu.com/opinion/op-ed/what-rising-inequality-means/article37999556.ece, (last visited 25 Aug., 2022).

[3] WEF, THE INCLUSIVE DEVELOPMENT INDEX 2018 SUMMARY AND DATA HIGHLIGHTS (2018). *available at-* http://www3.weforum.org/docs/WEF_Forum_IncGrwth_2018.pdf (last visited 25 Aug., 2022).

[4] *Id*.

[5] UNCTAD, INCLUSIVE GROWTH REMAINS ELUSIVE AS INEQUALITY PERSISTS GLOBALLY (21 Jun., 2022). *Available at-* https://unctad.org/news/inclusive-growth-remains-elusive-inequality-persists-globally, (last visited 25 Aug., 2022).

[6] David Garland, *What is the welfare state?* (28 Apr., 2016 OXFORD ACADEMIC). *Available at-* https://doi.org/10.1093/actrade/9780199672660.003.0001 (last visited 30 May, 2022).

continuous and expanding revenue stream with the government. But so that a state has a legitimate claim it needs to have a nexus to tax the income stream.[7]

II

CURRENT NEXUS FRAMEWORK FOR TAXATION

The nexus has two connecting factors namely the source and the residence principle.[8] The income is said to be sourced in a nation-state when it accrues in a particular jurisdiction after taking benefit from the ecosystem.[9] And the income is also taken from a resident who is staying in a nation's jurisdiction and takes the benefit of his residence. [10]The connection between residence and source is how income is taxed across jurisdictions.

But as this income can be sourced in multiple jurisdictions and be subjected to multiple rules this may lead to double taxation. To address this, we have the tax treaty network which consists of thousands of treaties demarcating the sharing of taxable income between the source and resident states. [11]Generally, the tax treaties are modeled on the Organisation for Economic Cooperation and Development (OECD hereinafter) Model Tax Convention and the United Nations Model Tax Conventions. The treaties classify different types of income and mention the negotiated division of income. The rate of income is also mentioned. Some features mentioned the mechanisms of dispute resolution in the event of a conflict.

The nexus rules for the current taxation framework were created for the economy where transactions were done in a physical mode. [12]In the brick-and-mortar environment having a fixed workspace was essential to start any business activity in any geography. Business transactions in the digital economy happen through platforms, and social media networks and are fuelled by algorithms. They can happen online without having a physical presence. As the workspace turned digital, locating the work locus was difficult as it got diffused in many territories. This created challenges for the

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[7] J Forester, Jay, and Mike Drumm, *Income Tax Nexus: No Physical Presence Necessary*, 37 FRANCH. LAW J. 65–76 (2017). *Available at-* https://www.jstor.org/stable/26421676 (last visited 30 May 2022).

[8] Income Tax Act, 1961, S.5.

[9] Income Tax Act, 1961, S.5.

[10] Income Tax Act, 1961, S.6.

[11] Charles Irish, *International Double Taxation Agreements and Income Taxation* (1974 INTERNATIONAL AND COMPARATIVE LAW QUARTERLY. *Available at-* https://perma.cc/TD9P-SSSD (last visited 26 Apr., 2022).

[12] Reuven Avi-Yonah, Young Ran Kim & Karen Sam, *A New Framework for Digital Taxation*, 63 HARV. INT'L L.J. 279 (2022).

existing framework in capturing the economic transactions for mapping the taxable event as it needs a nexus in the form of a source or residence.[13] Scholars started writing very early as to how the world of e-commerce will be a challenge for the tax man. [14]Also, how the digital economy needs a normative framework as the earlier one was created in a physical world.

III

EVOLVING NEW NORMATIVE ORDER FOR DIGITAL ECONOMY

The main efforts to build a new international tax order for the digital economy are being spearheaded by the OECD. [15] A tax is a cost of doing business with a company. Thereby they minimize the tax by innovative tax planning so that their effective tax rate is negligible. This can be done by showing the profits in the low-tax jurisdictions and the expenditures in the high-tax rate territories. This planning creates an opportunity for nil taxation. Concerned with excessive tax planning by the corporations the organization came up with the Base Erosion and profits shifting (BEPS hereinafter) project.[16]

It is important to evolve new normative order for the digital economy. The old framework was focused on the idea of nexus and was workable in a brick-and-mortar economy. [17]But now companies have a business presence without

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[13] Assaf Harpaz, *Taxation of the Digital Economy: Adapting a Twentieth-Century Tax System to a Twenty-First-Century Economy*, 46 YALE JOURNAL INTERNATIONAL LAW (2021). *Available at*- https://ssrn.com/abstract=3593936 (last visited 26 Apr., 2022).

[14] Julian Hickey J.B., *The Fiscal Challenge of E-commerce*, 2000 BRITISH TAX REVIEW 91-105 (2021); Yang, James G.S., *Emerging Issues in E-Commerce Taxation*, 31 JOURNAL OF STATE TAXATION 15-44 (2013); Stanley-Smith, Joe, *E-commerce: The Global Shift in Taxation*, 27 INTERNATIONAL TAX REVIEW 22-26 (2016); Gopal Saxena, *Legal and Taxation Issues concerning E-Commerce*, 11 IJLT 87-105 (2015).

[15] Ault, Hugh J., *Reflections on the Role of the OECD in Developing International Tax Norms*, 34 BROOKLYN JOURNAL OF INTERNATIONAL LAW 757-782 (2009); Elliot Ash and Marian Omri, *The Making of International Tax Law: Empirical Evidence from Tax Treaties Text*, 24 FLORIDA TAX REVIEW 151-190 (2020).

[16] *See*, OECD /G20 BASE EROSION AND PROFIT SHIFTING PROJECT, *Read at*: https://www.oecd-ilibrary.org/taxation/oecd-g20-base-erosion-and-profit-shifting-project_23132612 (Last visited 13. Feb.2023); Matthew Herrington, *OECD BEPS Project-A Status Update*, 41 INTERNATIONAL TAX JOURNAL 25-28 (2015); Rajendra Nayak and Shweta Pai, *OECD BEPS Reports-An Indian Perspective, Asia Focus*, 25 INTERNATIONAL TAX REVIEW 30-31 (2014).

[17] *See*, ACTION PLAN 1 TAX CHALLENGES ARISING FROM DIGITALISATION, *Read at*: https://www.oecd.org/tax/beps/beps-actions/action1/ (Last Visited 10 Feb., 2023).

having any physical nexus so we must create a framework that works for the new age economy.[18]

The OECD is at the forefront of creating taxation norms in the era of globalization. Though accused of only looking at the perspectives of the developed economies it has created structures to make its processes more focused. Its BEPS project has tried to create solutions around the minimization of tax by multinational corporations by working out the different facets of international taxation. [19]Its Action Plan one report came up with suggestions like an equalization levy and a new nexus called the significant economic presence.[20]

In 2018 the BEPS project Interim report came out which studied in detail the various business models of the digital economy and how value generation takes place therein. [21]It pointed out how some want to reframe the international framework for the digital economy but others are not keen on the overhaul. The only consensus was that most nations agreed that the rules around defining nexus and creation of value have to be reframed.[22]

This followed the twinning proposal of the Secretariat of the OECD namely Pillar One and Two. Though Pillar one envisages the reallocation of the profits of the multinational in terms of value creation in different economies. [23]On the other hand, pillar two advocates a minimum corporate tax and gives preference to the nations where digital businesses reside.[24]

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[18] Jay Forester and Mike Drumm, *Income Tax Nexus: No Physical Presence Necessary*, 37 FRANCH. LAW J. 65-76 (2017).
[19] *See*, Yariv Brauner, *'What the BEPS'*, 16 Fla Tax Rev 55 (2014); Reuven S. Avi Yonah & Haiyan Xu, *'Evaluating BEPS'*, 10 Erasmus L Rev 3 (2017).
[20] *See*, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1-2015 FINAL REPORT. Published on October 05, 2015. *Read at*: https://www.oecd.org/tax/beps/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report-9789264241046-en.htm (Last Visited 15 Feb., 2023).
[21] OECD, TAX CHALLENGES ARISING FROM DIGITALIZATION-INTERIM REPORT 2018: INCLUSIVE FRAMEWORK ON BEPS, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT (2018 OECD PUBLISHING, PARIS). Read at: https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf.
[22] *Ibid*.
[23] *See*, OECD, SECRETARIAT PROPOSAL FOR A "UNIFIED APPROACH" UNDER PILLAR ONE.
[24] *See*, TAX CHALLENGES ARISING FROM THE DIGITALIZATION OF THE ECONOMY-GLOBAL ANTI-BASE EROSION MODEL RULES (PILLAR TWO), Read at: https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.html.

The European Union has been putting in a lot of effort in creating norms for taxing entities generating revenue in its territories through business models. The European Commission has come up with various directives for taxing the digital economy.[25] Encouraged by the directives of the European Union and the slow progress of multilateralism within the BEPS project many countries have started unilateral taxation. [26]The UK came up with its diverted tax. [27]Similarly, France proposed such a tax.[28]

IV

INDIAN EFFORTS TO TAX THE DIGITAL ECONOMY

The Indian income tax department has not been successful in taxing business models within the digital economy. Businesses are always inclined to plan their tax in a manner that stays at a minimum. Paying tax is a cost of doing business so the effort is to show income at a low tax jurisdiction. [29]And this tax planning

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[25] *See*, PROPOSAL FOR A COUNCIL DIRECTIVE FOR LAYING DOWN RULES RELATING TO THE CORPORATE TAXATION OF A SIGNIFICANT DIGITAL PRESENCE (21 Mar., 2018). Read at: https://taxation-customs.ec.europa.eu/system/files/201803/proposal_significant_digital_presence_21032018_en.pdf.; *See also*, PROPOSAL FOR A COUNCIL DIRECTIVE ON THE COMMON SYSTEM OF A DIGITAL SERVICES TAX ON REVENUES RESULTING FROM THE PROVISION OF CERTAIN DIGITAL SERVICES (21 Mar., 2018 EUROPEAN COMMISSION, BRUSSELS). Read at: https://taxation-customs.ec.europa.eu/system/files/201803/proposal_common_system_digital_services_tax_21032018_en.pdf; *See also*, COMMISSION RECOMMENDATION RELATING TO THE CORPORATE TAXATION OF A SIGNIFICANT DIGITAL PRESENCE (21 Mar., 2018). Read at: https://taxation-customs.ec.europa.eu/system/files/2018-03/commission_recommendation_taxation_significant_digital_presence_21032018_en.pdf.

[26] Jason Osborn, Michael Lebovitz & Astrid Pieron, *Unilateral Taxation of the Digital Economy: The Fight is Not over Yet-Its only Beginning*, 72 TAX EXECUTIVE 26 (2020).

[27] *See*, Alex Dunnagan, *The Diverted Profits Tax and Tackling Offshore Promoters of Tax Avoidance* (1 Dec., 2022). Read at: https://www.taxwatchuk.org/finance_bill_2021_2022/.

[28] *France orders tech giants to pay digital tax*, (26 Nov., 2020 REUTERS) *Available at:* https://www.thehindu.com/sci-tech/technology/france-orders-tech-giants-to-pay-digital-tax/article33182617.ece.

[29] Aman Chaudhary, *Tax Planning Strategies: Legitimate,* 1 INDIAN J & PUB POL'Y 52 (2014).

gets further exacerbated if it is combined with a business that runs on digital technology.[30]

Like any developing country India has to make serious efforts in tapping into the business models of the digital economy that are making money to increase its tax base. But the Indian court's efforts to tax the digital economy have not been successful. In a case concerning the delivery of flowers online, the court looked as to whether search engine websites can be taxed within the Indian jurisdiction. [31] As per the current framework, the foreign company running an online platform targeting Indian consumers had no physical nexus to be taxed in India. [32]The court followed the interpretation of the OECD commentary for its model convention and denied the taxability. [33]Since then, the government appointed a committee on E-commerce that studied India's challenges for the e-commerce sector in detail.[34] The committee followed the BEPS Action Plan 1 proposal and suggested imposing an equalization levy on online advertising and later extended to e-commerce. [35] Though a welcome move it was introduced only in the context of putting the levy in the finance act instead of amending the Income tax act. This was an instance of unilateral taxation which is discouraged as it runs afoul of India's commitment to its double taxation obligations. [36] This highlighted a big barrier in taxing the digital economy. As India is a signatory of the Double Tax Avoidance Agreements (DTAAs hereinafter) any changes can only be done bilaterally by talking to the country. Negotiating and changing the DTAAs to the detriment of the country is an impossible task. Therefore, solutions must be created by the route of multilateralism.

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[30] Tamer Budak, *The Transformation of International Tax Regime: Digital Economy*, 8 INONU U L REV 297 (2017); Thomas Fetzer & Bianka Dinger, *The Digital Platform Economy and its challenges to Taxation*, 12 TSINGHUA CHINA L REV 29 (2019).

[31] *ITO v. Rights Florists Pvt Ltd (ITAT Kolkata)*, (2013) 154 TTJ (KOL) 142.

[32] The case concerned the taxability of the advertising revenue earned by Google and Yahoo by allowing Indian companies to advertise on its platform.

[33] *Ibid*.

[34] *See*, AKHILESH RANJAN COMMITTEE ON TAXATION OF E-COMMERCE, CBDT (Mar. 2016).

[35] Introduced through Finance Bill 2016, Ch. 7 said that 6% of the consideration amount for specified services received or receivable by a non-resident not having a permanent establishment in India, Roma resident in India who carries out business or profession, or from a non-resident having a permanent establishment in India. Later through Finance Act 2020, it introduced a second version which taxed the non-residents supplying e-commerce services.

[36] *India has numerous bilateral agreements with nations to prevent double taxation. Available at-* https://incometaxindia.gov.in/pages/international-taxation/dtaa.aspx (Last visited 13 Feb., 2023).

It also introduced the connection of significant economic presence to map the digital economic model's businesses working in India.[37] The key idea underlying this new tax is that it allows taxability if digital businesses have consumers and a substantial revenue generation from the Indian territory. So, though the concept is good on its face the problem lies in how it is going to be operationalized. First, what is going to be the threshold of the companies on which this concept will be applied, and how many consumers have to be there before any presence is marked? Demarcating the details of this concept is not such an easy task as there will be no consensus as to what variable will create a presence.

V

CONCLUSION

The solutions to tax the digital economy can only be found in a multilateral manner. In a world where multilateralism seems to be eroding, this is a difficult exercise. The advent of Covid 19 also slowed down the efforts of the OECD and the European Union in finding solutions in an accelerated manner. But as the economy slows down and the world moves towards recession, finding tax solutions will become more important. Though the countries agree on the broad idea of taxing companies to generate revenue the differences come up when they start operationalizing the details of this arrangement.

Currently, the focus has shifted to the Pillar two proposal of the Secretariat of the OECD which advocates having a minimum corporate tax. The idea has been promoted by the United States as most digital companies generating money belong to the country. Any taxation of their profits in source jurisdiction will make their businesses uncompetitive in the long run. On the other hand, though the minimum tax advocated by Pillar two does generate revenue from the tech giants it does not answer the concerns of developing countries who want a reallocation of profits fairly. Focussing on pillar two shifts attention to the difficult question of allocating value and thereby profits within different jurisdictions. Countries like India can cooperate on the Pillar two proposal of having minimum taxation as a starting point. India has always advocated for the Pillar one proposal, which talks about giving a fair share of taxation to countries where value gets created. Therefore, it should not let the conversation

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[37] Introduced through Finance Act 2018. It was first mentioned in Action Plan 1 on Digital Economy for the BEPS Project. It was introduced in Section 9 of the Income Tax Act 1961. *See*, Vikas Vasal, *Significant Economic Presence in India-The new nexus rule* (19 Aug., 2021 LIVEMINT) *Available at:* https://www.livemint.com/money/personal-finance/significant-economic-presence-in-india-the-new-nexus-rule-11629386032160.html.

around pillar one slow down as that can only lead to a fair multilateral solution to tax the digital economy. Any multilateral solution should not only allow all to discuss international issues inclusively but also assure that some of the proposals of the developing world find mention in the final solutions. Though there is a rough road to achieving that, the nations' financial needs and welfare commitments will make them sit at the table and come up with actionable solutions to generate revenue.[38]

[38] Y. Brauner, *An International tax regime in crystallization*'s, 56 Tax L. Rev. 259-328 (2003).