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TAXATION OF DIGITAL ECONOMY IN INDIA

THE WAY FORWARD



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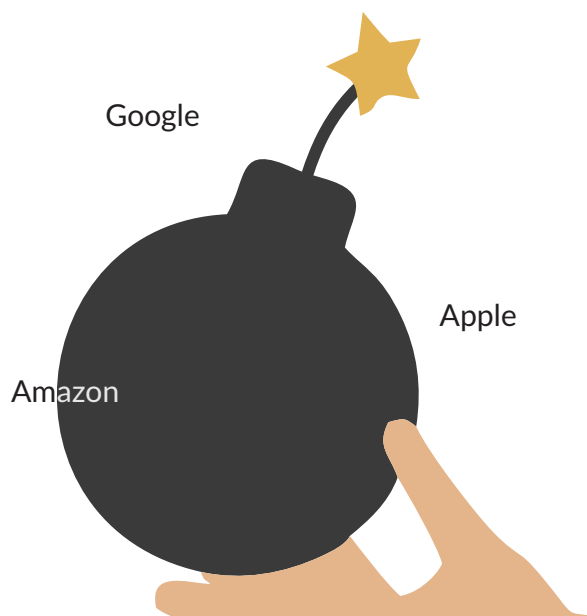
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I. BACKGROUND¹

One of the standout features of the ongoing debate around taxation of digital economy is the consensus that the tax regime, especially the international tax regime, needs to be reevaluated and reshaped. It's been reported that there are some 110 countries that have agreed to work towards framing international consensus by 2020 to tax digital business all across borders.² However, this consensus breaks down when it comes to recommending as to what should be the nature and content of the reshaped regime.

The conventional narrative is that the current



international tax regime was built for a brick and mortar economy and has failed to adapt itself to the commercial practices of the digital economy and hence, international tax rules and commensurate domestic tax rules need to be reformed.³ In tandem with this narrative, we find that the digital economy is a growing tax base which is ripe for taxation.⁴ This narrative focuses on large multinationals such as Amazon, Google and Apple whose enormous profits are partially attributed to their disproportionately lower tax contributions as a result of an outdated tax regime which therefore needs urgent reform.⁵ The sweeping recommendations for reform when probed further, reveal a disagreement on the steps that need to be taken, and the manner and direction in which the tax regime should be reformed.

We have identified three specific issues that need to be addressed in order to update tax laws for the digital economy, specifically in India. These three issues concerning taxation and the digital economy are: **first**, characterization of income derived from digital based economic activities; **second**, the anachronistic definition of Permanent Establishment ('PE') and **third**, the methods to be taken to attribute profit to PE. We briefly elaborate all these issues below with a view to describe the scope and nature of the problem faced by the extant tax law regime, particularly in India.

¹The Report do not endorse ring fencing the digital economy, that is that the digital economy should be treated separately from rest of the economy and businesses. But, certain peculiar features of digital world require that the tax governance addresses them specifically. The idea is that core principles of taxation law - fairness, certainty, etc. should be reflected in applying tax rules to digital businesses.

²Over 100 countries agree to seek digital tax consensus by 2020: OECD', (Fashion Network, March 19, 2018) available at <<https://uk.fashionnetwork.com/news/Over-100-countries-agree-to-seek-digital-tax-consensus-by-2020-OECD,959356.html#.XF0sqlUzaM8>> accessed 2nd January 2019.

³Schon Wolfgang, 'Ten Questions About How and Why to Tax the Digitalized Economy', (2017) Working Paper of the Max Planck Institute of Tax Law and Public Finance No. 2017-11, available at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3091496> accessed 27th November 2018.

⁴For more reference, See Annexure I and Annexure II of the Report that describes different business models that plan their businesses in a way to avoid tax.

⁵Italy initiated a probe against Amazon for tax evasion; Denmark took Microsoft to court for purchasing a Danish Company but avoiding payment of tax. For more information; Tax Challenges in the Digital Economy, Directorate General for Internal Policies, Policy Department A: Economic and Scientific Policy available at <[http://www.europarl.europa.eu/RegData/etudes/STUD/2016/579002/IPOL_STU\(2016\)579002_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/STUD/2016/579002/IPOL_STU(2016)579002_EN.pdf)>; Amazon has not been subject to corporate tax as they operate through fulfilment centres (warehouses) which falls under the exclusions of the definition of Permanent Establishment and thus not paying tax in Japan. For more information; Shigeki Morinobu, Cracking Down on Digital Tax Avoidance available at <http://www.japantax.jp/iken/file/20180201_4.pdf>; Hansrudi Lenz, Aggressive Tax Avoidance by managers of multinational companies as a violation of their moral duty to obey the law: A Kantian rationale, Working Paper (May 2018) available at <<https://app.oxfordabstracts.com/events/163/submissions/25328/question/.../download>>

I.1 Characterization of Income

Characterization of income has always been an important and contentious aspect in taxation of income, especially when there are different tax rates applicable on different kind of incomes. The three broad categories of income enlisted under Section 9 of the Income Tax Act 1961, that are applicable on non-residents and are deemed to accrue or arise in India are business income,⁶ royalty⁷ and fee for technical services.⁸ The issue of characterization of income relates to the head under which the income earned through the sale of goods or services ought to be classified. Depending on which head the income is classified, tax consequences differ. If income is characterized as royalty or fees for technical services, then it is taxed at the rate of 10%, even if a non-resident does not have a PE or “business connection” in India. However, if income is characterized as business income, the income is taxed at the rate of 40% only if the non-resident has a PE in India. Thus, there are considerable differences in the tax treatment of an income depending on how it is characterized.

The digital economy poses challenges to the task of characterization of income generated by its business models. For instance, it is unclear whether commissions earned by websites who work on a marketplace e-commerce model are in the nature of business income or fees for technical services. The Mumbai Bench of the Income Tax Appellate Tribunal, in case of *Ebay International AG*,⁹ held that user fee charged by Ebay is not fees for the provision of managerial services as Ebay merely allows buyer and sellers to interact with each other, without playing any role in completing

successful sales. However, revenue authorities in the same case have argued that such commissions should be treated as fee for technical services since services provided by the website operator are managerial in nature, as it is a platform where users can manage their orders.

Another difficulty with respect to characterization of digital economy is whether income generated through subscription fee is treated as business income or royalty. Indian judicial authorities have taken contradictory views on the taxability of such entities. In the case of *In Re: Dun and Bradstreet Espana, S.A.*,¹⁰ the AAR concluded that giving right to access to reports compiled using information available publicly does not result in royalty payment even though such services were accessible to subscribers only on payment of subscription fees. However, the Karnataka High Court in the case of *CIT v. Wipro Limited*,¹¹ held that payment received by way of granting a right to access the database amounts to a transfer of the right to use the copyright held by him and hence, taxable as royalty income. Further payment made, is for the license to use the database and hence, shall be treated as royalty and not business income. In the case of *In Re Cargo Community*,¹² Authority for Advance Rulings held that the payment made by Indian subscribers to the Cargo Community Network for providing a right to access and use the portal hosted from Singapore amounts to royalty. Thus, various judicial authorities seem to have contradictory views on the nature of payment made to access data, with some treating it as business income while other treating it as payment for license to use database and hence, characterizing it as royalty.

⁶Income Tax Act, 1961, Section 9 (1) (i).

⁷Income Tax Act, 1961, Explanation 2 in Section 9(1)(vi). Further, *Royalty is the sum payable for right to use someone else's property/asset for the purpose of gain as given in CIT v. Ahmedabad Manufacturing and Calico Printing Co.*, [1983] 139 ITR 806 (Guj).

⁸Income Tax Act, 1961, Explanation 2 in Section 9(1)(vii).

⁹*Ebay International AG v. Deputy Director of Income Tax (IT), Range-3(2)*, [2014] 61 SOT 62 (Mum).

¹⁰*In Re: Dun and Bradstreet Espana, S.A.*, (2005) 193 CTR (AAR) 9.

¹¹*CIT v. Wipro Limited*, [2013] 355 ITR 284 (KAR).

¹²*In Re Cargo Community*, (2007) 208 CTR (AAR) 184.

I.2 Establishment of Permanent Establishment in India

If it is established that the income generated by a non-resident is business income, the next step is to identify whether there exists a PE or a business connection in India for such income to be taxable in India. The concept of a PE is particularly problematic due to certain peculiar features of the digital economy.

First, several business models in the digital economy rely on intangible assets such as patents, algorithms, and economies of scale (particularly network effects) that allow firms operating in the digital economy considerable leeway in choosing the location of their central functions. Invariably firms choose jurisdictions which are neither where the parent company is resident nor where its consumers reside.¹³ The jurisdiction invariably tends to be the one that levies low or negligible taxes on the company. These online business model structures have been elaborated more with instances in [Annexure I](#) of the Report. For instance, in the case of [Uber India Services Ltd.](#),¹⁴ Uber India while questioning its tax liability argued that it only provides support services and acts as a collection and remittance agent and disburses payment as per the instructions from Uber B.V. which is a company incorporated in Netherlands - a jurisdiction that offers tax advantages for newly incorporated companies within it.¹⁵

Second, the digital economy makes it easier to offer goods and services to customers across the world without the necessity of setting up a physical presence

in the relevant market jurisdiction. These online business model structures have been elaborated more with instances in [Annexure II](#) of the Report. For instance, subscription-based websites like Netflix, Amazon Prime, Bumble, Westlaw, et al. which generate huge revenue through paid subscriptions do not necessarily need an office in India, to serve Indian customers.¹⁶ These websites generally operate through a server located outside India without establishing any real physical presence within the country and hence, fall outside the purview of tax laws which have limited extraterritorial reach.

I.3 Attribution of Profit to Permanent Establishment

If it is shown that the PE of a non-resident has been established in India, the next issue that needs to be addressed is the issue of attributing profit earned by non-resident to such PE. Article 7 of the Organisation for Economic Co-Operation and Development ('OECD') Model Convention provides for the basis for attribution of profits. Article 7 hypothesizes PE as a separate entity ascertaining risks, attributing assets, identifying functions and then comparing transactions of PE to transactions by unrelated parties and thus arriving at arms-length price for such transactions.¹⁷ In e-commerce transactions, the major issue that arises with respect to attribution of profit is that, if a server is considered as a PE, there may not be any personnel on ground to perform functions and hence it may be difficult to calculate functions performed and risk assumed by such server.¹⁸ Thus, alternate options have to be considered to attribute profits to digital PE.

¹³Allison Christians, 'How Starbucks Lost its Social License - And Paid 20 Million Pounds to Get it Back', (August 12, 2013) Tax Notes International, Vol. 71, No. 7, 2013, available at <<https://ssrn.com/abstract=2308921>> accessed 24th November 2018.

¹⁴*Uber India Services Limited v. JCIT*, SA NOS. 436 & 437/MUM/2018 (September 28, 2018) (Unreported).

¹⁵Jack Ewing, 'The Netherlands, A Tax Avoidance Centre Tries to Mend its Ways,' (The New York Times, September 20, 2018), available at <<https://www.nytimes.com/2018/09/20/business/netherlands-tax-avoidance.html>> accessed 12th December 2018.

¹⁶However, typically most of companies operating in the digital economy open an office that has skeletal staff and has some basic semblance of an office. This is true for Facebook, Netflix and companies like Amazon that have established offices in India even though it was arguably not necessary to do so.

¹⁷Radhakishan Rawal, *The Taxation of PEs: An International Perspective*, (2nd edn, Spirasmas Press Ltd, 2006).

¹⁸Lina Spinoso & Vikram Chand, 'A Long-Term Solution for Taxing Digital Business Models: Should the Permanent Establishment Definition be Modified to Resolve the Issue or Should the Focus be on a Shared Taxing Rights Mechanism?' (2018) 46 *Intertax*, 6/7, 476-494.

As per Rule 10 of the Income Tax Rules, 1962, a profit rate can be applied to India specific turnover of the foreign company for ascertaining profits attributable to operations carried out in India. Further, the Supreme Court in the case of *DIT v. Morgan Stanley & Co.*¹⁹ has clearly held that attribution of profit will be based on the principles of transfer pricing. However, there have been several decisions in India where courts have attributed profits to PE in an *ad hoc* manner.²⁰

Keeping the above issues in mind, we have divided this report into four parts. The first part of the report explains the three specific basic issues that need to be addressed while making laws to tax digital economy. The second part of the report analyses issues framed by international organisations and the role they have played in setting up the agenda to tax digital economy. The third part analyses various unilateral measures taken by foreign jurisdictions as well as India to tax such transactions. The final part concludes by making recommendations and suggesting a way forward. It is important to note that the report is India-centric, and the discussion of work undertaken by international organisations and unilateral measures taken by different countries is solely for the purpose of providing a context of what is happening across the world.

The report is supplemented by two annexures. Annexure I contains examples of online business models that result in tax avoidance. Annexure II contains examples of online business models that do not require physical presence and hence evade tax.



...

¹⁹ *DIT v. Morgan Stanley & Co.* (2007) 292 ITR 416 (SC).

²⁰ For instance, *Chand Mills Ltd v CIT* (1976) 103 ITR 548 (SC) - (15 % of profits), *Rolls Royce Plc v DDIT* (2008) 113 TTJ (Delhi) 446- (35% of Global Profits), *Motorola Inc v DCIT* (2005) 95 ITD 269 (Delhi) (SB) - (20% of Global Profits), *Galileo International Inc v DCIT* (2009) 116 ITD 1 (Delhi) - (15% of Revenue).

II. SETTING THE AGENDA - OVERVIEW OF THE OECD, UN AND EU INITIATIVES

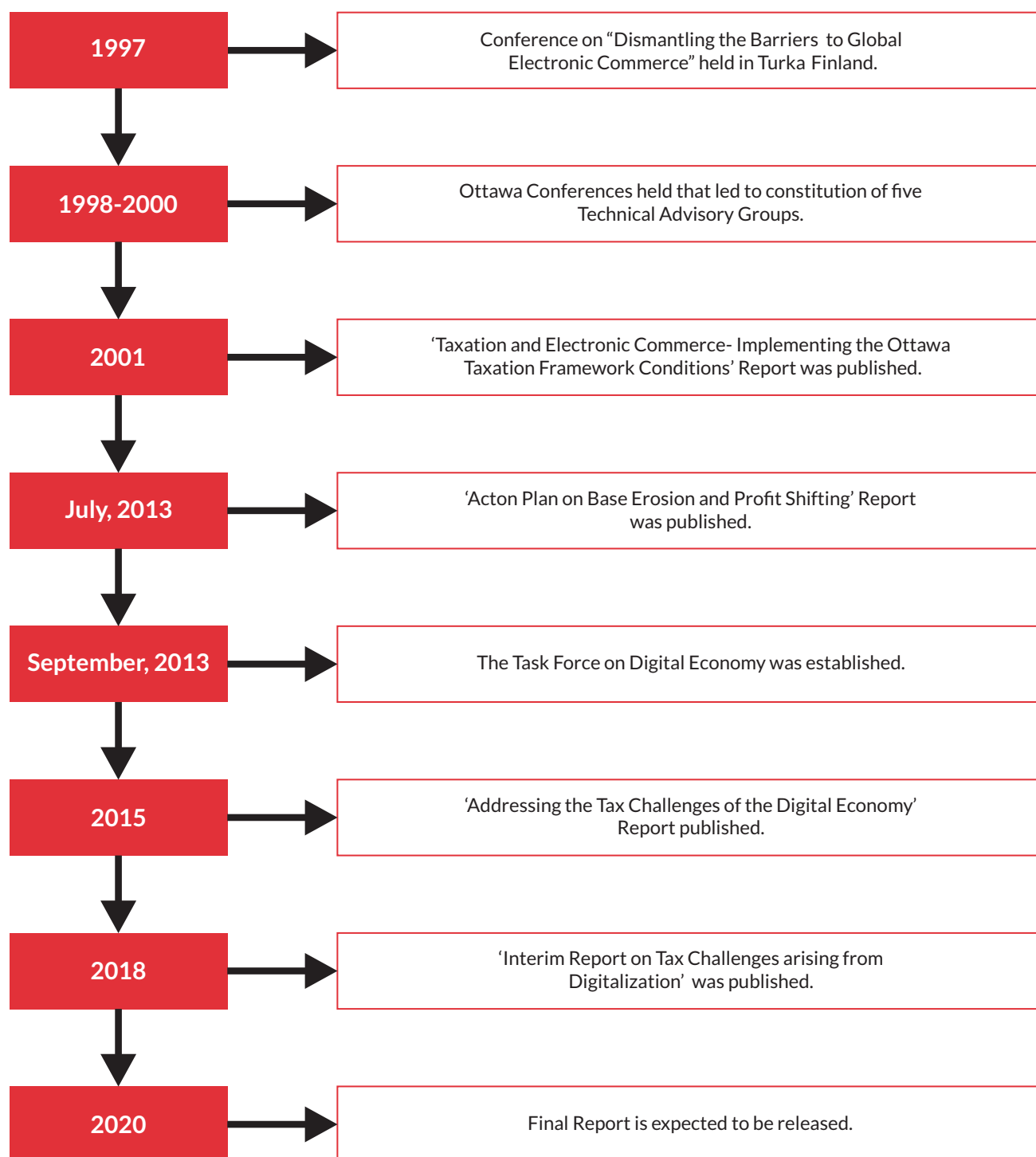
At the international level, it was the OECD which took initiative for re-evaluating the interface of tax regime with the digital economy. Since 1995, it has consistently set the agenda through its reports, discussions, conferences and acting as a de facto international tax organisation. The efforts of other international organisations such as the United Nations ('UN') and the European Commission ('EU') have essentially dovetailed the OECD's efforts with minor differences. For example, the UN has tried to distinguish its efforts by underlining the concerns of developing states claiming that the OECD is a self-

interested club of developed states. EU, on the other hand, has taken some of the issues highlighted by the OECD and tried to address them amongst its own union members to protect their tax base and alleviate concerns of revenue slippage from the increasing digitization of the economy.

This section of the report will be discussing the issues for taxation of digital economy as framed by each of these organizations, their role in setting the agenda and their prescriptions for the way forward.



II.1 Work of OECD on Taxing Digital Economy



Flow Chart 1. Work of OECD on Taxing Digital Economy

A. OECD's Efforts on Digital Taxation: 1997-2013

Electronic commerce and policy issues were a topic of discussion in many international meetings including G7 Ministerial Conference on Information Society held in Brussels, Belgium, in February 1995 as well as the Ministerial Conference on Global Information Networks held in Bonn, Germany, in July 1997.²¹

OECD initiated its work in the area of taxation of electronic commerce in November 1997 by organizing an international conference titled 'Dismantling the Barriers to Global Electronic Commerce' in Turku, Finland. Prior to this conference, the Committee of Fiscal Affairs organized an informal round table discussion between businessmen and governments to identify challenges posed by digital economy to tax systems, who then formulated taxation framework conditions.²² The challenges so identified, were taken further by OECD Ministers at the Ottawa Conference held in October 1998. The broad taxation principles for electronic commerce which were set out in the Ottawa conference were - **neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility.**²³ The Committee of Fiscal Affairs, in what was OECD's first report on digital taxation, concluded that such international taxation principles should maintain the fiscal sovereignty of a country to achieve fair sharing of tax base and should avoid

double taxation as well as unintentional non taxation.²⁴

The 1998 Conference was followed by another Ottawa Conference in 2000 which led to the constitution of five Technical Advisory Groups ('TAG') comprising of governments as well as business participants. TAGs were created to work on specific issues like characterization of income, rules for taxing business profit in digital economy, consumption taxes, technological inputs and professional data assessment.²⁵ In 2001, the Committee on Fiscal Affairs published a report titled 'Taxation and Electronic Commerce-Implementing the Ottawa Taxation Framework Conditions' that summarized the progress on issues of direct taxes, consumption taxes, tax administration and further identified future work that is to be done.²⁶

The Treaty Characterization TAG discussed the characterization of different types of e-commerce transactions under the tax treaties and provided comments on the difference between the concept of business profits as well as royalty.²⁷ The group concluded that there can be various e-commerce transactions where consideration of payment would have different elements and that the predominant character of the consideration must be accounted for before characterizing an income.²⁸

²¹OECD, 'Dismantling the barriers to global electronic commerce' (16 October 1997) available at

<<http://www.oecd.org/sti/ieconomy/dismantlingthebarrierstoglobalelectroniccommerce.htm>> accessed 23rd December 2018.

²²OECD, 'Electronic Commerce: Taxation Framework Conditions', Report by the Committee on Fiscal Affairs, as presented to Ministers at the OECD Ministerial Conference, "A Borderless World: Realising the Potential of Electronic Commerce" (8 October 1998) available at <<https://www.oecd.org/ctp/consumption/1923256.pdf>> accessed 23rd October 2018.

²³Ibid.

²⁴Ibid [6].

²⁵The five Technical Advisory Groups created were: Treaty Characterisation TAG, Business Profits TAG, Consumption Tax TAG, Technology TAG and Professional Data Assessment TAG. For reference, An Overview of Progress since Ottawa 1998 Conference, 2001, 13 available at <<https://www.oecd.org/tax/consumption/Taxation%20and%20eCommerce%202001.pdf>> accessed 24th October 2018.

²⁶OECD, 'Taxation and Electronic Commerce: Implementing the Ottawa Taxation Framework Conditions,' (2001) available at <<https://www.oecd.org/tax/consumption/Taxation%20and%20eCommerce%202001.pdf>> accessed 27th October 2018.

²⁷Ibid 214[5.5].

²⁸Ibid 216.

The Business Profit TAG considered the issue of applicability of existing treaty rules for taxing business profits arising from electronic commerce transactions and published its final report titled '*Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce?*' in 2005. It emphasized on the concept of PE, attribution of profit, transfer pricing as well as the place of effective management.²⁹ It explored plausible alternatives to the current treaty rules that allocate profits between the source country and the residence country.³⁰ The final report submitted by TAG listed various alternatives, but it did not recommend any one single alternative. It concluded that the viability of any of the options shall be subject of further research. The options suggested by it were:

- Modify PE's definition to exclude from its scope, activities that do not involve human intervention. It was concluded that it is unlikely to be adopted and shall not be considered.³¹
- Modify PE's definition to provide that a server cannot itself constitute a PE. Further, while applying the exception of preparatory and auxiliary activities from the concept of PE, the functions that are attributable to software should be excluded. However, TAG concluded that this needs further study to determine its practical difficulties and concerns.³²
- Eliminate all exceptions in Article 5 paragraph 4. However, it was concluded that such an option should not be pursued.³³ They also considered the option of eliminating exceptions for the storage, display or the delivery in Article 5 paragraph 4, as

well as subjecting existing exceptions with an overall condition of it being preparatory or auxiliary in nature. It was concluded by TAG that these options need to be monitored and require further study.³⁴

- Add force of attraction rule for e-commerce. However, it was not considered as an option worth pursuing.³⁵
- Adopt supplementary nexus rules in order to tax profits arising from provision of services and TAG concluded that this may require further studies.³⁶

TAG in its final report also considered fundamental modifications that are required to be made in the existing rules and gave four alternatives to it:

- Adopt rules to allow for source taxation of payments that relates to some form of e-commerce transactions (withholding tax). However, this may be practical only with regard to business-to-business ('B2B') e-commerce transactions and not ones between business-to-customers ('B2C').³⁷
- Adopt a new nexus rule which is supplementary to the rule of traditional PE, wherein, a country of consumption would be given a right to levy withholding tax on payments from its territory to a non-resident vendor. A non-resident vendor can file a tax return in consumption country as if income were attributable to a PE, situated in consumption country in lieu of suffering withholding tax. This option was also criticized for being practically relevant only for B2B e-commerce transactions but not for those between B2C.³⁸

²⁹OECD, 'Are Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce, Final Report,' available at <<http://www.oecd.org/ctp/treaties/35869032.pdf>> accessed 24th October, 2018.

³⁰*Ibid.*

³¹*Ibid* 30-32.

³²*Ibid* 33-38.

³³*Ibid* 38-41.

³⁴*Ibid* 38-44.

³⁵*Ibid* 44-47.

³⁶*Ibid* 47-50.

³⁷*Ibid* 51-53.

³⁸*Ibid* 54-58.

- Replacing separate entity accounting with formulary apportionment of profits of a common group.³⁹
- Incorporating a new nexus of electronic PE which can be done by extending the definition to virtual PE or to cover virtual agencies or cover on site business presence.⁴⁰

Further, Article 7 of the Double Taxation Avoidance Agreement provides that if the enterprise carries on a business through a PE, then business profits of such an enterprise would be taxed only as much as it is attributable to the PE.⁴¹ There has been a considerable amount of time spent by the Committee of Fiscal Affairs to ensure a consistent interpretation of the rules of Article 7. Minor changes to the wording of Article 7 as well as commentaries were made when the 1977 Model Tax Convention was adopted. However, the uncertainties surrounding the interpretation of the Article continued.⁴² Thus, the Committee acknowledged the need to provide for more certainty to taxpayers.

As a result, a report titled “*Attribution of Profits to PE*” was published in 2008, that focused on formulating an approach to attributing profits to a PE under Article 7 taking into consideration the modern-day multinational operations and trade.⁴³ The OECD recognized the need to make amendments to the commentary of Article 7 and harmonize the guidance

issued in the 2008 Report with the interpretation of Article 7, as contained in the Commentary.⁴⁴ This work was further taken over by OECD and a final report on the attribution of profits to Permanent Established was published in 2010.⁴⁵ The Report provided that the head office and the PE must be treated as two separate functional entities and presented a two-step analysis to arrive at a profit allocation between these two entities.⁴⁶

B. OECD's Efforts on Digital Taxation: 2013-Present

Multinational companies all around the world have had complicated tax structures that have highlighted a number of tax avoiding issues. For instance, Starbucks in 2012 had sales of approximately £400m in UK, but paid no corporation tax to UK, as they transferred some money to their Dutch sister company as royalty payment in furtherance of paying high interest rates to borrow from other parts of the business.⁴⁷ Another example is that of Amazon who reported a tax expense of £1.8m, while having sales of £3.35bn in UK in 2011 by reporting sales through a Luxembourg based unit. Similarly, Google paid £6m in tax, while having sales of £395m in 2011, by channeling its income via Ireland and Bermuda.⁴⁸ The French government demanded €1bn from Google, and also highlighted the issue of how the internet giant was avoiding tax in France and was of the view that it must not be acceptable and efforts must be made to harmonize the tax structure.⁴⁹ Further, the US Senate Panel also alleged that Apple is

³⁹*Ibid* 59-65.

⁴⁰*Ibid* 65-71.

⁴¹Articles of the Model Convention with Respect to Taxes on Income and Capital (January 28, 2003), Article 7.

⁴²OECD, 'Report on the Attribution of Profits to Permanent Establishment' (July 22, 2010) available at <<http://www.oecd.org/tax/transfer-pricing/45689524.pdf>> accessed 26th September 2018.

⁴³*Ibid* 8 [4].

⁴⁴EY, 'Allocating Profits to Permanent Establishment' available at <<https://taxinsights.ey.com/archive/archive-articles/allocating-profits-permanent-establishments.aspx>> accessed 29th October 2018.

⁴⁵OECD 2010 Report on the Attribution of Profits (n. 42).

⁴⁶OECD 2010 Report on the Attribution of Profits (n. 42).

⁴⁷Vanessa Barford & Gerry Holt, 'Google, Amazon, Starbucks: The rise of 'tax shaming'', (BBC News Magazine, May 21, 2013) available at <<https://www.bbc.com/news/magazine-20560359>> accessed 30th October 2018.

⁴⁸*Ibid*.

⁴⁹France will not tolerate tax avoidance, says Francois Hollande', (The Telegraph, 6 April, 2013) available at <<https://www.telegraph.co.uk/finance/personalfinance/tax/10622933/France-will-not-tolerate-tax-avoidance-says-Francois-Hollande.html>> accessed 3rd November 2018.

using complex web offshore entities to avoid taxes.⁵⁰ The corporate tax planning of such companies were brought into spotlight that initiated global debate about how multinational companies organize their tax affairs.

The OECD in July 2013 published a report titled '*Action Plan on Base Erosion and Profit Shifting*'. The Action Plan identified 15 actions for addressing the Base Erosion and Profit Shifting ('**BEPS**'), one of which was to examine how enterprises of digital economy are making profits and how can they be taxed under the current rules to prevent BEPS.⁵¹ G20 leaders in a meeting held on 5-6 September 2013 at St. Petersburg, endorsed the BEPS Action Plan and encouraged countries to participate in it. Pursuant to the BEPS Action Plan, the Task Force on Digital Economy ('**TFDE**') was established in September 2013. It was entrusted with the work of developing a report that identified issues and provided for possible actions to tax digital economy.⁵² TFDE analysed post Ottawa framework, work of TAG on Business Profits, invited public comments and inputs as well as heard presentations from delegates and finally came out with a report in 2015 titled '*Addressing the Tax Challenges of the Digital Economy*' which is also termed as Action Plan 1 Report.

The Action Plan 1 Report identified various measures that can be taken to address BEPS issues, which includes measures developed in course of work on Action 2 (neutralize the effect of hybrid mismatch arrangements), Action 4 (limit base erosion via interest deduction and other financial payments), Action 5

(counter harmful tax practices more effectively) as well as Action 8-10 (assure transfer pricing outcomes are in line with value creation).⁵³ The report also identified three main policy challenges that can be raised by digital economy which are:

1. Nexus and the ability to have significant presence without it being liable to tax: The definition of PE requires substantial physical presence in the country or requires an enterprise to carry out business via a dependent agent. With advancement of digital technology, some of the activities that were previously carried out by local personnel, can now be performed by automated equipments and leading to a situation where, the entities arguably have no PE in the source country. Another issue is that activities that may be considered as preparatory or auxiliary for traditional businesses may be significant components of businesses in the digital economy.⁵⁴

2. Data as well as attribution of value created by use of digital products and services: Companies collect data by being proactive and requesting users to provide data or by being reactive with the information provided largely that is in control of the users like social networking and cloud computing. Such data can be monetised by allowing enterprises to tailor offerings, improve development of products or services as well as aid in decision making. Such value of data is not reflected in the balance sheet and thus is irrelevant for determining profits. However, an outright sale of such data that is monetised can be reflected and hence taxed. Tracing the source of the data is also challenging.⁵⁵

⁵⁰ 'Apple used subsidiaries to dodge billions in taxes: US Panel', (The Indian Express, May 21, 2013) available at <<http://archive.indianexpress.com/news/apple-used-subsidiaries-to-dodge-billions-in-taxes-us-panel/1118600/>> accessed 5th November 2018.

⁵¹ OECD, 'Action Plan on Base Erosion and Profit Shifting', (2013), 14 available at <<https://www.oecd.org/ctp/BEPSActionPlan.pdf>> accessed 5th November 2018.

⁵² OECD, 'Addressing Tax Challenges in Digital Economy, OECD Action Plan 1: 2015', (2015) 17 available at <https://read.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en#page1> accessed 6th November 2018.

⁵³ *Ibid* 89 [6.2.2].

⁵⁴ *Ibid* 100-102 [253-261].

⁵⁵ *Ibid* 102-104 [262-267].

3. Characterization of Income derived from new business models: As per most tax treaties, business profits are taxable only in a country where PE is located. However, royalties and fees for technical services may be subject to withholding tax and do not require presence of PE. Thus, characterization of a transaction as business profits or as any other type of income is important as it results in different tax treatment. Therefore, there is a need to clarify application of existing rules to new emerging business models.⁵⁶

TFDE in Action Plan 1 Report gave three alternatives to address taxation issues in the digital economy.

1. Develop a new nexus based on the concept of significant economic presence: TFDE identified three factors as described below based on which a significant economic presence ('SEP') concept can be developed.

- 1) Revenue based Factors: While establishing revenue-based factor, consideration must be given to what kind of transactions are covered, threshold level of revenue as well as administration of such threshold.
- 2) Digital Factors: Certain digital factors that can be taken into consideration for testing SEP are local domain name, local digital platform and local payment options.
- 3) User Based Factors: A certain range of factors based on users that reflects the level of participation are number of monthly active users, number of online contracts conclusion and volume of digital content collected through digital platform.⁵⁷

TFDE underlined the importance of determining rules

for attributing profit to SEP.

2. A withholding tax on digital economy: A withholding tax can be imposed as a standalone gross basis final withholding tax or alternatively, can be imposed as a primary collection mechanism. Both these mechanisms raise technical issues with respect to the scope of transactions covered as well as collection. In case of withholding tax payments, the scope of transaction has to be clearly specified in order to avoid unnecessary complexities.⁵⁸ For collection of withholding tax, liability often shifts from a non-resident enterprise to the local collecting agent. Thus, the local collecting agent must have access to all information and must be reasonably expected to comply with its obligations to withhold. In cases of B2B, the business resident of a source country can be expected to comply with withholding obligations. However, when it comes to B2C transactions, withholding by the customer will be really challenging as individual customer will have no experience or incentive to declare and pay tax that is due. Furthermore, standalone gross basis final withholding tax may not be a viable option as it may be regarded as a violation of trade obligations.⁵⁹

3. Introducing an equalization levy: Equalization levy can be structured in various ways depending on the ultimate policy objective of such levy. The scope of equalization levy can be limited to only those businesses that maintain SEP or it can only involve those transactions that are concluded through automated systems, or through a digital platform. Alternatively, it can also be levied on data as well as contributions, that non-resident enterprises gather from customers and users of source country. However, a levy that is applied only to non-resident, can raise

⁵⁶ Ibid 106 [271].

⁵⁷ Ibid 107-110 [7.6.1].

⁵⁸ Ibid 113 [293].

⁵⁹ Ibid 113-115 [7.6.3].

potential trade issues and hence, it is more viable to impose such levy on both domestic as well as foreign entities. However, such option must take into consideration the corporate income tax so that the same income is not subjected to both corporate income tax as well as equalization levy.⁶⁰

TFDE finally concluded that all the three alternatives need further study and analysis and a report reflecting such outcome of work relating to tax in digital economy is expected to be released by 2020.⁶¹ It also recommended that countries can unilaterally introduce any of these options provided they are consistent with their existing treaty obligations.⁶²

Based on Action 1 Report, the OECD published an interim report in May 2018 titled "*Interim Report on Tax Challenges arising from digitalisation*". This interim report reflected the work carried on by TFDE, post the 2015 Action 1 Report and included latest developments in taxing digital economy.⁶³ The interim report shows that more than 110 members representing diverse economies were of the common view that unilateral approaches by each country will have adverse impact on growth and will increase the risk of double taxation. Thus, it is necessary to maintain coherent set of international tax rules.⁶⁴ The final report is expected to be released by 2020.



⁶⁰ Ibid 115-117[7.6.4].

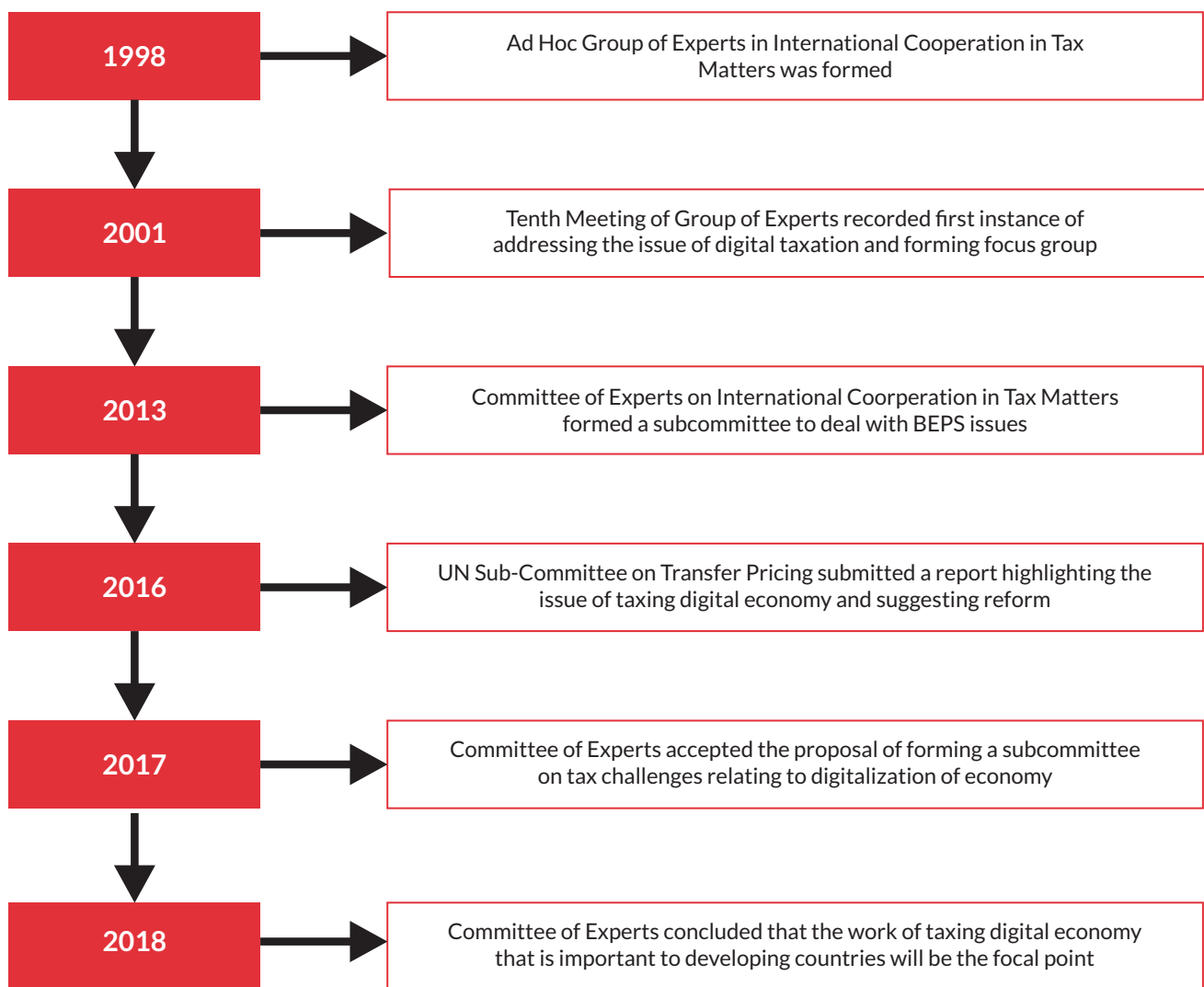
⁶¹ Ibid 138[361].

⁶² Ibid 137[357].

⁶³ OECD, 'Interim Report on Tax Challenges arising from Digitalisation,' (May 2018), 20 [25] available at <https://read.oecd-ilibrary.org/taxation/tax-challenges-arising-from-digitalisation-interim-report_9789264293083-en#page21> accessed 15th November 2018.

⁶⁴ Ibid 212[511].

II.2 Work of UN on Taxing Digital Economy



Flow Chart 2. Work of UN on Taxing Digital Economy

The initial detailed commentary on taxing e-commerce came up in a consultation document which was jointly prepared by Australia, Canada and United States in 1996 and thereafter many other countries as well as OECD and European Commission have submitted commentaries on taxing e-commerce.⁶⁵

The Ad Hoc Group of Experts on International Cooperation in Tax Matters was a group constituted by Economic and Social Council ('ECOSOC') vide a resolution 1980/13 of 28th April 1980 and were empowered to examine international taxation issues like transfer pricing, treaty shopping and treaty abuses, interaction of tax, trade and investment, financial taxation as well as taxation of e-commerce.⁶⁶ An observer in the seventh session of the Ad Hoc Experts on International Cooperation in Tax Matters group meeting in 1998 noted that the problem of tax haven would be becoming more worse with the advent of internet commerce and e-banking as funds can now easily be moved into such tax haven countries.⁶⁷ the focus here was more on the problem of tax evasion rather than the inadequacy of tax rules vis-a-vis electronic commerce.

The Tenth Meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters in 2001 is the first recorded instance when UN addressed the issue of digital taxation. While dealing with the issue of taxation of electronic commerce observed that the direct taxation of electronic commerce is

fundamentally more problematic than indirect taxation of electronic commerce. This was for two reasons: absence of international consensus as to what constitutes as PE in digital economy and disagreements on characterization of the transactions.⁶⁸ In light of the importance to tax e-commerce transactions, the Group of Experts in 2001 formed a focus group particularly to examine taxation of electronic commerce.

The focus group suggested that taxation of e-commerce needs co-operation among states and three issues need examination. **Firstly**, the concept of PE needs to be changed as per the evolving economic environment; **secondly**, impact of electronic commerce on traditional way of taxing in order to determine source of income and; **thirdly**, the practical ways for developing countries to respond to risk of loss of tax revenue from electronic commerce.⁶⁹

The Ad Hoc Group of Experts was renamed as Committee of Experts on International Cooperation in Tax Matters ('**The Committee**') vide a resolution 2004/69 of 11th November 2004. Committee of Experts on International Cooperation in Tax Matters in its second session in 2006⁷⁰ as well as seventh session in 2011⁷¹ took into account the issue relating to taxation of digital transactions however it was left for further consideration. It was never considered a priority issue till 2011 for the committee and was not pursued further.

⁶⁵ United Nations, 'Tax Consideration for electronic-commerce companies', Ad Hoc Group of Experts on International Cooperation in Tax Matters: Tenth Meeting, ST/SG/AC.8/2001/L.3 (Geneva, 10-14 October 2001) available at <<http://unpan1.un.org/intradoc/groups/public/documents/un/unpan001660.pdf>> accessed 15th December 2018.

⁶⁶ United Nations, 'Committee of Experts on International Cooperation in Tax Matters' available at <<http://www.un.org/esa/ffd/tax/overview.htm>> accessed 15th December 2018.

⁶⁷ United Nations, Report of Ad Hoc Group of Experts on International Cooperation in Tax Matters: Eighth Meeting, (Department of Economic and Social Affairs) ST/ESA/258 (New York, 1998) 4 [18] available at <https://digitallibrary.un.org/record/259800/files/ST_ESA_258-EN.pdf> accessed 16th December 2018.

⁶⁸ United Nations, Report of the Secretary General in Tenth Meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters, (United Nations Economic and Social Council), (17 January 2002) 7 [29] available at <http://digitallibrary.un.org/record/459657/files/E_2002_6-EN.pdf> accessed 10th December 2018.

⁶⁹ *Ibid* 11 [47].

⁷⁰ Committee of Experts on International Cooperation in Tax Matters, E/2006/45-E/C.18/2006/10, Report of the Second Session (30 October- 3 November 2006) 7 [26] available at <[http://www.un.org/ga/search/view_doc.asp?symbol=E/C.18/2006/10\(SUPP\)&Lang=E](http://www.un.org/ga/search/view_doc.asp?symbol=E/C.18/2006/10(SUPP)&Lang=E)> accessed 4th December 2018.

⁷¹ Committee of Experts on International Cooperation in Tax Matters, E/2011/45-E/C.18/2011/6, Report of the Seventh Session (24-28 October 2011) 23 [117] available at <http://www.un.org/ga/search/view_doc.asp?symbol=E/2011/45&Lang=E> accessed 8th December 2018.

OECD in 2013 released a report identifying specific BEPS issues and asked for a prominent role from the United Nations in providing its perspective. In response to it, UN in its ninth session in October 2013 formed a subcommittee to deal with BEPS issues for the developing countries and one of the major issues posed before it was protecting the tax base in the digital economy.⁷² The subcommittee analysed that due to the advent of digital economy, the tax base of developing countries is at risk. They cited three reasons for it: **firstly**, the income is not captured of some of the enterprises because of no physical presence; **secondly**, new business models provide a scope of businessmen to circumvent existing rules and **thirdly**, tax base cannot be administered effectively because of lack of enforcement mechanism.⁷³ Furthermore, Mr. Liao, Director of Tax Treaty, Department of International Taxation, State Administration of tax and Vice Chair of the Committee of while presenting the alternatives to address deficiencies of current rules for taxation of services particularly relating to the development of e-commerce suggested that there is a need for a revision of United Nations Model Convention with special focus to digital economy.⁷⁴

UN in its handbook in 2015 made a remark that it makes no sense to ringfence the digital economy as it violates tax neutrality principle and recommended that profits must be taxed where real economic activities took place and value is created.⁷⁵

The Committee established its first subcommittee on transfer pricing in 2009 which submitted its report in 2016. One of the issues raised by some members of the subcommittee in the report was that with the advent of digital economy, it is essential to amend key existing concepts like PE and introduce new concepts like equalization levy, virtual PE. Moreover, the subcommittee concluded that the rise of digital economy has made transfer pricing aspect more complex as intangibles are easy to transfer but difficult to value.⁷⁶

The report of the fifteenth session of Committee of Experts on International Cooperation in Tax Matters was published in 2017 that introduced the issue of taxation of digital economy. The first two presentations were made by Marc M. Levey and Styliani Ntoulaki highlighting challenges faced in the digitalized economy.⁷⁷ They also highlighted the issue of inconsistent treatment between online retailers and brick and mortar retail model. In their paper titled "*Tax Challenges in the Digitalized Economy*" as submitted to the Committee, they have concluded that it is necessary to have an elaborate policy with regard to taxing digital economy and there is a need of closer cooperation and representations among countries to have diverse ideas or opinions. However, the presentation addressed the issue of digital economy in an abstract term and lacked the discussion on what elaborate policy would be. They recommended to form subcommittee to examine all relevant issues and work on proposal to enhance international policy making on digital economy.⁷⁸ The Committee accepted the

⁷² United Nations, 'United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries' (New York, 2015) available at <<http://www.un.org/esa/ffd/wp-content/uploads/2015/07/handbook-tb.pdf>> accessed 25th December 2018.

⁷³ *Ibid* 434 [3.5].

⁷⁴ Committee of Experts on International Cooperation in Tax Matters, E/2013/45-E/C.18/2013/6, Report of the Ninth Session (21-25 October 2013) 17 [54] available at <http://www.un.org/ga/search/view_doc.asp?symbol=E/2013/45&Lang=E> accessed at 12th December 2018.

⁷⁵ United Nations Handbook on Selected Issues (n. 71) 438-439 [4.2].

⁷⁶ Committee of Experts on International Cooperation in Tax Matters, 'Coordinator's Report on Work of the Subcommittee on Transfer Pricing,' Twelfth Session: E/C.18/2016/CRP.2, (11-14 October 2016) 34 [B.1.10.13] available at <http://www.un.org/esa/ffd/wp-content/uploads/2016/10/12STM_CRP2_TransferPricing.pdf> accessed 23rd December 2018.

⁷⁷ Committee of Experts on International Cooperation in Tax Matters, Economic and Social Council, Report on the Fifteenth Session (17-20 October 2017) 11 [21] available at <http://www.un.org/ga/search/view_doc.asp?symbol=E/2018/45> accessed 27th December 2018.

⁷⁸ Committee of Experts on International Cooperation in Tax Matters, 'Tax Challenges in the Digitalized Economy: Select Issues for Possible Committee Consideration,' Fifteenth Session: E/C.18/2017/CRP.22, (17-20 October 2017) 34 [82-85] available at <http://www.un.org/esa/ffd/wp-content/uploads/2017/10/15STM_CRP22_Digital-Economy.pdf> accessed 15th December 2018.

proposal of forming a subcommittee on tax challenges related to digitalization of the economy.

In the report submitted in May 2018 by the Committee of Experts on International Cooperation in Tax Matters on their Sixteenth Session, the issue of taxation in the digital economy was discussed. It was stated by the coordinators of the subcommittee formed in the fifteenth session that they have not yet started working on the issue of taxation of digital economy because of the recent developments on the issue particularly at OECD as well as European Union.⁷⁹ It was agreed in the sixteenth session that the work needs to mainly focus on developing countries.⁸⁰ One of the coordinator of the subcommittee gave a presentation on recent developments focusing primarily on OECD's reports as well the European Commission's reports that can be used to provide a long terms solution to tax such digital transactions.⁸¹ It was finally concluded that work on the issue of taxing digital economy that is important to developing countries will be taken forward and will be a provisional agenda for the seventeenth session of the Committee of Experts on International Cooperation in Tax Matters.⁸²



II.3 Work of EU on Taxing Digital Economy

Apart from the OECD, the European Commission ('EC') has been a platform for debate on taxation of digital economy for the past few years. In September 2017, the EC issued a Communication titled 'A Fair and Efficient Tax System in the European Union for the Digital Single Market'.⁸³ This was followed by several meetings and discussions in the later part of 2018 on how to respond to the challenges of taxation of profits of the digital economy.⁸⁴

The debate and discussion in EC eventually culminated in late March 2018 with the released two digital tax proposals; which will, in all likelihood be applicable and implemented from 2020.⁸⁵

The first proposal is an interim 3% digital services tax ('DST') on gross revenues (i.e. turnover) derived from activities in which users are deemed to play a major role in value creation. The tax will apply to the following activities:

- i. The placing advertising on a digital interface targeted at users of that interface;
- ii. Making available to users of a multi-sided digital interface which allows users to find other users and to interact with them, and which may also facilitate supplies of goods or services directly between users;

⁷⁹ UN Committee of Experts on International Cooperation in Tax Matters, 'Note on the discussion of the "Tax consequences of the digitalized economy- issues of relevance for developing countries' Sixteenth Session (14-17 May 2018) available at <http://www.un.org/esa/ffd/wp-content/uploads/2018/05/2018-ECOSOC-ICTM_Informal-summary_digital-economy.pdf> accessed 23rd December 2018.

⁸⁰ *Ibid* 7 [22].

⁸¹ *Ibid*.

⁸² *Ibid* 21 [70].

⁸³ European Commission, 'Communication from the Commission to the European Parliament and the Council' (Brussels, 21 September 2017) COM (2017) 547 final available at <https://ec.europa.eu/taxation_customs/sites/taxation/files/communication_taxation_digital_single_market_en.pdf> accessed 21 November 2018.

⁸⁴ European Council meeting Conclusions EUCO 14/17, (Brussels, 19 October 2017) CO EUR 17 CONCL 5 available at <<https://www.consilium.europa.eu/media/21620/19-euco-final-conclusions-en.pdf>> accessed 24th November 2018.

⁸⁵ EY Global Tax Alert, 'European Commission issues proposals for taxation of digitalized activity' (21 March 2018) available at <<https://www.ey.com/gl/en/services/tax/international-tax/alert--european-commission-issues-proposals-for-taxation-of-digitalized-activity>> accessed 25th November 2018.

iii. Transmission of data collected about users and generated from users' activities on digital interfaces.⁸⁶

Companies with total annual worldwide revenues of €750 million or more and that have annual EU taxable revenues of €50 million or more would be subject to the tax.⁸⁷ Certain types of companies — such as digital advertisers and platforms designed to allow users to connect with one another and trade in goods and services — would be within the scope of the tax as currently proposed, while others, such as online marketplaces without user-to-user selling, would be outside the scope.

The Commission's second, longer-term proposal is far broader, with more than 50 different digital activities potentially subject to tax. A "significant digital presence" ("SDP") concept would result in a new digital PE definition, intended to establish taxable nexus, along with revised profit allocation rules to determine how the taxes on digitally-derived profits are distributed among countries.⁸⁸

Under this proposal, a company would be considered to have a significant digital presence (and therefore a PE) if the entity meets any one of three criteria: i) it exceeds €7 million in annual revenues from digital services in an EU Member State; ii) it has more than 100,000 users who access its digital services in a Member State in a tax year; iii) it enters into more than 3,000 business contracts for digital services in a Member State in a tax year.

The proposals that have emerged from EC have some obvious flaws. The first, from an organizational perspective, is the fact that EC's proposals reflect a certain impatience with the slow but steady approach adopted by the OECD which despite years of research efforts on the issue has been unable to prescribe a single solution to the digital taxation conundrum. Second, EC's proposal presumes and may further create a divide between what is considered to be the digital economy and the 'real economy'. A special tax regime that is applicable only to digital companies is contrary to what many scholars and commentators suggest.⁸⁹ Ring-fencing the digital economy is not necessarily a good idea and may further complicate an already complicated international tax regime. Third, it is unclear how many of the EC member states are on board the tax proposals. If not, it will create significant implementation problems; if yes, it is likely to create two divergent tax approaches worldwide with EC member states on one side and other jurisdictions broadly classified on the other side. And, it may require significant revisions of tax treaties which in itself is likely to be a long-drawn process, though in our view it is a necessity if the challenge of digital taxation is to be effectively challenged. Given this, the ambitious target of implementing these tax proposals by 2020 seems like a daunting challenge.



⁸⁶ European Commission, 'Proposal for Council Directive – on the common system of a digital services tax on revenues resulting from the provision of certain digital services', (Brussels, 21 March 2018) COM(2018) 148 final available at <https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_common_system_digital_services_tax_21032018_en.pdf> accessed 18th December 2018.

⁸⁷ *Ibid*; Ruth Mason, Leopoldo Parada, 'Digital Battlefront in the Tax Wars', Research Paper No. 2018-16 Virginia Law and Economics, available at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3279639> accessed 23rd November 2018.

⁸⁸ EC, Proposal for Council Directive (n. 86).

⁸⁹ See Michael Lennard, 'Act of creation: the OECD/G20 test of "value creation" as a basis for taxing rights and its relevance to developing countries' UNCTAD Report Transnational Corporations (2018) Vol 25 Number 3, available at <https://unctad.org/en/PublicationChapters/diaeia2018d5a4_en.pdf> accessed 22 December 2018.

III. UNILATERAL MEASURES OF STATES

While a consensus eludes the international community on the appropriate manner of taxation of digital economy, certain states have gone ahead and implemented unilateral measures to address digital economy taxation. Most of the measures are welcome from a revenue point of view, administrable from a practical point of view but the jury is still out if they are the best measures to accommodate the competing claims of involved jurisdictions over what they believe is their fair share of revenue. The implementation of

unilateral measures by different countries make it clear that taxing digital economy has been considered on a wide and global basis and can raise potential issues of double taxation.

This section of the report briefly describes various unilateral measures taken by different countries post the recommendation made by OECD allowing countries to take such measures to address the problem of taxing digital economy.

Table 1.1. Unilateral measures taken by different countries

SR.NO.	COUNTRY	MEASURES	DESCRIPTION
1.	ITALY	<i>Web Tax</i>	Levied on amount of consideration paid in exchange of services carried out through electronic means. Limits the application of the tax to B2B transactions and recipient of service needs to withhold the tax.
		<i>Amended Definition of PE</i>	Introduce the concept of significant economic presence and limited the exceptions only to activities that are preparatory or auxiliary in nature
2.	UNITED KINGDOM	<i>Diverted Profit Tax</i>	Aim was to deter diversion of profits by avoiding making arrangements lacking economic substances.
		<i>Multinational Anti Avoidance Law</i>	Applicable when foreign entity being a 'significant global entity' makes an arrangement and supply goods or services and obtain tax benefits.
3.	AUSTRALIA	<i>Diverted Profit Tax</i>	Aim was to ensure that global entities reflect economic substance and prevent diverting profits by way of arrangements that involve related parties. Applicable to Australian entities who arranges a scheme for obtaining tax benefit.

4.	ISRAEL	<i>Amended Definition of PE</i>	Introduced economic activities in the definition of PE if conducted primarily through internet.
5.	HUNGARY	<i>Advertisement Tax</i>	Levied on media content providers having sales revenue from advertisement activities.
6.	INDIA	<i>Equalization Levy</i>	Levied on amount of consideration received by non-resident not having PE in India for providing specified services.
		<i>Amended Definition of Business Connection</i>	Introduced the concept of significant economic presence.

III.1 Unilateral Measures taken by Foreign Countries

A. Italy

Italy is one of the first few European Union Member states to formulate laws to tax digital transactions. In 2018, the Italian Government introduced two measures to combat the issues relating to taxing digital economy. The first one is the introduction of a new web tax and the second one is the amendment of the definition of PE in the Italian Tax Code.

1. Web tax

Italy under Budget Law 2018 introduced a new tax called as Web Tax,⁹⁰ to tax certain digital transactions which will be made applicable from 1st January 2019.⁹¹ This web tax is applicable at the rate of 3%⁹² on the value of the digital transaction that has following

features:

- There is a supply of service through electronic means i.e. internet or other networks whose nature if considered, makes performance automated with minimal or no human intervention.⁹³ Such services are to be identified and issued by a Decree of the Minister of Economy and Finance.⁹⁴
- It involves Italian residents or Italian PEs of non-residents.⁹⁵
- Total number of transactions for a specific taxpayer should be above 3000 units in a given calendar year.⁹⁶

The tax is applicable exclusively on B2B digital transactions and has to be collected by the purchaser while making payment for the consideration and has to pay it to government by 16th day of month following the payment for consideration.⁹⁷ However, if the

⁹⁰Law of 27/12/2017 n. 205, Article 1, para 1011.

⁹¹Law of 27/12/2017 n. 205, Article 1, para 1017.

⁹²Law of 27/12/2017 n. 205, Article 1, para 1013.

⁹³Law of 27/12/2017 n. 205, Article 1, para 1011 and para 1012.

⁹⁴Law of 27/12/2017 n. 205, Article 1, para 1012.

⁹⁵Law of 27/12/2017 n. 205, Article 1, para 1011.

⁹⁶Law of 27/12/2017 n. 205, Article 1, para 1013.

⁹⁷Law of 27/12/2017 n. 205, Article 1, para 1014.

service provider mentions in the invoice or other relevant document that it will not exceed 3000 transactions, then the purchaser can abstain from withholding tax.⁹⁸ For any issues relating to ascertainment, collection, sanction as well as litigation of web tax, the provisions of value added tax will be applied.⁹⁹

2. Definition of Permanent Establishment

Article 162 of the Consolidated Income Tax, that defines the concept of PE was amended by the Italian government under the Budget Law, 2018. After the amendment, PE also includes a significant and continuous economic presence.¹⁰⁰ Furthermore, it limited the exceptions of constituting PEs to the fixed place of business, whose activity is preparatory or auxiliary in character.¹⁰¹

The Budget Law also introduced anti-fragmentation rules, which prevents foreign companies to split businesses into smaller units or use other related legal entities, to benefit from the exemption of preparatory or auxiliary nature of activities. Thus, exemptions will not be applicable to fixed place of business that is managed by the enterprise if:

- Same firm or closely related firms carries out activities in same place or any other location in Italy.
- Such location constitutes a PE for either enterprises or result of overall activities is not preparatory or auxiliary in character.

- Activities carried out by enterprises in the same place constitute complementary functions which is a part of unitary set of business operations.¹⁰²

Further, if any person acting in the State on behalf of non-residents, habitually concludes contracts which are either in the name of the enterprise or is for the transfer of ownership or the right to use property owned or used by enterprise or is for the provision of services by that enterprise, then such enterprises will be deemed to have a PE in that territory.¹⁰³ However, the above deeming provision will not be applicable if the activities performed, fall under the exception provided in para 4 of Article 162.¹⁰⁴ or is carried out by a person as an independent agent and acts within the scope of his ordinary activities.¹⁰⁵ However, it is important to note that if person acts exclusively or almost exclusively on behalf of an enterprise, to which it is closely related, then such person will not be considered as independent agents.¹⁰⁶

The amendment also elaborates on who will be considered as closely related to enterprise. It states that if one has control over another or both are controlled by same person, then it will be considered as closely related entities.¹⁰⁷ If it is exclusively related to a company, then if one directly or indirectly owns more than 50% of voting rights and shares capital in the other company or if a third person directly or indirectly owns more than 50% of aggregate voting rights and shares capital in both companies, then it will be considered as closely related entities.¹⁰⁸

⁹⁸ Law of 27/12/2017 n. 205, Article 1, para 1014.

⁹⁹ Law of 27/12/2017 n. 205, Article 1, para 1016.

¹⁰⁰ Consolidated text of 12/22/1986 n. 917, Article 162, para f-bis.

¹⁰¹ Consolidated text of 12/22/1986 n. 917, Article 162, para 4-bis.

¹⁰² Consolidated text of 12/22/1986 n. 917, Article 162, para 5.

¹⁰³ Consolidated text of 12/22/1986 n. 917, Article 162, para 6.

¹⁰⁴ Consolidated text of 12/22/1986 n. 917, Article 162, para 6.

¹⁰⁵ Consolidated text of 12/22/1986 n. 917, Article 162, para 7.

¹⁰⁶ Consolidated text of 12/22/1986 n. 917, Article 162, para 7.

¹⁰⁷ Consolidated text of 12/22/1986 n. 917, Article 162, para 7-bis.

¹⁰⁸ Consolidated text of 12/22/1986 n. 917, Article 162, para 7-bis.

B. United Kingdom

In U.K., the Finance Act, 2015, introduced diverted profit tax to tax diverted profits that arise in a company in an accounting period.¹⁰⁹ It is charged at the rate of 25% of the amount of taxable diverted profit as specified in the notice issued by a designated Her Majesty Revenue and Customs ('HMRC') officer.¹¹⁰ If the taxpayer has paid corporation tax in UK or in some foreign country on the same profits, then he can avail 'just and reasonable' credit against diverted profit tax for such amount.¹¹¹ However, diverted profit tax cannot be deducted or credited against any other tax.¹¹²

The main aim of diverted profit tax was to deter diversion of profit from UK by multinational enterprises by either avoiding creation of PE in UK or make arrangements or entities that lack economic substance.¹¹³ It applies to UK Companies that lacks economic substance¹¹⁴ or non-UK companies that either lack economic substance or carry out activities designed in a way that does not create PE to avoid tax.¹¹⁵ The avoidance of economic substance refers to the arrangement to artificially place assets to low tax jurisdictions.

It introduced the concept of '*avoided PE*' which is like a constructive PE, that is taxed in a way as if it actually

existed.¹¹⁶ The diverted profit of avoided PE are taxed as if there were profits of actual PE under the corporate law of UK.¹¹⁷ The taxpayer has responsibility to report to office of Revenue and Custom if they fall within the scope of tax and if the preliminary notice is issued, then they should show that DPT shall not apply.¹¹⁸

The diverted profit taxes effectively tax the PE's arrangements. However, it has been argued that it conflicts with UK obligations under international law. HMRC in its interim guidance report concluded that DPT is not a tax which is covered under the UK double taxation treaty as it is separate from income tax, capital gains tax as well as corporation tax.¹¹⁹ HMRC also argued the fact that since diverted profit tax is applied to arrangements that exploits provisions of tax treaties, there is no obligation under international law.¹²⁰

During the Spring Statement, the UK government issued an updated position paper on corporate tax and digital economy whose major fundamental object was to develop a framework to tax certain digital business.¹²¹ UK government is of the view that profits of businesses should be taxed in countries where value is created.¹²² The position paper provides for a long term solution as well as interim proposal to tax digital economy.

¹⁰⁹United Kingdom Finance Act, 2015, Section 77.

¹¹⁰United Kingdom Finance Act, 2015, Section 79.

¹¹¹United Kingdom Finance Act, 2015, Section 100.

¹¹²United Kingdom Finance Act, 2015, Section 99.

¹¹³HM Revenue & Customs, 'Guidance, Diverted Profits Tax,' (December 2018), 4 [DPT1000] available at

<https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/480318/Diverted_Profits_Tax.pdf> accessed 20 December 2018.

¹¹⁴United Kingdom Finance Act, 2015, Section 80.

¹¹⁵United Kingdom Finance Act, 2015, Section 81.

¹¹⁶United Kingdom Finance Act, 2015, Section 88.

¹¹⁷United Kingdom Finance Act, 2015, Section 86.

¹¹⁸United Kingdom Finance Act, 2015, Section 92.

¹¹⁹Guidance, Diverted Profits Tax, (n. 113) [DPT1690].

¹²⁰H.M. Revenue and Customs, Presentation on the Diverted Profits Tax (January 8, 2015) available at

<https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/400340/Diverted_Profits_Tax.pdf> accessed 16th December 2018.

¹²¹HM Treasury, 'Corporate Tax and the Digital Economy: Position Paper Update', (March, 2018) available at

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/689240/corporate_tax_and_the_digital_economy_update_web.pdf> accessed 15th December 2018.

¹²²*Ibid.*

The long term solution identified is to tax profits of a non-resident digital enterprises to the extent profits are attributable to value created by UK users by amending Article 5, 7 and 9 of OECD Model Convention and including user based participation as one of the criteria for constituting PE.¹²³ The main questions that have been looked into are: who would be taxed and to what extent will they be taxed. With respect to who would be taxed, UK will tax companies that receive residual profit of business after the activities of group service providers have been awarded at an arm's length return.¹²⁴ With regard to what extent shall they be taxed, the paper proposes to first measure user created value and then allocate between the countries where users are based which will then be subject to tax in a particular country. UK understands limitations of allocated based on number of users and is in favour of allocating on the basis of revenue that is generated from such users.¹²⁵ Furthermore, UK government is of the view that PE on the basis of creation of user value should only arise when there is material user base which is being monetised by the business.¹²⁶ The material user base can be determined based on combination of metrics which includes number of active users as well as revenue generated from such user.¹²⁷

The alternative interim measure that UK proposed is in the form of a revenue based tax which is either in the form of tax on revenue of business, based on a case by case assessment of specific characteristics and value drivers¹²⁸ or objectively define certain categories of business who mostly derive value from user participation and impose tax on revenue of such businesses¹²⁹ or tax on defined categories of revenue

of digital businesses.¹³⁰ There are many challenges identified with each approach and according to UK government, it might be a combination of each approach that can be used to tax digital transactions.¹³¹

UK government invited submissions and engagements from businessmen and other key stakeholders to discuss the position that is set out in the paper which makes it clear that UK is keen to indulge in a debate on taxing digital transactions and help in the ongoing work of OECD and EC to formulate international principles to tax digital economy.

C. Australia

Australian government has taken actions to combat multinational tax avoidance by bringing two major laws in place:

1. Multinational Anti-Avoidance Law (MAAL)

The Multinational Anti-Avoidance Law ('MAAL') was enacted by the Australian Government via Taxation Law Amendment (Combating Multinational Tax Avoidance) Act, 2015, to combat avoidance of tax by multinational enterprises operating in Australia. It is applicable on the following conditions:

1. When a foreign entity being a 'significant global entity' makes any supply to Australian customer; and
2. Activities directly connected to the supply are undertaken in Australia; and
3. Some of the activities are undertaken by Australian PE of a foreign entity who is

¹²³*Ibid.*

¹²⁴*Ibid* 19[3.11].

¹²⁵*Ibid* 20[3.18].

¹²⁶*Ibid* 22[3.45].

¹²⁷*Ibid* 22[3.44].

¹²⁸*Ibid* 25[4.15].

¹²⁹*Ibid* 25[4.16].

¹³⁰*Ibid* 25[4.17].

¹³¹*Ibid* 25[4.18].

commercially dependent on the foreign entity;
and

4. Income is derived by foreign entity from such supplies; and
5. Some or all of the income cannot be said to be attributed to Australian PE; and
6. One of the primary principle purposes for such arrangements is to obtain tax benefit.¹³²

Significant global entity is defined as an entity whose annual global income is \$1 billion or more, or the commissioner makes a determination that such entity is a significant global entity.¹³³ Once the conditions mentioned above are satisfied, determination is made under MAAL to undo tax benefits obtained. It has been reported that almost 31 multinationals have restructured in response to MAAL and 18 of these companies have returned more than \$6.4 billion in sales per annum.¹³⁴ Budget 2018 extended the application of MAAL to foreign partnerships as well as foreign trusts to ensure corporate structures be subject to tax laws.¹³⁵ The rules under MAAL may be difficult to apply and not enforceable in many situations where taxpayers do not cooperate with the Australian Tax Officers during the audit.¹³⁶

The budget 2017-2018 brought further amendments by establishing a strong Tax Avoidance Taskforce and implementing new Diverted Profit Tax on

multinationals that tries to artificially shifts profits offshore.¹³⁷ Furthermore, anti-hybrid mismatch rules were introduced to prevent banks and insurance companies from double dipping by getting both tax deductions as well as concession for a single payment. The Tax Avoidance Taskforce was established in 2016 to detect avoidance of tax and increase transparency.¹³⁸ Taskforce assisted to make nearly \$ 3 billion liabilities against large public groups as well as multinational corporations and \$ 1.8 billion in liabilities against wealth individuals as well as private groups in the year 2017-2018.¹³⁹



¹³² Tax Laws Amendment (Combating Multinational Tax Avoidance) Act No. 170, 2015, Schedule 2, Section 4.

¹³³ Tax Laws Amendment (Combating Multinational Tax Avoidance) Act No. 170, 2015, Schedule 1, Section 960-555.

¹³⁴ Multinational Anti Avoidance Law (MAAL) available at <[https://www.ato.gov.au/Business/Large-business/In-detail/Business-bulletins/Articles/Multinational-Anti-Avoidance-Law-\(MAAL\)/](https://www.ato.gov.au/Business/Large-business/In-detail/Business-bulletins/Articles/Multinational-Anti-Avoidance-Law-(MAAL)/)> accessed 18th December 2018.

¹³⁵ Toughening the Multinational Anti Avoidance Law (12 February 2018 to 23rd February 2018) available at <<https://treasury.gov.au/consultation/c2018-t261444/?>> accessed 9th January 2019.

¹³⁶ Australian Government, 'Consultation Paper: Implementing a Diverted Profit Tax', (May 2016) available at <https://static.treasury.gov.au/uploads/sites/1/2017/06/C2016-018_Diverted-profits-tax_discussion-paper.pdf> accessed 10th December 2018.

¹³⁷ Budget 2017-2018: Living within our means, available at <<https://www.budget.gov.au/2017-18/content/glossies/means/html/means-06.htm>> accessed 10th December 2018.

¹³⁸ Tax Avoidance Taskforce (8th October 2018) available at <<https://www.ato.gov.au/general/Tax-avoidance-taskforce/#Taskforceobjectives>> accessed 16th December 2018.

¹³⁹ Tax Avoidance Taskforce Highlights 2017-2018 (8th October 2018) available at <<https://www.ato.gov.au/General/Tax-avoidance-taskforce/2017-18-Taskforce-highlights/>> accessed 16th December 2018.

2. Diverted Profit Tax

The Budget, 2016-2017, announced the introduction of a levy of new diverted profit tax which came into effect on 1st July, 2017, and imposed 40% tax.¹⁴⁰ The main objective of levying such tax was to ensure that significant global entities properly reflect the economic substance of their activities and pay tax in Australia, and prevent diversion of profit outside by way of arrangements involving related parties.¹⁴¹

Diverted profit tax will apply if a taxpayer who is a significant global entity, has obtained a tax benefit in connection with the scheme, which is either carried out or entered by a foreign entity.¹⁴² Thus, diverted profit tax is applicable to Australian entity also who arranges a scheme with a foreign entity for the primary purpose of obtaining tax benefit. Diverted profit tax is not applicable to following entities:

- Managed investment trust;
- A foreign collective investment vehicle;
- A foreign entity owned by foreign governments;
- Complying superannuation entity; or
- A foreign pension funds.¹⁴³

Diverted profit tax is not self-assessed tax and Australian Tax Officer will notify taxpayers as an when they are subject to it who will then have 60 days to

make representations to correct factual matters.¹⁴⁴

D. Israel

Since, Israel was undergoing rapid expansion of Internet activities, the Israel Tax Authority issued a circular explaining how income of a foreign company would be taxed in Israel, for services provided through the internet.¹⁴⁵

In Israel, a foreign company is taxed only if it has a PE in Israel, which previously was defined as a fixed place, through which the business is wholly or partially carried out. However, the circular issued by the Israel Tax Authority laid down that an establishment could be deemed to be permanent, if the economic activity of the foreign enterprise, at its permanent place of business in Israel, is conducted primarily through internet, and satisfies other conditions. These conditions require that the representatives of foreign company be involved in:

- Identifying Israeli customers;
- Gathering information as well as managing relations with the customers;
- Providing service through internet by foreign company which is adaptable to Israeli customers like having language, style or currency that is used in Israel.¹⁴⁶

¹⁴⁰ Diverted Profit Tax (26th September 2018) available at <<https://www.ato.gov.au/general/new-legislation/in-detail/direct-taxes/income-tax-for-businesses/diverted-profits-tax/?=redirected>> accessed 6th December 2018.

¹⁴¹ Diverted Profit Tax (26th September 2018) available at <<https://www.ato.gov.au/general/new-legislation/in-detail/direct-taxes/income-tax-for-businesses/diverted-profits-tax/?=redirected>> accessed 16th December 2018; see also Treasury Laws Amendment (Combating Multinational Tax Avoidance) Act 2017, Section 177H.

¹⁴² Treasury Laws Amendment (Combating Multinational Tax Avoidance) Act 2017, Section 177J.

¹⁴³ Treasury Laws Amendment (Combating Multinational Tax Avoidance) Act 2017, Section 177J.

¹⁴⁴ Consultation Paper: Implementing a Diverted Profit Tax, (May 2016) 7 [43-46] available at <https://static.treasury.gov.au/uploads/sites/1/2017/06/C2016-018_Diverted-profits-tax_discussion-paper.pdf> accessed 12th December 2018.

¹⁴⁵ Israeli Tax Authority published guidelines regarding taxation of foreign corporation activity in Israel via the Internet (14th April, 2016) available at <https://taxes.gov.il/English/About/SpokesmanAnnouncements/Pages/Ann_11042016.aspx> accessed 16th October 2018.

¹⁴⁶ *Ibid.*

E. Hungary

In 2014, Hungarian Government passed an act, taxing advertisement activities to be paid by media content providers, depending on the revenue generated through advertisements. Companies earning more were subjected to higher progressive tax rates that ranges from 0 to 50%.¹⁴⁷ In 2015, the EC in-depth investigation, showed that the Hungarian advertisement tax is in breach of EU rules as the progressive tax rates favour smaller companies as they have to pay substantially less advertisement tax as compared to the companies with a higher turnover.¹⁴⁸ Thus, Hungary was asked to suspend this tax. However, Hungary brought an amended version of it without notifying EC about it.

The amended advertisement tax law brought by Hungarian government in 2015, though addressed few concerns of EC however still overlooked many. The progressive rate was now maintained at a smaller range (0% to 5.3%). In November 2016, EC again mandated Hungary to remove the unjustified discrimination in the Act and restore equal treatment in the market and comply with EU rules.¹⁴⁹

The Advertisement Act, 2014, was significantly amended in 2017, which raised the rate from 5.3% to 7.5% for taxpayers having sale revenue from advertisements that exceed HUF 100 million.¹⁵⁰ Under the new Act, only *quid pro quo* publication is taxable and

if the taxpayer is publishing advertisement for its own purpose, then it is not taxable under the Act.¹⁵¹ Advertisement published in media service; press products in Hungarian language; on outdoor advertising media; on any vehicle, printed material or real estate; on the internet in Hungarian language shall be subject to tax if it is for a consideration.¹⁵²

Further, tax declared and paid for financial years 2014, 2015 and 2016 will be considered as overpayment and refund would be granted for it or could be adjusted to some other tax as requested and tax declared, but not paid by publishers till 20 June 2017 need not be paid.¹⁵³

F. Spain

In 2012, the Tribunal Económico Administrativo Central ('TEAC') of Spain decided on the issue of whether sale of goods in Spain by Dell Ireland constitutes a PE or not. The Spanish tribunal held that Dell Ireland that operates in Spain through a subsidiary, formally acts as a sales agent, and hence, has a PE in Spain.¹⁵⁴ The main reasoning cited was that the Irish company had control of the activities as well as the staff of the subsidiary in Spain and was involved in the core business of the parent company and not in auxiliary or ancillary activities.¹⁵⁵ With respect to virtual PE, it took into consideration the relevant portion of the web pages maintained for the Spanish market and fed by personnel in Spain, even if server was not located in Spain and concluded that since activity was significant, the commercialization of the

¹⁴⁷Ulrika Lomas, 'Hungary Approves Advertising Tax Hike' (24 May, 2017) available at <https://www.tax-news.com/news/Hungary_Approves_Advertising_Tax_Hike___74329.html> accessed on 9th January 2019.

¹⁴⁸European Commission, 'State aid: Commission finds Hungarian Advertisement tax in breach of EU rules' (Press Release) (Brussels, 5th November 2016) available at <europa.eu/rapid/press-release_IP-16-3606_en.pdf> accessed 13th December 2018.

¹⁴⁹*Ibid.*

¹⁵⁰Key Rules on Advertisement Tax 2017 (1st July 2017) 4 [2.3].

¹⁵¹Key Rules on Advertisement Tax 2017 (1st July 2017) 1 [1].

¹⁵²Key Rules on Advertisement Tax 2017 (1st July 2017) 1 [1].

¹⁵³Key Rules on Advertisement Tax 2017 (1st July 2017) 8 [2.5].

¹⁵⁴'Dell Ireland to Pay Taxes in Spain| Permanent Establishment, available at <<https://www.accountinginspain.com/pe-spain-dependent-agent/>> accessed 6th December 2018.

¹⁵⁵*Ibid.*

products in Spain through web pages must be attributed to Dell Ireland.¹⁵⁶ Activities performed were economically significant, like sales, delivery and maintenance of the online store. Furthermore, Spanish tax authorities ignored the Commentary on Model Convention to Article 5, which clearly stated that websites do not constitute a PE in a State if there is no server physically located in the State and observed that since the OECD is studying e-commerce taxation, they will not consider the commentaries until and unless the OECD comes to a final conclusion.¹⁵⁷

This Ruling clearly shows that Spain has been reluctant to apply the theory of OECD and tried to redefine the definition of PE to include virtual PE's and not restrict it only to places where server is located.

G. Colombia

In 2013, Tax Authorities issued a Ruling N° 73092, which was with regard to the constitution of a PE in Colombia for a Swiss Company, that provided English courses abroad using a digital platform located in Brazil. Tax Authorities reached the conclusion that since the Colombian subsidiary had the authority to negotiate and conclude contracts on behalf of the Swiss company, it was to be considered as a dependent agent PE of Swiss company ignoring the fact that the

providing English courses through the internet may not trigger PE in Colombia.¹⁵⁸ With respect to e-commerce transactions, Colombian tax authorities in Ruling 74171 of 2005 and Ruling N° 6256 of 2005, held that the e-commerce transactions that are performed by non-resident are not taxable in Colombia.¹⁵⁹

III.2 Unilateral measures taken by India

According to the Internet and Mobile Association of India, India had around 481 million internet users in December 2017¹⁶⁰ and was ranked as the country having the second highest number of users just behind China.¹⁶¹ This number of internet users increased to 560.01 million at the end of September 2018.¹⁶² Further, as per India Brand Equity Foundation, India's internet economy is expected to double from US\$125 billion as recorded in April, 2017, to US\$ 250 billion by 2020.¹⁶³ Further, electronics was found to be the biggest contributor to online retail sales with a share of 48% in India. Apparels stood second at 29%.¹⁶⁴ While e-commerce is rapidly expanding in India, efficiently applying tax laws to this sector, remains a challenge. The challenges are in the form of rethinking old rules or adapting them to the digital world or others are purely administrative challenges. We elaborate India's efforts till date to combat these challenges.

¹⁵⁶ Michael Lang, *Tax Treaty Case Law around the Globe 2015: Schriftenreihe StR Band 97* (Linde Verlag GmbH, 12-Feb-2016).

¹⁵⁷ Spanish Tax Alert, 'The Spanish Substantialist Approach to Fragmented Structures of Business: The Dell Case, A Subsidiary as Permanent Establishment,' available at <https://www.ga-p.com/wp-content/uploads/2018/07/the_spanish_substantialist_approach_to_fragmented_structures_of_business_the_dell_case_a_subsidiary_as_permanent_establishment.pdf> accessed 20th December 2018.

¹⁵⁸ Angela Carlonia Vaca Bohorquez, Virtual PE: An Approach to the Taxation of Electronic Commerce Transactions., *Revista de Derecho Fiscal* n.º 8, 99 available at <<https://revistas.uexternado.edu.co/index.php/fiscal/article/download/4568/5249/>> accessed 26th December 2018.

¹⁵⁹ Angela Carlonia Vaca Bohorquez, Virtual PE: An Approach to the Taxation of Electronic Commerce Transactions., *Revista de Derecho Fiscal* n.º 8, 100 available at <<https://revistas.uexternado.edu.co/index.php/fiscal/article/download/4568/5249/>> accessed 26th December 2018.

¹⁶⁰ Surabhi Agarwal, 'Internet users in India expected to reach 500 million by June: IAMAI,' (ET Bureau February 20, 2018) available at <<https://economictimes.indiatimes.com/tech/internet/internet-users-in-india-expected-to-reach-500-million-by-june-iamai/articleshow/63000198.cms>> accessed 21st December 2018.

¹⁶¹ Top 20 Countries with the Highest Number of Internet Users, (December 31, 2017) available at <<https://www.internetworldstats.com/top20.htm>> accessed 9th January 2019.

¹⁶² Telecom Regulatory Authority of India, The Indian Telecom Services Performance Indicators, (January 8, 2019) available at <<https://main.trai.gov.in/sites/default/files/PIR08012019.pdf>> accessed 5th January 2019.

¹⁶³ India Brand Equity Foundation, 'E-commerce Industry in India' (December, 2018) available at <<https://www.ibef.org/industry/ecommerce.aspx>> accessed 8th December 2018.

¹⁶⁴ *Ibid.*

A High-Powered Committee was constituted by the Indian Government in 1999 to examine the position of e-commerce transactions under existing taxation law and determine changes if required.¹⁶⁵ The High-Powered Committee submitted its report in July 2001. The High-Powered Committee advocated a broader interpretation of the terms 'royalty' and 'fee for technical services' and concluded that most of the payments made as well as received for e-commerce, shall constitute royalty or fee for technical service and hence, taxable under the Indian tax treaties.¹⁶⁶

The Central Board of Direct Tax, the Department of Revenue and the Ministry of Finance constituted a Committee on taxation of e-commerce ('**Akhilesh Ranjan Committee**') under the chairmanship of Akhilesh Ranjan in 2016 to examine the tax issues arising from the digital economy specifically considering the OECD Report on Action 1 of BEPS Project. The Akhilesh Ranjan Committee also looked into various challenges relating to nexus as well as the characterization of income arising from digital transactions.

The three major options (**Nexus based on Significant Economic Presence; Withholding Tax on Digital Transactions and Equalization Levy**) as also provided in OECD Report were analysed by the Akhilesh Ranjan Committee. Members of the Akhilesh Ranjan Committee were of the view that with respect to the option of SEP concept as well as withholding tax, enforcement will be rendered ineffective until and unless it is incorporated in the tax treaties. However, with respect to the option of equalization levy, it is different from Income Tax and hence will not be subject

to the limitations of tax treaties. Thus, it can be levied unilaterally under domestic laws without change in treaties and hence is the most feasible option.¹⁶⁷

A. Equalization Levy

1. Nature of Equalization Levy:

The Akhilesh Ranjan Committee analysed the objectives of equalization levy which is to be imposed in accordance with the conclusions of the OECD Report on Action 1. It is to be imposed with the object of equalizing the tax burden, by imposing it on payments made to beneficial foreign owners for providing digital services who enjoy an unfair advantage over Indian competitors who provide similar service.¹⁶⁸ Further, equalization levy will provide greater clarity, certainty and predictability with respect to characterization of payment made for digital services which will ultimately minimize cost of compliance as well as tax disputes.¹⁶⁹

Equalization levy is imposed on the consideration received by non-residents and is not charged on the income arising from transactions and hence it does not fall within the scope of income tax. The major distinction between direct and indirect taxes as laid down by Supreme Court is that levy in cases of indirect taxes is never upon an individual and is upon a specific aspect of what is sought to be taxed as oppose to direct tax that is levied on an individual.¹⁷⁰ If we take into consideration the nature in which equalization levy is imposed, it seems to be a kind of indirect tax levied on consideration received for providing specified services. However, the powers to levy and collect it has

¹⁶⁵The ComTaxpert Group, 'Taxation of Electronic Commerce in India', (June, 2002) available at <http://www.nishithdesai.com/fileadmin/user_upload/pdfs/NDA%20Think%20Tanks/eComtaxpert%20Group.pdf> accessed 19th January 2019.

¹⁶⁶Proposal for Equalization Levy on Specified Transactions, Report of the Committee on the Taxation of E-Commerce (February, 2016) 41 [65] available at <<https://www.incometaxindia.gov.in/news/report-of-committee-on-taxation-of-e-commerce-feb-2016.pdf>> accessed 10th December 2018.

¹⁶⁷*Ibid* 81 [118].

¹⁶⁸*Ibid* 84 [125].

¹⁶⁹*Ibid* 84 [125].

¹⁷⁰*Peekay Re-Rolling Mills (P) Ltd. v. Assistant Commissioner and Anr.*, (2007) 4 SCC 30.

been given to assessing officer appointed under Income Tax Act and CBDT formed under Central Board of Revenue Act.

Pursuant to the Akhilesh Ranjan Committee Report, a Chapter titled 'Equalization Levy' was inserted in the Finance Act, 2016 to provide for an equalization levy of 6% on the amount of consideration received by a non-resident, not having PE in India for providing specified services.¹⁷¹ Specified services have been defined as "*an online advertisement, any provision for digital advertising space or any other facility or service for the purpose of online advertisement and includes any other services as notified by Central Government*".¹⁷² The term 'online' is also defined as "*a facility or service or right or benefit or access that is obtained through internet or any form of digital or telecommunication network*".¹⁷³ Thus, currently the scope of levy is proposed to be applicable only on advertisement services and can be extended to other services as notified by Central Government.

Equalization levy will not be charged if the non-resident has a PE in India or if the aggregate amount of consideration for specified service does not exceed one lakh rupees in the previous year or if the payment for the specified service is not for purpose of carrying out business or profession.¹⁷⁴

Every person while making payment to non-residents for specified service must deduct equalization levy from the amount paid to the non-resident. Further, if any assessee fails to credit equalization levy or any part of it to the account of the Central Government, he/ she

will have to pay a simple interest at the rate of one percent of such levy for every month.¹⁷⁵ If the assessee fails to deduct whole or any part of equalization levy, then he will be liable to pay penalty equal to the amount of equalization levy in addition to the equalization levy to be paid as per the charging section.¹⁷⁶ An assessee aggrieved by the order of imposition of penalty passed by the Assessing Officer, may appeal to Commissioner of Income Tax (Appeals) within 30 days from date of receipt of order passed by Assessing Officer.¹⁷⁷ Assessee may further appeal to the Appellate Tribunal within 60 days from the date of receipt of order passed by the Commissioner of Income Tax (Appeals).¹⁷⁸ There are certain provisions of Income Tax Act¹⁷⁹ that are applicable to equalization levy in the same way as they are applicable to income-tax.

2. Constitutional Validity of Equalization Levy

Equalization levy was enforced by the Central Government in 2016 prior to the enforcement of Goods and Service Tax ('GST'). The specified services as enlisted in the Finance Act that are brought under the purview of equalization levy mainly includes services relating to online advertisement. Entry 55 of List II of the Seventh Schedule prior to Constitution (One Hundred and First Amendment) Act, 2016 empowered State Government to make laws with respect to taxing advertisement other than advertisements published in newspapers and advertisements broadcast by radio or television. Entry 92C of List I empowered Union Government to make laws with respect to taxing services. Service Tax levied on advertising services was

¹⁷¹ Explanatory Notes to the Provisions of the Finance Act, 2016, F. No. 370142/20/2016-TPL, CIRCULAR NO.- 3/2017, Ministry of Finance, Department of Revenue, Central Board of Direct Taxes (January 20, 2017) available at <https://www.incometaxindia.gov.in/communications/circular/circular03_2017.pdf> accessed 7th January 2019.

¹⁷² Finance Act, 2016 (No. 28 of 2016), Section 164(i).

¹⁷³ Finance Act, 2016 (No. 28 of 2016), Section 164(f).

¹⁷⁴ Finance Act, 2016 (No. 28 of 2016), Section 165(2).

¹⁷⁵ Finance Act, 2016 (No. 28 of 2016), Section 170.

¹⁷⁶ Finance Act, 2016 (No. 28 of 2016), Section 171.

¹⁷⁷ Finance Act, 2016 (No. 28 of 2016), Section 174.

¹⁷⁸ Finance Act, 2016 (No. 28 of 2016), Section 175.

¹⁷⁹ Finance Act, 2016 (No. 28 of 2016), Section 178.

Section 178 says that: *The provisions of sections 120, 131, 133A, 138, 156, Chapter XV and sections 220 to 227, 229, 232, 260A, 261, 262, 265 to 269, 278B, 280A, 280B, 280C, 280D, 282 and 288 to 293 of the Income-tax Act shall so far as may be, apply in relation to equalization levy, as they apply in relation to income-tax.*

challenged before Madras High Court as unconstitutional. The Madras High Court while upholding the constitutional validity of service tax levied on advertising services clearly distinguished between the term 'advertisement' as well as 'advertising services'.¹⁸⁰

High Court held that impost of tax on advertisement would be mainly on a person whose goods or services are advertised or media that publishes such advertisement, however under service tax, the impost is on agency that is a commercial concern and is engaged in providing services or exhibition of advertisement in any manner.¹⁸¹ Thus, the High Court was of the view that the provisions under service tax was essentially only for services and falls under the ambit of Union Government (Entry 92C of List I).

Similarly, equalization levy is levied on online services provided by the provider and is mainly focusing on agencies that are engaged in providing services. Thus, the Union Government has the power to enact laws relating to taxing online advertising services in India. Furthermore, as per the Akhilesh Ranjan Committee Report also, members while looking into the constitutional validity of equalization levy took into consideration Entry 92C and 97 of List I of the Constitution of India and held that equalization levy as a tax on gross amounts of transaction made for digital services is within the power of Union Government and would satisfy the test of constitutional validity.¹⁸²

After GST was brought in force, Entry 92C of List I of the Seventh Schedule was omitted. Since there is no corresponding entry, it will fall under Entry 97 of List I of the Seventh Schedule and the Union Government will have exclusive power to legislate on it.

3. The Problem of Double Taxation because of imposition of Equalization Levy

Unilateral measures have mainly been criticized on the grounds of such measures leading to double taxation. However, it must be noted that though it is not desirable to have two taxes on the same subject-matter but there is no legal or constitutional bar under the laws of India that prevents double taxation.

a. Double Taxation in Global Scenario

Unilateral measures entail the risk of international double taxation as the state of residence will not be bound to provide any relief under the tax treaty as equalization levy does not fall under the ambit of the treaties. Thus, if the non-resident company paying equalization levy is also paying income tax in its residence country, it may result in double taxation as no credit can be claimed either in the State of Residence or in India.

Even the Akhilesh Ranjan Committee accepted this to be an inherent limitation of equalization levy or any of the unilateral measures imposed under domestic law, without it being covered by the tax treaties.¹⁸³ However, the Akhilesh Ranjan Committee was of the view that nothing prevents the Country of Residence to grant relief to the taxpayer to avoid double taxation. In fact, if the country of residence is also imposing equalization levy, they can enter into a reciprocal agreement to provide relief from income tax on such levy. Furthermore, as per the Akhilesh Ranjan Committee, the taxpayer can have partial relief from such double taxation by claiming deductions of equalization levy from its taxable income as business expense.¹⁸⁴

¹⁸⁰ *Advertising Club and Ors. vs. Central Board of Excise and Customs and Ors.*, (2001) 2 MLJ 656.

¹⁸¹ *Ibid* [8].

¹⁸² Report of the Committee on the Taxation of E-Commerce (n. 166) [130] 86-97.

¹⁸³ Report of the Committee on the Taxation of E-Commerce (n. 166) 101.

¹⁸⁴ Report of the Committee on the Taxation of E-Commerce (n. 166) 101.

b. Double Taxation as per Domestic Laws of India

As per Section 7 of Integrated Goods and Service Tax Act, 2017 ('**IGST Act**') which is a charging section, supply of services imported into territory of India is to be treated as supply of service in the course of inter-state trade or commerce and is chargeable under IGST Act. Further, as per IGST Act, for online information and data retrieval services ('**OIDAR services**'), the place of supply will be the location of the recipient of services.¹⁸⁵ As per Section 2(17) of the IGST Act, **OIDAR services** means services that are provided through the internet with minimal human intervention and includes electronic services such as advertising on internet etc.¹⁸⁶ The liability to pay GST is on the recipient in India if he/she is a registered entity under GST in cases where the supplier of such service is located outside India.¹⁸⁷

It is settled position that to constitute double taxation, taxes must be levied on same property or subject matter, by the same Government or authority, during the same taxing period and for the same purpose.¹⁸⁸ Under the current matrix of facts however, though IGST and equalization levy are both levied on online advertisement services the purpose of the levy is different for both the taxes. Equalization levy is imposed with the object of equalizing the tax burden, by imposing the levy on payments made to beneficial foreign owners for providing digital services who enjoy an unfair advantage over Indian competitors who provide similar business.¹⁸⁹ The purpose to levy IGST on the other hand, is to collect tax on inter-state supply of goods or services or both which includes import of

services. Thus, one can argue that the situation at hand does not amount to double taxation.

Another argument that may be raised to argue that the levy of both IGST and Equalization levy amounts to double taxation as is that the subject matter of both the taxes is the same. Both IGST and Equalization levy are charged on supply of online advertisement services provided by non-resident. In this regard, it is relevant to note that there is no provision under the Constitution that expressly or even impliedly bars double taxation. It was upheld by the Kerala High Court that unless the Constitution expressly or impliedly forbids double taxations, and as long as the statute is within the competence of legislature, double taxation cannot be a ground for invalidating a fiscal statute.¹⁹⁰ Thus, desirability of having equalization levy along with service tax (now IGST) has to be judged based on factors such as economic effects, compliance costs, administrative convenience and effects on economic efficiency.¹⁹¹

Thus, legally, there is no bar on taxing the same subject twice, however it is desirable to avoid double taxation which is also highlighted in the overarching principles of tax policy as laid down by OECD.¹⁹² Furthermore, this sector of economy has been untaxed for quite a long time which raises legitimate concerns of double non-taxation. Since, negotiating treaties with countries will take long time, competency of legislature passing equalization levy shall not be questioned on the grounds of it leading to double-taxation.

¹⁸⁵ Integrated Goods and Service Tax, 2017, Section 13(12).

¹⁸⁶ Integrated Goods and Service Tax, 2017, Section 2(17).

¹⁸⁷ GST Council, 'Online Information Data Base Access and Retrieval,' available at <<http://gstcouncil.gov.in/sites/default/files/GST-Fliers/38-OIDAR.pdf>> accessed 7th January 2019.

¹⁸⁸ *Krishna Das v. Town Area Committee, Chigaon*, AIR 1991 SC 2096; *Kerala Colour Lab. Association vs. Union of India (UOI)* 2003 264 ITR 633 Ker (Kerala High Court).

¹⁸⁹ Report of the Committee on the Taxation of E-Commerce (n. 166) 84 [125].

¹⁹⁰ *Kerala Colour Lab. Association* (n. 194).

¹⁹¹ Ashok K Lahiri, Gautam Ray, D.P. Sengupta, 'Equalization Levy,' Brookings Institution available at <https://www.brookings.edu/wp-content/uploads/2017/01/workingpapertax_march2017_final.pdf> accessed 10th January 2019.

¹⁹² OECD, "Fundamental principles of taxation", in *Addressing the Tax Challenges of the Digital Economy*, (Paris, 2014) available at <https://www.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy/fundamental-principles-of-taxation_9789264218789-5-en;jsessionid=eaM0aLeE-CqMDYaTVIO7dqWb.ip-10-240-5-187> accessed 12th January 2019.

B. Significant Economic Presence

1. Significant Economic Presence Concept under Income Tax Act, 1961

After the introduction of equalization levy in 2016, India became one of the first few countries to introduce the concept of SEP of foreign enterprises in its domestic law. The Finance Act, 2018, widened the scope of business connection in India by inserting Explanation 2A to Section 9(1) (i), that provides that a non-resident having SEP in India will also constitute business connection.¹⁹³ It will become enforceable from 1st April, 2019. However, the government has conceded that business profits will be taxed in accordance with existing treaty rules until new rules are introduced in the treaty and hence, SEP provision remains ineffective.

SEP is defined under the Income Tax Act, 1961, as:

- A transaction in respect of goods, services or property carried out by non-resident in India. The aggregate of payments arising from such transaction during previous year shall exceed a prescribed threshold amount.
- A transaction involving provision of download of data or software in India. The aggregate of payments arising from such transaction during previous year shall exceed a prescribed threshold amount.
- A systematic and continuous soliciting of business activities or engaging in interaction with number of users. The activity must exceed the prescribed number of users.

Central Board of Direct Taxes ('CBDT') has invited suggestions/comments from the stakeholders as well

as general public on the quantum of revenue as well as the user threshold that needs to be prescribed for determining SEP of a non-resident in India.¹⁹⁴

Further as per the first proviso to Explanation 2A to Section 9(1) (i) of Income Tax Act 1961, transactions shall constitute SEP irrespective of:

- Whether the agreement for such activities is entered in India or not; or
- Whether the non-resident has a residence or place of business in India or not; or
- Whether non-resident renders services in India or not.¹⁹⁵

2. Analysis of the concept of significant economic presence

a. Widely Worded terms in the provision

There are some widely worded terms in the provision such as 'systematic', 'continuous' or 'soliciting' which are not defined in the Act and hence, may result in different interpretations and future litigation. Though, some words need to be widely framed for proper interpretation, authorities must be cautious enough that interpretation of words shall be in accordance with the intention of the legislature.

Furthermore, the term 'user' has not been defined under the Act. A user can include a click-based user, a subscriber, a viewer etc. It is important for the government to identify who will constitute as a user and what level of engagement is needed in order to tax only a material user base that is utilized for generating money for a business. While defining the concept of user, it must be taken note of that it shall cater to all kinds of business models. Like for instance, users for

¹⁹³ Finance Act, 2018 (Act No. 13 of 2018), Section 4.

¹⁹⁴ Framing of Income-Tax Rules Relating to Significant Economic Presence as per Section 9(1)(i) of the Income Tax Act 1961, Comments and Suggestions reg., F. No. 370142/11/2018-TPL, Ministry of Finance, Department of Revenue, Central Board of Direct Taxes (New Delhi, July 13, 2018) available at <<https://www.incometaxindia.gov.in/news/sep-rules-calling-stakeholder-comments-13-07-2018.pdf>> accessed 8th January 2019.

¹⁹⁵ Income Tax Act, 1961, Proviso to Explanation 2A of Section 9(1)(i).

social media platforms are one who sign up through their account login details to use Facebook and they shall be considered to be material users. However, for entertainment platforms like Youtube, users are those who access their platform, click on videos and watch them. Under such platforms, users produce data by viewing specific kind of videos which is valorized in form of personal advertisements.

b. Rules of Attribution of Profit to Transactions

As per second proviso to Explanation 2A to Section 9(1)(i) of Income Tax Act, 1961, it was provided that only that income that is attributable to the transactions or activities that constitutes SEP, will said to be deemed to accrue or arise in India.¹⁹⁶

Rule 10 of Income Tax Rules, 1962 provides that for ascertainment of profit that is attributable to Permanent Establishment, a profit rate can be applied to India specific turnover of the foreign company. However, certain judicial precedents¹⁹⁷ have held that attribution needs to be based on the principles of transfer pricing. It is important to frame proper rules to determine how revenue will be attributed to such transactions for smooth enforcement of such a provision.

C. Tax Implications of Proposed Data Localization Laws¹⁹⁸

As per the tax treaties, hosting a local server on which a website or data or software is stored is a piece of equipment having a physical location and can be considered as a fixed place of business of the enterprise and can constitute PE, provided other conditions are satisfied.¹⁹⁹ Thus, once non-resident enterprises locate servers in India, they will fall under

the taxation regime. Under the Indian laws, there have been three measures proposed to be undertaken to mandate e-commerce websites to locate server in India.

First, the Reserve Bank of India ('RBI') recently had said that all payment system operators in the country will be required to store data only within India to ensure safety and security of users' information. The operators have been given six months' time to comply with the directive of the central bank.²⁰⁰ This means that payment system operators will have to store all the data only in India, which implies that they will have to host a local server in India, and they cannot transact with Indian customers from servers located in any other country. Thus, this will automatically bring them under the purview of taxation regime.

Second, the Draft National Policy on e-commerce has proposed that e-commerce websites as well as social media firms shall store customer data exclusively in India.²⁰¹ This, if enforced will again mandate the websites to host servers in India and hence making them taxable.

Third, the Justice BN Srikrishna Committee proposed Data Protection Bill 2018 that mandates every entity processing personal data shall ensure the storage of at least one serving copy of such data on server located in India.²⁰² Thus, in this case, every entity processing data will have to locate server in India that can be considered as a Permanent Establishment of a foreign entity provided functions are performed through that server.

Thus, data localisation will help in taxation as once the server is in India, it can automatically be considered as a PE in India.



¹⁹⁶Income Tax Act, 1961, Proviso to Explanation 2A of Section 9(1)(i).

¹⁹⁷*DIT v. Morgan Stanley & Co* (2007) 292 ITR 416 (SC)

¹⁹⁸*The Report is limited to only highlight the tax implication of Data Localisation. It does not deal with the merits of Data Localisation Laws.*

¹⁹⁹Are Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce, (n. 29), 51-53.

²⁰⁰Storage of Payment System Data, RBI/2017-18/153, DPSS.CO.OD, No.2785/06.08.005/2017-2018 (April 6, 2018) available at <<https://www.rbi.org.in/scripts/NotificationUser.aspx?Id=11244&Mode=0>> accessed 15th January 2019.

²⁰¹Reuters, 'Government Looks to Compel e-commerce companies to store data locally,' (*India Today*, July 30, 2018) available at <<https://www.indiatoday.in/business/story/government-looks-to-compel-e-commerce-and-social-media-companies-to-store-data-locally-1300246-2018-07-30>> accessed 13th January 2019.

²⁰²Personal Data Protection Bill, 2018, Section 40.

IV. SUGGESTIONS AND THE WAY FORWARD

1. The long-term solution to tax the digital economy is to introduce the corresponding nexus rule in tax treaties. This can be done in two ways:

- a. Negotiating with different countries to amend treaty provisions. This is a very tedious procedure and will take a long time to be accomplished. In the interim period, treaties shall be negotiated at a priority, with the countries whose residents are highly involved in digital transactions in India.
- b. Introducing a Multilateral Instrument ('MLI') which every country can adopt. However, one has to understand that treaty is a result of the negotiation process that takes into consideration, the economic as well as the tax policy of contracting states. The changes introduced in such treaties by way of introducing an MLI, will not take into account specific relations between each contracting state and hence, might not reflect economic as well as political dynamic of each state. Thus, every contracting state might not agree to be a signatory of such instrument.

The renegotiation to amend the tax treaties will involve changing the definition of PE²⁰³ as provided in Article 5 of most of the tax treaties as well as change in the attribution rules as provided in Article 7 of most of the tax treaties.

2. Having presumed that treaties are negotiated, there are still other policy decisions that will need to be made to ensure a proper legal framework to tax digital economy.

- a. Equalization Levy, a unilateral measure taken by the Indian government to tax digital economy, will have to be rethought. Its scope and perhaps even its

existence will need to be re-evaluated specially when there are chances of it causing double taxation.

- b. The provision of SEP as introduced in the Income Tax Act, 1961 will need to be amended to introduce greater clarity and objectivity and to avoid future litigation. For instance, there are two aspects that may need alteration:

First, it is important to identify who will constitute as a 'user' and what level of engagement of a user is needed. This is important to ensure that the government only tax a material user base that is utilized for generating money. This is a difficult aspect and may require an in-depth examination of the user models, statistics and evaluating what constitute thresholds in order to arrive at final solutions.

Second, proper rules for attribution of profits to such digital transaction will need to be introduced.

3. Even if treaties are not negotiated, once data localisation laws are in place, many websites may fall under the taxation regime. After the above proposed laws are enforced, every e-commerce model falling under those laws will have to comply with the said provisions and will have host servers in India to keep data in India. However, they can still avoid taxation by getting all their core functions done through servers located outside India. There needs to be a mandate just like the RBI directive, that data of Indian customers can be located only in India so that it becomes mandatory for every website to host servers in India that will perform core functions of the business.



²⁰³The detailed inquiry on Permanent Establishment with respect to issues regarding its interpretation as well as application will be elaborated in our next report.

ANNEXURE I: ONLINE BUSINESS MODEL STRUCTURES THAT RESULTS IN TAX AVOIDANCE

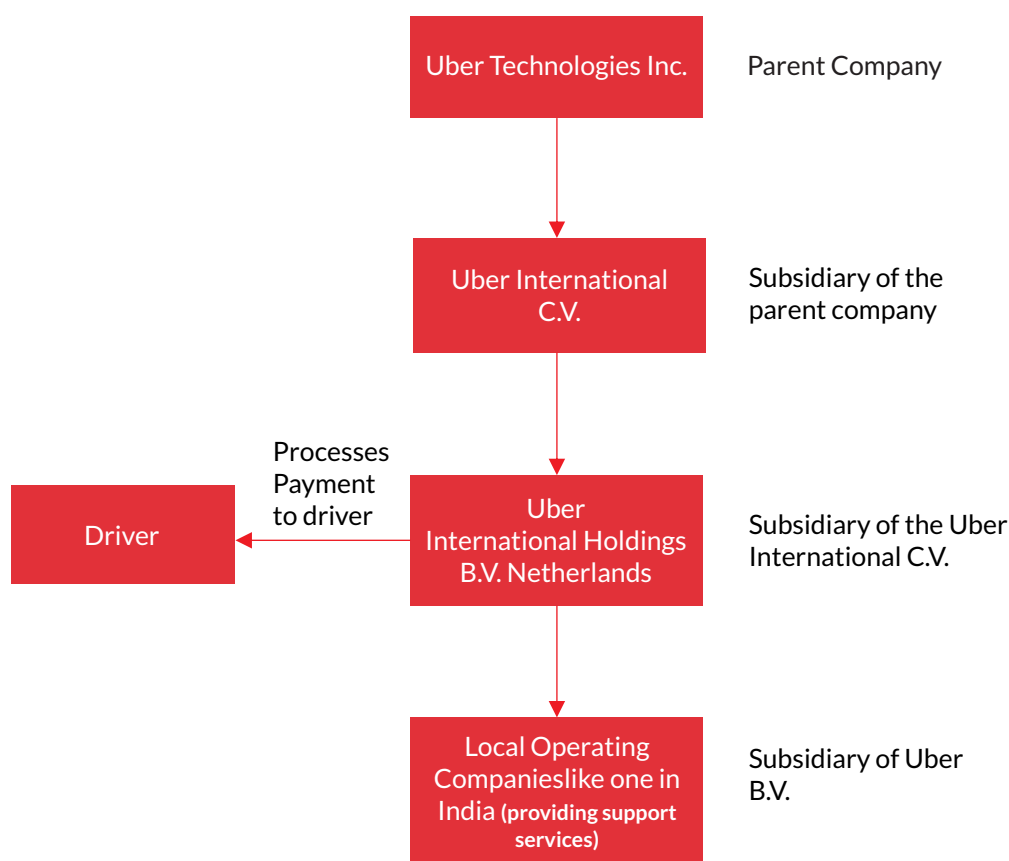
There are broadly two categories of Online Business Model Structures prevalent in e-commerce business that enable tax avoidance.

1. Aggregators (Cabs, Hotels, Travel Portals)

Aggregators is defined as a person who owns and manages a web-based software application, and by means of the application and a communication device,

enables a potential customer to connect with the persons providing services of a particular kind under the brand name or trade name of the aggregator. Uber, Airbnb etc., are examples of aggregators. The main taxation issue that arises is that whether local operating subsidiaries of the aggregators can be taxed or not, considering the fact that they generally provide support functions to the parent company.

a. Uber



Flow Chart 3. Business Model Structure of Uber

Uber is an electronic platform that is linked to an application that connects independent drivers with potential customers. Customers need to request a car using their location, which is then paired with the nearby drivers who then accept the request and complete the ride.

The company 'Uber' has a worldwide network of holding companies, partnerships as well as local operating companies. Uber Technologies Inc. is a Delaware corporation with many direct or indirect subsidiaries. Uber International C.V. is one such subsidiary which was formed in Netherlands and has its headquarters in Bermuda. Uber C.V. holds local operating companies through two Netherlands based holding companies, Uber International Holdings B.V. and Uber International B.V. that are in the form of

private partnerships. Uber B.V., a subsidiary of Uber C.V. processed worldwide payments of all Uber rides. It also pays the local Uber operating company a small fee for its services including marketing which is generally not taxable under domestic laws as they argue that they only provide marketing and support services.

b. Airbnb

Airbnb is another aggregator whose headquarter is located in Ireland. It also works on the same model as that of Uber and local subsidiaries only act as a support service and cannot constitute as a Permanent establishment. Thus, local subsidiaries though are incorporated in India however cannot be termed as PE as their activities merely be ancillary in nature.



2. Online Shopping sites/ e-tailing

There are two kinds of business models prevalent in e-commerce business. The first one is inventory led e-commerce model and the second one is the marketplace e-commerce model.

a. Inventory Based Model

Shopping web sites that take care of the whole process from starting from product purchase, warehousing to dispatching the product. One such example is Jabong.

b. Marketplace E-Commerce Model

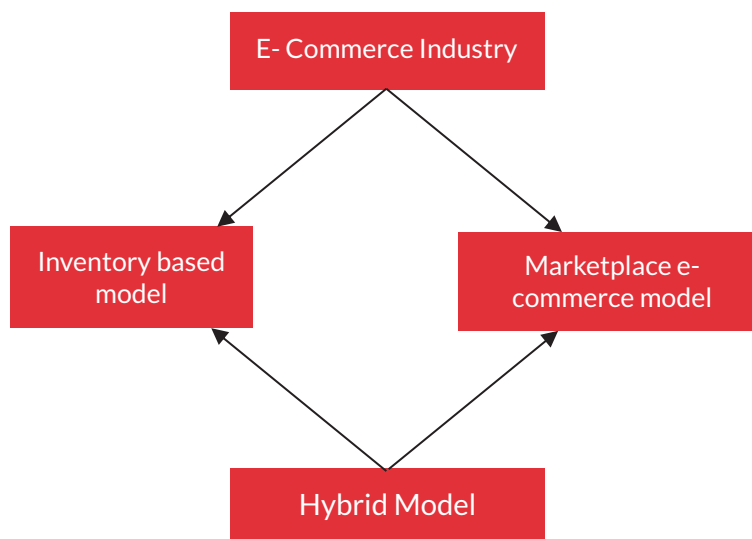
Such kind of model follows zero inventory model. They just act as a meeting ground for buyers and sellers

without storing goods. Some of them are eBay, shop clues, naapto etc.

c. Hybrid Model

This kind of model is a mix of both marketplace as well as inventory-based model. Some of the examples for this hybrid model are Flipkart, Amazon, Snapdeal etc. Under this, websites provide for the option of either self fulfilment of the order allowing for inventory storage to the website. Websites can come up with their own labels as well.

A lot of taxation issues arise to such e-commerce models. For example, Amazon model of business is a hybrid model.



Flow Chart 4. Business Model Structure of various online shopping site/e-tailing

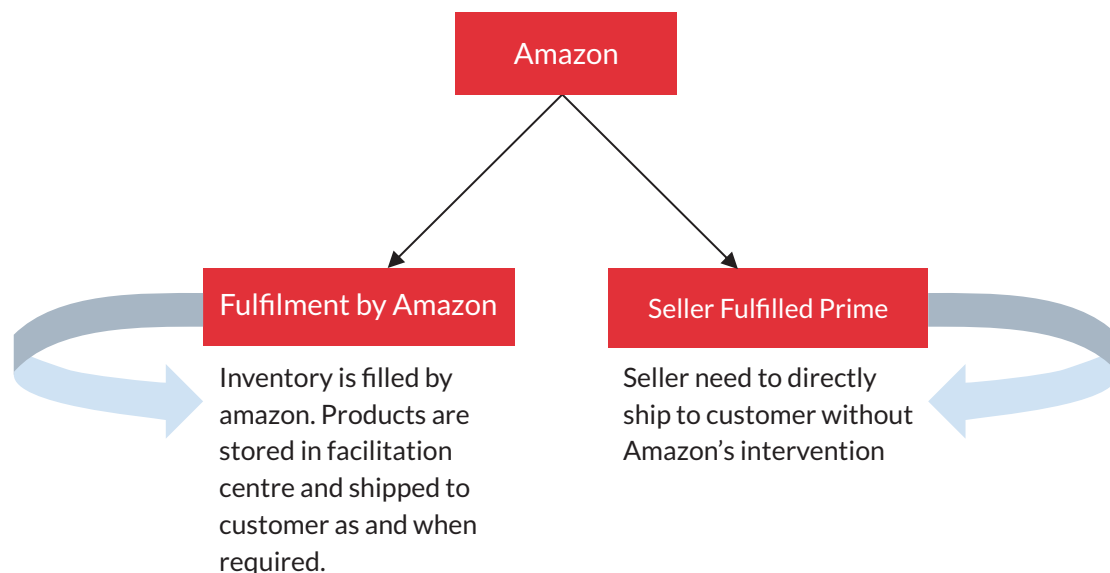
For fulfilment by Amazon model: Amazon has facilitation centres that stock goods that are sold through e-commerce portals. The place where goods are stored is operated by Amazon and it also collects proceeds of sale, deduct commission and pay it back to the dealer. Further, when the item is purchased online, the invoice is raised in the name of the seller and sent to the buyer while Amazon just collects commission for the services it offers.

The definition of PE clearly provides that a warehouse will constitute as a PE. However, the exception says that anything maintained solely for the purpose of storage, display or delivery will not be considered as a PE in India. Amazon can claim that the facilitation

centres are for mere storage and delivery and cannot constitute as PE in India.

For Seller Fulfilled Prime model: Amazon here only connects the seller with the buyer and the seller has to directly ship the product to the customer. Amazon just collects commission. Amazon here does not get involved in the commercial transaction and just act as a facilitator by allowing seller to take advantage of the e-commerce portal. For this kind of model, Amazon is just an online platform facilitation business and thus there is no physical presence of Amazon carrying on business wholly or partly and hence will not fall under the definition of PE.

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Flow Chart 5. Business Model Structure of Amazon

ANNEXURE II: ONLINE BUSINESS MODELS THAT DO NOT REQUIRE PHYSICAL PRESENCE IN INDIA AND HENCE EVADE TAX

1. Social Media websites

Social media websites are internet services that help people to interact with one-another and share as well as create content. It also provides for marketing opportunities for various businesses. Some of the well-known social media websites are Facebook, Instagram, Twitter, etc. These websites are involved in most user participation intensive businesses and the size of user base as well as level of engagement is critical for the success of the business which determines their financial performance.

Facebook has 294 million users in India as of October, says data site Statista, while its messaging platform WhatsApp in February, said that it had 200 million users in the country, making it the largest user base for both firms. Facebook India Online Services is set up in India to provide strategic support to Facebook Singapore Pte Ltd and Facebook Inc. USA. Thus, most of their activities are not taxed as Facebook India is not considered as a PE since it only provides support

function to the parent company.

The major source of revenue for such websites is through advertisement by converting the information of user's interest into valuable data and selling it to the advertisers. There has always been an ambiguity as to whether payment by Indian residents to non-resident companies for online advertisement or for uploading of banner advertisement on websites would be taxed as business income or royalty.

If revenue earned through advertisements is treated as royalty, then there is no need of a PE for taxing such income. However, if it is treated as business income, then there is a need to prove that an enterprise has a PE in India.

Further, it has been reportedly found that as per Facebook's financial statements, it is facing several tax disputes as equalization levy at the rate of 6% is levied on their advertising activities.



2. Websites requiring subscriptions

A business model that provides subscribers digital content such as information, music, videos etc. in lieu of a periodical fee charged as subscription fee to access the website. Some of the key examples of such websites are Netflix, Amazon Prime, Bumble, Westlaw, Heinonline, etc. The major issue that arises under the direct tax regime is with regard to characterization of such income. It is unclear as to whether income generated through subscription-based services will be considered as royalty or business income.

Subscription based websites does not necessarily need an India office to serve Indian customers. They earn a lot of money through paid subscriptions. Under the current regime, a physical presence is required to constitute a PE in India. Thus, if such income is characterized as business income, then it will not fall under the purview of taxation regime.

Equalization levy is also not applicable on such services as equalization levy is not levied on annual or monthly subscriptions to streaming websites.



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