Removing Roadblocks in Taxing Business Income in the Digital Era

Building global consensus for an equitable solution

June 2020

V | D H | Centre for Legal Policy

BMR Legal ADVOCATES

This report is the product of a collaboration between BMR Legal Advocates and the Vidhi Centre for Legal Policy, an independent think-tank doing legal research to help make better laws.

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The authors would like to thank Suchint Majmudar for his participation in and valuable contribution to the report.

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A. Introduction

1. Background

The definition of 'tax' agreed to by the Organisation for Economic Cooperation and Development ('**OECD**'), the International Monetary Fund and the United Nations System of National Accounts ('**SNA**') defines the concept as '*compulsory, unrequited payments to general government*'.[1] The primary objective behind the levy of tax is to generate revenue and finance public goods such as maintenance of law and order and public infrastructure.

The importance of tax revenue and the role of tax policy in the efficient functioning of a country as a whole, has been underscored with the outbreak of COVID-19 (Novel coronavirus). The spread of the virus and the consequent implementation of a lockdown in most countries, has had a debilitating effect on the global economy. Consumption and income generation capabilities have witnessed a steep fall, and tax revenues have thus taken a significant hit. Further, to mitigate the devastating impact of the pandemic, most countries, including India, have focused their tax policies towards boosting liquidity in the economy. With this aim, several tax compliance and collection relaxations have been offered, that have further eroded revenue from taxes. In parallel, the need to finance public services to support the vulnerable has been highlighted by the health-crisis. Though the world is gearing up to embrace the 'new normal', it is now apparent that trade is likely to witness only a slow recovery, at best. Therefore, the current economic and political climate has put immense pressure on most governments to explore new sources of tax revenue.

This unprecedented and unexpected global need to radically mobilise resources has come at a time when the international taxation ecosystem was on the brink of a landmark development. The rapid convergence of the global economy catalyzed by technological developments, had fueled a conversation around a revaluation of international tax principles. In the last five years, this conversation gained momentum. International organisations including the OECD, the United Nations ('**UN**') and the European Commission ('**EC**') have been working on devising a globally acceptable, consensus-based mechanism to effectively tax the digital economy. The Vidhi Centre for Legal Policy's report titled '*Taxation of Digital Economy in India, The Way Forward*' ('**Vidhi's Digital Tax Report**'), released in April 2019 identified the primary challenges faced in effectively taxing the digital economy and chronicled the progress made by the OECD, the EC and the UN in this regard.[2] In May 2019, the Programme of Work ('**PoW**') adopted by the member countries that for a part of the Inclusive Framework on Base Erosion and Profit Shifting ('**BEPS**') provided for two pillars to be developed, with a consensus solution to be agreed by the end of 2020.[3]Subsequently, in January 2020, the Inclusive Framework reaffirmed its commitment towards reaching an agreement on a consensus-based solution. The outline of the architecture of a Unified Approach on Pillar One was agreed on as the basis for negotiations and the progress made on Pillar Two was welcomed.

Amidst the COVID-19 crisis, while the relevance of a mechanism to tax the digital economy has been underscored, the ecosystem in which the OECD was working to build consensus on the issue has drastically changed. Not only is there a pressing need to bolster tax revenue, but the digital economy has also been touted as an attractive source for deriving such revenue. The Finance Minister of France Bruno Le Maire was quoted to state "*Never has a digital tax been more legitimate and more necessary,*" adding that such companies were doing better than most

[1] Organisation for Economic and Cooperation Development, Negotiating Group on the Multilateral Agreement on Investment 'Definition of Taxes' (April 19, 1996) available at <http://www.oecd.org/daf/mai/pdf/eg2/eg2963e.pdf> last accessed December 18, 2018.
[2] Rav P Singh and Vinti Agarwal, 'Taxation of Digital Economy in India, The Way Forward' (March 2019) available at <https://vidhilegalpolicy.in/wp-content/uploads/2019/05/DesignedReport_TaxingDigitalEconomyinIndia-TheWayForward.pdf> last accessed January 2, 2020
[3] Organisation for Economic and Cooperation Development, 'Public consultation document Secretariat Proposal for a "Unified Approach" under Pillar One 9' (October 2019 – 12 November 2019) available at < https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf> last accessed January 2, 2020

during the coronavirus crisis.[4] India infact widened the scope of Equalization levy to include e-commerce companies. Further, a large number of countries, with different policy priorities were negotiating to arrive at a consensus based solution to tax the digital economy. The economic impact of coronavirus is likely to negatively impact most countries' appetite for a compromise, hence fundamentally altering the course of the negotiations in the near future.

With the above background, this report analyses the international framework that governs the levy of tax on business income of multi-national enterprises in cross border transactions in light of the ever-augmenting digital economy. Vidhi's Digital Tax Report which was released in April 2019, identified the primary challenges faced in effectively taxing the digital economy and tracked the progress made by international organisations in this regard.[5] In continuation to that report, this report focusses on critically analysing the developments in this space since April 2019. This report analyses the progress of the issue both at India's domestic level, and at the global level with a focus on the progress made by the OECD in building consensus within the countries that constitute the Inclusive Framework. It also comments on the likely impact of COVID-19 on the OECD's efforts towards building consensus.

The primary issues that hinder the levy of tax on business income in the digital landscape are as under:

- Reallocation of Taxing Rights
- Attribution of Profit

Chapter B and Chapter C of this report deal with these two issues in detail, while Chapter D discusses the progress made on addressing these challenges since April 2019 both in India and at the OECD. Subsequently, Chapter F of this report critically analyses the current state of play and Chapter G provides actionable recommendations as to the way forward.

2. Guiding principles of tax policy

The development of guiding principles to shape tax policy has been of specific interest to nations across the world. This is not just a recent phenomenon. In the 18th century, Adam Smith, in his book The Wealth of Nations listed four primary maxims as provided in Figure 1 regarding the levy of tax.[6] These principles largely encouraged authorities to design taxes that were to be as equal as they could contrive; as certain, as convenient to the contributor, both in the time and in the mode of payment, and, in proportion to the revenue they brought in, as little burdensome as possible.[7]

Figure 1: Adam Smith's four maxims with regard to taxes in general as noted in the Wealth of Nations

Towards the end of the 20th century, similar principles were deemed appropriate for an evaluation of the taxation issues related to e-commerce.[8] The same principles with slight modifications are used as the

[4] Leigh Thomas, 'France to impose digital tax this year regardless of any new international levy' (May 14, 2020) Reuters, available at <https://in.reuters.com/article/us-france-digital-tax/france-to-impose-digital-tax-this-year-regardless-of-any-new-international-levy-idINKBN22Q25B> last accessed June 2, 2020

[5] Rav P Singh and Vinti Agarwal, 'Taxation of Digital Economy in India, The Way Forward' (March 2019) available at <https://vidhilegalpolicy.in/wp-content/uploads/2019/05/DesignedReport_TaxingDigitalEconomyinIndia-TheWayForward.pdf> last accessed January 2, 2020

[6] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Digital edn., MetaLibri, 2007) available at <https://www.ibiblio.org/ml/libri/s/SmithA_WealthNations_p.pdf> last accessed December 18, 2018.

[7] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Digital edn., MetaLibri, 2007) available at <https://www.ibiblio.org/ml/libri/s/SmithA_WealthNations_p.pdf> last accessed December 18, 2018.

[8] Organisation for Economic and Cooperation Development, 'Addressing the Tax Challenges of the Digital Economy' (September 16, 2014) available at <https://www.oecd.org/tax/addressing-the-tax-challenges-of-the-digital-economy-9789264218789-en.htm> last accessed December 18, 2018.

benchmark for sound tax policy by the OECD to determine the adequacy of taxation laws in the wake of digitalization. These principles are listed below:

1) Neutrality: Taxation should seek to be neutral and equitable between business activities.
2) Efficiency: Compliance costs to business and administration costs for governments should be minimised as far as possible.
3) Certainty and simplicity: Tax rules should be clear and simple to understand, so that taxpayers know where they stand.
4) Effectiveness and fairness: Taxation should produce the right amount of tax at the right time, while avoiding both double taxation and unintentional non-taxation. In addition, the potential for evasion and avoidance should be minimised.
5) Flexibility: Taxation systems should be flexible and dynamic enough to ensure they keep pace with technological and commercial developments.
6) Equity: Taxpayers in similar circumstances should bear a similar tax burden.

Each country's tax policy, and the weightage given to the aforementioned principles, varies based on the country's policy priorities. However, broad uniformity on the nature and design of several levies has been noticed across the globe. The levy of tax on the income of corporations for instance, is a common tool used by several countries to generate revenue. Typically imposed on net profits (receipts minus expenses) corporate tax was initially introduced to act as a prepayment of personal income tax due by the shareholders. However, the levy of tax on the income of corporations soon became a rampant exercise.

As noted above, the recent convergence of the global economy, catalyzed by developments in technology, has significantly increased the number of cross-border transactions. This has fueled a conversation around a revaluation of international tax principles as against the aforementioned overarching principles of tax policy.

B. Reallocation of Taxing Rights

As discussed in Vidhi's Digital Tax Report the principles of international tax laws have failed to maintain pace with the developments in digital technology. These laws stipulate that a business deriving income from cross border transactions is exigible to income tax in the country where such business' residence is located.[9] The concept of residence in-turn, is based on traditional principles of physical presence.[10] It does not account for technological developments that allow businesses to cater to markets remotely with either no physical presence, or with one that only provides support functions. Playing on these shortcomings of the law, businesses establish their residence in low-tax jurisdictions and employ technology to supply their products to the rest of the world.

This chapter of the report analyses the history behind the initial allocation of taxing rights. Subsequently, it seeks to demystify the complicated concept of Permanent Establishment ('**PE**') through a detailed analysis of the definition and judicial precedents. Further, the chapter explores popular re-structuring models adopted by businesses to minimize their tax liability.

1. The intellectual base for allocation of taxing rights

As global trade increased in the early 20th century, and concerns around instances of double taxation grew, the League of Nations appointed four economists to study the issue of double taxation from a theoretical and scientific perspective. One of the tasks of the group was to determine whether it is possible to formulate general principles as the basis of an international tax framework capable of preventing double taxation, including in relation to business profits.[11]

The group identified the concept of **economic allegiance** as a basis to design such international tax framework. Economic allegiance is based on factors aimed at measuring the existence and extent of the economic relationships between a particular state and the income or person to be taxed. The economists identified four factors comprising economic allegiance, namely:

1) Origin of wealth or income,
2) Situs of wealth or income,
3) Enforcement of the rights to wealth or income, and
4) Place of residence or domicile of the person entitled to dispose of the wealth or income.

Among those factors, the economists concluded that in general, the greatest weight should be given to "the origin of the wealth [i.e. source] and the residence or domicile of the owner who consumes the wealth".[12] The origin of wealth was defined for these purposes as all stages involved in the creation of wealth: "the original physical appearance of the wealth, its subsequent physical adaptations, its transport, its direction and its sale". In other

[9] Rav P Singh and Vinti Agarwal, 'Taxation of Digital Economy in India, The Way Forward' (March 2019) available at <https://vidhilegalpolicy.in/wp-content/uploads/2019/05/DesignedReport_TaxingDigitalEconomyinIndia-TheWayForward.pdf> last accessed on January 2, 2020
[10] Rav P Singh and Vinti Agarwal, 'Taxation of Digital Economy in India, The Way Forward' (March 2019) available at <https://vidhilegalpolicy.in/wp-content/uploads/2019/05/DesignedReport_TaxingDigitalEconomyinIndia-TheWayForward.pdf> last accessed on January 2, 2020
[11] Organisation for Economic and Cooperation Development, 'Addressing the Tax Challenges of the Digital Economy' (September 16, 2014) available at <https://www.oecd.org/tax/addressing-the-tax-challenges-of-the-digital-economy-9789264218789-en.htm> last accessed on December 18, 2018.
[12] Organisation for Economic and Cooperation Development, 'Addressing the Tax Challenges of the Digital Economy' (September 16, 2014) available at <https://www.oecd.org/tax/addressing-the-tax-challenges-of-the-digital-economy-9789264218789-en.htm> last accessed on December 18, 2018.

words, the group advocated that tax jurisdiction should generally be allocated between the state of source and the state of residence depending on the nature of the income in question.

Under this approach, in simple situations where all (or a majority of) factors of economic allegiance coincide, jurisdiction to tax would go exclusively with the state where the relevant elements of economic allegiance have been characterised. In more complex situations in which conflicts between the relevant factors of economic allegiance arise, jurisdiction to tax would be shared between the different states on the basis of the relative economic ties the taxpayer and his income have with each of them. On the basis of this premise, the group considered the proper place of taxation for the different types of wealth or income. Business profits were not treated separately but considered under specific classes of undertakings covering activities nowadays generally categorised as 'bricks and mortar' businesses, namely 'Mines and Oil Wells', 'Industrial Establishments' or 'Factories', and 'Commercial Establishments'.[13] In respect of all those classes of activities, the group came to the conclusion that the place where income was produced is "of preponderant weight" and "in an ideal division a preponderant share should be assigned to the place of origin". In other words, in allocating jurisdiction to tax on business profits, greatest importance was attached to the nexus between business income and the various physical places contributing to the production of the income.

The aforementioned views form the theoretical background on which various modern bilateral tax treaties are based.

2. Demystifying the definition of 'Permanent Establishment'

As discussed above, various countries entered into bilateral tax treaties to provide distributive rules and avoid double taxation. Pursuant to its executive powers under Article 73 of the Constitution of India, the Government of India has also entered into Double Taxation Avoidance Agreements ('**DTAA**') with various countries. Further, these treaties have been included in the Indian domestic law through Section 90 of the Income Tax Act, 1961 ('**IT Act**'). DTAA confer rights and impose obligations on the two contracting states. They intend to benefit taxpayers of the contracting state.[14] The interplay between domestic law and tax treaties is discussed in further detail in Chapter F

In India also, it has been a settled position that where a specific provision is made in a DTAA, that provision will prevail over general provisions contained in the IT Act for the purpose of a transaction between taxpayers in the contracting parties of such DTAA.[15] As per Section 90(2), where the Government of India has entered into such DTAA, then the provisions of the IT Act shall apply only to the extent that it is more beneficial to the assessee.[16] It can also be strengthened by the fact that the charging provision under the IT Act and scope of total income is subject to the provisions of the IT Act which includes Section 90 of the Act.[17] Thus, by implication, the IT Act is subject to the provisions of the DTAA entered into by the Government of India with the Government of any other country. However, it is important to note that the provisions of the DTAA cannot fasten a tax liability where liability is not imposed under the IT Act or the corresponding domestic law of the other contracting party.[18] Where

[13] Organisation for Economic and Cooperation Development, 'Addressing the Tax Challenges of the Digital Economy' (September 16, 2014) available at <https://www.oecd.org/tax/addressing-the-tax-challenges-of-the-digital-economy-9789264218789-en.htm> last accessed on December 18, 2018.
[14] Brian J. Arnold, 'An introduction to tax treaties' available at <https://www.un.org/esa/ffd/wp-content/uploads/2015/10/TT_Introduction_Eng.pdf> last accessed on January 17, 2020.
[15] CIT v. Davy Ashmore India Ltd., [1991] 190 ITR 626 (Calcutta High Court); CIT v. R.M. Muthaiah, (1993) 202 ITR 508 (Karnataka High Court); Arabian Express Line Ltd. Of United Kingdom and Ors. V. Union of India, (1995) 212 ITR 31 (Gujarat High Court).
[16] Income Tax Act, 1961, Section 90(2).
[17] Union of India (UOI) and Ors. vs. Azadi Bachao Andolan and Ors. 263 ITR 706 (Supreme Court); Commissioner of Income Tax, A.P. v. Vishakhapatnam Port Trust, (1983) 144 ITR 146 (Supreme Court).
[18] CIT v. P.V.A.L. Kulandagan Chettiar, (2004) 6 SCC 235.

tax liability is imposed under the IT Act, DTAA may be resorted to, to either reduce or altogether avoid the tax liability under the IT Act.[19]

Under the IT Act, the income of non-residents is taxable when it is received or deemed to be received in India or when it accrues or arises, or is deemed to accrue or arise in India.[20] Any income accruing or arising, directly or indirectly through a business connection in India, or from any property in India shall be deemed to be income accrued or arisen in India.[21] The Act does not contain a specific definition of the expression 'business connection'. However, there are specific inclusions added to the concept of business connection as provided in Explanation 2 and Explanation 2A of the IT Act. As per Explanation 2 of the IT Act, a person acting on behalf of non-resident and habitually concluding contracts shall be considered to be included in the concept of business connection. Further, as per Explanation 2A, significant economic presence ('**SEP**') of a non-resident in India shall also constitute business connection in India. It has been held that a relation to be a business connection must be real and intimate and must be through or from which income must accrue or arise whether directly or indirectly to the non-resident.[22] It was held that the essence of business connection is the existence of a close, real, intimate relationship and commonness of interest between non-resident company and India person.[23] Further, there needs to be continuity of activity or operation of non-resident company with Indian person and an isolated transaction is not enough to establish a business connection.[24] Business connection may take several forms and may include carrying on a part of the main business, or an activity incidental to the main business of the non-resident through an agent, or it may merely be a relation between the business of the non-resident and the activity in India, which facilitates or assists the carrying on of that business.[25]

While the establishment of a business connection is relevant for the application of Section 9 under the IT Act, the concept of PE is relevant for assessing income of a non-resident under DTAAs.[26] Under Article 7 of the UN Model Tax Convention and the OECD Model Tax Convention (which are two of the most widely adopted DTAA templates), the business profits of an enterprise in a Contracting State are taxable exclusively in said Contracting State, unless the enterprise in question carries on business in the other Contracting State through a PE. Business Connection is a wider term than PE. It has been held that if a non-resident has a PE in India, then business connection in India stands established.[27] Thus, in a case where an enterprise is a resident of a country with which India has entered into a DTAA, the business income of such enterprise can be taxed in India only when such enterprise has a PE in India. However, in a case where an enterprise is a resident of a country with which India does not have a DTAA with, then business income of such enterprise would be leviable to tax in India under the IT Act when such an enterprise has a business connection in India. Essentially, for countries with which India has a DTAA, the higher threshold of a PE is required to be satisfied, while for those with which no DTAA is executed, a mere business connection in India would attract the levy of tax. India has entered into DTAAs with 97 countries, which include countries like the United States, China, United Arab Emirates, Saudi Arabia and Hong Kong which are considered as top 5 trade partners of India.[28]

There has been a global consensus that the traditional definition of PE needs to be relooked and revised in accordance with the growing technological developments in the economy. Thus, before dealing with the tax challenges that are arising due to technological developments, it is essential to understand the meaning and the interpretation of the term PE.

[19] CIT v. P.V.A.L. Kulandagan Chettiar, (2004) 6 SCC 235.
[20] Income Tax Act, 1961, Section 5(2).
[21] Income Tax Act, 1961, Section 9(1)(i).
[22] CIT, Punjab v. R.D. Aggarwal & Company, AIR 1965 SC 1526
[23] Barendra Prasad Ray and Ors. V. Income Tax Officer, AIR 1981 SC 1047
[24] Barendra Prasad Ray and Ors. V. Income Tax Officer, AIR 1981 SC 1047
[25] CIT, Punjab v. R.D. Aggarwal & Company, AIR 1965 SC 1526
[26] Ishikawajma- Harima Heavy Industries Ltd. V. DIT, Mumbai, AIR 2007 SC 929
[27] Formula One World Championship Ltd v. Commissioner of Income Tax, International Taxation-3, Delhi and Ors, (2017) 394 ITR 80 (Supreme Court)
[28] Department of Commerce, 'Total Trade: Top Countries. Export Import Data Bank', (January 17, 2020) available at https://commerce-app.gov.in/eidb/iecnttopn.asp last accessed on January 17, 2020.

3. Definition of Permanent Establishment as per OECD and UN Model tax convention

Article 5 of the OECD Model tax Convention defines PE. The concept of PE postulates the existence of a substantial element of an enduring and permanent nature of foreign enterprise in the source jurisdiction.[29] It should be of such a nature that it should amount to virtual projection of foreign enterprise of one country into soil of another country.[30] It is now well settled that the mere presence of a business in a jurisdiction would not in itself amount to the establishment of a PE.

Since the source country has the right to tax business income of a non-resident enterprise only in cases of the non-resident enterprise having a PE in such source country, there have been several long-drawn cases on the interpretation of the scope of PE. In order to understand the provision of the DTAAs that define PE, it is important that it is read holistically with the general rule, the specific inclusions as well as the specific exclusions. Paragraph 1 of Article 5 provides for a general rule defining PE as a fixed place of business of an enterprise that is wholly or partly carrying on business of such enterprise. Paragraph 2 of Article 5 gives inclusive list of certain establishments that would be considered as PE such as a place of management, branch, office, workshop etc. This list is not an exhaustive list and thus other establishments not listed under Paragraph 2 of Article 5 may also constitute as PE. Paragraph 3 of Article 5 specifically includes building sites or construction or installation projects if such locations are established for more than 12 months. Paragraph 4 of Article 5 provides for an exclusion of certain activities that are preparatory or auxiliary in nature. It stipulates that if such preparatory or auxiliary activities are performed at a place of business, then such place of business would not constitute a PE. Some of the activities listed therein include cases where a place of business is used solely for the purpose of storage, display or delivery of goods etc; for the purpose of purchasing goods for the enterprise, or for collecting information for the enterprise provided such activities are preparatory or auxiliary in nature.[31] Paragraph 5 of Article 5 deals with Agency PE where if any person acts on behalf of an enterprise and is engaged in habitually concluding contracts or habitually playing a principal role in conclusion of contract, then such person can constitute Agency PE.

The UN Model Tax Convention is very similar to that of OECD Model Tax Convention in so far as the definition of PE is concerned. The only major difference between the two model conventions is that the OECD Model Tax Convention does not recognise Service PE, whereas the UN Model Tax Convention has specifically included Service PE within its definition. As per the UN Model Tax Convention, in cases where services are provided for more than 183 days in any 12-month period, the enterprise will satisfy the conditions of a PE.[32] It appears that such PEs were consciously excluded from the scope of the OECD Model Tax Convention as it was thought that their inclusion would increase compliance and administrative burden of the enterprise.[33] The OECD Commentary acknowledged that since service PE is generally established on the basis of time spent by personnel in a country providing services, it may be difficult for enterprises to determine in duration of their personnel's stay in advance, specifically in cases where their stay may be extended due to unforeseen circumstances or on request of a client.[34]

Thus, as noted above, there are three major types of PEs recognised by OECD and/or UN:

- Fixed Place PE
- Agency PE

[29] Ensco Maritime Ltd v. DCIT, [2004] 91 ITD 459 (Income Tax Appellate Tribunal Delhi)
[30] Commissioner of Income Tax, A.P.. v. Vishakhapatnam Port Trust, (1983) 144 ITR 146 (Supreme Court).
[31] Formula One World Championship Ltd v. Commissioner of Income Tax, International Taxation-3, Delhi and Ors, (2017) 394 ITR 80 (Supreme Court) [66]
[32] United Nations "Model Double Taxation Convention between Developed and Developing Countries" (2017), available at <https://www.un.org/esa/ffd/wp-content/uploads/2018/05/MDT_2017.pdf> last accessed on January 2. 2020 (hereinafter as UN Model Tax Convention) paragraph 3 (b) of Article 5.
[33] Organisation for Economic and Cooperation Development, 'Commentary on Article 5: Concerning the Definition of Permanent Establishment' (2019) available at <https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-2017-full-version_5cd2b87b-en#page1> last accessed January 20, 2020 (hereinafter as OECD Commentary on Article 5) 53 [133]
[34] OECD Commentary on Article 5, 53 [133]

- Service PE

Fixed Place PE is defined as a fixed place of business through which the business of an enterprise is wholly or partly carried on.[35] Agency PE is constituted in cases where a person acting on behalf of the non-resident enterprise habitually concludes contracts or plays a principal role in leading to conclusion of contracts.[36] Service PE is constituted when an enterprise furnishes services including consultancy services through employees or other personnel engaged by enterprise for furnishing such services for a period more than 183 days in any 12 month period. [37] Each type of PE has its own different requirements. For instance, fixed place PE requires a fixed place of business; agency PE requires a person acting on behalf of the non-resident enterprise and service PE requires employees or personnel engaged by the non-resident enterprise for furnishing services for more than 183 days in any 12 month period. However, for constituting any type of PE mentioned above, there is a common factor that needs to be satisfied. This common factor requires that the activities performed by the establishment must not fall under the exclusions mentioned in paragraph 4 of Article 5. Thus, the business activity test needs to be satisfied in each of the above-mentioned types of PEs.

3.1. Business activity Test

Paragraph 4 of Article 5 provides for an exclusion list where an enterprise carrying on certain activities of the nature stipulated therein would not deem to constitute PE provided such activities results in activities of a preparatory or auxiliary character.[38] It is recognized that while a place of business performing preparatory or auxiliary activities may contribute to the productivity of the enterprise, but it excludes them from the scope of PE test as it is based on the premise that such services are remote from the actual realization of profits by the enterprise and it is thus difficult to allocate any profit for such activities.[39] Accordingly, this exclusion was added to the definition of PE under the DTAA essentially stating that if a place of business performs activities that are preparatory or auxiliary in nature, then such place of business would not constitute a PE.

Some of the exclusions listed in paragraph 4 of Article 5 of OECD Model Tax Convention are:

- Use of facilities solely for the purpose of storing, displaying or delivering its own goods or merchandise;
- Maintenance of stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;
- Maintenance of stocks of goods belonging to the enterprise solely for the purpose of processing by another enterprise;
- Premises used solely for the purpose of purchasing goods or merchandise for the enterprise, or for collecting information for the enterprise;
- Premises maintained solely for the purpose of carrying on, for the enterprise any activity that is preparatory or auxiliary in character

These activities listed in paragraph 4 of Article 5 will not constitute PE provided such activity is preparatory or auxiliary in nature. If an enterprise performing these activities listed above is not in the nature of preparatory or auxiliary, then such enterprise performing such activities may constitute PE provided they satisfy other conditions mentioned in other paragraphs of Article 5. Thus, paragraph 4 prevents an enterprise of one Contracting State from being taxed in another Contracting State if it only carries on activities of a purely preparatory or auxiliary character.[40] For instance, whether the activity of storing, displaying or delivering constitutes as preparatory or auxiliary character will have to be determined in light of factors such as the overall business activity of the enterprise. Where, for instance, an enterprise of State R maintains in State S a very large warehouse wherein significant number of employees work for the main purpose of storing and delivering goods owned by the

[35] Organisation for Economic Cooperation and Development, 'Articles of the Model Convention with Respect to taxes on Income and on Capital' (January 28, 2003) available at <https://www.oecd.org/tax/treaties/1914467.pdf> last accessed on January 2, 2020 (hereinafter as OECD Model Tax Convention), Article 5, paragraph 1.
[36] OECD Model Tax Convention, Article 5, paragraph 5.
[37] UN Model Tax Convention, Article 5, paragraph 3 (b).
[38] Brown and Sharpe Inc. v. Commissioner of Income Tax, [2015] 281 CTR 91 (Allahabad High Court); Commissioner of Income Tax v. Hyundai Heavy Industries Co. Ltd., (2007) 291 ITR 450 (Uttaranchal High Court)
[39] OECD Commentary on Article 5, 24 [58]
[40] OECD Commentary on Article 5, 24 [58]

enterprise, then in this fact-pattern, storage and delivery activities performed through the warehouse in question represent an important asset and involve a number of employees. The same would thus not amount to preparatory or auxiliary in character.[41] Contrary to this, where an enterprise of State R maintains in State S a warehouse only for the purpose of delivering goods, however the main functions such as conclusion of contracts, receipt of payment etc. happens in State R, then such warehouse in State S shall not constitute PE. It has always been a question of judicial interpretation as to whether functions performed by the enterprise are preparatory or auxiliary in nature.

Notably, under the UN Model Tax Convention, the word 'delivery' has been omitted from paragraph 4 of Article 5. This means that delivery alone, as an activity, can constitute a sufficient economic nexus to provide source country the right to tax business profits that are attributable to PE.[42] Although, it makes little difference as delivery alone if considered as preparatory or auxiliary activity, will still be excluded from the definition of PE.

It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which are significant in nature. The decisive criterion is usually whether or not the activity of a place of business in itself forms an essential and significant part of the activity of the enterprise as a whole.[43] As a general rule, an activity that has preparatory character is one that is carried on in contemplation what constitutes the essential and significant part of an enterprise as a whole.[44] An activity that has an auxiliary character generally corresponds to an activity that is carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole.[45]

In India, it has been held that if no part of the main business and revenue earning activity of the multinational enterprise is carried on through a fixed business place in India which has been put at their disposal and Indian company renders only support services, then this outsourcing of work to India would not give rise to a fixed place PE because of the exception listed in paragraph 4 of Article 5.[46] Further, it has also been held that if the enterprise is engaged in merely providing back office functions through a fixed place of business in India, then such fixed place shall not constitute a PE as it is performing functions that are preparatory or auxiliary in character.[47] If the place of business is engaged in providing only advertising services or marketing services and the main function of the enterprise is performed outside India, then also it was held that will be considered as providing preparatory or auxiliary function and hence such place of business shall not constitute PE in India.[48] Liaison office is generally not considered as PE in India[49], however it depends upon activities undertaken by such office.[50] For instance, it was held that where liaison office merely performs function to simply download information from the main servers, then it is considered as a mere support function and thus shall not constitute PE.[51] However, in another case it was held that if the liaison office promotes sales of the goods of the assessee company through its employees to whom a sales incentive plan was provided for achieving sales target, it will be considered as PE as this is not preparatory or auxiliary function.[52]

Thus, while determining whether an enterprise has any type of PE as mentioned above, it is important to satisfy that such place of business/person/employee performs functions in the source country which is not merely preparatory or auxiliary in character. In addition to the above, there are certain other specific requirements that need to be satisfied with each type of PE.

[41] OECD Commentary on Article 5, 26 [62]
[42] Michael Lennard, 'The Un Model Tax Convention as compared with the OECD Model Tax Convention – Current Points of Difference and Recent Developments' (January – February 2009) Asia- Pacific Tax Bulletin 6.
[43] OECD Commentary on Article 5, 25 [59]
[44] OECD Commentary on Article 5, 25 [60]
[45] OECD Commentary on Article 5, 25 [60]
[46] Assistant Director of Income Tax v. E-fund IT Solution and Ors., AIR 2017 SC 5470
[47] DIT (International Taxation) Mumbai and Ors, v. Morgan Stanley and co. Inc. and Ors., (2007) 7 SCC 1.
[48] Director of Income Tax v. B4U International Holdings Limited, (2015) 277 CTR 213 (Bombay High Court)
[49] National Petroleum Construction Company vs. Director of Income Tax (International Taxation), (2016) 284 CTR 373 (Delhi High Court)
[50] Income Tax v. Nokia Networks OY, [2012] 253 CTR 417 (Delhi High Court)
[51] U.A.E. Exchange Centre Ltd. v. Union of India and another, [2009] 313 ITR 94 (Delhi High Court)
[52] Brown and Sharpe Inc. v. Commissioner of Income Tax, [2015] 281 CTR 91 (Allahabad High Court)

3.2. *Fixed place Permanent Establishment*

Paragraph 1, that provides for the definition of fixed place PE consists of two important conditions:

1. There needs to be an existence of a fixed place of business
2. This fixed place of business must carry on business of the enterprise either wholly or partly and thus shall not fall under the exclusions mentioned in paragraph 4 of Article 5.[53]

The term 'place of business' has been interpreted to cover any premises, facilities or installations used for carrying on business of the enterprise whether or not they are used exclusively for that purpose.[54] It has also been specifically stated that the term 'place' needs to be interpreted in light of the object and purpose of Article 5 of OECD Model Tax Convention and thus a certain leeway for including movable property is given if such property is fixed to a soil. However, it has been held to not include in its ambit a moving vehicle which operates near a fixed place.[55] Further, it has also been held that purely intangible property cannot qualify as place of business.[56] It has been held that to determine whether there is fixed place of business or not, the place of business must have three characteristics: stability, productivity and dependence.[57]

Stability

Since the place of business must be fixed, it also follows that a PE can be deemed to exist only if such place of business has certain degree of permanency and thus stability attached to it. As per the OECD Commentary on Article 5, the prevalent practice shows that a PE has been considered to exist where the place of business was maintained for a period longer than six months.[58] However, it has also been noted that a place of business may, constitute a PE even if it exists in practice only for a short period of time if the nature of the business is such that it will only be carried for such a short period.[59]

Dependency

An enterprise having a space at its disposal for carrying on its business has been held to constitute a PE even if no formal right to use that place vests with the enterprise. It has been held that the place would be treated as at the disposal of the enterprise in question, when the enterprise has the right to use the said place and has control thereupon.[60] Further, it was held that it is not necessary that the premise is owned. The same may even be rented by the enterprise. A PE has also been held to be established when location used for carrying on business is illegally occupied by the enterprise.[61]

It is generally accepted that the existence of a subsidiary company does not, by itself constitute the presence of a PE because for the purpose of taxation, subsidiary company constitutes an independent legal entity.[62] However, the mere fact that subsidiary companies are separate tax entities also does not in itself mean that they could never constitute a PE of its holding company.[63] It was held that a parent company may have a PE in a contracting state as a subsidiary if it is at the disposal of the parent company and carries on business either wholly or partly through that subsidiary.[64] It was also noted by thr Apex Court that it would be fundamentally erroneous to conclude that

[53] OECD Model Tax Convention, Article 5
[54] OECD Commentary on Article 5 4, [10]
[55] DCIT v. Subsea Offshore Ltd., (1998) 661 ITD 296 (Income Tax Appellate Tribunal Mumbai)
[56] Formula One World Championship Ltd v. Commissioner of Income Tax, International Taxation-3, Delhi and Ors, (2017) 394 ITR 80 (Supreme Court)
[57] Formula One World Championship Ltd v. Commissioner of Income Tax, International Taxation-3, Delhi and Ors, (2017) 394 ITR 80 (Supreme Court) [24]
[58] OECD Commentary on Article 5.
[59] OECD Commentary on Article 5.
[60] Formula One World Championship Ltd v. Commissioner of Income Tax, International Taxation-3, Delhi and Ors, (2017) 394 ITR 80 (Supreme Court) [26]
[61] OECD Commentary on Article 5.
[62] OECD Commentary on Article 5, 47 [115]
[63]Adobe Systems Incorporated v. ADIT, (2017) 292 CTR 407 (Delhi High Court)
[64] OECD Commentary on Article 5, 47 [116]

merely by contracting with a 100% subsidiary, a PE would be created without looking at the functions that a subsidiary would be performing.[65]

Productivity

For attracting the taxing statute, there has to be some activity performed through the PE. It has been acknowledged by courts in India that if income arises without any activity carried out by the PE, tax liability in respect of the overseas services would not arise in India.[66] The activity shall be carried out on a regular basis through the place of business, though there can be some interruption of operation.[67] Further, the activity performed shall be substantial in nature and shall not be preparatory or auxiliary as it will then fall under the exclusion list mentioned in paragraph 4 of Article 5.

3.3. Agency Permanent Establishment

Paragraph 5 of the OECD Model Tax Convention highlights that Agency PE is constituted if the person habitually concludes contracts in the name of the enterprise or plays a principal role in leading to the conclusion of a contract which are routinely concluded. To constitute Agency PE, there are some mandatory requirements to be satisfied:

1. There needs to be a person acting on behalf of an enterprise; and
2. such person much undertake activities on behalf of the enterprise, including habitually concluding contract or playing principal role in leading to the conclusion of contract; and
3. Activities undertaken by such person shall not fall under the exclusion list mentioned in paragraph 4 of Article 5.

A *Person acting on behalf of the enterprise*

Agency PE covers cases where contracts are concluded with clients by an agent, a partner or an employee of an enterprise so as to create legally enforceable rights and obligations between the enterprise and the clients.[68] It has also been held that if the contracts are concluded elsewhere, however the implementation of such contracts happens at the place of business in the contracting state, then such place of business shall not be considered as Agency PE since no contracts were concluded therein.[69]

Notably, a place of business does not amount to an agency PE if the person performing activities on behalf of the enterprise is an independent agent and is acting in the ordinary course of his business.[70] Whether such person performing activities is an independent agent or a contractor would depend upon the control of the enterprise and the activities performed by such person in his ordinary course of business. Contractors are generally regarded as an independent agent as they are independent of any control or interference and are only bound to produce specified results. On the other hand, agents have to exercise their authority in accordance with lawful instructions given to them by the principal and are also subject to direct control or supervision of the principal.[71] It was held that where a person's commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by such enterprise, then the person in question cannot be regarded as independent of the enterprise.[72]

Further, it was held that when the activities of an agent are wholly or almost wholly made on behalf of the enterprise, he will not be considered to be performing in the ordinary course of business and thus cannot be said

[65] ADIT v. E-funds IT Solution and Ors., Civil Appeal No. 6082 of 2015 (Supreme Court)
[66] Ishikawajma Harima Heavy Industries Ltd. V. Director of Income Tax, Mumbai, AIR 2007 SC 929
[67] OECD Commentary on Article 5
[68] OECD Commentary on Article 5, 39 [92]
[69] DIT (International Taxation) Mumbai and Ors, v. Morgan Stanley and co. Inc. and Ors., (2007) 7 SCC 1.
[70] OECD Model Tax Convention, Article 5 paragraph 6.
[71] In Re: ABC, (2005) 193 CTR 328 (Authority for Advance Rulings Delhi)
[72] OECD Commentary on Article 5, 43 [103]

to be acting as an independent agent.[73] In one of the cases, Amadeus India Private Limited was providing data processing and software development services together with relative distribution of Amadeus Products to the subscribers in India. The company also had the authority to enter into agreements with subscribers on behalf of the parent company. This company was considered as a dependent agent of the assessee as it was carrying on activities which was not in his ordinary course of business and cannot be said to act as an independent agent.[74]

B *Person carrying out activities including habitually concluding contract or playing principal role in conclusion of contract*

The term 'habitual' implies that the activity must take place repeatedly and not merely in isolated cases.[75] For constituting an agency PE, persons acting on behalf of the enterprise must carry out activities on behalf of the enterprise including habitually concluding contracts or playing principal role in leading to conclusion of contract. It was noted in the OECD Commentary on Article 5 that a person soliciting and receiving orders which are sent directly to a warehouse from which goods belonging to the enterprise are delivered and where the enterprise routinely approves these transactions will be considered as a person who is habitually playing principal role leading to conclusion of contracts.[76] Where employees working in an enterprise established in a Contracting States actively takes part in negotiation of important parts of contracts for sale of goods to buyers in that State, such enterprise shall be considered to have been taken principal role in leading to conclusion of contract. Thus, even though it does not habitually conclude contracts, it will be considered as an Agency PE.[77]

In cases where subsidiaries act as an agent of its holding company, the income from the activities conducted by said subsidiary for, and on behalf of its principal would be assessed in the hands of the principal. With respect to activities undertaken on behalf of parent company, the subsidiary would only be liable to pay tax with on the remuneration receivable as an agent.[78] It may also constitute an agency PE if subsidiary has the authority to conclude contracts in the name of its parent and habitually exercises this authority unless such activity is triggered by the exception and is said to be purely preparatory or auxiliary functions.[79]

3.4. Service Permanent Establishment

The emergence of technology has seen revolutionary growth in the service sector. Physical presence is no more required for rendering services. The use of services to erode the tax base of developing countries has been recognised as a serious issue that involves several types of services and the provisions of both domestic law and tax treaties. Different countries take different approaches to levy tax on services. In OECD, a majority view has been that in a bilateral treaty, the test for which country should have the right to tax profits should be the same as equivalent for test for services.[80] A minority view including India however, have taken a different view and considered services as different from goods and that it can be tested against a lighter physical presence rule.[81]

Paragraph 3(b) of Article 5 of the UN Model Tax Convention encompasses Services PE in cases where employees or personnel engaged by the enterprise furnishes services including consultancy service within a contracting state for more than 183 days in any 12-month period. As noted above, this is the a point of distinction between the UN Model Tax Convention and the OECD Model Tax Convention, with the latter specifically choosing not to include such PEs in order to avoid the imposition of administrative costs on enterprises. However, most of the developing countries have incorporated this provision in their DTAA including India. It is important to note that India also added the provision for taxing fees for technical services in 1976 which includes services in the nature of managerial, technical or consultancy.

[73] DIT (International Taxation) v. Delmas France, (2015) 281 CTR 265 (Bombay High Court).
[74] Amadeus Global Travel Distribution SA v. Deputy Commission of Income Tax, (2008) 113 TTJ 767 (Income Tax Appellate Tribunal, New Delhi)
[75] OECD Commentary on Article 5, 35 [83]
[76] OECD Commentary on Article 5, 38 [89]
[77] OECD Commentary on Article 5, 31 [72]
[78] Adobe Systems Incorporated v. ADIT, (2017) 292 CTR 407 (Delhi High Court)
[79] Schoueri, L. and Günter, O., "The Subsidiary as a PE", Bulletin for International Taxation (2011, vol. 65).
[80] OECD Commentary on Article 5, 54 [135]
[81] OECD Commentary on Article 5, 54 [135]

Service PE is created only when services are furnished by the employees or other personnel of non-resident enterprise.[82] It was held that where employees continue to be on the payroll of the non-resident enterprise or they continue to have their lien on their jobs with non-resident enterprise while furnishing services, a service PE can emerge.[83]

According to the UN Model Tax Convention, service PE is triggered when services are furnished in the Contracting State. In the case of Linklaters LLP v. ITO[84], it was argued that the firm renders services and do not furnish services. Tribunal held that the term 'rendering' and 'furnishing' are interchangeable and it will be too farfetched to agree that furnishing excludes rendering of professional services. Thus, a foreign firm engaged in practice of law rendering services to clients in India for more than a period of 183 days (or number of days as provided in the DTAA with the respective country) shall be considered as Service PE and hence taxable.

4. Permanent Establishment and the advent of technology

The advent of technology has changed the conduct of business from brick and mortar to digital shops. Instead of a traditional store, computer servers can now perform functions similar to those of traditional PEs, as software within the server can display a web page on the internet, take customers' orders, accept payment and transmit digital goods and services.[85] The traditional definition of PE as discussed above does not take into account technological developments that allow businesses to cater to markets remotely with either no physical presence, or with one that only provides support functions. Playing on these shortcomings of the law, businesses establish their residence in low-tax jurisdictions and employ technology to supply their products to the rest of the world. There may only be automated equipment such as computers, servers, etc. installed in the contracting state for performing business in that state. A question has often arisen as to whether such automated equipment can be said to constitute PE in the contracting state. Further, issues with respect to whether various intangible objects that aid enterprises in performing businesses in the contracting state such as websites, software etc constitute PE or not have also arisen.

4.1. Computer equipment or server as Permanent Establishment

Servers have been defined as a computers that store information for access by users of a network.[86] Servers on which websites are stored, are a piece of equipment having a physical location and such location may constitute fixed place of business of the enterprise that operates that server.[87] Server will have to be located at a certain place for a sufficient period of time so as to constitute fixed place of business. It has been noted in the OECD Commentary on Article 5 that where an enterprise operates computer equipment at a particular location, PE may exist even though no personnel of that enterprise is required at that location for the operation of the equipment.[88] The important condition is that the server or computer equipment in question must be at the enterprise's disposal to constitute a fixed place of business.[89] Complete control over computers installed at the premises of subscribers has also been held to constitute a fixed place of business.[90]

[82] DIT v. e-funds IT Solution and Ors., (2014) 42 taxmann.com 50 (Delhi High Court); Assistant director of Income Tax v. E-fund IT Solution and Ors., AIR 2017 SC 5470 [20]
[83] DIT (International Taxation) Mumbai and Ors, v. Morgan Stanley and co. Inc. and Ors., (2007) 7 SCC 1.
[84] Linklaters LLP v. ITO, (2010) 40 SOT 51 (Income Tax Appellate Tribunal Mumbai)
[85] Arthur Cockfield, 'Reforming the Permanent Establishment Principle Through a Quantitative Economic Presence Test' (2003) 38 Can. Bus. L. J. 400-422.
[86] Office of Tax Policy, U.S. Department of The Treasury, Selected Tax Policy Implications of Global Electronic Commerce 45 (1996), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/Internet.pdf> last accessed February 2, 2020.
[87] OECD Commentary on Article 5, 49 [123]
[88] OECD Commentary on Article 5, 50 [127]
[89] OECD Commentary on Article 5, 50 [127]
[90] Galileo International Inc. v. Deputy Commissioner of Income Tax, (2008) 19 SOT 257 (Income Tax Appellate Tribunal Delhi)

It is relevant to note that like any of the other PEs discussed in the preceding sections of the report, the activities performed by the server or computer equipment in question must not be preparatory or auxiliary in nature in order to qualify as a PE. It has been held that where a server concludes contracts with customers, processes payments and delivers products automatically such activities are not merely preparatory or auxiliary and the server would thus constitute a PE.[91] Some of the activities that are generally considered as preparatory or auxiliary are:

- Providing a communication link between suppliers and customers
- Advertising of goods or services
- Relaying information through a mirror server for security and efficiency purposes
- Gathering market data for the enterprise
- Supplying information[92]

As per the OECD Commentary on Article 5, server or computer equipment shall constitute a PE only after following conditions are satisfied:

- Server, computers must be a fixed place of business
- Such server or computer equipment must be at the disposal of the enterprise
- The business of the enterprise must be carried on through the server or computer which shall not be preparatory or auxiliary in nature. [93]

4.2. *Internet website/software as Permanent Establishment*

An internet web site is a combination of software and electronic data that does not, in itself constitute tangible property and therefore does not have a location that can constitute a place of business, as there is no facility such as premises or in certain instances machinery or equipment.[94] It is common for the website through which enterprises carry on their business to be hosted on a server. Government of India has expressed reservation on the issue of whether fixed server should be required in order to constitute PE stating that website may constitute PE in certain circumstances. However, Kolkata Tribunal has taken a contradictory view and has held that a search engine's presence in a location is only on internet or by way of a website which is not a form of physical presence and thus shall not constitute PE unless web servers are located in the same jurisdiction hosting such website. [95]

Sometimes, the website is hosted on internet service provider which is not at the disposal of the enterprise. In such a case, there is no fixed place of business of the enterprise. It has been noted that if enterprises carry on business through a website that is hosted on a server which is either owned or leased and is at the enterprise's disposal, it may constitute PE if other requirements are met i.e. activities performed are not merely preparatory or auxiliary in character.[96]

Once the website is hosted on a server which is at the disposal of the enterprise, the next factor that needs to be satisfied is that such website shall not perform merely preparatory or auxiliary functions. If the location is being used to operate servers that host a website which is often used exclusively for advertising, displaying a catalogue of products or providing information to the potential customers, then such website or server may not be considered to constitute a PE as it may be considered as merely performing preparatory or auxiliary function.[97] However, if the location is used for conclusion of contract with customer, processing of payment and delivery of products, then these activities cannot be considered as mere preparatory or auxiliary in character and thus such location where website has been hosted on a server may constitute a PE.[98]

[91] OECD Commentary on Article 5, 49-52 [119-131]
[92] OECD Commentary on Article 5, 49-52 [119-131]]
[93] OECD Commentary on Article 5, 49-52 [119-131]
[94] OECD Commentary on Article 5, 49-52 [119-131]
[95] Income Tax Officer v. Right Florists Pvt. Ltd, (2013) 143 ITD 445 (Income Tax Appellate Tribunal Kolkata)
[96] OECD Commentary on Article 5, 49 [124]
[97] OECD Commentary on Article 5, 51 [130]
[98] OECD Commentary on Article 5, 51 [130]

There have been arguments made that Internet Service Providers constitute Agency PE. It has been held that internet service providers will not typically constitute as an agent of the enterprise to which websites belong as they do not conclude contracts or play principal role in conclusion of contracts. Further, they act as an independent agent working in ordinary course of business and thus may not be termed as PE.[99]

Thus, internet websites or software cannot be considered a PE unless and until the following three conditions are satisfied:

- Website or software is hosted on a server located in the source State;
- Such server is at the disposal of the non-resident enterprise and
- Such server carries on activities that are not preparatory or auxiliary in nature and thus does not fall under the exclusion list mentioned in paragraph 4 of Article 5.

[99] OECD Commentary on Article 5, 52 [131]

C. Tricks of the Trade: Common Mitigation Measures

As noted in the preceding sections, the creation of a PE is a prerequisite to the levy of tax in the source jurisdiction under both the OECD Model Convention and the UN Model Convention. Further, as discussed above, several factors determine the formation of a PE. Therefore, the adoption of tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax jurisdictions where there is little or no economic activity has become a prevalent practice across all sectors.[100] However, such practices have special relevance in the digital economy. Enterprises in this ecosystem have certain characteristic features such as mobility, reliance on data, use of multi-sided business models, and volatility, which enable them to create value in a jurisdiction without any physical presence. In this section of our report, we identify certain business models in the digital ecosystem and explore various structures adopted by enterprises to minimize their tax liability. The objective of this exercise is to identify common practices adopted by enterprises to avoid the establishment of a PE as it is currently defined.

1. Business models in the digital ecosystem

A business model is a model-based description of the logical mechanisms showing how an organisation or enterprise generates values for customers, reaches out to customers, and secures business return.[101] Enterprises may define their business models based on several factors, such as their method of value creation, their revenue stream etc. For the purpose of this report, we attempt to categorise business models based on the core function that they perform, which may or may not draw them revenue. We also recognize that a single enterprise may be involved in several different business models.

1.1. Provision of goods or services, digitally, for one-time payment

Several enterprises in the ecosystem supply content - which may include goods or services - through digital means, in exchange for one-time payment. The content in question may include e-books, software, movies, advertisement services etc. and examples of established enterprises running such businesses include Coursera, Amazon (to the extent that it allows the purchase of e-books for a one-time payment), App Store (to the extent that they allow purchase of apps for one-time payment) etc.

It is relevant to note that enterprises operating under this business model may be distinguished from subscription-based models (discussed in subsequent paragraphs) in the form of payment. While subscription based models require users to pay a certain sum for a defined period, the one-time payment model as the name suggests requires a lump sum payment in exchange of goods or services. It may be relevant to illustrate this distinction using the example of YouTube Premium, which grants its users access to exclusive content upon the payment of a monthly fee and the service on YouTube that allows users to access a specific film upon one-time payment. Notably, the 'goods and services' supplied by enterprises operating under this business model are envisaged to be those that can be entirely supplied and consumed electronically. This would exclude services, the supply of which is intrinsically linked to another activity that requires physical action. For instance, an e-book supplied by Amazon will qualify under the scope of this business model, as both the supply and consumption is done digitally and in not

[100] Organisation for Economic Cooperation and Development/G20 Inclusive Framework on BEPS available at <https://www.oecd.org/tax/beps/flyer-inclusive-framework-on-beps.pdf> last accessed December 1, 2019
[101] EFI, 'Business models of the digital economy', (2016) available at <https://www.e-fi.de/fileadmin/Chapter_2016/2016_B3_EN.pdf> last accessed January 10, 2020.

intrinsically linked to an external physical event. On the other hand, the service of connecting buyers to sellers of tangible products by the Amazon Marketplace would fall outside the scope of this business model. Even though Amazon's service in this case is limited to enabling a connection between buyers and sellers through a digital mode, the same is intrinsically linked to the physical delivery of the tangible product. Therefore, such services would be deemed to fall outside the scope of this business model.

1.2. *Subscription based models*

An enterprise that enables the continuous provision of goods or services in exchange for recurring payments may be classified as one operating on a subscription based business model.[102] From music-streaming business models to subscription access to bundled digital and physical products, these business models are becoming increasingly prevalent in the B2C space. Consumers may find such models convenient, especially for the recurring purchase of goods that require replenishment, including many common household goods. Similarly, firms can benefit from lower marginal costs, reduced frictions and long-term recurring revenue flows.[103] Examples of established enterprises running such businesses include Netflix, Amazon Prime Video, Spotify etc.

1.3. *Participative network platforms*

Participative networked platforms facilitate social communication and information exchange. They are services based on technologies such as the web, instant messaging, or mobile technologies that enable users to contribute to developing, rating, collaborating and distributing Internet content and developing and customising Internet applications, or to conduct social networking.[104] This category is intended to include social networking sites, video content sites, online gaming websites and virtual worlds.[105]

Participative networked platforms are often based on community models whereby users have a high investment in time on these platforms. Revenue can be based on the sale of ancillary products and services, voluntary donations, or advertising and subscriptions for premium services. Although business models are still in flux, the rise of social networking and success of product versions tailored to mobile use show that the Internet is well suited to community models. Examples of established enterprises running such businesses include Facebook, Twitter, Wikipedia, Reddit, StumbleUpon, Skype instant messaging etc.

1.4. *E-commerce marketplace*

E-commerce market places are categorised as platforms that seek to establish a connection between buyers of certain goods or services to sellers of such goods or services. The unique feature of an e-commerce marketplace is that it brings *multiple* buyers and sellers together (in a ''virtual'' sense) in one central market space.[106]

These platforms are covered under the broad category of multi-sided platforms' that enable, by electronic means, direct interactions between two or more customers or participant groups (typically buyers and sellers).[107]
Such platforms have two key characteristics:

- Each group of participants ("side") are customers of the multi-sided platforms in some meaningful way, and

[102] Organisation for Economic and Cooperation Development, 'Unpacking E-commerce Business Models, Trends and Policies', (May 2019) available at < https://www.oecd.org/going-digital/unpacking-ecommerce.pdf> last accessed January 10, 2020.
[103] Organisation for Economic and Cooperation Development, 'Unpacking E-commerce Business Models, Trends and Policies', (May 2019) available at < https://www.oecd.org/going-digital/unpacking-ecommerce.pdf> last accessed January 10, 2020.
[104] Organisation for Economic Cooperation and Development, 'Economic and Social Role of Internet Intermediaries' (April 2010), available at <https://www.oecd.org/internet/ieconomy/44949023.pdf> last accessed March 10, 2020
[105] Organisation for Economic Cooperation and Development, 'Economic and Social Role of Internet Intermediaries' (April 2010), available at <https://www.oecd.org/internet/ieconomy/44949023.pdf> last accessed March 10, 2020
[106] Martin Grieger, 'Electronic Marketplaces: A Literature review and a call for supply chain management research' European Journal of Operational Research 144 (2003) 280–294 available at <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.457.8690&rep=rep1&type=pdf> last accessed February 10,2020.
[107] Organisation for Economic Cooperation and Development, 'The Role of Digital Platforms in the Collection of VAT/GST on Online Sales' (March 2019) available at <http://www.oecd.org/tax/consumption/the-role-of-digital-platforms-in-the-collection-of-vat-gst-on-online-sales.pdf> last accessed January 10, 2019.

- The multi-sided platform enables a direct interaction between the sides.

Examples of established enterprises running such businesses include Amazon, MakeMyTrip.

1.5. Aggregators

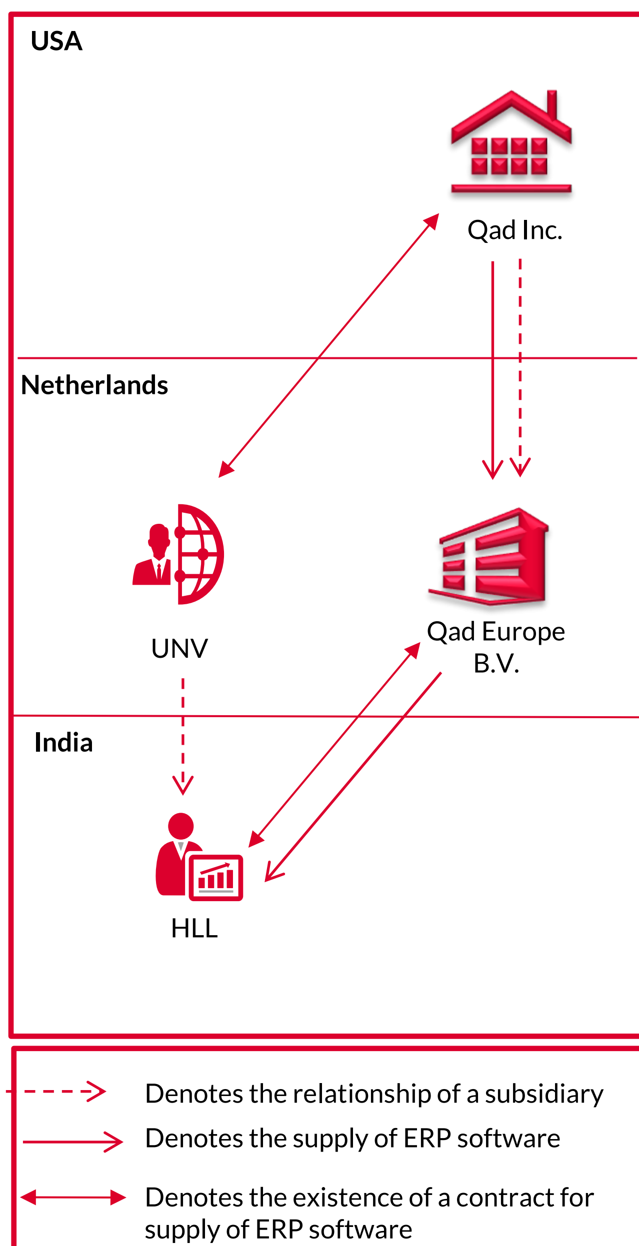
Aggregators is defined as a person who owns and manages a web-based software application, and by means of the application and a communication device, enables a potential customer to connect with the persons providing services of a particular kind under the brand name or trade name of the aggregator. Examples of established enterprises running such businesses include Uber, Airbnb etc.

2. Established case studies

As noted above, this section of the report studies strategies adopted by enterprises to minimize their tax liability. While there may be several ways in which an enterprise may structure its business to achieve this goal, in this section, we focus only on routes that allow these enterprises to circumvent the establishment of a PE in the source jurisdiction. Further, we also wish to clarify that although some of the schemes detailed in this section may be argued to be illegal, most are not. However, we believe that they all undermine the fairness and integrity of tax systems.

Case study - 1

In order to conduct a case study on an enterprise operating under this business model, we have identified QAD, which is an enterprise providing integrated business software for manufacturing companies, with customers in over 100 countries around the world.[108] The structure of the enterprise in question was discussed by the Income Tax Appellate Tribunal ('**ITAT**')[109] and for the purpose of this case study, we have relied on the facts set out therein. The facts are also represented in Figure 2.



Case Study 1

We understand that Qad Europe B.V. is incorporated in the Netherlands where it is also a tax resident. It is a 100 per cent. subsidiary of Qad Inc., USA ('**Qad Inc.**') which is the ultimate parent company of Qad group. Qad Inc. was engaged during the period relevant for the case, in the development and sale of enterprise resource planning ('**ERP**') software products. Typically, Qad Inc acted as a distributor of the aforesaid software products only in

[108] QAD About us, Our story, available at < https://www.qad.com/about> last accessed December 1, 2019

[109] QAD Europe B.V. v. Deputy Director of Income Tax (International Taxation) I.T.A. Nos.83 & 84/Mum/2007 (December 21, 2016) (Income Tax Appellate Tribunal Mumbai)

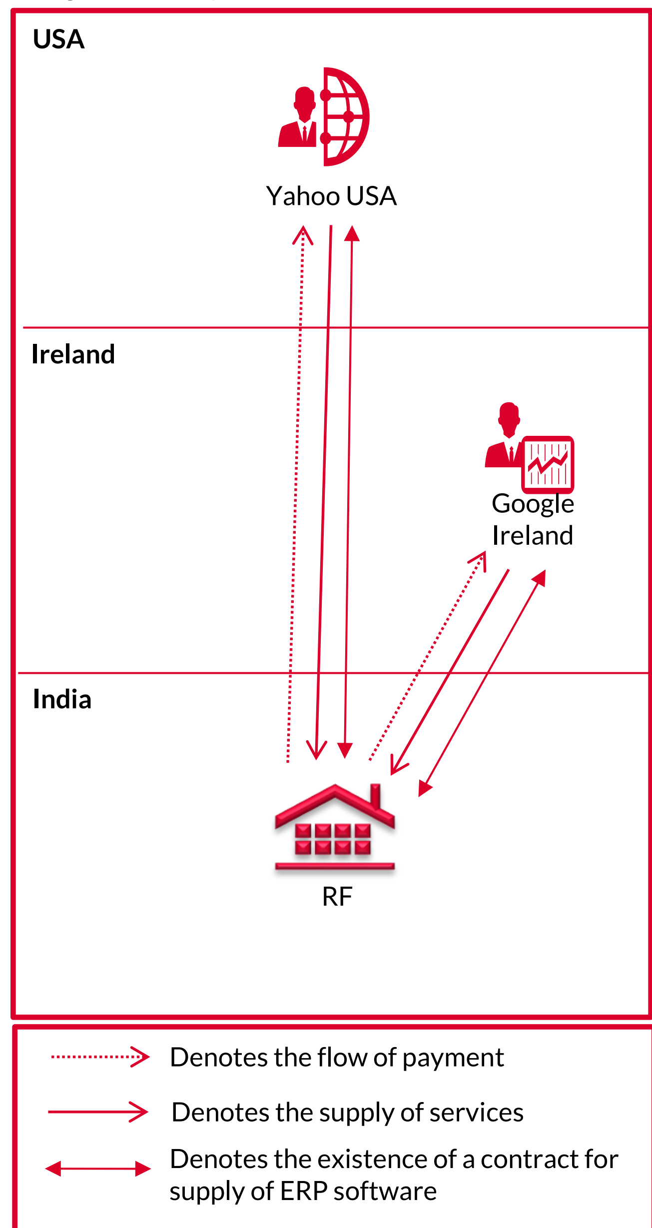
USA and Latin American countries, whereas the other Qad group companies worldwide, including Qad Europe B.V., undertook marketing responsibilities for countries other than USA and Latin American countries.

During the period relevant to the case, Qad Europe B.V. purchased software from Qad Inc. and resold the same to multinational companies outside USA and Latin American countries. Further, Qad Inc. entered into a multinational software product licence agreement with M/s. Unilever N.V, ('**UNV**') a multinational company incorporated in the Netherlands for sale of licensed product, i.e. ERP software either directly or through its subsidiaries to UNV and its subsidiaries for a consideration to be received either from UNV or through any of its subsidiaries, as the case may be. In pursuance of the said agreement, the Qad Europe B.V. entered into another agreement with M/s. Hindustan Lever Ltd. ('**HLL**') which is an Indian subsidiary of UNV for the sale of licensed product, i.e. ERP software by the Qad Europe B.V. to HLL. Now, in pursuance of the agreement entered into with HLL, ERP software was sold by Qad Europe B.V. to HLL. Income arising from the said transaction was held to be business income, and in absence of any permanent establishment in India, the same was not offered to tax in India.

In the aforementioned fact-pattern, despite clearly deriving revenue by virtue of a contract with an Indian company (HLL) and suppling goods through a digital mode to such company, the non-resident enterprise (Qad Europe B.V.) was not required to pay income tax in India. Had the nature of the product itself not been such that it did not need to be transferred through a physical or a tangible mode, the supplier i.e. Qad Europe B.V. in this case would have had to either appoint an agent in India or establish its presence in the country to supply to customers therein. This case therefore illustrates how characteristic features of the digital economy, enable the supply of goods and services without a physical presence and hence dilute the relevance of the current international taxation framework that heavily relies on such principles.

Case study - 2

Under the advertising services business model, we also want to discuss a landmark judgment passed by the ITAT on whether the maintenance of a website would satisfy the establishment of a PE.[110] As per the facts of the case *also represented in Figure 4) the assessee was a florist ('**RF**') who availed online advertising services from entities based overseas, namely Google Ireland Limited ('**Google Ireland**') and Overture Services Inc. USA ('**Yahoo USA**').



Case Study 2

The ITAT in this case concluded that the only presence that Google and Yahoo had in India was through its website. It subsequently analysed whether a website could satisfy the requirement of a PE. In this regard, it concluded that a website per se, which is a combination of software and electronic data, does not constitute a tangible property as it cannot have a location which constitutes place of business. Therefore, the website itself cannot satisfy the requirement of PE. However, a

[110] Income Tax Officer v. Right Florists Pvt. Ltd. (2013) 02 ITR (Trib.) 0639 (Income Tax Appellate Tribunal, Kolkata)

web server, on which the web site is stored and through which it is accessible, is a piece of equipment having a physical location and such location may thus constitute a "fixed place of business" of the enterprise that operates that server. Based on the above, the ITAT proceeded to hold that Yahoo USA and Google Ireland, which only have its presence in India through its website, cannot therefore be a permanent establishment unless their web servers are located outside India.

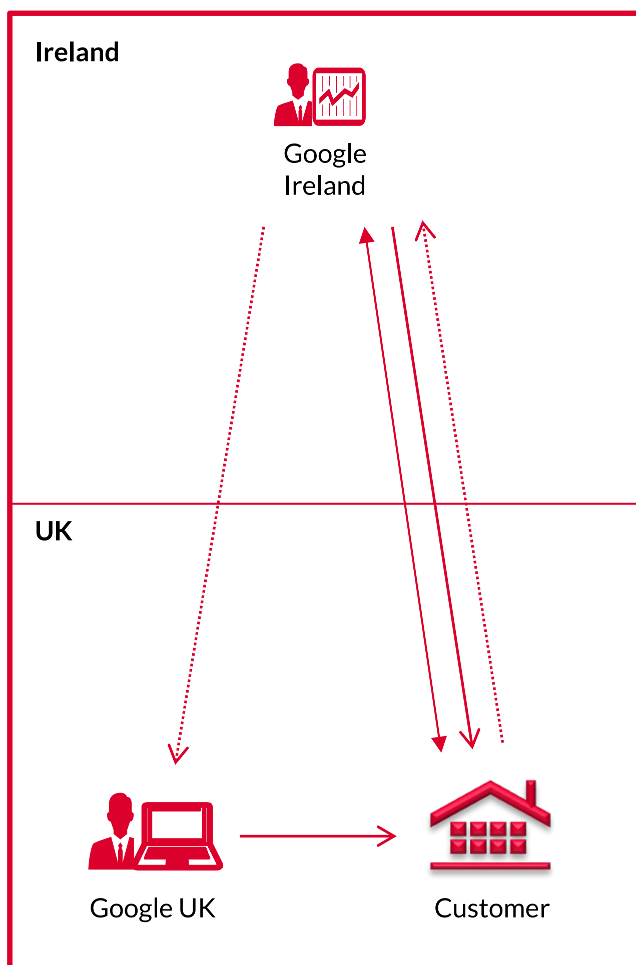
Therefore, despite providing services to a company in India and deriving income from India, overseas entities are not leviable to tax purely due to their failure to maintain a physical presence.

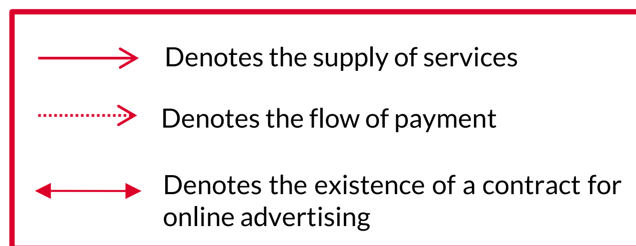
Case study - 3

In addition to the aforementioned instances of tax avoidance by enterprises engaged in the supply of goods and services in the digital ecosystem in India, we have also analysed certain business models that prevail in other parts of the world. For the business model adopted by Google UK for instance, we rely on the exhausted investigation conducted by the House of Commons Committee of Public Accounts.[111]

We understand that in addition to their two establishments, one in California, USA ('**Google USA**') - where technology is built, and a significant amount of intellectual property is held - and the second in Bermuda ('**Google Bermuda**') - where intellectual property rights for outside of the US are held - the enterprise has two other establishments that are relevant for this analysis – one in the UK ('**Google UK**'), and the second in Ireland ('**Google Ireland**').

Google Ireland is the base of the enterprise's operations for Europe. It has data centers and the enterprise has invested tens of millions of euros in space, equipment and people in Ireland.[112] Everybody outside the US who buys advertising from Google, buys advertising from Google Ireland therefore, a vast majority of Google's sales outside the US are billed in Google Ireland.[113] While during the period relevant to the House of Commons Committee proceedings, Google Ireland had nearly 1700 employees, of which '*a couple of hundred-something*' were selling from Ireland into the UK.[114] The employees in Google UK on the other hand conducted activities principally around promoting Google's products and making sure they work in the UK for UK consumers. These services are subsequently charged by Google UK to Google Ireland. Further, Google UK pays corporate tax in the UK.





Case Study 3

[111] House of Commons, 'Committee of Public Accounts Tax Avoidance–Google' Ninth Report of Session 2013–14 (June 10, 2013) available at < https://publications.parliament.uk/pa/cm201314/cmselect/cmpubacc/112/112.pdf> last accessed on January 2, 2020
[112] Ibid.
[113] House of Common, Public Accounts Committee – Minutes of Evidence HC 716' (November 12, 2012) available at < https://publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/121112.htm> last accessed on January 2, 2020
[114] Ibid.

During the proceedings of the House of Commons Committee, the representative from the enterprise stressed that Google UK was not a permanent establishment for Google Ireland as it was not engaging in sales in the UK. He stated that as part of an Ireland-UK tax treaty, an Irish company would be subject to UK tax on its profits earned from UK activities only if it were trading in the UK through a 'permanent establishment'. He stated that if employees of Google UK had authority to conclude contracts on behalf of Google Ireland, and they habitually exercised that authority, then Google UK would qualify as a 'permanent establishment' However, he was also adamant that staff in Google UK were not engaged in sales that concluded contracts with UK clients, aiming to support Google's defence that it did not have a 'permanent establishment' in the UK.[115]

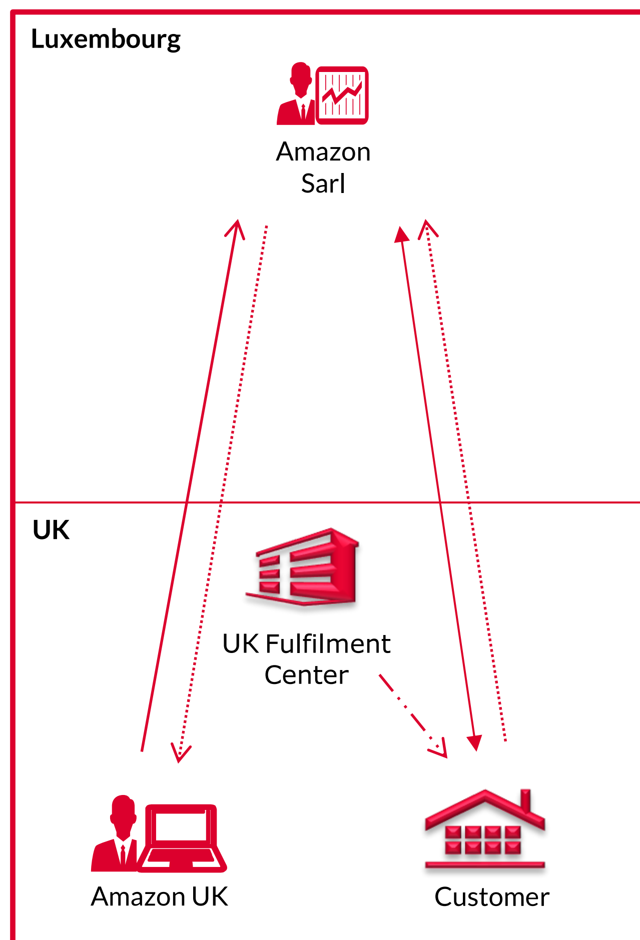
Moreover, the representative from the enterprise also maintained that the enterprise pays its dues for its activities in the UK and that the development of technology – which drives the enterprise's income in conducted in the USA. He stated '*We pay corporation tax here on the activity that our people here do. But, if you think about Google, it is technology. The 17,000 engineers in California who build and continue to invest in developing the technology create the economic value for Google… What creates economic value for Google is the technology and the computer science*'[116]However, the House of Commons Committee appears to have suggested that Google UK was reducing its profits by shifting them to its entities in other jurisdictions and paying an amount characterized as '*tiny in relation to your (Google's) turnover and tiny in relation to the UK business*'.[117] Notably, many of the assertions made by the representative of the enterprise regarding the activity performed by the staff of Google UK were refuted by whistleblowers, however the UK HMRC stated that the evidence presented by these whistleblowers might not be directly relevant to whether the enterprise has a 'permanent establishment' in the UK.[118] It may however impact the amount of value created by Google UK in the UK and perhaps increase the amount of corporate tax payable.

Case study – 4

Similar to Google's case discussed above, we rely on the exhausted investigation conducted by the House of Commons Committee of Public Accounts for our analysis of the Amazon business as well.[119]
We understand that the enterprise operates a single European company, through Amazon EU Sarl ('**Amazon Sarl**') incorporated in Luxembourg. All sales in the Europe are booked at Amazon Sarl and bills to European customers are also raised by Amazon Sarl. However, the supply of goods is fulfilled by one of the enterprise's warehouses storing the product. The enterprise has a warehouse in the UK ('**UK Fulfilment Centre**').

[115] House of Commons, 'Committee of Public Accounts Tax Avoidance–Google' Ninth Report of Session 2013–14 (June 10, 2013) available at < https://publications.parliament.uk/pa/cm201314/cmselect/cmpubacc/112/112.pdf> last accessed on January 2, 2020
[116] Ibid.
[117] House of Common, Public Accounts Committee – Minutes of Evidence HC 716' (November 12, 2012) available at < https://publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/121112.htm> last accessed on January 2, 2020
[118] House of Commons, 'Committee of Public Accounts Tax Avoidance–Google' Ninth Report of Session 2013–14 (June 10, 2013) available at < https://publications.parliament.uk/pa/cm201314/cmselect/cmpubacc/112/112.pdf> last accessed on January 2, 2020
[119] House of Commons, 'Committee of Public Accounts Tax Avoidance–Google' Ninth Report of Session 2013–14 (June 10, 2013) available at < https://publications.parliament.uk/pa/cm201314/cmselect/cmpubacc/112/112.pdf> last accessed on January 2, 2020

In addition to the warehouse, the enterprise also has a company in the UK, Amazon.co.uk Ltd, (‘**Amazon UK**’) which operates as a service company for group companies including Amazon Sarl.[120]Amazon UK is remunerated by the Amazon Europe companies for providing them services such as operating the fulfilment centres, which receive inventory, picking, packing etc. Amazon UK pays corporate tax in the UK on this income. However, the enterprise maintains the stand that neither Amazon UK, nor the UK Fulfilment Centre amount to a PE in the UK.[121] This arrangement has often been analysed and in this regard it has been stated that “*Amazon isn't dodging UK tax, it's most certainly not using tax evasion, it's not even tax avoidance.*’[122] Yet the House of Commons Committee appears to have suggested that the tax paid by the enterprise in the UK is not sufficient when compared to the value derived from its operations there.[123]



Denotes the supply of services

Denotes the flow of payment

Denotes a billable relationship

Denotes the supply of goods

Case Study 4

3. Hypothetical case studies

Case study - 1

This case study refers to Business to Consumer to Business (B2C2B) model where a a platform operating company provides for a free product for user engagement to create a customer base for business users to collect consumer user data and market their product accordingly.

A company ‘A’ incorporated in Ireland is providing an online social media platform to end users to interact among each other and with businesses.

The platform of non-resident A is an ad-driven platform showing advertisements tailored to each end user’s preferences based on demographic factors and their interaction in the platform such as age, location, likes, search history etc.

A non-resident ‘B’ is a company resident in USA is engaged in manufacture of smartphones who wishes to target customers of India who fit a particular demographic profile.

[120] House of Common, Public Accounts Committee – Minutes of Evidence HC 716’ (November 12, 2012) available at < https://publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/121112.htm> last accessed January 2, 2020

[121] Ina Kerschner, Maryte somare, *Taxation in a Global Digital Economy: Schriftenreihe IStR Band 107* (Linde Verlag GmbH, October 4, 2017)

[122] Yim Warstoll, Amazon's Tax Dodging Tricks in the UK, (April 5, 2012) available at < https://www.forbes.com/sites/timworstall/2012/04/05/amazons-tax-dodging-tricks-in-the-uk/#1687fdd14ba4> last accessed January 2, 2019

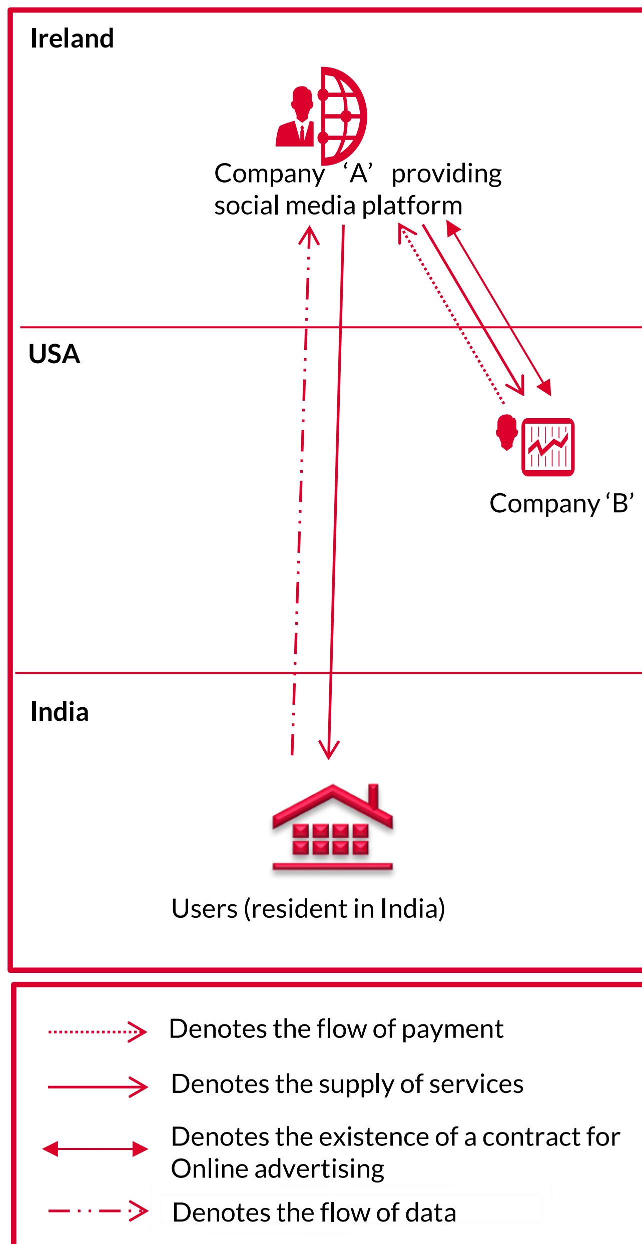
[123] House of Common, Public Accounts Committee – Minutes of Evidence HC 716’ (November 12, 2012) available at < https://publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/121112.htm> last accessed January 2, 2020

Company A provides advertisement services to company B by displaying the advertisements for the product of company B in their platforms to the targeted users.

Company A collects the data of the users using such social media platform. These users include users residing in India or users who are not residents of India but have visited India and have had access to such website using internet protocol address located in India. On the basis of data collected, the advertisement of smartphones manufactured by company 'B' is displayed to the targeted audience on the social media platform.

There are three actors involved in this business model. A social media platform that actively engage with the end-users and collect data of such users. The role of end-users is to give consent to the collection of their personal data which can be used in the marketing activities in exchange of services received by the platform. Such data is purchased by the business to market its product to the targeted end-user.

The contract of purchasing of the data collected from the end users who are located in India is entered in USA between Company A and Company B. Such transaction will not be taxed as per the tradition rules of PE as no physical presence is established in India and the contract is also not concluded in India. It is important to note that the value is derived because the advertisement is displayed to the targeted audience residing in India or using internet protocol address located in India.



Case Study 1

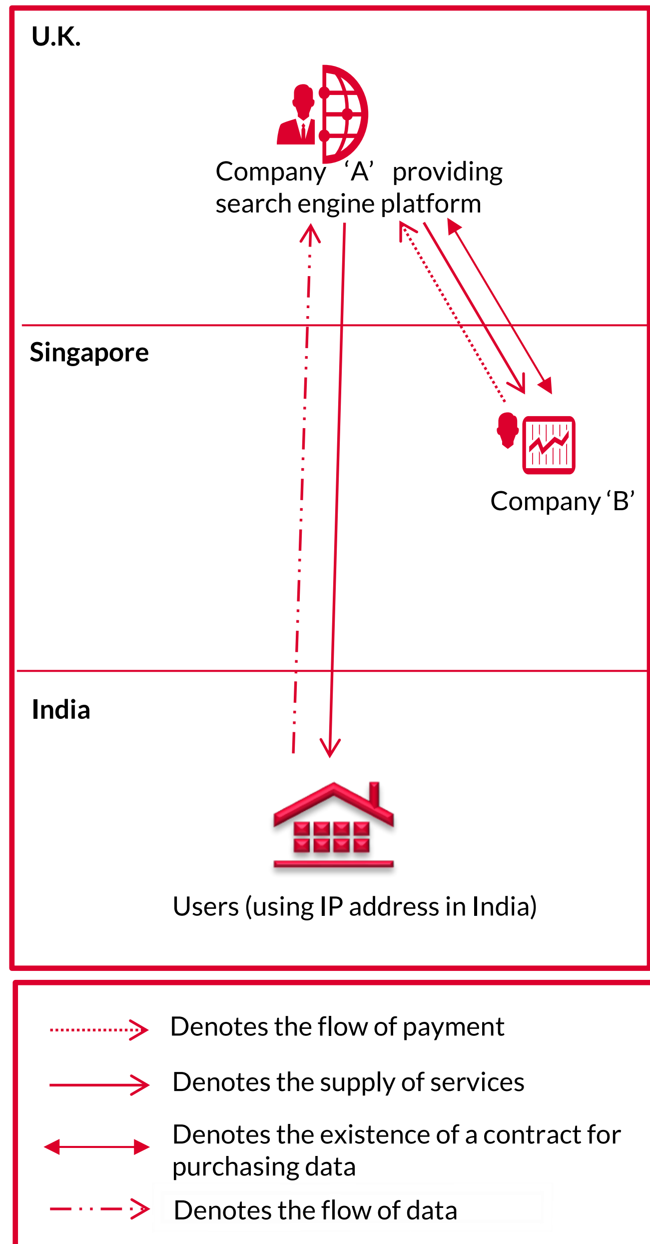
Case study – 2

This case study refers to another B2C2B model. A company 'A' is a non -resident incorporated in U.K. providing a search engine platform to users. The platform allows users to systematically search for various queries or information from the collated results produced from the world wide web.

While users are provided a platform to collect information, the company 'A' collects data of the users with respect to the search histories of its users through cookies. For instance, if a user shops on a website, cookie allows the website to remember which items have been added to the virtual shopping cart. Cookie also allow website to collect data about user activities.

A company 'B' is incorporated in Singapore and is engaged in manufacturing and distributing fashion apparels. The company wants to collect data pertaining to number of female users in India below the age of 30 years who prefer to wear particular list of items such as jeans, ethnic wear, sale etc. This is to identify a target audience and tailor its marketing as well production policy according to the needs of the people. Company A sells data to company B of end-users which also included users residing in India or using internet protocol address located in India

Company B contracts with company A to purchase data collected by company A by using such cookies in lieu of the consideration paid. The contract is entered in Singapore and is between the two non resident companies. As per the tradition definition of permanent established, this transaction will not be taxed in India even though the value is obtained by collecting data of users residing in India or users using internet protocol address in India.



Case Study 2

Case study – 3

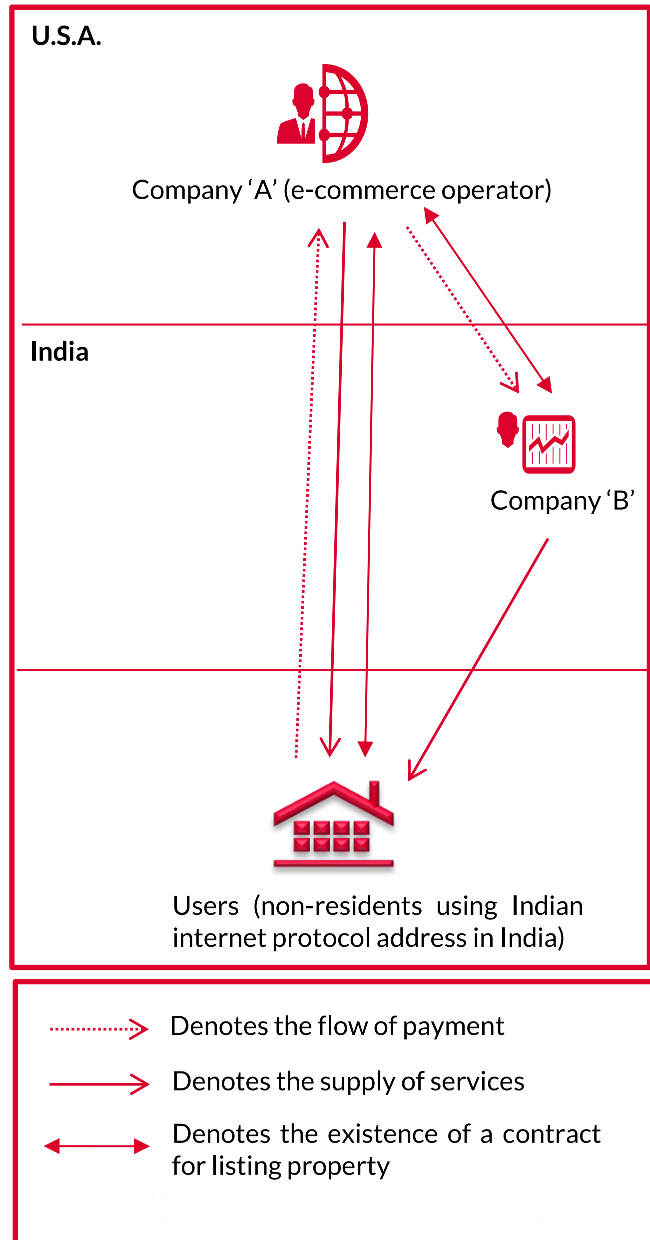
This case study refers to Business to Business to Customer (B2B2C) model where a digital platform along with the business enterprise provides goods and services to end consumers.

An e-commerce operator company 'A' is a non-resident in USA who is engaged in offering lodging services to the users. It offers such services through an online platform that is accessed through applications on mobile phones or through website. It provides accommodation as well as other services while staying to users on rent.

This is done by engaging with the property owners listing the property on the platform. Company A has set standards and conditions for such property owners on its platform by defining the requirements. The users who are willing to consume accommodation services have to be sign in through the application on their mobile devices or through their websites by inserting their personal data followed up by request for specified services on the platform.

Company 'A' aids in connecting users to the property owners, administer digital platform, address consumers' needs and requests, perform post sale services and collect payments.

Company 'B' incorporated in India is one of such property owners who have listed its properties on the platform owned by Company A. It receives requests from users who are resident in India or non-resident using Indian internet protocol address in India. It provides necessary assets and resources to deliver services, perform business function and bear low performance risk.



Case Study 3

There are two business operators involved in this business model: an e-commerce platform and business user being service providers. Both business operators act together to provide the service of accommodation on rent to users. However, the core function is performed by the e-commerce platform while service providers perform preparatory or auxiliary functions. The contract is entered between Company A and the users and the payment is also directly received by Company A. Thus, it may be argued that Company A is not liable to tax as per the traditional rule because they do not have a physical presence in India.

It is interesting to note that the hypothetical business models described above will be covered in the expanded scope of the equalization levy as imposed in India. The expanded scope is introduced in the Union Budget 2020. It covers all transactions where sale of advertisement or sale of data will be under the scope of equalization levy if it is targeted to a customer who is a resident in India or accesses the advertisement through internet protocol address located in India.

Therefore, from the aforementioned case study it is clear that the large enterprises may establish a physical presence in a jurisdiction. However, by ensuring that no contracts for sale are executed by the employees in such jurisdiction, they may seek recourse to the preparatory and auxiliary activities exception and legally avoid the establishment of a PE. Instead, they pay corporate tax due on the activities of such office. However, as alleged in this case, they may shift the profit earned in the said jurisdiction and accordingly minimize their corporate tax liability.

From the above, it is clear that large enterprises may establish a physical presence in a jurisdiction, however, by ensuring that the activities conducted by such physical presence fall under the exceptions to the ambit of PE, circumvent the payment of adequate tax.

D. Attribution of Profit

Where a non-resident has a business connection or a PE in India, the next step is to compute the taxable income. As discussed in the above section, if the multinational enterprise is a resident of a country with which India has entered into DTAA with, then the provisions of DTAA will be applicable. However, if the multinational enterprise is a resident of a country with which India does not have DTAA with, then the provisions of IT Act will be applicable.

1. Profit attribution under Income Tax Act, 1961

Under the IT Act, for computing the taxable income of a non resident, non-resident has a responsibility to maintain books of account. However, an unbridled empowerment is available to the tax administration to apply Rule 10 (akin to global formulary approach) if the tax inspector is of the opinion that the actual income from the business connection cannot be definitely ascertained. In our view, in situations when the tax administration exercises power to apply formulary approach under Rule 10 for the computation of income from business connection, arm's length standard set under Section 92 of the Income Tax Act cannot be ignored.

1.1. Methods under rule 10 of Income Tax Rules, 1962

If the Assessing Officer believes that the actual income cannot be definitely ascertained, then the Assessing Officer may calculate the amount of income for the purpose of assessment to income tax under any of the three following methods:

a) Rule 10(i): that the amount calculated at such percentage of the turnover so accruing or arising as the Assessing Officer may consider reasonable, or
b) Rule 10(ii): Any amount which bears the same proportion to the total profits and gains of the business of such person as receipts so accruing or arising bear to the total receipt of the business, or
c) Rule 10(iii): In any other manner as Assessing Officer deems suitable.[124]

The apportionment of profits under any one of the above three prescribed methods should be on a rational basis considering the facts and circumstances of each case at hand.[125] It is clear from the wording of this rule that before invoking Rule 10, the Assessing Officer must demonstrate that the income of the non-resident accruing or arising from any business connection in India cannot be ascertained from accounts or from material available on record. If Assessing Officer fails to give such reasons, he cannot straightaway apply Rule 10 and reject the income computed by the assessee.[126]

Rule 10(i) signifies the test of reasonableness thereby leaving the scope to apply the arm's length principle. However, Rule 10(ii) restricts the assessing officer to follow a pure mathematical approach. The powers given to the Assessing officer under Rule 10(iii) are very wide and allows the Assessing Officer a lot of subjectivity while making the assessment and the courts have held that the assessment should not be arbitrary.[127]

Once the assessment has been made by the assessing officer and he has taken into account all the relevant facts and circumstances and come to a fair estimate, the courts cannot interfere with the assessment.[128] Even if the apportionment was based on guesswork, the courts might not interfere if the assessee had not placed proper

[124] Income Tax Rules, 1961, Rule 10.
[125] Hukumchand Mills Ltd. v. CIT [1968] 70 ITR 450 (High Court of Bombay); DDIT v. Nortel Networks India International Case (2014) TS – 355 / TII – 71 (Income Tax Appellate Tribunal Delhi)
[126] Hyundai Rotem Co. v. ADIT, (International Taxation) [2012] 53 SOT 142 (Income Tax Appellate Tribunal Delhi)
[127] Annamalais Timber Trust & Co. v. CIT [1961] 41 ITR 781 (High Court of Madras)
[128] Hukumchand Mills Ltd. V. CIT [1968] 70 ITR 450 (Bom.)

material before the income tax authorities which would have facilitated the making of a more definite and certain apportionment.[129] It is clear from established jurisprudence that Rule 10 allows a broad discretion to the tax authority without any clear or specific guidance leading to adhocism.

1.2. *Arms length principle under section 92 of the Income Tax Act, 1961*

Chapter X of the IT Act relate to "Special provisions relating to avoidance of tax", and applies when there is an income from an international transaction which needs to be computed at arm's length price. For the application Section 92 there must be:

1. An international transaction (as explained under Section 92B)
2. Between associated enterprises – related parties (as explained under Section 92A)
3. For computation of arm's length price (as explained under Section 92C)

In case there is a difference between the transfer price reached by the assessee and the arm's length price reached by the tax authority under guidance from the statute, adjustments can be made by the tax department to arrive at an appropriate transfer price. As per Section 92(3), the provisions of Section 92 will apply only if such adjustment is resulting into an increase in income chargeable to tax computed on the basis of entries made in the books of account in respect of previous year.[130]

The expression 'international transaction' has been defined in an inclusive manner and it includes every kind of transaction having at least one non-resident and having a bearing on the profits which includes revenue and capital transactions.[131] If there is no possibility of shifting profits outside India then those transactions will not fall within the preview of transfer pricing regulations.[132] The definition of 'associated enterprise' under Section 92A is also inclusive and includes any relationship between the enterprises which may result in manipulation of prices of their transactions.[133]

Section 92C lists the methods for determining the 'arm's length price'. The selection of the most appropriate method should be made having regard to the nature of transaction or functions performed and thus differs from facts and circumstances of each case.[134] Some of the methods prescribed by the Board are Comparable Uncontrolled Price Method, Resale Price Method, Cost Plus Method, Profit split method and Transactional Net Margin Method. The burden of proof is on the Revenue to demonstrate that why the method chosen by the assessee is not the most appropriate method.[135]

The transfer pricing methods under Comparable Uncontrolled Price Method, Resale Price Method, Cost Plus Method and Transactional Net Margin Method provide for an arm's length range of comparables which are as follows:

- If there are 6 or more data points in the set, the range is from the 35th percentile to the 65th percentile of the data set. The Arms Length Price is the median.
- If there are less than 6 data points in the set, the mean represents the Arms Length Price and 3 percent of the transfer price is taken to be the permitted deviation.[136]

[129] Blue Star Engg. Co. (Bombay) (P.) Ltd. v. CIT [1969] 73 ITR 283 (High Court of Bombay)
[130] Income Tax Act, 1961, Section 92(3).
[131] Perstorp Chemicals India (P.) Ltd. v. ITO, I. T. A. No. 6078 and 7160/Mum/2011 (Income Tax Appellate Tribunal Mumbai) ; Siro Clinpharm Pvt. Ltd. v. DCIT [2016] 177 TTJ 609 (Income Tax Appellate Tribunal Mumbai)
[132] IJM (India) Infrastructure Ltd. v. Asstt. CIT [2014] 147 ITD 437 (Income Tax Appellate Tribunal Hyderabad)
[133] Morgan Stanley and Company Inc. v. DIT (2007) 7 SCC 1
[134] *TP analysis is accepted to the extent that it remunerates Functions, Assets and Risks (FAR)], Further, in the same case, Rule 10(iii) was accepted as FAR analysis was not enough to enough to attribute profits*. For reference, GE Energy Parts Inc. v. ADIT ITA No. 671/Del/2011 (Income Tax Appellate Tribunal Delhi)
[135] UCB India Pvt Ltd v ACIT, (2009) 317 ITR(AT) 292 (Income Tax Appellate Tribunal Mumbai)
[136] Income Tax Rules, 1962, Rule 10CA.

The transfer pricing methods under Resale Price Method, Cost Plus Method and Transactional Net Margin Method provide for the use of current year and 2 previous year data of comparables in determining the weighted average of the profit level indicator.

1.3. Attributing profits to marketing intangibles in the form of advertisement, marketing and promotion expenses

The exploitation of marketing intangibles[137] in the form of Advertisement, Marketing and Promotion ('**AMP**') expenses is a much-debated issue. The value of marketing intangibles depends on various factors, such as the reputation and credibility of the MNE, organization of the MNE and its communication with the external world.[138] The types of intangibles considered as marketing intangibles are tough to characterise, evaluate and price; due to their specific features and increasingly complex intra-group arrangements. AMP expenses are incurred for increasing sales though it may contain an element of enhancing brand value. There is a concept of economic ownership of the brand which is different from legal ownership (the local Associated Enterprise('**AE**') which incurs the AMP towards brand enhancement, benefits from brand value, resulting in economic ownership for the AE). Essentially, the contention of the Revenue is that by incurring AMP expenditure, the Indian entity is providing a service to the AE, in terms of which the AE is able to establish a market for its goods or services in India (marketing intangible), and such incurrence of AMP expenditure calls for a compensation in the hands of the Indian entity. On the contrary, it is the taxpayers' contention that the incurrence of AMP expenditure is not an international transaction with an AE.

After delineating AMP expenditure into expenditure towards sales and expenditure towards brand enhancement, there are two approaches that may be followed for arriving at brand enhancement AMP. Under the first approach, it may be treated as an international transaction and the local AE may be compensated for enhancing the brand value of the foreign associated enterprise. The second approach treats the AMP expenditure as a function and a Transactional Net Margin Method may be used to compensate the local AE.

The first approach is the bright line test ('**BLT**') which was followed by the Revenue and affirmed by the Special bench in the case of *LG Electronics*[139] and later BLT ratio was negated by the Delhi High Court in the case of *Sony Ericsson Mobile Communications*[140]. Under BLT, the ratio of the percentage of AMP expenditure to sales of the tested party and the comparable is calculated. The difference between the two ratios (as the ratio of the tested party is higher due to higher AMP expenditure) is calculated and multiplied with the sales of the tested party which is then enhanced by an appropriate mark-up. So, the adjustment is made to the tested party and not to the comparable and the AMP expenditure is treated as a separate international transaction.

The second approach (the intensity adjustment) was followed in the case *of Sony Ericsson Mobile Communications*. As the AMP expenditure is treated as a function, adjustment is made to the comparable. If Transactional Net Margin Method is used, then the position of the comparable is equalised with that of the tested party by increasing the AMP expenditure and the revenue of the comparable, to arrive at an appropriate Profit Level Indicator ('**PLI**'). The profit margin is calculated based on an updated PLI of the comparable and applied to the tested party. Under this method, no separate benchmarking of any international transaction is done.

[137] *An intangible which relates to marketing activities, aids in the commercial exploitation of a product or service and/or has an important promotional value for the product concerned.*
[138] N. Gentile, 'Transfer Pricing dei Beni Immateriali - Panoramica sugli Ultimi Sviluppi a Livello OCSE in Ambito di Prezzi di Trasferimento tra Società Collegate, Diritto Tributario Internazionale e dell'UE', (2016) available at <http://novitafiscali.supsi.ch/494/1/Gentile_niccolo_Transfer%20pricing%20dei%20beni%20immateriali.pdf> last accessed January 20,2020.
[139] L.G. Electronics India (P.) Ltd. v. ACIT, [2013] 140 ITD 41/29 taxmann.com 300 (Income Tax Appellate Tribunal Delhi)
[140] Sony Ericsson Mobile Communications India (P.) Ltd. v. CIT, [2015] 374 ITR 118/231 (Income Tax Appellate Tribunal Delhi)

In absence of any statutory justification in the law, for applying the BLT, courts have resorted to applying the intensity adjustment approach. A final view on the approach will be taken once the batch of cases are decided by the Supreme Court of India.

2. Profit attribution under double taxation avoidance agreement

If the resident country of the non-resident has a DTAA with India, the threshold of PE is generally governed by Article 5 of the DTAA. If the non-resident has a PE in India under Article 5, then the profits shall be attributed to the non-resident under Article 7 of the DTAA.

The provisions of Article 7 of the Indian DTAAs are based on Article 7 of the UN Model Tax convention. Once a PE has been established, the profits are to be attributed to the PE as if it were a distinct and separate entity engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the non-resident of which it is a PE or with other enterprises with which it deals.[141] The provisions of Article 7 are akin to the application of arm's length principle. The profit attribution under Article 7 shall be based on the financial accounts of the PE. However, if for any reason the assessing officer disagrees with the accounts, it will be square one for the taxpayer in terms of application of Rule 10 as discussed above. Thus, Article 7 attributes profits to a PE using direct accounting method based on separate accounts of the PE and refers to Rule 10 for the same.

2.1. OECD's approach in attributing profits

Under the Authorise OECD Approach, PE is treated as a separate and independent enterprise, engaged in same or similar activities under the same or similar conditions. The profit is attributed at arm's length to the PE taking into account the functions performed, assets used and the risks assumed (FAR analysis).[142] It is a two-step analysis under which step one involves a functional and factual analysis of all the dealing of the PE and under step two, pricing all these recognised dealings at arm's length to attribute profits to the PE. [143] The arm's length pricing is reached by determining the comparability between controlled and uncontrolled transactions taking into account the characteristics of property or services, functional analysis, contractual terms, economic circumstances and business strategies. India has made strong reservations against this approach of the OECD saying it favours capital exporting countries (developed nations) and adversely affects the capital importing countries (developing nations). It also does not address the issue of digital business models as digital nexus rules are not taken into account.

OECD in its E-commerce report on 2005 examined the question concerning the distribution of the corporate tax base based on two perspectives, i.e., supply and supply-demand.[144] Under the former approach, the income of an enterprise is allocated to the country on the basis of production and origin factors ignoring the presence of a consumer base or a consumer market. Whereas, the latter approach, the interaction of supply and demand factors to earn profits is the focal point in allocating taxing rights.[145] The supply approach was preferred by various members of the Technical Advisory Group (TAG) Committee.[146]

[141] Un Model Tax Convention, Article 7.
[142] Galileo International Inc. v. DCIT [2011] 336 ITR 264 (Income Tax Appellate Tribunal Delhi)
[143] Organisation for Economic Cooperation and Development, 'Additional Guidance on the Attribution of Profits to Permanent Establishments under BEPS Action 7' (2018) available at < https://www.oecd.org/tax/beps/additional-guidance-attribution-of-profits-to-a-permanent-establishment-under-beps-action7.htm> last accessed January 20,2020.
[144] Organisation for Economic Cooperation and Development, 'Additional Guidance on the Attribution of Profits to Permanent Establishments under BEPS Action 7' (2018) [40] available at < https://www.oecd.org/tax/beps/additional-guidance-attribution-of-profits-to-a-permanent-establishment-under-beps-action7.htm> last accessed January 20,2020.
[145] A. Baez & Y. Brauner, Taxing the Digital Economy post BEPS. Seriously, (2019). available at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3347503&download=yes> last accessed February 2, 2020.
[146] Organisation for Economic Cooperation and Development, Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-commerce? Final Report, [41] available at <http://www.oecd.org/tax/treaties/35869032.pdf> last accessed March 2, 2020.

However, India favoured the supply-demand method.[147] Additionally, the supply approach is reinforced by the BEPS project. One of the key objectives of the BEPS project was to ensure that income should be taxed where value is generated, and economic activities are conducted.[148] In this regard, various actions of the BEPS plan have fortified the utilization of activity-based concepts such as comprehensive guidance provided under Action 8-10[149] on the concept of control over risk.[150]

From a tax standpoint, where an MNE in a country is conducting its business activities in another country through supply, value creation, or origin, then taxing the income generated by the MNE in the country where the business is conducted is validated. This is due to the fact that the enterprise derives benefits from that country's infrastructure.[151] From an economic standpoint, the factors for value creation, such as labour, could be located in a country where the business is operating in the form of a PE[152] or a separate related entity. From the profit allocation standpoint, profits are allocated to PE[153] or to separate related entity[154] by applying arm's length principle. Functions, assets, and risks (FAR analysis) are analysed for profit allocation to market jurisdictions. But, in the case of PE, formulary methodology might be used based on the country practices involved.[155] Nonetheless, in most of the cases, profit allocation rules and current nexus rules are connected to the pre-requisite of physical availability, specifically the presence of personnel.

There is a glaring concern with the ascent of digitalization, that MNEs , particularly the ones which are highly digitalized, can acquire vast income shares from other market jurisdictions with minimal or no presence by centralizing its operations and supplying its products and services on a remote basis, especially by conducting major operations over the internet. In addition, technological advances can be utilized by the MNEs to accumulate information from users of an online platform with a goal to spread and commercialize their own product/service. The question that follows after considering all the above-mentioned features is regarding the tax presence of the MNEs by such market jurisdictions, if the enterprise is conducting its operations digitally and how to attribute value to the intangibles used by them to run their business. This is due to the manner in which an enterprise is conducting its business and is emerging from tangible presence to an intangible framework.

2.2. Hard to value intangibles

According to the recent OECD Transfer Pricing Guidelines,[156] intangibles are intended to address something which are – i) not physical or financial assets; ii) which are capable of being owned or controlled for use in commercial activities and; iii) whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances. The hard to value intangibles ('HTVI') approach was introduced by the OECD in the Final Report on Action Plan 8-10, titled "Aligning Transfer Pricing Outcomes with

[147] Ministry of Finance, India, Report of the Committee on Taxation of E-Commerce. available at <https://www.incometaxindia.gov.in/News/Report-of-Committee-on-Taxation-of-e-Commerce-Feb-2016.pdf> last accessed February 15, 2020 ; Central Board of Direct Taxes, 'Section 9 of the Income Tax Act, 1961-Income deemed to accrue or arise in India- Taxation of Business Process Outsourcing Units in India, Circular No.1 / 2004 (January 2, 2004) available at <https://incometaxindia.gov.in/Communications/Circular/910110000000000292.htm> last accessed January 15, 2020.
[148] Organisation for Economic Cooperation and Development, BEPS Project Explanatory Statement – 2015 Final Reports, [1] available at <https://www.oecd-ilibrary.org/docserver/9789264263437-en.pdf?expires=1575873751&id=id&accname=guest&checksum=2D6A67E4705F296E16525B1725B798E1> last accessed December 31, 2019
[149] *BEPS Actions 8-10 address transfer pricing guidance to ensure that transfer pricing outcomes are better aligned with value creation of the MNE group. In this regard, Actions 8-10 clarify and strengthen the existing standards, including the guidance on the application of the arm's length principle and an approach for appropriate pricing of hard-to-value-intangibles within the arm's length principle*
[150] Organisation for Economic cooperation and Development, 'Aligning Transfer Pricing Outcomes with Value Creation ACTIONS 8-10: 2015 Final Reports,' [1.65-67] available at <https://www.oecd-ilibrary.org/docserver/9789264241244-en.pdf?expires=1575874497&id=id&accname=guest&checksum=68E595C3BC4A670D77736749851AED7C> last accessed January 20, 2020.
[151] D. Pinto, *E-Commerce and Source-Based Income Taxation*, Vol. 6, section 2.2.1. (IBFD Doctoral Series, 2003) available at <https://research.ibfd.org/#/doc?url=/linkresolver/static/esii_s_2.#esii_s_2> last accessed March 2, 2020.
[152] OECD Model Tax Convention, Article 5.
[153] OECD Model Tax Convention, Article 7(2)
[154] OECD Model Tax Convention, Article 9(1).
[155] OECD Model Tax Convention, Article 7(4).
[156] Organisation for Economic Cooperation and Development 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations' (2017), [6.6] available at <https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2017_tpg-2017-en#page1> last accessed February 10, 2020.

Value Creation",[157] and has been incorporated in the OECD Transfer Pricing Guidelines, 2017.[158] The OECD also released application guidance[159] to tackle the issue of transactions involving intangibles (especially HTVI).

HTVI are intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises, (i) no reliable comparables exist, and (ii) at the time the transaction was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer. HTVI possess one or more of the following characteristics:

i. they are partially developed at the time at which they are transferred;
ii. it is not anticipated that the HTVI will be exploited for commercial purposes for several years following the transaction;
iii. they also comprise of intangibles that are not necessarily hard-to-value but are linked with the development of those intangibles that are HTVI as defined;
iv. at the time of transfer they are anticipated to be exploited in a novel manner.

Action Plan 8 focuses on the importance of the functions performed, the assets used and the risks assumed (FAR analysis) in the development, enhancement, maintenance, protection and exploitation ("DEMPE") of intangibles.[160] As per the OECD Guidance on Transfer Pricing Aspects of Intangibles Action 8: 2014 Deliverable,[161] in order to determine arm's length conditions for the use or transfer of intangibles it is important to consider as part of the comparability and functional analysis: (i) the identification of specific intangibles; (ii) the legal ownership of intangibles; (iii) the contributions of MNE group members to their DEMPE; and (iv) the nature of the controlled transactions involving intangibles including the manner in which such transactions contribute to the creation of value. In this context, it is crucial to consider the remuneration that would be paid between independent parties in transactions involving intangibles.

Legal ownership of an intangible does not bestow any right to retain any returns from exploiting an intangible, even where such returns may initially accrue to the legal owner as a result of legal or contractual rights.[162] Instead, the returns ultimately retained by the legal owner depend on the contributions it makes to the anticipated value of the intangibles, relative to the contributions made by other group members, through the functions performed, assets used and risks assumed that contribute to the value of the intangibles.[163] It is also essential to consider the control functions in relation to intangibles, i.e. the ultimate decision-making entity in respect of DEMPE functions and the entity with controls over the risks in respect of such functions , and in fact, its ability to exercise control over such risks.[164] In these cases, the entity performing control functions, if different from the legal owner, must

[157] Organisation for Economic Cooperation and Development, 'Final Report on BEPS Action Plan 8-10' available at <https://www.oecd-ilibrary.org/docserver/9789264241244-en.pdf?expires=1574922251&id=id&accname=guest&checksum=44D0ECD3E37B0A8F5994C301282376A8> last accessed January 15, 2020

[158] Organisation for Economic Cooperation and Development, 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017; Section D.4 of Chapter VI' available at <https://www.oecd.org/tax/transfer-pricing/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-20769717.htm> last accessed March 5, 2020

[159] Organisation for Economic Cooperation and Development, 'Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles Inclusive Framework on BEPS: Action 8 available at <https://www.oecd.org/tax/transfer-pricing/guidance-for-tax-administrations-on-the-application-of-the-approach-to-hard-to-value-intangibles-BEPS-action-8.pdf> last accessed January 10, 2020

[160] Organisation for Economic Cooperation and Development/G20 BEPS, Guidance on Transfer Pricing Aspects of Intangibles Action 8: 2014 Deliverable, [6.47] available at <https://read.oecd-ilibrary.org/taxation/guidance-on-transfer-pricing-aspects-of-intangibles_9789264219212-en#page1> last accessed March 5, 2020.

[161] Organisation for Economic Cooperation and Development/G20 BEPS, Guidance on Transfer Pricing Aspects of Intangibles Action 8: 2014 Deliverable, [6.4] available at <https://read.oecd-ilibrary.org/taxation/guidance-on-transfer-pricing-aspects-of-intangibles_9789264219212-en#page1> last accessed March 5, 2020.

[162] Sagar Wagh, 'India - Transfer Pricing Aspects of Marketing Intangibles: An Indian Perspective,' Bulletin for International Taxation Volume 69 (July 24, 2015) available at <https://research.ibfd.org/#/doc?url=/collections/bit/html/bit_2015_09_in_1.html#bit_2015_09_in_1_fn_12> last accessed January 20, 2020.

[163] Organisation for Economic Cooperation and Development/G20 BEPS, Guidance on Transfer Pricing Aspects of Intangibles Action 8: 2014 Deliverable, [6.42] available at <https://read.oecd-ilibrary.org/taxation/guidance-on-transfer-pricing-aspects-of-intangibles_9789264219212-en#page1> last accessed March 5, 2020.

[164] Organisation for Economic Cooperation and Development/G20 BEPS, Guidance on Transfer Pricing Aspects of Intangibles Action 8: 2014 Deliverable, [6.33] available at <https://read.oecd-ilibrary.org/taxation/guidance-on-transfer-pricing-aspects-of-intangibles_9789264219212-en#page1> last accessed March 5, 2020.

be compensated at arm's length.[165] Consequently, if the legal owner performs no relevant functions, uses no relevant assets and assumes no relevant risks, and acts solely as a title-holding entity, the legal owner is not ultimately entitled to any portion of the returns derived by the MNE group from the exploitation of the intangibles other than arm's length compensation, if any, for holding the title. Action 8 also states that an entity which has just funded the development of an intangible development and has not assumed any further risk would only be entitled to a risk-adjusted rate of anticipated return on its funding.[166]

From an Indian perspective, no specific amendments have been made in Transfer Pricing provisions under the Income-tax Act, 1961 post the recommendations in Action Plan 8 of BEPS.[167] As per the Income-tax Act, 1961, intangibles have been given an inclusive definition.[168] It covers:

a. marketing related intangible assets, such as, trademarks, trade names, brand names, logos;
b. technology related intangible assets, such as, process patents, patent applications, technical documentation such as laboratory notebooks, technical know-how;
c. artistic related intangible assets, such as, literary works and copyrights, musical compositions, copyrights, maps, engravings;
d. data processing related intangible assets, such as, proprietary computer software, software copyrights, automated databases, and integrated circuit masks and masters;
e. engineering related intangible assets, such as, industrial design, product patents, trade secrets, engineering drawing and schematics, blueprints, proprietary documentation;
f. customer related intangible assets, such as, customer lists, customer contracts, customer relationship, open purchase orders;
g. contract related intangible assets, such as, favourable supplier, contracts, license agreements, franchise agreements, non-compete agreements;
h. human capital related intangible assets, such as, trained and organized work force, employment agreements, union contracts;
i. location related intangible assets, such as, leasehold interest, mineral exploitation rights, easements, air rights, water rights;
j. goodwill related intangible assets, such as, institutional goodwill, professional practice goodwill, personal goodwill of professional, celebrity goodwill, general business going concern value;
k. methods, programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data;
l. any other similar item that derives its value from its intellectual content rather than its physical attributes.

However, pursuant to Circular No. 6/2013,[169] CBDT has directed the revenue authorities to examine functional and risk characterization of Contract R&D centres based on the conduct of the parties. Guidance provided by the CBDT that precedes DEMPE is largely in line with the recommendations in Action Plan 8 of BEPS. In a judicial ruling[170], while deciding between the usage of ex ante projections and ex post outcomes, the Tribunal rejected the Transfer Pricing Officer's proposition to replace projected cash flows used for valuation of IP with actuals available at the time of assessment. This ruling was in agreement with the decision in *Tally Solutions Pvt Ltd v. DCIT*,[171] wherein the Bangalore Tribunal rejected the approach adopted by the taxpayer of replacing projected

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[165] Organisation for Economic Cooperation and Development/G20 BEPS, Guidance on Transfer Pricing Aspects of Intangibles Action 8: 2014 Deliverable, [6.52] available at <https://read.oecd-ilibrary.org/taxation/guidance-on-transfer-pricing-aspects-of-intangibles_9789264219212-en#page1> last accessed March 5, 2020.
[166] Organisation for Economic Cooperation and Development/G20 BEPS, Guidance on Transfer Pricing Aspects of Intangibles Action 8: 2014 Deliverable, [6.61] available at <https://read.oecd-ilibrary.org/taxation/guidance-on-transfer-pricing-aspects-of-intangibles_9789264219212-en#page1> last accessed March 5, 2020.
[167] Vishal Gada, ' Intangibles – Planning Perspective Seminar on International Taxation – WIRC' (May 18, 2019) available at <https://www.wirc-icai.org/images/material/Intangibles-Planning-Perspective.pdf> last accessed March 5, 2020.
[168] Income Tax Act, 1961, Explanation to Section 92B(2).
[169] Central Board of Direct Taxes, Section 92C of the Income Tax Act, 1961- Transfer Pricing- Computation of Arm's Length Price- Clarifications on Functional Profile of Development Centres engaged in contract R&D services with insignificant risk- Conditions Relevant to identify such development centres- Amendment of Circular No. 3/2013 Dated 26-3-2013, Circular No. 06/2013 [F.No. 500/139/2012] (June 29, 2013) available at <https://www.incometaxindia.gov.in/communications/circular/910110000000000665.htm> last accessed March 9 2020.
[170] DQ (International) Limited v. ACIT [ITA No. 151/ Hyd/ 2015 (Income Tax Appellate Tribunal, Hyderabad)
[171] Tally Solutions Pvt Ltd v. DCIT, ITA No. 1235/ Bang/ 2010 (Income Tax Appellate Tribunal, Bangalore)

cash flows with actual results (available at time of assessment) to revisit the IP value. We are therefore reluctant to agree with the guidance on HTVI as provided by the OECD.

Hard to Value Intangibles and Anti-abuse

Section D.4 of Chapter VI of OECD TP Guidelines (2017) describes the approaches for tax administrations to determine the correct compensation according to the arm's length standard for transfers of certain intangibles. Developments or events affecting the future value of such intangibles are difficult to foresee by parties with limited knowledge and insight into the functioning of an MNE involved in the transfer and its business environment. There can be a mismatch in the information available to tax administrations compared to the taxpayer, and the latter is presumed to have an advantageous basis for determining an arm's length price. The solution promoted by the OECD and United Nations (UN) is to allow the ex post[172] value to become presumptive evidence of the appropriateness of the factors and uncertainties considered as an ex ante[173] basis for the price, under certain circumstances. The ex post outcome may provide a pointer about the arm's length nature of the ex ante pricing arrangement agreed upon, according to the Guidelines. Unless explained by unforeseen developments or events, a difference between the projection and the result indicates that the efforts made to produce a correct ex ante valuation were inadequate. This can be used as an anti-abuse measure by the tax authorities to counter tax avoidance and base erosion and profit shifting.

Value Creation and Hard to Value Intangibles as Transfer Pricing Tools

OECD TP Guidelines consider HTVI approach to be compatible with the arm's length principle. It is justified by not allowing the use of taking ex post results for tax assessment purposes without considering what could have been known by the taxpayer.[174] However, it has been suggested that the HTVI approach (by using the ex post outcomes as presumptive evidence) is not compatible with the ALP.[175] Independent entities, agree upon the price at the time of transfer of intangible, cannot amend the price of the transaction according to the future developments. Therefore, using ex post outcomes as presumptive evidence for valuing the transaction may be a departure from the ALP.

The compatibility of HTVI approach with the ALP may depend upon whether the transaction was that of a transfer of intangible or the rights thereto. The transfer of intangible involves the possibility of generating future profits and the risks (e.g. environment of the market[176] and/or users' preferences) associated with the intangible. Usually, the primary risk bearer is the person/entity who acquires the intangible and the risk of deviation from the financial projections should therefore be characterized as normal business risk.[177] Thus amending the original price of the contract, which accounted for the associated risk of the intangible may not be compatible with ALP as per the ex post outcome.

However, taxpayers may rebut the presumptive evidence used in the ex post outcomes based on at least one of the following exemptions:

[172] *Actual (or ex post) remuneration refers to the income actually earned by a member of the group through the exploitation of the intangible*. For reference, UN Transfer Pricing Manual, page 297

[173] Anticipated (or ex ante) remuneration refers to the future income expected to be derived by a member of the MNE group at the time of a transaction. For reference, United Nations, 'Practical Manual on Transfer Pricing for Developing Countries (2017) 297 available at <https://www.un.org/esa/ffd/wp-content/uploads/2017/04/Manual-TP-2017.pdf> last accessed January 15, 2020.

[174] Jonah Hagelin, 'International - Ex Post Facto Considerations in Transfer Pricing of Hard-to-Value Intangibles: Practical and Methodical Issues with the HTVI Approach,' International Transfer Pricing Journal, Volume 26 (October 10, 2018) available at <https://research.ibfd.org/#/doc?url=/collections/itpj/html/itpj_2019_01_int_1.html> last accessed January 18, 2020.

[175] O. Fedusiv, Transactions with Hard-to-Value Intangibles: Is BEPS Action 8 Based on the Arm's Length Principle?, 23 Intl. Transfer Pricing J. 6 (2016), Journals IBFD.

[176] United Nations, 'Practical Manual on Transfer Pricing for Developing Countries (2017) [B.5.2.18] available at <https://www.un.org/esa/ffd/wp-content/uploads/2017/04/Manual-TP-2017.pdf> last accessed January 15, 2020.

[177] Organisation for Economic Cooperation and Development, Public Comments Received on Discussion Draft on BEPS Action 8 (Hard to value intangibles) (June 19, 2015) [94-95] available at <http://www.oecd.org/ctp/transfer-pricing/public-comments-beps-action-8-hard-to-value-intangibles.pdf> last accessed January 10, 2020.

1. Where the taxpayer can demonstrate the reliability of the information used at the time of the transfer to determine the pricing arrangement and if there is a difference in the financial projections and the actual outcomes due to an unforeseeable event;
2. A bilateral or multilateral advance pricing arrangement is in place for the HTVI transfer; or
3. The difference between financial projections and ex post outcomes does not lead to a valuation discrepancy of more than 20 percent as compared to the original valuation;
4. Five years have passed after the year in which the HTVI was transferred to the time it first generated third party revenues and the difference between financial projections and actual outcomes do not exceed 20 percent in this period.

E. Addressing the Challenges: Progress thus far

As discussed in the preceding sections, there have been significant developments in the debate surrounding the optimal solution to address the challenges highlighted in the preceding chapters. This chapter critically analyses these developments both at a domestic level and at the global level.

1. Global progress

As discussed in Vidhi's Digital Tax Report, the OECD has been leading international efforts towards setting the agenda to re-evaluate the interface of tax regime with the advent of technology. Since 1997, through its reports, conferences and discussions, it has been addressing the issue and attempting to conceptualise a viable solution to effectively tax the digital economy. After drawing analysis from Action 1 Report, Interim Report and other discussions, a number of proposals were made which were categorized by the OECD in two pillars.

Pillar One addressed the broader challenges of the digitalized economy and focuses on the re-allocation of taxing rights.[178] Several proposals were made to allocate more taxing rights to market or user jurisdiction in cases where value is created by a business activity through participation in the user or market jurisdiction.[179] The inclusive framework agreed to explore these proposals. Pillar Two on the other hand, deals with other remaining BEPS issues and addresses the continued risk of profit shifting to entities subject to no or very low tax. Under Pillar Two, the Inclusive Framework agreed to explore basic taxing rights that would strengthen the ability of jurisdictions to tax profits where other jurisdictions with taxing rights apply a low effective rate of tax to those profits.

1.1. Pillar one

The three broad proposals articulated under Pillar One were the 'User Participation' approach, the 'Marketing Intangibles' approach and the 'Significant Economic Presence' proposal.

The User Participation proposal was supported by U.K. and other European countries. This proposal is based on the premise that soliciting sustained engagements, as well as active participation of users are critical components of value creation for certain highly digitalized business.[180] This proposal focuses on three highly digitalized business models i.e. social media platforms, search engines and online marketplaces.[181] The primary critique faced by this proposal has been its limited scope which only covers certain highly digitalized business models. Further by focusing on only these three models, it also ring-fences the digital economy. Under this proposal, the profit that is allocated to a user jurisdiction is in respect of activities performed therein is proposed to be calculated through a non-routine or residual profit split approach.[182] The economic rationale of this proposal is that value is generated

[178] Organisation for Economic Cooperation and Development/G20 Based Erosion and Profit Shifting Project, Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note, (January 23, 2019) available at <http://www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf> last accessed March 2, 2020.
[179] Organisation for Economic Cooperation and Development/G20 Based Erosion and Profit Shifting Project, Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note, (January 23, 2019) available at <http://www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf> last accessed March 2, 2020.
[180] Base Erosion and Profit Shifting Project, Public Consultation Document: Addressing the Tax challenges of the Digitalisation of the Economy (February 13- March 6, 2019) available at <https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf> last accessed February 2, 2020.
[181] Base Erosion and Profit Shifting Project, Public Consultation Document: Addressing the Tax challenges of the Digitalisation of the Economy 10 [19] (February 13- March 6, 2019) available at <https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf> last accessed February 2, 2020.
[182] Base Erosion and Profit Shifting Project, Public Consultation Document: Addressing the Tax challenges of the Digitalisation of the Economy 10 [21] (February 13- March 6, 2019) available at <https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf> last accessed February 2, 2020.

from the active participation and engagement of users in some business models (in particular specified digital business models which entail interaction with consumers and users) and this value addition should be taxed by the jurisdiction where the users are located. Some objective thresholds and exclusions will need to be implemented to effectively apply this proposal to avoid unprincipled allocation of profits.

The Marketing Intangibles proposal was mainly supported by the U.S. Unlike the User Participation proposal that focuses on highly digitalized business, the Marketing Intangible proposal is wider in its scope. It identifies an intrinsic functional link between marketing intangibles and the market jurisdiction.[183] Marketing intangibles may include customer data and preferences, trademarks, customer relationship, etc. As there are no objective criteria for identification of marketing intangibles and their contribution to the value creation, it presents a vague basis as well as poses practical challenges in its implementation and may lead to disputes across jurisdictions particularly if it is supplemented with domestic law changes. The proposal suggests modification in the current transfer pricing and treaty rules to require marketing intangibles and risks associated with such intangibles to be allocated to the market jurisdiction.[184] The proposal suggests determination of different methods for allocation of non-routine or residual income between marketing intangibles and other income producing factors such as application of normal transfer pricing principles or revised residual profit split method.[185]

The Significant Economic Presence proposal was mainly supported by India and other G-24 countries. Under this proposal, a taxable presence in a jurisdiction would arise in case a non-resident has a significant economic presence on the basis of factors that evidence a sustained interaction with jurisdiction via technology and other automated means.[186] Some of the factors that may be considered for constituting sustained interaction and thus creating significant economic presence are:

- Existence of a user base and associated data input;
- Volume of digital content derived from the jurisdiction;
- Billing and collection in local currency;
- Maintenance of a website in local languages;
- Responsibility for final delivery of goods to customers or provision by enterprise of other support services such as after-sale services or repairs or maintenance; or
- Sustained marketing and sales promotion activities either online or otherwise to attract customers.[187]

According to this proposal, the allocation of profit to a significant economic presence could be based on a fractional apportionment method. Further, this proposal also contemplates the imposition of a withholding tax as a collection mechanism and an enforcement tool.[188]

The three proposals discussed above have some commonalities as well as differences. All three proposals are based on the principle that business profits should be taxed in countries in which value is created. However, all these proposals have taken different policy stances to arrive at this conclusion. The user participation proposal only covers highly digitalized businesses within its ambit while market intangibles proposal seeks to respond to wider impact of digitalization and does not limit its scope to business models under the digital economy. The

[183] Base Erosion and Profit Shifting Project, Public Consultation Document: Addressing the Tax challenges of the Digitalisation of the Economy 10 [30] (February 13- March 6, 2019) available at <https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf> last accessed February 2, 2020.
[184] Base Erosion and Profit Shifting Project, Public Consultation Document: Addressing the Tax challenges of the Digitalisation of the Economy 10 [32] (February 13- March 6, 2019) available at <https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf> last accessed February 2, 2020.
[185] Base Erosion and Profit Shifting Project, Public Consultation Document: Addressing the Tax challenges of the Digitalisation of the Economy 10 (February 13- March 6, 2019) available at <https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf> last accessed February 2, 2020.
[186] Base Erosion and Profit Shifting Project, Public Consultation Document: Addressing the Tax challenges of the Digitalisation of the Economy 10 [51] (February 13- March 6, 2019) available at <https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf> last accessed February 2, 2020.
[187] Base Erosion and Profit Shifting Project, Public Consultation Document: Addressing the Tax challenges of the Digitalisation of the Economy 10 [51] (February 13- March 6, 2019) available at <https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf> last accessed February 2, 2020.
[188] Base Erosion and Profit Shifting Project, Public Consultation Document: Addressing the Tax challenges of the Digitalisation of the Economy 10 [55] (February 13- March 6, 2019) available at <https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf> last accessed February 2, 2020.

significant economic presence proposal is similar in scope to the marketing intangible proposal as it has also has a wide import.[189]. Further, user participation approach creates a taxing right in the user jurisdiction by attributing the value generated by user participation to that jurisdiction. The marketing intangibles approach similarly seeks to grant the market jurisdiction taxing rights owing to the intrinsic functional link created by marketing intangibles, The Significant economic presence approach advocates for creation of taxing right in the source jurisdiction based on factors such as revenue and number of active and passive users.[190] The user participation and marketing intangibles proposal allocate profits through a non-routine or residual profit split approach. Significant economic presence on the other hand proposes development of formulaic approach that considers factors such as users/employees, revenue, assets and so forth.[191]

In May 2019, a Programme of Work was prepared and adopted by OECD to develop a consensus-based solution to the tax challenges that arise due to digitalization of the economy. For the new nexus rule, Programme of Work identified the need for a development of a new nexus rule that is not constrained by physical presence requirements and allow market jurisdictions to exercise taxing rights over the measure of profits allocated to them under new profit allocation rules. In the need for a clear direction, the OECD Secretariat had undertaken extensive consultations and developed a Unified approach ('**The Secretariat's Proposal**') which was based on the commonalities between the three proposals.

1.2. The Secretariat's Proposal: Pillar one

In October 2019, the OECD released a document titled 'Public consultation document Secretariat Proposal for a "Unified Approach" under Pillar One' ('OECD Secretariat Proposal'), which built on the significant commonalities identified in the PoW. [192] The OECD Secretariat Proposal took into account the views expressed during a Public Consultation in Paris, and sought to consider the different positions of the members of the Inclusive Framework.[193] The OECD Secretariat Proposal was also discussed by the Task Force on the Digital Economy and subsequently released to the public for comments.

Given that it is built on the commonalities of the aforementioned three proposals, the OECD Secretariat proposal, like these three proposals, also suggests a mechanism to create a new nexus and proposes calculations to attribute profit to the market jurisdiction. This section of the report critically analyses the OECD Secretariat Proposal.

Scope of the proposal

The scope of the OECD Secretariat Proposal focused on 'consumer-facing businesses' and defined the expression to mean businesses that either generate revenue from supplying consumer products, or from providing digital services that have a consumer facing element.[194] While the ambit of 'consumer facing element' was not defined at the stage of the OECD Secretariat Proposal, 'consumers' were defined as individuals who acquire goods or

[189] G-24 Working Group on Tax Policy and International Tax Cooperation, "Proposal for Addressing Tax Challenges Arising from Digitalisation" (January 17, 2019) available at <https://www.g24.org/wp-content/uploads/2019/03/G-24_proposal_for_Taxation_of_Digital_Economy_Jan17_Special_Session_2.pdf> last accessed January 17, 2020
[190] G-24 Working Group on Tax Policy and International Tax Cooperation, "Proposal for Addressing Tax Challenges Arising from Digitalisation" (January 17, 2019) available at <https://www.g24.org/wp-content/uploads/2019/03/G-24_proposal_for_Taxation_of_Digital_Economy_Jan17_Special_Session_2.pdf> last accessed January 17, 2020
[191] G-24 Working Group on Tax Policy and International Tax Cooperation, "Proposal for Addressing Tax Challenges Arising from Digitalisation" (January 17, 2019) available at <https://www.g24.org/wp-content/uploads/2019/03/G-24_proposal_for_Taxation_of_Digital_Economy_Jan17_Special_Session_2.pdf> last accessed January 17, 2020
[192] Organisation for Economic Cooperation and Development, Public consultation document Secretariat Proposal for a "Unified Approach" under Pillar One, (9 October 2019 – 12 November 2019), available at < <https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf> last accessed February 2, 2020
[193] Organisation for Economic Cooperation and Development, Public consultation document Secretariat Proposal for a "Unified Approach" under Pillar One, (9 October 2019 – 12 November 2019), available at < <https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf> last accessed February 2, 2020
[194] Organisation for Economic Cooperation and Development, Public consultation document Secretariat Proposal for a "Unified Approach" under Pillar One, (9 October 2019 – 12 November 2019), available at < <https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf> last accessed February 2, 2020

services for personal use.[195] The OECD Secretariat Proposal also specifically included certain B2B business models within its scope, such as businesses that supply products to consumers through intermediaries.[196]

From its general inclusion of consumer facing businesses and the specific inclusion of a few B2B models, it appeared that the OECD Secretariat Proposal meant to apply to businesses that cater to individual consumers' personal needs, regardless of whether or not they supply directly to such consumers. This basic rationale behind the scope appears to have a solid foundation in so far as it is aimed to target businesses that remotely interact and draw from their consumers to make products suited for them. However, the stipulated scope was likely to cause three significant difficulties. First, by basing its roots in the abstract concept of 'personal use' OECD Secretarial Proposal raised the question - would the use of a product depend on its nature, or on the purpose for which the recipient actually purchases it? While the former would have raised significant drafting nightmare as it would be virtually impossible to coin a globally acceptable definition of 'products for personal use', the latter would significantly increase the supplier business' compliance burden. The second flaw with the scope of the OECD Secretarial Proposal is that its rationale fails to justify the general exclusion of B2B businesses. There may be several situations where businesses specifically cater to the requirements of their customers, but the customers need not necessarily be individuals purchasing the product for personal use. This lacuna can be illustrated through the example of a business providing cloud computing services to a law firm. Since the law firm is not an individual or an intermediary for the business, it will be carved out of the scope of the OECD Secretarial Proposal, despite receiving highly digitalised services that are specifically customized to suit its needs. Lastly, a general exclusion of B2B businesses could also potentially incentivize restructuring. Given the dynamic nature of the digital economy, such a broad-based exemption may also be unsustainable in the long term as novel business models emerge in the ecosystem.

Further, some sectors were specifically proposed to be carved out from the scope of the OECD Secretarial Proposal. Extractive industries and commodities, financial services etc. are some of the sectors that were specifically sought to be excluded from the scope as these industries did not interact with consumers and the market jurisdiction did not have a significant role to play to create specific value in such cases (e.g. extractive industries derive substantial value from their source jurisdiction).

In addition to the aforementioned exclusions on the basis of the nature of the business, the OECD Secretarial Proposal suggested to also exclude all enterprises that did not exceed a certain consolidated revenue threshold. While the exact threshold amount was not finalized at that stage, it was indicated that the threshold could be €750 million as under country by country reporting requirements. [197]

New nexus

Once businesses fall under the aforementioned scope, the OECD Secretarial Proposal envisaged that the new nexus rule would be applicable in all cases where a business has a sustained and significant involvement in the economy of a market jurisdiction, such as through a consumer interaction and engagement, irrespective of its level of physical presence in that jurisdiction.[198] The proposal deemed revenue as a pre requisite for establishment of a new taxing right. It had stipulated that for the provision of a revenue threshold that would include country specific sales thresholds to ensure that jurisdictions with smaller economies can also benefit. Despite prescribing 'revenue' as the primary determinant for the establishment of a nexus, the OECD Secretariat Proposal

[195] Organisation for Economic Cooperation and Development, Public consultation document Secretariat Proposal for a "Unified Approach" under Pillar One, (9 October 2019 – 12 November 2019), available at < <https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf> last accessed February 2, 2020

[196] Organisation for Economic Cooperation and Development, Public consultation document Secretariat Proposal for a "Unified Approach" under Pillar One, (9 October 2019 – 12 November 2019), available at < <https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf> last accessed February 2, 2020

[197] Organisation for Economic Cooperation and Development, "Secretariat Proposal for a 'Unified Approach' Under Pillar One — Public Consultation Document" (October 2019) [20] available at <https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf> last accessed February 2, 2020.

[198] Organisation for Economic Cooperation and Development, "Secretariat Proposal for a 'Unified Approach' Under Pillar One — Public Consultation Document" (October 2019) available at <https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf> last accessed February 2, 2020.

categorically acknowledged businesses such as online advertising services that are directed at non-paying users in locations that are different from those in which the relevant revenues are booked.[199] While this acknowledgement was commendable, the OECD Secretariat Proposal failed to prescribe a mechanism for the attachment of value to such non-paying users for ascertaining revenue threshold.

This new nexus is intended to be introduced through a standalone rule- on top of the PE rule- to limit any unintended spill over effects on other existing rules[200]. It is acknowledged in the proposal that there is a need to change nexus as well as profit allocation rules not just for situations where there is no physical presence but also for those where there is. This is because taxpayers would otherwise simply side-step the new rules by using alternative forms of an in-country presence making new taxing right elective for taxpayers and creating an open invitation for tax planning.[201] However, there is no clarity on the interplay between the traditional rule of establishing PE and the new nexus rule.

Allocation of profit

After establishment of a right to tax in a jurisdiction, the next step is to determine the value of profits that would be attributed to such establishment. The OECD Secretariat Proposal specifically acknowledged the use of existing rules to allocate profit would not serve the purpose as they are based on traditional concept of physical presence and hence account for the functions performed and the location of assets.[202] The proposal thus recognised the need for new profit allocation rules, that would go beyond the arm's length principle. While it did not explicitly spell out this new rule, the OECD Secretariat Proposal highlighted the need for a simple mechanism that would avoid double taxation, and significantly improve tax certainty relative to the current position.[203]

The proposal suggested a three-tier mechanism. First, it proposed that a portion of an enterprise's deemed residual profits be attributed to the market jurisdiction. Second, it proposes to allocate revenue from baseline activities of distribution conducted in the market jurisdiction. Third, the proposal acknowledged that in addition to the two considerations factored above, there might be other functions that are conducted in the market jurisdiction and proposed to compensate the market jurisdiction for the same. The three profit allocation mechanisms as proposed are:

1. Amount A – a share of deemed residual profit allocated to market jurisdictions using a formulaic approach, i.e. the new taxing right;
2. Amount B – a fixed remuneration for baseline marketing and distribution functions that take place in the market jurisdiction (ALP approach); and
3. Amount C – binding and effective dispute prevention and resolution mechanisms relating to all elements of the proposal, including any additional profit where in-country functions exceed the baseline activity compensated under Amount B.

It proposes to retain profit allocation (between taxing jurisdictions) based on arm's length principle in cases where it is working as intended; a formula based solution is introduced for cases where it has failed to allocate appropriate profits particularly on digital business models. The proposal has not highlighted application of any

[199] Organisation for Economic Cooperation and Development, "Secretariat Proposal for a 'Unified Approach' Under Pillar One — Public Consultation Document" (October 2019) [22] available at <https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf> last accessed February 2, 2020.

[200] Organisation for Economic Cooperation and Development, "Secretariat Proposal for a 'Unified Approach' Under Pillar One — Public Consultation Document" (October 2019) [16] available at <https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf> last accessed February 2, 2020.

[201] Organisation for Economic Cooperation and Development, "Secretariat Proposal for a 'Unified Approach' Under Pillar One — Public Consultation Document" (October 2019) [16] available at <https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf> last accessed February 2, 2020.

[202] Organisation for Economic Cooperation and Development, "Secretariat Proposal for a 'Unified Approach' Under Pillar One — Public Consultation Document" (October 2019) available at <https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf> last accessed February 2, 2020.

[203] Organisation for Economic Cooperation and Development, "Secretariat Proposal for a 'Unified Approach' Under Pillar One — Public Consultation Document" (October 2019) available at <https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf> last accessed February 2, 2020.

objective criteria to conclude situations in which arm's length is not satisfied and hence a formula based solution should apply. New nexus rules have been created which are based on sales and user participation, without physical presence. It allocates taxing rights to emerging economies, where the users of highly digitalised business models are located.

The new profit allocation rules go beyond the arm's length principle and the limitations imposed on taxation due to physical presence. They work in tandem with the existing scheme of rules to allocate profits in market jurisdictions in a way which is simple, avoids double taxation and improves tax certainty.

1.3. The after-effects of the Unified Approach

The OECD Secretariat Proposal underwent extensive public consultation and many stakeholders expressed their views and raised concerns on certain technical aspects of the proposed approach. Some of the critical public comments were received on Unified Approach. [204] These comments are particularly important for growth and demand driven economies such as India. Our tax policy approach seldom pre-analyses spill over effects or a proactive impact assessment. With an ambitious digital agenda as integral to India's economic policy, move to impose additional tax burden or onerous compliance or regulations which are ambiguous, will have to be kept in mind. Some of the comments received are:

1. Netflix – does not support attribution of profit based on formulaic methodology. It suggested a two-tier mechanism arguing that amount C under the three-tier mechanism may result in double counting
2. GSK – was in favour of carrying out an impact assessment on future investments, employment and growth.
3. Uber – supported distribution of residual profits principally based on DEMPE functions and establishing the new approach on economic principle rather than targeting select business models.
4. Amazon – suggested applying the new approach to both loss making and profit making businesses and not ring fencing the digital economy.
5. Johnson & Johnson – advocated for a clear delineation between the fixed return under amount B and arm's length return under amount C.
6. P & G – was of the opinion that ring fencing the business models will create ambiguity and risk overly narrow or overly broad interpretations by the taxpayers and tax authorities. [205]

On March 6, 2019, the French government decided to levy 3 percent digital service tax on gross revenues generated by companies providing digital interface services and targeted advertising services.[206] In July 2019, the US Trade Representative initiated an investigation of the levy of digital service tax by France under their Trade Act to focus on whether the digital service tax is discriminatory against US companies or was unreasonable as tax policy.[207] US threatened France to impose duties of up to 100% on imports of champagne, handbags and other French products.[208] France also retaliated by stating that if US imposes trade sanctions, it would deeply affect their relationship.

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[204] Organisation for Economic Cooperation and Development, 'Public comments received on the Secretariat Proposal for a "Unified Approach" under Pillar One, (November 15, 209) available at <https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm> last accessed January 2, 2020.

[205] Organisation for Economic Cooperation and Development, 'Public comments received on the Secretariat Proposal for a "Unified Approach" under Pillar One, (November 15, 209) available at <https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm> last accessed January 2, 2020.

[206] United States Trade Representative, 'Report on France's Digital Service Tax Prepared in the Investigation order under Section 301 of the Trade Act of 1974 (December 2, 2019) available at <https://ustr.gov/sites/default/files/Report_On_France%27s_Digital_Services_Tax.pdf> last accessed February 15, 2020.

[207] United States Trade Representative, 'Report on France's Digital Service Tax Prepared in the Investigation order under Section 301 of the Trade Act of 1974 (December 2, 2019) available at <https://ustr.gov/sites/default/files/Report_On_France%27s_Digital_Services_Tax.pdf> last accessed February 15, 2020.

[208] Update 1- France warns U.S. against digital tax retaliation (Reuters, January 6, 2020) available at <https://www.reuters.com/article/france-usa-tax/update-1-france-warns-u-s-against-digital-tax-retaliation-idUSL8N29B124> last accessed January 10, 2020.

Similarly on 2nd June 2020, United States Trade Representative initiated an investigation in relation to Digital Services Taxes (DSTs) adopted or under consideration by Austria, Brazil, the Czech Republic, the European Union, India, Indonesia, Italy, Spain, Turkey, and the United Kingdom. Section 301 of the Trade Act of 1974 renders, policies and practices of a foreign country that are unreasonable or discriminatory and burden or restrict U.S. commerce, actionable under the United States law. Such actions by foreign jurisdictions, on investigation, could be considered unreasonable, unfair or inequitable, though they may not be in violation or inconsistent with the international legal rights.

On December 3, 2019 a letter was issued by US Treasury Secretary to OECD secretary General Gurria reiterating the US political support for a multilateral solution and including proposal to implement Pillar one on safe harbour basis. If the safe harbour principle is implemented, then companies would be empowered to opt into or out of the unified approach under Pillar One provided they abide by some agreed measure. However, many inclusive framework members have raised concerns that implementing pillar one on safe harbour basis may raise a lot of difficulties and increase uncertainty.

1.4. The Globe Anti Base Erosion Proposal: Pillar two

Pillar Two proposal is supposed to develop consensus based set of rules to address the risks from structures that allows MNEs to shift profit to jurisdictions where they are subject to no or very low taxation. The consultation document was released on 8th November, 2019, and all stake holders were asked for inputs on specific technical issues (use of financial accounts for determining tax base, combining of high tax and low tax income to determine effective tax rate and carve-outs and thresholds under the proposal).

The four components of GloBE proposal are:

1. Income inclusion rule – that would tax income of a foreign branch or controlled entity if it was taxed at an effective tax rate below a minimum rate
2. Untaxed payments rule – that denies deduction in source jurisdiction if that payment (to related party) is not taxed at or above a minimum rate
3. Switch-over-rule – would allow the residence jurisdictions to switch from an exemption to credit method when profits attributable to a PE or income derived from immovable property is taxed below the minimum rate
4. Subject to tax rule – would complement the untaxed payments rule and subject such payments to source taxation and its eligibility for treaty benefits, when it is taxed below the minimum rate.

This proposal has a very wide scope and it is not restricted to digital business models. It proposes substantial changes to the international tax rules. Getting consensus from all stakeholders keeping in mind their policy choices will be a difficult task, thus implementation is going to be a problem.

2. India's domestic law position

As noted in Vidhi's Digital Tax Report, India has been one of the front-runners in the debate surrounding taxing the digital economy. The Report has explained in detail some of the efforts such as imposition of Equalisation levy[209] and introduction of the concept of Significant Economic Presence.[210] After the introduction of equalisation levy and significant economic presence, Central Board of Direct Taxes ('CBDT') had issued a consultation paper examining the scheme of profit attribution to PE under Article 7 of DTAAs. Further, some changes have also been brought through the Union Budget 2020 although they will take effect from the subsequent financial year, to allow time for the Inclusive Framework to reach a consensus.

[209] Committee on Taxation of e-commerce, 'Proposal for Equalization Levy on Specified Transactions, (February, 2016) 41 [65] available at <https://incometaxindia.gov.in/News/Report-of-Committee-on-Taxation-of-e-Commerce-Feb-2016.pdf> last accessed 10th December 2018.

[210] Income Tax Act, 1961, Explanation 2A of Section 9(1)(i)

2.1. CBDT consultation paper on profit attribution

To bring greater clarity and predictability, the Central Board of Direct Taxes (CBDT) formed a committee to examine the existing scheme of profit attribution to PE under Article 7 of the DTAAs and recommend changes to Rule 10 of the Income Tax Rules. The Committee released the proposal for public consultation on 18th April, 2019. The proposal first discussed the applicable regulations in context of taxation of non-residents specifically with respect to the DTAAs and Rule 10 which was leading to concerns of excessive taxation due to its uncertainty and ad hoc basis for determining profits attributable to a PE. Further, concerns were expressed on attribution of profits generated from digital businesses and the need to address the importance of user participation in emerging economies.

It was pointed out by the committee that three versions of Article 7 (UN, pre-2010 OECD & 2010 OECD) in the Model conventions had different standards for attribution of profit to the PE. The pre-2010 version having a lot of similarities with the UN version which in addition also has the 'force of attraction'[211] rule and 'limitation of deductible expenses'. However, both versions allow the application of apportionment method by the source state if it is in accordance with the domestic laws. The 2010 OECD version introduced FAR analysis under the AOA approach by doing away with the apportionment method. The committee was of the opinion that as sales in the market jurisdiction is not a consideration under the FAR analysis, the 2010 OECD version of Article 7 is purely a supply side approach[212]. It was observed that India had expressed its disagreement with the 2010 OECD version of Article 7 by not only reserving its right not to include it in its tax treaties, but also rejecting the AOA approach.[213] As the FAR analysis did not take into account the demand side factors of the sales revenue and attributed profits based only on functions, assets and risks (regarding the PE as a distinct and separate entity), none of the Indian treaties have incorporated it.

Accordingly, the committee concluded that both demand and supply of goods were integral contributors to business profits and a mixed approach that accounts for both these factors should be used to attribute profits.[214] As the market jurisdictions maintain markets that enable their residents to pay for the goods and services, leading to sales, their contribution is essential and profits should be allocated based on this economic justification.

The committee then analysed landmark cases and exhibited that the Indian courts have endorsed Rule 10 (UN Model customary approach) even when the DTAAs were applicable and observed that apportionment was permissible under the Indian treaties.
The committee was concerned that different methodologies had been applied in various cases without any universal justification, leading to uncertainty and further tax litigation.[215] All these discrepancies in attribution of profits seemed to arise from the discretionary powers given to the tax administration under Rule 10 and a lack of universal methodology for doing so. The need for providing a universally applicable rule for all stake holders, which would bring certainty and reduce tax disputes was advocated by the committee.

The committee rejected the option of using formulary apportionment as it would require country wise information of the MNEs to arrive at their global profit for apportionment. Even if the information is received under the Country-by-Country (CbC) reporting under BEPS Action 13 and Income-Tax Rules 10DA & 10DB, 1962, it would

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[211] *Any income such as other business profits, dividends, interest and royalties arising from the source State become taxable even if it is not attributable to the permanent establishment.*

[212] Committee on Taxation of e-commerce, 'Proposal for Equalization Levy on Specified Transactions, (February, 2016) [45] available at <https://incometaxindia.gov.in/News/Report-of-Committee-on-Taxation-of-e-Commerce-Feb-2016.pdf> last accessed 10th December 2018.

[213] Position of Non-member countries, Materials on International, TP & EU Tax Law- Volume A, selected and edited by Kees van Raad, Seventeenth Edition, (2018) International Tax Center Leiden, 295.

[214] Committee on Taxation of e-commerce, 'Proposal for Equalization Levy on Specified Transactions, (February, 2016) [59] available at <https://incometaxindia.gov.in/News/Report-of-Committee-on-Taxation-of-e-Commerce-Feb-2016.pdf> last accessed 10th December 2018.

[215] Committee on Taxation of e-commerce, 'Proposal for Equalization Levy on Specified Transactions, (February, 2016) [54] available at <https://incometaxindia.gov.in/News/Report-of-Committee-on-Taxation-of-e-Commerce-Feb-2016.pdf> last accessed 10th December 2018; see also Formula One World Championship Ltd. V CIT, 394 ITR 80 (SC); see also DIT v. Morgan Stanley and Co. Inc. (2007) 292 ITR 416 (SC); see also Rolls Royce Singapore v. ADIT [(2011) 202 Taxmann 45 (Income Tax Appellate Tribunal Delhi)]; see also Arrow Electronics India Ltd. TS-142-2017 (Income Tax Appellate Tribunal Bangalore)

pose practical difficulties in application thus limiting the options of applying formulary apportionment method. Instead, fractional apportionment was suggested as it takes into account only those profits that have been derived from India and then apportioning them based on certain factors. The committee was of the view that fractional apportionment could form the uniform method under Rule 10, bringing clarity and objectivity to the attribution of profits. To note that Rule 10 comes into play only in cases where books of accounts are not maintained by the PE, which could be arguably on an arm's length basis.

Listing the merits of this approach, the committee said that fractional apportionment takes into account both demand and supply side factors, uses a three factor formula to allocate profits (one third to sales and two third to supply), has a long precedence in international practice and was recently proposed by the European Union. The three-factor formula of sales, manpower and assets is in vogue in the US in relation to state taxation. It is relatively simple and does not require extensive country by country information, thus avoiding disputes and litigation.

To apply this method, in practice, the following steps were recommended by the committee:

1. By determining the profits in relations to the India operations. In case the MNE is incurring a global loss or the operational profit margin is lower than 2%, profits derived from India will be taken at 2% of the turnover derived from India.
2. By apportioning the profits from Indian operations of an Enterprise on the basis of three factors of sales (33%) and manpower and assets (together 67%).
3. By deducting any profits from India operations of the enterprise, any profits that may have already been taxed in India, whether in the hands of the non-resident enterprise or its associated enterprise in India.

After discussing the role of user participation (in digital businesses) and their significant contribution to the profits of the enterprise, the committee concluded that where applicable, it should also be taken into account for profit attribution as the fourth factor for apportionment in addition to the other three factors. The business models were divided into three categories depending on the intensity of user participation (low, medium and high). The low and medium user participation was assigned a weight of 10% and high user participation was assigned a weight of 20%. It was also decided that to accommodate this fourth factor, a downward adjustment would have to be made to the weight assigned to the other two supply side factors, namely employees and assets. A complex formula was finalized by the committee.

Profits attributable to operations in India =
'*Profits derived from India*[216]' x [SI/3xST + (NI/6xNT) +(WI/6xWT) + (AI/3xAT)][217]

Profits attributable to operations in India in cases of low and medium user intensity business models=
'*Profits derived from India*' x [0.3 x SI/ST + (0.15 x NI/NT) +(0.15 x WI/WT) + (0.3 x AI/3xAT)] + 0.1]

In case of digital models with high user intensity, the users should be assigned a weight of 20%, while the share of assets and employees be reduced to 25% each after keeping the weight of sales as 30%, as under:
Profits attributable to operations in India in cases of high user intensity business models =
'*Profits derived from India*' x [0.3 x SI/ST + (0.125 x NI/NT) +(0.125 x WI/WT) + (0.25 AI/3xAT)] + 0.2]

The committee recommended the changes to Rule 10 to incorporate such fractional apportionment method. Several considerations arise from this proposal:

[216] *Profits derived from India' = Revenue derived from India x Global operational profit margin*
[217] *SI = sales revenue derived by Indian operations from sales in India*
ST = total sales revenue derived by Indian operations from sales in India and outside India
NI =number of employees employed with respect to Indian operations and located in India
NT = total number of employees employed with respect to Indian operations and located in India and outside India
WI= wages paid to employees employed with respect to Indian operations and located in India
WT = total wages paid to employees employed with respect to Indian operations and located in India and outside India
AI = assets deployed for Indian operations and located in India
AT = total assets deployed for Indian operations and located in India and outside India

1. It is supposed to address profit attribution to non-residents in all forms of businesses, but the proposal provides no clarity on its application in context of the treaties. The whole rationale of this proposal is to reduce the arbitrariness in allocation of profits (from formulary to fractional apportionment) though the same has not been achieved and may result into litigation due to double taxation.

2. As Rule 10 is applied only in specific situations (when the accounts of the PE are not available or amount of profits attributable to the PE is incapable of determination in the view of the Indian tax authority or the ascertaining thereof by that tax authority presents exceptional difficulties); this restricts the scope of the proposal.

3. The proposal disregards established arm's length transfer pricing principles and tax is being proposed based on revenue and non-profitability criteria. The proposal has introduced taxation without considering whether that activity in India is resulting in profit and assumes that the global operating profit margin is commensurate with the functions and risks of the Indian PE, which may not be the case. It taxes income in India even in situations of global loss.

4. The proposal's reliance on Article 7(4) of the UN Model, specifically by using the term 'customary approach' does not necessarily mean reliance on Rule 10 of the Income Tax Rules, 1962 which lays down rudimentary principles for global formulatory approach. Neither does the customary approach mean that reliance cannot be placed on arms-length principle. The comprehensive transfer pricing principles contained in Chapter-X of I-T Act, 1961 have, in our view, assumed the character of a 'customary approach'. Chapter-X of the statute has not just been practiced; it has been perfected with jurisprudence evolving around arms-length principle. Hence, to presume that the customary approach under Article 7(4) (of the UN treaty), guides us to Rule 10 seems a flawed approach. Furthermore, the courts have affirmed arms-length principle since its legislation. Also, the commentary to Article 7(4) of the 2008 OECD Model suggests that even if an apportionment method is used, the method should "produce figures of taxable profit that approximate as closely as possible to the figures that would have been produced on a separate account basis"

5. It is based on revenue and non-profitability criteria, which is presumptuous and most likely erroneous, levying tax on revenues instead of profits. Allocation keys have been assigned in an ad hoc manner without economic policy rationale. It suggested a pure formula-based approach by considering three factors (allotting one third of the profit to sales and two third to supply). For business models with user participation as a factor, it has suggested assignment of weights based on their intensity (low, medium or high user participation), resulting in a lower weight being assigned to supply.

6. If we go by this proposal, different approaches will have to be used to attribute profits to a PE and a subsidiary. In case of a PE, the formulary approach will be followed and the arm's length approach in case of a subsidiary. This sounds economically illogical as enterprises will be incentivized to adopt the form of business presence that will reduce their tax liability.

7. To arrive at the global operational profit margin, country wise information will be required that may not be available.

The application of Rule 10, akin to India's global formulatory approach predates the 1961 law and found mention even in the 1922 law, at a time when arms-length principle had not evolved. Ideally, Rule 10 should have been amended alongside the introduction of Chapter-X as comprehensive Transfer pricing regulations have rendered Rule 10 irrelevant, if not redundant. Rule 10, besides being ad-hoc in its application is predicated upon the tax administration forming an opinion that 'income' accruing or arising to a non-resident cannot be definitely ascertained. This rule is to deal with specific situations where the non-resident either has not maintained its books of accounts or based on the books maintained, the income cannot be ascertained due to non-reliance or adjustments to income cannot be undertaken. Further, Rule 10 and its three sub-rules, though not in the order of priority has laid out three options:

• Option 1 to compute income at percentage of turnover as may be reasonable. The reasonableness test shall factor the nature of business, net profit margin of non-residents from such business (global net profit margin), usual rate of profit in that line of business and more importantly, type of business operations in India.

• Option 2 to compute income based on proportion of global profits, by introducing the factor of global revenues to Indian revenues. This is a classic global formulatory approach, however, the emphasis is on profitability though the attribution principles introduced revenue criteria. The Indian courts while interpreting this rule have held that 'profits/gains' will include the total result of a particular business segment and if that results in a loss, they are as much to be apportioned as the profits of business.

• Option 3 can be resorted only if the above two methods fail, discretion for which is left to the tax administration.

The computational proposals of the committee seem to jump to Option 3 with a pre-determined formula. It however skips the first two options and more importantly ignores profitability as a criteria in its pursuit to focus on demand side factors. The application of profit attribution rules as laid out in the proposals should clearly articulate the situations to which such Rules will apply. For instance, is it meant to apply in situations where a non-resident is from a treaty country? Ordinarily, it shouldn't since the relevant articles (Article 5 & 7) should first guide the determination of PE and thereafter, the attribution of profits to the PE as per the treaty provisions. If treaty provisions guide its determination under the separate entity approach, Rule 10 attribution principles (as proposed) should not apply. Similarly, in situations where the taxpayer has maintained books of accounts, attribution of profits in situations where PE exists should be as per the books and Revenue should not resort to customary approach. Adequate safeguards should be built for not rejecting books of accounts and hence option 3 read with proposals, should be an option of 'last resort'. Hence, it follows, that the only situation in which the attribution rules shall apply would be with non-treaty partners and where books of accounts are not maintained or cannot be drawn up (for Indian operations). Even in those situations, determination of profits can be made under Rule 10 (ii) (second option) as per the attribution rules.

There appears to be a disconnect in the thinking of policy makers emphasising on importance of Section 92 as determinant of arm's length price with reference of a transaction, whereas, section 9 and Rule 10, a determinant of profit which is to be attributed to a PE in accordance with the arm's length principle. The disconnect between price determination and profit attribution is a structural weakness arising from the different approaches under Section 92 and Rule 10. This may result in a valuation discrepancy as Section 92 approaches the arm's length price from a micro lens, while under Rule 10, the profit determination is from a macro perspective. Union Budget 2020 proposals seek to augment such thinking process by proposing to embrace the extensions of safe harbour rules and advance pricing agreement framework for attribution of profits to business connection under Section 9(1)(i). While undoubtably, safe harbour and APA determination for profit attribution will curtail litigation in this vexatious area, its implementation and approach will determine the success.

2.2. Amendments through the Union Budget 2020

As discussed in Vidhi's Digital Tax Report and in the preceding sections of this report, amendments to the I-T Act as far as the scope of 'business connection' is concerned, only apply in cases where no DTAA exists between India and the other residence jurisdiction of the enterprise in question. The applicability of the provision relating to SEP has been deferred. Initially when Explanation 2A was inserted under Section 9 of the I-T Act in 2018, the same was to come into force with effect from April 2019. Notably, for the provision in question to come into effect, rules regarding the following thresholds needed to be prescribed:

- The amount of aggregate payments in respect of transactions carried out by a non-resident in India and
- The number of users with which engagement and interaction is carried out through digital means

These thresholds were not prescribed. Therefore, though the provisions of Explanation 2A came into effect in April 2019, their applicability was never triggered. Subsequently in the Union Budget 2020-21, the applicability

of SEP was categorically deferred to assessment year 2022-23. In the Budget Memorandum, this change was attributed to the ongoing discussion on the issue in G20-OECD BEPS project.[218]

In addition to deferring the applicability of Explanation 2A of Section 9 of the I-T Act, a new Explanation 3A was also inserted.[219] While Explanation 3 specifically states that only the income attributable to the business connection shall be deemed to accrue and arise in India,[220] the new Explanation 3A categorically lists certain income that will be attributable to the operations carried out in India. This list includes income from:

- such advertisement which targets a customer who resides in India or a customer who accesses the advertisement through internet protocol address located in India;
- sale of data collected from a person who resides in India or from a person who uses internet protocol address located in India; and
- sale of goods or services using data collected from a person who resides in India or from a person who uses internet protocol address located in India

Making the proposal effective from April 1, 2020 has taken non-resident digital business service providers by surprise. The timing is particularly intriguing given that SEP proposal implementation was delayed. For non-treaty non-residents, this certainly raises the bar on taxation under business connection source rules.

Another significant change that has been brought through the budget is expanding the scope of equalization levy. With effect from April 1, 2020, the scope of Equalisation levy has been expanded to cover non-resident e-commerce operators making, providing or facilitating e-commerce supply of services by imposing 2% equalization levy on the amount of consideration received by such e-commerce operator. This expansion would potentially cover all kinds of digital transactions engaged in sale of goods or provision of services.[221] The expansion goes beyond goods and services supplied to Indian residents and also includes non resident availing services using Internet Protocol address. It also includes non residents transacting with e-commerce operators in selling of advertisement targeting Indian customers or selling data collected from Indian consumers. In cases of services in the nature of online advertisement, Indian resident paying consideration was obligated to deduct and pay to the government. However, the collection and recovery of equalization levy under the current expansion imposes obligation on the concerned e-commerce operator to pay equalization levy.[222]

Besides the above legal changes, there has been no other significant legal change relating to the taxation of the digital economy that has been introduced. In the Indian domestic income tax law, there appears to be a shift in the thinking of policy-makers. In the past, laws were typically conceived with traditional brick-and-mortar businesses in mind, however, now there appears to be a conscious recognition of businesses operating in the digital landscape at the time of conception of policies itself. Outside of tax laws, this thinking has manifested in several dedicated schemes and policies such as the e-commerce policy and the Data Protection Bill. Even within the ambit of income tax laws, a new Section 194—O was added in the Union Budget 2020 – 2021 in order to widen and deepen the tax net by bringing participants of e-commerce within its coverage.[223] Said provision places a responsibility to deduct tax at source on e-commerce operators (resident or non-resident) that are facilitating sale of good or provision of services of an Indian resident ecommerce participant through its digital or electronic facility or platform.[224]

[218] Finance Bill, 2020, Provisions Relating to Direct Taxes available at <https://www.indiabudget.gov.in/doc/memo.pdf> last accessed February 22, 2020
[219] Finance Act, 2020, Section 5.
[220] Income Tax Act, 1961, Explanation 3 of Section 9(1)(i)
[221] *The criticisms that we have been highlighted in the Vidhi Digital Tax Report still remains the same.*
[222] *Similar to United State's response to France's contemplation about the levy of Digital service tax, the US has opposed the expansion of EL by India. United States Trade Representative launched a Section 301 Trade Investigation.*
[223] Finance Act, 2020, Section 85.
[224] Income Tax Act, 1961, Section 194 - O

F. The State of Play

After the US-France disagreement, and the US' reaction to other similar levies imposed by countries across the globe including India, the importance of a consensus-based framework solution to cater to the issue at hand was reiterated and a glimpse of what its absence would ensue was exposed. Not only would the lack of consensus undermine the importance of the principles of international taxation, but it would also lead to digital taxation and significantly reduce certainty and foreseeability in the framework. That said, while a consensus is ideal, the US' response underscores different priorities at the negotiating table and highlights how difficult reaching a consensus could be.

With a focus on driving consensus, in January 2020, OECD/G20 Inclusive Framework published another document containing the outline of the architecture of a unified approach to Pillar One ('**Inclusive Framework Proposal**') which will be used as a basis for negotiation of a consensus-based solution. Further, it was expected through this document that any consensus-based agreement shall include a commitment by members of the Inclusive Framework to implement this agreement and at the same time withdraw all relevant unilateral actions.[225]

At the same time, acknowledging that a complete consensus may not be realistically possible, Mr. Rajat Bansal, a member of the UN Committee of Experts on International Cooperation in Tax Matters, expressed his personal views on the matter and proposed a way forward.[226] He suggests a mechanism that would not require all countries to join, but instead give flexibility to countries to opt for the new system voluntarily.

While the Inclusive framework Proposal is a significant step in the right direction, there are still several open-ended questions therein. Similarly, while it is necessary to focus on developing a Plan B, should our endeavours to develop global consensus fail, Mr Bansal's proposal also has certain flaws.

This section of the report studies the open questions pertaining to the scope and nexus, the profit attribution mechanism and the implementation of the Inclusive Framework Proposal. It also critically analyses Mr. Bansal's note titled 'Tax Consequences of the digitalized economy' ('Note on tax consequences of the digitalized economy').

1. The Inclusive Framework Proposal: scope and nexus

The Unified Approach is designed to adapt taxing rights by expanding such rights to the market jurisdiction. To achieve this, the Inclusive Framework Proposal encompasses three types of taxable profits that may be allocated to the market jurisdiction which are Amount A, Amount B and Amount C.

Amount A creates a new taxing right over a portion of residual profits which are allocable to market jurisdictions. This will be limited to large multinational companies that fall within the scope and meet a new nexus test in the market jurisdiction concerned.

[225] Organisation for Economic Cooperation Development, 'Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalization of the Economy, (29-30 January 2020) 8 [9] available at <https://www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf> last accessed February 5, 2020

[226] Tax consequences of the digitalized economy – issues of relevance for developing countries, Committee of Experts on International Cooperation in Tax Matters Twentieth session, E/C.18/2020/CRP.25, May 30, 2020, available at <https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2020-06/CICTM%2020th_CRP.25%20_%20Digitalized%20Economy.pdf> last accessed June 10, 2020.

1.1. Scope of activities

Two broad sets of businesses have been accounted for while defining scope. First set of businesses are ones providing automated and standardized digital services to a large customer base. These are businesses that in general are able to provide digital services remotely to customers in markets using little or no local infrastructure. One of the criteria for qualifying automated digital services is that services may be provided on a standardized basis to a large population of customers across multiple jurisdictions. Some of the business models as listed in the inclusive framework proposal includes online search engines, social media platforms, cloud computing services, online advertising services etc. Whether services provided are on a standardized basis or not is a matter of interpretation which if not defined properly may result into a lot of uncertainty. For instance, G Suite services provided by Google are customized based on specific preferences of the user company such as option for unlimited cloud storage, custom email addresses. Since, it differs from user to user and is based on each user's preferences, it may be considered to be out of the scope of automated businesses. A specific carve out is made in cases where services might be delivered to a customer online but has high degree of human intervention such as legal, architectural or consulting services. Since there seems to be no policy justification in the Inclusive Framework Proposal as to why such businesses are excluded, it may result in the absence of neutrality which merits that all subjects should typically be taxed in the same manner.

The second broad set of businesses included within the scope are consumer facing businesses. This set covers businesses that generate revenue from the sale of goods and services of a type commonly sold to consumers for personal use and not for commercial or professional purposes. Some of the business models falling within the scope are businesses selling personal computing products, branded foods and refreshments etc. While it is laudable that the OECD has clarified that the interpretation of consumer facing businesses would be based on the nature of the product and not on who the ultimate purchaser is, however, defining what nature of products would qualify as consumer facing may be difficult, if not impossible. This brings in scope not only businesses that sells goods and services directly to consumers but also those that sell consumer products indirectly through third-party resellers or intermediaries that perform routine tasks such as minor assembly and packaging. Again, what amounts to minor assembly is a matter of interpretation. This will also include businesses generating revenue from licensing rights over trademarked consumer products or consumer brand such as under a franchise model.

Further, businesses selling intermediate products and components are carved out except if the product is commonly acquired by consumers for personal use. What is commonly acquired for personal use or not is a matter of interpretation which may result into uncertainty for businesses. For instance, automobile tyres are generally used as an intermediate product, however some consumers may buy them for their personal use. Some specific industries such as extractive industries, financial services and airline and shipping businesses are specifically carved out from the scope.

1.2. Thresholds

In order to ensure that the compliance and administrative burdens are proportionate to the intended benefit, certain thresholds have been prescribed. First, only those multinational enterprises that meet a certain gross revenue threshold will be covered. Second, a further carve out is made in cases where the total aggregated in-scope revenue of a multinational enterprise is less than a certain threshold prescribed. Third, where total profit to be allocated under a new taxing right do not meet a certain de minimis amount, multinational enterprise will be carved out. This may cover a situation of a large domestically focused company with a minimal level of foreign income. Fourth, multinational enterprise will be taxed under Amount A only if the amount of aggregated deemed residual profit exceeds certain threshold. Lastly, a country specific threshold may also be prescribed.

1.3. Nexus

Once a business falls within the scope, the next step is to satisfy the new nexus rule, which is based on indicators of a significant and sustained engagement with market jurisdictions. For automated businesses, revenue threshold

is considered to be the only test required, however for consumer facing businesses, in addition to the revenue threshold, other possible factors need to be taken into consideration. Since the treatment of both types of businesses are different, it is important to explain clear distinction between the two business models and avoid potential overlap. One may argue that automated digital services and sales of services which are consumer facing may overlap. For instance, Uber may be said to be providing an automated digital service and also can be considered to be providing consumer facing service.

2. The Inclusive Framework Proposal: profit attribution

2.1. Quantum of Amount A

Amount A is largely based on a formula designed to identify the portion of residual profits that is to be allocated to the eligible market jurisdictions and excludes business activities in scope that do not exceed a certain level of profitability. The calculation of Amount A will be based on a measure of profit derived from consolidated group financial accounts. Among the different profit level indicators, consultations indicated that profit before tax is a preferred profit measure to compute Amount A. Further, to capture only in scope business segments, segmentations among business lines or multiple regions may be required. It is acknowledged in the proposal that the design of the segmentation rule must account for simplicity, accuracy as well as reduction in compliance burden. Moreover, the proposal recognises that the quantum of Amount A may be weighted to account for different degrees of digitalization between in scope business activities ('digital differentiation'). After determining quantum of Amount A, such amount shall be distributed to the eligible market jurisdictions based on an agreed allocation key.

2.2. Quantum of Amount B

It is a fixed remuneration based on the arm's length principle for defined baseline distribution and marketing functions that take place in the market jurisdiction. The overall purpose of Amount B is to achieve a greater degree of simplification in the administration of transfer pricing rules for tax administrations and lower compliance cost for taxpayers and enhance tax certainty about the pricing of transactions. The definition of baseline distribution activities will likely include distribution arrangements and routine level of functionality, no ownership of intangibles and no or low limited risk.

2.3. Quantum of Amount C

The return under Amount C covers any additional profit where in-country functions exceed the baseline activity compensated under Amount B. This new approach will be supported by a clear, administrable and a binding process for early dispute prevention.

The Inclusive Framework Proposal is a policy document and a lot needs to be done before a binding legal instrument can be issued. As per the Inclusive Framework Proposal, the Steering Committee will continue to work towards reaching an agreement in the inclusive framework on key policy features of a consensus-based solution to the Pillar one by July 2020. The final report is expected to be out by end of 2020 that will set out the technical details of the consensus-based solution agreed by the Inclusive Framework.

3. The Inclusive Framework Proposal: implementation

As discussed in the preceding sections, the 137 countries that currently form a part of the Inclusive Framework have reaffirmed their commitment to bridge the remaining differences and reach agreement on a consensus-based solution to tax the digital economy.[227] Assuming that such a consensus-based solution to grant new taxing rights and reallocate profits is indeed designed within the stipulated timeframe, it becomes necessary to examine the potential ways to implement it across jurisdictions.

Currently, the OECD Statement discusses this issue only briefly. It states that implementing the new approach would require changes to domestic legislation and to tax treaties to remove existing treaty barriers.[228] It also discusses the possibility of negotiating a new multilateral convention to implement the changes. With regard to this multilateral convention, the OECD Statement also states that such convention would apply between jurisdictions that do not currently have a bilateral treaty, supersede the relevant provisions of existing treaties concluded to eliminate double taxation and contain all the international rules needed to implement the unified approach.

This section of the report analyses the role that multilateral and bilateral treaties play in the international tax ecosystem. It studies their legal validity and aims to determine whether a multilateral convention would be an effective tool in implementing the unified approach.

3.1. A background to tax treaties

The Vienna Convention on the Law of Treaties states that '*A treaty is an international agreement (in one or more instruments, whatever called) concluded between States and governed by international law.*'[229] Bilateral tax treaties form a key component of the broad international tax architecture.

Under the current income tax framework, while domestic tax laws of countries provide the mechanism to tax cross-border transactions, they may lead to conflicting claims from multiple jurisdictions over the same taxable amount and may lead to double taxation. To settle such issues, most countries have entered into bilateral tax treaties through which contracting states agree to restrict the applicability of their domestic tax laws under certain situations.[230] These treaties lay down distributive rules that determine which contracting state will receive taxation from a particular transaction or event.[231]

At first, only federally related or closely allied states were involved in the execution of these treaties but following World War I an extensive treaty network developed in Central Europe. Subsequent efforts of the League of Nations contributed substantially to an assimilation of the existing bilateral treaties and to the development of uniform model treaties. The preparatory research of the League of Nations was then built upon by the

[227] Organisation for Economic Cooperation and Development/G20 Base Erosion and Profit Shifting Project, 'Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy, As approved by the OECD/G20 Inclusive Framework on BEPS ' (29-30 January 2020) available at <https://www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf> last accessed February 1, 2020

[228] Organisation for Economic Cooperation and Development/G20 Base Erosion and Profit Shifting Project, 'Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy, As approved by the OECD/G20 Inclusive Framework on BEPS ' (29-30 January 2020) available at <https://www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf> last accessed February 1, 2020

[229] *While India is not a signatory to this Convention, the VCLP has now been widely acknowledged as the customary international law. Further, the Standard Operating Procedure issued by the Ministry of External Affairs in respect of Memorandum of Understanding/Agreement with foreign countries also incorporates the same principles. For* reference, United Nations, Multilateral Vienna Convention on the law of treaties (with annex), Concluded on Vienna (May 23, 1969) Article 2, available at < https://treaties.un.org/doc/Publication/UNTS/Volume%201155/volume-1155-I-18232-English.pdf> last accessed January 2, 2020. (hereinafter 'Vienna Convention on Law of Treaties')

[230] Klaus Vogel, 'Double Tax Treaties and Their Interpretation' (1986) 4 Int'l Tax & Bus. Law. 1 <https://scholarship.law.berkeley.edu/cgi/viewcontent.cgi?article=1039&context=bjil> last accessed January 11, 2019

[231] Klaus Vogel, 'Double Tax Treaties and Their Interpretation' (1986) 4 Int'l Tax & Bus. Law. 1 <https://scholarship.law.berkeley.edu/cgi/viewcontent.cgi?article=1039&context=bjil> last accessed January 11, 2019

Organization of European Economic Cooperation and the OECD which eventually culminated in the preparation of the OECD Model Tax Convention and its commentaries.[232] In parallel, other opposing models were also developed. For instance, the member states of the Andean Group in 1971 developed one suited to the special interests of developing countries. Another model treaty intended to serve the interests of developing countries was published by the United Nations in 1980. Further, The United States Treasury Department published its own model treaty in 1976 to serve as the basis for U.S. treaty negotiations.[233] These Model treaties typically merely act as the basis for negotiation between the concerned countries. In 2015, over 3,000 bilateral income tax treaties were said to be in effect and most of these treaties were based on the template provided under the OECD Model Convention or the UN Model Convention.[234]

3.2. The interplay between domestic law and tax treaties

At the outset it is relevant to note that States can levy taxes only in accordance with their own domestic law, and the applicability of a tax treaty does not change that. Their applicability does not lead to the application of foreign law. Rather, tax treaties avoid double taxation by limiting the content of the domestic tax law of both contracting states in cross-border cases. Treaty requirements apply in addition to domestic law requirements; the legal consequences derived from them alter domestic law, either by excluding application of the domestic tax law of one of the states where it otherwise would apply, or by obligating one or both states to allow a credit against their own tax for taxes paid in the other state.[235] It is thus necessary to appreciate the interplay between domestic law and tax treaties. In order to do so, it is first imperative to understand the various steps involved in the conclusion of a treaty and understand their impact.

Negotiation

Consent

Internal implementation

The conclusion of a treaty is preceded by negotiations.[236] In the United States for instance, the Constitution vests treaty-making power in the hands of the President with advice and consent of the Senate.[237] Further, in parliamentary democracies, with Great Britain, Australia[238] and the remaining members of the Commonwealth constituting notable exceptions, the executive ordinarily must obtain the consent of parliament to conclude important agreements.[239] India too appears to fall under the aforementioned list of exceptions. The Constitution of India, under Article 73 empowers the Union alone to sign treaties in exercise of its executive powers.[240]

A treaty however does not become applicable merely after it has been negotiated. For purposes of international law, a tax treaty comes into existence upon the declaration of consent by both contracting states.[241] The method by which the contracting states declare their consent is left up to the contracting parties. Some of these methods may include consent signature, exchange of instruments constituting a treaty, ratification, acceptance, approval or accession, or by any other means if so agreed.[242] Notably, there is a significant difference between the declaration of consent to abide by the treaty, and internally implementing it. The former only renders the treaty

[232] International Conventions on Double Taxation available at <https://shodhganga.inflibnet.ac.in/bitstream/10603/252313/8/08_chapter2.pdf> last accessed February 4, 2020
[233] Klaus Vogel, 'Double Tax Treaties and Their Interpretation' (1986) 4 Int'l Tax & Bus. Law. 1 <https://scholarship.law.berkeley.edu/cgi/viewcontent.cgi?article=1039&context=bjil> last accessed on January 11, 2019
[234] Brian J. Arnold, 'An introduction to tax treaties' available at <https://www.un.org/esa/ffd/wp-content/uploads/2015/10/TT_Introduction_Eng.pdf> last accessed February 5, 2020.
[235] Klaus Vogel, 'Double Tax Treaties and Their Interpretation' (1986) 4 Int'l Tax & Bus. Law. 1 <https://scholarship.law.berkeley.edu/cgi/viewcontent.cgi?article=1039&context=bjil> last accessed January 11, 2019
[236] Klaus Vogel, 'Double Tax Treaties and Their Interpretation' (1986) 4 Int'l Tax & Bus. Law. 1 <https://scholarship.law.berkeley.edu/cgi/viewcontent.cgi?article=1039&context=bjil> last accessed January 11, 2019
[237] U.S. Constitution. art. II, §2, cl. 2
[238] Chow Hung Ching v. The Kind (1948) 77 CLR 449; Bradley v. The Commonwealth (1973) 128 CLR 557; Simsek v. Macphee (1982) 148 CLR 636
[239] Klaus Vogel, 'Double Tax Treaties and Their Interpretation' (1986) 4 Int'l Tax & Bus. Law. 1 <https://scholarship.law.berkeley.edu/cgi/viewcontent.cgi?article=1039&context=bjil> last accessed January 11, 2019
[240] Ashwani Kumar vs. Union of India (UOI) and Ors. (2019) 2 SCC 636.
[241] Vienna Convention on Law of Treaties, Article 9(1),
[242] Vienna Convention on Law of Treaties, Article 11.

binding under international law. However, in order for a treaty to be made internally applicable in domestic law, further steps may need to be undertaken.

The determination of whether or not such further steps need to be undertaken for the treaty to apply to a country's domestic law depends on whether its constitution adopts the doctrine of 'monism' or 'dualism'.[243] The Dutch constitutional law for instance adopts monism, pursuant to which a treaty becomes applicable domestically at the time it enters into force.[244] However, in dualist states a treaty ratified by the Government does not alter the laws of the state unless and until it is incorporated into national law by legislation. This is a constitutional requirement: until incorporating legislation is enacted, the national courts have no power to enforce treaty rights and obligations either on behalf of the Government or a private individual.[245] Several countries including Australia[246] and the United Kingdom[247] adopt the doctrine of dualism. Even the Indian constitution adopts the same. As noted above, the signing and negotiation of treaties has been designated as an executive function under Article 73 of the Constitution of India. Unlike countries like the U.S. where the Senate is involved in the process of signing and ratification, under the Indian legal framework this exclusively exercised by the executive. Further, Article 253 of the Constitution of India empowers the Parliament to make laws for the whole or any part of the territory of India for implementing any treaty, agreement or convention.[248] Therefore it is clear that the mere act of executing a treaty under Article 73 would not make the same applicable over domestic law.

It now become relevant to analyse the legal significance of a signed and ratified treaty, which has not been adopted into domestic law by legislative action under Article 253 of the Constitution. Several Indian and international cases have analysed the legal impact of such treaties and laid emphasis on Article 51 of the Constitution of India. Said Article lists the Directive Principles of State Policy and states that the State shall endeavour to foster respect for international law and treaty obligations.[249] Accordingly, the Supreme Court, on several occasions, has held that while a treaty entered into by India cannot become law of the land unless Parliament passes a law as required under Article 253, it is still the duty of the courts to construe legislations so as to be conformity with International Law and not in conflict with it.[250] Several Australian cases also hold that where a statute or subordinate legislation is ambiguous, the courts should favour that construction which accords with Australia's obligations under a treaty or international convention to which Australia is a party at least in cases where the legislation is enacted after, or in contemplation of, entry into, or ratification of, the relevant international instrument.[251] Therefore, It is now an accepted rule of judicial construction that regard must be had to international conventions and norms for construing domestic law when there is no inconsistency between them and there is a void in the domestic law.[252]

When it comes to fiscal treaties dealing with double taxation avoidance too, the situation is the same. Different countries have varying procedures of rendering the same internally applicable. In the United States such a treaty becomes a part of municipal law upon ratification by the Senate. In the United Kingdom such a treaty would have to be endorsed by an order made by the Queen in Council. Since in India such a treaty would have to be translated into an Act of Parliament, a procedure which would be time consuming and cumbersome, a special procedure was evolved by enacting section 90 of the Act. Said section was introduced to enable the executive to negotiate a DTAC and quickly implement it.[253] Subsequently, other provisions were also inserted in the IT Act to give effect to the Multilateral Instrument under BEPS Action 15.[254]

[243] The State of West Bengal vs. Kesoram Industries Ltd. and Ors. (2004) 10 SCC 201; Klaus Vogel, 'Double Tax Treaties and Their Interpretation' (1986) 4 Int'l Tax & Bus. Law. 1 <https://scholarship.law.berkeley.edu/cgi/viewcontent.cgi?article=1039&context=bjil> last accessed January 11, 2019
[244] Klaus Vogel, 'Double Tax Treaties and Their Interpretation' (1986) 4 Int'l Tax & Bus. Law. 1 <https://scholarship.law.berkeley.edu/cgi/viewcontent.cgi?article=1039&context=bjil> last accessed January 11, 2019
[245] The European Scrutiny Committee, 'The UK's legal relationship with the EU' available at <https://publications.parliament.uk/pa/cm201011/cmselect/cmeuleg/633/63304.htm> last accessed February 5, 2020.
[246] Chow Hung Ching v. The Kind (1948) 77 CLR 449; Bradley v. The Commonwealth (1973) 128 CLR 557; Simsek v. Macphee (1982) 148 CLR 636
[247] The EU Bill and Parliamentary Sovereignty - European Scrutiny Committee, 'The UK's legal relationship with the EU' available at <https://publications.parliament.uk/pa/cm201011/cmselect/cmeuleg/633/63304.htm> last accessed February 5, 2020.
[248] Constitution of India, Article 253
[249] Constitution of India, Article 51
[250] Kesavananda Bharati v. State of Kerala AIR 1973 SC 1461
[251] Chu Kheng Lim v. Minister for Immigration (1992) 176 CLR 1
[252] Vishaka and Ors. v. State of Rajasthan and Ors. AIR 1997 SC 3011
[253] Union of India (UOI) and Ors. vs. Azadi Bachao Andolan and Ors. 263 ITR 706 (SC)
[254] Income Tax Act, 1961, Section 90 (1)(b).

3.3. *Note on tax consequences of the digitalised economy*

In his note on the tax consequences of the digitalized economy, Mr. Bansal brings to light some key drawbacks of the Inclusive Framework Proposal. While several of these issues have been discussed in the preceding sections of this report, the primary issues highlighted by Mr. Bansal are as under:

- The Inclusive Framework Proposal is expected to only have a modest revenue impact, which does not justify the large-scale changes in the system of taxing MNEs not only for digital businesses but much beyond, as proposed thereunder;
- For Amount A, there is no sound basis for allocating only the non-routine profits to market jurisdictions.
- It is not possible to distinguish conceptually between routine i.e. locally generated and residual i.e. internationally generated profits of a multinational enterprise, as all profits are essentially the result of global activities of the firm.
- Amount A would sit above the arm's length price driven profits. This will, on one hand, require the existing methods of determination and dispute resolution to continue and on other hand introduce a completely new method of determination as well as dispute resolution.
- The policy rationale for Scope for the 'Consumer facing businesses' is not transparent;
- A mechanism to eliminate double taxation has not been explored;
- The mechanism is very complex, difficult to administer and a complete departure from existing way of taxing foreign entities.

As an alternative to the Inclusive Framework Proposal, in his note on the tax consequences of the digitalized economy, Mr. Bansal suggests that the in scope activities covered under the Inclusive Framework Proposal be confined to automated digital services only in respect of revenue derived directly from the market jurisdictions, not through a subsidiary or a permanent establishment. He further suggests that these activities should be confined to online search engines; social media platforms; online intermediation platforms, including the operation of online market places, irrespective of whether used by businesses or consumers; digital content streaming; online gaming; cloud computing services; and online advertising services.

The intent behind Mr. Bansal's note on the tax consequences of the digitalised economy lends greater degree of clarity in so far as the scope is concerned. It materially improves upon the fractional apportionment suggested in the CBDT public consultation paper on profit attribution published in April 2019. Infact this report also highly recommends the conception of a Plan B, in case no global consensus is arrived at. Further, the critiques of the Inclusive Framework Proposal as pointed out by Mr. Bansal are also largely echoed in this report.

However, limiting the scope of the new taxing right to only the automated digital services mentioned in his proposal would ring-fence the digital economy. His proposal is thus significantly different from the SEP approach that India has proposed, and similar to the user participation proposal supported by U.K. and other European countries. Further, the new approach proposed by Mr. Bansal does not effectively deal with the challenges posed by the use of technology in businesses in a holistic manner. As opposed to building a principled approach to tax businesses' remote reach into market jurisdictions, Mr. Bansal's proposal aims at targeting the existing highly digitalised business models. Moreover, business models in the digital economy continue to evolve and as most businesses incorporate technology as an integral part of their functioning, the line between brick and mortar businesses and automated businesses would soon be blurred. Therefore, the inclusion of only the specifically listed automated digital services inadvertently excludes several other models that are developed in the future. The proposed scheme may thus be unsustainable in the long term. Limited inclusions would also encourage businesses to restructure their operations and argue that they do not provide any of the in scope activities and allow tax leakage.

Despite the aforestated flaws, it is important to appreciate that in the current global environment where consensus looks unlikely, it may be prudent to prioritise. Therefore, it is necessary to analyse the revenue and administrative costs of limiting the scope of the proposal. At the same time, it is imperative to study the revenue

benefits that would accrue from taxing only the limited number of in scope activities. It should then be acknowledged that such amendments to tax treaties would not be conducted periodically and if the benefits of limiting the scope still outweigh its costs, the same may be considered.

G. Recommendations

Devising a consensus-based mechanism to tax the digital economy is an exercise that will benefit all the countries that constitute the Inclusive Framework. With the proliferation of unilateral levies, the tax framework applicable to the digital economy is becoming increasingly complex. The companies operating in this sector are required to pay a slew a levies and satisfy compliance requirements across the globe. In addition to the legal inconsistencies associated with the levy of unilateral taxes levies as discussed in Vidhi's Digital Tax Report, such levies also contradict many guiding principles of tax policy. Therefore, a consensus-based multilateral mechanism to tax the digital economy is the ideal way forward. That said, in a context where negotiations remain uncertain and highly contested, the virus will change the practical means of discussion, shift short-term political attention away, and present unique and severe challenges for developing countries to participate in shaping a sustainable global consensus. On top of these practical challenges, a new fiscal politics emerging from the coronavirus pandemic threatens to waylay the ambitious schedule put forward by the OECD.[255]

In light of this background, this chapter of the report first recommends changes to the establishment of nexus and the process of attribution of profits under the Inclusive Framework Proposal. It then proceeds to recommend how such a proposal may be implemented working under the premise that consensus is indeed built. Lastly, this chapter highlights the repercussions of the absence of a consensus-based solution to tax the digital economy.

1. Nexus

1.1. The absence of a policy rationale

From the regular flow of developments in this space, it is apparent that the OECD is actively working towards developing consensus among the countries that constitute the Inclusive Framework. While the OECD's efforts are appreciated, it is relevant to understand that instead of devising an ideal mechanism to tax the digital economy based on a sound policy rationale, it has shifted focus towards devising a mechanism that is likely to be acceptable to all the countries involved.

Given the varying policy-priorities of the countries that constitute the Inclusive Framework, compromises and trade-offs are inevitable. However, such compromises and trade-offs must not overshadow the overall policy rationale behind a chosen approach. Doing so, would not only dilute the relevance and sustainability of this otherwise landmark reform, but the absence of a clear intent would also impact tax certainty in the future. One of the primary areas in the current draft of the proposal that lacks such a policy rationale is its scope.

Notably, the OECD Secretariat Proposal completely excluded most enterprises operating on a B2B model from within its scope. However, under the Inclusive Framework Proposal, there seems to have been a specific departure from that view and a larger number of B2B activities have been included. For instance, all 'Automated digital services' have been added irrespective of whether they have a consumer facing element or not. It seems that the unintended exclusion of highly digitalized services such as cloud computing was one of the reasons for such change in ideology.

As discussed in the Inclusive Framework Proposal itself, the basic idea behind allocation of new taxing rights is to tax businesses that generally benefit from exploiting powerful customer or user network and generate substantial value. The OECD Secretariat Proposal which worked on the same rationale, appeared to adopt the hypothesis that consumer goods/services allow for the establishment of the aforementioned customer or user network. This overall premise appears to have been carried forward under the Inclusive Framework Proposal too and is

[255] Rasmus Corlin Christensen, "The impact of Covid-19 on global digital tax negotiations' (April 1, 2020) available at <https://www.ictd.ac/blog/impact-coronavirus-global-digital-tax-negotiations-oecd/> last accessed June 1, 2020.

reflected in the general exclusion of B2B activities from the scope of 'Consumer-facing businesses' and the exclusion of intermediate products and components that are incorporated into a finished product sold to consumers. However, the general inclusion of B2B 'Automated digital services' appears to contradict this ideology.

This contradiction appears to suggest that there has been a shift in the premise behind the regime, which has not been discussed in the Inclusive Framework Proposal. While it still aims to allocate taxing rights to countries where businesses generate substantial value from exploiting powerful customer or user network, there is now the much needed acknowledgement that some businesses may do so without only catering to individual consumers who purchase products for personal use. In the Inclusive Framework Proposal, this manifests in the inclusion of both B2B and B2C services under the scope of 'Automated digital services'. It is recommended that the Inclusive Framework Proposal clearly identifies the policy rationale that on the one hand justifies the general exclusion of B2B activities from the scope of 'Consumer-facing businesses', however also merits the inclusion of B2B activities as far as 'Automated digital services' are concerned. As noted above, doing so would help the new regime be more robust and sustainable.

Notably, while the scope of 'Automated digital services' has been widened, it still excludes professional services such as legal, accounting, architectural, engineering and consulting. One of the reasons for the exclusion of these services may be what is mentioned in the Inclusive Framework Proposal - the involvement of a high degree of human intervention. However, a stronger policy rationale to justify such an exclusion which is missing from the Inclusive Framework Proposal, is that in the performance of such professional services, the service provider puts in special effort for each user. Unlike other services that are under the scope of this proposal that are generally automated and cater to a large user-base, there is no benefit accruing to the business of the identified professional services on account of the existence of the user base itself.

The scope of the Inclusive Framework Proposal appears to function on two primary pillars. First, it recognises the need to tax businesses that cater to consumers and are most likely to benefit from exploiting them. Second, it also seeks to tax automated digital services. As far as businesses that fall under the latter bracket are concerned, the proposal recognizes that even businesses not catering purely to individual consumers may be benefiting from their users.

1.2. Unintended exclusions from the scope

It is abundantly clear that the scope of the Inclusive Framework Proposal is broader than that of the OECD Secretariat Proposal. The OECD Secretariat Proposal had several unintended exclusions which have now been included under the Inclusive Framework Proposal. Most notably, cloud computing services that previously fell outside the ambit of the OECD Secretariat Proposal have now been included. However, despite the coverage of 'Automated digital services' and 'Consumer-facing businesses' within the scope of the Inclusive Framework Proposal, there may still be certain businesses that are meant to be covered within its ambit, but do not fall within it.

There may be certain businesses providing services, that may not be construed as 'Consumer facing businesses' or 'Automated digital services' in the ordinary sense of the phrases. However, they may still derive substantial revenue from the source jurisdiction. These services may include support services provided by businesses to e-commerce companies such logistic services, transportation services, warehousing services, consumer support services etc. Given that these businesses transact with another business i.e. the e-commerce service provider, they may not fall within the scope of 'Consumer-facing businesses'. Further, these services need not necessarily be automated, and may thus also fall outside the scope of 'Automated digital services'. However, the revenue generated by such businesses is usually intrinsically linked to the user base of the e-commerce service provider in question, in the source jurisdiction.

It is thus recommended that a proper analysis is made in respect of the inclusion or exclusion of each of these services. Further, if deemed necessary, a positive list of services, not ordinarily in the nature of 'Consumer facing businesses' or 'Automated digital services' may also be added to the scope of the Inclusive Framework Proposal. This list may be periodically reviewed.

1.3. The absence of the clear and precise definition of consumer facing businesses

As discussed in the preceding sections of this report, two broad sets of businesses that have been included within the scope of the Inclusive Framework Proposal are 'Automated digital services' and 'Consumer facing businesses'. The ambit of 'Consumer facing businesses' as per the Inclusive Framework Proposal, includes businesses dealing in goods or services, or both that are commonly sold to consumers for personal use and not for commercial purposes. Notably, businesses dealing in intermediate products and components have been categorically carved out from the scope of 'Consumer facing businesses' and hence from the scope of the Inclusive Framework Proposal.

While we appreciate that the document outlining the architecture of the Inclusive Framework Proposal is a policy document and definitions of various terms still need to be designed, it is recommended that the scope of 'consumer facing businesses' must be clearly spelled out.

There can be several kinds of goods that may be used as components or intermediate products and may also be used by consumers for their personal use. For instance, a keyboard or a mouse. While such products can be said to be a component product used with computers or laptops, however, they can also be interpreted to be used commonly by consumers and can be interpreted as consumer facing. In the absence of global consensus on a proper and clear classification of businesses that are considered to be consumer-facing, each country involved is likely to interpret the expression in a unique manner. The same may also be left to be decided on a case-by-case basis. This is likely to lead to uncertainty in the framework and initiate several disputes which would render the landmark reform redundant.

There are various international benchmarks[256] created to classify industries into various sectors such as basic materials, industrials, consumer goods etc. Reference can be taken from such international benchmarks and a new classification guideline for the purpose of classifying them into consumer products, components products or intermediate products may be considered to be introduced. Like every other classification, a residuary clause shall be added to the list. A periodical review shall be conducted of such classification and depending upon the development of the economy, goods or services can be considered to be reclassified or the list can be expanded by adding new goods or services. The review may be organized by OECD having representation from all inclusive framework countries and a consensus-based amendment may be made to such a list. This exercise will also enable countries to keep pace with the emerging development of the economy.

1.4. Factors to be considered while establishing a nexus for consumer facing businesses

As discussed above, once businesses fall within the in-scope activities, the next step is to satisfy the nexus rule that is based on indicators of a sustained and significant engagement with the market jurisdictions. For 'Automated digital services', the revenue threshold is considered to be the only test required, however for

[256] *There are majorly two competing systems for classifying goods into sectors and industries i.e. Global Industry Classification Standard and the Industrial Classification Benchmark*. For reference Global Industry Classification Standard, available at <https://www.spglobal.com/marketintelligence/en/documents/112727-gics-mapbook_2018_v3_letter_digitalspreads.pdf> last accessed March 20, 2020; Industry Classification Benchmark (Equity) available at <https://research.ftserussell.com/products/downloads/ICB_Rules.pdf> last accessed March 2, 2020.

'Consumer facing businesses', other factors need to be taken into consideration. These factors however have not yet been defined under the Inclusive Framework Proposal.

In order for a business to satisfy the nexus requirement and establish significant economic presence in a market jurisdiction, the Action Plan 1 report[257] provided for various factors that could be considered. Some of the following factors discussed can be taken into consideration in cumulative while defining nexus under the Inclusive Framework Proposal.

- Revenue based factors: The revenue of a particular enterprise may be considered as a factor to establish a sustained engagement in the source jurisdiction.
- Digital Factors: The ability to establish and maintain a peaceful and sustained interaction with users via online factors depend on a range of digital factors such as use of a local domain name, local digital platform, local payment options.
- User Based Factors: A range of factors based on users could also reflect on the level of participation in the economic life of a country. Such factors include monthly active users, online contract conclusion, data collected from users etc.

It is important to determine the thresholds for these factors so that some certainty is provided to businesses with respect to the scope of 'sustained and significant engagement'. Determination of objective thresholds would also ensure that only businesses having such 'sustained and significant engagement' are brought under the ambit of this approach. Further, such factors should be exhaustive so that it does not leave scope for businesses to restructure or replan to avoid taxation in the source jurisdiction.

1.5. *Interplay between the PE rule and the new nexus rule*

India always was of the view that the PE rule cannot be sufficient to tax e-commerce.[258] The major reason cited was that such activities if taxed through existing traditional principles will result into levy of a low tax as profit attributed to activities undertaken by them in the source jurisdiction will be very low. While the Inclusive Framework Proposal is a working policy document and a lot of issues still needs to be addressed, there is no clarity on the interplay between the PE rule and the new nexus rule.

If the OECD along with the Inclusive Framework decided to introduce the new nexus rule over and above the PE Rule, many companies will be overburdened with the compliance of both the PE rule and the new nexus rule. This is because there can be companies who have a fixed physical presence and thus PE in the source jurisdiction while are also engaged in consumer facing business and thus falling under the scope of the new nexus rule.

If they decide that the new nexus rue will be a standalone rule, then the new nexus rule shall not leave any scope for business models to restructure and replan by establishing a local operating subsidy constituting PE. However, to reduce the tax liability, such PE may perform only minimal functions but derives substantial revenue since performance of minimal functions would result into attributing less profit to such PE.

[257] Organisation for Economic Cooperation and Development/ G20 Base Erosion and Profit Shifting Project, 'Addressing the Tax Challenges of the Digital Economy, Action 1-2015 Final Report' (October 5, 2015) available at <https://www.oecd-ilibrary.org/docserver/9789264241046-en.pdf?expires=1590574398&id=id&accname=guest&checksum=AD2BCDBA9D03D41126D2CE944772FB09> last accessed January 5, 2020.

[258] E-commerce and taxation report (by Ministry of Finance) Chapter 1: Introduction to the Electronic Commerce available at <https://www.rashminsanghvi.com/articles/taxation/electronic_commerce/chapter_1-introduction_to_Electronic_commerce.html> last accessed January 5, 2020.

2. Attribution of Profit

2.1. Quantum of Amount A

Allocation of Amount A in the Statement is based on a formula approach. Profitability threshold and sales as an allocation key has been used for market jurisdictions. Group consolidated financial accounts have been used as an appropriate basis for the calculation and profit before tax is the preferred measure. Loss carry forward rules will be developed for Amount A. Section 3.2 has identified that business line segmentation or regional segmentation may be required for in-scope and out of scope activities. Revenue sourcing rules will be considered in situations where it is difficult to identify the end user or consumer. It will be applied on a multi-lateral basis so an effective dispute prevention will be mandatory for the application of the new mechanism as it is important that all jurisdictions accept a common assessment.

India has taken the position on fractional formulary apportionment as a methodology of attribution of profits, as contemplated in the Discussion Paper on Attribution of Profits to PE issued in April 2019. The difference between this approach and the proposed Unified Approach is that the Unified Approach adopts the residual profit approach for formulary profit allocation, as compared to the entire profit approach adopted for formulary apportionment. This fundamental difference (aside from the matter of ratio and proportion) can be bridged by setting the routine returns to the lowest levels, towards the factors of production. All other returns towards value creation, including those to synergies, location specific advantages, and associated group related factors, may be attributed towards non-routine or residual returns. Amount A thereby can be a function of this residual profit base. In the process, the difference between the fractional apportionment method and the Unified Approach, can be brought to a minimum, which also can be rationalised as being towards contributory factors of production, i.e land, plant, property equipment, labour and capital (all of which will be risk weighted returns).

2.2. Quantum of Amount B

The architecture of Amount B under Section 4 of the Statement is quite similar to the public consultation document of 2019. It is a fixed return based on arm's length principle for baseline or routine marketing or distribution activities performed in the market jurisdiction. The fixed return would consider differences based on region and industry. Amount B will be applied on a bi-lateral basis by agreeing on fixed rates of return.
Amount B represents baseline distributor return. It is useful to refer to the Israel and Australia guidance on marketing support service providers and categories of distributors (for risk assessment). India also has defined wholesalers for the purpose of tolerance range. It is in order for the baseline return in Amount B to be conditioned for different categories of low-intensity function distributors:

- Wholesalers
- Sogo sosha type, match-making entities
- Low risk distributors not carrying on substantive AMP or distribution channel building or value addition (based on the application of a Value Added Expense to sales filter)
- Service distributors (e.g. distributors of software licenses or internet services or automated digital services)

This would have to be based on country-by-country distributor profiling and benchmarking analysis.

3. Implementation of a consensus based solution

The implementation of the unified approach would be successful only if there is a consensus between all countries to adopt it in their tax treaties. The sheer number of bilateral treaties makes it difficult to update the current tax treaty network. It takes substantial amount of time and resources to introduce any amendment to the treaties if negotiated bilaterally. For this reason, governments generally agree to explore the feasibility of Multilateral instrument that would simultaneously renegotiate and amend bilateral tax treaties of countries who sign and ratify such instrument. A one-stop shop approach for aligned introduction and application will ensure simplicity and certainty for all countries.[259]

On 5 October 2015, OECD released its report for developing a multilateral convention for implementing tax treaty related measures to prevent BEPS. All jurisdictions who agreed to be a signatory of MLI had to meet certain treaty related minimum standards. Each of such minimum standards had multiple options which provided flexibility to accommodate positions of different jurisdictions.

Thus, it is recommended that while drafting a multilateral instrument for implementation of Inclusive Framework Proposal, certain minimum standards can be made compulsory to be adopted by every jurisdiction signing such instrument so that the main purpose of adding such provision is not defeated.

4. Preparing for Plan-B

It is critical to recognize that stakeholders of the issue at hand represent vastly different economies, with varying policy priorities. Complete uniformity among such different countries in the exercise of a sovereign function such as the levy of tax was always difficult to achieve. This difficulty has further been underscored by the ongoing health and economic crisis. For developing countries, Covid-19 presents a real and serious risk that their views and interests could be marginalised in global negotiations over digital taxation.[260] The outbreak of the virus will certainly shift the interests and preferences of governments in digital tax negotiations, as economic and political circumstances change. This could potentially raise the dilemma for governments in global tax negotiations of ensuring contributions from digital businesses that are profiting from a crisis that is pushing millions of users to online services, while tempering political appetite for increasing taxes during or after an economic crisis.[261] Several countries that serve as the resident jurisdictions of online businesses and thus earn tax revenue from them, would also be reluctant to share such revenue with source jurisdictions, which is the primary purpose of these negotiations.

The absence of at least a broad consensus on a mechanism to tax the digital economy could lead to double taxation, reduce tax certainty, and undermine the relevance and sustainability of the international tax framework.[262] Therefore, it is imperative that efforts are made to continue negotiations. The implementation of unilateral measures have assisted in propelling the debate to tax the digital economy and have also contributed towards initiating global consensus on the matter.[263] Therefore, if there is no movement on the issue at the global level, there may be some merit in the continuation of these unilateral measures in the interim. However, it is imperative that the unilateral measures such as equalization levy, in their current form are revisited such that their legal

[259] ICC Comments on OECD public consultation document: Addressing the tax challenges of the digitalisation of the economy available at <www.iccwbo.org.> last accessed (January 20,2020)
[260] Rasmus Corlin Christensen, "The impact of Covid-19 on global digital tax negotiations' (April 1, 2020) available at < https://www.ictd.ac/blog/impact-coronavirus-global-digital-tax-negotiations-oecd/> last accessed June 1, 2020.
[261] Rasmus Corlin Christensen, "The impact of Covid-19 on global digital tax negotiations' (April 1, 2020) available at < https://www.ictd.ac/blog/impact-coronavirus-global-digital-tax-negotiations-oecd/> last accessed June 1, 2020.
[262] Vidushi Gupta, "How Unified In the OECD's Unified Approach' Tax Notes International, (December 23, 2019).
[263] Vidushi Gupta, "Unilateral measures and the quest for a globally agreeable digital tax", Bloomberg Tax, (March 18, 2020), available at <https://news.bloombergtax.com/daily-tax-report/insight-42> last accessed June 1, 2020.

infirmities are addressed. Specifically, it should be ensured that such a levy is not discriminatory, it is implemented after adequate stakeholder consultation, imposed at a net operating profit level, and the rate as well as the revenue thresholds are determined after conducting extensive cost-benefit analysis.

At the global level, instead of targeting complete consensus, international organisations such as the OECD may refocus their efforts towards devising an equitable framework that minimizes unilateral measures, while still granting countries a certain degree of flexibility to address the tax challenges of digitalization.