

INDIA AND THE DIGITAL ECONOMY – THE EMERGING P.E. AND ATTRIBUTION ISSUES¹

Author
Sunil Agarwal

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Sunil Agarwal, advocate, has been a senior tax partner with AZB & Partners in New Delhi, India, for more than 12 years. He works primarily on international tax, transfer pricing, and corporate tax matters from both the advisory and litigation side. Sunil represents clients before various forums, such as the Income Tax Appellate Tribunal, the Authority for Advance Rulings, the High Court, and the Supreme Court.

BACKGROUND

Do you remember the first thing you ever bought or sold online? As we have been living with a digital economy for an entire generation, many of us would need to take a long stroll down memory lane in order to find the answer. In fact, it was just over 20 years ago in Ottawa in 1998, when the O.E.C.D., together with Canadian government, held the first international ministerial meeting on electronic commerce – what we now call the digital economy. It is worth recalling that, in 1998, Google was in its infancy and Facebook, YouTube, and Twitter were still a long way off. Many mobile phones still sported visible antennas and the price of internet access was steep. Truly, we have come a long way.²

Almost a century ago (in the era of League of Nations), value creation in a cross-border business was pictorially described as below:

The oranges upon the trees in California are not acquired wealth until they are picked, not even at that stage until they are packed, and not even at that stage until they are transported to the place where demand exists and until they are put where the consumer can use them. These stages, up to the point where wealth reached fruition, may be shared in by different territorial authorities.³

The above paragraph highlights value creation in multiple jurisdictions and value realization in the market jurisdiction, which is typical of a transnational business carried on by a multinational enterprise (“M.N.E.”). Prior to the advent of digitalization, the M.N.E. could not do significant business in a market jurisdiction without having some kind of a physical presence there. This led to an allocation of taxing powers between the country of residence and the market jurisdiction based primarily upon the presence or absence of a tangible physical nexus, a so-called Permanent Establishment (“P.E.”), in the market jurisdiction.

More recently, the explosive growth and development of information and communication technology has enabled M.N.E.’s to sell goods and services in a market jurisdiction without the need for a traditional brick-and-mortar P.E., thereby avoiding payment of taxes to the jurisdiction where the M.N.E. derives a significant share of revenues.

¹ First published at the International Tax Conference organized by International Fiscal Association at New Delhi on April 26-27, 2019.

² “Going Digital: Back to the Future,” *OECD Observer*, no. 317 (2019).

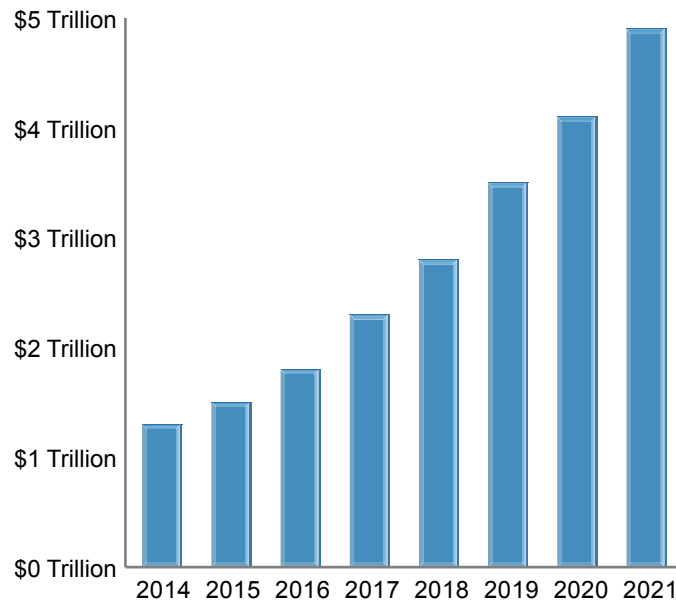
³ Excerpted in the Memorandum Explaining the Provisions in the Finance Bill, 2018.

EXPLOSIVE GROWTH OF INTERNET USERS⁴

Rank	Country	Internet Users (Millions)
1	China	746
2	India	699
3	USA	245
4	Brazil	123
5	Japan	117
6	Russia	110
7	Mexico	75
8	Germany	73
9	Indonesia	66
10	Pakistan	62
11	United Kingdom	62
12	Philippines	57
13	France	55
14	Nigeria	47
15	South Korea	47
16	Turkey	46
17	Vietnam	43
18	Iran	42
19	Egypt	37
20	Spain	37

⁴ [“List of Countries by Internet Users.”](#) Worldatlas, last updated January 15, 2019.

WORLDWIDE RETAIL E-COMMERCE SALES⁵



INDIAN RETAIL AND E-COMMERCE MARKETS⁶

Year	Total Retail Market	E-commerce Retail (out of total)
2017	\$795 billion	\$24 billion
2021 (projected)	\$1200 billion	\$84 billion

TAX ISSUES ARISING FROM EXPONENTIAL DIGITAL GROWTH⁷

The exponential expansion of information and communication technology has made it possible for businesses to conduct themselves in ways that did not exist earlier. It has given rise to new business models that rely almost exclusively on digital and telecommunication networks, do not require physical presence, and derive substantial value from data collected and transmitted through digital networks. These new business models have created new challenges for tax authorities around the world

⁵ “Global Retail E-commerce Sales 2014-2021.” Statista.

⁶ “Indian E-commerce Market to Touch USD 84 Billion in 2021: Report.” *The Economic Times*, February 26, 2019.

⁷ T. N. Pandey, “Income Taxation in Digital Economy.” (presentation, Slideshare, July 4, 2017).

in terms of nexus, characterization, and valuation of data and user contribution. These challenges are recognized by the international community and have been formally addressed by the G-20 and O.E.C.D. under B.E.P.S. Action 1.

The ambiguities surrounding the taxation of income from the digital economy and the resulting tax disputes are not only a bane for tax authorities. They also place constraints on taxpayers, who may be subject to inconsistent approaches on the part tax authorities – a situation that, at best, should be avoidable.

POPULAR DIGITAL BUSINESS MODELS

The O.E.C.D. report on B.E.P.S. Action 1 lists some of the more prevalent forms of digital businesses in paragraphs 118 to 121:

4.2.1.1 Business-to-business models

118. The vast majority of e-commerce consists of transactions in which a business sells products or services to another business (so-called business-to-business (B2B)) (OECD, 2011). This can include online versions of traditional transactions in which a wholesaler purchases consignments of goods online, which it then sells to consumers from retail outlets. It can also include the provision of goods or services to support other businesses, including, among others: (i) logistics services such as transportation, warehousing, and distribution; (ii) application service providers offering deployment, hosting, and management of packaged software from a central facility; (iii) outsourcing of support functions for e-commerce, such as web-hosting, security, and customer care solutions; (iv) auction solutions services for the operation and maintenance of real-time auctions via the Internet; (v) content management services, for the facilitation of website content, management and delivery; and (vi) web-based commerce enablers that provide automated online purchasing capabilities.⁸

4.2.1.2 Business-to-consumer models

119. Business-to-consumer (B2C) models were among the earliest forms of e-commerce. A business following a B2C business model sells goods or services to individuals acting outside the scope of their profession. B2C models fall into several categories, including, for example, so-called “pureplay” online vendors with no physical stores or offline presence, “click-and-mortar” businesses that supplemented existing consumer-facing business with online sales, and manufacturers that use online business to allow customers to order and customize directly.⁹

120. The goods or services sold by a B2C business can be tangible (such as a CD of music) or intangible (*i.e.* received by consumers in an electronic format). Through digitization of information, including

⁸ *Id.*, para 4.2.1.1.

⁹ *Id.*, para 4.2.1.2.

text, sound, and visual images, an increasing number of goods and services can be delivered digitally to customers increasingly remote from the location of the seller. B2C e-commerce can in many cases dramatically shorten supply chains by eliminating the need for many of the wholesalers, distributors, retailers, and other intermediaries that were traditionally used in businesses involving tangible goods. Partly because of this disintermediation, B2C businesses typically involve high investment in advertising and customer care, as well as in logistics. B2C reduces transaction costs (particularly search costs) by increasing consumer access to information. It also reduces market entry barriers, as the cost of maintaining a website is generally cheaper than installing a traditional brick-and-mortar retail shop.¹⁰



4.2.1.3 Consumer-to-consumer model

121. Consumer-to-consumer (C2C) transactions are becoming more and more common. Businesses involved in C2C e-commerce play the role of intermediaries, helping individual consumers to sell or rent their assets (such as residential property, cars, motorcycles, etc.) by publishing their information on the website and facilitating transactions. These businesses may or may not charge the consumer for these services, depending on their revenue model. This type of e-commerce comes in several forms, including, but not limited to: (i) auctions facilitated at a portal that allows online bidding on the items being sold; (ii) peer-to-peer systems allowing sharing of files between users; and (iii) classified ads portals providing an interactive, online marketplace allowing negotiation between buyers and sellers.”¹¹

CHARACTERISTICS OF THE DIGITAL ECONOMY

Digitalized business models have the following three characteristics:

- Scale without mass
- Heavy reliance on intangible assets
- Data & user participation

DISTORTIONS CAUSED BY THE DIGITAL ECONOMY

The most demonstrable distortion caused by digital businesses is horizontal inequity, whereby a nonresident enterprise selling goods and services in a jurisdiction does not pay taxes on the income earned from sales in that jurisdiction because of the absence of P.E., while at the same time a domestic enterprise engaged in similar business activities in the same jurisdiction would have to pay tax.

¹⁰ *Id.*

¹¹ *Id.*, para 4.2.1.3.

If this distortion is not addressed in a timely manner, this may lead to obvious undesirable economic effects in the economy of source jurisdiction, and consequently impede the transnational flow of goods, services, capital, and personnel.

OVERARCHING PRINCIPLES OF TAX POLICY

The following well-established principles of tax policy must be kept in mind when addressing the distortions caused by the digital economy:

- **Equity:** Taxpayers in similar circumstances should bear a similar tax burden.
- **Neutrality:** Economic choices available for carrying on businesses should be tax-neutral.
- **Efficiency:** Minimal compliance costs should apply to the taxpayer, as well as minimal administration costs for governments.
- **Certainty and Simplicity:** Tax rules should be simple and easy to understand for the taxpayers.
- **Effectiveness and Fairness:** Taxation should produce the right amount of tax at the right time, avoiding either double taxation or double non-taxation.
- **Flexibility:** Taxation systems and policies should be flexible and dynamic enough to ensure they keep pace with technological and commercial developments.

O.E.C.D. PROPOSED SOLUTIONS¹²

During the course of deliberations on Action 1 of the B.E.P.S. Project, the O.E.C.D. recommended a two-pronged approach:

There should be a significant salutary impact of other BEPS measures on BEPS concerns caused by Digital Economy, namely:

- Changes suggested by BEPS Action 7 which could control artificial avoidance of PE status
- Changes suggested by BEPS Action 8-10 strengthening transfer pricing rules

Pending an evaluation of the impact of other measures on the base eroding effects of the digital economy, the O.E.C.D. considered various options but stopped short of adopting any O.E.C.D. recommended standard. Rather, it left it to countries to consider whether to adopt any of the proposed options, either alone or in conjunction with other approaches, subject to countries having regard to existing treaty obligations.

The table in the following section evaluates the fundamental characteristics of the three options proposed by the O.E.C.D.

¹² O.E.C.D., “[Tax Challenges of Digitalisation: Comments Received on the Request for Input – Part II](#),” October 25, 2017.

THREE APPROACHES TO TAXING THE DIGITAL ECONOMY¹³

	Option 1: Significant Economic Presence (“S.E.P.”)	Option 2: Equalization Levy	Option 3: Withholding Tax
Type of Tax	Net income tax on M.N.E.’s	Tax on final consumption	Tax on final consumption
Tax Base	Net business income (gross receipts minus costs)	Gross receipts on sales to customers	Gross receipts on sales to customers
Geographic Concept	Residence (where firm is headquartered) and/or Source (where economic activity is located)	Destination (where customer is located)	Destination (where customer is located)
Scope of Tax	Applies to <ul style="list-style-type: none"> • income earned within the taxing country or • worldwide income 	Limited to final consumer purchases	Limited to final consumer purchases

“Some countries have decided to impose a withholding tax on the gross amount of revenue derived by an M.N.E. from the source jurisdiction, while others have opted for an equalization levy.”

THE CURRENT SITUATION

In view of the hands-off, wait-and-watch approach adopted by O.E.C.D., some countries have decided to impose a withholding tax on the gross amount of revenue derived by an M.N.E. from the source jurisdiction, while others have opted for an equalization levy.

Some details are outlined below:

- India imposes a 6% Equalization Levy on specified base-eroding digital businesses. This levy has been kept out of the tax treaty network, hence there are issues on the ability of the affected nonresident to receive a foreign tax credit for taxes withheld in India.¹⁴
- The E.U. recommended 3%. However, some countries in E.U. have opposed this levy, namely Ireland, Sweden, Denmark, and Germany.
- The U.S. has opposed the imposition of a digital tax, as it would have significant effect on the foreign tax exposure of the U.S. tech giants, like Facebook, Google, and Amazon, by forcing them to pay taxes in the countries where

¹³ *Id.*

¹⁴ *Id.*

they do business, instead of in low-tax jurisdictions like Ireland or Luxembourg. It also will raise no tax in the U.S.

- The U.K. introduced a Digital Services Tax in 2017, and Austria, France, and Italy are proposing unilateral digital services taxes as well.¹⁵
- Bangladesh has also imposed a V.A.T. on digital businesses.

It is evident that these measures are unilateral and uncoordinated among countries. By their very nature, they are *ad hoc*, inconsistent, and lacking clarity, which will lead to the imposition of a disproportionate tax burden on M.N.E.'s operating in multiple tax jurisdictions.

Such measures cannot provide a lasting solution to the problem.

POSSIBLE FEATURES OF S.E.P.-BASED ECONOMIC NEXUS¹⁶

The new P.E. nexus may consist of the following elements:

- Specified sale and service transactions carried out digitally
- User threshold
- *De minimis* revenue threshold

For this purpose, a new Article 5(8) may be introduced in the O.E.C.D. Model Tax Convention (Article 5(9) in the United Nations Model) with the following suggested wording:

If an enterprise resident in one Contracting State provides access to (or offers) an electronic application, database, online market place or storage room or offers advertising services on a website or in an electronic application used by more than 1,000 individual users per month domiciled in the other Contracting State, such enterprise shall be deemed to have a permanent establishment in the other Contracting State if the total amount of revenue of the enterprise due to the aforementioned services in the other Contracting State exceeds XXX (EUR, USD, GBP, CNY, CHF, etc.) per annum.

The advantage of this method is that the allocation of taxing powers can be implemented in line with the arm's length principle or through a combination of the arm's length principle and formulary apportionment.

As regards the former scenario, it may be necessary to amend the current O.E.C.D. Transfer Pricing Guidelines in order to allocate income between an enterprise and its P.E. based on digital presence.

¹⁵ See "[Austria, France, and Italy to Introduce Digital Services Taxes.](#)" *Insights* 6, no. 4 (2019).

¹⁶ See Peter Hongler and Pasquale Pistone, "[Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy.](#)" (working paper, IBFD, 2015).

DUAL APPROACH: WITHHOLDING TAX PLUS OPTIONAL S.E.P.-BASED NET TAXATION¹⁷

This option considers both installing a withholding tax mechanism as the primary response to these challenges and using withholding taxes in support of a S.E.P.-nexus based solution.

A nexus-based solution should prove superior to the withholding tax solution since it is consistent with the O.E.C.D.'s approach to the matter; it is likely to be more efficient (*i.e.*, less wasteful); and it would likely be easier to fine-tune in order to reach a stable balance between taxation in the market and residence jurisdictions.

Consequently, a practical way could be to impose a global consensus-based standard X%¹⁸ final withholding tax on all base-eroding business payments to registered nonresidents, with specific, again global, consensus-based exemptions to payees registered to be taxed in the market jurisdiction under a net taxation scheme. Such net taxation scheme may be a nexus-based solution or an elective scheme to avoid the withholding tax proposed here.

This proposal depends on a reliable, global consensus-based standard, quick, cheap, and automatically-shared registration system shared by at least the major economies actively participating in the B.E.P.S. Project spearheaded by G-20 and O.E.C.D. countries.

Payments to unregistered payees would be subject to a higher percentage of withholding tax as compared to nonresidents covered in the previous paragraph. These would include payments to accounts in or owned by low- or no-tax jurisdictions (*e.g.*, corporate tax at or below 15%). This tax may be non-final and partially refundable upon filing.

B2C transactions would initially be exempt as non-base-eroding. Yet, if countries are already concerned with the revenue division implications of such a decision, a complimentary final withholding tax of X%¹⁹ could be collected on all payments cleared by financial institutions, unless the payees register to be taxed under any net taxation scheme.

The withholding tax scheme is not perfect. However, in the event that countries cannot reach agreement on a nexus-based scheme, it permits a simple, if crude, response to the challenges of the digital economy. As such, however, it requires monitoring and perhaps tweaking over time based on experience gained. Therefore, the scheme should be accompanied by a review mechanism.

In addition, the multilateral instrument (Action 15) may be used for efficient standardization of the solution. Advances in reporting (*e.g.*, Country-by-Country (“CbC”) Reporting) and automatic information exchange, as well as all monitoring aspects (Actions 11-13) also fit well with the necessary review mechanism.

“A nexus-based solution should prove superior to the withholding tax solution.”

¹⁷ See Yariv Brauner and Prof Andres Baez, “[Withholding Taxes in the Service of B.E.P.S. Action 1: Address the Tax Challenges of the Digital Economy.](#)” (working paper, IBFD, 2015).

¹⁸ This is a conscious departure from the working paper by Brauner and Baez.

¹⁹ *Id.*

LONG-TERM PERSPECTIVE

In the long term, it appears that net basis taxation using S.E.P. as a nexus, in addition to the traditional brick and mortar P.E. concept, may be the most effective approach to address the taxation of the digital economy.

Basis of S.E.P.-Based P.E. Threshold

The nexus should be uniform globally. As an example, gross revenues from digital businesses derived by an M.N.E. from purchasers in one jurisdiction amounting to, say, \$X million or an equivalent amount in local currency in a tax year. In other words, this basis would not work if every country were to decide its own threshold. A cue can be taken from the €750 million CbC Reporting threshold on transfer pricing matters under B.E.P.S. Action 13.

S.E.P.-Based P.E. Income Computation

Net income from the S.E.P.-based P.E. could be computed either on an attribution basis under the arms' length principle or using formulary apportionment, or a mix of the two. It should be noted that the O.E.C.D. has always preferred attribution over formulary apportionment. However, one cannot forget the old adage that "necessity is the mother of invention." Unique problems do call for unique solutions. There are obvious constraints in applying the attribution principle. In a digital business, it is likely that most of functions, assets, and even some of the major risks will not be located in the market jurisdiction. Only sales, revenue realization, and post-sale warranty obligations will happen there. Under these circumstances, it is anybody's guess how effective it will be to apply the arm's length principle.

However, if a global consensus on the attribution basis is achieved, it will be further desirable to apply all principles applicable to computation of business income as contained in Article 7 of double tax treaties, as far as possible, since the S.E.P.-based P.E. will also be a P.E. on par with a traditional brick and mortar P.E. In particular, a deduction should be allowed for business expenses of the S.E.P.-based P.E., including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred, whether in the market country or elsewhere.

ROLE OF THE MULTILATERAL INSTRUMENT

Since the S.E.P.-based P.E. will require an amendment to existing double tax treaties, the proposal suggested herein can be efficiently achieved only through the multilateral instrument already existing in terms of B.E.P.S. Action 15.