DIGITISED WORLD
THE NEW TAX FRONTIER

PREFACE

In today's world, with technology seeping into virtually every section of the economy, the 'digital economy' is becoming intertwined with the traditional economy such that making a clear delineation of the digital economy is getting harder and harder. Taxation is a very important aspect of any economy and is no different in a digital economy.

The digital economy is increasingly being viewed by governments as the 'catalyst', enabling enterprises to make use of the gaps that exist between different tax systems to reduce taxable income or shift profits to low-tax jurisdictions. Today, several countries are not content with the taxation outcomes produced by the current international tax system leading to international tax issues becoming high on the global political agenda. It is not a secret anymore that the rules were developed to cater to the traditional ways of doing business and are not able to cope with current businesses and structures in the context of the digital economy.

In this context, the Organisation for Economic Cooperation and Development ('OECD') project to address Base Erosion and Profit Shifting (BEPS), needs no introduction to the tax world. The first and foremost Action Plan of the BEPS project was to address the tax challenges of the digital economy and significant progress has been made on this front. The rapid march towards tax reform in the digitised world has shown no signs of dwindling in 2019, with the OECD being extremely proactive towards attempting to reach a consensus based long term solution.

In the recent past, a lot of countries have been adopting a unilateral approach towards taxing the digitised economy which has made life complex for multinational corporations and has led to significant uncertainties and tax leakages. The challenges faced can only be suitably addressed through multilateral reform and we hope to see sustainable reform come through in 2020 by way of a consensus based solution.

We, at Dhruva Advisors LLP, are pleased to present to you a snapshot of the work done by the OECD, issues being faced, possible solutions and tax policies implemented / being implemented across the globe.

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INTRODUCTION

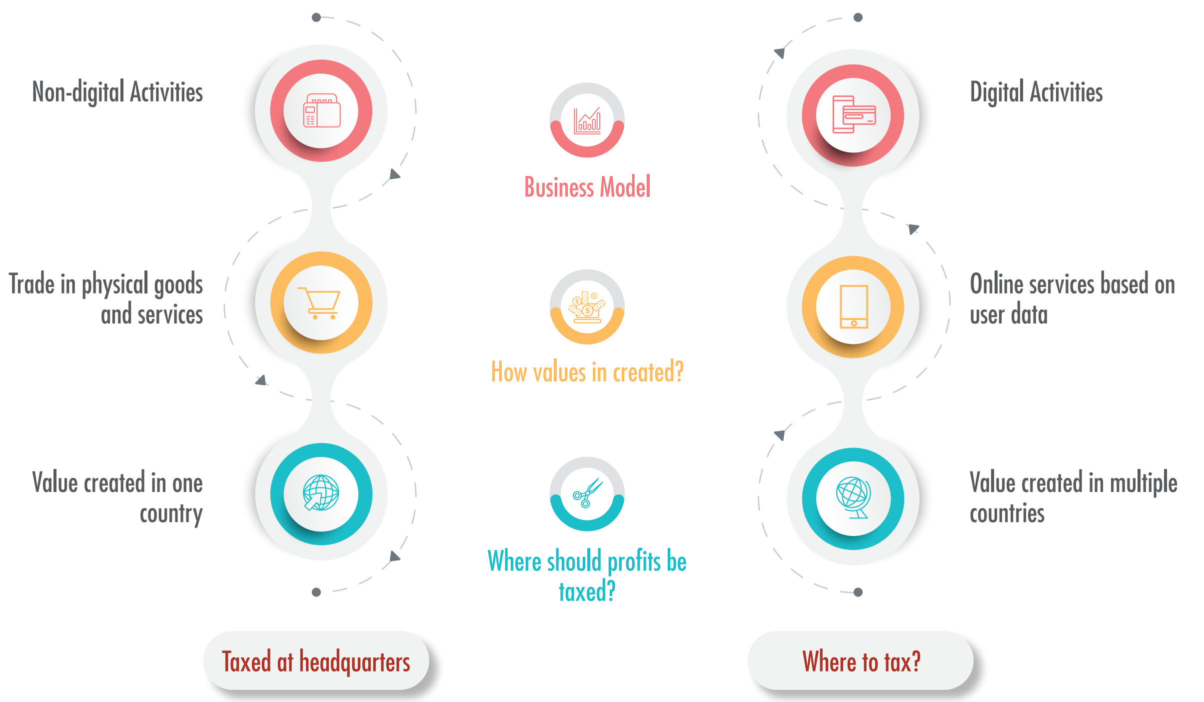
ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY

The changing business environment from the traditional brick and mortar system to the modern "digital system" has fundamentally changed the way businesses carry out their global activities. Enterprises can now carry out business across different jurisdictions without maintaining and/or having a physical presence in a particular jurisdiction. For businesses making cross border supplies, digitalisation can radically alter the 'tax take' of a particular country.

International tax issues are high on the global political agenda today given that the rules were developed to cater to the traditional ways of doing business and are not able to cope with current businesses and structures in the context of the digital economy. In today's world, with technology seeping into virtually every section of the economy, the 'digital economy' is becoming intertwined with the traditional economy such that making a clear delineation of the digital economy is getting harder and harder. The digital economy is increasingly being viewed by governments as the 'catalyst', enabling enterprises to make use of the gaps that exist between different tax systems to reduce taxable income or shift profits to low-tax jurisdictions. Hence, international tax rules require revision to ensure that profits are taxed where economic activities take place and where value is created.

The question which arises is whether the international tax framework is flexible enough to accommodate different business models within the digital economy and ensure fair outcomes that align profits with value creation.

Digital /Traditional: how profits are made and where they are taxed



Recognising the enormity of the situation and with a view to developing a unified approach for tackling the tax challenges posed by the digital economy, the Organisation for Economic Co-operation and Development ('OECD'), at the request of the G20 Finance Ministers, launched an Action Plan on Base Erosion and Profit Shifting ('BEPS') in July 2013. Action 1 of the BEPS Action Plan called for work to address the tax challenges of the digital economy. The objective of the plan was to develop a new set of standards for offering a global roadmap to governments to collect tax revenues, while simultaneously giving businesses the certainty needed to invest and grow.

A task force on the digital economy ('TFDE') was set up in September 2013, which is a subsidiary body of the Committee on Fiscal Affairs in which non-OECD/G20 countries participate as 'associates' on an equal footing with OECD countries. The TFDE issued an interim report in September 2014 and continued its work in 2015 as well. India is one of the participant countries in the TFDE.

The final reports under the BEPS project were released by the OECD in October 2015 and consisted of 15 Action items which inter alia included 'Action Item 1- Addressing the Tax Challenges of the Digital Economy'.

The report recognised that BEPS challenges are exacerbated by the peculiarities of the digital economy especially with reference to the allocation of taxing rights between source and residence jurisdictions. At the same time, when opportunities exist for achieving double non-taxation, they also create BEPS issues. This leads to undermining the integrity of the tax system as a whole.

To elaborate on these aspects the report recognised the following policy challenges for the digital economy as a whole:

- **Nexus:** The reduced need for extensive physical presence in order to carry on business, combined with the increasing role of the internet to interact with customers, has raised questions as to whether the current rules to determine nexus with a jurisdiction for tax purposes are appropriate.
- **Data:** Information technologies have permitted companies in the digital economy to gather and use information across borders to an unprecedented degree. This raises the issue of how to attribute value created from the generation of data through digital products and services and how to characterise for tax purposes a person or entity's supply of data in a transaction.
- **Characterisation:** The development of new digital products or means of delivering services creates uncertainties in relation to the proper characterisation of payments made in the context of new business models.
- **VAT challenges:** absence of an effective international framework to ensure VAT collection in the jurisdiction of consumption.
- **Administration:** determination of the extent of activities, information collection and verification and identification of customers.

The comprehensiveness of the BEPS Action Plan will ensure that, once the different measures have been implemented in a co-ordinated manner, taxation is more aligned with the location in which economic activities take place and will put an end to the phenomenon of so-called 'stateless income'.

The BEPS issues associated with the digital economy are expected to be addressed by the various measures developed in the context of 'other actions' in both the state of residence and the market/source state as follows:

- **Market / source jurisdiction:** Work undertaken as part of Action 7 (Artificial avoidance of PE Status) will ensure that core activities in the digital economy cannot inappropriately benefit from the exception from PE status and that artificial arrangements relating to sales of goods and services cannot be used to avoid the PE status;
- **Residence jurisdiction:** Work undertaken as part of Action 3 (Controlled Foreign Company) could be leveraged to ensure that CFC provisions capture the types of revenue that are typically generated in digital economy transactions such as license fees and income from sales of digital goods and services. Such an approach could limit the use of offshore structures used to defer income from tax in the residence jurisdiction;
- **Both market and residence jurisdiction:** Work in respect of Action 8 to 10 (Transfer Pricing) can help address BEPS challenges in the context of the digital economy by de-emphasising the legal ownership of intangibles and by instead focusing on ensuring an appropriate return for companies performing the important functions, contributing important assets and controlling economically significant risks.

The final report on Action Item 1 also evaluated other potential options to address the BEPS challenges in the context of the digital economy which included:

- A new nexus based on the concept of 'significant economic presence': a taxable presence would be created in a country on the basis of factors that evidence a purposeful and sustained interaction with the economy of that country via technology and other automated tools.
- Determining the income attributable to the significant economic presence: Net basis taxation with deemed profit attribution methods.
- A withholding tax on digital transactions on payments by residents of country for goods and services purchased online from non-resident providers may be imposed as a standalone gross basis final withholding.
- Introducing an equalisation levy: to avoid some of the difficulties arising from new profit attribution rules for purposes of nexus based on significant economic presence an equalisation levy could be considered as an alternative which will be a transaction-based tax.
- Collecting VAT/GST on cross-border B2C transactions and on imports of low value goods: this will facilitate cross border digital transactions being subject to tax in the market country.

The report recommended that countries apply the principles of the International VAT/GST guidelines and consider the introduction of the collection mechanisms included therein.

None of the other options, i.e. a new nexus in the form of significant economic presence, a withholding tax or an equalisation levy were recommended at this stage. The reason being that the measures developed in the BEPS project (as mentioned above) will mitigate some of the broader tax challenges and that consumption taxes will be levied effectively in the market country. Countries could however introduce any of the above three options in their domestic laws as additional safeguards against BEPS provided they respect existing treaty obligations in their bilateral treaties.

Given that these conclusions may evolve as the digital economy continues to develop, it was agreed that a report reflecting the outcome of the continued work in relation to the digital economy should be produced by 2020.

TAX CHALLENGES ARISING FROM DIGITALISATION
INTERIM REPORT 2018

After the 2015 BEPS package and given the fact that the G20 wanted to engage an even broader range of countries in the implementation of the measures, the OECD/ G20 Inclusive Framework on BEPS was established in June 2016 which is open to interested countries and jurisdictions. Today the Inclusive Framework has more than 110 participating members on an equal footing, committed to the implementation of the 2015 BEPS package and to working together on BEPS related issues. International consensus is the key to ensure commitment to global solutions in the digital economy.

With the establishment of the Inclusive Framework, a further mandate of the TFDE was agreed which included the delivery of an interim report by the end of 2018 and a final report in 2020. The TFDE issued a request for inputs on the tax challenges raised by digitalisation in September 2017 which saw more than 50 submissions. The overall objective of the TFDE is to work with the OECD and G20 countries to develop measures to identify and resolve challenges posed by the digital economy.

The Interim Report 2018 on the 'Tax challenges arising from Digitalisation' reflects the recent work of the TFDE and the overall progress made by the Inclusive Framework. The Interim Report outlines a number of areas where there are clear differences of view held by countries, including the need for future reform of the international tax system by way of a consensus-based solution that bridges different positions. This will take shape in the Final Report to be issued in 2020.

It would be relevant to note that at this point, the report recognises that there is no consensus on the merits of, or need for, interim measures by different countries. Hence, the interim report contains no recommendations.

The report also identifies the potential problems arising in international taxation against the three critical factors prevalent in highly digitalised businesses:

Cross-jurisdictional scale without local mass

Heavy reliance on intangible assets, especially intellectual property (IP)

Importance of data, user participation and their synergies with IPs

Given the challenges posed, the positions held by members on taxation are divided into three broad categories:

- First group of countries: misalignment between nexus and profit allocation is not produced by any specific BEPS arrangement or tax planning strategy but is the result of new and unique features observed in highly digitised business models that is not captured by the existing tax framework. As per this group of countries, targeted changes in tax rules (based on a review of the business models) are required including re-consideration of the rules relating to profit allocation and nexus;
- Second group of countries: the continued growth of the digital economy present challenges, i.e. nexus and profit allocation, to the existing tax framework and these challenges are not specific to highly digitised business models.
- Third group of countries: consider that the BEPS package has broadly addressed the aspect of double non-taxation of income though it is still too early to assess the full impact. The countries are broadly satisfied with the existing tax system and do not currently see the need for any significant reform of the international tax rules.

As evident from the above, there is no consensus between member countries on the extent of change required to international tax principles. However, members share a common interest in maintaining a relevant set of international rules.

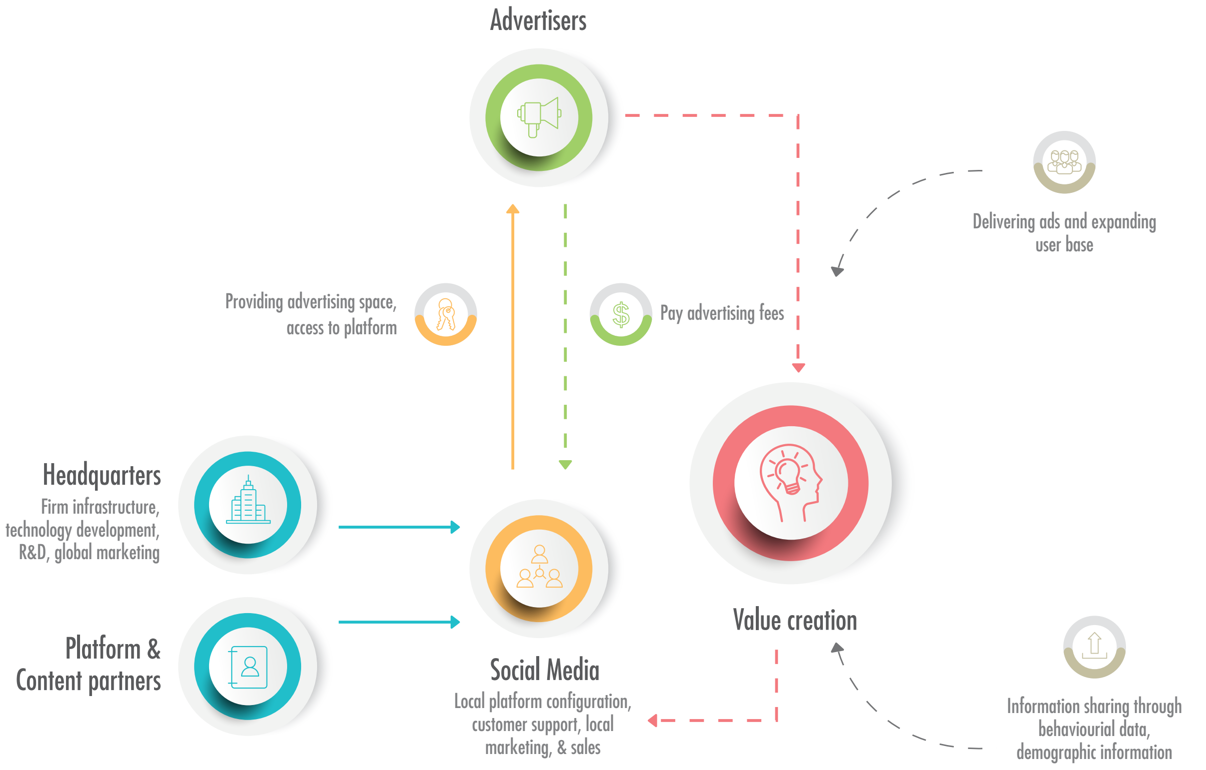
As a next step, one of the main issues for the Inclusive Framework is to consider is whether the challenges described in this report relating to alignment of profit with value creation would be best addressed with a focus on certain digitalized business models or whether such a solution should be applicable to the broader economy. Feasibility of different options would need to be tested and work will be done towards a consensus-based solution by 2020.

Business models and value creation in the context of the digital economy

As mentioned earlier, one of the main issues for the Inclusive Framework to consider is whether the challenges described relating to profit allocation with value creation would be best addressed with a focus on certain digitalized business models or whether such a solution should be applicable to the broader economy.

One of the key aspects of the Interim Report is the analysis of the key value creators for various business models in the context of the digital economy to get a better understanding of the challenges faced by the digital economy. In the ensuing paragraphs we have discussed some of the key business models with the main focus being to understand the features relevant for a tax system.

A. Social network model



The value network of a social network model comprises the following:

- **Network promotion and contract management:** The first step for a social network business is to create means to attract users/customers to foster customer network. The more users and the more they engage, the more content they create and the more they are available to be targeted by advertising.
- **Advertisers connected to users - service provisioning:** The most important benefit that a social network offers is individual targeting of customers for advertising, i.e. it tends towards being a more focused and customised approach for each individual.
- **Network infrastructure operation:** This comprises two important aspects – forming strategies to reach the target audience and setting rates according to different advertisement characteristics.

  A social network gathers real time user-generated content and is able to customize product promotions for each customer. On setting rates, in some instances social networking companies rely on demand and supply to determine prices of their advertising products.
- **Technology:** The social network where the users meet and interact (value creation) requires substantial investment of technology -computer hardware, software engineers, website designers, etc.

B. Ride-for-hire company model

This model has the following value network:

- **Network promotion and contract management:** User specific information helps to create user profiles over time (of both the drivers and the passengers which includes their ride histories, willingness to pay, etc.). This enables improvement of the quality of their networks and this quality assurance results in value creation of this digitalised business model.

  Another source of value is the global network that is achieved by the company through their ability to maintain network of drivers and passengers on a global basis. In this model, the drivers need to have only limited requirements which include driver's license, appropriate vehicle, insurance, etc., when compared to traditional models where the driver needs to pass a specific exam and other stringent regulatory requirements, etc. This enables creating a vast network with lower entry barriers. Furthermore, in the case of passengers also, the company is able to create a global consumer base through transmission of data without presence of employees or management in non-headquarter jurisdictions.
- **Service provisioning:** Under this model, there are three basic steps that are followed – i) the driver and the passenger must be matched through the app ii) once matched (real time), they complete the ride and iii) the passenger pays for the ride. In this scenario, IT infrastructure and the synergy between data and algorithms are major drivers of value creation.
- **Network infrastructure operation:** This section includes the activities associated with maintaining and running physical information infrastructure and includes – data describing the precise location of the driver and customer, collection and storage of user data (ride histories, user profile, payment details) which helps them in product development and quality maintenance. Additionally, these companies use user data as inputs for price setting algorithms that sets fares depending on the traffic, supply of drivers and demand of passengers in a given geographical location.
- **Technology:** Technology in such companies comprises physical aspects (such as computer hardware) as well as knowledge-based capital (software engineers) and intellectual property components. This leads to the issue of whether such companies should be classified as transport companies or digital service companies.

The above models are few emerging business models in the world of digital economy – the questions as to what is the 'value' created and location of the value creation, and how significant are users in the value creation process, are riddles posed by these models. Furthermore, though nations around the world are progressing towards a harmonious tax solution, one may have to wait and watch other evolving trends in this dynamic landscape of digital economy.

Implementation of BEPS

The BEPS project substantially revamped the international tax rules and through various measures has attempted to align the location of taxable profits with value creation. The key question which remains is whether the BEPS measures address the broader direct tax challenges identified in the 2015 BEPS Action 1 report regarding nexus, data and characterisation. Concerns about the inadequacy of the current rules to deal with broader tax challenges is being evidenced by the increasing number of unilateral measures being adopted by various countries.

The challenges faced by the digital economy are already being addressed by certain other measures as outlined in the BEPS package. The most relevant BEPS direct tax measures are a) amendments to the PE definition under Article 5 of the OECD Model Tax Convention (Action 7) b) revisions to the OECD Transfer Pricing Guidelines (Action 8-10) and c) domestic tax measures, i.e. guidance based on best practices for jurisdictions intending to limit BEPS through CFC rules (Action 3). Other measures of the BEPS package also considered are the standard on treaty abuse (Action 6) and measures related to harmful tax practices (Action 5).

There is already a positive sense regarding the impact of the BEPS Action report on corporate structures, transfer pricing positions, tax planning etc., of the MNE groups. The BEPS measures and its progress / impact with respect to the digital economy are laid down in the following action points that are part of the BEPS Action Report:

- **(Action 7) Prevent artificial avoidance of permanent establishment ("PE") status:** Some digitised structures allowed a business to avoid a dependent agent PE under Article 5(5) such as online provision of advertising where contracts were substantially negotiated in a market jurisdiction through a local subsidiary but were

not formally concluded in that jurisdiction. Action 7 provides for the amendment of the dependent agent PE definition through changes to Article 5(5) and 5(6) of the OECD Model Tax Convention.

Where the recommendations of Article 7 are implemented, structures and arrangements would result in a PE for the foreign parent company if the local sales force habitually plays the principal role leading to the conclusion of contracts in the name of the parent company and these contracts are routinely concluded without significant modification by the parent company.

Action 7 also recommended an update of the specific activity exemptions found in Article 5(4) of the OECD Model. The proposed amendment prevents the automatic application of these exemptions by restricting their application to activities of a "preparatory or auxiliary" character. This change is particularly relevant for some digitalised activities, such as those involved in business-to-consumer (B2C) online transactions and where certain local warehousing activities that were previously considered to be merely preparatory or auxiliary in nature may in fact be core business activities.

The above measures are being implemented by countries through the Multilateral Convention to Implement Tax Treaty related measures to prevent BEPS as well as through bilateral negotiations. Though the implementation progress has been very slow, it is anticipated that some more countries would withdraw their reservations as part of the Inclusive Framework project on 'Attribution of Profits to Permanent Establishments'. Furthermore, the 2017 OECD Model which has incorporated the above-mentioned changes may also continue to serve as a model for countries to negotiate their bilateral tax treaties.

- **(Action 8-10) Assuring that transfer pricing outcomes are in line with value creation:**

  The guidance developed under BEPS Actions 8-10 was incorporated into the OECD Transfer Pricing Guidelines in 2016 to ensure

that transfer pricing outcomes are aligned with value creation – which also equally applies in the context of the digital economy. Tax administrations are now equipped to address BEPS scenarios through mechanisms such as:

a. Actual conduct taking precedence over contractual terms where necessary;

b. Contractual allocations of risk being respected only when supported by actual decision making;

c. Guidance to accurately determine the actual contributions made by an AE that solely provides capital without functionality;

d. Guidance on transactions that involve the use of intangibles which ensures legal ownership alone does not determine entitlement to returns;

While the Transfer Pricing Guidelines play a major role in shaping the transfer pricing systems of OECD and many non-OECD jurisdictions, the effective implementation of these changes depends on the domestic legislation and/or published administrative practices of the countries.

- **(Action 3) Strengthen Controlled Foreign Company ('CFC') Rules:**

  Generally, in digitalised economies, a local subsidiary of the MNE group located in a low tax jurisdiction typically owns the intangible assets (developed by the parent or group entity) and using them sells goods remotely to customers located in other jurisdictions. However, it does not perform any significant activity in relation to the online sales such as marketing and promotion, after sales services, etc.

  In this way, the profits arising from such online sales would be subject to minimal tax rate and would never be subject to tax in the hands of the shareholders (parent company of the MNE Group). This is because most countries do not have a robust CFC regime which could address these issues. For this reason, the BEPS Action report under Action 3 provided recommendations to amend the CFC rules to provide for a list of exhaustive approaches and combinations on which these rules could be based. Specific consideration is given to a number of measures that would target income typically earned in the digital economy, such as income from intangible property and income earned from the remote sale of digital goods and services to which the CFC has added little or no value.

  A few examples of countries amending / looking to amend their CFC rules are as follows:

  - All the 28 EU Member States are required to introduce CFC rules [under the EU Council's Anti-Tax Avoidance Directive];
  - As part of the US tax reforms, the United States has implemented a number of key measures one of which includes the tax on Global Intangible Low-Taxed Income ('GILTI'). This tax is on the excess of the shareholders' actual net CFC income over a routine/ ordinary income and also applies on excess returns that are attributable to intangibles and risk-shifting derived outside the United States from online sales and services.

    In addition, a deemed repatriation rule or transition tax has also been introduced which is a one-time tax (which can be paid in instalments over an eight-year period) on post 1986 deferred foreign earnings. The transition tax is computed such that ensures an effective tax rate of 15.5% for liquid assets and 8% for illiquid assets.
  - Japan has also amended its CFC rules and implemented many of the recommendations of Action 3
  - Other countries (such as Columbia, Chile) have also recently adopted recommendations of Action 3 into their domestic tax law.

- **Other relevant direct tax measures:**

  - To address concerns around Treaty shopping arrangements, a minimum standard was agreed under Action 6 on anti-abuse provisions that countries must include in their treaties. The minimum standard requires the inclusion of an explicit statement in the preamble of each treaty clarifying that the treaty is not intended to create opportunities for non-taxation or reduced taxation through tax avoidance or evasion.

- To address concerns on preferential regimes for intellectual property, a minimum standard was agreed under Action 5 which requires that preferential tax regimes provide benefits only where substantial activities are undertaken by the taxpayer (the nexus approach).
- Furthermore, as part of Action 5, members of the Inclusive Framework on BEPS have committed to the compulsory spontaneous exchange of information on tax rulings that could pose BEPS risks.

• **Indirect tax measures**

Some of the indirect tax measures introduced to ensure a level playing field between domestic and foreign suppliers are:

- Place of taxation rules for B2B supplies: the right to levy VAT will vest with the jurisdiction where the services and intangibles are used for business purposes (irrespective of how supply and acquisition of these services/ intangibles are structured);
- Destination principle for collection of taxes on B2C sales – under this the tax authorities of the customers' jurisdiction are to collect VAT on services and intangibles supplied cross-border by foreign suppliers to final consumers in that jurisdiction (i.e. the jurisdiction where the customer is located). However, the Report stated that the effectiveness of these measures depends on the ease of compliance for the foreign sellers. Accordingly, there were recommendations for simplified registration and collection regime for foreign sellers without similar rights and obligations as local sellers. This has resulted in greatly enhanced compliance levels by promoting more consistent and effective implementation of the agreed approaches.
- To date over 50 countries have adopted rules for the VAT treatment of B2C supplies of services and intangibles. An overview of the tax policies implemented/to be implemented by various countries is highlighted in the next chapter.

TAX POLICY DEVELOPMENTS

Many countries are increasingly applying unilateral steps to tax the digital economy given the slow progress at the international level and the significant quantum of revenues at risk. The BEPS report captures all the unilateral country specific changes which have been made.

The term 'unilateral action' refers to any individual country modifying their domestic tax laws (direct and indirect) in an attempt to capture taxes related to revenues / profits derived from a digital activity, without engaging in the re-negotiation of a bilateral treaty or without the need for consulting comprehensively with other countries.

Globally, many countries, including India, have implemented measures to tax the profits that are derived from the digital activities of multinational enterprises (MNEs) with "significant economic presence" in their territory, as a part of their domestic legislation. While a few countries are taxing them by way of levy of VAT, a few others are taxing them by way of introduction of withholding taxes.

The unilateral approach being adopted by countries has made life complex for multinational corporations and has led to significant uncertainties and tax leakages. However, all these measures seek to improve tax neutrality by restoring a level playing field between foreign suppliers of certain digital goods and services and similar domestic suppliers, as well as between suppliers of certain digital goods and services and more conventional brick and mortar suppliers of competing goods and services.

European Commission proposes new rules on the taxation of the digital economy

Just after the release by the OECD of its Interim Report on the "Tax Challenges Arising from Digitalisation" on March 16, 2018, the European Commission ('the EC') on 21 March 2018, issued certain proposals regarding the taxation of digital economy in the EU.

The EC states that the existing corporate tax framework is now outdated and requires a fundamental reform due to the complex nature of the manner in which businesses are being carried out in the digital era. This proposal highlights the need for effective and fair taxation for the digital economy.

It is important to note that the EC firmly believes that the solution must ultimately be a global one to ensure proper global governance and global rules. To this effect, the EC is working closely with the OECD to support the development of an international solution. However, given the fact that the progress at an international level has not been significant due to the complex nature of the problems and the wide variety of issues being faced, the EC believes that there is a need for a comprehensive structural solution within the EU as well. Furthermore, some Member States have introduced unilateral interim measures to address the challenges of taxing the digital economy which is leading to disparities within the EU.

The Digital Economy: Key Facts

Digital companies are growing fast

Average annual revenue growth of the top digital firms is 14% compared to between 0.2% and 3% for other multinationals

Digital companies rely less on physical presence

Only 50% of the affiliates of digital multnationals are foreign based, compared to 80% for traditional multinationals

Digital companies pay lower tax rates

Companies with digital business models pay on average half the effective tax rate of companies with traditional business models

The tax package proposed by the EU is two-fold:

- **Comprehensive solution:** Directive on the corporate taxation of a significant digital presence
- **Interim measure:** Directive on imposing a common system of a digital services tax ('DST') on revenues resulting from the provision of certain digital services

The scope of each of the proposals and the services proposed to be covered are highlighted in detail below.

1. Directive on the corporate taxation of a significant digital presence

This Directive provides a solution within the existing corporate tax system, addressing the problems of 'where to tax' and 'what to tax' in the digital economy. It lays down rules for establishing a taxable nexus for digital businesses operating across borders with no or limited physical presence. Furthermore, it also sets out principles for attributing profits to such a business having a significant digital presence.

This concept of significant digital presence is intended to establish a taxable nexus and builds on the existing PE concept.

A business is said to have a significant digital presence if the business carried on consists wholly or partly of the supply of digital services through a digital interface[1] and one or more of the following criteria are met by the entity carrying on that business taken together with each of that entities associated enterprises in aggregate:

- proportion of total revenues obtained in that tax period and resulting from the supply of those digital services to users located in that Member State exceeds EUR 7,000,000;
- number of users of one or more of those digital services who are located in that Member State in that tax period exceeds 100,000;
- number of business contracts for the supply of any such digital service that are concluded in that tax period by users located in that Member State exceeds 3,000.

1. Digital interface means any software, including a website or a part thereof and applications, including mobile applications, accessible by users

Furthermore, digital service is defined to mean services that are delivered over the internet or an electronic network and the nature of which renders their supply essentially automated and involving minimal human intervention, and which are impossible to ensure in the absence of information technology including the following:

- supply of digitised products generally, including software and changes to or upgrades of software;
- services providing or supporting a business or personal presence on an electronic network such a website or a webpage;
- services automatically generated from a computer via the internet or an electronic network, in response to specific data input by the recipient;
- transfer for consideration of the right to put goods or services up for sale on an internet site operating as an online market on which potential buyers make their bids by an automated procedure and on which the parties are notified of sale by electronic mail automatically generated from a computer;
- Internet service packages;
- A list of other services including – website hosting, accessing or downloading of music on to computers and mobile phones, accessing and downloading of films/games, etc.

Furthermore, a list of services that are not deemed to be digital services has also been provided, which includes radio and television broadcasting services, telecommunication services, etc.

It is imperative to note that this Directive, once implemented in Member States national legislation, will apply to cross border digital activities within the Union, even if the applicable double taxation treaties between the EU Member States have not been modified. It will also apply to a business established in a non-EU jurisdiction with which there is no double tax treaty with the Member State. However, it does not affect taxpayers established in a non-EU jurisdiction where there is a double tax treaty in force, unless such treaty includes a similar provision on significant digital presence.

On the basis of the above criteria, digital services performed by a significant digital presence in the EU may become taxable in the EU. The EC has also proposed rules for attributing profits to a significant digital presence.

In this context, the EC has stated that attribution of profits to a significant digital presence should be based on a functional, asset and risk analysis. The attribution of profits should also take into account the development, enhancement, maintenance, protection and exploitation of intangible assets in the performance of the economically significant activities by the digital presence even if these are not linked to people functions in the Member State. Furthermore, as activities in a digital business contribute in a unique manner to value creation, the profit split method should normally be used for arriving at fair allocation of profits to the significant digital presence. However, the taxpayer is free to choose an alternative method in line with the internationally accepted principles if he can prove that outcome of the functional analysis using the alternative method is more appropriate.

The EC proposes that the Directive should apply from January 1, 2020. The EC has also recommended that Member States should adapt their double taxation treaties with non-EU jurisdictions to include provisions as per the above Directives.

2. Directive on imposing a common system of a DST on revenues resulting from the provision of certain digital services

The objectives of this Directive aim at protecting the integrity of a single market concept in the EU by discouraging Member States from taking divergent solutions. The interim tax is aimed at targeting the most urgent gaps in the taxation of digital activities and will ensure that activities which are not currently taxed will begin to generate immediate revenue for Member States.

The proposed Directive provides that a new Digital Services Tax ('DST') would be levied at a single rate of 3% on gross revenues derived in the EU, resulting from the supply of certain digital services characterised by user value creation. The business models captured in this Directive are those which would not be able to exist in their current form without user involvement. The DST is proposed to be levied with effect from 1 January 2020.

The revenues included in the scope of this tax (net of value added tax and other similar taxes) would be derived from the provision of any of the following services:

- the placing on a digital interface of advertising targeted at users of that interface;
- the making available to users of a multi-sided digital interface which allows users to find other users and to interact with them, and which may also facilitate the provision of underlying supplies of goods or services directly between users;
- the transmission of data collected about users and generated from users' activities on digital interfaces.

An entity that meets the following thresholds qualifies as a taxable person and would be subject to DST irrespective of whether they are established in a Member State or in a non-EU jurisdiction:

- Total annual worldwide revenue reported by the entity for the latest complete financial year exceeds EUR 750 million;
- Total annual taxable digital revenues in the EU during that financial year exceeds EUR 50 million

The first threshold (i.e. total annual worldwide revenues) limits the application of the tax to companies of a certain scale and will also exclude small enterprises and start-ups for which compliance burdens would be disproportionate. The second threshold (total annual taxable revenues in the EU) is set at the EU level in order to disregard differences in market sizes, within the Union. If a business belongs to a consolidated group for financial accounting purposes the thresholds have to be applied in respect of total consolidated group revenues.

It is pertinent to note that it is user involvement in the digital activities of a company which generates value for that company and hence DST is due in the Member State where the users are located. If the users are located in different Member States, the proposal also provides for the tax base to be attributed between Member States based on certain allocation keys.

The fact that a taxable person may be resident for corporate income tax purposes in a Member State has no impact in determining the Member State of identification for the purpose of DST, given the different nature of the tax.

It would be relevant to note that as DST would be levied in the Member State where the users are located, the tax could be due in multiple Member States. In order to manage the administrative aspects, a One-Stop-Shop ('OSS') simplification mechanism is made available to all taxable persons whereby multiple DST obligations (identification, submission of the DST return and payment) could be fulfilled through a single contact point - the Member State of Identification.

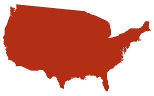
Furthermore, to alleviate possible cases of double taxation where the same revenues are subject to corporate income tax and DST, Member States will allow businesses to deduct the DST paid as a cost from the corporate income tax base in their territory, irrespective of whether both taxes are paid in the same Member State or in different ones.

The EC proposes that the Directive should apply from January 1, 2020. The tax is clearly intended to be a temporary solution to address immediate issues. The more holistic solution will give Member States the right to tax digital activities via new corporate tax rules as envisaged keeping the broader concept of a 'significant economic presence' in mind.

The EC's proposals will now be sent to the Council and the European Parliament. The Directives need to be formally adopted by the Council by a unanimous vote, after consultation of the European Parliament and the Economic and Social Committee. It is envisaged that there will be significant discussion regarding the proposed Directives and it remains to be seen whether these proposals will be approved by all EU Member States.

It is pertinent to note that, as per latest news reports ministers from smaller nations, including Luxembourg and Malta, have opposed the plan of DST stating that an overhaul of digital taxation should be done globally and involve a long-term solution. The EU Member States have not yet reached consensus on the above proposals. One would need to wait and see how and when these proposals are implemented.

A brief overview of how various other countries are seeking to unilaterally tax the 'digital economy' (other than India), is provided below to get an indication of the current global scenario (indicative and not exhaustive).



United States of America ('USA')

In 2008, New York passed the 'Amazon Tax Law'. As a result, Amazon and similar businesses have started collecting taxes for all transactions with US resident consumers.

Local US legislators also seek to tax income from e-services. Consequently, in 2015, Chicago introduced the "Cloud Tax" to address income from services in relation to databases, i.e. non-possessory computer leases, and streaming, i.e. electronically delivered entertainment. A few other states in USA have adopted the Sales and use taxes which is leviable on certain digital goods and services. However, each state has its own definition of digital goods and services.

It is also pertinent to note that the USA strongly opposes unilateral measures adopted by countries to tax digital activities. Steven Mnuchin, US Secretary of the Treasury on 16 March 2018 said -

"The U.S. firmly opposes proposals by any country to single out digital companies. Some of these companies are among the greatest contributors to U.S. job creation and economic growth. Imposing new and redundant tax burdens would inhibit growth and ultimately harm workers and consumers. I fully support international cooperation to address broader tax challenges arising from the modern economy and to put the international tax system on a more sustainable footing."

As part of a broader tax reform, USA introduced the base erosion and anti-abuse tax ('BEAT'). The BEAT was introduced to target the tax base erosion in USA by imposing an additional tax liability on certain corporations. The BEAT applies to resident corporations and otherwise branches subject to US income tax and is limited in scope to specific intra-group transactions. Furthermore, the provisions are applicable only if the average annual US domestic gross receipts of the resident corporation exceed USD 500 million over a three-year period. It relies on a formula-based approach and includes certain adjustments to be made to determine any potential tax liability.

As part of the US tax reforms, the United States also Introduced tax on GILTI. This tax is on the excess of the shareholders' actual net CFC income over a routine/ ordinary income and also applies on excess returns that are attributable to intangibles and risk-shifting derived outside the United States from online sales and services.

Furthermore, a deemed repatriation rule or transition tax has also been introduced which is a one-time tax (which can be paid in instalments over an eight-year period) on post 1986 deferred foreign earnings. The transition tax is computed such that ensures an effective tax rate of 15.5% for liquid assets and 8% for illiquid assets.

United Kingdom ('UK')

The United Kingdom decided to address digital taxation issues through its diverted profits tax ('DPT'), which took effect in April 2015.

The DPT targets profits of multinationals that are artificially diverted from the UK. The law targets non-resident companies that trade in the UK but structure their business to avoid creating a PE, thereby avoiding or substantially reducing their tax liability in the UK. The DPT is taxed at the rate of 25%, when the UK sales revenue of the company (including connected companies) exceeds 10 million pounds in any twelve-month accounting period.

In its November 2017 autumn budget, the UK announced another proposal targeting digital multinationals. The proposal imposes a withholding tax on royalties paid by non-UK resident companies to other non-resident companies located in low-tax or no-tax jurisdictions if the royalties are paid in connection with sales to UK customers. Currently, the UK only taxes royalties paid by companies with a physical presence in the country. The measure is effective from April 2019.

In addition to the above, the UK Government has issued a position paper titled "Corporate tax and the digital economy' in November 2017 calling for various inputs from stake holders. An updated position paper has been released in March 2018. The updated paper sets out the government's view that there is a need to consider interim measures such as revenue-based taxes deriving significant value from UK user participation. The view of the UK Government is that while it continues to support the principle underpinning the international corporate tax system that the profits of a business should be taxed in the countries in which it creates value, it believes that this principle is being challenged by business models for which value creation is in part reliant on the engagement and participation of users.

Following the above consultation process, the UK Government effective from April 2020 has introduced a new 2% tax on the revenues of search engines, social media platforms and online marketplaces which derive value from UK users. These businesses will be liable to DST when the group's worldwide revenues from these digital activities are more than £500m and more than £25m of these revenues are derived from UK users. The government is committed to dis-applying the DST once an appropriate international solution is in place. A guidance note to this effect was also introduced.

Furthermore, the UK Government has also amended the rules with respect to value added tax ('VAT') to ensure taxes are collected based on the destination principle. Some of the changes incorporated are:

- Effective from 1 January 2015, for taxing cross border digital supplies, VAT is levied based on the destination principle, i.e. where the customer is located (or where the customer belongs) rather than the supplier location.
- The UK has also enacted special rules on the VAT liability of online platforms. The introduction of these rules would ensure that the overseas businesses selling goods to UK consumers via online marketplaces would meet the UK VAT compliance obligations. Some of these include:
  - Online marketplaces are jointly and severally liable for the unpaid VAT of overseas businesses that are non-compliant with UK VAT rules and use their platforms to sell goods to UK customers;
  - Online marketplaces to ensure that VAT numbers displayed on their websites are valid.

Austria

On 5 April 2019, the Austrian Federal Ministry of Finance published a draft bill that would introduce a new digital advertising tax. Austria's draft bill introduces a 5% tax (as compared to the 3% tax originally announced in January 2019) on Austrian digital advertising revenue for all groups with worldwide revenues of at least €750m and Austrian digital advertising revenue of at least €25m, effective 1 January 2020. This measure aims to levy taxes on international groups that currently pay minimal taxes in Austria, according to the Austrian Government.

Another measure in the same bill was proposed which shall enter into force as from 1 January 2021, strengthens Austria's VAT regime for imports from non-EU countries. Under this proposal, internet selling platforms will be treated as recipients and suppliers of import distance selling and intra-EU sales to non-entrepreneurs in the EU, performed by non-EU suppliers using the platform. Insofar as such supplies have their place of supply in Austria, the platforms will have to pay VAT and will have to report all VAT information in Austria.

A third measure aims to increase the reporting obligations of online platforms that connect the buyers and sellers of goods and services. Operators would be obliged to report all bookings and revenue in Austria to the tax authorities from 2020 onwards.

Australia

Australia is also pursuing a multi-pronged approach to taxing the digital economy. The country currently relies on its multinational anti-avoidance legislation ('MAAL'), which went into effect in January 2016 and targets non-resident multinationals that do business in Australia but purposefully structure their affairs to avoid the country's PE rules.

The law hits large multinationals – it cancels all tax benefits that a multinational derives from tax avoidance schemes and imposes increased penalties on companies that experience tax shortfalls after the MAAL is applied.

Australia also has its own diverted profits tax regulations to ensure that enterprises that undertake economic activities in Australia are subject to tax and to deal with the issue of companies in the digital economy that carried on sales activities in Australia without giving rise to a PE. The DPT applies to both Australian headquartered entities with foreign operations and the local operations of foreign-headquartered multinationals, who have an annual global revenue of AUD 1 billion or more. The diverted profits tax took effect from July 1, 2017.

From an indirect tax perspective, Australia expanded the scope of goods and service tax ('GST'), popularly called the 'Netflix tax' to cross border supplies of digital products and other services imported by Australian customers. GST is imposed at the rate of 10% on the value of the supply, with effect from 01 July 2017. The services on which GST is levied inter alia include digital products such as streaming or downloading of movies, music, apps, games and e-books.

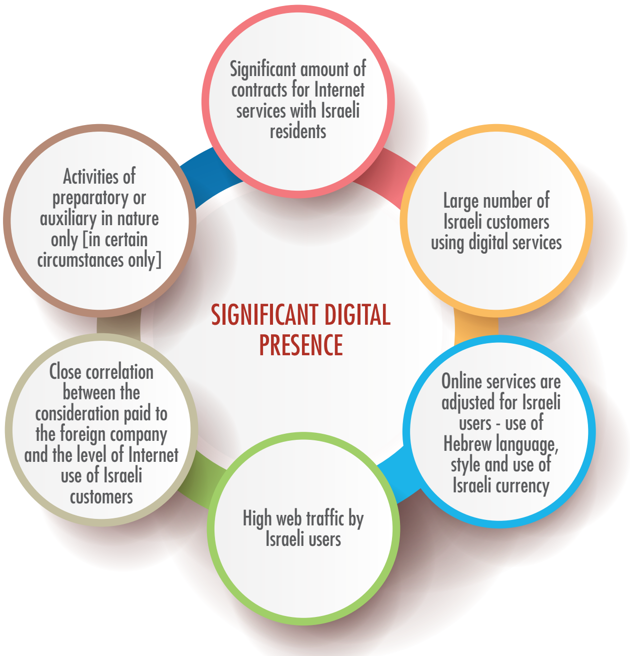
It would also be relevant to note that the Australian GST legislation makes specific reference to electronic distribution platforms. A platform (such as an app store) is deemed to be the provider of the digital service to the end customer. In this scenario, GST registration, in addition to the collection and remittance of GST to the Australian Government is the platform's responsibility.

Israel

The Israeli Tax Authorities issued a Circular in April 2016 to tax foreign companies providing services in Israel through the internet. The Israeli legislation emphasises that income of foreign digital providers of services and goods to Israeli residents should be taxed even if they have no physical presence in Israel, on the basis of 'significant digital presence' involving Israeli users.

Different approaches have been provided to taxation based on whether the foreign enterprise is resident in a treaty state or non-treaty state. Unlike the erstwhile definition of PE, wherein an activity in the nature of preparatory or auxiliary character would not be regarded as PE, the amended provisions state that under certain circumstances, a foreign enterprise may be considered to have a PE even if the activity is of preparatory or auxiliary character only.

The diagram below highlights the situations in which a significant digital presence is created in Israel under the Circular.



In addition to the above, amendments have also been proposed to the existing VAT laws, which if passed would require non-resident suppliers of digital services to register and account for VAT in Israel. Under the draft bill, it is generally business to customer (B2C) supplies of digital services that would give rise to local VAT obligations on the part of the non-resident suppliers. The draft bill applies to non-resident suppliers themselves and non-resident operators of online stores.

It is interesting to note that, where a PE is deemed to exist for income tax purposes, it is presumed that the company will register for VAT as well.

Italy

The Italian 2018 Budget Law introduced a new tax on digital transactions – called the 'Web Tax' related to the performance of services carried out through electronic means rendered by both resident and non-resident enterprises to Italian businesses and to Italian PEs of non-residents (currently only a B2B tax).

"Services carried out through electronic means" shall be those supplied through the internet or an electronic network, the nature of which makes the performance completely automatic, with minimum human intervention and for which the information technology component is essential. A further condition in order for the transaction to be subject to the tax is that the provider has to put in place at least 3,000 transactions per year.

The Web Tax is levied at the rate of 3% on the value of each digital transaction, net of value added tax, and **regardless of whether the transaction is concluded**. The Web Tax is settled by the buyers of the services and is like a withholding tax. **It is also important to note that Web Tax is not creditable against Italian Income tax.** The Web Tax is applicable from January 1, 2019.

The Italian 2018 Budget Law also amended the domestic definition of PE which implies the possibility of a PE presence even in a case where a company does not have a physical presence in the Italian territory, to the extent other factors may indicate a significant presence.

Italy is also considering the following –

- Imposition of a 25% withholding tax on the activities of virtual PEs defined on the basis of "significant digital presence";
- Implementation of VAT on the provision of digital services

Japan

The most significant unilateral reform in Japan, in the context of digital economy, is the introduction of the Japanese consumption tax. The key driver behind Japan's decision to introduce this legislation were the concerns from Japanese ecommerce businesses of an unbalanced marketplace as they compete with foreign ecommerce businesses.

To eliminate the imbalance, Japan introduced a 'consumption tax' on digital services supplied to Japanese customers, if the recipient is located in Japan (on the basis of the recipient's address or domicile for individuals or location of head office or principal office for corporations). The concept of digital services is specified as services provided via electronic and telecommunication networks, such as hosting advertising on the internet, providing cloud services, consulting business via telephone or email or providing e-books, music or software via telecommunication networks.

This operates through a reverse charge mechanism for B2B digital services whereby the obligation to pay consumption tax lies with the business receiving the digital service. For B2C services provided to a domestic consumer, the non-resident supplier is liable to pay the consumption tax.

France

In 2004 the scope of indirect-tax was expanded to include online video-on demand services where movies and audio-visual content are accessed through electronic communications in exchange for a payment.

In 2016, the tax was further extended to online video-on-demand services provided for free but monetised through the advertisements displayed to the viewers. This tax is popularly also called the "YouTube tax". This is primarily a destination-based tax and thus, suppliers providing specified services to customers in France are required to report and remit the tax.

On July 11, France's Senate passed the bill creating a 3% tax on big tech companies providing services to French users. Officials from France and the United States have reached a compromise on a new French tax on services provided by large internet companies, potentially defusing the threat of a trade conflict between the two countries. Under the terms of the agreement, France would repay companies the difference between their digital tax and whatever taxes come from a planned mechanism being drawn up by the OECD.

Slovak Republic

The Financial Administration of the Slovak Republic recently published a release concerning the new PE rules for digital platforms introduced by the Tax Reform Law for 2018. Under the new rules, the **provision of transport and accommodation services arranged through a digital platform can result in a PE for the digital platform.**

Accordingly, with effect from January 1, 2018, foreign operators of digital platforms for such services are required to register a PE in the Slovak Republic. In case the foreign operators are not registered as PE, the Slovak tax resident using the platform for the sale of their services are obligated to deduct tax from the payments made to the foreign operators of the digital platform for the intermediary service provided.

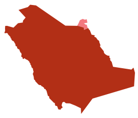
Malaysia

The Malaysian tax authorities recently issued a guidance note regarding withholding tax on income from digital advertising provided by a non-resident. The tax treatment on payments to non-residents in relation to digital advertising is explained below:

- Non-resident without a PE/business presence in Malaysia – (a) If the payer purchases or uses an app that allows the payer to create its own advertising campaign, the payment will be treated as royalty income; (b) If the payer solely relies on the service provider to deal with all aspects of digital advertising and there is no purchase or use of an app, the payment will be treated as technical service fee income
- Non-resident with a PE/business presence in Malaysia - Payment constitutes business income

Hungary

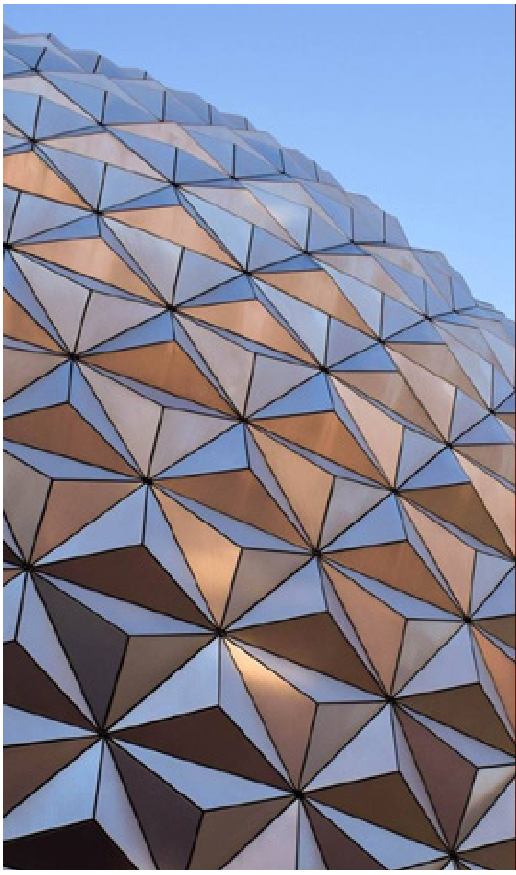
Hungary has introduced an online advertising tax on content providers that make over HUF 100 million (about $392,000) in annual advertising revenue. The tax applies to companies that receive revenue from publishing advertising for others and providing advertising services. The tax is levied at the rate of 7.5%.



Kuwait and Saudi Arabia

Kuwait and Saudi Arabia have introduced a "virtual service" PE, which is deemed to exist with no physical presence but rather as the result of the provision of services for more than the threshold period provided for by tax treaties.

A few other countries have introduced/expanded the scope of the consumption-based taxes as an interim measure to tackle the tax challenges in the digital era. Albania, Iceland, New Zealand, Argentina, South Africa and South Korea are a few countries who levy indirect taxes (in the form of VAT/GST) in the customers' jurisdiction on services and intangibles supplied cross-border by foreign suppliers to final consumers. The specified digital services on which the indirect taxes are levied vary in each country though, principally, the taxes are destination based.



Conclusion

The challenges that the digital economy poses to the effectiveness of the international corporate tax rules can only be suitably addressed through multilateral reform. The international tax framework needs to continuously evolve to achieve sustainable results on this front.

As a next step one of the main issues for the Inclusive Framework to consider is whether the challenges described in this report relating to alignment of profit with value creation would be best addressed with a focus on certain digitalised business models or whether such a solution should be applicable to the broader economy. Feasibility of different options would need to be tested and work will be done towards a consensus-based solution by 2020. Overall, there is emergence of support for undertaking a coherent approach to tackle the challenges posed by digital economy. This process would involve further dialogue between the members of the Inclusive Framework and stakeholder groups.

It has also been agreed that as a next step consideration should also be given to the development of appropriate legal instruments to facilitate and accelerate the adoption of measures which are agreed.

INCLUSIVE FRAMEWORK'S ROADMAP 2019

The Inclusive Framework met in July 2018 and agreed to hold a public consultation on the plausible solutions to the tax challenges facing the digital economy. As part of this process, a Public Consultation Document was issued which described the proposals on the above two aspects discussed in the Interim Report at a high-level, seeking inputs from the public on technical and policy aspects. The interested parties were invited to send their comments by March 6th, 2019.

The most important issue that the Public Consultation Document puts forth is remote participation in the domestic economy enabled by digital means but without a taxable physical presence and allocation of profits generated as a result of such participation. With a view to expand the taxing rights of user and market jurisdictions, it puts forth the manner of modifying the rules based on the following three proposals (at a policy design stage and broad level) - user participation, marketing intangibles and/ or concept of significant economic presence. The main common objective of the proposals based on the above concept is to recognise the economic value created by a business activity that in the view of some countries is not recognised by the current international framework.

On the other hand, one can also see that countries across the globe are increasingly applying unilateral steps to tax the digital economy (refer Chapter II), given the slow progress at the international level coupled with the fact that traditional taxing laws are unable to overcome the challenges of the digital economy. Governments across the world recognise the need for immediate action with respect to taxing the digital economy, given the significant quantum of revenues at risk.

Having said the above, the Inclusive Framework is concerned that proliferation of uncoordinated and unilateral action will not only undermine cross border activities but will also adversely impact the global investments. In this backdrop, the Inclusive Framework, has released a Document on the Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digital Economy ('the Document').

Highlights of the Document

The work involves an analysis based on two broad pillars – Revised nexus and profit allocation rules and Global anti-base erosion proposal.

Revised nexus and profit allocation rules

The revised nexus and profit allocation rules highlight the importance of value being created in a market jurisdiction through remote participation, which is currently not recognised in the current framework for allocating profits. The following options/approaches will be deliberated upon to determine the method that addresses the issues, also keeping in mind the administrative and compliance burden and avoidance of double taxation:

- Modified residual profit split method - the non-routine profits would be subject to the new taxing right.
- Fractional apportionment method - total profits would be considered for apportionment and a distinction would not be drawn between routine and non-routine profits.
- Distribution-based approaches - options for allocation of profits to market jurisdiction based on marketing and distribution activities would be explored.
- Amending Articles 5 and 7 of the OECD Model Convention to accommodate new profit allocation rules. Also implementing changes through the Multilateral Convention or establishing a new multilateral convention will also be explored.
- Introduction of new provisions giving market jurisdiction taxing rights.

In all of the above approaches, determination of the amount of the profits that would be subject to the new taxing rights is the most critical aspect. The Document also acknowledges the fact that the principles and mechanisms should not only apply to profits but should equally apply to losses. Another important aspect that could have a significant impact is the importance of claim of tax credits to avoid double taxation and adequate dispute resolutions to be built into the system. This is something which the Inclusive Framework would have to closely monitor as one of the key aspects of the BEPS project is to not only avoid non-taxation but to also avoid double taxation.

Some other aspects that would be deliberated upon are measures to be used to limit the administrative and compliance burden both for tax authorities and taxpayers and delineate the rules among business line and regional segmentation. Overall, principles would have to be put in place to determine how adjusted profits could be applied where the group has no established tax presence in the market jurisdiction.

While the above proposals in the form of user participation, marketing intangible, and significant economic presence have also been significantly deliberated upon in the public consultation report, the revised nexus and profit allocation rule seeks to address all the three.

The Document also highlights the possibility of implementing a withholding tax. While in the Final Report, the OECD did not recommend this option at all, this option will again be deliberated upon.

Global anti-base erosion

The global anti base erosion proposal would be applied through amendment to domestic tax laws and tax treaties. The approach is based on a mechanism that leaves it to the respective jurisdictions to determine the manner in which they would want to apply the rules, to ensure that those instances are captured where income is taxed at an effective rate below a minimum rate.

Unlike the revised nexus and profit allocation proposal this proposal, would apply not only to the digital economy but would apply in a broader context, particularly in connection with profits relating to intangibles. Thus, this proposal would not only aid in resolving taxation issues in the context of digital economy but also seeks to address the remaining BEPS risks of profit shifting to entities subject to NIL or very low taxation.

The Document highlights that this proposal would be implemented through the following two interrelated rules:

- **Income inclusion rule –** To bring to tax those situations where income is subject to tax at an effective rate below a minimum rate. The Document further provides options that could be

explored under the rule, viz, top up to minimum rule, use of a fixed percentage, a switch over rule.

However, it is imperative to note that under this proposal there is a risk that genuine transactions could get covered, as a consequence of which an enterprise may end up paying higher taxes. For instance, in case of losses, treatments amongst jurisdictions may vary and in a genuine case, the entity may end up paying taxes, even in a situation of tax loss, owing to the fact that minimum taxes would mandatorily have to be paid. Thus, objectives sought to be achieved through this proposal could potentially lead to an adverse impact.

- **Tax on base eroding payments –** This would operate by way of denial of a deduction or imposition of source-based taxation along with changes to tax treaties, to state that treaty benefits would be available only if the item of income was subject to tax at a minimum rate. The Document further provides options that could be explored under this rule, viz, undertaxed payments rule or a subject to tax rule.

In order to reduce the undue compliance and administrative burdens the Document acknowledges the fact that design principles will have to be laid down to restrict the application of rules, say via specified thresholds or carve out for specific industries/sectors, etc.

The Document also identifies that while exploring the above proposal it is also imperative that an economic analysis and impact assessment on the economy as a whole, needs to be featured as part of the programme. This becomes extremely important as implementation of new taxing rights would not only increase costs of doing business but would also have an impact on cross border activities.

Way forward

One can see continued and commendable efforts of the OECD towards reaching for a consensus based long-term solution on the broader challenges facing the digital economy

Work on all of the above aspects will be undertaken throughout the remainder of 2019 by the Working Parties. Given the intensity of the technical details involved, the Working Parties will meet and deliberate on various aspects under the leadership and coordination of the Steering Group. The feasibility of the proposals, along with additional options would be explored to develop a unified approach. Thereafter, the Inclusive Framework will deliver a final report by 2020.

INDIA
DIGITAL TAX IMPACT

India, like the global community, has also been keeping a keen eye on the tax issues arising from the digital economy and has constantly been evolving its tax policy to ensure it gets its fair share of revenues.

Ecommerce: Highlights in India

- Indian e-commerce market expected to grow to US$ 200 billion by 2026 from
- Currently, there are 1-1.2 million transactions per day in e-commerce retailing
- Innumerable small and large e-commerce companies selling provisions and food items like Grofers, BigBasket, etc.
- Electronics is currently the largest segment in e-commerce in India with a share of 47 per cent and is expected to grow at a CAGR of 43 per cent by 2020
- The apparel segment has the second highest share of 31 per cent in the e-commerce retail industry
- With the increase in awareness about the benefits of online trading, there has been a significant rise in investment in e-commerce business. Hand in hand with offline trading, many established businesses, e.g. Shoppers Stop or Lifestyle, have setup online transaction channels

Sources: media reports and publicly available documents

As an early starter, India picked up on issues specific to the e-commerce industry way back in 2001 and set up a High Powered Committee ("HPC") constituted by the Central Board of Direct Taxes. The HPC submitted its report on "Taxation and E-Commerce" in September 2001. The report considered and contemplated upon the need for introducing a separate tax regime for e-commerce transactions However, based on the principle of 'neutrality', the HPC maintained that the existing laws back then were sufficient to tax e-commerce transactions and no separate regime for the taxation of e-commerce transactions was required.

More recently, considering the potential of the digital economy and to address the challenges in terms of taxation of digital transactions, in February 2016, a Report of the Committee on Taxation of E-Commerce was published (appointed by the Central Board of Direct Taxes). The Committee analysed in detail the current status of the Digital Economy and future growth, tax challenges from Digital Economy, issues related to value of data and user activity in multidimensional business models, options to address broader tax challenges of Digital Economy in the Indian context and its recommendations. The committee in its Report in consonance with BEPS Action item 1 - Addressing the Tax Challenges of the Digital Economy' considered three options to address broader tax challenges of the Digital Economy viz.:

- new nexus based on significant economic presence;
- withholding tax on digital transactions;
- equalisation levy

After analysing the options in detail, the Committee recommended that the only option that appeared to be feasible and could be resorted to, without violating the obligations under a Double Taxation Avoidance Agreement, was an 'Equalisation Levy' which was introduced vide Finance Act, 2016 (discussed in more detail later).

Over the years India has made significant changes to the domestic tax law to ensure it gets its fair share of tax with respect to the digital economy. Some key changes include:

- Amendment to the definition of royalty in 2012;
- Introduction of an equalisation levy in 2016;
- Introduction of GST on July 1, 2017;
- Amending the definition of business connection to include a significant economic presence in 2018;
- Aligning the scope of 'business connection' with the modified PE rule as per BEPS Action 7

A detailed discussion on each of the aforesaid amendments is provided below:

Amendment to the definition of royalty in 2012

Section 9(1)(vi) of the Income-tax Act, 1961 ('the Act') provides that any income payable by way of royalty in respect of any right, property or information is deemed to accrue or arise in India. Given the conflicting judicial views on the definition of 'royalty' a clarificatory amendment was brought in vide Finance Act 2012 [inclusion of Explanation 4 and Explanation 5 under section 9(1)(vi) of the Act]. The amended definition clarified the following:

- Transfer of all or any rights in respect of any right, property or information includes and has always included transfer of all or any right for use or right to use a computer software (including granting of license) irrespective of the medium through which such right is transferred.
- Royalty includes and has always included consideration in respect of any right, property or information, whether or not:
  - The possession or control of such right, property or information is with the payer;
  - Such right, property or information is used directly by the payer;
  - The location of such right, property or information is in India
- The expression 'process' includes and shall be deemed to have always included transmission by satellite (including up-linking, amplification, conversion for down-linking of any signal), cable, optic fibre or by any other similar technology, whether or not such process is secret.

In addition to the above, it would be relevant to note that on perusal of the definition of royalty under the Act vis-à-vis the OECD/UN Model Convention, it can be inferred that while the Act covers **imparting of any information** concerning technical, industrial, commercial and scientific knowledge, experience or skill, the OECD/UN Model Convention generally cover **use of information** concerning industrial, commercial or scientific experience. Most of the tax treaties entered into by India contain wordings similar to that of the OECD/UN Model Convention. Thus, the definition under the Model Conventions and tax treaties is narrower in scope than under the domestic tax legislation. Though shelter under a tax treaty could be obtained by a tax payer, India has expressed several reservations to the OECD commentary on the definition of royalty (discussed in detail later) and Indian tax authorities have many times contended that Tax Treaty provisions should be interpreted in line with the domestic tax laws.

Equalisation levy

Drawing from the suggestions of the OECD BEPS report - Action Plan 1 and considering the potential of the digital economy, India introduced an equalisation levy vide Finance Act, 2016, popularly known as the 'Google tax'.

The equalisation levy was introduced to tax the consideration received or receivable towards online advertisement services, provision of digital advertising space or any other facility or service for the purpose of online advertisement and can include any other service as may be notified by the Central Government in this behalf, provided by non-resident to a person resident in India carrying on business or profession or to another non-resident having a PE in India.

It is imperative to note that the equalisation levy forming part of Finance Act, 2016 does not form part of the Act and is an independent Chapter in itself containing all the applicable provisions like charging of tax, scope of revenues liable to tax, collection machinery, assessment, penalty, prosecution and appeals.

This levy is not applicable in the following cases:

i. The services provided by the non-resident is effectively connected with its own PE in India;

ii. The aggregate consideration received in the previous year by the non-resident from the above-mentioned persons does not exceed one lakh rupees;

iii. The payment received is for services not in relation to the business and profession of the resident or the PE of another non-resident as the case may be.

The levy would be applicable at the rate of 6% on the amount of consideration received or receivable and the resident or PE of another non-resident shall deduct this tax while making payment to the non-resident service provider. The tax deducted shall be paid to the credit of the Central Government by seventh of the month following the calendar month in which such tax was deducted. Furthermore, on failure to deduct such tax from consideration paid to the non-resident service provider, the resident would still be liable to pay the tax to the government and the expense shall not be allowed as a deduction while computing the profits from business and profession. This is to ensure compliance on the part of the tax payers. In addition to the above, there are interest, penal and prosecution provisions also provided as part of Finance Act, 2016 for failure to comply.

Furthermore, it would also be relevant to note that in a situation where income has been subjected to Equalisation Levy it shall be exempt from tax in the hands of the non-resident recipient in India. Accordingly, there will be no double taxation of the same income within India.

Goods and Services Tax

Consumption taxes in the form of GST is levied on certain specified services in India. The GST provisions require every person supplying online information and database access or retrieval services ('OIDAR') from a place outside India to a person in India (Government, local authority, governmental authority, an individual or any other person not registered and receiving online information and database access or retrieval services in relation to any purpose other than commerce, industry or any other business or profession, located in taxable territory) to take registration in India and pay GST.

OIDAR is defined to mean services whose delivery is mediated by information technology over the internet or an electronic network and the nature of which renders their supply essentially automated and involving minimal human intervention and impossible to ensure in the absence of information technology and includes electronic services such as:

i. advertising on the internet;

ii. providing cloud services;

iii. provision of e-books, movie, music, software and other intangibles through telecommunication networks or internet;

iv. providing data or information, retrievable or otherwise, to any person in electronic form through a computer network;

v. online supplies of digital content (movies, television shows, music and the like);

vi. digital data storage;

vii. online gaming

Furthermore, specific services have been carved out where the aforesaid provision would not apply. Some of the services which are not covered under the ambit of OIDAR are supplies of goods, where the order and processing is done electronically, services of lawyers and financial consultants who advise clients through email, booking services or tickets to entertainment events, hotel accommodation or car hire, educational or professional courses, where the content is delivered by a teacher over the internet, advertising services in newspapers, on posters and on television. In respect of import of OIDAR by unregistered, non-taxable recipients, the supplier located outside India will be responsible for payment of taxes. As a corollary, in case of import of OIDAR by registered, taxable recipients, the recipient of the OIDAR services is required to register and pay GST.

The service provider (or intermediary as the case may be) will be required to take a single registration for paying GST under the Simplified Registration Scheme to be notified by the Indian Government.

Significant economic presence

OECD under its BEPS Action Plan 1 addressed the tax challenges in a digital economy wherein it had discussed several options to tackle the direct tax challenges arising in digital businesses. One such option is a new nexus rule based on "significant economic presence". As per the Action Plan 1 Report, a non-resident enterprise would create a taxable presence in a country if it has a significance economic presence in that country on the basis of factors that have a purposeful and sustained interaction with the economy by the aid of technology and other automated tools.

Currently, emerging business models such as digitised businesses, which do not require physical presence of itself or any agent in India, do not get covered within the scope of the term 'business connection' under clause (i) of sub-section (1) of section 9 of the Act. The scope of existing provisions of clause (i) of sub-section (1) of section 9 is restrictive as it essentially provides for physical presence-based nexus rule for taxation of business income of the non-resident in India. Explanation 2 to the said section which defines 'business connection' is also narrow in its scope since it limits the taxability of certain activities or transactions of non-resident to those carried out through a dependent agent.

Given the above, Finance Act 2018 has amended clause (i) of sub-section (1) of section 9 of the Act to provide that significant economic presence' in India shall also constitute 'business connection'. Significant economic presence has been defined to mean:

i. transaction in respect of any goods, services or property carried out by a non-resident in India including provision of download of data or software in India, if the aggregate of payments arising from such transaction or transactions during the previous year exceeds such amount as may be prescribed; or

ii. systematic and continuous soliciting of business activities or engaging in interaction with such number of users as may be prescribed, in India through digital means.

The conditions mentioned above are mutually exclusive. The amount of income attributable to transactions or activities referred to above shall be deemed to accrue or arise in India.

Furthermore, the provisions also provide that the aforesaid transactions would constitute a 'significant economic presence' whether or not:

i. The agreement for such transactions or activities is entered in India; or

ii. The non-resident has a residence or place of business in India; or

iii. The non-resident renders services in India.

The Government has announced that it will begin a consultation process with different stakeholders to determine what should be the threshold limits for qualifying as "significant economic presence". However, given that these provisions are introduced by amendments to domestic tax legislations one could still take protection under the respective Tax Treaties.

Determining the income attributable to the significant economic presence in India would be complex and a highly subjective exercise. Given that these provisions are still at a nascent stage, adequate guidance on this front would be required.

The proposed amendment in the domestic law will enable India to negotiate for inclusion of the new nexus rule in the form of 'significant economic presence' in the Double Taxation Avoidance Agreements. The Memorandum to the Finance Act, 2018 has also clarified that unless corresponding modifications to PE rules are made in respective Treaties, cross border business profits will continue to be taxed as per the existing Treaty rules.

Amendment to the definition of Dependent Agent and aligning the scope of 'business connection' with BEPS Action 7

Under the existing provisions of Explanation 2 to clause (i) of sub-section (1) of section 9 of the Act, "business connection" includes business activities carried on by a non-resident through dependent agents and is similar to the provisions relating to Dependent Agent Permanent Establishment (DAPE) in India's Tax Treaties.

In terms of the DAPE rules in tax treaties, if any person acting on behalf of the non-resident, is habitually authorised to conclude contracts for the non-resident, then such agent would constitute a PE in the source country. However, in many cases, with a view to avoiding establishing a PE under Article 5(5) of the DTAA, the person acting on the behalf of the non-resident negotiates the contract but does not conclude the contract. Furthermore, under paragraph 4 of Article 5 of the DTAAs, a PE is deemed not to exist when a place of business is engaged solely in certain activities such as maintenance of stocks of goods for storage, display, delivery or processing, purchasing of goods or merchandise, collection of information. This exclusion applies only when these activities are preparatory or auxiliary in relation to the business as a whole.

The OECD under BEPS Action Plan 7 reviewed the definition of 'PE' with a view to preventing avoidance of payment of tax by circumventing the existing PE definition by way of commissionaire arrangements or fragmentation of business activities.

In order to tackle such tax avoidance scheme, the BEPS Action plan 7 recommended modifications to paragraph (5) of Article 5 to provide that an agent would include not only a person who habitually concludes contracts on behalf of the non-resident, but also a person who habitually plays a principal role leading to the conclusion of contracts. Similarly, Action Plan 7 also recommends the introduction of an anti-fragmentation rule as per paragraph 4.1 of Article 5 of OECD Model tax conventions, 2017 so as to prevent the tax payer from resorting to fragmentation of functions which are otherwise a whole activity in order to avail the benefit of exemption under paragraph 4 of Article 5 of DTAAs.

To facilitate the above modifications in Tax Treaties, the recommendations under BEPS Action Plan 7 have now been included in Article 12 of the Multilateral Convention to Implement Tax Treaty Related Measures (herein referred to as 'MLI'), to which India is also a signatory. Consequently, these provisions will automatically modify India's bilateral tax treaties covered by MLI, where the Treaty partner has also opted for Article 12. As a result, the DAPE provisions in Article 5(5) of India's tax treaties, as modified by MLI, shall become wider in scope than the current provisions in Explanation 2 to section 9(1)(i).

Similarly, the antifragmentation rule introduced as per paragraph 4.1 of Article 5 of the OECD Model Tax Convention, 2017 has narrowed the scope of the exception under Article 5(4), thereby expanding the scope of PE in DTAA vis-a-vis domestic provisions contained in Explanation 2 to section 9(1)(i) of the Act. In effect, the relevant provisions in the DTAAs are wider in scope than the domestic law.

In order to align the DAPE provisions under section 9(1)(i) of the Act with the provisions in the DTAA as modified by MLI, the term "business connection" has been amended to include any business activities carried through a person who, acting on behalf of the non-resident, habitually concludes contracts or habitually plays the principal role leading to conclusion of contracts by the non-resident.

It is also proposed that the contracts should be –

i. in the name of the non-resident; or

ii. for the transfer of the ownership of, or for the granting of the right to use, property owned by that non-resident or that the non-resident has the right to use; or

iii. for the provision of services by that non-resident.

The above amendments ensure that India's domestic tax law is now in line with the Tax Treaties in the above context.

Proposal for amendment of rules for profit attribution to permanent establishment

The Central Board of Direct Taxes ("CBDT") issued a recommendatory report on attribution of profits to PEs on 18th April 2019, prepared by a Committee formed by the CBDT for the said purposes. The CBDT is yet to finalise its views on such issue, which are expected to be introduced through amendments to the provisions of the Act and the Income-tax Rules, 1962 ("Rules").

In summary, the Committee has said that arm's length principles under transfer pricing cannot be applied for attribution of profits to PEs under the Indian model tax treaties; and that a formulary approach needs to be adopted for such attribution, by applying the global operational profit margin of a foreign enterprise to the revenue derived from India, as further adjusted with references to certain weightages relating to various factors.

From a digital economy perspective, the Report recommends adoption of user base as an additional factor for attribution of profits under the formulary approach in view of the increased role of user contribution in digital businesses.

One would have to wait and see how the above recommendations would be implemented and the impact it would have on the MNCs carrying out cross border transactions.

India’s positions on some important transactions in the context of the digital economy

The Indian Tax Authorities, under the current domestic tax legislation, have been seeking to tax e-commerce and internet-based business models in a manner that conflicts with international approaches. Global enterprises catering to Indian customers have faced difficulties as a consequence and there has been significant litigation in this respect, especially in relation to characterisation of income and withholding taxes.

Issues discussed in the OECD Commentary	Views of the OECD	Position adopted by India
Leasing of tangible or intangible property like industrial, commercial and scientific equipment, etc.	Leased facility will not constitute a PE of the lessor provided the contract is limited to the mere leasing of the ICS equipment	Tangible or intangible properties by themselves may constitute a PE of the lessor in certain circumstances
Enterprise having significant economic presence	As discussed above – subject to the final report to be issued in 2020	India reserves the right to include an enterprise having a significant economic presence in a Contracting State, based on criteria identified in Chapter VII of the final report on Action 1 of the BEPS Project.
Website hosting arrangements	Website hosting arrangements do not typically result in the server and its location being at the disposal of the enterprise, even if the enterprise has been able to determine that its web site should be hosted on a particular server at a particular location. In such a case, the enterprise does not have a physical presence at that location since the web site is not tangible. Thus, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement	An enterprise can be considered to have a place of business through a website on any equipment, if opening the website on that equipment includes downloading of automated software, such as cookies, which use that equipment to collect data from that equipment, process it in any manner or share it with the enterprise
Definition of royalty		India reserves the right to include in the definition of royalty, payments for the use of, or the right to use, industrial, commercial or scientific equipment.

Income characterisation in the context of the digital economy has assumed immense significance given the various reservations expressed by India to the OECD positions and also the aggressive approach of the Tax Authorities in India. The views expressed by the Courts in India on a few contentious issue in the digital space are summarised below:

Sale of software

Tax authorities argue that consideration for sale of off-the-shelf software from foreign vendors to customers in India should be characterised as royalty income which will be subject to withholding tax (of around 10% on a gross basis) in India. In ordinary cases (based on internationally recognised approaches) such income should be characterised as ordinary business profits since the sale of software does not lead to a license of the underlying intellectual property. The income arising from an ordinary sale of software would then be taxable in India only if the foreign vendor has a PE or a business connection (in the absence of a tax treaty) in India.

While on one hand, various judicial precedents have held that the transactions involving payment for outright purchase of software should not be regarded as royalty by clearly outlining the distinction between transfer of a 'copyright' and a 'copyrighted article'; contrary views have also been taken where payments for software have been characterised as royalty.

The Karnataka High Court in the case of *CIT vs Synopsis International Old Limited 28.taxmann.com 162 [2012],* held that the words "transfer of all or any of the rights" includes the right to grant license in respect of copyright. In this case, the High Court drew attention to the expression 'in respect of' which means attributable to, hence giving it a broader meaning.

This view was upheld by the Karnataka High Court in the case of *CIT vs Samsung Electronics Co Ltd 16 taxmann.com 141 [2011].* The Karnataka High Court in the case of *CIT vs Sonata Information Technology Ltd, 21 taxmann.com 312 [2012],* after considering both the above cases reiterated that consideration of right to use software/computer programme in respect of copyrights falls under 'royalty' as defined under sub clause (v) of Explanation 2 to clause (vi) of section 9(1) of the Act. This matter is now pending before the Apex Court of India.

Furthermore, subsequent to the insertion of explanation 4 to the amendment made to section 9(1)(vi) of the Act vide Finance Act, 2012, the scope of royalty under the Act has been expanded to include use of computer software. The memorandum to the Finance Bill, 2012 states that the object behind the amendment was to clarify that the **consideration for use or right to use of computer software is royalty.** Hence, on the basis of the judicial precedents as discussed above and on the insertion of explanation 4 to section 9(1)(vi), payments for use of off-the-shelf or shrink-wrapped software would fall under the definition of royalty under the Act.

Website as a PE

Website hosting is provision of space on server to store information relating to a website. OECD is of the view that website hosting arrangements do not result in PE for the enterprise that carries on business through the hosted web site as the OECD believes that these contracts typically do not result in the server and its location being at the disposal of the enterprise. However, India does not agree with the above interpretation and is of the view that depending on the facts, an enterprise can be considered to have acquired a place of business by virtue of hosting its website on a particular server at a particular location.

Notwithstanding the above, in line with the OECD's position, the Indian Tax Authorities in the case of *ITO vs Right Florists Private Limited (154 TTJ 142)* have held that website does not constitute a PE and reservation of India on OECD commentary would have no impact on the interpretation.

In addition to the above, the Mumbai Tribunal in the case of *DDIT vs Savvis Communication Corporation IT Appeal no. 7340 (Mum) 2012]* held that payment received by assessee, an American company for providing web hosting services though involving use of certain scientific equipment could not be treated as 'consideration for use of, or right to use of, scientific equipment' which is a sine qua non for taxability under section 9(1)(vi), read with Explanation 2 (iva) thereto and also Article 12 of Indo-US Tax Treaty. However, it is pertinent to note that the definition of royalty under the Act was amended to cover payments for access to or use of scientific / technical equipment even if no control / possession is granted over the equipment. Given this, payments made for website hosting could also fall under the ambit of the definition of royalty under the Act, post the amendment.

Subscription to online database

Subscription to online database access is yet another example which remains a major litigated issue in India. Such database access could be for various types of information such as knowledge, portals, industrial reports, research reports etc. Typical tax issues encountered on evaluation of the online database transactions are whether the transaction can be treated as royalties, based on whether the payment is towards a right in a copyright or whether the payment is for imparting industrial, commercial or scientific information.

In this context, the Karnataka High Court in the case of *CIT vs Wipro Ltd [IT Appeal NOS. 2804, 2805 & 2807 OF 2005]* held that the payment made by the subscriber (Wipro) for access to online database (provided by Gartner) is in the nature of royalty as what is granted to the subscriber is a licence to have access to the database maintained by Gartner owing to which, there is transfer of copyright right. Accordingly, the payments made by the subscriber were in the nature of royalty and the same cannot be considered akin to subscription made to a journal or magazine. This view has also been upheld by the Bangalore Tribunal in the case of *ITO vs Cross Tab Marketing Services Private Limited [ITA 1507/ Bang/2012] and the Mumbai Tribunal in the case of Gartner Ireland Limited vs ADIT [ITA No 7101/ Mum/2010].*

Concept of a virtual PE

The Indian Tax Authorities are also beginning to recognise the concept of a virtual PE. In this context reference may be drawn to the decision of the Delhi Tribunal in the case of *Amadeus Global Travel v. DCIT 19 SOT 257 (2008)*, wherein the Delhi Tribunal concluded that booking fees received from Indian entities by non-resident companies providing computerised reservation system are liable to be taxed in India. The Tribunal came to the conclusion on the ground that these companies have a "virtual presence" in India which constitutes a virtual PE.

Furthermore, in the context of the India-UAE Treaty, the Bangalore Tribunal in the case of *ABB FZ - LLC vs Deputy Commissioner of Income Tax [IT(TP)A.1103/ Bang/2013 & 304/Bang/2015]* held that in order to determine whether a service PE under the India-UAE Treaty has been established, it is not important to determine the number of days the employees of the non-resident company have been in India, but rather the number of days the non-resident company has been providing services in India on a continuous basis. The Tribunal further stated that in this age of technology such services could be easily provided without having employees physically present in India.

Internet domain receipts

Domain name registration is the process of registering a domain name that identifies one or more IP address with a name that is easy to remember and use in URLs to identify particular web pages. In a recent decision, the Delhi Tribunal held that receipts from domain name registration by GoDaddy.com LLC will be taxable as royalty in India given the fact that "the rendering of services for domain registration is rendering of services in connection with the use of an intangible property which is similar to trademark." The Tribunal concluded that the charges received by the taxpayer for services rendered in respect of domain name were taxable as royalty within the within the meaning of clause (vi) read with clause (iii) of Explanation 2 to section 9(1) of the Act.

Concluding remarks

The Indian Tax Authorities, under the current domestic tax legislation, have been seeking to tax e-commerce and internet-based business models to maximize tax revenue with aggressive positions. Global enterprises catering to Indian customers have faced difficulties as a consequence and there has been significant litigation in this respect, especially in relation to characterisation of income and withholding taxes.

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