TAXING DIGITAL ECONOMY: EMERGING TRENDS AND ARGUING FOR SOURCE-BASED TAXATION

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Abstract—The new digitalized way of conducting business has a severe impact on the collection of public revenue, which directly affects the execution of government welfare schemes and plans such as MGNREGA (Mahatma Gandhi National Rural Employment Guarantee Act, 2005'). Corporate giants such as Facebook, Amazon, Apple, Netflix, Google etc. are conducting their digital businesses, virtually and are generating huge profits in emerging Asian and African economies such as India, without paying their share of due taxes, by applying tax strategies such as 'treaty shopping', 'forum shopping', etc. Digital Economy has completely changed the rules of business and transactions as also the manner of conducting business because of its digital presence which also carries tax disruptive technologies. The success of the digital economy largely depends on International Tax Rules, based on negotiating sovereignty. Accordingly, an international consensus is required to reform existing international tax rules in order to make them compatible with the growing digital economy and already existent tax laws of the State, without compromising their sovereignty to tax. At a fundamental level, international consensus is the need of the hour. In the first part of this research paper, the growth of the digital economy and its overall impact on the present direct tax structure (both, domestic and international) in collecting fair taxes, has been discussed. In the second part, the tax strategies applied by the multinational

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Companies challenging the existing rules of Permanent Establishment, have been examined. In the third part, the building of the international consensus for taxing the digital economy in order to tackle tax strategies has been discussed whereas the fourth part discusses, the evolution of the digital economy and the manner in which it works. The fifth and sixth part examine the challenges faced in taxing the digital economy and the impact of the application of traditional rules of international taxation on the digital economy. The seventh part analyses the existing unilateral trend of charging the digital economy by various countries such as USA, United Kingdom, Australia and India. In the eighth part, the international initiatives from 'Ottawa Taxation to BEPS 2.0 Action Plan One' to 'Pillar 1 and 2 Initiatives' have been analysed to check their viability in the present scenario. At the end, the ninth part argues for source-based taxation.

Keywords: Digital Taxation, Digital Economy, Equalisation Levy, Permanent Establishment, Base Erosion, Profit Shifting.

I. INTRODUCTION

In the 'digital economy', the businesses which are being 'conducted digitally'[1] and 'digital businesses'[2] are generating profits, without paying adequate taxes.[3] Levying tax is a sovereign function of the State by which it raises funds, for spending on various types of public services including, maintenance of law and order and protecting the State from the external aggression. The State, time to time, also executes various types of welfare schemes and programmes for the marginalized and disadvantaged persons of the society, by charging and collecting taxes. Taxation therefore, is one of the most essential functions of the State, which provides a conducive environment necessary for

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1 The businesses which are "conducting digitally" are those, which have structured their businesses virtually. These businesses are conducting online board room meetings on virtual platforms, using cloud services for creating their presence in different parts of the world, thus, bypassing the tax rules of the States.

2 'Digital businesses' are those businesses, which deal in digital goods and services such as Netflix, Google, Apple, etc.

3 Adequate taxes refer to the actual tax paid by similar companies in the similar situation. Digital companies, such as Google via advertising, generate much larger volume of profits in India, than the tax paid by them and therefore, by Finance Act, 2016, India came up with equalisation levy.

the persons to develop.[4] The business *firstly*, generates profit and big businesses with better technological tools generate big profits, by utilizing the economic and social resources of the State. *Secondly*, liberalization of the economies leads to increase in the cross-border trade and transactions, by multiple times. *Thirdly*, tax strategies allow multinational companies to conduct their businesses, by bypassing paying the taxes, both in the 'Resident' as well as in the 'Source' State.[5] These models on the one hand are penetrating the economies, especially the developing economies to the core while on the other hand, they have started disrupting the domestic tax law structure of both the developed and developing economies. It has started challenging the international taxation rules, which are based on traditional profit allocation and territorial nexus rules (Permanent Establishment). These digital giants are growing exponentially and continued to grow even when the pandemic[6] was at its peak. But, despite thereof, their contribution to the State in the nature of tax, is extremely limited. The 'Fourth Industrial Revolution' is responsible for completely changing the rules of engagement – between humans and technology.[7] Either through e-commerce or through Information and Communication Technology ('ICT') or goods and services provided through online platforms such as, Amazon or Flipkart – the digital economy is penetrating human relations with technology. More than 749 million internet users were reported in India in 2020, and by one estimate, this number will grow up to over 1.5 billion by 2040[8], which clearly indicates, as to how huge, the Indian market would be. The coming decade is going to be a 'Techade'[9] and the technology will drive this decade[10]. Already, in 2019, India ranked second, only after China as an online market[11]. Similar, is the situation in African nations, where there are more than 200 million Facebook users and more than 21 million people are regular users of online platforms.[12] This increase in the profit numbers of the digital giants like Google in India, does not correspond with the tax revenue shared by them with the Indian tax authorities and with the other rising economies of the world

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4 *See* Lorenzvon Stein, On Taxation, translated from German by Jacques Kahane in R.A. Musgrave (eds.), Classics in the Theory of Public Finance, p. 28, International Economic Association, 1958.

5 *See* Smarak Swain, Loophole Games: A Treatise on Tax Avoidance Strategies, 148 (Wolters Kluwer 2020).

6 The Spread of Covid-19 (Coronavirus) from March 2020 to March 2022 (approximately).

7 *See* Klaus Schwab, The Fourth Industrial Revolution, 18-19 (1st ed., Portfolio Penguin United Kingdom 2016).

8 The penetration of internet usage is equal in both, rural and urban populations in India.

9 The term Techade has been used by the Finance Minister of India, Ms Nirmala Sitharaman for explaining the present decade as the decade of technology.

10 Finance Minister, Ms Nirmala Sitharaman, *Upcoming Decade is Going to be a 'Techade': Sitharaman*, The Sunday Express, November 13, 2022, p. 13.

11 Tanushree Basuroy, *Number of Internet Users in India 2010-2040*, July 27, 2022, https://www.statista.com/statistics/255146/number-of-internet-users-in-india/ (last visited on Dec 26, 2022).

12 See Favourate Y. Mpofu, *Taxation of the Digital Economy and Direct Digital Service Taxes: Opportunities, Challenges, and Implications for African Countries*, Economies, vol. 10, p. 219.

which is an area of deep concern as it can have larger ramifications on the functioning of the State.[13]

II. MULTINATIONAL COMPANIES, DIGITAL ECONOMY AND STRATEGIC TAX PLANNING: EMERGING TRENDS IN PERMANENT ESTABLISHMENT ('PE') OR MOVING AWAY FROM IT?

There is a strong need to build new rules for charging tax on cross-border trade, keeping in mind the growth and impact of digital economy on national and international tax laws, so as to remove the mismatches between the tax rules and the way, the digital economy works. This ultimately will reduce the chances of tax planning by the big MNCs, which often do so, to reduce or evade their tax liabilities. These big digital giants[14], often opt for Artificial Avoidance of their PE[15], by way of various tax strategies such as (i) through Commissionaire arrangements , a foreign company engages in the sale of their goods in the local market of the State, although this is not done directly, but, through local distributors of the area. And, the local distributors become the agent and thereby, can be classified as Agency PE. Therefore, these big digital multinational corporations have made changes to the agreement between the foreign company and the local distributors, whereby, the local distributors are termed as the commission agents. And, in this way they easily avoid creating any PE in the Source State.[16] (ii) The foreign companies also follow the anti-fragmentation rules, by which they, relocate the already coherent activities of the corporation, by breaking these activities into small operative activities to be done by the different businesses and in this way, they convert the activities either into preparatory or auxiliary activities[17] and take the benefits

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[13] See "*Google, Facebook made Rs 10,000 Crore; paid Rs 200 Crore as Tax in India, Modi Government Plans to Bring Companies that Derive Revenues from Indian Users but Pay Taxes Elsewhere into the Corporate Tax Net*", Business Standard, July 9, 2019, https://www.business-standard.com/article/companies/google-facebook-made-rs-10-000-crore-paid-rs-200-crore-as-tax-in-india-119062700393_1.html, (last visited on Feb. 2 2023). Also see Sachin Dave, "*India Wants Fair Share of $100 Billion Global Taxes from Google, Facebook*", The Economic Times, 27.02.2020, https://economictimes.indiatimes.com/tech/ites/india-wants-fair-share-of-100-billion-global-taxes-from-google facebook/articleshow/74328198.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst, (last visited on Feb. 11, 2023).

[14] Here the term "Digital Giants" is used to manifest the MNCs who do Digital Businesses such as Facebook, Amazon, WhatsApp,Google, Apple and Netflix, etc.

[15] Art. 5 of OECD Model Tax Treaty provides a provision for the PE, which connects the physical presence of foreign entities with the Source State for the purposes of charging tax.

[16] See Nilesh Modi, Thelaw and Practice of Tax Treaties, 399–410 (2nd ed. CCH, a Wolters Kluwer Business, India 2014).

[17] See Smarak Swain, Loophole Games: A Treatiseon Tax Avoidance Strategies, 148 (1st ed.,Wolters Kluwer, India, 2019).

of DTAAs.[18] (iii) The MNCs also many times, for the purpose of executing their contracts, split their contracts into multiple parts, to be executed by multiple companies, where the time required for completion of the contracts is more than six months[19], so as to, conveniently complete the big projects and contracts, by bypassing the duration threshold of the DTAAs[20], which many a times is six months[21]. (iv) Similarly, is the case of, 'thin capitalization', in which an entity has more debt than the capital owned by it, and accordingly, is liable to pay less tax. This situation is intentionally created to avoid tax liability. There are other tax issues also which are affecting the digital economy such as online peer-to-peer transactions, the gig-economy, etc. Presently, there is also a strong need to build an international consensus on regulating crypto-assets[22], which work virtually, without any physical presence and which carry a possibility of leading to a new economic crisis.[23] Indubitably, India is slowly and steadily, heading towards, a digital economy. But, this is also a hard-corefact that their share of public revenue is shrinking every day and it is not proportional to the increase in the footfalls of digital businesses in their territorial boundaries.[24] And, in the absence of adequate collection of public revenue via direct taxation, it would be impossible for these economies to fulfil their commitments related to Sustainable Development Goals ('SDGs') by 2030.

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[18] The Double Taxation Avoidance Agreements ('DTAAs') are bilateral in nature and are executed between the two States, so as to avoid charging double tax on a single transaction of goods or services. These agreements are based on the customary rule of International law, *pacta sunt servanda*. For example, 'X' a Company is engaged in trading goods in a Country 'A' and has paid source-based tax there. Later, if the said Company is paying taxes on the same transaction in its resident Country 'B' also then this makes a case for double taxation. The primary purpose of DTAAs thus, is to avoid the above situation of charging double tax on the same transaction. By DTAAs, two countries agree on charging 'source based taxation' and 'resident based' taxation on different transactions. For example, countries may agree to charge residence based taxation on royalty income, whereas, source based taxation on rent income generated from the immovable property. See also Vienna Convention of the Law of Treaties, 1969, art. 26.

[19] Generally, while executing the big construction contracts, MNCs follow split contract method, by paying less or nil tax in the Source State.

[20] See Klaus Vogel, *Double Tax Treaties and Their Interpretation*, vol. 4, International Tax & Business Lawyer, pp. 5–6(1986).

[21] Art.5(4) of the Model OECD Tax Treaty.

[22] See Reuters"*G20 Wants to Build Consensus on Crypto Assets*", The Indian Express, p. 17, Thursday, December 15, 2022, The consensus was also built to study the impact of crypto assets on the economy, monetary policy and the banking sector.

[23] See ENS Economic Bureau, "Next Crisis will Come fromPrivate Cryptos: RBI Governor", The Indian Express, p. 17, Thursday, December 22, 2022.

[24] See Dilasha Seth, "*India Notifies Digital Tax Threshold of Rs 2 Crores and 300,000 Users, This is Part of the Significant Economic Presence (SEP) Principle, Which was Introduced in the Finance Bill 2018-19*", The Business Standard, May 04, 2021, https://www.business-standard.com/article/economy-policy/india-notifies-digital-tax-threshold-of-rs-2-croreand-300-000-users-121050400156_1.html, (last visited on Feb. 11.2023).

III. PARADIGM SHIFT: TAXING DIGITAL ECONOMY WITH INTERNATIONAL COOPERATION

The digital economy has opened new ways of conducting business based on value generation, data storage and transfer.[25] And, these big digital giants to establish their businesses, far from their consumers and where either little or practically, negligible economic activities take place.[26] In fact, the revenue generation of these businesses is not merely from the customers, but rather through virtual effects and networking. Digital businesses are based on algorithms and therefore, are in a positive position to provide a seaming service chain, which helps in fulfilling the demands of the customers easily even from very far. In this way, data generation plays a huge role in collecting information and data processing helps in reaching better corporate goals, which also means that the digital economy works more with the unprecedented use of intangible property, along with the personal data information of the customers. OECD (The Organization for Economics Cooperation and Development) has been working for quite a long time on the action plan for the Base Erosion and Profit Shifting ('BEPS') project. On 08.10.2021, first time ever, 140 OECD members mutually agreed to have, the Inclusive Framework on BEPS,[27] which is based on a two-pillar structure. The 'Pillar One' introduces an altogether new system of allocating the taxing rights over the digital giants (multinational enterprises) to the jurisdictions, where the income is earned and profits are generated.[28] The 'Pillar Two', on the other hand, provides for the reduction of chances for base erosion and profit shifting.

Tax Strategies and Differential Standards of Treatment by States: Some Interconnections: The differential standard of treatment amongst the States helps the corporate and digital giants avoid payment of taxes by using tax strategies. Profit shifting is one such tax strategy which is used by the corporate giants through the 'Intra Group Services' model, to avoid the payment of taxes by using the domestic tax laws of two or more States. For example, a Company 'A' (Holding Company), resident of State 'X' (Low Tax Jurisdiction) can outsource its non-core services such as marketing, sales and other related

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[25] See Michael P. Devereux, Alan J. Auerbach, Michael Keen, Paul Oosterhuis, Wolfgang Schön, and John Vella, Taxing Profit in a Global Economy: A Report of the Oxford International Tax Group, p. 13,1st ed. Oxford University Press, United Kingdom 2020) and Omri Marian, "*Taxing Data*", 47(2) Brigham Young University Law Review, pp. 511-576(2022).

[26] Victoria Plekhanova, "*Value Creation within Multinational Platform Firms: A Challenge for the International Corporate Tax System*", 17(2) EJournal of Tax Research, p. 284, March 2020.

[27] These reforms are also addressed as 'BEPS 2.0 reforms'.

[28] In many ways, from the very outset, Pillar One looks like a revolutionary step rather than an evolutionary one. See Reuven S. Avi-Yonah, *A Positive Dialectic: BEPS and the United States*, 114 American Journal of International Law Unbound, p. 258 (2020).

administrative services such as procurement[29] to another Group Company 'B' (Operational Company) situated in State 'Y' (High Tax Jurisdiction). Now, by using this strategy, the operational Company 'B' makes payment for the intra-group services to Company 'A' and in this way, books the expenses and reduces the profits in the books of accounts. Indubitably, in a perfect world, it is a good business strategy. But, if the purpose of such transactions is shoddy, then, it is easy to make sham or excessive payments or simply change the character of the payments in this manner. A number of times, in such cases, operational companies hardly hire any staff, and therefore, it is easy to identify. Now, if States 'X' and 'Y' have a DTAA, according to which, there is no tax on management services, then the whole income transferred to State 'X' would be tax-free. To avoid such situations, corporate transparency is promoted through international initiatives, such as the exchange of information. Anti-avoidance and anti-treaty abuse rules have also been introduced in order to check strategic tax planning. The initiative is also to propose changes in domestic tax laws so as to be in consonance with the present norms of the digital economy. The States have also started taking unilateral measures such as the 'Digital Services Tax' and 'Equalization levy[30]' which is alarming, as it may lead to unhealthy tax competition.

IV. EVOLUTION OF DIGITAL ECONOMY

Taxing the digital economy is all about racing against time and technology. The moment, the State is able to tackle, one of the many issues of digital technology, a new technology pops up with altogether different dimensions.[31] The incident of Digital Economy happens, whenever any transaction, consisting of both the digital products[32] and digital industries[33] happens in an economy. The digital economy consists of those economic activities, whose factors of production are primarily 'digitized information and knowledge'[34]. Digital technologies, such as the internet and fintech along with cloud computing and big data primarily analyse the information collected and stored, which later can be used to drive innovation in an economy. The issues that emerge out of the digital economy are not so trivial to be termed as a tempest in a teapot,

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[29] These services are primarily known as 'Intra-Group Services' and are inclusive of 'Management Services'.

[30] India had started charging two percent 'equalisation levy' from 01.04.2020, by way of the Finance Act, 2016, s. 165-A.

[31] The digital economy has grown from, an online platform-based business, such as Amazon or Google to online platform-related activities, such as gig-economy/sharing economy, which are posing challenge to the existing tax structure.

[32] Digital products consist of those goods and services, which essentially generate, process and store digital data, such as 'software development', 'online gaming', 'web publishing', 'online media streaming', 'telecommunication services' and 'support services', etc.

[33] The industries which produce digital products and services are termed as digital industries. Amazon, Netflix, E-bay and Uber are classic examples of digital products and services.

[34] Information and Knowledge in the virtual form – Software.

rather they have disrupted the way our civilization was growing.[35] Businesses like WhatsApp are making their mark in an altogether different manner in the business circle and there is no clear and concrete way to regulate such businesses, which do not *stricto* require physical locations though have economic allegiance with the consumers. However, while achieving little success, India has tried a way to check its hold by regulating such businesses.[36]

1. **Economic Transactions and the Digital Characteristics or Elements:** Any economic transaction would be termed as having the elements of digital[37], which primarily relies on data encoding technology. Any economic transaction or business model, that is inclusive of any one of the digital characteristics such as digital automation or digital payment, digital content or digital distribution, etc. can be considered digital. Many of these digital elements are tax-disruptive in nature, which have transformed the way the earlier transactions were done, for example, digital payments [Automated Teller Machines (ATM), online wallets (Paytm, Amazon Pay, etc.), electronic fund transfer, credit and debit cards, etc.], digital contents (software, mobile applications, e-books, websites, digital audio and video, digital images, world wide web, search engines, web pages, cloud data storage, online media streaming, etc.), digital distribution (e-mail, peer-to-peer sharing, online gaming and gambling, online streaming of digital media, etc.), digital communication (internet), and digital automation (customer support, online bookings, search engines, etc.). If we examine, both the digital content and the distribution, two aspects emerge, *first,* is a situation, where only digital content is subject to digital distribution and *second*, is a situation where the transfer or sale of the digital content is only subject to digital distribution. These are tax-disruptive digital economic transactions. Then comes the business models which are tax disruptive[38] in nature.
2. **Digital Business Models with Tax Disruptive Tendencies:** Wherever in any business model, the digital content and distribution along with digital automation are present, it means such digital business models are tax-disruptive in nature. The sale and purchase of digital goods through websites is a classic example of a digital business model. In the case of Netflix, the content (media content, both, audio and video) is also

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[35] See Maria S. Domingo, *Queen's Gambit 2.0 the International Tax Edition: What If Someday the Whole Game Changed?*42 North East Journal of Legal Studies, pp. 48-49 (2022).

[36] Anirudh Suri, The Great Tech Game: Shaping Geopolitics and the Destinies of Nations, 328 (1st ed. HarperCollins Publishers India, 2022).

[37] Digital generally means, 'Binary Digit Data Coding Technology'.

[38] Tax disruptive business models carry digital presence instead of physical presence, thus, the existing rules of income tax in the present form are not applicable to them, as they are applicable only to those foreign entities, which, either have a physical presence/permanent establishment in India or have a business connection with significant economic presence in India. Thus, tax disruptive business models affect the effective and efficient collection and administration of income tax under the Income Tax Act, 1961 over those businesses, which have digital elements.

digital, its distribution is in a digital form (online streaming) and there is a presence of digital automation (it can be accessed either through computers or mobile applications, with the help of active internet connection and its payment is also made through an online gateway). Easy access to broadband internet with almost negligible cost is provided by the source country, which is necessary to have enough Wi-Fi infrastructure, where both the digital content provider and the digital content access are at ease which has really multiplied the market of these digital business models. Many traditional functions such as payment have been transformed in many ways in the present times (online payment). There are digital business models, where the goods and services still need to be delivered via door services, in such cases, it is convenient for the tax authorities to tab the economic transactions in an economy. There is another business going on at the backside which is the monetization of the personal data of the users/consumers, which is sold by the digital content providers without the knowledge of the consumer. This includes (i) the sale of the user's behavioural data which consists of lifestyle, attitude, values and most importantly, the personality of the user (ii) the sale of the user-created content, which is provided voluntarily by the user, for example, the content created on the blogs, reviews on the websites, the shared media files, etc. (iii) sale of user-created contents, for example, the video games and other fun related activities (iv) sale of users' demographic data (gender, race, income, education and other personal data)and (v) sale of users' internet activities and access to digital advertisement. In such a type of business model, the user is paying cost for the access to digital business models by accessing internet services whereas, the business model is not paying anything for collecting and distributing such data. The above referred collected data is also helpful for the digital business, as helps in enhancing the digital experience according to the preferences of the consumers. There are various types of digital business models, which are tax disruptive in nature, for example (i) user-related digital business model (user contributed data such as Facebook, LinkedIn and Instagram, user targeted digital advertising such as, Google Ads and YouTube), (ii) content related digital business model (Kindle store is the example of sale of non-user content and Oracle and Microsoft are related to non-user licensing of the digital content and subscription based non-user content such as Amazon Prime) and (iii) multisided digital business platforms such as Amazon and Flipkart.[39] Digital business models, lack physical presence and can be termed as scale with the mass.

[39] See Cristian Oliver Lucas-Mas and Raul Felix Junquera-Varela, Tax Theory Applied to the Digital Economy: A Proposal for a Digital Data Tax and a Global Internet Tax Agency, 23 (1st ed. World Bank Group, Washington, DC, US, 2021).

V. CHALLENGES IN TAXING DIGITAL ECONOMY

There are significant challenges posed by the digital economy. *Firstly*, because of its virtual nature, it requires least physical presence and therefore, it is very easy for such companies to follow tax strategies. *Secondly*, the international taxation rules (Permanent Establishment rules) have been ineffective while charging tax on the digital economy and therefore, it is easy for the big corporations to do tax planning. *Thirdly*, lack of effectiveness of the domestic tax laws in charging tax on the digital economy, in consonance with the international tax rules. In fact, India carries, both, the effective law to calculate tax on the basis of Arm's Length Price ('ALP') while applying transfer pricing provisions[40] and also the provision to charge tax on the profits earned by the foreign company, if the economic activities happen within the parameter of the concept of the significant economic presence[41] or under the definition of PE. *Fourthly*, non-applicability of traditional rules of Income Tax Laws, in the digital economy. *Fifthly*, it is difficult to tax all incomes generated from the shared economy or peer-to-peer economy or gig economy such as, Uber, Ola, Airbnb etc., because it is very difficult to characterize the nature of the transactions happening on these Applications. For example, whether the person who is working with Fever or Guru Applications would be termed as an employee or an independent professional and similar, is the fate of transactions in cases related to taxi apps such as Uber and Ola. *Sixthly*, the digital economy works more on intangibles such as brands, intellectual property rights (IPR), goodwill etc., which are often located in the low-tax nations. It is necessary to tackle these challenges, before resorting to digital business transactions and models, which are tax-disruptive in nature.

VI. APPLICATION OF TRADITIONAL INTERNATIONAL TAX RULES ON DIGITAL ECONOMY: THE GAPS AND ROAD AHEAD

The traditional international taxation rules revolve around business connection tests[42] and PE, therefore it is essential to see its application in the context of the digital economy, particularly, digital business models (tax-disruptive) and economic transactions. The Finance Act 2018 has introduced the concept of Significant Economic Presence (SEP)[43] whose purpose is to tax the business profits arising out of the activities, which have an economic allegiance with India. SEP, therefore, is applicable in the case of those economic transactions also, where the digital content (software download) is downloaded and

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[40] See ITA, 1961, ch. X.

[41] See ITA, 1961, s. 9.

[42] See ITA,1961, s. 9. It taxes all the income accruing or arising in India (whether directly or indirectly) through or from any business connection in India.

[43] See ITA, 1961, s. 9(1)(i) expln. (2-A).

is under consideration. The provision is further amended by the Finance Act 2020, where SEP is considered to be applicable in those cases where all the operations of the company are not carried in India, in such circumstances, only that income is subject to tax, which can reasonably be attributed to the operations carried out in India. For the time being, the application of this provision is deferred for the financial year 2022-2023. Now, let us examine PE in the digital economy in the Indian context. Let's take an example, Company A has its registered office in the US and provides maintenance services to the IT infrastructure, remotely in India, through an automatic machine (works on Artificial Intelligence). Company A also has a subsidiary, Company C, which provides support functions. The automatic machine sent by Company A is assembled in India by Company C. Company A maintains the IT infra through clips, images, and live streaming sent by the Automatic Machine. In the US, the AI-based software analyses the information sent by the automatic machine and thereby, better maintains the infrastructure. The machine was in India for around 95 days. Now, there are various questions which have to be addressed (i) whether the automatic machine can be termed as Fixed Place/Equipment PE in India, or any other type of PE such as, Service PE, etc.? Article (5) of the DTAA, defines the term PE, according to which, certain conditions need to be fulfilled such as there has to be a place of business where a business activity is being performed and which must be located at some place and the foreign company should have to right to use such place, for a certain period of time. All the above conditions need to be fulfilled to be called a PE. The Supreme Court had applied 'a disposal test' and held that the racing track was at the disposal of the foreign company, which makes a case for PE in India.[44] Though it is still convenient to read automatic machines/Robots into the traditional PE, but when it comes to digital business models and transactions, it would be difficult but to apply. And therefore, the countries in the absence of any multilateral treaty, opted to take unilateral stands. The unilateral steps taken by some of the States to tax the digital economy are discussed below.

VII. UNILATERALLY TAXING DIGITAL ECONOMY: AUSTRALIA, UNITED KINGDOM AND INDIA

In the absence of any multilateral tax treaty, the countries are losing their tax base very quickly, and therefore, many of them have come up with indigenous ways of charging tax on the digital economy.

1. **India:** India in 2016, by way of a Finance Act 2016, as a unilateral measure, started charging equalization levy[45] on digital transactions in India. The same is criticized by many developed States such as the US as the levy is inconsistent with the tax treaties of India, though it is not on the net income. In fact, in 2020, the scope of the equalization levy

[44] Formula One World Championship Ltd. v. CIT, (2017) 15 SCC 602.
[45] See the Finance Act, 2016, s. 165-A, ch. VIII.

was expanded and now it is reduced from 6 per cent to 2 per cent and it is chargeable on any transactions related to e-commerce, where any consideration is either received or is receivable. Interestingly, the equalisation levy is not introduced in the ITA 1961 but is introduced through a Finance Act 2016.

2. **Diverted Profits Tax ('DPT') of the United Kingdom:** DPT was enacted before the BEPS project and was applicable from 01.04.2015. The Act was intended to tackle the issues arising from Google's Double Irish Dutch Sandwich. To understand this concept better, let's look at the example, Company 'X' (a US Company of the Multinational Corporate Group) owns a Company 'Y' (a subsidiary), a resident of Ireland. The Company 'Y' is the owner of all the Intellectual Property (IP) and by way of an arrangement, it licenses all its Intellectual Property Rights to another Company 'Z' (resident of Netherlands). The Company 'Z' also, by way of an arrangement, further transfers all its Intellectual Property Rights to another Company 'A' (resident of Ireland itself). Now,Company 'A' has all the ownership rights over Company 'B'. The Company 'B' does business in UK, by doing sales and other necessary and related services. As per the arrangement, the sales contracts are supposed to be first confirmed by Company 'A'. After carefully going through the above arrangements, it can be easily be gathered that all are sham arrangements and done either to evade paying taxes completely or to pay less taxes. By applying the existing international tax principles, we can easily find that Company 'B', which is subject to tax in UK, is minting huge profits on the basis of cost-plus method[46] and it is also going to pay very less tax. The Companies, 'A', 'Z' and 'Y' because, do not have any PE in UK, therefore, are not subjected to tax in UK. The income of Company 'A' is fully taxable in Ireland and also because all the IP licenses belong to Company 'Z', therefore, the maximum profit generated in the nature of royalties also belongs to it and it will pay most of the profits to Company 'Y' itself, which is situated in a tax haven (Ireland). Here treaty shopping also comes into play. Because of the presence of Netherland-Ireland Tax Treaty, there cannot be any withholding of tax which also means that there would not be any tax charged either between company A and Z or between Z and Y, because Netherlands does not charge any tax on the outbound royalty transactions. Interestingly, these are those tricky scenarios, where even the US Controlled Foreign Corporation (CFC) rules would not be applicable because only Company X is US-based, the rest companies are not US based and even otherwise, the Company Y has its residence in Ireland. The above-referred situation, is fit for the application of UK's DPT because the main purpose of this arrangement is

[46] Cost plus method is one of the most commonly used methods to calculate the transfer pricing of inter-company transactions. This method is applied by comparing the international transactions and profits of a similarly situated third-party corporate with that of the assessee to examine as to whether the assessee corporate is allocating its profits fairly.

tax reduction. Knowingly,the Company 'A' has made this arrangement, so as to avoid making Company 'B', a PE in UK. But, the fact is that it has used UK's economy for the purposes of selling goods and services and the Company has generated huge profits out of it. It is pertinent to note that no one can challenge such actions, because these actions were taken much before the BEPS project, therefore, it is very much within the legal framework. In April 2020, the United Kingdom came up with Digital Services Tax of 2 percent on the profits generated from the businesses of search engines, online markets and various types of social media platforms, which particularly derive their value from the users of the United Kingdom.[47]

3. **Australian Measures to Prevent Tax Avoidance by Tax:** May 2015 was crucial for Australia for the purposes of initiating a unilateral measure, Multinational Anti-Tax Avoidance Law ('MAAL'). The primary purpose of this legislation was to prevent those particular Companies from paying either less taxes or no taxes in Australia,despite they are working and minting profits in Australia. The MAAL is applicable only on those Companies, whose annual turnover is more than AUD I billion[48]. This rule was created to tackle the issues arising out of Double Irish Dutch Sandwich. The explanatory material provided by the Act, clarifies the situation with the help of a situation where Company A owns a Subsidiary Company B in Australia and provides all necessary support for business purposes. All the contracts are entered into by company A, who further pays handsome royalties to the Company C outside Australia in some non-tax jurisdiction, without withholding any taxation. In such a situation, for the purposes of tax, deemed PE status would be given to the Company A, and therefore, the economic transaction, between the Company A and the Company C, which is in the nature of royalties, would be characterised as an expense and therefore, withholding tax would be charged on that.

4. **The US Base Erosion and Anti-Abuse Tax ('BEAT'):** The US, which actively participated in the BEPS project since 2013, took a back step by saying that it already complies with the minimum BEPS standards and therefore, would not go beyond the country-to-country reporting mechanism ('CbCR') and that is why, it did not sign Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ('MLI') and therefore, is not obliged to implement BEPS measures through tax treaties.[49] As far as European Union ('EU') is concerned, it is working hard on Anti-Tax Avoidance

[47] HM Revenue & Customs (HMRC) of UK has introduced the Digital Services Tax. Also see Nicole Lim, *A Digital Economy*, Singapore Comparative Law Review, p. 134 (2020).

[48] See the Income Tax Assessment Act (ITAA), s. 177DA of Australia. It is applicable only to non-residents of Australia.

[49] See Allison Christians and Tarcisio Diniz Magalhaes, *A New Global Tax Deal for the Digital Age*, 67(4), Canadian Tax Journal, pp. 1168-1169 (2019). The US rather proposed to come up

Directives ('ATAD'). Many, therefore, think that US is becoming a tax haven, which is not a correct view. The BEPS principles are going towards the single tax. The Tax Cuts and Jobs Act, 2017 ('TRA,17') was enacted to tax past accumulations and provides for a one-time deemed repartition tax.[50] TRA, 17 in many ways is a departure from the worldwide taxation system to limited territorial taxation, which has the element of minimum tax on foreigners – GILTI[51] provision, which is supposed to tax the income from intangible assets. In BEAT, the taxpayer is required to pay a tax which would be (i) a minimum tax amount and (ii) is related to the base erosion. BEAT is applicable to those Corporations and Real Estate Investment Trusts ('REITs') which have an average annual gross receipt of $500 million dollars for the last three consecutive years. BEAT has received criticism from many quarters.[52] For many, it shows that US has no trust over their own Transfer Pricing mechanism and therefore, it came up with automatic penalties in most cross-border related party transactions.[53] One can think that it is a case of violation of tax treaty by the US, which is not the case because it is not equivalent of a denial of deduction.[54] Even otherwise, BEAT is applying a true minimum tax on those Companies, who are making inward investments with the related US based Companies.[55] These unilateral stands taken by various countries are though safeguarding their countries' interest by applying tax sovereignty but, it would definitely affect the treaty network. And, therefore, it is necessary to implement uniform international initiatives and in this regard, October 2021, BEPS initiatives can be termed as landmark in this context.

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with a mechanism for creating taxing rights in relation to marketing intangibles in order to get back the taxes from Europe to US.

50 See the TRA17, s. 965.

51 Global Intangible Low Taxed Income.

52 E.J. Stevens and P.A. Barnes, *Insight: BEAT Strikes the Wrong Note*, 53 Bloomberg Tax: Daily Tax Report, p. 16, 19th March 2018, https://www.caplindrysdale.com/publication-insight-beat-strikes-the-wrong-note, (last visited on Jan. 12, 2023).

53 See Itai Grinberg, *International Taxation in an Era of Digital Disruption: Analyzing the Current Debate*, 97 Taxes: The Tax Magazine, pp. 79-83, 2019. GILTI lead US to an already acceptable worldwide taxation system, based on outbound transactions.

54 See Reuven S. Avi-Yonah, Advanced Introduction To International Tax Law, 96 (2nd ed. Edward Elgar Publishing, Northampton, US, 2019).

55 See Arthur J. Cockfield, Tax Wars: How to End the Conflict over Taxing Global Digital Commerce, 17(2) Berkeley Business Law Journal, p. 370 (2020).

VIII. INTERNATIONAL INITIATIVES OF ADDRESSING 'TAXING DIGITAL ECONOMY': OTTAWA TAXATION TO BEPS 2.0 ACTION PLAN ONE AND PILLAR ONE AND TWO INITIATIVES.

OECD nations have been taking constant steps to address the issues that arise out of the digital economy.[56] After the Ottawa taxation framework, BEPS Action Plans were the next major steps towards addressing the tax challenges born out of the digital economy. And, since 2013, OECD was also working towards building an international consensus on allocating taxing rights in the present digital economy. Action Plan One addresses the issues of taxing the digital economy whereas the Action Plan Two looks at neutralising the detrimental effects of the 'hybrid mismatch arrangements' of the MNCs. Similarly, Action Plan Seven addressed the problem of 'artificial avoidance' of the PE status intentionally created by the MNCs, as a tax strategy. BEPS 2.0 therefore, can be termed as, one of the major developments of the present century, where, Pillar One and Two are, developed after building an international consensus, to tackle the challenges, both at the level of digital business models (tax-disruptive) and arrangements affecting the tax base of the State. 8th October 2021, can be considered as a landmark day for international taxation, especially for the OECD because on this day, 136 countries agreed (i) to have new rules for taxing MNCs based on the place, where they are selling their goods and services (Pillar One) and (ii) to charge global minimum tax at the rate of 15% for the large MNCs (Pillar Two). The countries also agreed to take back their digital services tax to have US also on the same platform,[57] because US was opposing Digital Services Taxes ('DSTs') imposed by various States, particularly against their digital giants such as, Google, Amazon, Facebook and Apple, etc. Pillar One will help in ensuring the fair distribution of both the profits and the rights, amongst the countries and the big MNCs. These news rules provide simplicity and certainty and that is why, mandatory dispute resolution process forms a part of it. The decisions of these dispute resolution processes will be binding on the parties. To make this system more efficient, OECD came up in March, 2022 with the Global Anti-Base Erosion Rules (GloBE) Rules, which came up with a system of Top-up Taxes - an Income Inclusion Rule ('IIR') and an Undertaxed Payment Rule ('UTPR'). This process will reduce the total taxes paid on the "MNE's Excess Profit" up to the Minimum Rate, in a jurisdiction.[58] Detailed provisions are provided in the

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[56] See Oladiwura Ayeyemi Eyitayo-Oyesode, *Source-Based Taxing Rights from the OECD to the UN Model Conventions: Unavailing Efforts and an Argument for Reform*, 13(1) Law and Development Review, pp. 193-227 at 194 (2020).

[57] See Connor L. Smith, "*Reflections from the Brink of Tax Warfare: Developing Countries, Digital Services Taxes, and on Opportunity for More Just Global Governance with the OECD's Two Pillar Solution*", 63(5) Boson College Law Review, pp. 1797-1798(2022).

[58] OECD (2022), *Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti Base-Erosion Model Rules (Pillar Two)*, Oecd, Paris, https://www.oecd.org/

OECD guidelines for calculating the IIR and the UTPR[59]. It is the IIR, which will be considered as the primary rule applied by a Parent Entity, which would be from within the Multinational Enterprise ('MNE') Group. Rules related to tax neutrality and distribution regimes are also covered in the guidelines. For implementing Pillar Two[60], OECD shared detailed guidance on the 'Safe Harbours and Penalty Relief' rules along with 'the GloBE Information Return and Tax Certainty' rules. The international taxation rules are under consultation and it will incrementally replace the unilateral measure adopted by the States. On 16.12.2022, while sharing a statement on Pillar Two, a 'new special purpose nexus' rule was introduced for discussion, which would essentially permit the allocation of Amount A to the jurisdiction of the market, especially when the "MNE will derive atleast 1 million euros in revenue from that jurisdiction. For smaller jurisdictions, with GDP lower than 40 billion euros, the nexus will be set at 250000 euros. The special purpose nexus rule applies solely to determine as to whether a jurisdiction qualifies for the Amount A allocation. Compliance costs (incl. on tracing small amounts of sales) will be limited to a minimum."[61] In this way Pillar One and Two would definitely bring much needed certainty in the International Tax Laws.

IX. CONCLUSIONS AND SUGGESTIONS

It was in 1962, when for the first time, in history, any country in the world reacted by using economic blockade against the nation, where its businesses are shifted. France imposed an economic blockade on Monaco, as a reactionary measure to show its dissent of shifting of French industrial residence to Monaco. Technically, French companies were doing treaty shopping and were actually shifting their profit structure to Monaco.[62] In the present times, no country follows such reactionary measures, but, these digital business models (especially tax disruptive) and transactions have impacted the already jumbled rules of international taxation, and the countries are feeling helpless in the absence of international rules to tackle such tax issues and therefore to tackle such intrinsic issues, the countries, started enacting unilateral tax laws to tax

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tax/beps/tax-challenges-arising-from-thedigitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf (last visited on Jan. 12, 2023).

[59] On 16th December, 2022, 138 members of the OECD nations, issued a particular statement on BEPS 2.0, *A Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy.*

[60] See Connor L. Smith, "*Reflections from the Brink of Tax Warfare: Developing Countries, Digital Services Taxes, and an Opportunity for More Just Global Governance with the OECD's Two-Pillar Solution*", 63 Boston College Law Review, p. 1797, (2022).

[61] OECD/G20 Base Erosion and Profit Shifting Project,*Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*, p. 1, 16 December 2022, https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf, (last visited on Jan. 14, 2023).

[62] See Michael Keen and Joel Slemrod, Rebellion, Rascals, and Revenue: Tax Follies and Wisdom Through the Ages, 251-253 (1st ed. Princeton University Press, 2021).

digital business models and their transactions. But, these new innovative tax strategies violate the already established and accepted rules of international taxation.[63] *Firstly*, these unilateral tax strategies blatantly violate the principles of neutrality, whenever, these rules while implementing the law, do not impose the neutral tax treatment on traditional and digital business models.[64] *Secondly*, these new tax innovations neither follow the principle of fairness and nor they are effective, because of their disproportionate tax on the diverted profits, which arguably is based on notions of abstractness only. *Thirdly*, these taxes are different in nature though, are a part of tax sovereignty of the States but many times, they are aggravating the problem of double taxation, instead of solving it. *Fourthly*, these new unilateral laws are also not in consonance with the Ottawa Taxation Framework[65], which categorically acknowledged the need for the new tax rules. These should be enacted to assist the existing international tax principles.[66] *Fifthly*, such new measures will increase the complying costs, which would obstruct the foreign direct investment in the State. Pillar One and Pillar Two BEPS steps are positive steps in the right direction. These are nothing but incremental strategies, by which PE can be expanded and can include significant consumer country sales. One of the steps in this direction is fixing the threshold for quantitative economic presence. A coordinated effort of the countries is the need of the hour and therefore, any step towards Quantitative Economic Presence Permanent Establishment ('QEPPE') would, in many ways, help in restoring the already existing concept of PE in a different tangent altogether, without disrupting the existing international rules of taxation. The purpose of BEPS 2.0 is to build a comprehensive international framework based on consensus and therefore, the overall design of Pillar Two is to interlock, both the international taxation rules (GloBE) with the domestic rules and treaty-based rules, with limited source taxation rules.[67] OECD has already put Pillar Two rules for public consultation in March 2022. These incremental developments will soon help in changing the landscape of international taxation rules in consonance with the evolution and growth of digital technology.

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[63] See Katherine E. Karnosh, *The Application of International Tax Treaties to Digital Services Taxes*", 21(2) Chicago Journal of International Law, p. 535 (2021). Also see Mutiara Elisabet and Yetty Komalasari Dewi, *Digital Services Tax Regulation and WTO Non-Discrimination Principle: Is the Deck Stacked*?, 19(1) Indonesian Journal of International Law, pp. 39-57 (2021).

[64] Commission Expert Group on Taxation of the Digital Economy, Report of the Commission Expert Group on Taxation of the Digital Economy, p. 5 (28.05.2014), https://www.editionmultimedia.fr/wp-content/uploads/2014/06/Report-CE-Taxation-of-the-Digital-Economy-28-05-14.pdf, (last visited on Jan. 12, 2023).

[65] See OECD Ministerial Conference on Electronic Commerce, Ottawa, October 1998.

[66] See Arthur J. Cockfield, *Balancing National Interests in the Taxation of Cross-border E-Commerce*, 74 Tulance Law Review, p. 343 (1999).

[67] *Supra* note 59 at p. 8.