Business Standard

Taxing digital economy

Analysts are increasing their understanding of it

Parthasarathi Shome | New Delhi February 18, 2020 Last Updated at 21:12 IST

How best to tax the digital economy is an issue that attracts international policymakers' concern. Last August, ITRAF1 researchers pointed to constraints associated with both its direct and indirect taxation and, a few days back, have published their findings in a volume, the fourth in an annual series on international taxation2.

Blockchain and its tax challenges are addressed by Shikha Mehra and Rohit Roy. The corporate income tax uses profit as its base. However, modern business models of richly valued internet companies — WeWork and Uber — are shifting from profit to growth centric models, bypassing traditional tax nets. In response, global efforts to address tax base erosion and profit shifting (BEPS) are being made by the Organisation for Economic Co-operation and Development (OECD), United Nations, European Union and individual countries.

According to OECD's interim report, technological advances in the Web 2.0 era brought high profits to companies operating on data aggregation such as Facebook, Uber, and Amazon, with little income to the original data owners — the users. Moreover, such companies have minimal or no economic presence in countries from where they source the data. Countering it, Web 3.0 technology allows users to own their data and monetise it by selling it to these companies for use, with user consent. If operationalised, this would enable tax jurisdictions, where user-generated data is collected, to identify sale of such data at its source. Creation of data market places through technologies such as blockchain would allow tax jurisdictions to tax the sale of such data at its source. Indian tax legislation is introducing provisions to enhance their ability to accommodate such technological change.

Three essential elements for taxation of the digital economy are listed by Alok Prasanna Kumar

and Vinti Agarwal. They comprise

Illustration: Binay Sinha

characterisation of income, identification of a nexus to the digital economy, and designing proper rules to attribute profits once the existence of a permanent establishment (PE) is determined. Tax treaties allocate the right to tax profits if a PE or business connection/nexus is established. The tax is set at 40 per cent for business income and 10 per cent for royalty. Tax authorities prefer business income characterisation while businesses prefer royalty. Obviously disputes arise, for example, over the characterisation of income from subscription fee. Further, though a PE has a geographical connection, a digital enterprise may not require local personnel. Thus arm's length price based on functions performed remains a challenge for PE type calculations.

OECD's final report is expected in 2020. It deliberated upon three alternatives comprising an equalisation levy (EL), a withholding tax, and adherence to the concept of significant economic presence (SEP). SEP was developed by a task force to determine nexus and evidence of a PE, thus moving away from physical presence. SEP includes revenue-based, user-based, and digital factors — the latter reflecting local domain name, local digital platform and local payment options, moving forward the means to tax digital economy.

India's EL suffers from an ambiguous nature and associated uncertainty. After the goods and services tax (GST), EL should not exist independently. EL is not deductible against the income tax, hence a source of double taxation. The Reserve Bank of India's (RBI's) data localisation requirement mandating payment systems operators in India to store data only in India may provide protection to customers. Yet it indirectly converts these businesses to PEs and brings them under Indian taxation.
The US and other advanced economies view it as ring-fencing the digital economy. The future course of this tax and its variants elsewhere in the world, therefore, remain uncertain.

Krupa Venkatesh deals with indirect tax, its revenue collection, and constraints in value added tax/GST and customs. The GST is a tax on consumers though businesses collect it as an agent of government. It is not intended to be borne finally by businesses though they actually suffer compliance costs of collection, completing and filing numerous tax returns, waiting for refunds, and being audited and scrutinised. Thus, the burden on businesses is far from light.

Taxation of cross-border trade of goods is relatively straightforward compared to that of services. For goods,

GST on imports is collected at customs border, and exports are zero-rated. Thus, imports face the same tax as domestic goods, while exports carry no tax on inputs since they receive input tax credit.

However, taxing services provided across the border, mainly electronically supplied services (ESS), is a challenge since it can escape tax more easily. Business models of ESS include “order to fulfilment” services, such as ticketing services, software downloads, radio and TV broadcasting, and telecom.

There is a hybrid category — online order with offline fulfilment, including online retail and hotel booking. They possess complex structures that are layered with multiple service providers. An exhaustive list of digital services appears in the IGST Act Section 2(17) though homogeneous taxation of the hybrids remains a challenge.

Other considerations comprise a varying mix of delivery and customers, for example, B2B (both parties GST registered) or B2C (customers unregistered). If a business (B) is also unregistered, it would be taxable as C. In “peer to peer”, again, both parties are unregistered, and it includes one-off or pre-owned product sales. Such characterisation of a service as well as determination of the taxing jurisdiction pose challenges. The actual basis of collection reflects whether the supplier is located in the jurisdiction or not.

Collection becomes more complex in the hybrid model especially in defining digital supply. Venkatesh demonstrates through international court cases the complexity of indirect taxation. A case against Uber ruled that the service provided by Uber was an integral part of the principal service of providing transportation, hence could not be included as e-commerce.

The jurisdiction issue in taxing ESS intensifies as businesses locate themselves in low tax jurisdictions. It is difficult to enforce, investigate or audit overseas ESS. The OECD and EU provide guidance on mechanisms for effective collection of GST where the supplier is not located in the taxing jurisdiction—here place of supply should be the location of the service recipient and not of the service provider.

One cautionary note: Whether in the process, policymakers are quashing the social productivity of digital economy, clearly higher than that of government expenditure, seems of little concern despite a recessionary global economic environment. Ironically, US policymakers may provide a brake on this relentless process.

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1. International Tax Research and Analysis Foundation (ITRAF).
2. International Taxation in the Digital Era, Oakbridge Publishers, New Delhi, 2020