TAXMANN®'S

Digital Taxation
A Holistic View

Foreword by
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We thank God for His kind grace

Dedication

We dedicate this book to the Devoted Income-tax Officers in the Indian Government who have defended India's "Right to Tax".
They are no less than the soldiers defending India's geographical boundaries.

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Objective

Objective is to analyse following issues:

1. *OECD started working on E-commerce taxation in the year 1997 or before. OECD & G20 started working on Digital Taxation under BEPS Action One group in the year 2013.*
2. *What were the objectives of the Groups?*
3. *Have they achieved the objective; or are they in the direction of achieving objective?*
4. *Apparently objectives have not been achieved so far.*
   What are the reasons?
5. *Do we have an alternative suggestion?*

IN OUR SUBMISSION:

The OECD Secretariat's Unified Approach dated 9th October, 2019 doesn't serve the purposes.

It is not even in the direction to serve the purposes.

It is too complicated in compliance and administration.

It is unfair & inequitable to Countries of Market Jurisdiction.

Digital Taxation need not be complicated.

These views are explained in this book.

We also present an alternative tax system for Digital Taxation.

About the Authors

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Foreword

Taxation in the digitalised economy is the current hot topic of discussion in several multilateral forums as well as amongst policy makers in different countries. Over the years, as the impact of digital technology in business gathered force, various Committees and tax expert groups attempted to understand this impact and consider whether any change in the rules of international taxation was required to deal with it. But it was only during the G-20/ OECD BEPS project of 2013-15 that the newly emerging business models were examined in detail and it was concluded that while it was not possible to ring-fence the digital economy, some serious tax challenges are certainly posed by the rapid increase of digitalisation in business.

The BEPS Action 1 report, however, did not reflect any consensus among countries on the manner in which these challenges are to be addressed. Certain options were recognised and discussed in the report, including the levy of a flat equalisation tax and the creation of a new nexus in the form of a significant economic presence. But no recommendations were made on adopting any of these options. Indeed, several countries were of the view that the various other BEPS measures recommended in the different reports could be effective in dealing with BEPS risks even in the case of digital businesses and that no new or unique measure was required to address the tax challenges of the digital economy.

In the absence of consensus, several countries resorted to unilateral tax measures that could raise some tax revenue from digital businesses operating and earning profits from within their jurisdictions. India was the first country to introduce the Equalisation Levy and was followed by others. The UK and Australia launched their respective versions of a 'diverted profits tax'. The European Union (EU) came out with a draft proposal

of a digital services tax in the short term (similar to the Indian equalisation levy) and a tax based on a significant digital presence in the long term. These various measures and proposals (together with the expectation that several other countries might act similarly) persuaded the global tax community to come back to the discussion table. A plethora of unilateral taxes imposed by different countries would not only lead to large-scale double taxation but would also adversely affect the economic cooperation and trade among countries. The G-20 group of advanced and emerging economies (India is a prominent member of the group) consequently called upon the OECD to bring countries together and develop a consensus-based solution to the issue of taxation in a digitalised economy, by the end of 2020.

Over the last one year or so, these multilateral discussions taking place in the Inclusive Framework (a grouping of more than 135 countries set up by the OECD for effective monitoring and review of the implementation of the BEPS recommendations) have gathered pace. The Unified Approach now prepared by the OECD Secretariat, which has been put out for public consultation, is an attempt to find a single approach that can combine the best features of the three different proposals placed before the Framework - the User Contribution approach, the Marketing Intangibles approach and the Significant Economic Presence approach (the last being the model proposed by India and by the G-24 group of developing nations).

The primary objective is to find a solution that can ensure the taxation of a portion of the profits of an MNE in a jurisdiction where it actively carries out business without having a physical presence therein. Such active business interaction will typically involve factors associated with marketing, including marketing intangibles and market demand, and with the data contributed by users of digital services and products. The challenge is to find a simple, objective and principle-based way of allocating profits of an MNE to jurisdictions where it has a physical presence and to those where it does not have a physical presence but does substantial business activity, in a manner that can be implemented by countries both developing and developed and that can minimise

the creation of disputes between countries. The Unified Approach represents a significant and substantial effort in this direction. It cannot be expected to represent a complete and ideal solution, but at the same time it should promise a solution that is perceived to be fair and just and that addresses the original issue in as comprehensive a manner as possible.

This book by Rashmin Sanghvi, Naresh Ajwani and Rutvik Sanghvi critically analyses the issue of 'digital taxation', tracing the history of the debate, setting out the basic issues in simple terms and presenting clear and unequivocal views on the various issues involved. It is a book written in simple language, trying to bring out and explain concepts with clarity even to those who are not tax professionals. It is an especially heartening work for developing nations including India, as it substantially clarifies and endorses the view taken by them and presents a simple and logical explanation for such endorsement. Most importantly, the book suggests a viable model of taxation of digital transactions that can move further towards ensuring a more just and equitable world order in international taxation.

I have known Rashmin bhai for long. I have known him as a Chartered Accountant with in-depth knowledge of accounts and tax law. I have known him as an outspoken advocate of the need to follow the principles of taxation, regardless of who these principles would favour in a given situation. I have known him as someone distinct from the multitude, a person who values his independence and professionalism and integrity and fiercely protects these attributes from getting corrupted. Above all, I have known Rashmin bhai as a very fine human being who is not afraid to speak his mind on any issue and at the same time maintains a high level of respect for every individual and for society at large. All these qualities and attributes are reflected in the views expressed in this book, making it a truly remarkable and engrossing piece of work. They are especially reflected in the small chapters on 'Maya' and on 'Beatitudes' contained in Part I, which serve as strong reminders of the fact that every principle that we human beings seek to espouse, including principles of taxation, must ultimately derive their bases from the philosophical principles of life itself.

I commend this book to taxpayers and tax professionals alike, in the sincere belief that it will go a long way in helping to achieve a more comprehensive understanding of a particularly complex taxation issue.

AKHILESH RANJAN
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Central Board of Direct Taxes
Ministry of Finance
Government of India
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Main Contents

This book discusses digital taxation - legal aspects as well as the impact of digital technology & philosophy. Tax experts interested in only the digital taxation may simply read Part III.

Over past 20 years, we have written a series of articles on E-commerce/Digital Taxation. Some of these are available on our website - www.rashminsanghvi.com. At each stage there has been a progression in our thinking. As our thinking progressed, we improved upon our thoughts and even discarded some of them. Therefore if one looks at the past articles, one may find some differences compared to what has been proposed in this book.

Important Note: All the company names used in this book are purely for illustration. Actual business activities, their profits or revenues and tax practices of the companies referred here may be totally different. We have used some names only to describe the kind of activities under Digital Commerce.

Contents

Short Forms & terms used in this Book

Ad:	Advertisement.
BC:	Business Connection.
BPO:	Business Process Outsourcing.
CBIC:	Central Board of Indirect Taxes & Customs
CFB:	Consumer Facing Business. It may be digital or non-digital.
CIT:	Commissioner of Income-tax.
COE:	Country of Economic Base/Foot Print/PE
COP:	Country of Payment
COR:	The country in which the Digital Corporation is tax resident is called Country of Residence.
COS:	The country other than COR in which the Digital Corporation has its Permanent Establishment (PE); performs certain functions and/or has assets, employees etc. is called Country of Source.
COM:	The country in which the Digital Corporation markets and sells its goods and/or services without a PE & without any functions, assets or employees in that country; is called the Country of Market.
Digital Commerce:	Commerce conducted through digital instruments. A global corporation sells goods and/or services in COM without a PE in the COM by using digital instruments. In this book the terms "digital commerce" and "e-commerce" have been used as meaning the same kind of business.
DTA:	Double Tax Avoidance Agreement (Treaty).
Digital Tax:	For the sake of convenience in this book, the tax on digitalised business may be called **Digital Tax.** Tax payable at Country of Market - on profits earned from digitalised business is Digital Tax.

Digital Corporation: (DC)	The Taxpayer or the Corporation conducting digitalised business liable to pay Digital Tax is referred to in this book as Digital Corporation. In reality it may be a company or any other form of business entity. Sometimes, short form DC is used to indicate Digital Corporation. One may consider consumer-facing business entities as explained in the UA, same as DC. Even B to B companies (which are not Consumer Facing are considered as DC.
E-commerce:	When a businessman conducts his business with customers in other countries by using electronic instruments & communication channels; without physically meeting the customers and without having a permanent establishment in the country of market, it is called Electronic Commerce. In this book we are referring to only cross border E-Commerce. We have considered E-commerce same as Digital commerce and used both terms interchangeably.
EDT:	Elimination of Double Taxation.
FII:	Foreign Institutional Investors.
GC:	Global Corporation which does business in many countries **without having PE** in those countries.
GDP:	Gross Domestic Product.
GOI:	Government of India. Mainly Income-tax Department.
IPR:	Intellectual Property Rights.
ITA:	Indian Income-tax Act.
Industrial Countries:	Countries which are not tax haven are referred to as "Industrial Countries" - irrespective of whether they are "Developing Countries" or "Developed Countries". Purpose of this name is to indicate regular countries which would try to minimise Tax Avoidance & Tax Evasion.
MNC:	A multinational corporation which does business in many countries by **having PE** in most of the countries. Its focus is on traditional business & not E-Commerce.
NR:	Non-resident of COM.
OECD UA:	OECD Secretariat's Unified Approach document for addressing challenges of the digitalisation of the economy - dated 9th October, 2019.
PE:	Permanent Establishment.
SEP:	Significant Economic Presence. It is an alternative proposal for "Fixed Place PE".

TDS:	Tax Deduction at source. It is same as With Holding Tax (WHT)
TV:	Television
USA:	United States of America.
US:	Something pertaining to USA. For example, US Government.
WHT:	Withholding of Income-tax by the Payer.

Preface

OECD has published several reports on Digital tax. OECD's website provides these reports. The last report - Unified Approach (UA) on Pillar One is published by OECD Secretariat on 9th October, 2019. ("Pillar Two" published in November 2019 on anti-avoidance is ignored for this book.)

1. *There is a huge* **Technological Revolution** *which has revolutionised the way business is done and the way we socialise, and consume media. OECD has not taken a holistic view of the Techno - Business Revolution. The Unified Approach presented by OECD Secretariat is not fit even for today's world and certainly not for the world in the year 2030. In this book we are explaining the serious flaws in the Unified Approach (UA) and presenting solutions.*

Current Techno-Business revolution is a **multi-dimensional ongoing process of global scale**. *It has revolutionised business as we conduct; and the way we enjoy news & entertainment media today. Nobody knows what will be the future. We can only do one thing: Encourage and facilitate the technological & commercial revolution and do not cause any negative hurdles for the revolution.*

2. Requirements *of a* **Digital Taxation System** *that will encourage the technical commercial revolution and will not hamper it:*

(i) The digital taxation system should be absolutely **simple, efficient and dynamic**. *It should not bother the digital corporations and the users with burdensome compliance and threats of penalty and prosecution from a hundred different countries. Such a system can be called "***Future Ready***".*

(ii) The **digital corporations** *also have to understand and accept the fact that they will have to pay a digital tax in*

every country from where they earn revenue. Their hugely complex tax planning will be demolished and ignored. If they avoid taxation, they will face consequences in the Countries of Market. If they pay up the tax, they can do business & grow.

(iii) *All the* **Countries of Market** *(COM) have to state clearly to COR and OECD that they (COMs) have a clear right to tax digital profits. They will tax the profits and any attempt at avoiding COM tax is only hampering technological revolution and finalisation of objective of BEPS Action One.*

3. OECD UA is a work-in-progress. *Many issues still need to be developed. After formation of BEPS Action One Group - Task Force on Digital Economy (TFDE) all reports have been published by TFDE. However, TFDE members could not arrive at a consensus. Hence, this last (October) Unified Approach is published by OECD's Secretariat. It acquires any significance only if in subsequent meetings TFDE accepts the same. Today it is a suggestion for consideration. It is a poor suggestion.*

4. *There are* **three major challenges** *in taxing digitalised commerce:*

(i) *Determining the* **Scope of income** *that should be covered within the digital taxation.*

(ii) *Determining* **Nexus** *- PE/SEP for establishing "Right to Tax".*

(iii) **Attributing** *taxable profits to the Country of Market. In other words, recognising the COMs'* **"Right to Tax"** *digital commerce profits.*

4.1 Scope of business *covered under Digital tax has been "expanded" from Digitalised Economy to Digitalised Economy* **plus Consumer Facing businesses**. *One important issue: there is considerable B to B digital commerce (***Business to Business)**. *It is not Consumer Facing business. It should also be subject to digital tax. This situation has not been brought out clearly in the UA.*

4.2 *The OECD Unified Approach (UA) provides for a* **new nexus** *for taxing consumer-facing businesses largely based on sales. This is a major step forward. Instead of continuing with "Fixed Place Permanent Establishment" concept; OECD Secretariat has*

presented a **sales based** *provision for determining nexus for such businesses as far as Market Jurisdictions are concerned. The Nexus rules are not affected for COR & COS.*

4.3 *As pointed out in the UA, under the present tax system there are no rules for* **attribution of profits** *if the Seller has no presence in the Country of Market (COM). In our submission, various steps discussed in the Unified Approach (UA) are subjective and involve several variables. The end result may leave hardly any profits attributed to the market jurisdiction (COM); and will cause avoidable litigation. In our view, the attribution of profits system in the UA Approach needs to be replaced with a simpler* **SEP & WHT based system**.

5. Structure & style of this book:

This book is meant for beginners of international taxation as well as for experts. Hence we have tried to explain all matters in simple language. At the same time, conceptual, and holistic issues are also discussed. Some issues are found very difficult. They are repeated in the book at different stages. This book may be complex for some readers. Some complex issues are first mentioned. Then in a separate part elaborated. Then repeated in conclusion. This is the style adopted in "Yoga Vasistha" as well as in "Conversations with God"[1]. It helps many. Some experts may find repetition unnecessary. We are sorry.

There are some radical thoughts.

Probably the issues involved are fairly simple for a person practicing or administering international taxation. However, digital commerce has disrupted - old business models as well as old law. Since tax practitioners have studied the old law, accepting new concepts seems difficult. Consider two developments:

(i) Digital commerce has disrupted some old businesses. New businesses using digital means - like Google & Amazon have been tremendously successful.

(ii) Digital commerce has also challenged existing law for last twenty-four years. But draftsmen have not yet changed the law. There is an urgent need for overhauling the law. If you

1. Note: These are spiritual books. "Yoga Vasistha" is ancient spiritual book in Sanskrit; and "Conversations with God" is a modern spiritual book in English. Both tackle complex conceptual subjects in this style.

consider the facts that tax laws have been disrupted and new laws are unavoidable necessity, accepting digital taxation may be easier.

6. The issues *considered are: Scope of Total Income, Deeming provisions extending the scope; determination of COS & COR; Permanent Establishment, Attribution of profits to PE, Jurisdiction of a Government to tax and so on. We are discussing core issues. And in Part III we are presenting a new system of taxing Digital Commerce.*

7. A bit of history:

Finance Ministry, Indian Government had appointed a **High Powered Committee** *to make recommendations on* **Digital taxation**. *The committee presented its report in* **year, 2001**. *Committee made some important observations & suggestions. Some of these suggestions are already implemented by GOI. One of the authors to this book had the privilege of being a member of the Committee. Some issues discussed in the Committee report are discussed in this book.*

8. OECD *had appointed a committee (TAG) to study Digital Taxation and make recommendations.* **In the year 2005**, *the Committee presented its report. Committee concluded that "There is no alternative taxing rule (i) which is clearly superior to existing rules; and (ii) which is widely acceptable. Hence no changes may be made in existing tax treaty rules."*

The American Economic Crisis erupted in the year 2008; and engulfed Europe. Some major countries including USA faced serious difficulties. For the first time, countries which are more into being COR, accepted that the MNCs & GCs were avoiding & evading taxes to unacceptable extents. G20 and OECD together decided to come out with new rules for international taxation. **In the year 2013,** *OECD reversed its stand (which was declared in the year 2005) and accepted that "The Existing rules of International Taxation are inadequate". G20 & OECD together started BEPS Programme to curb tax avoidance. At that time, for the BEPS group, e-commerce tax was the most important issue. Hence it was the first action group. Target was, to publish actionable report within one year.*

Unfortunately, even now OECD is not able to give clear, fair rules on taxing digital commerce. We appreciate the difficulties faced in the process. And yet we endeavour to present our views on possible solutions.

9. Present situation *: Everyone understands that there are problems in taxation of digital commerce. However, so far no clear solution has emerged. This may be because,* inter alia *we want to apply the tax principles of Traditional Commerce to digital commerce.*

10. *In this book we are discussing the international tax issues* **focussing on India.** *However, the principles discussed here may be applicable in other countries also.*

11. Key Objectives:

11.1 *Key objective for the COM* **governments** *is:* **"Sharing of taxing Rights"** *by two or more Governments on the profits earned by a Global Corporation. The Global Corporation (GC) conducts its business in such a manner that it earns revenue from many countries and does not have a PE in most of the countries. Hence the countries from which the revenue flows (COM), do not know how to tax the income contained within the cash flows. We present a way.*

Key issues for the **assessees** *are of* (i) *avoiding double taxation,* (ii) *having certainty and clarity in tax rules. This book tries to present a system that can fulfil this objective.*

Some assessees have the objective of: Either "Zero tax"; or "Restrict taxes only to COR. Avoid all taxes in COM". This book tries to show how to block such objectives.

11.2 *Can the Double Tax Avoidance Agreements be so amended that Double Tax as well as Double Non-Taxation of Digital Commerce is avoided? And the Countries of Market (COM) get their fair share of Taxing Rights? This may amount to* **reworking some Treaty principles like Permanent Establishment and Attribution of Profits.** *And even a fresh look at the* **Connecting Factors** *of "Residence" and "Source".*

11.3 *Can Government of India make fair provisions in the* **Income-tax Act (ITA)** *to avoid both - double taxation and double non-taxation?*

Conclusion: *Under the existing rules of international taxation assessees doing their business through Digital Commerce can avoid almost total tax. They can shift their operations to a tax haven and avoid COR tax. Their incomes may generally be categorised as "Business Income". They have no PE in most of the Countries of Market from which they earn their revenues. Hence they escape COS tax also.*

Governments cannot sit idle and watch billions of dollars' worth of incomes go tax free. It may be sometime before Treaty models are effectively modified to cover E-Commerce. GOI has made amendments in Section 9 of ITA - which are still work in progress. GOI may need more comprehensive amendments to the Income-tax Act to tax these incomes. Part III gives detailed suggestions for provisions to be enacted by COM Governments like India.

DEMYSTIFYING DIGITAL TAXATION

CHAPTER 1

DEMYSTIFYING DIGITAL TAXATION

1.1 INTRODUCTION

Today digital taxation has acquired **hallow and a mystery**. Several Governments, organisations like OECD, G20, European Union and others are trying their best to develop a system for digital taxation which can take care of the special issues raised by digital commerce. The efforts are going on from the year 1997 when OECD published its Ottawa report on E-commerce. BEPS group is working exclusively on it from the year 2013. Still there is no consensus on a good digital taxation system. What is so complex that world cannot resolve after 22 years' efforts?

We submit that it is eminently **possible** to present a **simple, just & fair digital taxation system**. In this book, we analyse the so called complexity of digital taxation and present it before you in simple constituents. It will be apparent that there is no big deal in digital taxation. Problem is not with digital commerce. Problem is that the existing system of international taxation is outdated and needs to be changed. There is resistance to change. Resistance is normal. Once we look at the basic simple facts, probably everyone should be able to see the alternatives available clearly. This is our attempt.

Income-tax is basically a simple matter of Government taking a share of our income. It is accepted that in absence of Government, the business will be difficult and there will be much less income if at all. Government contributes to the society in several different manners and hence it has a right to levy tax. This "**Right to Tax**" is also referred to as "**Jurisdiction**".

When we talk of Income-tax, the business through which the income is earned is completely irrelevant. At the basic level, a person may earn income from trading, industry, speculation, research and development, rocket science or through digital commerce. **Business is business. If the business earns income, it is liable to tax.**

1.2 BASIS OF TAXATION

When a person is resident of a country called COR (Country of Residence) and conducts its business in the same country, people do not even question the Government's jurisdiction to tax. When the same person earns income from another country, it becomes a matter of "International taxation". In international taxation which Government has the "Right to Tax" or "Jurisdiction" is the matter of international tax debates. This matter is normally resolved by bilateral tax treaties/conventions or Double Tax Avoidance Agreements. In digital commerce, the matter is not restricted to two countries. The digital corporation can conduct its business simultaneously in a hundred countries. Hence, the matter of **sharing the taxing rights** amongst the hundred countries arises. This makes it necessary to have a "**Multi-lateral Treaty"** rather than a bilateral treaty.

Under the **traditional commerce** (also called Bricks & Mortar business), if the resident of COR wanted to earn revenue from another country, it was necessary to have some **business presence** in that country. His presence in the other country - Country of Source (COS) - gave the **jurisdiction** to COS to tax his income. In simple terms, if an Indian resident earns income from USA, primarily India as the COR has a jurisdiction to tax his income. USA as the COS also has the jurisdiction to tax his income. Based upon the historical nature of business being conducted until the development of internet, this business presence was named - "**Permanent Establishment**". A Permanent Establishment (PE) was understood to be a shop, a factory, an office or similar other **physical fixed base** within the **COS geographical boundaries**. Once the law has been made, it has become a solid concept in the mind of everyone concerned.

1.3 DIFFICULTIES IN EXISTING TAXATION SYSTEM

Digital taxation has made it practical that the Indian resident can do business in USA **without having a Permanent Establishment** in USA. This technological development has **confused tax law draftsmen** who

could not accept that the old taxation system was inadequate for the modern business. Last 22 years have been spent in accepting and understanding the weaknesses of the existing system.

Now while searching for an alternative system, there are significant **differences of opinion**. The differences are so significant that there is a situation of **Tax War** in the world. The situation is exacerbated as most companies affected by the Tax War are in one country - USA. When Britain wanted to impose tax on American MNCs, there was a huge opposition from USA. When European Union passed an adverse verdict on Ireland (a tax haven) for granting special tax reliefs to **Apple Corporation**, there was huge opposition almost amounting to a tax war. However, if we look at **human psychology** of resistance to change; and strong resistance to change that may appear to be a financially losing proposition; it boils down to very simple issue: "Greed of the governments negotiating treaties". We are presenting in this book the crux of the problem. The alternative system proposed in this book is fairly simple.

For the income-tax officer, *prima facie* digital commerce should be a non-issue. **Illustration**: If **Elon Musk** does the travel business of taking tourists to the moon in his rocket and makes profits; officer does not have to understand the science & complexity of rocket travel. If Elon makes profits, he pays tax. If Elon makes losses, the law can allow him to carry them forward.

Concept: How a businessman makes profits is no concern for the tax officer. Officer is only interested in his tax revenue. If the businessman offers tax honestly & voluntarily, matter gets closed. It is only when - the businessman tries to avoid or evade taxes - that the officer has to scrutinise businessman's claims. When several tax haven and even industrial governments help the businessman in avoiding his taxes, the matter acquires a complexity - which we will explain in this book.

Today Income-tax departments and world governments are involved in debates over digital taxation because - digital corporations have been successful in using the weaknesses of the outdated international taxation and thus avoiding taxation in many countries - especially, the Countries of Market (COM). This is the crux of the issue for this book, and for BEPS Action One Exercise.

2 CHAPTER

DEMYSTIFYING COMPUTERS

Computer is a machine. Mobile phone is a machine. Machines may be used to conduct commerce and make money.

Digital machines like computers & mobile phones are used to conduct what is called Digital Commerce. See the fantastic magic of digitalisation.

Tape recorder is a machine which we used to listen to music. Camera is a machine which we used to capture photographs. Telephone is a machine that we used to talk. All three machines together would weigh upto a kilogram. Digitalisation has converted all these machines into software applications. They all sit on your mobile phones & weigh nothing. And your smart phone may carry twenty or more applications. These applications now relate with each other. Earlier, your telephone could not talk with your camera. Even today, your landline telephone & your SLR camera may sit on the same table but can't talk with each other. Digitalisation has made them talk with each other. And in the process, created products & services which were not imagined earlier.

And yet, through all these fantastic developments, one thing remains common. Some corporations are doing business & making money. When a person makes money, he pays tax. Simple. Whether he uses an ordinary machine or sophisticated machine should make no difference.

We have some **hallowed impressions** of some instruments, some institutions, some taxation systems, etc. In this Part I, we want to place a few of such impressions at their right place. Main issue is - our

hallowed impression about computer, its processing power and the efficient communication system that it uses. Because of the hallowed impressions about digital commerce today and about OECD, we are drifting away from some basic and simple truths. Let us analyse.

Computer is a machine. Mobile phone is a machine. A communication system - whether internet, ordinary post, television or inter space communication - is still a communication to be used by human beings. Ultimately, when we want to talk of taxation of income arising out of any commercial venture - a machine is a machine and a communication system is a system. If we stay with the simple and basic principles, we can draft a tax system which is simple. If we get awed by the glamour of the machine or the communication system, we miss the fundamentals and draft unnecessarily complicated systems.

The proposals by OECD suggested in October 2019 (Unified Approach) are in this category. The issue about a tax system is discussed separately. In this chapter, let us proceed further on the concept of a machine.

The stapler that we use in the office to staple the papers together is a machine. It uses the force of our hands and manipulates the force in such a manner that staple pin pierces the papers and attaches them together. This simple task of stapling the papers together cannot be done by hands alone. The machine - the stapler helps us in using the energy in desired manner.

There are many basic and simple machines. When they acquire some sophistication, we call them instruments. Fundamentally again there is no difference between an instrument and a machine.

A motor car is a machine which carries people from one place to another. That machine utilises a hundred different machines within its body. The engine is a machine. The petrol transmission mechanism is a system using pipes & pumps. The steering wheel and the gears are machines. When we use several smaller machines to make a bigger machine, we forget the relevance & sometimes even the existence of the smaller machine - called a component in a motor car. Let us be clear that all that we use in our human endeavour are machines.

Today, we are using computers and mobile phones for our commercial ventures as well as for personal entertainment and family time. They

are today's machines. Tomorrow there will be different machines more appropriate for tomorrow.

Scientists will keep discovering new methods of providing the same services or new services. Soon we will have newer machines. Fundamental issue remains that whether we use one machine or another, whether we use one communication system or another; we communicate. Communication can be business or pleasure or education or anything else. In the process, **if someone makes money, he is liable to Income-tax.**

3 CHAPTER

DEMYSTIFYING OECD

3.1 OECD CANNOT "GRANT" OR "ALLOT" TAXING RIGHTS

Consider following extracts from UA:

Page 9, Paragraph 16:

> "In a digital age, the **allocation of taxing rights** can no longer be exclusively circumscribed by reference to physical presence. The current rules dating back to the 1920s are no longer sufficient to ensure a fair allocation of taxing rights in an increasingly globalised world."

Page 9, Paragraph 17:

> " The Secretariat's proposal is designed to address the tax challenges of the digitalisation of the economy and **to grant new taxing rights to the countries** where users of highly digitalised business models are located."

3.1-1 In this Unified Approach paper OECD has used the language as if the OECD secretariat "creates and grants" or "allots" taxing rights to different countries. This is incorrect. OECD has no jurisdiction over any country to give to any taxing rights to that country. Correct language should be **"Treaty countries voluntarily restrict their taxing rights to avoid double taxation."**

3.1-2 Consider for illustration India's taxing rights. It is the **Constitution** of India which authorises Indian Parliament to pass appropriate Income-tax Act. Parliament has passed Indian **Income-tax Act**, 1961. This law authorises Government of India to collect Income-tax from income earners. For any taxing right, the only authority required by Government of India is the authority of Indian Income-tax Act. This is irrespective of whether India is a "Country of Residence" or "Country of Source" or "Country of Market".

3.1-3 Most Governments have understood that double taxation would harm international trade and investment. Hence, they **voluntarily want to avoid double taxation**. For this purpose, India would voluntarily enter into an agreement with another country where both countries find matching of ideas. India has signed agreements with about 96 countries. Each and every agreement is a voluntary agreement between the respective countries.

3.1-4 The main **service that OECD provides** is providing a model agreement & its commentary. The OECD Model agreement is a **draft available** to OECD members as well as non-members. Any two or more countries signing a double tax avoidance agreement may adopt the OECD model or may not adopt. However, it is also very practical that the Governments follow a common model convention. It is also practical that the Governments interpret the agreement in largely similar manners. Hence, OECD has provided the draft agreement as well as commentary on the draft agreements.

It is **like a lawyer** providing professional service of giving a draft partnership deed. Ultimately it is for the partners to decide the terms of their partnership deed. Normally, the lawyer's draft as well as OECD's model have **a lot of intellectual value. But no binding force.**

OECD is a voluntary association of Member Countries. Compare OECD with a professional association where a professional is a member. OECD has some small binding effect over its members and absolutely no binding effect over non-members. Now distinguish OECD from professional association. In case of OECD, the members of the association are Governments of Different countries. To even think that an association secretariat can "Grant" something to Constitutional Governments is preposterous. Countries largely follow OECD model & its commentaries for **good decorum in international trade & investment.**

Use of the terms "Allot" or "Grant" is inappropriate.

3.1-5 There are different methods adopted for avoidance of double taxation. As far as business income is concerned, where two or more countries contribute to the same income, it is understood that these contributing countries should have a right to tax the income. If each country were to levy full tax on the whole income, then there would be double taxation. Hence, the concept of **"Attribution of Profits"** has been developed. **Through the DTA the treaty countries will**

decide how much profits will be attributed to which country. Once the profits are attributed to a specific country, **Income-tax would be charged as per the domestic law** on the profits attributed to a country**.** In other words, "Attribution of Profits" would determine the "Taxing Rights" of the Treaty Countries. For the sake of clarity, it is repeated that the Attribution of Profits itself is voluntarily agreed upon by the treaty countries.

3.1-6 One may refer to Late Professor Klaus Vogel's book on Double Taxation Conventions. We are giving herewith reference to the page numbers and paragraph numbers of the 4th Edition (2015) published by M/s. Wolters Kluwer.

3.1-6a Page 14, Note No. 11. *"Customary international law **does not forbid double taxation**. Double taxation, resulting from the interaction of the domestic laws of two or more states will be consistent with international law as long as each individual legislation is consistent with international law."*

Thus, a country is not forced into avoiding double taxation. A country appreciates that avoidance of double taxation is beneficial for its own economy. Hence, the country **voluntarily** negotiates and signs agreements with other countries.

3.1-6b Page 23, Paragraph 30. "S*tates levy taxes, however, only on the basis of their own tax laws. .....**Tax treaty rules** assume that both Contracting States tax according to their own law; unlike the rules of private international law, treaty rules do not therefore lead to the application of foreign law. Rather, treaty rules to secure the avoidance of double taxation, **limit** the **content** of the tax law of both Contracting States."*

In simple terms, the treaty countries **voluntarily restrict their own Taxing Rights** to avoid Double Taxation. As a matter of good international commercial practice, they follow a common model & commentary to the extent both countries find these acceptable. This means that OECD model & commentaries; provide legal guidance to the countries for executing a Double Tax Avoidance Agreement. These documents have **immense intellectual value and zero binding force.**

BEPS Action One Report will similarly give legal guidance for Attribution of Profits arising out of Digitalised Economy. MLI itself provides several options to the countries—

(*i*) To sign the MLI or not to sign the MLI. For example, USA has not signed the MLI.

(*ii*) On individual clauses, whether to accept fully, partially, or not to accept at all.

(*iii*) Certain minimum standards are provided to control tax avoidance.

3.2 OECD MODEL IS "FOR THE COR, BY THE COR"

OECD model convention is in favour of Countries of Residence i.e. Supply side of the commerce. The Demand side or the Market Jurisdiction is not considered for Taxing Rights. The **Right to levy Income-tax** has to be shared by the Governments of all the countries which contribute to the entire safety/economy/infrastructure systems that make it possible for people to stay and enjoy life, to do business; and for the corporations to provide the services and earn profits. It is the right of that Government to tax the income arising because of its provision of the system. OECD model convention is not neutral. This book discusses this issue in greater details.

3.3 LAW DELAYED IS JUSTICE DENIED

OECD has been considering Ecommerce taxation for **22 years**. Not being able to provide legal guidance for 22 years amounts to professional failure.

On all three counts - 3.1, 3.2 & 3.3; OECD stands Demystified.

4 CHAPTER

DEMYSTIFYING DIGITAL CORPORATIONS

4.1 EVERYBODY HAS TO PAY TAX

Digital Commerce Corporations are doing a fantastic job of constantly discovering newer and better products. This is great. However, they do not want to pay tax in COR as well as COS. This is not acceptable. Howsoever great a business person you may be, **if you make money, you have to pay tax.** This is a very simple, hard fact of life. When a teacher teaches in the school and earns salary, he pays tax. Google and Apple use some complex algorithm or make some sophisticated machines/products/services to sell to you and make money. They are in it to make money. It is not at all different from any other businessman who wants to make money. **Remove the hallowed impression about all digital corporations. They all have to pay tax like you & me.**

4.2 REASONS FOR TAX LAWS BEING HARSH

If we consider the combined effects of "Transfer Pricing", "GAAR", "BEPS" and several other anti-avoidance measures; the compliance with law is extremely difficult. And consequences of non-compliance are very harsh. Not because of the tax rates. Most countries today have reasonable tax rates. However, Governments are constantly afraid that the largest MNCs are avoiding maximum tax. Since the MNCs avoid tax within the four corners of law, Governments feel helpless. You Tube Video of the interviews of MNC executives - by British Parliament Committee under the Chairmanship of Ms. Margaret Hodge on 12th November, 2012 is a classic illustration of **Government's frustration.** Videos for the interviews are available on You Tube. Interested readers may see the videos on following links:

Amazon - https://youtu.be/21Xf8ADFvdc

Google - https://youtu.be/B9-BZ4TeAg0

This frustration at Parliament level caused by MNCs' aggressive tax avoidance has **given rise to BEPS Actions** & so many other anti-avoidance provisions. These have made the tax laws harsh. **Transfer Pricing** chapter in the tax law has made tax law highly subjective. A subjective law gives rise to several interpretations with no real guidance to come to a single conclusion. This causes litigation. On top of Transfer Pricing provisions, when all the BEPS Reports will be implemented, the global tax system will be so burdensome that the global economy can go into recession. **We need a system where no MNC can avoid taxes and yet, the system is simple.**

5 CHAPTER

DEMYSTIFYING THE GAP BETWEEN TECHNOLOGY & TAX LAW

A HOLISTIC VIEW

Explaining how a big gap has arisen between Modern Digital Commerce and the outdated international taxation system.

5.1 TECHNOLOGY & BUSINESS REVOLUTION

Two chief developments are in the field of **Processing Power and Communication**. Several individual Technologies are growing at **geometrical progression**. When computer processing power doubles every two years at half the cost, it is a geometric progression twice beneficial. (Moore's Law.)

No one probably has made a statement on the exponential growth in communication technology. However, the growth in speed, efficiency and distances covered by the communication systems - normally referred to as "Internet" has been even more dramatic.

Convergence of different technologies enables new products and instruments that were unimagined. Whole range of these new products may be called in a very broad term as "**Digital Instruments**". They have utilised several independent technologies in their growth process. For example, "Satellite technology", "miniaturisation of processing power (computer chips)" and "smart, child friendly touch screen instruments" have revolutionised mobile telephones. All digital products together have disrupted the economy and made **globalisation deeper & wider.** Scientists and Digital Corporations are leading this digital revolution. With technology, business models are changing fast & **disrupting** old business models as well as **old laws**. This is a **Global Revolutionary Process** which probably started fifty

to seventy years ago; and will probably go on for a few more decades before stabilising. (All revolutions at some stage become accepted and then lose the wonder and charm. People just use the revolutionary products & services as normal commodities. This is also referred to as "Commoditisation" of a wonderful product.)

Quoting Wikipedia

> *"The **Digital Revolution** is the shift from mechanical and analogue electronic technology to digital electronics which began anywhere from the late **1950s to the late 1970s** with the adoption and proliferation of digital computers and digital record keeping that continues to the present day. Implicitly, the term also refers to the sweeping changes brought about by digital computing and communication technology during (and after) the latter half of the 20th century. **Analogous to the Agricultural Revolution and Industrial Revolution, the Digital Revolution marked the beginning of the Information Age.***
>
> *Central to this revolution is the mass production and widespread use of digital logic, MOSFETs (MOS transistors), and integrated circuit (IC) chips, and their derived technologies, including computers, microprocessors, digital cellular phones, and the Internet. These technological innovations have transformed traditional production and business techniques."*

There is no individual, institution or government that has planned, imagined or developed the **Global Techno-Business Revolutionary Process** that is going on today. Too many geniuses have contributed to the practical success of this revolution. To us, it looks like a **Divine Plan** going on. Somewhat comparable to the biological evolution from single cell life to human life.

Future: The fact that the revolutionary process is going on is evident from Artificial Intelligence, Autonomous cars, Block Chain Technology and Internet of Things. We cannot at present envisage how the global business, currency and financial systems, accounting & audit; banking business & even personal life - especially the news, entertainment and social media will be functioning in next ten years. Revenue models of the future cannot be envisaged. How to plan taxation system for such unpredictable process?

US Government and the whole American environment of taking entrepreneurial risks have done exceptionally well in allowing and encouraging this techno-business revolution; and especially in not burdening this revolution with legislative and bureaucratic hurdles.

US markets have supported extremely risky - new ventures. Overall, for several reasons, maximum growth of digital corporations has materialised in USA. Excluding China, no other country has succeeded in encouraging the Digital Revolution within their own jurisdiction.

Listen to a Mr. Sundar Pichai or to technology giants like Mr. Elon Musk, or Late Mr. Stephen Hawking - anyone who talks about future. What will be the future ten years from now? **Futurology is so exciting.** The way Science & technologies are progressing, human life itself; and especially commerce are bound to be far better. These technocrats are making practical - conveniences and business models - which were not even imagined just a decade back.

5.2 OECD'S UNIFIED APPROACH

Now look at **OECD's Unified Approach - a proposal for Digital Taxation**. Will it produce an international taxation system which will free Mr. Sundar Pichai and Mr. Elon Musk from **tax compliance burden**? Will the new tax system encourage technological growth or frustrate businessman? For an answer to this question, let us look at more details.

Unified Approach for digital taxation is a sharp contrast from the techno-business revolution. It is still a proposal for the traditional kind of complicated law. We need to have a taxation system which leaves these technocrats & their corporations - free to grow after paying a nominal tax in every country where they make sales. They should have minimum - next to "Nil" compliance botheration.

The **Unified Approach (UA)** presented by OECD suggests a digital taxation system - which requires **assumptions built upon estimates built upon subjective formulae.** Every assumption creates a scope for difference of opinion, controversies and litigation. When there is a **series of assumptions**, that law becomes frustrating. Compliance for the tax payer becomes costly and cumbersome; and administration becomes impractical for the tax officer.

OECD and BEPS draftsmen - when they draft such complicated laws, are ignoring **ground realities**. Let us present the ground reality in some countries. Let us say, a non-resident digital corporation files its COM Income-tax return disclosing taxable income at $ 1,000,000. Income-tax officer - empowered by the series of assumptions provided by Unified Approach based tax law at his command, can easily assess the income at $ 10,000,000 - ten times the returned income.

Then he can raise the tax demand, freeze the bank account of the Corporation for forceful recovery of tax and even initiate prosecution on allegation of concealed income. This is not imagination. Such prosecutions have happened in some countries. And we are convinced that human beings are same in every country. Once power is given in the hands of an officer, he is more likely to abuse the power than not to abuse the power. The **solution** to this danger lies in drafting a law with minimum subjective provisions and with clear guidelines to be followed by judiciary in case of differences of opinion.

5.3 RADICAL CHANGES IN FUTURE

Communication revolution of last fifty or more years has completely changed the way people communicate and do business. It is certainty that in next ten years, technology will give new products, communication instruments and business models that are not imagined by tax draftsmen today.

Look at the trend : Globalisation of commerce started with multi-national corporations going all over the world. Communication technology has given a much greater depth and scale for globalisation. "Borderless World" book by **Mr. Kenichi Ohmae** was published in the year 1990. He could see it in 1990. But, our tax laws and in fact majority of the legal system remain bound by political, geographical boundaries. While the regulatory laws like Companies Act, Securities Regulation Act, etc. may not hamper globalisation, tax laws directly affect globalisation. A complicated law can hamper globalisation. A simple law can encourage globalisation and growth.

Are we drafting digital tax law for tomorrow? Unified Approach is not a law even for today's digital world.

We need an international taxation system which can encourage global business and investment even in the year 2030. For making such a pragmatic law, we do not need to predict future. Prediction is impossible. But we need extremely simple and dynamic law. **Unified Approach is neither simple, nor dynamic. It is a proposal for a complicated law.**

Disruption is the common phenomenon today. New technologies and new business models have disrupted several existing business models. At the same time, they have also disrupted the tax law. It has taken us more than two decades to realise that we are administering a disrupted, broken, impractical law. Any patch work in this law is

not going to help. We need a clean, simple predictable and different system.

Reason for gap between commerce & taxation is clear inability by the draftsmen to look into the Techno-Business Revolution that is going on for several decades. It is ordinary human weakness. There is no mystery in OECD's failure.

6 CHAPTER

DEMYSTIFYING THE DIFFICULTIES IN DRAFTING DIGITAL TAXATION SYSTEM

6.1 WEAKNESS OF DIGITAL TAXATION SYSTEM

If the entire digital taxation is as simple as claimed here, what are the problems in finding right system? "**What is so unique** about Digital commerce taxation that one needs modification in Treaty Rules?"

Answer to this query is: Domestic tax laws and Treaty models have been drafted mainly considering (*i*) business in **goods**; and (*ii*) traditional methods of doing business. In these businesses, if a person resident in one country wanted to do business in another country, it was a practical necessity to establish a PE in that another country.

Today (*i*) **services** business has become larger (in terms of turnover) than the commodities business; and (*ii*) technology has made **globalisation** of business easy. For some digital businesses, PE is redundant. Methods of doing certain businesses have changed while for many businesses the traditional methods still continue. Old methods of tax sharing (avoiding double taxation) had not envisaged Digital commerce. And Governments as well as OECD are reluctant to change the traditional methods of tax sharing. It is only in October 2019 (Full six years after the BEPS programme started in year 2013) that OECD has shown some readiness to modify the existing model DTA.

This book at various places shows that the present system of international taxation has **serious weaknesses**. These weaknesses need to be removed. This is plain analysis of a legal system. No criticism is intended.

Any suggestion for taxing Digital Commerce will necessitate a **radical departure** from the existing system. Legal minds may oppose

departures from tradition. This opposition may become milder if we realise that the existing system is faulty.

6.2 OECD'S APPROACH RESULTS IN CONFLICT

In India & some other countries - Goods & Services are treated differently. Even amongst services, there is discrimination. Business income arising out of goods is taxable only in COR. While some services are taxable in COS, rest of the services are not taxable in COS.

OECD Model Convention does not have any Article on Fees for Technical Services (FTS) and Independent Services (professional income) (Article 14). While there are Articles for Royalty, Capital Gains and Shipping & Airline incomes; maximum taxing rights are with COR.

It is a widespread understanding that OECD model favours COR at the cost of COS. There is a history to it. See the model conventions by League of Nations and also proposals by Latin American countries. Early models demanded "Right to Tax" in the hands of COM even in absence of a PE. These demands were ignored and an international taxation system favouring COR has come into widespread use. OECD model is in favour of the COR. Digital commerce made it necessary that the COM should get right to tax in absence of a PE. OECD & others resisted change. This is what has caused 22 years delay in having a just & efficient system of digital taxation.

6.3 NEED FOR GLOBALLY ACCEPTABLE SOLUTION

A globally acceptable solution for Digital Taxation system has not emerged till October 2019. But **Digital Business has been a reality**. People did business. Tax officer passed orders. In the absence of a clear law and clear treaty guidelines; tax officers tried to work out a fair balance and pass assessment orders. There were differences. Courts tried. But Courts cannot come out with complete code on Digital Taxation. They can decide only under the law as exists on statute books.

Government of India (GOI) **cannot wait** for OECD or UN to come out with new Treaty rules. Some deeming provisions have already been made. However, a complete solution for taxing GCs has not emerged. Similarly several Governments have tried to pass similar laws - protecting their own tax bases. This can mean a "Free for all." When the "**Tipping Point**" will be crossed, some new norms have to

be found out. Under BEPS Action One programme, in October, 2019, OECD secretariat has published a note titled "Unified Approach". In our submission, it still does not give a fair, simple & efficient system for digital taxation. BEPS actions are discussed at length separately.

6.4 DISTINCT APPROACH METHOD TO DEAL WITH DIGITAL TRANSACTION

There are several companies like **Unilever**, Colgate, BASF which do business in several countries. However, their main focus is on commodities. So they have PE where they operate. It is useful to distinguish these companies from digital companies like **Google** & Face book. Hence in this book, companies dealing with traditional PEs are called **MNCs or Multi-National Corporations**. Global Companies dealing with Digital Commerce are called **Global Corporations (GCs).**

In real life, there may not be a demarcation - except in some rare cases. Even Unilever uses Digital Commerce to a great extent. And Google also needs PEs. Amazon uses both Digital Commerce & physical logistics simultaneously for despatch of sold goods. Different companies have emphasis for different methods. But few companies may be exclusively into digital commerce.

This probably means that **we cannot have different rules for taxing different kinds of businesses.** OECD has committed to "**neutrality**" in taxing Digital Commerce & Traditional Commerce. This same issue is also told in a different language: digital commerce **cannot be "Ring fenced."**

6.5 NEED FOR PRECAUTIONARY APPROACH

There is another issue. If any type of business is treated differently, then people will try to attribute maximum profits to that type of business - which gets more tax relief. This will lead to **litigation**. The vested interest in different kinds of treatment for business based on "instruments used for communication in business" must be avoided.

Normal tax issues are compounded by anti-avoidance provisions like "Transfer Pricing" and "GAAR".

In this book we have discussed **tax havens** and how Global Corporations (GCs) can easily avoid taxes. However, such discussion is only to highlight the inadequacies of the present system of taxation. The theme of this book is on a fair & proper system of digital taxation.

This book is on: **"What should be the digital tax law of future".** Hence there is no discussion on case law - which can only interpret existing law.

We had a query: "What is so unique about Ecommerce/digital commerce? Why tax law for it cannot be drafted for 22 years?"

This query stands answered and hence demystified. There is nothing unique about Ecommerce. The relevant technology & business keeps growing with geometric progression. So do the medical science, quantum physics, astronomy and so many other fields. Scientists and businessmen will keep growing. Problem is with legal drafting. We get stuck to the past. Hence the gap between modern business and tax law keeps increasing.

This problem gets aggravated by the human greed. Corporations do not want to pay taxes. They can prolong new tax law being developed. Treaty negotiating countries cannot rise above their own greed and find a Just & Equitable - "Win- Win" solution for all.

At the end, it is all human psychology. Limitations of human psychology are philosophically called: "Maya". (For more discussion on Maya *see* Annexure I)

CONCLUSION OF DEMYSTIFICATION

Once all hallow and mystery is removed, digital taxation is a simple matter.

If a proposal for taxation system is such that even regular practitioners in international taxation find it difficult to understand and comply with; and administrators find it difficult to administer, there is something seriously wrong with the proposal. When Mahatma Gandhi spoke, entire nation including totally illiterate villagers understood his message. They were ready to stand up against the Colonial rulers. The message given must be understood by the audience to whom it is given. If the message is not understood, ignore the message. Discard the digital taxation UA proposal irrespective of who has proposed it.

There is simply no big deal about digital taxation. We need to scrap all the cobwebs around digital taxation. It is eminently possible to give a simple and efficient system of digital taxation. We have presented the same in this book – Part IV. And it is no magic. It can be a very simple system on which many governments are already working. Consider our presentation in this book as a draft of the system. Analyse it, examine it and improve upon it. Let us all sit together and develop a simple system. Come up with a fine system which is **just and equitable for all the participants in the digital commerce.**

MAYA

When some thing seems to be going wrong for too long, probably, philosophy can indicate the root cause. We are mentioning some thoughts for you to consider.

Maya is an Indian philosophical concept. It is a force that tempts some people and makes them act inappropriately. Maya has six forces: (काम) Desires, (क्रोध) Anger, (लोभ) Greed, (मद) Ego, (मोह) Temptations and (मत्सर) Jealousy. These are the six forces through which Maya binds the man in this material world. One cannot free himself from these forces by – his intelligence, power, wealth, prestige etc. In fact, each of these characteristic of man can become a force of Maya.

Sanskrit term 'Maya' is comparable to the English term 'Illusion' but is far more than illusion. Illusion: when a person realises that the notion that he holds is an illusion; he simply becomes disillusioned without any further action. But when a person fully understands that he is under the forces of Maya; he still gets tempted by it.

Knowledge is not enough to be free from Maya. Realisation is necessary for freedom from Maya. Realisation, to all except the spiritually evolved, comes only by experience. Experience jolts an unrealised person out of the temptations of Maya.

This may be one reason why observers of human history who try to infer futurology observe that:

"At times, individuals, societies, institutions, countries; and with globalisation, even global institutions seem to be rushing towards crisis. But they do not learn except when a serious crisis jolts them. Some people are so strongly under the influence of Maya that even a strong crisis is not enough for realisation. So nature sends them series of crises."

May God bless us all.

BEATITUDES

1. Blessed are the poor in spirit, for theirs is the kingdom of heaven.
2. Blessed are those who mourn, for they will be comforted.
3. Blessed are the meek, for they will inherit the earth.
4. Blessed are those who hunger and thirst for righteousness, for they will be filled.
5. Blessed are the merciful, for they will be shown mercy.
6. Blessed are the pure in heart, for they will see God.
7. Blessed are the peacemakers, for they will be called children of God.
8. Blessed are those who are persecuted because of righteousness, for theirs is the kingdom of heaven.
9. Blessed are you when people insult you, persecute you and falsely say all kinds of evil against you because of me.
10. Rejoice and be glad, because great is your reward in heaven, for in the same way they persecuted the prophets who were before you.

II

PART

INTERNATIONAL TAXATION EXPLAINED

CHAPTER 7

INTERNATIONAL TAXATION EXISTING PRINCIPLES/ CONCEPTS

7.1 SCOPE OF THIS CHAPTER

This book does not discuss tax issues where the tax payer (income - earner) and his source of income are within the same country - and the income wholly arises in the same country. Such income is called domestic income. This book discusses **only "Cross Border tax" issues or "International tax" issues.**

There is traditional method of business. For example, in commodities manufacturing or trading business there will be Permanent Establishments (PE). This business will constitute a significant part of GDP for a long time to come. The concept of PE will be a useful concept to determine taxability in such cases.

7.2 ACCEPTED INTERNATIONAL TAXATION PRINCIPLES

For International Taxation, there are some important principles which OECD and majority of the world have accepted. There have been discussions between developed & developing world. Developed world has succeeded in adopting **pro-residence** principles in the treaty model. Without any criticism let us discuss all the issues afresh.

"Digital Taxation" is a branch of "International Taxation" which itself is a branch of "Income taxation". To be an expert in digital taxation, one has to first become expert in the Income-tax Act. And should be very good in the subject of international taxation. At the same time, good understanding of Constitution, Jurisprudence, etc. also helps. In this book, we will not discuss all these subjects. We will only start from international taxation.

When a person earns income from a country in which he is not a resident, both countries would want to tax his income. Thus, for illustration, we take Mr. Patel. He is an Indian resident. Hence, India is his Country of Residence (COR). Let us assume that he has invested in a London bank British Pounds 1,000. He earns annual interest income of GBP 20. Since the income is sourced from Britain, his Country of Source (COS) is Britain. The **classical system** of International Income-tax is such that:

COR - India would want to tax his interest income of GBP 20. India has a nexus with Mr. Patel as he is a resident of India. India would want to tax his global income. At the same time, Britain also would like to tax the interest income of GBP 20. Britain has the nexus of source of income. Britain would restrict its right to tax a non-resident of Britain to his income sourced within Britain.

Since, the same income in the hands of the same person is taxed by two separate Governments, there is double taxation. It is built in, in the current widely prevalent income-tax system.

However, if Mr. Patel is at the highest income-tax brackets, and if both Governments tax him at the highest tax rates, he may end up paying more than 50% in taxation. If the income earner is a US resident, he may end up paying Federal Income-tax, State Income-tax, City Income-tax & social services contribution. Altogether, would go up beyond 50% in some cities. With double taxation, it can go up beyond 70%.

If any businessman has to pay such high taxes, either he will stop doing business and taking risks or he will conceal the income. He will evade Income-taxes altogether. All Governments are aware that double taxation can frustrate international trade and investments. Hence, most of the Governments are keen on eliminating double taxation. For this purpose, they sign a Double Tax Avoidance Agreement (DTA). International Taxation includes compliance with, and implementation of a Double Tax Avoidance Agreement. This simple explanation of International Taxation is further explained with more specific details.

Same country can be COS for non-resident assessees and COR for resident assessees. One person may earn income from several countries and hence have several COS. One person may be a resident of several countries. This looks impractical. However, different Governments have different definitions of residential status. For

example, under Indian law, if a person stays in India for 182 days or more in a financial year, he is treated as a Indian resident. However, if a person has been always living in India, and then in a particular year, he has gone abroad but had been in India for 60 days or more, then he would still be treated as Indian resident.

This needs an illustration. Let us say Mr. Iyer is aged 65 years, he is retired and has always been residing in India. For the Financial Year 2019-20, he left India in the month of June, 2019. He was in India for more than 60 days. His children are US citizens. They invited Mr. Iyer to settle down with the children. They completed all the formalities and obtained a Green Card (permission to stay permanently within USA) for Mr. & Mrs. Iyer. On the strength of the Green Card, both - Mr. & Mrs. Iyer will be now staying in USA. Hence, under the US tax law (Internal Revenue Code) they have become tax residents in USA. They will be liable to **US Income-tax on their global incomes.** At the same time, under Section 6(1)(*c*) of the ITA, they would be considered as Indian residents and even Government of India would demand **Indian Income-tax on their global income**. Here is a case of dual residence because of different provisions in tax laws of different countries.

Now reverse this illustration. Mr. Patil went to USA for studies. Got employed in USA and even got citizenship of USA. Hence, he is a US tax resident. In the year 1999; at the age of 35 years, he decided to return to India. He has resigned from his American service, sold all his assets in USA and is now permanently settled in India. Financial Year 2019-20 is his twentieth year of being tax resident in India. However, since he has retained **US citizenship,** the US Government still considers him as a tax resident of USA.

The short point being discussed here is that one and the same person can be considered to be resident in two or more countries.

Some people assure that they stay in India for less than 182 days in every year. They are Indian citizens. Balance six months are spent in two or more countries. Hence, they are not tax residents of any country. These are **"Tax Nomads"**.

7.3 TAXING RIGHTS

The Government of any country acquires taxing rights by its own legal system. In India, the Constitution of India authorises Indian

Parliament to pass a tax law. The Parliament has passed Indian Income-tax Act, 1961. Government of India is authorised to collect Income-tax from its subjects as provided in the Income-tax Act. If Government of India - Income-tax department tries to collect tax which is not authorised under the Indian Income-tax Act (ITA), then Indian Courts would strike down such an effort by the department.

It is an important issue to appreciate that the taxing right of a Sovereign Government is by its own constitutional and legal system. No outside authority can either grant the taxing right or restrict the taxing right.

7.4 INTERNATIONAL LAW

Normally, by "law" we understand something which has been made by a body with appropriate powers and which is backed by enforcement machinery.

International Tax Law is not passed by any Authority. There is no codified, written law. There is no enforcement system. It is a set of legal principles which have been customarily accepted by majority of Governments & Courts. Charters & Conventions issued by international organisations like United Nations (*e.g.* Vienna Convention) form International Tax Law. It is more like a "Gentlemen's Understanding" then like an enforceable law. There is of course an International Court of Justice. And yet, compliance is a matter of protocol rather than force.

Interpretation of DTA is quite a different practice. DTA interpretation is supposed to be in "Good Faith" as compared to domestic tax practice where people do aggressive hair spilt interpretation. But many practitioners & revenue officers do not accept this difference & hence we have huge litigation.

7.5 JURISDICTION

To tax any person, a Government must have a jurisdiction. Any Act done without jurisdiction would be *void ab initio*. For example, Government of India would like to tax a non-resident having its income outside India. If that were permitted Government of India would have no budgetary deficit. At the same time, business persons would be exposed to tax attempts by several countries. Global business and investments would go down. Hence, under International taxation, it has been accepted that a Government can tax any income only if it has a jurisdiction to tax the same. A jurisdiction is acquired by a

"Connecting Factor". Connecting factor is also known as **"Nexus".**

There are two kinds of connecting factors. For the assessee/tax payer, normal connecting factor is his **residential status**. Thus, if a person is resident of India, Government of India (GOI) has a jurisdiction to tax his global income. Please note that the connecting factor of "residence" grants to the concerned Country of Residence taxing rights for the global income of that person.

Another connecting factor is "**Source**". If the income is sourced from a country, the Government of that country has a right to tax that income irrespective of the residential status of the person. Thus, in our earlier illustration, Mr. Patel is not a resident of Britain. However, his income is sourced from Britain. Hence, Britain has a right to tax the income. It may be noted here that the country of source has a right to tax only the income sourced from that country. Any income earned by a non-resident outside the country cannot be taxed by the COS. With reference to Indian Income-tax Act, the same issue is explained as under.

7.6 CONNECTING FACTORS

7.6-1 The charging section 4 levies a charge of Income-tax -

On an **ASSESSEE**

For his Total **INCOME.**

These two are important factors on which the charge of tax is determined. We would say, these are the two pillars of the tax system.

A Government needs a **connection**, a nexus to have a jurisdiction to levy a tax. For each pillar, there is a different Connecting Factor.

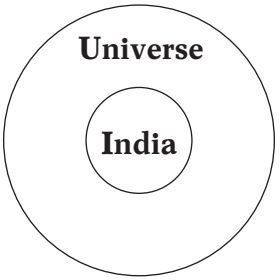
7.6-2 For the ASSESSEE, the connecting factor is - Residential Status.

For an individual, the residential status is determined by his personal connection with the country. For example, he should be **resident** of that country, or citizen, domicile etc. In case of a **non-individual** entity, the logical factor is its seat of power, where the control and management is situated. In practice, most countries' Income-tax Acts simplify the whole issue by providing that the place of **registration** of the company shall determine its residential status. All factors affecting residential status are **geographical** in nature.

7.6-3 In case of INCOME, the connecting factor is Source.

In other words, an assessee is taxable if he is resident of India; and an income is taxable if it is sourced in India. If income is sourced in India, it will be taxable even if the assessee is a non-resident. Similarly, if the assessee is an Indian resident, his income will be taxable in India even if the income is foreign sourced income.

7.6-4 Income - Tax Base



Indian Tax Base is determined by the Connecting Factors:

Resident of India - Universal income is taxable in India.

For a Non-Resident of India - Indian sourced income is taxable in India.

Non-Resident's income sourced outside India is not a tax base for India.

Erosion of tax base is an important issue in Anti-Avoidance measures.

7.6-4a *Assured Overlapping* - An Indian Resident's income sourced in say, U.K.; and a U. K. Resident's income sourced in India - both incomes are **Tax Bases** for both the countries. Thus there is assured overlapping of Tax Bases.

7.6-4b *Tax Base* - For the Indian draftsman, India is at the centre of the Universe.

But similarly, for 200 countries' draftsmen, their own country is at the centre of the universe. Everyone (almost) wants to tax income accruing even outside his own country. Hence there is ASSURED OVERLAPPING of tax base.

7.7 RESIDENTIAL STATUS

Most countries have adopted residential status as the connecting factor that grants jurisdiction to tax. However, it is for the Government

to decide what would be the connecting factor. For example, US Government has considered citizenship to be the connecting factor. Hence, if a person is a US citizen, or a Green Card holder, then the US Government would exercise its right to levy tax on that citizen even if he is a non-resident of USA for several years. Normally, residential status would be defined clearly in the domestic tax law. Under Article 4 of the OECD Model, residential status is not defined. The treaty says that the residential status of the person shall be determined under the domestic Income-tax Act.

7.8 SOURCE

Section 5 of the Income-tax Act provides for the scope of total income. Any income which is covered within the scope under Section 5 shall be considered to have been sourced from India. Hence, GOI would claim a right to tax the same. **Section 9** of the ITA **extends the scope** by making deeming provisions. It may be noted here that under Section 5, the fact that an income has accrued or arisen in India is sufficient for GOI to tax the same.

7.9 RIGHT TO TAX - COR & COS

7.9-1 Next issue is: for which incomes the Country of Source (COS) should levy tax, levy full tax or lower tax, and which incomes should be exempted by COS? For this purpose, **categorisation of income** (articles 6 to 22) have been provided in the model DTA.

Which country should tax **business income** - COS or COR? In these discussions, COS may be considered as the country where the supplier has any operations or source of income. COR may be considered as the **supply**/performance/production side.

History has so developed that OECD had more finances and did more work. Treaty division of U.N. with limited finance did very little work. The OECD members had most of the companies exporting goods & technology to the developing world. So majority companies in international business had their "residence" in OECD member countries. Hence a clear bias towards supply side/COR has been adopted by OECD. Most tax professionals have accepted this without questioning.

An illustration - till 1972, global trade position was that the developed countries imported commodities at low prices and exported value

added goods at very high price. Hence majority of incomes were earned by the companies residing in the developed world. They also exported technical knowhow and gave licenses for use of the knowhow, patents, etc. OECD model (year 1972) provides that all these incomes may be taxed only in COR (subject to PE profits).

Under article 7 which covers business income, primarily all rights to tax are given to COR. In the year 2010, OECD modified the model convention and brought in FAR analysis. Its effect is interpreted to be that the Country of source has a lower right to tax as compared to pre-2010 position. Why so? This is a basic question. (Such interpretation is also doubtful. This is another matter of debate.)

It may be noted that the present international tax system is considered to take into account the "supply side" of the business and not the "demand side". By "supply side", it is meant as the contribution of the businessmen for earning the income. Businessman is the supplier of goods or services or technology. He will operate from the COR. If he operates in the COS, then COS gets the right to tax. "Demand side" means the customers or the market which gives rise to demand. Even if the business happens due to supply side and demand side contributions, income-tax rules are based on supplier's activities - i.e. supply side factors. If there is no activity by the supplier in the "demand country" [or the Country of Market (COM)], the "demand country" cannot levy income-tax. This principle is what we have suggested to be amended to have a fairer tax system.

7.9-2 The Latin American countries protested the bias towards COR. In the model treaties prepared by the League of Nations, more taxing rights were attributed to COS. However, in OECD negotiations - developed world has been successful in maintaining the bias towards COR. League of Nations has been forgotten.

7.10 CONNECTING FACTORS: FURTHER DEVELOPMENTS

A country gets its income- tax jurisdiction by any one or both of the following two Connecting Factors: Residential Status and Source.

In absence of any connecting factor, the country has no jurisdiction to tax. Thus a **Non-Resident's foreign sourced income** cannot be taxed. Problems arise when the non-resident assessee claims that his income is not sourced in India; and the GOI claims that the income

is sourced in India. In controversial cases, GOI has made two kinds of amendments.

(*i*) GOI has stated its position on the scope of total income by extending the Scope of Taxable income. This is achieved by making deeming provisions in Section 9. In such cases, if the DTA provision is more beneficial to the assessee, DTA provision applies. This is the normal case.

(*ii*) Some provisions like GAAR - chapter X-A & amendments to S. 90 are **anti-avoidance provisions**. These **override the DTA provisions** also.

7.10-1 Present International Taxation has emerged in a peculiar manner. When it comes to **business income**, a non-resident assessee claims that it has no physical presence & no agent in India. Income-tax Officer claims that the NR assessee has a PE in India. Since Digital Commerce does not require a PE in India, Income-tax Officer claims a **Virtual Business Connection** in India & then claims a jurisdiction to charge income-tax on such incomes. Different concepts have been tried for a Virtual Business Connection (BC). **Footprint** of a Television Channel has been considered a Virtual BC. GOI's observations on OECD commentary on Articles 5 & 7 give **GOI position**.

7.10-2 In case of incomes categorised as "**Royalty**" or "**Fees for Technical Services**" (FTS) Governments see **no need to establish that the source of** income exists within their boundaries. These are considered "**passive incomes**". Just because **payment** for these categories is made from within their boundaries; or made by their resident assessees, it is considered adequate to tax such remittances. Hence Income-tax Officer attempts to categorise Digital Commerce payments made to non-residents as royalty or FTS. Assessee claims it as "Business Income" or FTS not "imparting knowledge".

7.10-3 On the other hand when a **Resident** earns income from within the country, both the connecting factors are applicable. Hence his income is considered "Domestic Income". The cross border tax issues do not arise in the case of domestic income. An Indian Resident assessee never raises the issue of "Jurisdiction to tax". In all cases, his income is liable to tax in India.

7.11 RESIDENCE UNDER TREATY. DTA ARTICLE 4

Treaty does not define residential status. If the domestic law of a country considers an assessee to be liable to tax in the country by the criteria like - residence, domicile, place of management or similar other criterion - then that person is considered to be resident of that country.

Thus the domestic law determines residential status of the assessee. Treaty does not determine residential status.

It is clarified in the treaty that if a country levies tax based on the connecting factor of "Source"; then such tax liability does not make the assessee "Resident". Countries like France, Singapore, Hong Kong etc. adopt "**Territorial System**" of taxation. They tax only income sourced within the country. This is a different matter altogether. India, U.K., U.S.A. etc. have adopted "**Classical System**" of taxation. A non-resident of India is liable to tax in India only on income sourced in India. Because he is liable to tax on source basis, he does not become an Indian resident.

7.12 RESIDENCE UNDER ITA SECTION 6

A company's residential status is determined by:

(*i*) Place of Incorporation; and

(*ii*) Place of Effective Management (POEM).

"Place of Effective Management" is a concept discussed at length by OECD.

Why place of incorporation? Normally, in the past, companies used to be registered in the country in which majority of shareholders (ownership) and directors (management) were located. Major part of the Company's business would be located in the country of incorporation. That company would benefit from the economy, stability, infrastructure, legal system of the country and should pay tax to the country of incorporation. It was legitimate to consider it to be a resident of the country where it is incorporated.

7.13 SOURCE

This word has two different meanings. Some illustrations: **"Source of Income"** may be: in case of dividends - the company declaring

dividends; employer - in case of salary income, a firm - in case of share of profit etc.

Country of Source means the country from which an income has been earned/sourced. In this book when we refer to "Source"; we are referring to Country of Source (COS).

7.14 PERMANENT ESTABLISHMENT - DEVELOPMENT OF THE CONCEPT

7.14-1 A non-resident conducting business outside the country is not liable to tax in the country. In other words, a person doing business **with India** is not liable to tax in India. However, if he does business **within India** then he is liable to tax in India.

If the non-resident's business in India is too small, the cost of tax assessment and recovery may be more than the revenue. Hence the non-resident's income is considered for taxation only if his presence in India is beyond a threshold. **This threshold is called a Permanent Establishment (PE). PE is essentially linked to geography.**

If a non-resident has a PE in India, the profits attributable to the PE's activities are taxable in India. The country where the PE is situated can be referred to as: the **"Host country"** or the **COS.**

7.14-2 Until the development of internet, it was necessary for the buyer and seller of goods or services to physically meet and transact the business. The meeting could be through a branch or factory or any other establishment. The treaty draftsmen could not envisage a situation where business could be transacted without a physical place of business establishment or without personal meetings. Hence the concept of Permanent Establishment is largely **geographical**.

E-commerce by definition does not need a physical meeting place for business. **Digital Commerce defies geography**. Hence the concept of PE cannot be applied to Digital-commerce.

The concept of PE will continue to be applicable for Traditional Commerce. But it fails in its application to Digital Commerce. We need to develop a new concept.

Country where the PE is situated is COS for the income attributable to the PE. In case of Digital Commerce, a non-resident earns income from India without any PE in India. How do you tax him?

This problem does not arise in Traditional Commerce. (Traditional commerce needs a PE in the COS.) But it becomes the core issue in E-commerce. Existing **Treaty Models** and their commentaries are **inadequate to deal with** this problem. Hence special issues/ controversies are arising in the matter of E-commerce. **This book discusses issues arising out of inadequacy of treaty model.**

CHAPTER 8

JUSTIFICATION FOR THE "RIGHT TO TAX"

8.1 RULES OF JURISDICTION

Note: "Right to Tax" is provided by each country's legal system, its Constitution and the relevant domestic tax law.

Justification for "Right to Tax" is a matter of International law -which again is a matter of international protocol, mutual respect with no enforcement powers.

8.1-1 Residence

There is a justification for a country to tax its **resident's global income.** When an Indian resident conducts the business, he benefits from Indian economy, infrastructure, legal system & so on. India contributes to the value addition made by the resident. It is appropriate to expect the resident to contribute tax to the economy which has helped him earning the income. COR has a greater justification because the assessee owes his very home, his safety, his passport & all to the COR.

8.1-2 Source

There is a justification for India to tax a **non-resident's Indian sourced income.** When the non-resident conducts the business within India, he benefits from Indian economy, infrastructure, legal system & so on. India contributes to that part of value addition which is made by the non-resident in India. (More involved issues are discussed later in the book.) It is appropriate to expect the NR to contribute tax to the economy which has helped him earning the income.

A further principle accepted under OECD model and accepted + elaborated by us in our earlier E-Commerce presentation is as under:

Country of Source has a right to tax only that much income which is attributable to the **activities carried out by the assessee** within the COS. Assessee's activities outside COS do not give rise to any taxable income within COS. In other words, if the assessee has not carried out any activity within India; India has no right to tax his income. This is a simple summary of FAR analysis. This concept is extensively reviewed in the present book.

8.1-3 Country of Source

COS has not been defined either in Indian Income-tax Act or in the Treaty models. OECD and UN have left it to the Treaty countries to decide which income would be considered as sourced within their borders. A good **definition** can be:

When an assessee - by his own activities - within a particular country - makes value addition - that particular country is the Country of Source. The taxable profits earned out of the value addition are taxable in that country. This principle was accepted by us in our E-Commerce Presentations. In this book - Para 16.2 in Part IV - we are briefly reviewing this principle.

8.1-4 Indian Income-tax Act (ITA) has not properly defined "Source".

Section 5 determines Scope of Total Income & section 9 makes deeming provisions extending the scope. This "Scope" includes even incomes which are simply **received** within India. Even if a non-resident receives his foreign income within India, he becomes liable to tax in India. Hence Sections 5 & 9 cannot be said to be defining "Source".

DTA does not normally define "Source". Yet, in some cases, the DTA places restrictions on what can be termed as "Sourced" in COS and what cannot. In cases where domestic law and DTA provisions are at variance, DTA prevails. To this extent "Scope of Total Income" gets reduced.

8.1-5 Except for the contribution by the COR & COS to the assessee & to his income, there is no other fundamental reason why these countries should have jurisdiction to tax the income. If any other justification is found to change income-taxation principles that also should be fine. If necessary, the relevant laws can always be changed.

Tax legal systems have been set up considering these Connecting Factors. All other relevant issues have fallen in line with this basic structure.

8.2 IMPORT OF GOODS

8.2-1 When goods are imported into India, it is **a presently accepted position** that India has no right to levy Income-tax on the income earned by the non-resident exporter. **The logic/Justification** probably is that the exporter has made full value addition/completed his manufacturing activity outside India. It is a Non-Resident's foreign income. Hence India has no jurisdiction to tax his income.

The facts that: (*i*) India is a market, (*ii*) goods are sold in India, and (*iii*) but for the sale, the non-resident would not have earned profits; are not considered relevant. (Here India is the Country of Market or COM. India is not a COS.)

Similarly when India exports goods to other countries, those countries do not charge any income-tax on the Indian exporters' incomes.

8.2-2 There is no doubt that **COM contributes** to the value of goods. For example, a product sold in India may command a price of ₹ 100. When the same product is sold in USA, it may command ₹ 200 net of all transport cost. This extra price is the contribution of value by US as an economy. Still, as per the existing rules of international taxation, USA has no right to levy income-tax on Indian exporter. Its right to collect taxes is executed by **indirect taxes** like customs duty and octroi. This position is accepted by almost all countries and treaties.

8.2-3 Another concept may be discussed here. Many times, **payment** may be made from one country. That country need not be where the assessee-income earner has any functions, assets or risks. Yet the country may choose to tax simply because payments have been made from the country. This is done mainly to "passive" incomes. Such a country is referred to in this book as **Country of Payments or COP**. Country of Source, Country of Market & Country of Payment - each term describes different characteristics. It is possible that one and the same country has all these three characteristics. It is also possible that different countries may have these characteristics.

8.3 IMPORT OF SERVICES

8.3-1 OECD model does not have the Article pertaining to Fees for Technical Services. Hence FTS would be governed by Article 7 - business income. OECD model does not have a separate clause for Service PE in Article 5 or for professional services. UN Model has service PE clause in Article 5(3)(*b*).

Article 7 gives priority in taxing rights to the COR. Under OECD model, COR gets priority for business, services & profession.

India has retained Service PE clause in Article 5 as well as FTS clause and separate article for professional services. India - US DTA Articles 5(2)(*l*), 12 and 15. **What is the logic for treating "services" different from "Goods"?**

There is absolutely no logical reason - except that it is a **tradition** followed for a long time. In the past, services constituted a small portion of total GDP. Hence law makers never bothered about services. For example, we have a "Sale of Goods Act" but no "Sale of Services Act". This, despite the fact that today, in Indian GDP, "Services" sector is the largest sector.

8.3-2 Customs duty on import of goods has been levied since long. There was no customs duty on import of services. This distinction is now reduced by the Goods and Services Tax (GST) provision of "Reverse Charge". An importer of service has to pay the service tax on the value of services imported. Under indirect taxes, India has reduced the distinction between "import of goods" & "import of services".

However, India has retained distinction in international-income taxation between "import of goods" & "import of services" in favour of COS. OECD has removed the distinction in favour of COR.

All these details are discussed here only to highlight that there is no fundamental logic/justification for this distinction. It is simply a tradition that India and some countries follow. This is an existing weakness in the international taxation practised in India.

The weakness in OECD model is that it gives disproportionately larger taxing rights to the COR.

8.3-3 Thus in India, services are treated differently. In case of import of services, it is possible that the non-resident exporter of services has completed all his value addition outside India. In other words, he has

"**performed**" his services outside India. He has no activity and no PE in India. Still India claims and exercises a right to levy tax on "Fees for Technical Services" (FTS). [Explanation after section 9 (2)]. GOI's claim is that the services are "**utilised**" in India. Modern technology has made it possible that the "Country of Performance of Service" can be different from the "Country of Utilisation of Service". Just as "Country of **Production** of Goods" can be different from the "Country of **Consumption** of Goods".

Similar position is accepted by many countries. This is an important **change** from the basic principles of international taxation.

Similarly under Indian DTAs royalties are taxed without examining whether India is the Country of Source. Just because an Indian resident has made the **payment**, the royalty is considered taxable in India. Under OECD model royalties are taxable in COR.

8.4 E-COMMERCE DEFINITION

8.4-1 Literal meaning of E-commerce is "Commerce conducted through electronic instruments". Traditionally it is restricted to business transacted through **computers and internet**. Recently **mobile phones** are also included in the list of instruments used. Televisions are also electronic instruments and part of the business is conducted through TV.

Telephone land lines in India may be analog instruments. However, if someone conducts commerce on these phones, it also should be included in E-Commerce. One can say that "Commerce conducted through electronic instruments" is only a **description. Not definition**. Having described a business, all similarly conducted commerce should be included in the term E-commerce. Thus E-Commerce may include commerce conducted without a PE or other physical presence in the COS. Instruments used may be: Internet & computers, television or radio, mobile phones or any other instruments.

8.4-2 E-Commerce is fast evolving. Ideas about what constitutes E-Commerce are also evolving. We may divide E- Commerce into two broad categories:

(*i*) Marketing, order Booking & payment are made by electronic means. However, actual service is provided physically. Like Air Line & hotel bookings.

(*ii*) Even the service is provided online. Like Google & Face Book.

Airlines & hotels can sell their spaces on the internet. A potential customer can visit their website, survey the opportunities available, book a seat or a room & make payment through internet. Contract is completed on internet. Hence it is considered E-Commerce. However, consider the fact that the real service to be rendered is - carrying the passenger for the airline; and providing room for the Hotel. Those services are physically, personally given. Contract is completed only when services are provided. In this book we are focussing on the 2nd category of E-Commerce.

8.4-3 Instrument used for communicating or for conducting business **cannot be a basis for any tax rules**. It is accepted by OECD & many others that there cannot be separate rules for E-commerce. Indian **High Powered Committee** on E-commerce has discussed this issue and reported that under the concept of **neutrality**, all services should be taxed similarly. Hence there is no need to define E-commerce. A description of the concept is sufficient for discussion purposes.

8.4-4 Import of Goods

We have considered that import of services *via* E-Commerce should be liable to income-tax. This means that import of goods via E-commerce should not be liable to tax. One can place order on say, Amazon.com or similar companies through internet. Ordered goods will be supplied physically. They may be liable to customs duty. No income-tax will be chargeable. Main reason is that goods imported otherwise than through E-Commerce are not liable to income-tax. Neutrality may be maintained within the sector of goods.

9 CHAPTER

TAX AVOIDANCE – ABUSE OF LAW

When Tax Payers violate the laws for not paying taxes, it is called **Tax Evasion**. *The legal machinery will deal with the evasion.*

When tax payers use existing law, double tax avoidance agreements & tax havens for not paying taxes, it is called **Tax Avoidance**. *The legal enforcement machinery is blunted. Both (evasion & avoidance) are unethical & immoral. But the tax payers claim: "There is no place for ethics & morality in taxation." Aggressive tax avoidance mechanisms frustrated governments & BEPS programme, GAAR, Transfer Pricing etc. were brought about.*

9.1 POSSIBLE TAX AVOIDANCE SCHEMES

Some of the Tax Avoidance schemes that Global Corporations (GCs) use may be briefly considered.

In science there is a tremendous progress in **several technologies and** all these technologies are **converging**. Today's latest mobile phone uses all the technologies together to provide the best solution to the user. And several companies are **competing** fiercely to come out with the **best products to do business - more efficiently.**

Similarly, on **tax planning** front, the consultants are using several "technologies"/concepts together. They are competing with each other to present the **best tax avoidance "products"** for the tax payer. Following instruments/circumstances help them:

(*i*) **Concepts** like - "company is a separate legal entity", "it is resident where it is registered" are used even where the facts are not applicable to the concept. With the help of these concepts, residence of a company is shifted to (*i*) a tax haven to pay zero or low tax; and (*ii*) do Treaty Shopping.

(*ii*) **Tax haven Governments** are competing with each other to present laws suitable for tax avoidance. Tax havens are used extensively by MNCs & GCs for (*i*) shifting their revenue profits and (*ii*) shifting capital gain transactions - outside COS.

(*iii*) Convergence of **technologies** discussed earlier.

Thus, Inappropriate application of very old legal concepts/ principles; tax havens and modern communication technologies help in aggressive tax avoidance schemes.

It is easy to incorporate a company in a tax haven, have the website etc. in a tax haven; and then do a global business. The GC is resident of a tax haven. It earns from several countries around the world. But it has no PE in any source country. So it pays no tax on "Source" basis.

9.2 GOOGLE'S TAX PLANNING

Above stated theory is illustrated based on an illustration taken from media. Now it is said in media reports that Google has set up corporate structure & tax planning schemes which are referred to as "**Double Irish**" and "**Dutch Sandwich**". It earns substantial advertisement revenue from Great Britain but pays little tax in Great Britain. Members of British Parliament and tax experts are discussing: (*i*) Google's arrangements are legal; (*ii*) but evil & not acceptable; (*iii*) so how to make Google pay a fair share of tax to the British Government.

Google's tax planning has added **two new dimensions:**

(*i*) In the software outsourcing business the services are provided in **one** country - India. Services are utilised in **another** country - USA. So there is **no confusion about COS or COR.**

In case of service providers like Google, You Tube, Face Book etc. the service is provided **all over the world**; service users are all over the world; the users pay smaller amounts; main revenue - advertisement is earned globally. How do you tax these companies' net profits? Which countries are COS and which are COR? Who will check their accounts, who will calculate a fair net profit? How will the profits be attributed - based on users - footprints, advertisers or place of residence? Their taxation **defies geography**. And existing tax systems are based on Geography.

Further - all these companies do not really provide their own services. Google relies on millions of databases all over the world. Face book relies on the data given by the users themselves. You Tube relies on millions of people uploading video clips. In short, these three companies are providing **merely communication services**. Some free data available in some corner of the world is made accessible globally. And they earn billions of dollars in advertisement revenue. Fantastic business model. And almost tax free.

(ii) In the U.K. Google and other companies' tax avoidance has become a **public debate.** Members of Parliament seriously criticise tax avoidance. Media supports MPs and criticises tax avoidance. Common men stage processions against the companies & ask for boycotting these companies. This second development is a recent phenomenon. In the past common men did not criticise tax avoidance by tax planning. U.S. & European financial crisis has caused this phenomenon.

In India almost the whole of **media and profession praises tax avoidance schemes**. **Government seems to be confused and susceptible to lobbying. CBDT is sometimes on the defensive sometimes aggressive**. Similar trend was prevalent in Greece - until it went insolvent.

9.3 CATEGORISATION OF INCOME

Within **domestic taxation** categorisation of income is essentially for computation of income. "Business income", "salary income", "capital gains" - each category needs and has been provided different rules for computation of income and different rules for granting reliefs. Once the income is computed, all incomes are added as Gross Total Income and then same rate of tax is applied to the Total Income.

Whole scheme of DTA is that: COS will restrict its "Right to Tax". COR will give credit for taxes in COS. In this manner double taxation will be avoided. COS will restrict its Right to Tax based on "Categorisation of Income". For example, "Income from Immovable Property" will be fully taxed by COS. However, in case of business income, COS will levy no tax except in case of PE. For some other categories of income, COS will levy a flat rate of tax on gross revenue.

Different rates of tax depending upon categories of income induce tax payer and tax officer to take conflicting stands on categorisation.

This causes litigation. For example, a NR financial institution earning capital gains in India may want to claim that: "Sale & purchase of securities is its business. Resulting gain is business profit. The NR has no PE in India. Hence its income is not liable to tax in India". For the same tax payer, the tax officer would like to claim that: "the NR has earned Capital Gains. Assets are situated in India. Hence the NR is liable to Indian income tax." Thus Categorisation of income with different rates of tax opens up probabilities of abuse of law by both sides.

"Categorisation of Income" is a significant cause for tax avoidance and hence cause for tax litigation. This is another existing weakness in International Taxation. Can we eliminate or reduce categorisation?

9.4 COMPANY IS A SEPARATE LEGAL ENTITY

This concept has been developed with a specific purpose. To allow people to collect small amounts of share capital from a large number of people and grow the business to a size which would otherwise be impractical. Separation of company's assets and liabilities from the shareholders' personal assets and liabilities; separation of management and ownership are some important characteristics of a company.

The status of a separate legal entity is granted to support these characteristics. Where the shareholders practise no separation, consider company's assets as their own assets; that company in reality does not exist as a separate legal entity. Yet, lawyers argue that once a company has been incorporated, irrespective of the fact that it is in a Tax Haven, it must be considered a separate legal entity. We will see below (*i*) how this assumption can be abused and (*ii*) how place of incorporation is becoming irrelevant.

9.5 CORE PRINCIPLE: JUSTIFICATION FOR TAX JURISDICTION

It is said that the core of every religion is "Love & Truth". As long as this core lives, a thousand cobwebs hiding the core cannot affect the core. A religion propagating love & truth will always survive. In international taxation, can we find such a fundamental core?

Our submission on Tax Jurisdiction. A nation gets right to tax that part of income - which has been earned due to some contribution by the nation. No contribution to income, no jurisdiction to tax. Contribution can of course be made in a broad manner by supporting/ safe-guarding the economy so that people can do business. This is

further discussed in more depth. It also means - when there is no income, there can be no tax. If two or more nations contribute an income, those nations share the tax revenue. And when a nation has contributed to a particular income; it must have a right to tax that income. No amount of tax planning can be permitted to take away that right. If a nation voluntarily forsakes a right to tax, that is its right to do so.

There will be several compromises and variations in calculating income and attributing profits to a particular nation. Difficulties in administration of law will force compromises from the core/ fundamental principle. However, the system will continue to work if we do not stray too far away from the core principle. And every time we make a compromise, we recognise the compromise. A further compromise if it takes us away from core, should be avoided. At times it so happens that one compromise leads to another & yet another compromise. Ultimately one forgets the core. That is when serious risks start.

10 CHAPTER

ILLUSTRATIONS OF GLOBAL TAX AVOIDANCE

10.1 EXISTING RULES FAIL IN SOME DIGITAL TRANSACTIONS

Let us see a few illustrations of digital commerce where it becomes difficult to apply existing rules of international taxation.

10.1-1 Business Process Outsourcing (BPO) is a classic illustration of E-Commerce. A common illustration of BPO is: An American software developer company (let us say Microsoft) out sources some development work to an Indian software developer. (Let us say Infosys.) When Microsoft outsources software development work to a third party like Infosys: or to Microsoft's own subsidiary/branch in India; what Tax issues arise? Can it be said that Microsoft has a PE in India? What portion of Microsoft's profit can be attributed to the Indian PE?

When Infosys provides a service to a foreign Company, can the Government of that country tax the FTS earned by Infosys on 'Gross Basis'? Consider a DTA where the "Make Available" clause is not included.

10.1-2 Cricket Four country teams play a series of cricket matches in all the four countries - India, South Africa, West Indies & U.K. There are sports associations in all these countries that manage the cricket teams. The cricket players get **remuneration** from the organizers and they also get **advertisement fees** from different countries.

Four organizations share the **ticket revenue**. Tickets for all countries' matches are sold in all countries. There are different companies that "own" different teams. A group of companies gets right for **broadcasting** the cricket matches on television in several different countries. Let us say some of them are non-residents of India. They pay

to the organizers & team owners. These TV broadcasting companies get their revenues from (*i*) cable operators; (*ii*) TV viewers - DTH, (*iii*) Indian advertisers & (*iv*) Foreign advertisers.

Cricket is played and broadcast globally. Many different entities earn different kinds of incomes globally. Which revenue can Government of India tax? On what basis?

Let us say, a European Company selling high fashion garments pays for advertisement to a foreign TV broadcasting company. The company is broadcasting cricket matches in several countries. The advertisement is targeted to several countries. It has footprint all over.

Can Government of India tax this revenue on any grounds?

10.1-3 TV Footprint

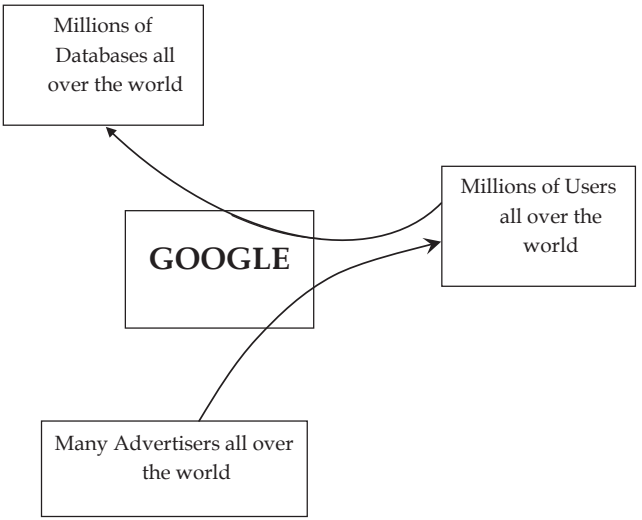
In other cases of TV channels etc., **Indian** Income-tax department has claimed that it will tax advertisement revenue when the **TV footprint** is in India. Can Government of India tax (*a*) a non-resident company, (*ii*) doing broadcasting business outside India (*iii*) having no PE in India and (*iv*) earning advertisement revenue from other no-resident companies? If yes, on what grounds? Is it permitted by DTA?

Above illustrations are for starters.

Now let us move to a sumptuous illustration.

10.2 GLOBAL CORPORATION: ILLUSTRATION OF GOOGLE

10.2-1 Google's Business Model



Google helps internet users to access data base. Google provides the service to advertisers for being able to advertise. To attract more advertisement, Google attracts more users. To have more users, it provides more and more data in more efficient manner. When we are considering the taxability of Google as an assessee, Google's value addition is - providing a medium for advertisement. For providing this base, Google provides the data access services. Google's revenue is (*i*) mainly from advertisers and (*ii*) from data users. Since we are considering from the viewpoint of COS, following issues are relevant.

Value creation by assessee Google is by the provision of entire system whereby: (*i*) the advertisers can make their advertisements reach targeted users; and (*ii*) Internet Users can search the data. Everything else is a cost in that value creation.

Google has its massive server banks (hardware) at several countries. The connection amongst the data bases, user bases and advertisers are provided by innumerable Internet Service Providers (ISPs).

Key instrument is the algorithm and software which makes all these accesses possible.

10.2-2 Where is the value addition made?

Is it where the server banks are situated? (Hardware)

Or Where the users are situated? (Part of the Market)

Or Where the data are situated?

Or Where the advertisers are situated? (Main Market)

Or Where the software is situated?

Where is the software situated?

Where does the software function?

Probably all these functions at all these places contribute to value addition. If that is true, there is no practical way to attribute profits to a specific country.

Experts in internet advise: Google has software which identifies every user, and his country; his choices based on past use of Google and such other information. It helps advertisers in targeting their advertisements to potential customers. Some advertisements may be open to all users.

10.2-3 For India, Google is a non-resident. What is Google's **business**? It provides: (*i*) Data access service to internet surfers and (*ii*) advertisement service to advertisers.

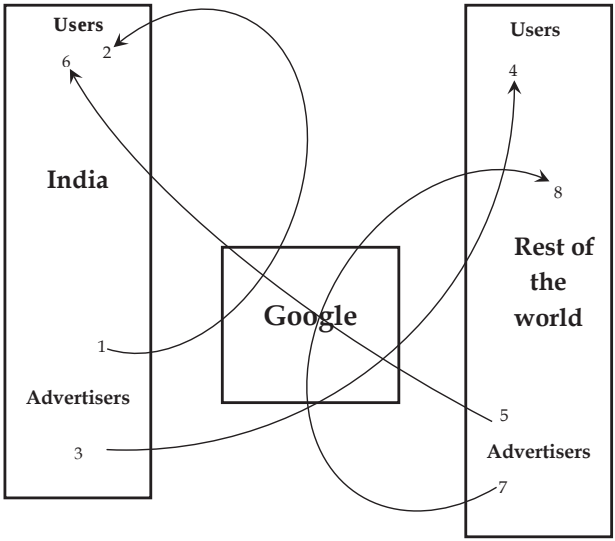
Where is the **value addition** made by Google? All over the world.

However, the tax should be on the basis of: (*i*) where advertiser is situated; or (*ii*) where user is situated? **Where is the service provided** by Google to the advertisers?

10.2-4 Google - Chart explaining its Business Model.

Google provides service to advertisers.

Advertisers pay revenue to Google.



Notes on the Diagram

1-2 Indian Advertisers pay for Indian users.

3-4 Indian Advertisers pay for foreign users.

5-6 Foreign Advertisers pay for Indian users.

7-8 Foreign Advertisers pay for foreign users.

For which advertisement revenue can GOI tax Google?

If we consider the **internet user as a base**, GOI can tax Indian as well as foreign advertisers (1 & 5) for their advertisements targeted to Indian users (2 & 6). However, in such a case, GOI cannot tax the ad revenue paid by Indian advertisers (3) targeting foreign users (4).

If we consider **advertisers as a base**, GOI can tax only ad revenue from the Indian advertisers (1 & 3). GOI cannot tax Google's revenue from foreign advertisers targeting Indian users (5). Foreign advertisers targeting foreign users is out of reach for GOI.

10.2-5 If we consider both - **internet users as well as the advertisers** as the bases for taxing Google's advertisement revenue there can be different ways of considering tax base:

10.2-5a All charges paid to Google by Indian users as well as Indian advertisers. (Irrespective of targeted users).

10.2-5b Above plus foreign advertisers targeting Indian users.

What happens if other countries retaliate by making similar provisions in their domestic laws? On what grounds will different countries share tax on Google's income.

We have to note that most of the DTAs are bilateral DTAs. In Google's case, there may be **several countries simultaneously** being the **COS** for the same ad revenue. DTA system does not provide for sharing of tax revenue amongst several COS. If - Internet Users & Advertisers - both are considered as the base for COS jurisdiction, then an unsolvable tax problem may arise.

However, if each country claims only the **payments** made from within the country (by both - internet users and advertisers) as the tax base; then the tax base becomes simple to administer.

10.2-6 "**Simplicity in Administration**" is an attraction for any Government. And GOI also is taxing Google on this ground. However, what about the **source definition** - "Value addition by the assessee by performance within the boundaries of COS"? (**Note:** no such definition is made under domestic law or treaty. This is a principle adopted in International Taxation. Specific wordings for the definition have been used by the authors. There is no base for this definition except tradition.) (For the time being we continue with the tradition.)

Let us assume for our illustration that Google has no hardware and no PE in India. Where does it provide its services? It is only exporting its service from a base country like Ireland. Google India's employees are in India only to collect the revenue. Value attributed to their work like a collecting agent may be only 2%. Can GOI tax 100% of Google's income?

10.2-7 Google - Indian Tax

On what grounds can GOI tax Google's advertisement revenue? Let us examine.

10.2-7a Google is a Non-resident of India. Hence the connecting factor of COR does not apply.

10.2-7b For applying the COS connection, anyone of the following circumstances should exist:

(*i*) Google should have a PE in India and the PE should provide services. This is non-existent.

(*ii*) Google should be providing technical services and earning FTS. Then Section 9(1)(*vii*) can apply. Consider the fact that **Explanation after Section 9(2)** clarifies that FTS can be taxed in India even if the service provider has no PE in India; and the services are not "rendered" in India. Hence GOI has clarified that India wants to tax NR's income based on **"Utilisation" of services** & not just based on the "Performance" of services.

However the basic issue is: Are Google's services covered within the **definition of "Technical Services**"? Refer to Explanation (2) to Section 9(1)(*vii*). A service to be covered under S. 9(1)(*vii*) must be a technical, managerial or consultancy service.

10.2-7c Google provides two types of services.

(*i*) The service provided to **internet users** (people who search on internet) is comparable to any other communication service provider like telephone or internet companies. This is neither technical nor managerial nor consultancy. This service is not covered u/s. 9(1)(*vii*). It is true that- Google uses high level complex technology. In the same manner, an airline uses complex machinery - aeroplane, and several high technologies. When the airline carries a passenger from one place to another; it is simply a carrier service. It is not considered "Technical Service". There can be several such illustrations. Google's service to its users is not a technical service.

Google has a subsidiary in India. Probably this establishment receives the subscription/advertisement revenue from Indian internet users & advertisers. Any revenue "received" or deemed to be received in India is taxable in India. Hence if Google re-

ceives the subscription revenue in India, it would be **taxable in India u/s. 5**. Entire discussion on Section 9 is unnecessary.

(Notes: 1. Even if an income is taxable u/s. 5, one will have to sill look at DTA. A Non-Resident's business income without a PE in India is not taxable in India. And DTA will override the domestic law. Under the existing domestic law & DTA, Google's income cannot be taxed in India.)

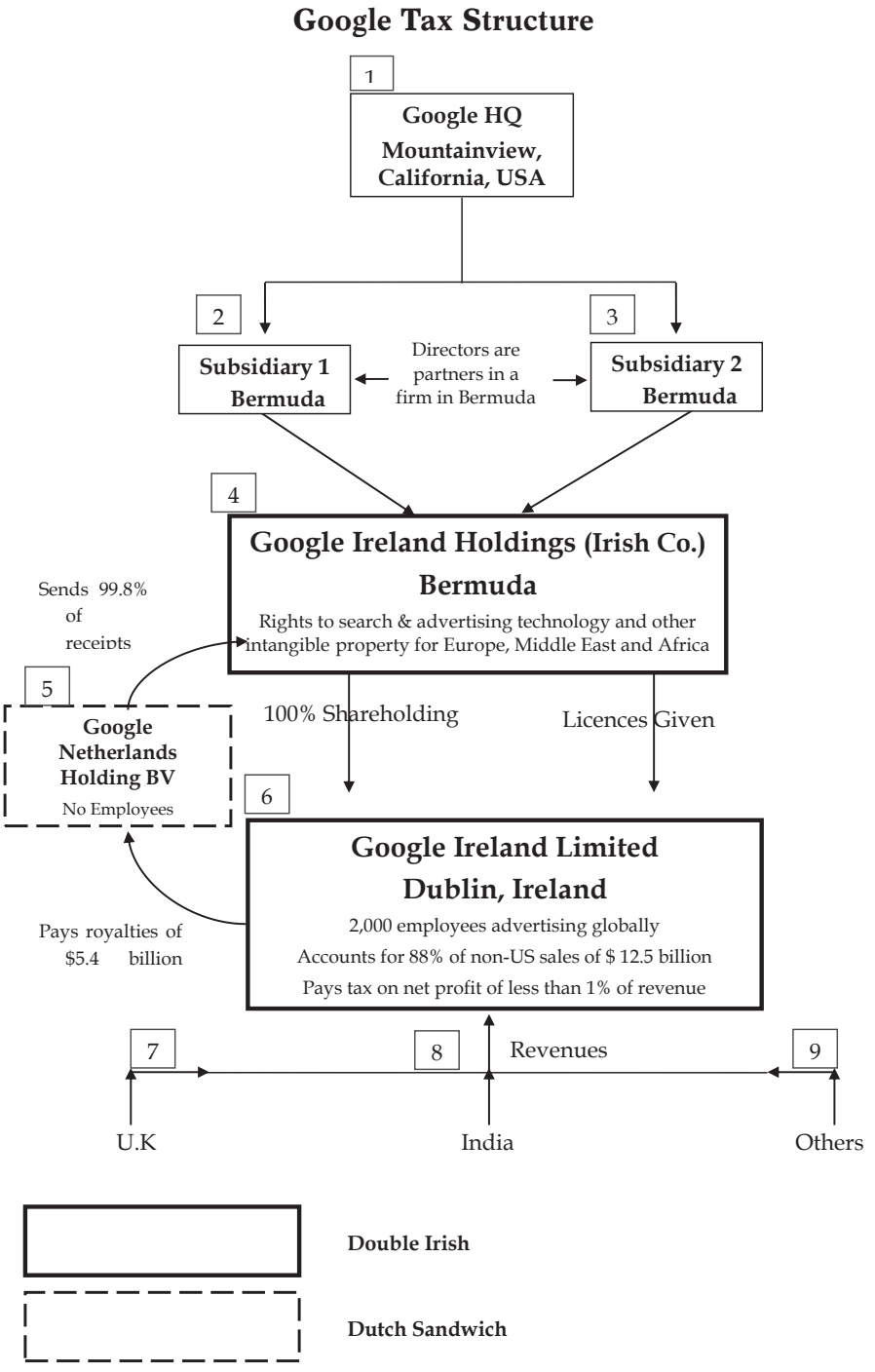
(*ii*) The service provided to **advertisers** is similar to the advertisement service provided by non-resident media like- Economist or any such magazine published abroad; or BBC/CNN or any such media company doing business outside India. They are doing business "with" India and not "within" India. Their service is neither technical nor managerial nor consultancy. Hence even this service is not covered by Section 9. If the Ad charges are received in India by a subsidiary or agent of India, they would be covered within the Scope of Taxable income u/s. 5. However, under DTA, they would not be taxable in India.

10.2-7d *Observation* - Even after the introduction of Explanation after Section 9(2); Google's revenue **cannot be taxed in India under Section 9.**

10.2-8 We have seen that taxation of Global Corporation is difficult even if they do not resort to tax avoidance. But E-commerce makes it eminently possible to avoid COS taxation ensuring that the GC has no PE/no presence in the COS. When GC resorts to tax avoidance, tax administration becomes more difficult. This fact is compounded by the fact that existing rules and practice of International Taxation are inadequate. (This is simply an analysis of facts. No criticism is intended.)

10.2-9 Tax Avoidance by Global Corporation (G.C.)

This tax planning is explained by taking the illustration of one Global Corporation - Google. (The tax planning details are taken from old media reports. Chart below and explanatory notes are prepared by us to explain the tax planning. It is possible that media reports are incorrect. We are interested in discussing tax planning that is possible for Global E-Commerce.)


Google Tax Structure
1
Google HQ
Mountainview, California, USA
2
3
Subsidiary 1 Bermuda
Directors are partners in a firm in Bermuda
Subsidiary 2 Bermuda
4
Google Ireland Holdings (Irish Co.)
Bermuda
Rights to search & advertising technology and other intangible property for Europe, Middle East and Africa
Sends 99.8% of receipts
5
Google Netherlands Holding BV
No Employees
100% Shareholding
Licences Given
6
Google Ireland Limited
Dublin, Ireland
2,000 employees advertising globally
Accounts for 88% of non-US sales of $ 12.5 billion
Pays tax on net profit of less than 1% of revenue
Pays royalties of $5.4 billion
7
8
Revenues
9
U.K
India
Others
Double Irish
Dutch Sandwich

10.2-10 Google's Tax Planning

Explanations to the diagram - Explanatory notes on each entity.

(1) Google USA is a resident of USA.

(2 & 3) are Bermuda companies ultimately beneficially owned by Google USA.

(4) Google Ireland Bermuda (GIB) is a company incorporated in Ireland. However, its central management & control is situated in Bermuda. Hence as per Irish law, it is a non-resident of Ireland. Hence no Irish tax.

Global revenues received through two Irish companies remain tax free. Since two Irish companies are used, it is called **"Double Irish".**

Since between the two Irish companies, a Dutch company is situated; it is called a **Dutch Sandwich**. Netherlands can be replaced by some other tax haven also.

Provision for treating the company as a non-resident of Ireland is **comparable but contrary to** section 6(3)(*ii*) of the Indian Income-tax Act. Under the Indian Income-tax Act, the attempt is to treat a foreign incorporated company as an Indian resident if its place of effective management is situated in India. Objective is to prevent tax avoidance by incorporating companies abroad while the control and management remain in India.

Ireland treats a company incorporated in Ireland as a non-resident of Ireland based on the claim that its control & management is situated outside Ireland. Note the comparison of provisions and the contrary objectives.

This is how revenues from India, U.K. & other countries reach Bermuda without paying any substantial taxes anywhere.

(5) Google Ireland does not make payments directly to Google Ireland - Bermuda (GIB). It first makes payments to Google Netherlands (5). Because of a treaty between Ireland & Netherlands, no tax is deducted at Ireland. From Google Netherlands full payment goes to Google Ireland - Bermuda.

(6) Ireland levies a corporate tax of 12.5%. However, Google Ireland pays substantial expenditure to Google Ireland - Bermuda. From the balance it deducts expenses incurred for a large establishment within Ireland. On the net profits, it pays 12.5% tax to Irish Government.

(7) & (9) All advertisers pay their ad charges to Google Ireland (6).

(8) Google India gets advertisement revenue from Indian advertisers. This amount is fully paid to Google Ireland (6) without any TDS. (Please see paragraph 10.2-7 for the possible reasons for non-deduction of tax at source.)

10.2-11 Tax Planning explained

Google's tax planning works on using all of the following principles/ facts:

(1) It does not need a PE in any country where it provides services to the data users and advertisers.

(2) Google is a U.S. company.

(3) Google incorporates subsidiaries in tax havens. It claims these subsidiaries to be **separate legal entities**. Hence the subsidiaries' income is not taxable in Google's tax returns in USA. Since the subsidiaries are "**incorporated**" in tax havens, they are claimed to be "**residents**" in tax havens. Google avoids COR tax in USA. (Note: USA has now amended its tax laws & brought in anti avoidance provisions named as: GILTI & BEAT. The planning discussed here may not be practical now. This illustration shows aggressive tax avoidance facilitated by several agencies.)

(4) Tax Haven Governments provide legal systems which facilitate tax avoidance. And they work out elaborate Treaty (DTA) network. Google and other customers of tax havens can seek treaty protection against tax department of Governments like India, U.K., etc. (BEPS provisions have now made it extremely difficult to - use Tax Havens for resorting to such tax planning.)

(5) All revenues from countries like India & UK are paid over to Tax Haven Company. Advertisement charges & data use charges are neither FTS nor Royalty. Hence no TDS/withholding tax in India/U.K. Indian corporate tax rate of 30% (or 40% for foreign corporations) and TDS of 10% on gross - both are avoided.

(6) Ireland charges a corporate tax of 12.5%. Most of this tax is avoided by using schemes like "Double Irish" and "Dutch Sandwich".

(7) Revenue is accumulated in tax havens. Dividends are not declared to the ultimate parent company in USA. Hence no tax is paid in USA.

Note: An important reason for starting Base Erosion & Profit Shifting programme in the year 2013 was that the US MNCs -digital and non-digital corporations - were avoiding European taxes. BEPS Action One report was to be the main anti-avoidance provision. It has remained non-working till November, 2019. However, with the GILTI & BEAT provisions within US domestic law, US MNCs' avoidance of US taxes has been blocked. US MNCs can now park funds in tax havens only after paying US taxes. However, their avoidance of European & all COM taxes continue.

10.2-12 Tax planning explained by illustration

Google's tax planning looks complex. Whole scheme may be easier to understand if we consider following purely hypothetical illustration.

Times of India (TOI) group has several publications which are printed & circulated. The group's revenue is mainly from advertisers. It attracts even foreign advertisers. When an advertisement is printed in media and circulated, it is traditional commerce.

Now TOI group has its own TV channel and website. Advertisements released on TV channel & website constitute E-Commerce.

Now consider a hypothesis: TOI group opens a subsidiary in a tax haven. The subsidiary then hosts the website. Subsidiary holds all foreign advertisement rights & IPR. That subsidiary will earn substantial revenue - which will be free from Indian Income-tax. The subsidiary can accumulate revenue and not declare dividends.

This subsidiary can get into a simple tax plan or an elaborate, complex tax plan - depending upon the reach of India's anti-avoidance provisions.

Like TOI, there are many Indian TV channels, websites like "Shadi.com" and "Make My Trip" which also attract foreign advertisements.

Can GOI claim that - while the foreign subsidiary is a non-resident of India conducting its business outside India -its business footprint is in India - the Indian readers/users of TOI news? Can such revenue be taxed in India? Under the existing rules of international taxation, "No". There is no fixed base PE in India. Concept of SEP has not yet

been brought out in DTA. Is it tax avoidance? Ethically, "Yes". What can GOI do to prevent such tax avoidance?

10.2-13 Comments

Theme of this chapter is not "Tax Havens". A highly complex tax planning is over simplified in this chapter. Objective of this discussion is to establish a hypothesis stated below.

(*i*) Global Corporations that conduct their business through E-Commerce can easily shift almost all their revenues to companies incorporated in tax havens. **They avoid COR tax.**

(*ii*) They can **claim to have almost no COS.** They do not need factories for manufacturing, transport or crossing country borders because they are not dealing with tangible goods. Their only hardware is server banks and connecting cables etc. Profits attributable to servers may not be more than the hire charges - if these servers were taken on lease.

(*iii*) The hypothesis that -: **"COS is where the assessee makes value addition" - is easily avoided.** Google will have no PE, no hardware & almost no men in the countries from where they get revenue. Hence under the existing international tax system, no country can claim taxation on the grounds of COS. If Connecting Factor cannot be applied for particular taxation, one cannot determine the tax base. It (Connecting Factor) has to be discarded and alternative Connecting Factor has to be considered.

Our submission: For a global Corporation, under the existing rules, the **Connecting Factor of "Source" cannot be applied.** It is not just that the traditional concept of PE is not applicable to E-commerce. **Whole connecting factor of "Source" is not applicable to a Global Corporation conducting E-Commerce.**

Response has to be:

Change the existing rules of international taxation.

10.2-14 Some issues about tax avoidance by the Digital Corporations.

(*i*) They are doing everything legal and yet unethical.

(*ii*) They earn substantial money.

(*iii*) Executives do not believe they have done anything wrong. They are doing "duty to their shareholders" - of minimising tax cost and maximising net revenues.

Still public at large has not understood the losses due to tax planning. So tax avoiders and tax consultants are not criticised. Tax Officer's simple answer to the issue of "Duty to Shareholders" may be:

> "Okay. You do your duty to your shareholders. My duty to my nation asks me to stop you. And I will do everything possible to stop you. If existing principles are weak/inadequate, I will create new principles/rules."

10.2-15 Summary of Part II Chapter 10

Paragraph 10.2-1 gives business model of Google.

Paragraph 10.2-4 analyses the business model in more depth.

Paragraphs 10.2-1 to 10.2-8 raise the difficulties in taxing Google.

Paragraphs 10.2-9 to 10.2-11 briefly explain the tax planning done by Google.

Note: We have no personal/authentic information on Google & its activities. All information is taken from media. **One may assume that all the information discussed here does not pertain to Google**. This is only an illustration. Purpose of using the name is only to identify an activity under E-Commerce.

11 CHAPTER

TAX HAVENS

1. **Peter Principle:** Anything that Can go wrong Will go wrong.

   Tax Avoidance Principle: Any tax that can be evaded or avoided Will be evaded or avoided.

2. **Oscar Wilde:** "I can resist anything but temptation."

   Global Corporation: "I will pay anything but taxes."

   Tax Haven: "Welcome. Our legal system is for you to avoid taxes of other countries".

3. There are almost 50 tax haven Governments - ready to make new laws & modify existing laws to help tax avoiders of the world.

4. **Our respectful submission**: The Courts make an error in treating all Governments as same. (Azadi Bachao Andolan 263 ITR 706)

   Compare: All citizens are equal. All citizens have the right - of free movement, freedom of speech etc. And yet, when someone commits an offense, he is punished by the Courts. He may even be put behind the bars. His fundamental right of free movement will be gone.

   Similarly, all Governments are equal. But when some Governments actively collude with tax consultants & tax avoiders of the world, can we ignore their crime? Can we afford to treat them equally?

5. **OECD & G20** are seriously concerned about Tax Avoidance. They all want to co-operate & minimise tax avoidance. At the same time, some of these countries/politicians of these countries have vested interest in tax havens, treaty shopping

& ultimate tax avoidance. Hence a good system is not emerging. For Global Corporations it is extremely easy to abuse tax havens, tax treaties and avoid taxes. This makes it all the more necessary to have a new taxation system. Now with BEPS actions, abuse through tax havens and treaty shopping should be very difficult. However, in the process, tax laws have become complicated, cumbersome to comply with; and discretionary & difficult to administer.

6. Children play. Some children deliberately violate the rules of the game to get extra advantages. If & when they are caught, they start crying & screaming that the other children are nasty. If the mother is not smart enough, she will console the crying child & punish the honest children. Game continues even when they become adult. GCs avoiding taxes complain that Income-tax Officers are harassing them. Governments are as confused as the mother.

12 CHAPTER

OTHER WEAKNESSES OF EXISTING SYSTEM

International tax system has other weaknesses which are elaborated below.

12.1 CONFLICT OF CATEGORISATION OF INCOME

12.1-1 Can we reflect on the term "**Fees for Technical Services**" (FTS) in Section 9(1)(*vii*)? When this clause was introduced in the year 1976; Indian industrialists were entering into "foreign collaborations" and importing technology. They were paying fees for such technologies. In some cases, GOI could not tax such fees. Hence this clause was introduced. Then the clause has been expanded to include managerial and consultancy services.

What is "technical" or "consultancy"?

Today cooks in five star hotels are paid very well. They are masters in their technology of cooking. If a foreign visiting cook teaches his technology to a cook in a five star hotel, can we say that he has provided technical service and imparted (made available) technical knowhow? Apparently yes. Mother or mother-in-law teaching cooking to daughter or daughter-in-law also amounts to imparting technical knowhow. But since no "fees" are paid, it is not "Commerce".

Point to be noted is: the phrase - "Technical/managerial/consultancy service" is too wide. And causes litigation. Either delete this clause and fall in line with OECD or drop the words "managerial, technical or consultancy" and tax all services. If the second alternative is adopted, then GOI will be able to tax E-commerce companies like Google, Facebook, Yahoo, etc. (Provided of course DTA is also amended).

12.1-2 FIS - Fees for Included Services

Our suggestions discussed later in Part IV are that **all services** may be taxed by the COS/COM. Concept of "Included Services" is a relic of the past when our main import of services was technology. Today the scope of import of services has expanded widely. There seems to be no logic; why we should tax only certain kind of services and not others. Such a discrimination goes against the concept of neutrality.

12.1-3 Shipping

People who know global shipping industry inform that - this industry is ultimately owned by a few holding companies. Ninety per cent of the revenue would flow to six countries in the world (ignoring tax havens). All other nations renounce their rights to tax a service and these six nations enjoy the tax revenue of global shipping industry. Airlines also have a similar story. There seems to be no logic for this anomaly. Article 8 of Model Treaty needs to be modified. Countries from where cargo and passengers originate; and the countries where the cargo terminates, should have a share in the right to tax the revenue.

In administration it will be easier to ensure that the payer of fare/ freight deducts tax at source.

12.2 EXISTING TREATY RULES

We have also seen that COM is also a major contributor of income.

Can we say that the Country of Purchase of Goods and Services is a contributor to the income? GOI tries to tax a NR buyer of services from Indian BPO service provider if the BPO becomes a PE. Here India is the country from which a NR is purchasing services, or India is the **Country of Purchase.**

It is said that Diamond Trading Corporation's income depends on (*i*) low cost purchase of rough diamonds from some countries; (*ii*) low cost of cutting & polishing of the rough diamonds in India; & (*iii*) undervalued currencies of mining countries & India. Microsoft earns major income by sourcing software development at low cost from several countries. The list of factors contributing to profits can be long. And all these may claim right to tax.

A fully evolved international tax system should attribute "Right to Tax" to every country that contributes to income. Existing system is far from an evolved system.

12.3 FAR ANALYSIS

We submit that the FAR analysis is highly subjective. Hence it is bound to create litigation. It would be best to avoid such litigious concepts in tax law. This subject has been debated at length. Many experts are against the concept. But we will not discuss the concept in details here.

12.4 COR

Present Treaty Models assume only one COR for the assessee. Country of Incorporation is of course irrelevant for GC. Even when we consider Place of Effective Management, we realise that it is spread out over many countries. Ten years back, it was difficult to envisage. Today it is reality. **GC has several CORs.**

12.5 COS

It is understood that in a business, all functions of the assessee contribute to the value addition and not just sales or marketing. Similarly there are so many other forces/factors which contribute to the profits of the assessee and hence can have a claim to tax the profits. In case of Global Corporations, several functions are performed in several countries. Hence it is evident that **GC has several COS** - not just one.

12.6 SUMMARY

We have seen how traditional principles of International Taxation cannot be applied to E-Commerce.

There are two separate but related matters:

(*i*) Since the existing system of international taxation relies on geography, it cannot be applied to E-Commerce. For e-commerce, "Geography is history".

(*ii*) Global Corporations are avoiding income-tax. It is reported in media that Google chairman called it as normal part of the capitalist system. Many GCs are proud of tax avoidance. E-Commerce helps them.

13 CHAPTER

CONNECTING FACTORS NOT APPLICABLE TO GLOBAL CORPORATIONS

All the difficulties discussed in Part II have long been anticipated. Now, we will discuss difficulties that go to the core of International Taxation. Whole system is based on tax sharing by COR & COS. In taxation of Global Corporation, can we apply the connecting factors of Residence & Source?

We discuss below in Paragraph (13.1) "Residential Status" and in paragraph (13.2) "Source".

(We are saying in this book that Google is spread out Globally. But China has banned Google. And there may be some countries where Google has not reached. In a practical sense when a Company is spread out over scores of countries, we call it a Global Corporation.)

13.1 RESIDENTIAL STATUS

13.1-1 Globalisation

Imagine a position in a near future. A company like Google has shareholders & directors spread over many countries. Its shares are quoted in six different countries' stock exchanges. Board meetings are held over video conferences. Senior management is spread over several countries. Its business is transacted from several countries. Its customers are spread over several countries.

We have seen that the logic for COR getting the jurisdiction to tax global income is that the company has its ownership, management & business located in the COR. When all these are spread out globally, which country can claim prerogative of a right to levy tax on global income? None. **The place of incorporation loses its importance.** No

single country can claim that the corporation is its exclusive entity, or that it is the only COR for a GC.

This is a clear development from globalisation of business. It establishes our claim that "Place of Incorporation" has lost its significance as a "Connecting Factor". At least for Global Corporations.

13.1-2 Tax Havens

A Tax Haven Government grants incorporation for any company that pays its fees. In some tax havens, pay just $ 500 per year and you have your company. It grants incorporation even when ALL the shareholders, all the directors (except the nominee directors) and entire business may be outside the country. In fact many tax havens simply **prohibit** the offshore companies from doing any business within their boundaries - except keeping bank balances. We have seen in that Global Corporations can incorporate companies in tax havens & claim to be residents of tax havens. There is NO justification for those tax haven Governments to claim jurisdiction to levy tax on the global income of the Global Corporations. Tax havens do not levy any tax. They devise ways whereby in "Form" a tax is levied. In substance the tax paid is "Nil" or "Insignificant". So the tax haven companies can claim DTA benefit & achieve Double Non-Taxation.

This position establishes the claim that "**Place of Incorporation**" has lost its significance as a Connecting Factor. At least for all entities incorporated in tax havens.

"Place of Incorporation" and "Country of Residence" **both concepts** have lost their meaning for GCs and for tax haven companies.

13.1-3 India published the draft "**Direct Taxes Code**"; specifying that a company that has no business in the country of incorporation will be considered a **Controlled Foreign Corporation (CFC).** A Tax haven went ahead and changed its laws. Earlier, offshore companies were prohibited from doing business in the tax haven. Now the prohibition has been removed. These countries will go to any extent to ensure that their clients can avoid regular tax; and that the "anti-avoidance provisions" don't apply to them. For these **tax havens, it is their business to help avoid regular taxes.**

There are dozens of tax haven countries that make specific laws separating substantial facts and legal form. The form is totally at variance from substance.

Our submission is: **"Form" must always state the "Substance"**. When the "form" is at variance with "substance", "form" has to be rejected. Whole controversy about Substance vs. "Form" is incorrect.

The very fact that "**Place of Incorporation**" can be easily manipulated is a strong factor to state that the place of incorporation should not be considered as a determinant for a company's residential status.

For practical and legal compulsions, a GC has to have a registered office. Many corporations register the main holding company in tax havens. Then subsidiaries may be registered in several countries. These corporations have to a large extent avoided income-tax on the basis of "Residence".

13.1-4 Traditional principles of International Taxation establish "residence" as one of the two connecting factors which grant tax jurisdiction to any Government. It will continue for a long time for many companies. But it will no longer be relevant for a truly global corporation.

(This issue was discussed in the year 2000 by the High Powered Committee on E-commerce. Today it has become a reality.)

An - analogy: A Banyan tree spreads its branches in all directions. These branches spread their own roots. Some years after the branch roots have established themselves, the original trunk dies. Eventually one cannot find out which was the exact location of origin for the Banyan tree. "Kabirvad" in Gujarat is such a Banyan tree. A Global Corporation may originate in one country. Then it spreads. It can dissolve original registration and decide that it is no longer incorporated in the Country of Origin.

There is nothing "Fundamental" or "Sacrosanct" about International Taxation. In fact, there is nothing fundamental about taxation. A hypothesis works as long as it works. And then it needs to be discarded. However, "discarding" an accepted principle/hypothesis is anathema to **legal profession**. We love the past. We cling to the past.

Whereas **technology** loves demolishing/disrupting the old and building the new. Scientists and technocrats will keep coming out with radically new ideas and instruments. Businessmen will eagerly jump for the latest instruments and methods of doing business.

The gap between (*i*) outdated laws and treaties and (*ii*) modern ways of doing business will keep widening …… until ……. the law becomes impossible to administer/comply with. Collapse of existing

treaty models will bring about new treaty models --- unless someone bold enough drafts a new model before the collapse.

13.2 CONNECTING FACTOR - "SOURCE"

We have seen that a good definition of "Country of Source" is: "That country in which the assessee makes value addition by its own functions, assets and risk taking." Now consider Google and Facebook. We have seen that these companies cannot be taxed on the connecting factor of COS. If GOI decides to tax Google, on what basis can it tax?

13.2-1 Data Base

What does Google do? The data that we search on Google may not be provided/created by Google. (Google has started creating its own data base and providing the same to the users. Google Map is an illustration. However, Google's own data is a fraction of the global data being researched through Google.) The data exists all over the world. Much of it is free. Some of it is not free. But most of it is provided by different persons in many countries.

Google's main function is to make this data available to us. This data cannot be a tax base. (This issue is refined further below.) If at all, the data may be a cost centre. If Google or the internet surfers pay any charges to the data provider, it is a separate issue. We are considering Google's taxable income here.

When Mr. M in Mumbai talks on telephone or through internet with Mr. U in USA and transacts a business; what is the importance/value of the telephone or internet? Re. 1 per minute for telephone land line; or no marginal cost for internet. Similarly, in internet search, Google's function seems to be insignificant. And yet it earns billions of dollars.

13.2-2 Users

Who constitutes the market for Google? There are millions of users of Google facility. They are spread out all over the world. But many of them don't pay anything to Google. They are not Google's primary market.

13.2-3 Advertisers

Most of us, users don't pay any charges to Google for using its e-mail facility, access to data and maps (and other services which keep coming). Where does it get its revenue of $ 136 billion (in the year 2018).

Google gets its major revenue from the advertisers. Businessmen all over the world pay advertisement charges to Google. These may be small businessmen in remote places. Or large corporations. Beauty of internet advertising is that even small businessmen can advertise themselves to the world and yet to targeted audience. The advertiser can, at a relatively low cost expand the base and yet, be specific. If the customer is on a look out, he will reach the businessman with a small budget.

For Google, the advertiser is the main customer and not the user of the website. User doesn't pay. Even if some users pay, it may be a small amount. Real market/Real customers are advertisers. This is the case with most newspapers, magazines and TV channels. User/reader/watcher constitute a base to attract the advertiser.

13.2-4 We have discussed earlier that as per present principles of international taxation, the assessee's actions determine COS. Market or footprint do not determine COS. If this principle is accepted, both - users and advertisers are not relevant for determining COS.

OECD has presented material on **FAR analysis**. Assume that we want to apply FAR analysis to the assets employed by Google, functions performed by Google and the Risks taken by Google. How do we attribute profits based on these three factors to several COS?

While theoretically it may be possible; in practice it is a non-workable idea.

So the issue is: What constitutes the "Foot Print", the "Connecting Factor"? The users or the advertisers? The Income-tax Officer should look at the assessee's market (advertiser) or the market of the market (users)? How far can the taxman stretch his reach and imagination?

In either case, both are spread all over the world.

13.2-5 Software & Hardware

Google owns software & hardware. These are the "assets" that may be considered for applying the FAR analysis. Software is intangible & hardware is tangible.

For determining the location of an intangible asset like software, let us consider similar intangibles like Intellectual Property Rights and Goodwill. It is a sound principle that intellectual property right cannot be said to be located where it is patented/registered. Probably it is located where it is used.

Let us say a company has immense goodwill. Customers trust it for its fair trade practices and for the quality of the goods and services it provides. Where is the Goodwill located? It is where the customer, relying on the goodwill, makes a "buy" decision. Goodwill is where the market is.

Google needs massive infrastructure for providing the facility of accessing data and communicating *via* e-mails. It needs special algorithm for anticipating what a particular regular user seeks. Then finding out data from a vast global database and arranging/displaying on the user's computer in a particular order of priority. This operation goes on every second for numerous people all over the world.

Which asset has created the value?

Does data base add value?

Does the user base add value?

Does entire infrastructure consisting of hardware and software add the value?

In either case, where is it located? Which country can claim the right to tax its income based on the connecting factor of "Source"?

Google's server farms are located in some countries. Entire network of communication satellites and cables is situated in many countries and also outside the borders of all countries (in the oceans and in the sky). Where is the software located? Where is all the Intellectual Property Right owned by Google located?

Intangibles have no fixed place. They defy geography.

If we say that Google adds value by its hardware and software; then it is spread all over the world. It defies the concept of "Country of Source". Hence we can't use the Connecting Factor of "Source" to tax Google's income.

13.2-6 Conclusion on "Source" as a Connecting Factor

FAR analysis or concept of **PE** (with present definition) cannot be applied to Global Corporations. If **any other base** is to be adopted, there can be diverse claims for taxation based on "Source". Any particular factor that may be adopted - will render an impractical method of attribution of profits. "Source" as a connecting factor for attribution of the profits of a truly global corporation is not workable.

Both the Connecting Factors - "Residence" & "Source" will fail for determining tax jurisdiction for a Global Corporation. Existing rules of International Taxation will not work for E-Commerce.

Analogy: There was time when people used bullock carts and horse carriages. Kings would make rules for better traffic management. Today people drive cars and fly aeroplanes. Can we apply the bullock cart rules to cars and aeroplanes? Bullock carts are still used in many parts of India. Completely different rules for aeroplanes have to co-exist with bullock cart rules.

Different principles for taxation of Traditional Commerce & E-Commerce existing simultaneously have become a necessity. Note: This statement is **contrary to the principle of neutrality** about which we have talked earlier. The arrangement of this book is: in the beginning we have said the "Accepted Principles". Then we have stated difficulties in the application of "Accepted Principles". Then we will try to raise hypothesis on solutions to the difficulties. And also see whether we can still have neutrality & different rules together.

A. Indian High Powered E-Commerce Committee Report. Some extracts from summaries.

Weblink for the full report:

https://www.rashminsanghvi.com/articles/taxation/electronic_commerce/finmin.html

6.1 Residence based taxation:

The Committee is of the view that there is no real alternative to the concept of **'place of effective management'**, which should continue to be used. It is not possible to set down a single rule. The concept has to be applied considering the facts and circumstances of each case. Where in the case of a **globally integrated enterprise**, no unique solution is available through the concept of place of effective management, the solution could be '**source based' taxation only**. The provisions of the Act and the DTAs do not require any revision on this account**.**

6.2 Source based taxation:

The source based taxation of business income depends on physical presence in form of fixed place of business or a dependent agent in the source country. It also depends on the characterisation of income. With e-commerce, the need for physical presence ceases. This affects sharing of revenue between countries. The change in mode of delivery from physical to online raises characterisation issues. Lack of physical presence also creates problems in enforcement of tax laws.

6.2.1 Concept of permanent establishment ("PE"):

"The OECD is of the view that in terms of Article 5 of the OECD Model Tax Convention, a server at the disposal of an enterprise and hosting its website could constitute a PE, if it is kept at a fixed place for a sufficient period of time and performs core business functions of the enterprise. The views of the OECD are consistent with the existing provisions of Article 5 of the OECD and UN Model Tax Conventions. However, within OECD some countries like UK, Spain and Portugal have different views.

> **"The Committee is of the view that applying the existing principles and rules to e-commerce does not ensure certainty of tax burden and maintenance of the existing equilibrium in sharing of tax revenues between countries of residence and source. The Committee is also**

firmly of the view that there is no possible liberal interpretation of the existing rules, which can take care of these issues, as suggested by some countries. The Committee, therefore, supports the view that the concept of PE should be abandoned and a serious attempt should be made within OECD or the UN to find an alternative to the concept of PE."

B. OECD report 8th October, 1998 extract:

OECD website link:

https://www.oecd.org/tax/consumption/1923256.pdf

The Ottawa OECD Ministerial Conference in 1998 "A Borderless World – Realising the Potential of Electronic Commerce", concluded the following as guiding principles for E-Commerce taxation.

Neutrality

(*i*) Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.

Efficiency

(*ii*) Compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible.

Certainty and simplicity

(*iii*) The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted.

Effectiveness and fairness

(*iv*) Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counter-acting measures proportionate to the risks involved.

Flexibility

(*v*) The systems for taxation should be flexible and dynamic to ensure that they keep pace with technological & commercial developments.

C. OECD report 9th October, 2019 extract:

OECD website link:

https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf

2.1. Summary of the proposal

14. It is thus essential to design a solution that attracts support from all members of the Inclusive Framework. The Secretariat's proposal for a "Unified Approach" has been developed with this goal in mind.

15. That proposal is summarised here at a relatively general level, recognising that certain aspects still require further work. A number of implementation and administration questions also need to be addressed. However, the technical work of the Secretariat, as well as consultations with the membership, indicate that this is a viable option. It draws on the three alternatives under Pillar One and the ensuing public consultation process, and aims to identify the key features of a solution, which would include the following:

- Scope. The approach covers highly digital business models but goes wider – broadly focusing on consumer-facing businesses with further work to be carried out on scope and carve-outs. Extractive industries are assumed to be out of the scope.
- New Nexus. For businesses within the scope, it creates a new nexus, not dependent on physical presence but largely based on sales. The new nexus could have thresholds including country specific sales thresholds calibrated to ensure that jurisdictions with smaller economies can also benefit. It would be designed as a new self-standing treaty provision.
- New Profit Allocation Rule going beyond the Arm's Length Principle. It creates a new profit allocation rule applicable to taxpayers within the scope, and irrespective of whether they have an in-country marketing or distribution presence (permanent establishment or separate subsidiary) or sell *via* unrelated distributors. At the same time, the approach largely retains the current transfer pricing rules based on the arm's length principle but complements them with formula based solutions in areas where tensions in the current system are the highest.
- Increased Tax Certainty delivered *via* a Three Tier Mechanism.

The approach increases tax certainty for taxpayers and tax administrations and consists of a three tier profit allocation mechanism, as follows:

Amount A – a share of deemed residual profits allocated to market jurisdictions using a formulaic approach, *i.e.* the new taxing right;

Amount B – a fixed remuneration for baseline marketing and distribution functions that take place in the market jurisdiction; and

Amount C – binding and effective dispute prevention and resolution mechanisms relating to all elements of the proposal, including any additional profit where in-country functions exceed the baseline activity compensated under Amount B.

III

PART

ANALYSIS OF OECD UA AND PROPOSAL FOR SIMPLIFIED SEP & WHT BASED DIGITAL TAXATION SYSTEM

14 CHAPTER ANALYSIS OF OECD UA PROPOSAL AND COMPARISON WITH SEP & WHT BASED TAXATION

14.1 EXPLAINING OECD UNIFIED APPROACH

The OECD publication on Unified Approach is difficult to understand. One needs several readings to understand what the OECD Secretariat wants to say. Hence, for the ease of the reader, we are explaining the OECD Unified Approach in three different manners.

(*a*) Paragraph 14.2 below briefly **lists** the steps necessary for computing profits attributable to COM as per UA.

(*b*) The **chart** given in Paragraph 14.3 below briefly narrates the UA in a different manner.

(*c*) **Table** 1 in Paragraph 14.4-3 below illustrates this exercise by assuming certain profit figures and specifying a company doing digital business.

(*d*) Table 2 in Paragraph 14.4-4 gives steps required for an SEP + WHT based system.

A brief list of steps to be understood for attribution of profits is given below. OECD divides the profits into **three different categories of profits** - A, B & C - which may become taxable in COM. Category A is more difficult to understand. For all the three categories, steps are listed below.

14.2 DIFFERENT CATEGORIES OF PROFITS THAT MAY BE ATTRIBUTED TO COM

14.2-1 Category A Amount

1. The Non-Resident Digital Corporation has no presence/PE/SEP in COM. Its profits attributable to COM may be consid-

ered on following lines. For illustration, consider Alphabet Inc. There is **no need** to establish a **PE**. In other words, for taxing a non-resident for its digital commerce in COM there is no need to establish a Physical Nexus. This is an important departure from the existing OECD Model. Probably, **sales turnover** above a threshold will be considered to be the SEP. (Paragraphs 50 & 51 on page 13 of the UA.)

2. Consider the non-resident digital corporation's (DC's) Alphabet's **global consolidated profits**. Assume that Alphabet's global profits are US$ 1,20,000. (Paragraph 53 on page 14 of the UA.)
3. Separate the profits by different business lines. Assume that Google's profits are US$ 1,00,000. Balance profits are from other businesses. (Paragraphs 51 & 52 on page 13 of the UA.)
4. Deduct routine profits. Assume $ 90,000. (Paragraphs 51 & 54 of the UA.)
5. Result will be non-routine profits. Balance $ 10,000.

   (See paragraphs 51 & 52 on page 53 of UA.)

   For different allocations, use following methods as may be applicable:

   (*a*) Residual profits split method.

   (*b*) Fractional Apportionment Method.
6. Calculate remuneration of non-routine activities. Divide this non-routine profits ($ 10,000) amongst COR & COM. Let us assume that in this division COMs together get $ 1,000. (Paragraphs 57, 58 & 59 on page 15 of the UA.)
7. Consider the profit of that business which is conducted in the COM. Profit of that business as arrived at by the above process will be apportioned over different COMs. Thus, for example, if Google Corporation gets revenue from 190 countries, then its marketing non-routine profit ($ 1,000) will be apportioned over 190 countries. Probably it will be based on sales revenue. Assume that Indian turnover is 1% of Global turn over. (The Global turnover includes US turnover. USA gets attribution of profits as COR as well as COM.) (Paragraph 60 on page 15 of the UA.)

   Finally, India will get $ 10 as attributed to Indian operations.

8. Apply Indian Income-tax rate to the attributed profit. Indian tax rate for foreign companies is 40%. Hence Indian tax will be $ 4 under category A.

14.2-2 Category B of profits

The non-resident (NR) digital corporation (DC) has no business activity in the COM. Hence, under existing FAR analysis canvassed by OECD, there will be no further attribution of profits to COM. However, in this illustration let us assume that Google conducts some **baseline marketing & distribution activities** in COM, India. For its services of - Google Search Engine, Gmail, Google Map etc. it may not have any marketing & distribution activities in India. However, Google earns revenue from advertisements. Actual booking of advertisements and collection of revenue is sales & distribution activity & not marketing activity. Let us say, further profit of US $ 5 is attributed to India on account of marketing & distribution. (Paragraphs 62 & 63 on page 15.)

Indian income tax @ 40% will be additional $ 2. Total tax so far will be $ 6.

14.2-3 Category C of profits

If the NR DC conducts activities which are in excess of the baseline activities, further profits will be attributed to COM. (Paragraphs 64 & 65 on page 16.) If one cannot say that Google does any more activities, there will be no further attribution of profits to COM.

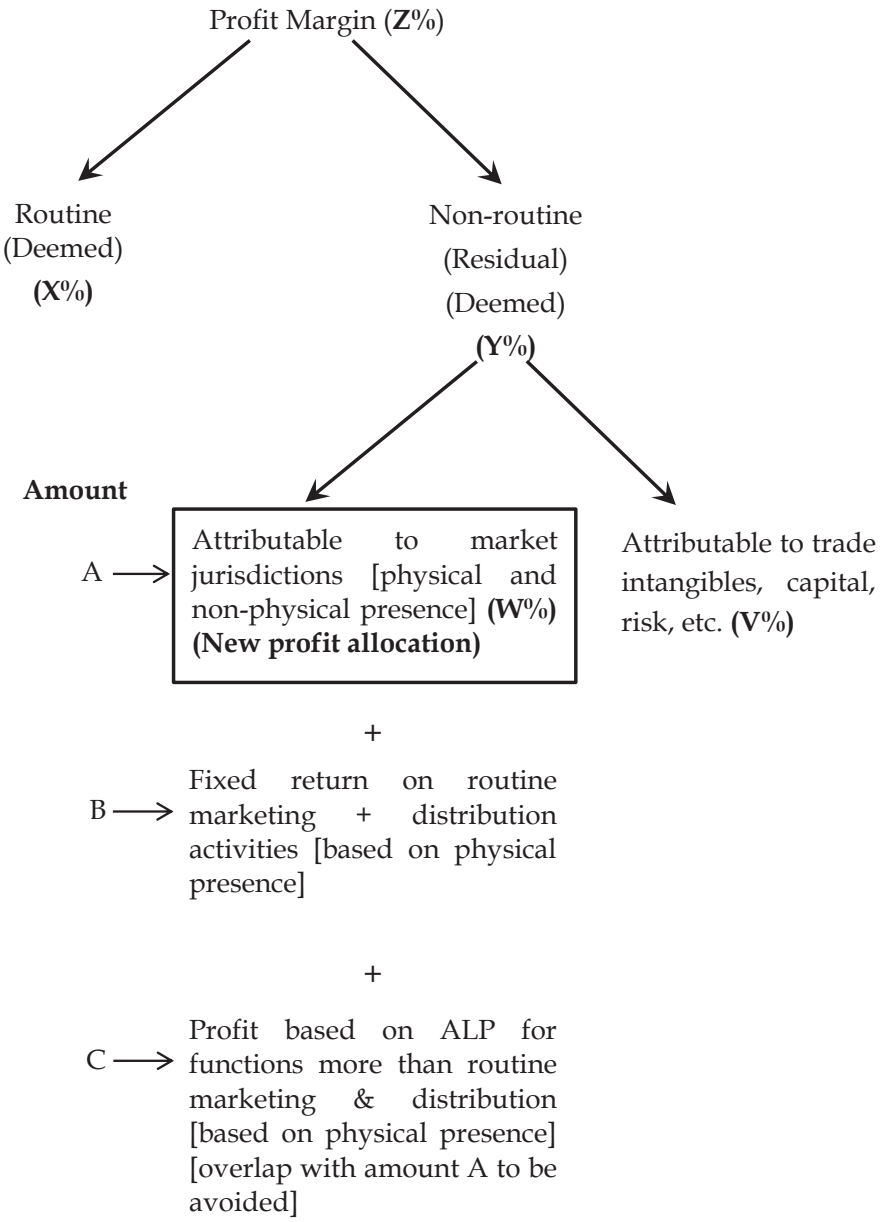
14.2-4 Total Tax in India

Total tax in India - A + B + C = $ 6.

Note: We have listed eleven steps to understand the process required for computing profits taxable in COM as suggested by OECD UA. In reality there can be more steps depending upon facts and circumstances.

14.3 OECD approach for profit attribution

Chart Showing OECD's categories of profits attributable to COM. Please see the Appendix to OECD UA pages 13 to 16.



14.4 TABULAR COMPARISON OF 'OECD UA' AND 'SEP + WHT BASED TAX SYSTEM'

14.4-1 Tables

Table 1 below shows how OECD's Unified Approach **UA proposal** will give rise to a complicated law.

Table 2 below shows **SEP & WHT** based simple system which can reduce chances for tax avoidance/evasion and yet remain simple & dynamic.

14.4-2 There are two significant matters

(*i*) Fair & equitable attribution of profits to COM.

(*ii*) Simplification of law by minimising estimates, controversies, litigation & need for cross country information. Significance of both these matters is also explained.

The UA proposal involves some steps, estimates & assumptions. These steps are briefly stated and illustrated below. We consider the **illustration of Alphabet Incorporation -** with all assumed figures & facts**.**

14.4-3 Table 1 - System suggested by Unified Approach (OECD UA)

Steps	Description of the steps	Percentages as given in UA.	Assumed Amounts in U.S. $
One	Identification of MNC **Group's Profits**. Alphabet Inc.'s Global, consolidated, net profits as per published accounts.		1,20,000
Two	Carve out only **Google's profits** & ignore its businesses like Autonomous Car, Artificial Intelligence etc.		
	Google's profits assumed here @ 10% of gross revenue of $ 1,000,000.	Z%	1,00,000
Three	Deduct **Routine Profits**. There is no objective guideline for separating routine & non-routine profits.		
	Assume Routine Profits:	X%	90,000
	Hence Non-Routine Profits:	Y%	10,000

Steps	Description of the steps	Percentages as given in UA.	Assumed Amounts in U.S. $
Four	Segregate the non-routine profits. Divide the non-routine profits amongst COM countries on some fixed ratio to be decided internationally.		
	Assume **COR** which gets attribution because of Google's special algorithm, software and brand name.	V%	9,000
	COM attribution - resulting figure probably based on marketing intangibles.	W%	1,000
Five	Google is operating in say, 190 countries. So distribute $ 1,000 amongst the 190 COM countries.		
	Let us assume one particular COM's revenue is 1% of the Global revenue. Global revenue also includes US (COR) revenue. COM's taxable profits will be 1% of $ 1,000. (**This is the New taxing right - Amount A as per UA**) Refer Appendix for amount A explanation.		10
Six	Allocate profits based on baseline marketing activities and any additional activities (Amounts B and C as per UA). Assuming Google has no presence in COM no profits would be attributed towards Amounts B and C.		0
Seven	Assume COM's Income-tax rate for foreign companies is 40%. Tax in COM would be $ 4.		4.

14.4-4 Table 2 Now consider the same case under the SEP & WHT Taxation

Steps	Description	US$
One	**COM revenue received** by Google. To be verified by COM systems as described in our book. 1% of Google's global turnover.. …. …. … ..	
	COM tax officer does not have to look at any global figures or any other country's turnover. He is not concerned with exchange rate between COM currency & US $. He need not consider Google's global accounts, etc.	1,000

Steps	Description	US$
	He will ask for audit of COM revenue figure by registered auditors of COM.	
Two	Apply the agreed upon digital tax rate of 3%. COM tax will be	 30.

SEP & WHT approach is clearly simple. Avoids maximum uncertainties, controversies, estimates & hence litigation. There is no need to get information from other countries. Whole assessment can be completed within a short period. And minimum interaction is needed between MNC officers and COM tax officers. A whole lot of subjective calculations that may reduce attribution of profits to COM are eliminated.

14.5 DIFFICULTIES IN UA APPROACH

Now consider the UA approach in details. The subjective steps that are controversial and open to tax avoidance/evasion abuse and consequent litigation are given below. Then see in next Chapter whether all these controversies can be minimised under SEP & WHT approach or not. Chapter 16 emphasises the ways to minimise the difficulties.

14.5-1 Step One. Difficulties posed by Published accounts

(*i*) The published net profits of the MNC may or may not be reliable. COM tax officer has no way to determine whether the MNC has resorted to any tax avoidance by diverting revenue and profits to other tax haven SPVs. To ascertain, the MNC must produce full global & COR accounts to COM officer as well as all the 190 countries' tax officers.

(*ii*) OECD Secretariat itself states that published accounts may not be "easily" manipulated. That means that there is a scope of manipulation.

(*iii*) Whole BEPS programme was initiated as MNCs resort to Base Erosion and Profit Shifting. Therefore, believing that MNCs, especially those in Digital Business, would provide correct accounts is debatable.

(*iv*) Which profits should be considered - operating profit, EBITDA? Guidance needs to be provided by TFDE. Various profit figures such as Operating Profits, EBITDA etc. are reported. There is

no clarity as to which profits should be considered. The only way would be for TFDE to publish guidelines. These guidelines will be subjective and will require interpretation which will give space for Subjective Arguments and may lead to lengthy litigation.

(*v*) Consolidated profits have to be considered. There can be situations where under the COM regulations, audit of accounts is not required. Or there can be situations where consolidation of accounts is not required. There can be situations where the turnover will be less than the prescribed threshold. In these situations, how will the tax officer even know the revenue amounts?

14.5-2 Step Two

It is possible in principle to determine only digital business profits. However, it is impractical to separate out the profits in a contiguous business. UA has suggested using segmental data published in accounts. However, following points to be noted:

(*i*) As in step one above, how to ascertain that segmental profits are correct? If such profits are sought to be taxed in multiple countries, MNCs may resort to tax avoidance by manipulating such data.

(*ii*) How to divide profits only for digital business? It would be extremely difficult to figure out segmental profits when various divisions work in tandem. For example, Google Inc. uses various parts of its business seamlessly. Separate teams would be working on Google Maps, Google Search, Google Play, Google Home devices, Google Drive, Android, etc. And all of them would be linked to its main business of advertising.

(*iii*) It would be very difficult to separate out profits which are subject to tax in one country and not the other. The UA itself states that this could "create challenges". It further states that dividing the profits based on business line and/or region would "need further consideration" and would form part of "overall package of work."

(*iv*) This means that this step would only get finalized when each country agrees on first the operational/segmental allocation, and then the geographical allocation.

14.5-3 Step Three. Routine & non-routine profits

There is no objective way (and there cannot be any objective way with diverse and constant development of new business models) - to calculate what is routine & what is not routine. Our concerns:

(*i*) Each company, each business and each market may have different estimates. As the company and the market grow; as new competition arises; the division between routine & non-routine will keep changing. Each country's tax officer may challenge the figures presented by the MNC.

(*ii*) UA has mentioned that one of the approaches to determine the routine profits would be to agree to a fixed percentage. However, there is a high chance that countries may not agree to the fixed percentage determined by the COR. Say in Google's example, if USA sets a high rate for routine profits other countries may not agree.

(*iii*) There is a high chance that after carving out routine profits, there may not be enough non-routine profits left to be distributed among the market jurisdictions. This is the main grievance to the UA. It is supported by the OECD Secretary Generals' submission in his October 2019 Report to the G20 Finance Ministers and Central Bank Governors. The Report provides Preliminary findings of Impact Assessment of Pillar One (Page 8 of the Report) where it is admitted that UA would lead to only a "modest" rise in tax revenues for the market jurisdictions.

(*iv*) This approach also means that if there is no residual profit, market jurisdiction does not get any tax! This is different from SEP where market jurisdiction gets some tax as "demand" is also considered to give rise to profits.

14.5-4 Step Four. Divide profits between the COR, COS & COM

There is no objective manner of dividing profits between residence jurisdiction & market jurisdiction. FAR analysis cannot be applied as admittedly, the MNC has no functions or assets in COM. Whether it carries risks in the COM or not is a disputable issue.

Present Transfer Pricing rules cannot be applied.

Hence TFDE needs to work out a new method of distributing profits between COR & COM. The UA suggests adopting an internationally-

agreed upon fixed percentage. Different percentages might be applied to different industries or business lines. Therefore, determining this percentage would again be subjective. Sure shot for litigation.

14.5-5 Step Five. Distribution amongst several COMs

The MNC may be operating in 190 countries. Each country market size and profitability can be different.

(*i*) Most countries have different currencies. Their exchange rates into US $ and their purchasing power parities can be vastly different. A straight allocation of global profits based on market revenue may not be a very good criterion.

(*ii*) What is each Market's share in the global revenue?

(*iii*) Will one COM's share be agreed by another COM; or of all COMs' share agreed by the COR? This will cause perennial global tax disputes.

(*iv*) There is no clear method to determine the market share of each COM in the global revenue. This gives a scope for dispute amongst countries regarding the share of revenue.

(*v*) If there are losses, the UA refers to "claw back" or "earn out" mechanisms. How will they function? This also means that if there are no "non-routine" profits, COM will not get any share of the taxes.

14.5-6 Step Six. Allocate profits for baseline marketing activities and any additional activities

(*i*) This allocation relies on existing Transfer Pricing rules which are subjective by themselves. This has been recognised by OECD also.

(*ii*) There could be some overlap between the new allocation profit (Amount A) and other profit allocations (Amounts B and C). How does one determine this?

(*iii*) Again, how does the tax officer of one country determine - whether the global revenues and their allocation to the particular country reflect true & fair position or not. Information sharing mechanisms worked out under BEPS programmes have increased the compliance burden hugely and commensurate clarity in profit attribution is not available.

(*iv*) Information sharing will take a few years.

So we have unreliable information which itself takes a few years to collect. This will leave tax officers to depend on unreliable information which would still take a few years to collect.

For the MNC, every year's tax assessment may invite litigation on several issues; and may take a few years to complete the first stage appeal. Litigation for each assessment may take five to twenty years for finalisation. Until then, the MNC's claim at COR for tax credit may be in limbo. Risks of penalties and prosecution in 190 countries may be too big a price to pay for the MNC.

For both - the tax payer & the tax officer, the time & efforts to be put in for taxation under UA will be disproportionately large.

14.6 OBSERVATIONS ON OECD UA

In our submission, the UA's profit attribution mechanism is not a practical approach. UA suggests a **top-down mechanism** - start with the global profits to work out the profits taxable in the Market jurisdiction. In the process, several variables are built in. These may cause considerable litigation and controversies.

In our view, it should be the other way round. Keep the **revenues received in the Market jurisdiction as the tax base**. The information is readily available or obtainable. Apply a percentage of withholding tax in the COM. COR should provide credit for tax paid in COM. This simple approach is brought out in the Table 2, paragraph 14.4 above.

14.7 CONSUMER FACING BUSINESS (CFB):

The OECD UA describes & discusses the "Scope" of business which should be covered under Digital Tax. This is another avoidable issue arising because of ambiguous language of the OECD UA.

14.7-1 Extracts from UA are reproduced below:

(*i*) Summarised Scope as given in UA Page 5, paragraph 15:

Scope. *The approach covers highly digital business modes but goes* ***wider****- broadly focusing on consumer-facing businesses with further work to be carried out on scope and carve-outs. Extractive industries are assumed to be out of the scope.*

(*ii*) Same subject is discussed in details on page 7 of the UA: *Paragraph 20:*

"This supports the idea that the proposed "Unified Approach" ***should be focused on large consumer-facing businesses****, broadly defined, e.g. businesses that generate revenue from supplying consumer products or providing digital services that have a consumer-facing element. It would also suggest that some sectors (for example, extractive industries and commodities) would be carved-out. Further discussion should take place to articulate and clarify this scope, including consideration of how a consumer-facing business might be defined and how the concepts of consumer products or consumer sales would deal with the supply of goods and services through intermediaries, the supply of component products and the use of franchise arrangements. Further discussion should also take place to consider whether other sectors (e.g. financial services) should also be carved out, taking into account the tax policy rationale as well as other practicalities. Such discussion should also include consideration of size limitations, such as, for example, the €750 million revenue threshold used for country-by-country reporting requirements.*

(*iii*) ***Note 7 at the bottom of page 7 of UA:***

"*The term "****consumer****" generally refers to individuals who acquire or use goods or services for personal purposes (i.e. outside the scope of a professional or business activity), while the term "****customer****" generally includes all recipients of a good or service (including business customers that are not end-users).****"***

(*iv*) Look at the "questions for public comments" on page 17 of the UA. Question 1-

Scope. *Under the proposed Unified Approach,* ***amount A would focus on****, broadly, large* ***consumer*** ***(including user)*** ***facing businesses.***

14.7-2 Comments on OECD UA proposals on Consumer Facing Business

Language in summary [(*i*) above] suggests that the scope of business to be covered under Digital Tax is to be **expanded**. Language in (*ii*) & (*iv*) above probably suggest that the scope is to be **limited** to Consumer facing Business.

Primarily, digital business is understood to include business carried on with the help of computers, internet and mobile phones. However, in principle, there is no need to restrict the scope. Any other business where the seller of goods and services can transact business with the consumers without having a PE in the Country of Market should be covered.

The **language of the UA is not very clear**. While the above extract (*i*) does not suggest restrictions, further paragraph 20 in UA reproduced above probably suggests restrictions on scope. Do they want to restrict the scope of digital taxation to Consumer Facing Business? Or is there no suggestion for restriction? In other words will "B to B" (Business to Business) be covered under the scope for digital taxation? If "Yes", then the proposal to expand the scope of digital taxation is okay. If the proposal is to exclude B to B, then the UA is not acceptable. We assume that there is no such proposal to restrict the scope. However, by any chance, if there is a proposal to restrict the scope, then we offer our observations on the implications of such a restriction.

14.7-3 Implications of any restriction of Scope of Digital Taxation to CFB and excluding the Customer Facing Business

Theory : In many digital corporations, the Consumer Facing Business gets no revenue and incurs huge expenses. Only the B to B activities generate revenue and profits.

Illustrations: Note: We do not know actual facts of the companies considered below. However, we have assumed amounts as well as different divisions based on media information. All the information given in this Book is just assumed for this illustration. What is important is: "the concepts and principles highlighted by these illustrations".

(*i*) Facebook: Who are the Consumers/Users? Millions of people who use Facebook to share their family news etc. are the Consumers/Users. What do they pay to Facebook? Nothing. So, consumer facing business of Facebook has only expenditure and no revenue, no profits and hence no tax liabilities in the COM. Its revenue is from advertisers and businesses who take data from Facebook. They pay for the data analysed advertisement opportunities on Facebook. This is B to B. It is not a Consumer Facing business. It is a Customer Facing business. On a reading of description of scope together with Note No. 7,

it may appear that OECD does not want to cover this Customer Facing Business.

Pure accounting logic suggests that one cannot separate the expenditure side and revenue side into two separate businesses and then accord different tax treatments to both. For illustration - a textile mill buys cotton from the farmer and sells readymade cloths to retailers. Cotton buying is "Farmer Facing Business" and Cloth selling is "Retailers Facing Business". But both faces belong to the same entity. They cannot be separated. Hence the logic discussed in the paragraph above on Facebook has to be rejected as absurd. Facebook's profits would be calculated by considering the revenue that it generates by (*a*) advertisements to users and by (*b*) sale/licence of data which has been collected from users. Cost of providing services to users - is the purchase cost of the data. Licence revenue on data is the reward for incurring purchase costs.

(*ii*) Amazon: Amazon India claims (in this illustration) that it is not selling any goods or services to Indian consumers. It is only providing its marketing platform on its website. Retailers use this marketing platform. Amazon has no Consumer Facing business. Hence, no revenue and no tax liability in India. Amazon's only business is B to B - "Customer Facing Business". Should it be taxable in India? In our submission, it must be taxed as a Digitalised Business. If OECD UA suggests otherwise (we hope it is not suggesting otherwise) then it should be rejected.

14.7-4 It seems that the UA wants to restrict the Scope to **"Highly Digitalised Businesses"**. What is a highly digitalised business?

Before discussing this issue, even more important issue is - What is the root objection to existing system of international taxation?

Is the objection against **"Digital"** business not getting taxed? Or

Is the objection against any **"Remote"** business that a Non-Resident conducts within a Country of Market without having a PE in the COM?

To use, OECD UA language - please see Page No. 7, Paragraph 2.2, 19 explaining the Scope to be covered under digital tax.

> *"The allocation of a new taxing right to market jurisdictions through* ***new nexus and profit allocation rules*** *would recognise that in today's globalised and increasingly digitalised economy* ***a range of businesses can project themselves into the daily lives of consumers*** **(*including***

users*), *7 interact with their consumer base and create meaningful value without a traditional physical presence in the market. *These features could be said to be relevant for any business, but they are most relevant for digital centric businesses which* ***interact remotely with users***, *who may or may not be their primary customers, and other consumer-facing businesses for which customer engagement and interaction, data collection and exploitation, and marketing and branding is significant, and can more easily be carried out from a remote location. This would include highly digitalised businesses which interact remotely with users, who may or may not be their primary customers, as well as other businesses that market their products to consumers and may use digital technology to develop a consumer base."*

Whole idea is a NR can be virtually present in a country without having a fixed place of business; or without having an Agency PE.

Today's popular model of business before our eyes is digitalised business. However, in the **history,** there have been many Remote businesses and in **future,** certainly there will be businesses - that would not be digital businesses and yet will do business remotely without a PE in COM.

Illustrations:

(*i*) Catalogue Sales: Many decades before there were Canadian businessmen who were marketing/Advertising their products in the U.S. market. They would simply post catalogues into USA. The Canadian sellers did not have any shop or other fixed place of business in USA. They did not appoint any agents in USA. Based on the catalogues if any US customer wanted to buy the goods, he would contact the seller by telephone or post. The Canadian seller would post or transport goods to the US customer.

This was exactly a **Remote Business** where - A NR of USA was selling goods in USA without having a PE in USA.

But he **did not use digital communication system** as internet was simply not available.

For the Canadian Seller, Canada was COR.

USA was COM. He had no PE in USA.

Under the OECD Model then prevailing & under the US-Canada DTA, Canadian seller's profits arising from the business were not taxable in USA.

(*ii*) Illustration of Remote Business which is not digitalised business:

Television and Radio companies have been doing Cross Border or Remote business for several decades. Probably when they did this business, let us assume that they were not digitalised business. Internet was not available. Senior Indian professionals may remember following business:

Within India, Radio broadcasting was the monopoly of Central Government of India. **Radio Ceylon** was resident of, under the jurisdiction of and taxed in Ceylon (Now known as Sri Lanka). It was not affected by Indian law. **Indian law had no jurisdiction** over a company doing business outside India. Radio Ceylon ran programmes that were specifically targeted for Indian audience. **Binaca Geetmala** was a very popular programme. Indian businessmen advertised their products and services on Radio Ceylon. I was a student at that time. I do not know whether Radio Ceylon paid any Income-tax to Indian Government.

Radio and Television businesses are **historical illustrations** of "Remote Businesses" that were not digitalised businesses. Today, we do not know whether these businesses can be called digitalised businesses. Assuming that they are "**Remote Businesses" but not "Digitalised Businesses";** Under the OECD UA would their income from India be liable to Income-tax in India?

This illustration is to highlight the fact that there can be Remote business which is not digitalised business.

Countries of Market have a ground that - A NR seller can be virtually present in the COM; can earn significant revenue from COM; and yet under the existing OECD model such sellers would not be liable to Income-tax in COM. Governments are not concerned - whether the seller uses internet/digital instrument or any other method of doing business. In our submission the term: **"Digitalised Business" should be replaced by the term "Remote Business".** It should be clarified that the method/instrument of communication cannot affect charge of Income-tax.

Data Business is also discussed further. Please see Chapter18.

14.8 FUTURE UNPREDICTABLE

As discussed separately, "multi-dimensional digital technological commercial revolutionary process" has assured that future is uncertain & unpredictable. Today what we can see, and observe can be viewed in the light of following facts:

14.8-1 Natural inability of human beings to have a holistic, futuristic view

There is an ancient Indian story to explain "**Anekantvad**" (Comparable to the concept of "Lateral Thinking" and "Concept of Relativity" but much more in scope & depth than "Lateral thinking" & "Concept of Relativity"). The story is of **six blind men** touching an **elephant's legs &** trying to guess the shape and size of the elephant. They have only touched the legs of the elephant. They do not know the size, shape & strength of the elephant. They cannot appreciate the elephant as a whole, powerful animal. It is difficult for most people to have a holistic view of some thing that they cannot observe or experience.

14.8-2 Metamorphosis

A butterfly lives through four stages in its life: egg, caterpillar, pupa & finally the butterfly. The digitalised business that we are observing today may be like the caterpillar. And we are already drafting the law on the butterfly.

Conclusion: A complicated tax law will not work. Not just in digital taxation. Entire tax laws must be simple to encourage & facilitate growth in technology & business. OECD UA which is neither holistic nor futuristic does not pass the test.

14.9 CONCLUSION ON OECD SECRETARIAT'S UNIFIED APPROACH:

(*i*) **Scope:** *Prima facie* it is a good proposal that needs to be clarified and fully developed.

(*ii*) **Nexus:** Accepting Sales as Nexus in COM without disturbing rest of the International Taxation is a good suggestion. However, it is still unfinished agenda.

(*iii*) **Attribution of Profits:**

(*a*) It is unnecessarily complicated. It will generate avoidable controversies and litigation.

(*b*) The share of "Right to Tax" attributed to COM is too limited and hence unjust & unfair.

(*iv*) **Future Ready:** Being too complicated, it is not good even for today, leave aside tomorrow. It fails to take a Holistic View of the Multi-Dimensional Global Technological - Business Revolution Process that is going on for a few decades.

15 CHAPTER

NEED FOR CHANGE & SUMMARY OF THE SEP & WHT BASED DIGITAL TAX SYSTEM

15.1 NEED FOR CHANGE IN INTERNATIONAL TAX SYSTEM

This need has been felt for a long time. Indian High Powered Committee on Ecommerce taxation had said in its report in the **year 2001** that the concept of PE needed changes. Extract from the Committee Report: Paragraph 6:

> ***"6.2.1 Concept of permanent establishment ("PE"):***
>
> *The Committee is of the view that applying the existing principles and rules to e-commerce does not ensure certainty of tax burden and maintenance of the existing equilibrium in sharing of tax revenues between countries of residence and source. The Committee is also firmly of the view that there is no possible liberal interpretation of the existing rules, which can take care of these issues, as suggested by some countries. The Committee, therefore, supports the view that the* ***concept of PE should be abandoned and a serious attempt should be made within OECD or the UN to find an alternative to the concept of PE.***
>
> ***6.2.2 Alternative to the concept of PE:***
>
> *The concept of PE evolved because in traditional commerce physical presence was required in the source country if any significant level of business was to be carried on. Absence of a PE implied only insignificant business activity, which could be overlooked for tax purposes. This concept lost relevance with the technological advance in communication and development of teleconferencing. With that and the development of the Internet in the 1990s, the correlation between the size of business and the extent of physical presence in the source country ceased to exist. In all transactions undertaken through the Internet, even where delivery is in the traditional manner, the tax base in the source country would be nominal."*

OECD's acceptance of Sales based Nexus for COM and not disturbing the Nexus for rest of the economy is really a good proposal. OECD has accepted that existing rules of international taxation for establishing **Nexus** (Permanent Establishment) and for **Attribution of Profits** are not adequate to deal with Digital commerce tax. In absence of a PE which can be applied to Digital commerce, the Non-Resident (NR) Digital Corporation (DC) cannot be taxed by the Country of Market (COM) irrespective of the revenue earned by the DC from COM. Having now accepted these facts, the OECD UA Document presents an approach combining three proposals (Which were presented in February, 2019 by TFDE) for addressing the digital tax challenges.

Now we proceed further. We need to find **new ways** of establishing **Nexus and Attribution of Profits** that can be applied to Digital commerce. We are trying to present a system which is far simpler to comply with by the digital corporation & simpler to administer by the tax officers.

Compared to the term "Attribution of Profits", a simpler term & tax system will be computation of **Tax Base** for the COM. This matter is discussed further in paragraph 16.11 below in this book.

15.2 SUMMARY OF THE SEP & WHT BASED DIGITAL TAX SYSTEM AS PROPOSED IN THIS BOOK

The taxation system will require changes in Domestic Income-tax Act as well as in Treaties. We suggest that profits derived from Digital commerce may be taxed in the COM in following manner:

(*i*) **Scope of the Business to be covered under Digital Taxation:** Digitalised businesses including Consumer Facing Businesses (CFB) even if CFB do not use digital technology should be covered within the scope of digital taxation. Digitalised B to B will be covered within the scope of digital taxation. Appropriate businesses should be listed by TFDE under MLI. Bilateral treaties can, if necessary, include the lists as negotiated.

(*ii*) The non-resident digital corporation (NR DC) may establish a subsidiary or a PE in the COM and provide some services etc. from such presence within the COM. In such cases, the income attributable to services provided within the COM will be dealt with under existing normal provisions under domestic tax law as well as the DTA. If the NR DC simultaneously provides some

services from outside COM, the gross revenue on such services will be treated under the SEP + WHT based system presented here.

(*iii*) **Nexus: Simplified Significant Economic Presence** (SEP) will establish the **nexus** for the Country of Market (COM) to tax a non-resident Digital Corporation's income from **prescribed business**. For formation of SEP two criteria will have to be satisfied: Tax Base and Virtual Presence.

(*iv*) **Tax Base:** Revenue receipt within/from the COM in excess of prescribed threshold will constitute the **Tax Base** in COM.

(*v*) **Virtual Presence** in COM means: The NR DC is virtually present within the COM in some manner. This manner of presence will be determined by an appropriate criteria depending upon the kind of business. (*a*) The non-resident is "performing" on the instruments existing within COM - computer, mobile phone or any other instrument that is amenable to digital/remote services. Or ..(*b*) COM resident within COM is "utilising" the NR's services through digital/remote communication. Or..

In some manner, the NR continues to be virtually present within COM.

Thus, in case of **Consumer Facing Business**, a criterion of at least **10,000 users** in COM may be fixed. In a B to B organisation like **Credit Card Transaction Processing** services provided by a NR DC, a **single user criterion** may be appropriate. Since every kind of digital business may require different criteria, these may be listed by TFDE and bilaterally negotiated by the Treaty Countries.

Thus, Tax Base & Virtual Presence together will determine the presence of SEP. Article 5 of the OECD model may be amended and two clauses for SEP & Data may be added. Similarly, domestic Income-tax Act may be amended and proper provision for SEP may be included.

(*vi*) For determining the COM's "**Right to levy Digital Tax**" the concept of **Attribution of Profits may be replaced** by Computation of **Tax Base**. Difficulties in Attribution of Profits have been seen above in our comments on OECD UA. These are further discussed below. Drop it for digital tax. The concept of Tax

Base will be useful in determining SEP as well as calculation of tax payable in COM.

(*vii*) With Holding Tax: (WHT):

A Withholding Tax on the gross revenue received in/from COM (on the Tax Base) being a **final tax** (like tax on royalty) may be imposed as **Digital Tax**. Since this will be a tax on active business revenue, the withholding **tax rate may be 3%** or such other low rate. Royalty etc. are normally taxed at 10% or higher rate. In this process, Tax Base is instrumental in determination of SEP. It is also direct step to determine total tax payable.

Option to file a detailed tax return & claim lower tax liability may be given subject to the DC satisfying the COM tax officers that it has not resorted to BEPS, TP, GAAR etc.

(*viii*) Elimination of Double Tax: The tax withheld/paid in the Country of Market (COM) should be available for set off against the tax liability in the Country of Residence (COR). [Note: Global income of DC would be taxable in COR. Hence, set off given by COR would still enable them to earn the fair share of tax revenue.]

(*ix*) SEP & Attribution of Profits are discussed separately for Data & other Digital commerce businesses.

(*x*) Compliance & Administration Machinery: The NR DC will file a Short Income-tax return in every COM in which it has SEP. It will provide evidence of tax withheld (WHT) by its consumers and customers. Balance tax payable if any, will be paid by the NR DC. The return will be accompanied by accounts giving details of: Total Revenue received within/from COM, total WHT and balance tax paid. These accounts will be audited by an independent auditor practising in COM.

Under this proposal the tax system will be fairly simple for both - the taxpayer (Digital Corporation) and the tax administrator - Government of COM.

16 CHAPTER

ALTERNATIVE TAXATION SCHEME: SEP & WHT BASED SYSTEM IN DETAIL

16.1 Note: **OECD Secretariat UA** has already moved forward & in principle accepted that Market Jurisdiction can have a Right to Tax even in absence of the physical base. Following discussion can be considered to be in support of this move forward. Until October 2019, this stand was not accepted. In case, there is any backward movement, this discussion may help in preventing the backward movement.

We have seen earlier that the system of Elimination of Double Taxation involves: (*i*) COS taxing the income of a NR at a lower rate; and (*ii*) COR granting credit or exemption. When we can design a system ensuring that the NR assessee gets credit in COR for the taxes paid in India; it will be a fair & proper system. This new system will require amendments in domestic law as well as DTA.

GOI (or any other COM) would like to tax a NR GC's revenues earned from India. Since the assessee is a NR, GOI can tax it only on the Connecting Factor of "Source". We have seen that in absence of a Fixed Base PE, the Connecting Factor ("Source" as defined under the existing system) fails for Digital Commerce. Hence India needs to evolve new concepts for the connecting factor of source to tax Digital Commerce. Amend the ITA appropriately, provide for SEP as the Connecting Factor & canvass for amending the DTA.

16.2 JUSTIFICATION FOR TAXING NR

There can be different logics or **justifications for taxing a NR**:

16.2-1 He is **performing** services in India and hence he has a Virtual Presence in India. This is **supply side** or assessee's side.

16.2-2 Irrespective of performance, we are taxing him because Indian Residents are **utilising** his services in India. This also amounts to saying that India is the **Country of Market.** COM has a right to tax because COM contributes to the NR assessee's profits. This is **demand side** or customer side. [GOI has considered that when services are "Utilised" in India, the fees payable are taxable in India even if the NR has no "Performance" in India. In the year 1976 it enacted following provisions: Section 9(1)(*vii*).]

16.2-3 India may be considered COM even though the service is neither performed nor utilised in India. This can be a situation when an Indian advertiser pays advertisement charges for a foreign viewer/user. Indian Resident advertiser is **utilising** GC's services for its **business carried on in India**. Hence we say that for Google, the market is in India.

We examine all approaches and see their implications.

16.3 SIGNIFICANT ECONOMIC PRESENCE

16.3-1 Facts

Google, Face Book, Yahoo, You Tube, Star TV, CNN, BBC Radio & BBC TV are providing different kinds of services. Amazon.com provides even E-books. This is largely comparable to sale of books, CDs & DVDs. Can these non-residents providing digital commerce services be treated as having a Significant Economic Presence (SEP) in India? If yes, on what grounds? What are the issues/difficulties in such a modification of the existing concept?

16.3-2 The Hypothesis of SEP

It is accepted that E-Commerce defies geography. Concept of PE is a geographical threshold. Hence as far as digital commerce is concerned, we have to find an alternative PE. SEP based on **Virtual Presence and Revenue receipt** may be an alternative for E-Commerce.

16.3-3 Virtual Presence

Google from USA/Ireland is service provider. Indian viewer is the service user. "Where" is the service **performed**? Google is the assessee. User is not the assessee. Has Google performed services in India?

It is difficult to construe that Google is providing services in India because: It has no human beings and no assets in India. In similar

circumstances (Asia Satellite & B4U cases) Indian appellate authorities have ruled that there is no PE in India. No tax can be levied. Even the retrospective amendments to S. 9(1)(*vi*) are of no avail as DTA overrides domestic law. In this book we are considering: "What should be the future law to tax Digital Commerce?". Hence these decisions are not of much help. Except for a reminder that: Any amendments to the domestic law will be of no avail as long as we do not take care of the fact that DTA has no provision for Digital Commerce taxation. And DTA will override ITA.

New law may be based on the consideration that: Geography is history for digital commerce. Google is providing services to Indian users. We are not able to see Google performing those services in India. However, Indian users are utilising Google's services in India. Hence Google has a presence in India. Google's intangible services are "**performed" where they are "used**". If we accept this position, accepting taxability of Google's income will be in line with the principle that **Google has a Virtual presence where its services are utilised.**

16.3-4 Let us say: These service providers operate on the **computers/ TVs/Mobile phones/Radios** or other instruments of the users of the services. Hence we can say that they are performing services on the instruments at the places where the instrument is situated; or that the users are utilising their services on the instruments. Normal perception under "traditional commerce" is that the service provider is present where it has people, assets etc. In the present "Virtual World" it is present virtually, simultaneously in 190 countries where its services are being utilised. These 190 countries are its Countries of Market. They all have a Right to Tax Google's profits arising from the provision of digital services. This **Virtual Presence** combined with revenue threshold constitutes the SEP.

At the same time, we may consider the fact that there may be different situations. For illustration: An Indian user searches the US treasury website by using Google Search Engine to look out for US tax laws. He then downloads certain data. In this case, it is the user who is using the Google Search Engine situated outside India. He could have directly gone to the database by using any Internet service provider. He has used **Google only as a search engine**. User is acting on database computer *via* the search engine. **Google is not acting on the Indian computer**.

Another illustration: Google places an advertisement on the user's computer, **Google is acting on the User's computer**.

When **Infosys** people based in India operate upon and maintain software on US customer's computer located in USA, Infosys is **acting in USA**. However, it is possible that the customer may be using "**Cloud Computing**" facilities. Its server hosting its software & database may be situated anywhere. Then Infosys' services are being utilised by a US customer globally. Since US is the Country from where the Payer of the service charges is conducting its business, Infosys has a Virtual Presence in USA. Here **we are going one step further. Linking the Virtual Presence to the Country of Payment.**

When **STAR TV** (assuming it to be a NR of India) broadcasts its programme with Indian footprint in mind, does it actually operate/ function in India?

We can consider several illustrations. Each illustration will have its own different answer to the question: "where the assessee is functioning?"

16.3-5 Monetary Threshold

For constituting an SEP, two factors should be present: Virtual Presence as described above; and **Receipt of Revenue** from the COM. It is not practical to administer income-tax for **small assessees**. Hence, we may provide a **threshold**: Only when the Revenue receivable from the COM is more than ₹ 10,00,00,000 (Indian Rupees Ten Crores) the assessee will be deemed to have Tax Base in India. Any amount may be fixed as a threshold. It is for the countries to bilaterally decide. The amount may be different for different kinds of digital businesses. This threshold of amounts is only to avoid dealing with small payments, small service providers.

Another factor of maximum importance is **Utter Simplicity** for: the service provider to comply with the law; and tax officer to administer the law. For business entities operating globally - who also want to comply with law in spirit & in substance; simplicity is of prime importance. Hence we further provide that only the **Revenue Received** by the service provider during the relevant financial year shall constitute the Tax Base. We are not interested in accounting for outstanding dues, bad debts & so on & so forth. Just pay WHT on revenue received.

"Revenue" is an important criterion to determine existence of SEP. It is being simplified by linking with only the "Revenue Received". Hence we call it a **Simplified SEP**.

We are suggesting a **TDS/WHT rate of 3%.**

Such service provider will be liable to file its Income-tax return in India, get its accounts audited, and pay advance tax. Claim credit for all TDS and pay net tax on self-assessment. All the **accounting & audit** will be only for (*i*) the amount actually received, (*ii*) tax deducted at source by the "Payers" from the COM and (*iii*) "balance payable" by the service provider. This "balance payable" arises because many small payers paying amounts less than the threshold would not have deducted tax at source. (*See* below paragraph 16.3-6.)

The assessee **remains a NR of India** and hence is not liable to comply with certain procedures like TDS on payments made by the assessee to NR persons.

For the **Concept of Digital Commerce** an additional clause in Article 5 of the treaty model shall provide for SEP. And SEP will depend upon two further criteria: (*i*) Revenue receipt/tax base of more than ₹ 10,00,00,000 (Indian Rupees Ten crores); and (*ii*) Virtual Presence.

16.3-6 Threshold for the Payer

Just as we have a threshold for the assessee, it is necessary to have a threshold for the payer also. Home consumers/users will find it difficult to comply with TDS procedure. COM government would not like its home consumers and other small payers to get into the hassle of TDS procedures. Hence we may consider another threshold. An individual or an HUF payer will not be liable to TDS procedure if both of the following conditions are satisfied:

(*i*) The payer is not liable to tax audit and is not claiming the payment as a tax deductible expenditure.

And

(*ii*) Pays less than ₹ 1 lakh per year; then he will not be required to deduct tax at source.

Such small payments will be taken care of by the bank/payment gateway collecting funds on behalf of Google. We have worked out a system in principle. CBDT, CBIC and RBI can work together and develop a mechanism whereby in case of small payments, even by

credit cards, etc., the payment gateway will deduct tax at source and credit CBDT or CBIC as may be applicable. When Google will file its own tax return in India, it would claim credit for the tax deducted by the bank/payment gateway.

16.4 COM - UTILISATION

In the concept of PE we consider whether the service provider - Google - is performing any function etc. in India or not. In this para we consider whether the Indian user is utilising services provided by Google.

16.4-1 As long as the services are utilised in India and paid for by Indian residents, India has a right to tax the revenue. India is the **Country of Market,** it contributes to the value addition made by & profits earned by the NR assessee & hence it is treated as the **Country of Market**. GOI will tax only those GC assessees whose revenue from India is more than ₹ Ten Crores per financial year.

16.4-2 Justifications

(*i*) Google and the TV channels are providing services to the users/ viewers AND to the Advertisers. Hence for them these people constitute the market. (*ii*) For the tax department, it is simple to administer (*iii*) For the assessee it is simple to comply with. There is no need to attribute any profits/revenue to any COS.

Here we are justifying India's jurisdiction to tax because India is the Country of Market. This involves (*i*) amending Income-tax Act and (*ii*) modifying Article 7 in the DTA.

16.5 METHOD OF TAXING: "TAX ON NET PROFITS ATTRIBUTED" OR "WHT ON REVENUE/TAX BASE"

For the sake of clarity, let us examine the issue of "Revenue Receipt" in more details.

16.5-1 (*a*) Consider that Google is operating within India. It is providing services where the services are used. Number of users is more than the prescribed threshold; services are provided for more than the prescribed period, etc. all conditions would be satisfied. Hence it has a **Virtual Presence** in India. It also has revenue in excess of the threshold of ₹ Ten Crores. Hence Google has an SEP in India. Google's

gross revenues minus expenses attributable to Indian operations give taxable net profits that may be attributed to India.

OR

(*b*) Consider Google's revenues. Levy a tax @ 3% on gross revenues.

Details:

(*a*) First option (Net Profits attributed to India) requires Google to prepare separate books of account, consider FAR analysis & calculate net profit in India. Get the accounts audited + tax audited, maintain transfer pricing records and get transfer pricing audit done and comply with elaborate Indian legal procedures. Assessment, appeals & probable prosecution. Google may have to do this in a hundred and ninety countries. And defend itself from GAAR provisions in all countries where GAAR has been made a law.

This is what OECD UA proposes by providing for a system of attributing three different categories of profits to the COM depending upon several different subjective criteria, assumptions, formulae & so on. Such a requirement to compute amounts "A", "B" & "C" together with the fact that these MNCs have proved to be resorting to aggressive tax avoidance strategies makes it necessary that these service providers should submit themselves to deep scrutiny of their submissions in every COM. This would require the service provider to share global data with 190 countries.

(*b*) It seems, the second alternative of paying lumpsum tax on revenue received will be better for administration as well as compliance. No application of FAR & no need to prepare separate profit & loss account, no transfer pricing audits.

16.5-2 Combined Effect

Non-Resident provider of digital services will be liable to tax in India only if all of the following conditions are satisfied:

(*i*) **Services** are provided to an **Indian resident** or to any person for his business conducted in/from India. (This will mean services for home consumption also will be covered.)

(*ii*) Indian resident (other than Individuals & HUFs) - whether the User of free services or advertiser makes **payment** from India.

(Advertiser is another aspect discussed separately under the chapter of taxation of Data.)

(*iii*) Service provider provides services in a manner that amounts to a **virtual presence** in India. He may be providing services for more than 60 days in a financial year. Or has more than 10,000 users in India. Or such other criteria as may be prescribed.

(*iv*) Service Provider - the Global Corporation (GC) earns gross annual revenue of ₹ Ten Crores or more from India.

(*v*) If all these conditions are satisfied, the GC will be liable to tax in India & the payer shall deduct tax @ 3% of the payment. Payer will only look at his threshold of payment of ₹ 1,00,000 or more.

16.6 AVOIDANCE OF TDS

In this system **avoidance** of TDS procedure may be easy for some payers. Consider an illustration: There is a Global Advertiser - Corporation. It has subsidiaries in several countries including some tax havens. It places advertisements on a global TV channel for India as well as several other markets. Let us say, the ad charges payable for Indian market are ₹ 10 crore.

This advertiser will pay ₹ 2 crore from India and balance ₹ 8 crores from a tax haven company. It will comply with TDS procedure for ₹ 2 crore and save tax on ₹ 8 crore.

How does one deal with it? Advertiser and TV channel are not "Associated Enterprises" (AE). Hence the Transfer Pricing provisions (domestic or international) will not apply to this transaction.

Since comparable ad rates for other advertisers will be available; finding out market rates won't be difficult. And under invoicing/over invoicing can be enquired into under normal scrutiny assessment procedure also. One does not need the crutches of TP - deeming provisions for such matters.

Another way of looking at the tax avoidance by paying from tax haven is as under. When a Corporation pays from a tax haven, and does not pay from India, it cannot claim that payment as a tax deductible expenditure in its Indian tax returns. Hence it is not a big loss to Government of India.

16.7 VIRTUAL PE

The concept of PE discussed above raises several issues. Some of these are discussed below.

16.7-1 FAR Analysis: Assets & functions

One view is: Google has its functions performed, assets situated and risks taken where its hardware and software are situated - Let us say, in USA & Ireland. It has no functions and assets in India. So under the FAR analysis, no profits can be attributed to India/COM based on SEP.

Risk: Probably we can say that anyone who does business with/ within India takes a business risk in India. Consider a TV channel broadcasts a programme with Indian footprint. Some Indian viewer files a case against the broadcaster for offending his religious views or for defamation. The risk has arisen in India. The risk is taken/ borne by the company outside India.

16.7-2 Illustration

A singer or a **performing artist** is performing on a stage in India. Viewers come, pay for tickets, listen to/watch the performance. Here we agree that the performer is physically present in India and is providing entertainment service in India. He/She is liable to tax in India even under the existing Treaty rules (OECD model - Article 17). In this illustration, viewer/listener and performer are in the same room. Viewer, with his eyes watches. Listener with his ears listens. Performer performs.

In many cases, the audience is very large. The organisers put up large TV screens. Viewers actually see the performance on the TV screen. Actual performer would be so small in relation to the size of stage that if one were to watch only the performer, his facial expressions and subtle acting won't be seen by the viewer. It is also possible that the viewer and performer may be in **different rooms**.

Today, in almost all cases, the singer uses a microphone or such audio system. All listeners listen only through the sound system. What difference exists when some viewers/listeners are watching/ listening from another country? The **space between** the performer and the viewer may be 10 feet or 100 feet or a thousand kilometres. They may be separated by a wall partition (another room) or by a country border.

Performer performs. Wherever he is. Listener listens. Wherever he is. Since we have accepted that in digital commerce **physical presence** and **space** are immaterial, anyone who receives revenue from India must pay tax to India. **Forget about the concept of virtual PE.** The fact that **someone earns from India** is sufficient to make him liable to tax in India. This argument favours "**Demand Side**" and places reliance on "**Utilisation**" of service.

Note: In this book we are discussing the issue of neutrality in some details. We have also discussed that there is considerable difficulty in achieving a consensus amongst treaty partner countries. Until a consensus is achieved & DTAs are modified, neutrality will not be achieved. Hence some difference will remain between the treatment of digital commerce services & other services as well as goods. Until then all categories of incomes (including performing artists' remuneration) which are covered under different articles should be treated under those articles. Digital taxation will apply only to digital services.

16.8 POPULARITY OF SEP

There is a substantial support for the concept of Significant Economic Presence. **European Union** (EU) has made concrete proposals for SEP. **India** has already proceeded with legislation of SEP. **France & Italy** have made similar proposals. **USA** follows it for sales tax on inter-State trade. Several other countries are at different stages of legislation for taxing Non-resident's Digital commerce income. The work on SEP is incomplete because of non-conclusion of BEPS Action 1 Report. The remaining work can be completed soon after TFDE publishes final report on BEPS Action 1.

16.9 INADEQUACY IN EXISTING TAX BASE ALLOCATION

16.9-1 Digital Corporations' global profits are a **global tax base** for all countries that contribute to these profits. Under the existing system, many countries do not get their due share of global taxes. Global tax base is not fairly apportioned amongst different countries - COR & COM.

Let us try to understand in this book:

(*i*) Inequity in the **Existing** Treaty Models & practices.

(*ii*) **Failure** to remove the inequity under **OECD UA.**

16.9-2 Consider tax base attribution under existing Model.

It is clear that in global taxation, major profits are made by MNCs. The earnings by individuals, etc. are a fraction of MNCs' earnings. Within MNC earnings major portion is Business profits. Whole of Business income is taxable in COR. In case of Permanent Establishment (PE) the profit attributable to the PE -is available to the host country. But this is a small portion of business profits available to COR as tax base. **Largest portion of tax base - Business income stays with the COR.**

16.9-3 So far, all the discussion on profit allocation amongst different countries is based on the **functions performed, assets held and risks taken by the assessee - Digital Corporation.** Tax jurisdiction under existing model is based on **supply side** of goods & services. The **demand side** or **Market is given zero attention** in allocation of tax base. This is denial of Tax Base allocation on the basis of contribution to profits by the Country of Market.

It needs to be noted that:

For any business to happen & for profits to accrue, a transaction between the seller and the buyer is necessary. In absence of either the seller, or the buyer, there is no business and no profit.

The seller is facilitated/supported by the COR of the seller. The buyer is supported by the COM of the buyer. Hence, both countries - COR & COM should have the right to tax the profits of the PE.

The basic **defect in the OECD treaty model** needs to be amended. It is necessary to develop the concept of Country of Market (COM) as a distinct concept, separate from COR & COS. A country must get taxing rights because it provides market. **Market is the nexus just as Residence is the nexus.**

16.10 ILLUSTRATION OF DIGITALISED BUSINESS

Consider an MNC in digitalised business. It is tax resident of USA. Hence USA is **COR**. It has set up a giant server farm in Ireland. The MNC has a team of 2,000 employees managing these servers which form an integral part of MNC's global business. Let us say, this is an Irish branch for the US MNC. It is treated as a Permanent Establishment in Ireland. Hence Ireland is **COS** for the profits attributable to Irish Branch.

The MNC earns billions of dollars from rest of the world (other than USA & Ireland). These other countries are Countries of Market (**COM**).

Under the existing system they are entitled to zero tax base. They cannot get single dollar tax revenue from this MNC.

Please note the difference between COR & COS on **Supply side** & COM on the **Demand side**.

16.11 TAX BASE

Concept of levying a flat rate of tax on "Revenue Received" is discussed in further details in this paragraph. There is a difference between two concepts: "Attribution of Profits" & "Attribution of Tax Base".

16.11-1 Attribution of Profits as seen earlier involves computation of gross revenue, net profits (subject to several anti-avoidance measures), nexus with COR, COS & COM. Then based on certain formulae - attribute a portion of total profits to COS or COM. For establishing correct **Attribution of Profits,** under OECD UA it will be necessary for the DC to file tax returns in scores of countries and then provide substantial data in a manner in which the tax officers of the COM can verify correctness of the data. Information Exchange Agreements and sharing of consolidated data will not be adequate for COM tax officers. DC will have to establish before Tax officers of all COM that it has not resorted to tax avoidance under BEPS, Transfer Pricing, GAAR, GILTI & BEAT etc. This can be extremely subjective causing disproportionately large costs for compliance and administration. This can cause litigation. Detailed note is provided in Part III Table 1 and paragraph 14.5 - Difficulties in UA Approach. For this reason, **we propose that as far as digital tax is concerned, the concept of Attribution of Profits may be dropped.** This concept is necessary for determining COM's Taxing rights. It can be done in a simple manner by considering Tax Base and then applying flat WHT.

16.11-2 Tax Base Attribution

COS & COM find it difficult to verify several figures given by Digital Corporation. They need simplified methods to get their share of tax. Hence under Tax Base Attribution - the **gross sales amounts received from COM by the DC will be attributed to COM as Tax base**. (This is the Simplest method for attribution of Tax Base.) Thereafter it is the sovereign right (subject only to bilateral treaties) of the COM Governments to determine how to tax that revenue.

These Governments may find withholding tax on gross revenue as more efficient. **This eliminates examination of TP, BEPS, GAAR,**

GILTI, BEAT, etc. Many taxpayers also may find it far easier to submit simple details and pay tax without any controversy.

Appropriate sub-clauses may be added to Article 5 in the OECD model. It may be noted that separate sub-clauses will be required (*i*) for Data & (*ii*) for other digitalised businesses like advertisement or supply of goods & services through digitalised mode.

Under Article 5 of the OECD Model permanent establishment has been defined. Primarily, a fixed base within the COS is considered as PE. However, this is not sufficient to cover different kinds of business activities which a non-resident can conduct within the COS. Hence, there are eight different sub-clauses under Article 5. In the same way, for digital tax also one sub-clause will not be adequate. There will be **two sub-clauses** required under **Article 5** - one for **data** and second for all **other Digital commerce businesses.**

Market as the Nexus takes into account everything like - "Users", "Consumers", "Payers", "Market Intangibles", "Goodwill", or any other relevant factor. At the same time, this is utterly **simplified & principle based method to determine Nexus.**

16.11-3 Factors other than Market to establish SEP

SEP in COM can be established by several factors. Some factors can be "number of users", "participation by the **users**" or "marketing intangibles" deemed to be present in the COM. However, all these considerations have uncertainties. As an example, a taxpayer like FaceBook or WhatsApp may have number of users which keep fluctuating. Some users may use the platform extensively. Some users may use the platform sparingly. And these users may not pay any charges to the Digital Corporation. Hence, deciding a nexus based exclusively on fluctuating numbers can be difficult. However, a small number of users - say, 10,000 users may be considered to be DC's virtual presence in COM.

In other words, the **Market in the COM** (together with Virtual Presence) should be considered as the Digital Corporation's **SEP.** Total **revenue received** from COM will be the **Tax Base** for COM. Once a payment for goods and services has been made from COM, the presence of users/customers is proved. We need not worry about fluctuating number of users, the length of user time, etc. The kind of goods or services provided may change completely. Still, payment remains a common denominator.

16.12 TAX RATE

Based on the principle that COM is entitled to 50% of the Digital Tax Base, one can make some simple estimates of normal profits. Half the profits form Demand side - COM -Tax Base. Apply the COM tax rate & come to Digital Tax Rate. Alternatively, a Thumb Rule rate can be - say: 3% of the amounts received by Digital Corporation. Each country can arrive at its own rate for digital tax rate. Even for the normal tax rates, each country takes its own decisions.

In case of normal PE, the COS gets right to tax on full profits of the PE based in COS. In case of digital commerce we are suggesting COM's taxing rights on half the profits of the SEP. The reason for this distinction is explained here. In case of traditional commerce, the PE does functions etc. within the COS. Only profits attributable to the PE in COS are taxable in COS. Hence COS gets taxing right on full profits attributed to PE. In case of an SEP, admittedly significant part of functions, assets & risks stay outside the COM. Hence COM should get right to tax on only half the SEP profits.

16.13 PRESCRIBED BUSINESS

16.13-1 Which Businesses should be covered within the Scope

As we have seen separately, the internet-computer-mobile phone technology keeps advancing very fast. Hence, new business models keep being developed. Defining which particular business would be covered under the digital tax regime; and which would not be covered - can be difficult. To give an **illustration - a butterfly** passes through several stages in its life. Start with an egg laid on a plant by the mother butterfly. This egg then converts into a caterpillar. After some weeks, the caterpillar gets converted into a pupa or cocoon. It then **metamorphoses** into a butterfly. Can one define or even project the characteristics of a butterfly by observing the egg or the caterpillar or even the pupa? We do not know whether today's digital commerce can be compared with an egg, a caterpillar or a pupa. Only thing we know is that for some more years to come, every five years the digital commerce will completely change. **Hence do not try to define digital commerce.**

16.13-2 We suggest that relevant Government may **prescribe specific businesses** which would be covered under Digital Tax Regime.

Payments to Digital Corporation for only the prescribed businesses will be covered under Digital Tax. Reasons for this suggestion: In the late 1990s OECD considered **E-commerce** taxation and suggested that businesses conducted through **computers & internet** would constitute E-commerce. Then **mobile phones** were used for cross border business. Mobile phones are not called computers. Hence business conducted through mobile phones would escape E-commerce tax. Hence OECD/G20 used a new term - **Digital Commerce.** Now OECD/G20 have used another term: **Digitalised Businesses.** It is certain that soon there will be new business models which will not fit into current definition/description also. In any case, designing a new tax system based on mere **Instrument of Communication** is not proper. There should be more fundamental principles to design the taxation system. Howsoever broad description may be made.

16.13-3 At the same time, provision of service through digital means should not, by itself attract the provisions of digital tax. These issues are illustrated below.

(*i*) When PE definition was drafted, nobody imagined that business could be transacted in another country without a PE. When discussion on Digital commerce started in the 1990s, people did not imagine that business could be transacted through mobile phones. The business models of providing a platform without charging any fee at all was also not imagined. It was not understood that massive data could be collected, stored, processed and then licensed to advertisers for a fee. And yet, these business models are extremely successful. If the past were to be projected into future, one can be certain that in a few years from now, there will be new business models which we do not imagine today.

(*ii*) Consider the illustration of a **doctor** practicing in COR advices a patient residing and situated in COS. The patient sends all his medical reports by emails. After studying the reports, the doctor holds a video conference with the patient. The advice is given on the video conference. Medicine prescriptions are sent by email. The patient makes payment also on the internet. While a lot of transactions have been completed digitally, the business is of medical advice. Importance is of **medical knowledge.** Digital communication is simply a matter of communication. Also, a

doctor is not likely to have users/patients above the threshold of 10,000. Hence he will not have a virtual presence in COM. Such business **cannot be considered under digital tax.**

Another illustration: An architect or a **technocrat** is residing in COR. A client based in COS requests for technical designs and drawings. These are supplied on the internet. Discussions are held on video conferences. Payments are made through the internet. Even in this case, **internet is merely a communication instrument**. Real importance is of the technical knowledge that the consultant has. The architect is also not likely to have a virtual presence in the COM in the form of 10,000 users. Hence, even this business income cannot be considered under digital tax.

16.13-4 These two businesses and their likes will be excluded from digital commerce if we **build in within the definition of SEP a virtual presence consisting of say, ten thousand users in COM.** The number of 10,000 is illustrative. Governments may choose appropriate numbers.

16.13-5 Another illustration of Business which **should not be covered** under the scope of Digital Business:

A traveller may select an **airline and a hotel** on the internet. He can book his seat and hotel room on the internet and make payment on the internet. Thus, entire contract execution and payment have been made digitally. However, the service of carrying the passenger abroad; and the service of providing hotel accommodation are provided outside COM. The payment is for the services to be rendered abroad and not for the digital communication facilities. **These service providers have no virtual presence in the COM.** Hence, these businesses also cannot be covered under digital commerce.

It will be **difficult to draft a definition** which will: (*i*) cover the businesses that should be covered under digital tax; and (*ii*) will exclude the businesses that should not be covered. Assuming that we can develop such a definition, it may require frequent modifications.

16.13-6 Practical way out of this situation is that OECD/G20 and COM Governments may **specify** businesses that will be covered under this tax. It will be a **positive list**. Hence all businesses which are not specified will be free from digital tax. Countries to a double tax avoidance agreement can together negotiate and modify the list of prescribed businesses as and when necessary. Such a provision will **facilitate a dynamic law in keeping with the dynamic technology.** Those

businesses may use computers or any computerised instruments; or may use something totally different. Underlying common factor should be that a non-resident of COM can do business with COM residents without establishing a permanent establishment as defined under current Article 5 of the OECD model of Treaty. In simple terms, it may be called **"Remote Business".** Since the business models can be expected to change, OECD can go on specifying new businesses under Paper 5 as Remote Business. All treaty countries may prescribe same businesses under their tax law for the purposes of Remote Tax.

Once the underlying factor has been known as "NR's business **without PE**", the **name** of the business may be Ecommerce or Digital Commerce or Remote Commerce or any other name.

CHAPTER 17

SIMPLE MACHINERY PROVISIONS FOR DIGITAL TAX

17.1 REVENUE COLLECTION MACHINERY FOR THE DIGITAL CORPORATION

Some years back it was not possible for tax administration of COM to verify correctness of tax returns to be filed by Digital Corporations. A non-resident Digital Corporation wanting to earn revenue from COM through Digitalised business will be required to set up revenue collection machinery in the COM. The Digital Corporation may select one or more banks operating within COM for the collection. Notify these banks & accounts to the COM tax department. All payments to DC - whether by cheques, credit cards or debit cards; by electronic transfer or by any other payment mechanism will be deposited in the specified bank accounts only. The DC may give account information and instructions for electronic transfer of money on its website or any manner it chooses. No COM resident will be permitted to make any payment for Digitalised Business outside COM.

Note: It is possible that the legal & regulatory systems in some countries may permit all these procedures. In some other countries, the legal system may not permit this payment restriction. Then they have to find out machinery appropriate in their country.

17.2 WITHHOLDING TAX (WHT)

All payers from COM making payments above a threshold to non-residents of COM for specified business may be required to **withhold digital tax @ 3%.** The Digital Corporation should get credit for the tax paid in COM against the COR tax liability.

17.3 WHT & FINAL TAX RATE

The rate for final tax liability of the digital corporation, as well as the rate for withholding tax should be the same. We have proposed a tax rate of 3%. This is a suggestion. Countries may choose their own tax rates. The tax rate as per the domestic Income-tax Act may be a little higher as compared to the tax rate agreed under Double Tax Avoidance Treaty. This will be an incentive for Countries to sign Double Tax Avoidance Treaties.

17.4 TAX LIABILITY

A Digital Corporation which fulfils both the conditions specified below will be **liable to Digital Tax** in COM:

(*i*) It receives revenue above the specified **threshold** for **specified business income; and**

(*ii*) Has a **Virtual Presence**, *i.e.,* has some economic activity in the COM through its users, volume or value of services it provides or goods it sells, etc.

Amounts received in a year upto or less than the threshold will not be liable to tax. Amounts received for purposes other than specified business' sale proceeds will not be liable to Digital Tax.

Illustration: An **art library** in COR displays photographs of several paintings & sculptures. A few visitors from COM visit the website; download some photos and pay small amounts to the website. If the total amounts will be less than the threshold, or even if the number of users is less than the specified threshold of say, ten thousand; the art library will have no tax liability and no compliance responsibility in the COM.

17.5 DIGITAL TAX RETURN

The Digital Corporation liable to Digital Tax will be required to file its Simple Income-tax Return in the COM. The only figures to be provided in the return will be:

(*i*) Total **amounts received** for the prescribed business from the COM; and

(*ii*) Total **tax withheld** by different payers from the COM.

Three per cent of the gross revenue received from COM will be tax payer's final tax liability. After deducting the tax withheld, balance

short fall if any, will be payable by the taxpayer to COM on self-assessment.

17.6 TAXABLE AMOUNT

We are using the term **"Amounts Received" as distinguished from "Revenue".** If we use the term "Revenue", then the question of accrued revenue, outstanding invoices, etc. will come up. Then the accounting & auditing will be more elaborate. Simple computation of amounts received & tax payable will simplify everything.

17.7 SELF-ASSESSMENT TAX

Payments by COM residents for the prescribed business may be small or large. A threshold may be prescribed. Only payers making **payments above the threshold will be liable to withhold the digital tax**. It is possible that several small payments under the threshold may be received by the Digital Corporation. There will be no tax withholding by payers of such small amounts. Tax attributable to such amounts should be paid by the Digital Corporation directly on self-assessment.

17.8 THRESHOLDS

Thus there will be **separate thresholds** for the Digital Corporation's **revenue receipt** and for the payer's **liability to withhold tax.** For example, in India the threshold for digital corporation receiving revenue may be Rs. 10,00,00,000 (Ten Crores) . For the Indian resident payers, the threshold may be Rs. 1,00,000 (One lakh). Ultimate liability to comply with the law will rest on the Digital Corporation. It will be a fairly simple procedure.

17.9 AUDIT & VERIFICATION

The Digital Corporation may be required to get its **return audited** by COM auditors. Since only three amounts are to be audited, audit function will be simple and practical. All sale proceeds have to be deposited in notified bank accounts. Tax department can get the amounts verified with the banks.

17.10 BUSINESS TO CONSUMER (B TO C)

COM government cannot expect home consumers to withhold digital tax & pay to the government. Since there will be a practical threshold

for WHT, all home consumers will automatically get exempted from WHT responsibility. It will be practical to impose digital tax on Business to Business as well as Business to Consumer dealings. Tax not withheld by any consumers will be paid by the Digital Corporation. To **illustrate** this issue, let us considered following:

Business companies may advertise their products and services on **Google, Facebook** and through **Amazon** on different media. This advertisement business is a B to B. Withholding of tax by the payer is practical. However, **Netflix** and similar corporations may provide entertainment to consumers for a charge. Consumer making small payments to Netflix cannot be expected to withhold tax and make payment to the COM Government. Hence, the system should provide that it will be the responsibility of all digital corporations including Google, Facebook and Netflix to file their tax returns with COM. Netflix will provide audited accounts for total amounts received within the COM. Netflix will compute tax payable @ 3% and make payment to the Government. In a complete system of digital taxation, the digital corporation will be liable to pay tax, file returns and comply with necessary provisions. In such a case, digital tax on B to C businesses will be practical.

17.11 OPTION TO FILE DETAILED RETURN

17.11-1 SEP will become a PE under revised Article 5 of treaties. Hence, SEP may be given an option to file Income-tax return & claim that the tax payable is NIL or the PE has made loss.

One has to notice the fact that large **MNCs are experts in devising elaborate ways for avoiding their taxes**. The published figures of net profits cannot be taken as a base to start with. There can be huge diversions of entire revenues to tax haven SPVs. There can be phantom expenses. These are not imaginary allegations. Global actions under Transfer Pricing, BEPS, GAAR, GILTI, BEAT & FATCA prove that worldwide Governments have taken actions against MNCs for avoiding taxes. There are tax havens helping them.

Hence, if the digital corporation claims lower liability or losses, the tax department of COM cannot rely on just gross turnover or consolidated profit figures. Hence **Formulary method of attribution of profits is not practical.**

17.11-2 COM tax department cannot rely on information shared by the tax department of COR. The information flow may take too long a time delaying regular tax assessments.

17.11-3 When the NR DC seeks to file detailed tax return in the COM, how will the profits be attributed? Will the entire system go back to the existing system? No. As we have seen, under the existing system FAR analysis cannot be applied to the NR DC who has no functions & assets in the COM. We need to work out specific system for such DCs. A proposal:

We assume that the system works as under:

We start with the revenue received (tax base) within the COM. Ignore all revenue & expenses outside the COM. Of this Tax Base, we *prima facie* assume that the NR DC earns 10% net profits attributable to the COM. It will be for the NR DC to establish that even under this method, it has really incurred losses or earned less than 10% profits. This may be done by considering exclusively the expenses incurred within the COM; and after considering revenue received internally and externally by advertisement/data licencing.

COM tax department should get entire information necessary to examine whether the MNC has avoided taxes under various planning methods available or not. If it has avoided, get information on the extent to which tax has been avoided. It will be a **full scrutiny assessment** of the non-resident Digital Corporation in the same manner in which the COM may be taxing its own large corporations.

In short, if the Digital Corporation wants to exercise the option of filing tax return and claiming that its liability to pay Digital Tax is less than 3% of receipts from COM; then it must file detailed return and submit global accounts and information as the tax department may consider necessary. This option may be exercised separately for each COM. Alternatively it may simply pay up 3% tax on gross receipts.

17.11-4 Anti - Avoidance provisions

To protect its tax base, the COM Government can adopt following procedure for Digital Corporations that want to exercise the option of filing Income-tax return and claiming lower tax liability compared to 3% on gross receipts.

Note: Do not worry that the following seems to be too radical a suggestion. This has been largely suggested in the OECD/G20 PCD

in the 3rd paragraph titled "Global Anti-Base Erosion Proposal" to be adopted by Countries of Residence of MNCs. The same can be modified and applied to MNCs choosing to file tax returns in COMs instead of paying the 3% tax rate.

Procedure:

(*i*) Ask the MNC SEP to file its tax return declaring its profits taxable in COM. Submit on oath that it has not resorted to any tax avoidance arrangement under Transfer Pricing (TP), BEPS, GAAR etc.

(*ii*) Disallow fully all expenses paid to tax haven entities.

(*iii*) Disallow all "Imported Arrangements". This covers expenses paid to entities in industrial countries - which in turn make huge payments to tax haven entities.

(*iv*) Make a list of tax haven countries which cause tax losses to COM. Declare the list. Negotiate tax treaties with such tax havens & prevent tax avoidance.

(*v*) In case of non-deductible incomes like dividends paid to Tax Haven entities, levy full COM tax without giving any treaty or unilateral relief. Deductible items like interest payments to tax haven entities will invite (*i*) non-deduction of interest expenses for COM payer and (*ii*) full COM tax on interest income in the hands of the digital corporation.

Summary : Only those companies which are ready for deep scrutiny of their accounts - may be given the option of filing a tax return & claiming lower tax liability. In case of doubt, pay 3% and close the matter.

17.12 INCOME-TAX ACT: HOW TO MAKE A NR GC COMPLY WITH INDIAN LAW?

Google, Face Book etc. may get revenues from millions of home users. It is not practical to ask them to comply with TDS. However, Governments may consider the following: Every company that asks for a licence/permission to broadcast its TV channel or internet facility in India would be required to file Income-tax return in India. Today Yahoo, You Tube, Google, Face Book etc. may not need licence for providing the services in India. **Internet Law may be amended** to make provision requiring service providers to obtain requisite licence.

17.12-1 The company should in advance and as a consideration for the permission, agree on the following;

(*i*) It will file Indian Income-tax return;

(*ii*) It will agree to a withholding tax at the rates prescribed under the ITA.

(*iii*) It will submit itself to income-tax in India considering India as the COM.

17.12-2 This will require co-operation of several agencies:

(*i*) Central Government authorities that grant permission under FEMA & FDI policy- to a TV channel/internet facility provider - to provide its services in India shall make a condition that the applicant agrees on conditions (*i*) to (*iii*) above. (Note: If FIPB and CBDT had collaborated more extensively, the Hutchison - Vodafone deal could have avoided the tax controversy.)

(*ii*) RBI asking **all banks and pay channels** to ensure that any remittance going abroad meets with the TDS requirement. In fact, the company can be asked to receive all remittances from India into a few specified bank accounts within India. These banks can be asked to specifically ensure compliance with TDS procedure.

(*iii*) For all the remittances where no TDS is made (home/small remittances) the bank may deduct appropriate tax.

17.13 OBSERVATIONS & SUMMARY OF DISCUSSIONS SO FAR IN PART IV:

It is fair & practical to say that all revenues paid by Indian viewers/ users and Indian advertisers for E-Commerce services utilised in India, paid to the Global Corporations may be considered as liable to tax under the ITA. This is based on the ground that India as the COM is the COS.

Indian payers may comply with TDS procedures. Both - the GC & the payer will be exempt from tax & TDS procedure if the revenue/ payment are below the relevant thresholds.

Existing ITA does not make a NR GC liable to Indian tax. A **separate** deeming section may be made which will be a **complete code** by itself for taxation of E-Commerce. And a separate Article will be needed in the DTA. While the E-Commerce service charges will be taxed in

a manner similar to "Royalty"; they are business income. It would be improper to stretch the definition of royalty beyond its true meaning.

The proposed system will combine three principles: (*i*) COM has a Right to Tax, (*ii*) SEP (*iii*) Withholding tax on "revenue Received by NR GC (Tax Base).

18 CHAPTER

DIGITAL TAX ON INCOME ARISING FROM DATA

18.1 This issue is partly discussed in Chapter 14 - Paragraph No. 14.7 - Consumer Facing Business (CFB). There appear to be two **inconsistent statements by us**:

(*i*) The CFB paragraph says: provision of free data by digital corporations like Facebook & Google is the expenditure side of the business.

(*ii*) Data charges earned (B to B) by the same corporations constitute the revenue side of the business. In this chapter we are saying: Charge 3% WHT or TDS on the gross revenue earned.

The **reconciliation** between the two statements is as under:

We are recommending a flat rate of tax to be withheld/deducted from gross revenue earned. CFB will have no revenue, no taxable profit & hence it will not be a component in Tax Base Attribution. It can only be a component in determining SEP - Virtual Presence. The Tax base will depend upon the Data charges receivable.

Now SEP depends upon two factors: Virtual presence and Revenue collected. Both these factors are two different sides of the business: (*i*) CFB & (*ii*) B to B or Data.

18.2 In the digital business, data is extremely valuable. In some business models, revenue arising from Data is the main revenue. The data pertaining to the COM will be an asset owned by the Digital Corporation. For illustration, if Google has collected substantial data about Indian users, that data base is owned by Google and pertains to India. Since, India as a nation has provided a business opportunity - the market to Google, India has a nexus adequate to tax Google on the profits arising directly or indirectly out of data. The fact that the users for Google do

not pay any charges to Google is not relevant. The fact that the data may be stored on a server outside COM is also not relevant. A server is only a machine to store and process data. **Server cannot determine the location of the SEP.** Note: A server with or without attendant team of employees **may be considered to be a PE**. Hence the Country of location of server may be considered as COS. The DC may be liable to COS tax based on server on FAR analysis. We have already distinguished PE & SEP. The PE may be in COS & the SEP may be in COM.

Similarly, the data shall be considered to be situated in the country to which the data pertains.

18.3 Data is the asset based on which the Digital Corporation is **earning revenue.** Hence it is the **SEP like Immovable Property.** Hence all income earned by the Digital Corporation by using the COM data should be taxable in the COM. The income may be **revenue income or capital gains.** A Digital Corporation may have data pertaining to several countries. It will be liable to digital tax in a particular COM only on the profits arising from that COM's data.

This data may be used by the tax payer in any manner. It may be used for generating **advertisement** revenue. It may be l**icensed** to other advertisers or users for their businesses. In case of such licenses, the license fee will be similar to royalty. In case of digitalised businesses, a digital tax @ 3% may be levied. The person making payment to the Digital Corporation shall be liable to withhold tax and make payment to the Government of COM if the payer is a resident of COM. **In case of payments received from non-residents of COM, it will be the responsibility of the tax payer to pay the relevant tax to COM.** This feature will be different from the digital tax based on SEP as discussed in Chapter 16 above. Under SEP based tax payments made by non-residents get excluded from digital tax. In case of data, they are liable to tax.

18.4 DATA SECURITY

There have been serious investigations by Governments of USA and UK on the activities by digital corporations. The allegations include most serious charges of interference in political elections. There are several allegations against such organisations. However, we are not concerned with the allegations. Underlying fact remains that EU as well as India want these digital corporations to store their data within the COM. In other words, for security purposes, Governments want

that data pertaining to COM residents should be stored on servers located within the COM. Further, the data should not be stored anywhere outside the COM. Such laws may be effective very soon. These Servers will then be subject to regulations by COM.

Digital corporations may appoint their own branch or subsidiary; or outsource the function of maintaining data. The entity collecting, storing, processing and protecting the data will become the PE of the digital corporation. We propose that the PE will be required to issue all invoices for licensing of the data from within COM. The fees for such licensing should be received within COM. After payment of digital tax @3%; the net amount can be remitted by the PE abroad.

In India, the **Central Board of Indirect Taxes & Customs** (CBIC) has made certain provisions for non-residents of India earning revenue from India. The law requires the non-residents to appoint an agent in India. All revenues from within India must be received through the agent. It will be the responsibility of the agent to pay the indirect tax - GST to the Government of India. Same agent can also be made liable to pay digital tax to the Government of India.

These functions may be outsourced to several different organisations by **splitting the functions**. Any amount of splitting operations will not reduce the Digital Corporation's liability to pay Digital Tax in COM.

It shall be the responsibility of the SEP and PE to file return and declare global revenue earned by the digital corporation out of data pertaining to the COM. Compute total tax liability for SEP @3% This tax paid to COM should be available as set off against the tax liability in COR.

18.5 DIFFERENT USES OF DATA

At present, the widely known business model for generating income from data is - "Advertisement Revenue". Data collection as well as processing is done with a target for directed advertisement. However, it is possible that other business models also may developed. The owner of data may licence the use of data to other corporations for their businesses. Some such models which are already in existence but have not been considered as digital business are illustrated below. Now under BEPS Action One they should be considered for digital tax.

There are large companies dealing in **agricultural commodities**. These companies collect **weather data** from countries growing

agricultural commodities on a large scale. The companies use this data for projecting possible agricultural production and movement in agricultural prices. In this business model, no advertisement is involved. However, data is an essential instrument for trading.

Similarly, **financial institutions** investing in shares and securities of a country collect massive data about the country's economy, different companies, share price movements, changes in GDP of the country, applicable laws, etc. All this data will be utilised for projecting future price movements of shares and securities. Again, this is not a digital business. This illustration is given only to show that data can be collected and used for purposes other than advertisement. When the owner of data permits/licenses the use of data, it earns licence fee. Normally, such licence fees would be considered as royalty. However, for the purposes of digital business and for maintaining uniformity in tax rates, we propose that licence fees earned on data should be charged digital tax @ 3%.

18.6 OTHER ISSUES:

18.6-1 Final Tax

We propose that the tax withheld or paid by the digital corporation in COM should be the final tax. In case, the Digital Corporation wants to exercise the option of filing a return and claiming that either the tax liability is lower than 3% of revenue or that the digital corporation has incurred losses; it will have to comply with procedures described in Chapter 17, paragraph 17.11.

18.6-2 Difference between Direct & Indirect Tax

When a flat income-tax is imposed on gross revenue, without permitting deduction of expenses, etc., one may compare it with indirect tax. Following factors may be noted:

(*i*) Flat income-tax is proposed only for non-residents of COM. It is a well-accepted principle that flat tax is the most convenient method when a non-resident is being taxed. This principle is applied for royalty, fees for technical services, interest and dividend. In case of modern digital corporations that conduct businesses in several countries, it is not possible for them to submit their data to scrutiny by several Governments.

(*ii*) The important difference between direct and indirect tax is that an indirect tax imposed by COM is borne by the consumers of COM. Direct tax imposed by COM is borne by the Government of COR.

18.6-3 A summary of the suggested system. SEP + WHT based Digital Taxation

A non-resident digital corporation may earn revenue from COM in two broadly different manners. (*i*) By providing goods or services to the users in COM; and (*ii*) By using the data generated in COM. In both cases, the DC may pay tax only if it has an SEP.

SEP will be determined for revenue within COM by (*i*) revenue earned beyond threshold and (*ii*) virtual presence within COM.

SEP will be determined for data by: (*i*) revenue generated beyond a threshold from the COM data. This revenue may be generated from within COM or from outside. (*ii*) Holding of COM data valued beyond a threshold will be considered its virtual presence within the COM. This position will be considered irrespective of the location of the Servers that hold the data.

Work in Progress: These thresholds need to be worked out. Where it is possible to ask the digital corporation to store the data within the COM, verification of revenue earned etc. will be more practical. In other cases, it will be difficult.

18.7 CONCLUSION ON THE PROPOSED SYSTEM

In our submission this system is simple in compliance and administration because:

Tax Payer does not need to give any cross country data. He restricts his information filing in any country to the data of that country. Generally - there will be no need to convert foreign exchange rates or work out proportions amongst a hundred different countries. For the same reason, the administration by the tax officer also becomes easier. Tax avoidance opportunities get reduced.

The COM gets a fair share of revenue generated because of its contribution to international digital commerce.

IV

PART

FUTURE OF INTERNATIONAL TAXATION

19 CHAPTER

SEVERAL ISSUES TO BE CONSIDERED FOR FUTURE OF INTERNATIONAL TAXATION

Working out a Taxation system for Digital taxation will be end of one chapter and beginning of the next chapter. There are other weaknesses & inconsistencies in the OECD Model Convention. Some are briefly discussed below.

19.1 ALL PAYMENTS. (TRADITIONAL SERVICES & GOODS)

There have been arguments that there should be **no ring fencing of digital commerce.**

We say that the fact that digital commerce services are utilised in India; makes the service provider liable to tax in India. Irrespective of the time and place of provision of services.

Why not tax **other services**? Surely, the instrument used for communication/transmission of services cannot make a difference in taxation. Concept of **neutrality** requires that there should be no difference based on instrument or based on **services** and **goods**.

This leads to a view: "Tax all payments from India to all non-residents". (Excluding of course capital transfers & non-income type of revenue payments.)

19.2 SPACE

Consider the illustration of a music performer. He performs a music programme in one country and audience in several countries watch the same.

Performer & viewers are in two **different countries**. We hold performer liable to tax and payer liable to TDS. So what is the difference between **goods and services**? Producer produces goods in one country &

consumer consumes in another country. Can we hold an exporter of goods (without PE) liable to tax in India? When we import crude oil and gold into India, can we ask the importer to deduct tax at source? See paragraph 19.6-2 below for further discussion on this issue.

19.3 TIME

Performer performs today. Viewer watches after some time. May be after a day or after a year. He pays for watching. On payment tax liability arises. **Space and time of performance are irrelevant**. Place & time of payment are relevant.

19.4 ENTITY

Performer performs, takes his remuneration and goes out of the scene. **Producer** of the programme broadcasts the programme and earns revenue. Or producer may sell his IPR to someone else. Producer may still own the IPR but **You Tube** earns revenue because it permits the broadcasting of the programme. You Tube is the platform for advertising. Viewer may not pay anything. The **advertiser** pays because the viewer visits You Tube.

Who performs, who is the user, who owns IPR - all are irrelevant. **Someone earns revenue. He is liable to tax. Someone pays. He is liable to deduct tax.**

If we were to stop with TDS, things would be simple. At 3% TDS rate, the revenue earner may not mind it. He may not be bothered about claiming the TDS certificate from a million users and claiming set off in COR. Only when we insist on the system of Elimination of Double Tax (EDT) or claiming tax set off in COR; some problems arise.

19.5 UNIFORM RATE OF TAX

19.5-1 For Royalty, FTS, interest etc. we would levy tax @ 10% (or such other rate). Tax will be irrespective of the amount of receipt. However, in case of GC, we will levy tax only @ 3% and that too only if the receipt exceeds ₹ 10 crores.

This is contrary to the concept of **neutrality**. Apart from it being an issue of "**fairness**", there are important issues:

(*i*) When different kinds of incomes are taxed at different rates, the assessee goes for lower rate and the CIT goes for higher rate. This causes litigation.

(*ii*) Even when both parties are honest, there will be honest differences of opinion. Compliance of law as well as administration of law will be difficult.

19.5-2 Hence the rate of tax should be uniform for all kinds of incomes. Consider following calculation:

Calculation of profits taxable in India may be as under:

(*i*)	An assessee earns net profit of say,	20% on gross receipt.
(*ii*)	Half the profit accrues in India. Hence	10% on gross receipt.
(*iii*)	Corporate Income-tax @ 30%	3% on gross receipt.

Now consider following assumptions. There will be some businesses which earn more than 20% net profits. However, there will be some businesses that earn less than 20% net profits. When we are applying a uniform presumptive rate on all incomes, it may be fair to take 20% as a representative rate. There will always be views on a fair rate to be assumed.

When GOI insists on TDS @ 10%, based on the above calculation, the presumed net profit is 10 X 20 ÷ 3 = 67%. Consider full reverse calculation. COM levies TDS rate of 10%. It is assumed to be 30% of the net profits taxable in COM. Hence COM taxable profit is 33.33? This is half of total profits. Other half is to be taxed at COR. Hence total profits estimated come to 67%.

When TDS rate is 15%, the presumed net profit is 15 X 20 ÷ 3 = 100%. These rates cannot be applied to a full business.

19.5-3 Why the tax rate should be 3% and not more, not less? There will be no perfect scientific figure which can be applied to non-resident taxpayers. Facts in each and every case will be different. At the same time asking non-residents to file Income-tax return with detailed audited accounts in all the countries of market would be impractical. To make the tax compliance as well as tax administration simple and practical, it is necessary that a simplified mechanism is adopted while taxing non-residents. It will be a matter of negotiation between the treaty partner countries to arrive at a reasonable tax rate.

The **treaty negotiation** is an art and a skill. Different negotiators utilise different strategies. Let us see some different kinds of treaty negotiators.

(*i*) Some negotiators want to **get the maximum** out of a deal. They want the highest market price of their goods or rights and if possible, even more than the market price. They will bargain hard to get the maximum out of the deal even if it is at the cost of the other party to the negotiation. They would not mind threatening a "Tax War" as a part of negotiation technics.

(*ii*) There are other kind of negotiators who would want a **"win-win"** position. They want to avoid controversies and litigations. They want the business men to conduct business without fear or anxiety; and grow. They also want the economy of the other country to grow so that their own business men can do business globally. And they want to collect reasonable revenue for administering their own Government.

(*iii*) A third type of negotiators are there in business & personal life. We do not know whether they are there in treaty negotiations. Their psychology & philosophy are expressed in this extract from the book: "**Love is Letting Go of Fear**" by Gerald G. Jampolsky, published by Celestial Arts.

> ***"All that I give Is Given to Myself***
>
> *To give is to receive - this is the law of love. Under this law, when we give our Love away to others we gain, and whatever we give we simultaneously receive. The law of Love is based on abundance; we are completely filled with Love all the time, and our supply is always full and running over. When we give our Love unconditionally to other with no expectations of return, the Love within us extends, expands, and joins. So by giving our Love away we increase the Love within us and everyone gains."*

Similar pronouncement is made in Ish Upanishad:

"तेन त्यक्तेन भुंजीथा"

"They enjoy by giving/renouncing/gifting".

All the forces of "Maya" cannot touch these people.

Leave aside binding them.

There may or may not be such treaty negotiators. But one thing is sure. When our world reaches that kind of spiritual maturity, all tax laws will be simple with no harshness and no tax wars.

19.5-4 In practical life, there are several cross purposes working simultaneously. It is for the Governments to work out an acceptable rate of TDS.

It is also possible that for different businesses and different markets, different countries may agree to different rates of TDS. While, a model convention can recommend a range of tax rates, ultimate decision may be left to the treaty countries.

International tax system should be fair and simple. In fact, all tax system should be fair and simple. However, in case of international taxation, there are more practical difficulties and hence simplicity is a must. Transfer Pricing, GAAR and BEPS altogether will make tax compliance and administration extremely cumbersome and harm global economy.

We would submit that a TDS rate of 3% is reasonable.

Such a rate would also reduce considerable litigation. Most assessees would prefer to pay up the tax than to enter into litigation.

If this position is accepted, (tax all income payments to NR @ 3%), further discussion is not necessary. However, some readers may not accept this position. Then further details may be relevant.

19.6 NEUTRALITY DISCUSSED FROM DIFFERENT ANGLES

19.6-1 Neutrality within services

(*i*) We can raise an issue: If E-Commerce services are taxable and traditional services are not taxable; then there will be no neutrality between the two of services. And people will have a temptation to shift from E-Commerce to traditional services. We Submit all services imported into **India** should be liable to tax withholding.

We have also seen that the concept of FTS has become cumbersome. What is managerial/technical/consultancy; and what is not; is a matter of endless litigation. Ideally all service payments to non-residents should be liable to tax @ 3%. Royalty, FTS and all services.

(*ii*) Many of us (tax consultants) have clients abroad. They ask us advice on telephone & by e-mails. We also advise them through electronic means. This is E-Commerce. If Google can be taxed for providing E-Commerce services, all professionals & others providing goods or services through E-Commerce should also be taxed on the basis of COM. When a consultant advises on telephone and sends his opinion by **e-mail**, it is E-commerce.

Hence under this proposal he will be liable to tax. **Note:** If virtual presence at user base of 10,000 is established, most professionals will be out of the digital tax net. However, we are discussing here a principle.

Issue: What if he sends the opinion by **post**? What if he personally meets the client and renders advice? System has to be neutral to the means of communication.

Response to the issue: As seen above, until complete system of International Taxation is revised, differences between digital commerce services & other services will remain. It would be better to tax professional services under the existing article of "Independent Personal Services" - irrespective of whether the consultant provides services through E-Commerce or in traditional manner. When the complete international taxation system is overhauled then all the categorisation may be reduced and even these services may be taxed @3% by COM.

19.6-2 Neutrality with Goods

At present import of goods is not liable to income-tax. Why?

The argument runs as summarised below. Income-tax is on assessee's income. Assessee earns his income by his own functions, assets & risk taking. When the assessee exports goods from COR, he has completed the value addition function in the COR. Hence COS may not tax the same. However, this argument is entirely favouring the **Supply side.**

Country of Market does add value and contributes to the profits of the seller. This is the **demand side** of argument. In fairness, there is no reason for not taxing import of goods. Repeat: In fairness, accepting the principle of neutrality; and accepting that the Country of Market also contributes to the profits of the seller of goods & services; COM should have a jurisdiction to insist on the TDS on the import of all goods & services - whether by traditional commerce or by E-Commerce.

The practical issue is: India imports $ 100 billions worth of crude oil every year. Will the Saudi/Iraqi/Iranian Governments accept TDS of 3% from their bills? We are net importers of goods. If we tax the imports, in retaliation, our customer countries will tax our exports. If our exporters succeed in passing off the TDS burden to foreign buyers, fine. Otherwise we may end up with a situation: **"Heads I**

loose, Tails you win". There is a distance between the theory and the practice. This is where the Governments have to use "Vivek" (discretion) in the extent to which they can go.

19.6-3 Neutrality between R & NR assessees:

For E-commerce, we are taking a stand that the appearance of data/ picture etc. on user's computer/TV amounts to the **performance** within India by the non-resident assessee. This is a clearly a grey area. If we apply the same principle, **Infosys or TCS** (Tata Consultancy Services) staff operating from India and providing services to their customers at USA/Europe can be considered to be operating within USA/Europe. They would be having a virtual presence. Their revenues will exceed thresholds discussed here. Hence US Government would be entitled to tax them on the same principles.

Many Indian companies are providing **BPO services** to their foreign clients. Indian Income-tax department is making serious attempts to treat them as PE and tax the Non-Resident principals for the BPO services from India. If the concept of Virtual presence is accepted, countries where clients are being served, will demand tax from all these BPO companies. On elimination of Double Tax (EDT) under Double Tax Avoidance Agreement, India as COR for the BPO companies will have to give credit for such taxes paid abroad. India will suffer substantial tax losses.

We must be ready that - any deeming provision that we make, will be **retaliated** by other Governments. Irrespective of retaliation, any taxation system that we suggest must be on sound basis, and **fair** to all parties.

If we do not claim that the NR GC (like Google or Face Book) is operating/performing in India; and we still want to tax it; we have to rely on the concept: Country of Market has a right to levy income-tax. Under this principle, NR GC can be taxed without any compromise about performance/utilisation.

In other words: **"Country of Market can tax the income of a foreign buyer of services."** Now apply the concept of neutrality - what applies to digital commerce, should also apply to other services. This means, all the countries buying our software & BPO services; and of course all other services - tax consultancy, medical consultancy & so on - can tax the **Indian exporter**.

19.7 COUNTRY OF PAYMENT (COP)

19.7-1 Probably we can say that advertiser or user/viewer, anyone who makes payments from India for services must deduct tax at source for these services. This will be practical, enforceable & convenient in compliance also. However, it is unfair. Services utilised as well as performed outside India can be taxable under COP.

This **solution raises the issue**: Google & TV channels provide the service of **"transporting" data** & entertainment through electronic means. Shipping & Airline companies provide the service of transporting goods & passengers through ships/aeroplanes. If the former can be taxed, what is the logic for not taxing **shipping** & airline companies?

(*i*) Either tax all of them; or (*ii*) tax none of them; or (*iii*) clarify that we are making a distinction between E-Commerce & Traditional Commerce.

19.7-2 Let us distinguish between COM & COP

COM: If India claims jurisdiction as COM, it would tax following revenues:

(*i*) Indian viewers/users using GC services in India.

(*ii*) Indian advertisers using advertisement services which target Indian audience.

Above two will be practical & enforceable.

(*iii*) COM would also include NR advertiser paying to a NR GC for Indian audience. The advertisement service will be utilised in India. (It will appear on the computers etc. located in India. However, this will be difficult to enforce.

COP: If India claims jurisdiction as COP, it would tax following:

(*i*) & (*ii*) above. It will not tax (*iii*) above.

(*iv*) Indian advertiser making payment to foreign media for foreign audience. COM is logical. COP is practical. However, in this case, the ad service is provided by a non-resident & utilised abroad. It would be unfair & illogical to tax such revenue.

Right balance/compromise may be to tax only (*i*) & (*ii*) and not tax (*iii*) as long as efficient tax recovery system cannot be worked out.

19.7-3 We are considering here a system where India can tax a non-resident's income earned out of revenue earned from India. In

other words, we are considering India as the country of market. And justifying a Right to tax as the COM. Normally, the COM will also be the Country of Payment (COP). However, justifying a Country of Payment as a COS is not fair. Hence we may consider the fact that in principle COM has a jurisdiction of tax. There is a compromise for the sake of efficiency that COP will collect tax. This compromise is already practised under OECD as well as UN Models. Royalty is taxed by the Country of Payment.

19.8 INCOME-TAX ACT AMENDMENTS

GOI has already made some amendments to S. 9. See explanation inserted at the end of S. 9 and explanations 5 & 6 to S. 9(1)(*vi*).

19.8-1 Treaty Override

By these amendments, GOI has acquired right to tax a Non-Resident even if he has no PE/BC and services are not rendered in India. These amendments were to cover the SC decision in the case of **Ishikawajima Harima and some other decisions**. This is an extended power under ITA. None of the DTAs grant such power. And for section 9, the DTA prevails over the ITA. So in all cases of NR doing business from a DTA country, **this amendment will be of no avail.**

GOI needs to make a provision that these amendments to Section 9 - will override DTA. **See Section 90(2A).** It provides that the GAAR provisions under chapter XA will override DTA. Similarly anti-avoidance provisions in Section 9; and E-commerce taxation provisions need to be included in Section 90(2A). Of course, such amendments will be required only if BEPS TFDE cannot present a solution acceptable to COMs.

19.8-2 Amendment to **Section 9 - Explanation** at the end of the section is inadequate. It only covers (*v*) interest, (*vi*) royalty & (*vii*) fees for technical services. The subscription charges paid by viewers/users and the ad charges paid by the advertisers to Google are not covered by any of these categories. Hence **unless the law is amended**, these E-Commerce charges won't be taxable in India.

19.8-3 The system of E-Commerce taxation under ITA may be summarised as under: Make a separate chapter/section exclusively for E-commerce. It will make deeming provision to tax import of E-Commerce services and will provide for 3% tax rate. Section 195 will provide for TDS on E-Commerce payments. Disallow expenses

u/s. 40 if no TDS is made by payer and hold him to be a defaulter U/S. 201.

19.9 FURTHER ISSUES

19.9-1 Problems of Flat Rate

3% Flat TDS by COS may be attractive for many assessees who have good profit margins and for assessees for whom almost the whole receipt is taxable income. There may be some businesses which have low profit margins. For them this rate may be stiff. The negotiating countries may consider important industries/businesses and may make two or three additional categories. COS may exempt some categories and may levy a higher tax for some categories.

19.9-2 Base Erosion

Professor Richard Doernberg's theory of "Base Erosion" may be summarised as under:

If any assessee claims as expenditure, any amount payable to a Non-Resident, he erodes the tax base of the paying country. Hence a tax @ 3% should be deducted by the payer. This is a good & efficient mechanism. However, Companies like Google, Face Book & Amazon. com may earn substantial incomes from ultimate home consumers. Most of it will not be claimed as expenditure by the payers. Hence it will be paid without any TDS.

Our Suggestion is that even home service payments to Non-Residents should also be subject to TDS @ 3%.

19.9-3 Burden of Tax

Since this tax will work as a **tax on market** and **not on income**; quite likely, the tax burden will be passed on to the payer/consumer. That would mean that ultimately the tax would be borne by the Indian consumer/payer; Indian economy.

Since it will be a TDS of income-tax, the Global Corporation will be able to claim set off of income-tax in COR. If the GC claims credit at COR, then the tax will be borne by the foreign country/foreign economy.

Wherever the Indian payer is able to shift the tax burden on to the receiver, the tax will be borne by the foreign economy.

19.10 Existing Tax Balance

Present position under ITA is: On import of goods, we do not tax the NR supplier. On import of services - except FTS, royalty & interest - we do not tax the NR provider of services/earner of revenue. If we change this position, it would mean - we will tax on the basis of utilisation/import of goods and services.

Let us consider the position when other countries **retaliate** by taxing goods and services exported by us. Our Wipro, TCS & Infosys will be liable to tax in U.S., Europe, Japan, etc. We are net exporter of services - We will suffer.

We are net importer of goods. We can tax all non-resident suppliers of goods. Will they pay? Or will they ask Indian importer to pay & bear? If we assume that the Indian importer will be successful in deducting income-tax at source from the payments made to NR suppliers, on the whole; India will gain under this system. But the assumption does not seem to be practical at present.

In short, a net exporter benefits when the taxation is based almost wholly on supply side as it is today. Net importer would benefit if the taxation system was based almost wholly on demand side. This is a practical economic reality. Some countries have worked out great details of how their present tax balance will be affected by any change in tax policy.

20 CHAPTER

ELIMINATION OF DOUBLE TAXATION

20.1 CREDIT IN COR

We have considered different systems for levying tax on Global Corporations carrying on E-commerce business. Let us say, we arrive at a conclusion that GOI shall levy a 3% flat tax on the gross revenue received from India. Will the GC get credit for the Indian tax in COR? Some thoughts on the issue:

(*i*) Earlier in arriving @ 3% we have seen that we are assuming net profit of 20%. We assume the Indian share of net profit to be 10%. Hence the 3% tax is the fair share of Indian tax.

(*ii*) Article 23B for Elimination of Double Taxation reads as under: "Where a resident of a contracting state derives **income … which in accordance with the provisions of this convention**, may be taxed in the other contracting state, the first-mentioned state shall allow: …" In other words, the COR will give credit only for the tax paid in COS (India) according to the treaty. At present the treaties do not contain either the concept of a SEP or the concept of country of market having a right to tax income. Hence either way the tax imposed by GOI will not be available for credit in COR. Once the MLI is modified and all countries start giving credit for taxes paid in COM, this issue of credit will be resolved.

20.2 VOLUNTARY PE

As per media reports, Google has hundreds of employees in India. If Google itself admits that it has a permanent establishment in India, situation changes. Then the PE will receive entire revenue from India.

After paying 3% tax on gross, balance will be available for remittance abroad. The PE's profit will also be taxed in USA. It can legitimately claim credit for the taxes paid in India against the US taxes.

We have discussed earlier that GOI may insist on a license to provide the internet service to Indian users and advertisers. Then Google may file its own tax returns in India on the grounds that it has a PE in India. In such a situation, claiming tax credit in COR will not be a problem.

21 CHAPTER

SUMMARY, NOTES & CONCLUSION

21.1 A SUMMARY OF THE CONCEPTUAL DEVELOPMENT IN THIS BOOK

21.1-1 Under the existing international tax system there are two Connecting Factors: (i) Residence and (ii) Source. We are proposing to add a third Connecting Factor: (iii) Market. This will add a third phrase: (a) Country of Residence or COR, (b) Country of Source or COS and (c) **Country of Market or COM**. "Right to Tax" is to be shared amongst these three categories of Countries.

21.1-2 The fact that a NR of COM is selling goods or services in COM, establishes the first requirement for "Right to Tax" – having a Connecting Factor. However, to make administration of tax law practical, we provide for thresholds. The **threshold** in case of Digital Taxation will be "Simplified SEP".

21.1-3 A "Simplified SEP" is constituted by both of the following factors together:

(i) **"Sales Realisation"** above a monetary threshold; and

(ii) **"Virtual Presence"** above a threshold to be prescribed depending upon the kind of business.

The factor of "Virtual Presence" is brought in because "Digital Taxation" is still in an intermediate stage; a "Work - in - Progress". When the whole "International Taxation" is fully developed by removing all its weaknesses and inadequacies, "Virtual Presence" may not be necessary. "Sales Realisation" above a monetary threshold would be adequate "Connecting Factor".

21.1-4 "Simplified SEP" will give the COM a "Right to Tax" or a "Jurisdiction to Tax". But what is taxed is only "Income". Hence, in principle, the assessee should have a **"Right to file Return"** and claim that he has not earned income, or has made losses.

This principle has two obstacles:

(i) GCs & MNCs are known to have resorted to **aggressive tax avoidance**. COM tax officers cannot accept information furnished by the GC/ MNC without deep scrutiny. Deep Scrutiny is impractical for taxpayer as well as tax officer.

(ii) In current times of Globalisation, companies may sell goods or services to a hundred different countries. They may carry on businesses which are interwoven and inter dependent. "Segmental Accounting" becomes largely **subjective estimates & guesses**. This can cause huge litigation in determining "Right to Tax" by COS and COM.

21.1-5 As a Compromise, Right to file Return may be given only in exceptional circumstances – where the Tax Payer establishes that it has not resorted to any Tax Avoidance. In all other cases a four step exercise may be adopted:

(i) Drop "Attribution of Profits".

(ii) Adopt "Attribution of Tax Base". It will be dependent upon Simplified SEP, which in turn will depend upon (a) sales realisation within COM and (b) virtual presence. This will make redundant most of the subjective estimates, guesses; and need for information from a hundred different countries.

(iii) Levy a flat rate of Withholding Tax on gross revenue realised.

(iv) The non-resident GC will have a "Right to File Return" and establish lower income/losses provided that it can establish that it has not resorted to tax avoidance. It will be subjected to "Deep Scrutiny".

21.1-6 Tax paid in COM should be available as set off against tax payable in COR. This will eliminate double taxation.

21.1-7 Machinery provisions are detailed in Part IV in the book.

21.2 SUMMARY OF THE BOOK: PARTS I TO IV

Existing system of International Taxation has several weakness and compromises even as applicable to Traditional commerce. Digital

commerce by its very nature of conducting business challenges many principles and assumptions. It is easier for a digital corporation to avoid all income-taxes. GOI and other Governments may amend their domestic laws to tax digital commerce. If MLI is changed with consensus, then the digital taxation system will work fine. If MLI is not to the satisfaction of GOI, then the amendments in domestic income-tax Act must override treaties - otherwise the outdated treaty will make the amendments redundant.

The **domestic law** provision may be as under: A separate section or chapter exclusively to deal with digital commerce which will levy a flat tax @ 3% on all payments made by Indian residents to GCs providing digital commerce service. This tax shall be subject to the threshold of Significant Economic Presence.

At least to start with, we may have to sacrifice the rule of neutrality and tax digital commerce under its special rules. Eventually, if a consensus can be built, all incomes can be taxed on same principles & neutrality can be restored. Taxing import of other services will be the subsequent step. Taxing import of goods may be a third step.

21.3 NOTES

21.3-1 Normally, Government drafts tax provisions. Professionals interpret a law. They do not suggest on "What should be the law?" In this book we have analysed the global problem of digital taxation and made some suggestions. We realise possible criticism of our suggestions. We have tried to answer some of the criticisms briefly. More detailed responses will make the book too long. We also realise how many problems can arise for any particular course of action. We will be glad if the readers can examine this book and send their critical comments. We will try to improve the next edition of this book.

21.3-2 The best taxation system worked out today will be found to be inadequate after five years. Circumstances will always change. Taxation systems have to be dynamic to take care of changing circumstances.

21.4 CONCLUSION

The search for digital taxation system has taken 22 years. Several Governments around the world and several institutions have tried to find a solution. In our humble submission, the latest report - Unified Approach by OECD Secretariat is not a good solution. It proposes a

complicated compliance and administration system. Such a system will ensure controversies and litigation. The tremendous techno-business revolutionary process that is going on right now requires that a very simple and efficient system for digital taxation should be worked out. Such a system is possible and we have presented our draft for the same. We hope for an excellent dynamic system to emerge out of the ongoing BEPS discussions.

APPENDIX

Art of Debate

This was written by Rashmin Sanghvi in August, 1998.

It is still relevant for BEPS or any negotiations.

If we want to learn by debating at a conference, how should our minds work! What are the human weaknesses, which obstruct clear & faster learning! One weakness which affects a large number of people is lack of appreciation of - "lateral thinking" - or in simpler words a "democratic thinking" or in philosophical words "An Ekant Vad".

Let us see a few examples.

I. Democratic Thinking

Democratic thinking at the highest level :

Mr. A tells to Mr. B. -

1. "I disagree with you. However, I am prepared to fight for your right to - say what you want to say; and do what you want to do."

2. "I disagree with you. I believe, I am right. But I am open to correction. If you can logically convince me, I am prepared to change my opinion. At the same time, I do hope, you are prepared to listen to my views."

3. "I disagree with you. I will do it my way. You go ahead on your own way. We can still be friends."

4. Fascism: "I disagree with you. Hence you are wrong. I will not allow you to proceed on your wrong ways of working."

Now consider several different people and situations - your home. Your friends, relatives, your colleagues at office. Even people at different non-profit organisations where you may be working. How

many people come at the highest democratic level! And how many people come at the fascist level?

Now think of yourself. Are you a true democrat?

It is not that any one person is in one category at all the times. In different matters, at different times & with different people; a person may behave differently. Leave aside the outwardly behaviour. Consider your mental process. Do you want to learn? Are you open minded?

If yes, your future is great.

II. Lateral Thinking

Can you think differently?

Can you listen to someone who has thought differently ?

What is the extent of your tolerance in just listening to contrarian thinking?

Example 1

1. "Road Transport Police officers are nice people". They look after Mumbai's efficient transport system. If you closely look at the way they work at the signals, you will notice that it is their human touch that improves the efficiency beyond the electronic signals.

2. Rest of the India wonders - "how in Mumbai, every day morning and evening - a few million people are transported to and from …….".

The traffic police has a significant contribution in this wonder.

3. Consider - has any police ever asked for a bribe when you have not committed a violation of traffic rules!

Consider - how many times you have committed a violation and the police inspector has knowingly allowed you to get away with it!

4. If you can come so far with me, now try and give a smile to a police man. Any police man. Just as you would give to any other common Mumbai citizen - in those common circumstances. More often than not, you will be surprised with their sweet smile.

I have had a 100% success rate.

Example 2

A Hypothesis :

1. "The percentage of honest and decent chartered accountants - is same as - the percentage of honest and decent income-tax officers".

Do you find the very thought as "explosive"?

If yes, are you a "democrat"?

2. If you were appointed as an advocate to argue the department's case about honesty - would you be able to argue?

If not, isn't it fair when the department does not listen to your representations?

3. If someone can boldly say - "Vasudhaiva Kutumbakam";

But can not love the tax officer and the traffic havaldar -

Isn't his 1st statement hollow?!

4. Consider the fact that bribe taking and giving is a petty dishonesty. Intellectual dishonesty is the high order of dishonesty.

Do we indulge in it?

Exercise Can each one of you express one thought - which, till yesterday, you found abhorrent; but today you are prepared to consider it with reason?

Example 3:

A. I have written repeated essays on my submission: The western world is exploiting India and other developing countries by forcing an economic system. This system gives low price for all that the developing countries have and charges phenomenally high price for all that the developed world has.

Devaluation of our currencies and high valuation of their currencies is one part of the strategy.

How long will this exploitation continue?

B. Mr. Sharad Joshi of Pune has cried hoarse to communicate that - India has an exploitative economic system. The terms of trade are so designed that the urban industrialist and even urban worker gets more than the farmer and the rural worker. And a bureaucrat gets far more than what he gives to the society.

The communists have cried from the roof top that it is not the destiny of the poor to remain poor. They must work and have a strategy to end this exploitation.

Can you see a similarity between the two exploitations?

My hypothesis is -

The day India resettles its internal terms of trade to end the internal exploitation;

It would have ended the external exploitation also.

Can you give your considered views on the subject?

III. An Ekant Vad

Modern Rationalistic Thought says that on any issue, there can be only one right decision. And if one view is right, the contrary has to be wrong.

Indian Rationalistic Thought is different. There can be a thousand different thoughts. And each thought may be right for one person while wrong for another person. And all thoughts may be right simultaneously. God has not decreed that there should be unanimity amongst all the persons in a society.

Every soul has different functions. Every soul is progressing in different directions & is at different levels of progress. What could be right for one could be wrong for another.

What could be right for a person in particular circumstances at a time may not be right for the same person in different circumstances or at different times.

For example, when a beggar begs, it may be right for him. If a king begs, it may not be right for him. A young girl at the age of 16 would have fashion suitable to her. When the same person grows to the age of 36, she may have a different liking. At the age of 76, she will have quite a different sense of dressing.

These are very simple examples. When we look at life around us, there will be more complex examples. Let us consider one example in some details. Two different manners of discussion between two persons with different cultures are given below. Analyse for yourself both the discussions.

Discussion amongst: A vegetarian and a non-vegetarian.

First manner of Discussion :

1. Veg : Hello friend, how are you!

   Non-Veg : I am fine. Thank you. How are you!

2. Veg : Fine. Thanks. I am searching for answer to some perplexing issues. Can you help me!

3. Non-Veg : I will definitely try. Certainly, I will be the beneficiary at the end.
4. Veg : As a child I thought killing animals for food is bad. But now I see more. My mother does not eat green Vegetables throughout monsoon. Why? It is a reminder that there is life in all Vegetables. Which means: 'every day that I eat Vegetables and grains and anything, I am continuously committing "himsa". And yet I have to eat. How do I stop committing "himsa"?
5. Non-Veg: Oh God! I never thought that way. But surely, eating is most natural. How can something that is natural be "himsa" or an offence against nature?
6. Veg: I don't know. I have no answers. I am seeking answers. What I know is that if I hurt someone, there is something wrong somewhere.

   Non-Veg : You are absolutely right. Let us not worry about great theories. Let us see what our hearts tell us.

   To think of that, I do agree that we must cause minimum harm to any life.
7. Veg : I think both of us do not have final answers. Let us go to some good saint and seek his advice.

   Non-Veg : Yes. Before we go to a great thinker, let us prepare ourselves to be fit enough to talk to him. So let us read Gandhiji's auto biography and Khalil Jibran's philosophy.

   Then we will go to a philosopher.
8. Veg : Yes, you are absolutely right. We will prepare ourselves.

   Till then, I will fast once a month to do the "Prayaschit" (Repentance) for whatever wrong I might be doing unavoidably. Thanks for your help.

Consider an **alternative manner** of discussion.

1. Veg : You are killing animals. You are committing great "Himsa". You are a sinner.
2. Non-Veg : There is nothing wrong in killing for food. My religion permits me.

   In any case you Vegetarians commit greater "himsa" by ..... (1) ..... (2) ..... (3) .....

3. Veg: My religion is the greatest. Thousands of philosophers have meditated and continuously refined the philosophy. Your religion is ..... (1) .....(2).....
4. Non-Veg: I may kill one goat and our whole family will eat for one week. We would have killed only one soul.

   Your religion says that every soul is equal and that there is life in every grain of wheat.

   For your food, you individually kill everyday hundreds of lives. (grains, Vegetables, etc.)
5. Veg: You are a great sinner. You will rot in hell.

   The end of the discussion is predictable.

   Consider for yourself, why one discussion is bound to be more successful than the other.

In the **first discussion :**

1. Both the participants want to learn. No one wants to impose his views on the other.
2. Both know that their knowledge is limited. They have a desire to know more. They are open-minded.
3. Both are humble & courteous.
4. They know that to understand higher levels of knowledge; they must bring themselves up to that level. They must qualify to learn at the higher levels.

What are the wrongs in the **second discussion?**

1. The discussion is not with a view to learning the other person's view point.

   Both are convinced about their own viewpoints.

   Both want to defend their own viewpoint and attack the other person's viewpoint. They end up attacking the other person.
2. Ordinary human weakness -

   When you can't answer something which is apparently logical (paragraph 4), when you are cornered, you react violently with allegations.

   An attempt to see reason, patience, an inner and deep thinking would give much better results.

3. The Vegetarian is at a level of thinking where he thinks only killing animals is "himsa". The "himsa" that he himself is committing by hurting another person's feelings goes entirely unnoticed by him.

Conclusions

I. If you want to make tremendous progress, understand that:

   i. Different people will have different views. That is no reason for anxiety, anger or quarrel. Accept differences of opinions.

   ii. Most people around you will not believe in the above statement. They will try to impose their views on you and will dislike you for your different thoughts. You will not be able to explain to them the principles of An Ekant Vad.

   No body said life will be easy.

   If you are convinced that you are right, go ahead to succeed. And use your vivek (discretion) to avoid friction.

II. Why we find that -

   "As an individual, an Indian is great. But an Indian team is bad".

   The core reason is that we have forgotten the Indian deep philosophy of An Ekant Vad and have gone after the flat modern rational thinking.

   People with different views and different capabilities, different levels of thinking - when put together - can mean disaster.

   If you want to make progress at an aggressive speed, create an exclusive team of like-minded people who are broadly at the same level of capabilities, commitment & sincerity.

   It is difficult to find a large group of like-minded people. That is why, an exclusive group has to be a relatively small group.

   Date: 6th October, 2001

I am Sorry

I remember the days of my article ship. (Year 1973)

A nice old gentleman had came to the office for tax work. Let me write what I could not see then & what I do realise now:

He had great knowledge and hence depth. I was a bubbling youth.

He had come to me for work - so I presumed myself to be the superior. Our discussions drifted to religion.

He said "Religion is Sanatan (infinite) - dates back to the origin of the universe".

I just laughed at him. "Man made the religion. If the man's history is X years; how can religion be older than man!"

He tried to say something; then looked at me & left the attempt. He did not say anything.

I considered it as the victory of my logic.

Now I realise that he had realised that -

i. I was ignorant; and

ii. I was not capable of learning his ideas.

Now I realise that:

He was referring (by religion) to God's Law, which existed much before our earth or solar system existed. The laws which are infinite.

When the other party becomes silent; it does not mean I have won the debate. I am sorry that I did not know this at the age of 23.

Rashmin Sanghvi