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International Taxation Challenges
For Digitalised Economy
OECD/ G20's Public Consultation Document -13th Feb., 2019

Paper by Rashmin Sanghvi & Associates
Proposing SEP & Withholding Tax as Solution.

Date: 5th March, 2019

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1. Summary of the Paper & other details:

1.1 Terms used in this paper:

Digital Tax: For the sake of convenience in this paper, the tax covered under OECD/ G20 paper may be called **Digital Tax.** Tax at Country of Market - on profits earned from digitalised business is Digital Tax.

Digital Corporation: (DC) The Tax payer or the assessee conducting digitalised business liable to pay Digital Tax is referred to in this paper 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.

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 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.

OECD/ G20 PCD: OECD/ G20's Public Consultation Document for addressing challenges of the digitalisation of the economy – dated 13td February, 2019.

G4: Group of Four Nations: U.S., U.K., Germany & France. Countries that favoured Residence based tax. COR.

G3: Group of Three Nations: U.K., Germany & France. COS for Digital commerce. COR for rest of the incomes.

WHT: Withholding of Income tax.

Industrial Countries: There are tax havens. Countries which are not tax haven are referred to as **"Industrial countries"** – irrespective of whether they are "Developing Countries" or "Developed Countries".

Name of Tax covered under this subject: Digital Tax:

Name of this tax has changed several times. In 1990's it was called E-commerce Taxation. Then Digital Taxation. And now, Digitalised Businesses/ Economy. In near future, it is possible that people will be able to do business in a third country without having a PE and without using

digital instruments. Probably then a new name will have to be developed. That will mean changing almost three thousand treaties and a hundred domestic tax laws.

As long as we understand that we are referring to "taxation of profits arising from a Non-Resident selling goods or services in a Country of Market without a PE"; name does not matter. In this paper we are using the term **Digital Taxation.**

1.2 Need for Change in International Tax System:

(i) Inadequacy of old law to deal with modern business models:

It is now well accepted that existing rules of international taxation for establishing **Nexus** (Permanent Establishment) and for **Attribution of Profits** are not adequate to deal with digitalised business (Ecommerce). In absence of a PE which can be applied to Ecommerce, the non-resident Digital Corporation cannot be taxed by the Country of Market (COM) irrespective of the revenue earned by the entity from COM. Having accepted these facts, the OECD/ G20 Public Consultation Document presents three proposals for addressing the tax challenges.

We also accept this fundamental position and proceed further. In other words, we need to find new ways of establishing Nexus and Attributing Profits that can be applied to Ecommerce.

Compared to the term "Attribution of Profits", a simpler term will be computation of **Tax Base** for the COM. This matter is discussed further in paragraph (7) below in this paper.

(ii) Residence Vs. Source Conflict:

Residence Vs. Source conflict for attribution of profits (or tax base allocation) is an old controversy. Residence countries have won the battle. Major part of International Tax Base goes to Residence countries. We may broadly consider following countries as "favouring Residence based taxation"– U.S., U.K., Germany, France (G4) & a few other developed countries. Interestingly, E-commerce business has so developed that for E-commerce Tax Base, now mainly U.S. may be considered to be the COR. China is indifferent. Rest of the world is COS.

OECD/ G20's PCD– presents three proposals. We focus on the SEP proposal and explain why it is a good proposal.

1.3 Scope of this Paper:

(i) Domestic Taxation: When the tax payer is resident in a country and sells its goods and services in the same country; COR & COS are one and the same country. In such cases, there will be **domestic taxation**. It is **not discussed** in this paper.

(ii) Regular International Taxation: When the tax payer is resident in one country (COR) and performs its functions (or has assets/ employees etc.) in another country or earns revenue like royalty, fees for technical services, interest, etc. from another country (COS); there is **regular international taxation.** In this paper we are discussing Regular Taxation only to the extent it is necessary for main issue: Digital Taxation.

(iii) Digital Taxation: We are discussing in this paper only the business which is conducted by the Digital Corporation (DC) in a country which is neither COR nor COS but which provides market. The DC markets its products or services in a third country without having any PE etc. in that country. Taxation of such Ecommerce or **"Digitalised Business"** is discussed in this paper.

1.4 Summary of the tax system proposed: We suggest that profits derived from Digitalised Business/Ecommerce may be taxed in the following manner:

(i) 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**. Revenue Realisation above a threshold will be the Tax Base. Article 5 of the OECD model may be amended and two clauses for SEP & Data may be added.

(ii) For establishing correct **Attribution of Profits,** 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 administrators 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. Instead, a **Withholding Tax** on the gross revenue 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 5%** or such other low rate. Royalty etc. are normally taxed at 10% or higher rate.

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

(iii) Elimination of Double Tax: The tax withheld in the Country of Market (COM) should be available for set off against the tax liability in the Country of Residence (COR).

(iv) SEP & Attribution of Profits are discussed separately for Data & other Ecommerce businesses.

(v) Compliance & Administration Machinery: Under this proposal – WHT as final tax, the tax system will be fairly simple for both – the tax payer (Digital Corporation) and the tax administrator – Government of COM.

1.5 We are presenting separate parts for the following:

Part I **SEP:** Elaboration of the above referred summarised taxation system of digitalised business income; and justification for the same are given in Part I.

Part II **Other Two Proposals:** Our comments on the proposals – "**Marketing Intangibles" and "User Contribution"** are partly given in Part I. Details on these two proposals are given in Part II of this paper.

(i) In our submission, both these proposals will cause disproportionately large costs for compliance and administration.

(ii) These two proposals **allot unfairly small tax base to the COM.**

In our view both these proposals should be dropped and SEP as simplified in this Paper should be adopted.

Summary Completed.

Next page:

Part I – Simplified SEP based international taxation for Ecommerce business.

Part I: Simplified Significant Economic Presence (SEP):

2.1 Popularity of SEP:

(i) 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. **USA** follows it for sales tax on interstate trade. Several other countries are at different stages of legislation for taxing Non-resident's Ecommerce income. The work on SEP is incomplete because of non-conclusion of BEPS Action 1 Report. The remaining work can be completed soon after OECD/ G20 publish final report on BEPS Action 1.

(ii) US practices for Sales Tax on interstate trade:

Within USA states levy sales tax. When a corporation of one state sells goods in a second state (interstate trade) without having any presence in the second state; can the second state levy sales tax on the sale transaction? **US Supreme Court in the case of South Dakota V. Wayfair Inc.** upheld the right of the second state to levy the sales tax. Honourable Supreme Court has stated following important principles for validating sales tax:

"Validity of state taxes, …will be sustained so long as they (1) apply to an activity with a substantial nexus with the taxing State, (2) are fairly apportioned, (3) do not discriminate against interstate commerce, and (4) are fairly related to the services the State provides.

The ratio of the decision is comparable with the concept of SEP.

Translating these principles for international income-tax we can say that:

1. Any country can levy a tax only if there is a substantial **nexus** between the country and the activity.

2. The tax should be **fairly apportioned** between COR, COS and COM.

3. The tax should **not discriminate** against international business.

And

4. The tax should be related to the **Contribution by that state** to the international business.

With highest respect for the US SC, we are trying to apply these principles to our proposal in this paper.

2.2 Inequity in Existing Tax Base Allocation:

A. Digital Corporations' global profits are a **global tax base** for all countries that contribute to these profits. But many countries do not get their due share of global taxes. Global tax base is not fairly apportioned/ allocated amongst different countries.

Let us try to understand in this paper:

(i) Inequity in the Existing Treaty Models & practices.
(ii) Attempt to continue similar inequity for E-commerce taxation.

B. Consider **tax base allocation** 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.**

C. So far, all the discussion on profit allocation amongst different countries is based on the **functions performed 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. OECD/ G20 PCD specifically states that these are "not relevant for allocation of a firm's profits under general tax framework." See page No. 12, paragraph No. 33. This is denial of Tax Base allocation on the basis of contribution to profits by the Country of Market. This 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.**

Since the fundamental existing method to determine Nexus is unfair, the allocation of Tax Base to COS & COM remains unfair. If this system is to be made fair, OECD model needs fundamental modifications.

2.3 Consider an illustration of Bricks & Mortar /traditional business:

A Japanese automobile company manufactures automobile cars in Japan. So Japan is **COR**. The company manufactures through its PE steel components in India. It has a factory in Malaysia to manufacture rubber tyres. Now India & Malaysia are **COS**. This company sells cars in USA without having any PE in USA. (This is assumed for illustration. In reality

it is impractical to sells cars in USA without establishing a PE in USA.) Now in our illustration USA is **COM**. It gets zero tax base under the present OECD & UN model treaties.

2.4 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 North 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 North Ireland is **COS** for the profits attributable to Irish Branch.

The MNC earns billions of dollars from rest of the world (other than USA & North Ireland). These other countries are Countries of Market (**COM**). They are entitled to zero tax base. Under the existing OECD & UN Model, they cannot get single dollar tax revenue from this MNC. This suits COR of the Digital Corporation.

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

3. Brief History of OECD work on Ecommerce Taxation during last 20 years:

3.1 In or before the year 1997 OECD started working on Ecommerce taxation. In the **year 1998** it published Ottawa report and stated that "*Electronic commerce has the potential to be one of the great economic developments of the 21st Century.*" The report further stated that:

"Box 4. The post-Ottawa agenda (continued) International tax arrangements and co-operation:

(viii) With regard to the OECD Model Tax Convention, clarifying how the concepts used in the Convention apply to electronic commerce, in particular:

*(a) To determine taxing rights, such as the concepts of "**permanent establishment**" and the **attribution of income**; and …………"*

Note that two important concepts for a better Ecommerce taxation system were identified in the year 1998: Permanent Establishment & Attribution of Income. After twenty years, in 2019, OECD is still debating these issues. Why it could not find a solution for twenty years?

3.2 **In the year 2001,** Indian Committee on Ecommerce Taxation presented its report. Committee reported that:

Page 12, Summary: "*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."*

However, Committee did not want unilateral action by India. Hence it reported that:

Page 14, Summary: *"No changes in the Act or the DTAs are required till international consensus on abandoning the concept of PE is reached."*

3.3 **In the year 2005,** OECD published a report stating that Ecommerce business was small, existing rules of international taxation were fine and there was no need for change. See OECD TAG report at: http://www.oecd.org/tax/treaties/35869032.pdf

Conclusion: Page 72, Paragraph 350:

"350. As regards the various alternatives for fundamental changes that are discussed in section 4-B above, the TAG concluded that it would not be appropriate to embark on such changes at this time. Indeed, at this stage, ***e-commerce*** *and other business models resulting from new communication technologies* ***would not, by themselves, justify a dramatic departure from the current rules****. Contrary to early predictions, there does not seem to be actual evidence that the communications efficiencies of the internet have caused any significant decrease to the tax revenues of capital importing countries."*

3.4 **In the years 2007 onwards** USA & Europe suffered serious economic crisis. This made loss of tax revenue unacceptable.

3.5 **Around year 2012 UK Parliament** was frustrated with aggressive tax avoidance by Starbucks, Google and Amazon. **Public Accounts Committee** investigated the matter. **Ms. Margaret Hodge**, who chaired the parliamentary committee, told the BBC that she thought it was right for customers to boycott the three companies.

"One of our concerns is that the ability of global companies to choose where to they put their costs and their profits gives them an unfair tax advantage that damages UK-based businesses," she said.

This Committee published a report in the June 2013. Summary:

"To avoid UK corporation tax, Google relies on the deeply unconvincing argument that its sales to UK clients take place in Ireland, despite clear evidence that the vast majority of sales activity takes place in the UK. The big accountancy firms sell tax advice which promotes artificial tax structures, such as that used by Google and other multinationals, which serve to avoid UK taxes rather than to reflect the substance of the way business is actually conducted. HM Revenue & Customs (HMRC) is hampered by the complexity of existing laws, which leave so much scope for aggressive exploitation of loopholes, but it has not been sufficiently challenging

of the manifestly artificial tax arrangements of multinationals. HM Treasury needs to take a leading role in driving international action to update tax laws and combat tax avoidance."

3.6 **Britain, France & Germany – G3** did not find tax avoidance by US MNCs as acceptable. At their insistence, in the year **2013, BEPS programme** started. Since they considered tax avoidance by Ecommerce MNCs as the most important issue, it was listed as BEPS Action 1.

3.7 **In November, 2015,** BEPS Action reports 2 to 15 were published. But Action 1 could not be finalised. Only an interim report was published. Till Feb 2019, there is no solution on Ecommerce taxation.

3.8 **In year 2016** European Union found a novel way to address tax avoidance by highly digitalised business corporation – Apple. EU levied a penalty on North Ireland – to be recovered from **Apple Corporation** for Euro 13 billion.

3.9 **In the year 2018 EU** has published reports recommending taxation based on **Significant Digital Presence**. Considerable work has been done by EU in this matter.

3.10 **In February 2019** OECD/ G20 have published this Public Consultation Document. The PCD presents three proposals. For all three proposals there are (i) factors to determine **nexus**; and (ii) factors for **attribution of profits**. When it comes to attribution of profits, OECD/ G20 PCD provides that routine profits will be taxable only in COR. Out of **non-routine profits** attribution to COM may be a small component. Going by British experience with Amazon, Google & Starbucks, the COM will get a small fraction of profits as British Tax base. The **fears expressed** in June 2013 by the British Public Accounts Committee (See paragraph 4.5 above.) have not been addressed at all. In fact, these fears now seem too real & permanent. Even the third paragraph for **anti-avoidance provisions** will help only COR; and may not help COM. If a US corporation avoids US – COR taxes, US IRS can apply GILTI & tax the corporation. But Britain as COM cannot apply such rules stated in OECD/ G20 PCD.

OECD/ G20 PCD proposals ignore demands by several nations to allocate tax base fairly. It proposes to allocate tax base mainly to COR. Serious efforts by UK & EU have not given results – at least so far.

4. Why US is against any significant change in Ecommerce taxation:

If COM countries levy tax on American MNCs, USA will lose that much tax. See table below for a clear idea.

Comparison of Tax Consequences when US company avoids tax in COS	No Avoidance U.S.$	Successful Tax Avoidance U.S.$
U.S. Digital Corporation		
Revenue from COM	1,000	1,000
Tax payable in COM @ 10%.........................	100	NIL
Tax payable in USA @ 21%	210	
Set off under Article 23B of OECD Model…	100	NIL
Balance tax payable to U.S. Government	110	210
If no tax is paid in COM, the tax payable in USA		210
Since COM loses that tax; other tax payers in COM have to suffer additional burden		100

This is the reason why U.S. Government would be happy when U.S. MNCs avoid taxes of rest of the world. Gain for USA is loss for rest of the world.

5. Summary of discussions so far (Paragraphs 1 to 5):

Existing system of international taxation **needs to be modified** for **two reasons:**

(i) Under existing system, while considering taxation of Digital business conducted by a Non-Resident, it is difficult to determine **nexus & attribution of profits**. Concept of PE as defined under existing models cannot be applied to E-commerce business.

(ii) Existing system is **inequitable** with larger allocation to COR & smaller allocation to COS.

This inequity is sought to be continued under OECD/ G20 PCD proposals. Having understood the inequity in the OECD/ G20 PCD, let us consider alternatives. We propose a tax system based on SEP. It is explained below.

6. Our Proposal:

(i) SEP based system for allocation of Tax Base. Market is the SEP.
(ii) A low withholding tax rate on **Tax Base** = gross **Revenue Realised** by DC as final tax. (Option to assessee for filing tax return may be given subject to conditions.)

(iii) Tax borne by Digital Corporation at COM to be credited against tax payable at COR.

7. Simplified Significant Economic Presence:

7.1 There is a difference between two concepts: "Attribution of Profits" & "Allocation of Tax Base".

Attribution of Profits 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. (Whole of the profit is taxable in COR. Hence attribution is not necessary for computing COR tax liability.)

Tax Base Allocation: 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 Allocation - the gross sales amounts received from COM by the DC will be allocated to COM. Thereafter it is the sovereign right 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 tax payers also may find it far easier to submit simple details and pay tax without any controversy.

7.2 Contributions by Countries:

We are presenting a principle: A **country contributes to the ability of a corporation/ business entity to earn profits.** This contribution by a country can be in the form of providing stability, etc. in the Country of Residence; or providing necessary facilities in the Country of Source; or providing a market in the COM. **COR & COS both refer to the supply side.** Both these concepts are applicable for the tax payer for providing goods or services; doing functions; or having assets or employees in the relevant country. **COM is the demand side.** In absence of a market, there is no business and no profit. In absence of COR there is no tax payer. In absence of COS, goods do not get manufactured. Hence no business.

Supply side and Demand side are equally important for the business and hence equally important for tax jurisdiction. Under the three proposals given in OECD/ G20 PCD; the COR takes away almost entire tax base leaving COM with a small tax base.

7.3 **Our proposal** is that because the COM contributes to the profits of the Digital Corporation by providing a market or Data; it has a nexus and a

jurisdiction to tax the profits earned from sales within COM; or from the use of COM Data. The fact that COM provides a **market is adequate nexus. Market itself becomes SEP for the Digital Corporation. This is completely independent of whether the tax payer conducts any functions**, has any asset or employee in the COM or not. Half of the amounts received by the Digital Corporation for the prescribed business from within the COM become its Tax Base. This half is taxable in Com and the other half is taxable in COR & COS.

7.4 **Weightage to be given to Supply Side & Demand Side should be equal.** In other words, from the total revenue earned by the Digital Corporation, half should be the tax base for Supply Side (COR & COS together); and the other half should be the tax base for Demand side – all the worldwide COMs. **This important change in existing OECD & UN model is necessary.**

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.

"Data" & Other "Digital Commerce"- separate clauses:

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 Ecommerce 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.**

When tax base is equally divided between Supply side & Demand side, a lot of controversies become irrelevant.

7.5 **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 tax payer like Face Book 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 on fluctuating numbers can be difficult.

At present, certain business models are prevalent. The idea of "User Base" as Nexus is based on present popular business models. It can be considered a certainty that in future, there will be new business models that have not been imagined by today's tax law draftsmen. Such new business models may require new characteristics to determine the nexus. If the definition of SEP / Nexus requires changes every time the business model changes; and if OECD etc. take a few years every time to change the definition; then the administration of international taxation will be very difficult. **We need a definition which will not change with the business models.** At the same time, the definition should be such that the Digital Corporation's profits & COM's jurisdiction are connected through the definition. The Nexus should be part of the definition.

Hence, we suggest that the **Market in the COM should be considered as the Digital Corporation's SEP.** Total amounts received from COM residents 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 go into counting the 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.

7.6 **"Market is the SEP and Amounts Received Constitute Tax Base"** is a statement of principle in simple words. There will be certain modifications or conditions necessary. These are discussed below:

For the convenience of tax payer in compliance and of the tax department in administration, it is necessary that a practical **threshold** is fixed. Payments equal to or below the threshold will not attract tax liability. Payments above the threshold will attract tax liability. This threshold may be fixed differently by different countries depending upon their perception of their cost benefit ratio. Ideally, the threshold should be reasonably large. For India, we would consider the threshold of US $ 1,00,000 – equivalent amount in Indian Rupees – say, Rs. Seven million as a practical threshold.

7.7 Having established a tax base for the COM, computation of tax payable to COM - **"the machinery provisions"** can be drafted in different manners. One may adopt a simple method similar to tax on royalty; or one may go into detailed computations.

7.8 **Tax Rate:**

Based on the principle that COM is entitled to 50% of the 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: 5% 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.

8. Prescribed Business:

8.1 Which Businesses should be covered:

As we have seen separately, the internet-computer-mobile phone technology keeps advancing very fast. Hence, new business models keep being developed. Defining a particular business which would be covered under the digital tax regime; and which would not be covered - can be difficult. Howsoever broad definition may be made, some new business models will be developed which will be outside the definition. At the same time, provision of service through digital means should not, by itself attract the provisions of digital tax. Both 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 Ecommerce 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 never 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. 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. Hence, even this business income cannot be considered under digital tax.

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. Hence, these businesses also cannot be covered under digital tax.

Thus, 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. In the circumstances, it will be better if the COM Governments prescribe the businesses to be covered under digital tax. It will be a positive list. Hence all businesses which are not prescribed 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.

8.2 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 **Ecommerce** taxation and suggested that businesses conducted through **computers & internet** would constitute Ecommerce. Then **mobile phones** were used for cross border business. Mobile phones are not called computers. Hence business conducted through mobile phones would escape Ecommerce 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 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.

Practical way out of this situation is that OECD/ G20 and COM Governments may specify businesses that will be covered under this tax. Those businesses may use computers or any computerised instruments; or may use something totally different. Underlying common factor should be that a person 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 Article 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.

8.3 There is an unnecessary **attachment towards computers and internet or digital methods of communications.** An important tax provision cannot, in principle, be based on the instrument of communication. One has to go for more fundamental issue.

Corporations can do remote business by using other instruments of communication also. For example, a business corporation can advertise its products through television, radio or any other media. With these - advertisement and other strategies, the corporation can generate a goodwill for itself in different countries. Once the brand name is known, potential buyers can visit the websites of the corporation and place orders for their requirements. Alternatively, they can simply telephone, write letters and place orders. The business transaction of goodwill generation, placement of order, supply of goods/ services and payment can be made partly or wholly without using digital means. **Canadian** companies marketing their products in USA through **catalogues** is an old and established method of doing business. Today, digital communication makes catalogues redundant. Tomorrow, there may be a method of doing business which will make digital communication redundant. Anything may happen. Our simple point is: "Do not emphasise on definition of a business and do not emphasise on instrument of communication. Just emphasise the fact that a non-resident can do business in COM without a PE."

9. Simple Machinery for Digital Tax:

9.1 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; 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.

9.2 Withholding Tax (WHT):

All payers from COM making payments above a threshold to non-residents of COM for prescribed business may be required to **withhold digital tax @ 5%.**

The Digital Corporation should get credit for the tax paid in COM against the COR tax liability.

9.3 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 5%. 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.

9.4 Tax Liability:

A Digital Corporation receiving payments above the specified **threshold** for **prescribed business income** will be **liable to Digital Tax** in COM. Amounts received in a year upto or less than the threshold will not be liable to tax. Amounts received for purposes other than prescribed 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, the art library will have no tax liability and no compliance responsibility in the COM.

9.5 Digital Tax Return:

The Digital Corporation liable to Digital Tax will be required to file its 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.

Five percent 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 tax payer to COM.

9.6 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.

9.7 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.

9.8 Thus there will be **separate thresholds** for the Digital Corporation's **tax liability** and for the payer's **liability to withhold tax.** Ultimate liability to comply with the law will rest on the Digital Corporation. It will be a fairly simple procedure.

9.9 Audit & Verification:

The Digital Corporation may be required to get its **return audited** by 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.

9.10 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 Netflix to file its tax return. Netflix will provide audited accounts for total amounts received within the COM. Netflix will compute tax payable @ 5% 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.

10. Detailed Machinery for Digital Tax: Option to file Return:

10.1 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 avoiding taxes. There are tax consultants & tax havens helping them.

Hence, the tax department of COM cannot rely on just gross turn over or consolidate profit figures. Hence **Formulary method of attribution of profits is not practical.** COM tax department should get entire information necessary to examine whether the MNC has avoided taxes under various planning methods available. If it has avoided, 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.

10.2 **COM tax department cannot rely on information shared by the tax department of COR**. There are some countries which practise a policy with their tax payers: "Do not avoid my taxes. If you are smart to avoid other countries' taxes, fine. We will help you in avoiding taxes levied by other countries."

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 5% of receipts from COM; then it must file return and submit global information as the tax department may consider necessary. This option may be exercised separately for each COM. Alternatively it may simply pay up 5% tax on gross receipts.

10.3 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 5% 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". Only problem is, this proposal mainly protects COR tax base and protects COS tax base to a smaller extent.

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 COS tax without giving any treaty or unilateral relief.

(vi) While taking action against tax haven entities, note the fact that USA has five tax havens within its boundaries. While US treaty may be continued, all entities in US tax havens should be treated like any other tax haven entity. Similar provisions need to be made for all industrial countries that support tax havens.

Summary: Only those companies which are ready to pay honest taxes in COM and ready to establish their honesty - may be given the option of filing a tax return & claiming lower tax liability. In case of doubt, pay 5% and close the matter.

11. Tax Avoidance apprehensions:

The apprehension of payments by non-residents of COM to avoid COM tax is considered below. The resident of COM may enjoy goods or services provided by a non-resident digital corporation. However, that corporation may collect its fees from an Associated Enterprise of the consumer which is resident outside COM. In such cases, it will not be practical to enforce the provisions of withholding of tax.

This may not be very serious issue. When a resident business entity of COM makes payment from within COM, it may be able to claim the

payment as expenditure. By claiming the expenditure, it will reduce its tax liability which may be much higher than 5% withholding tax. If a non-resident makes payment, then the expenditure will not be available for deduction.

Similarly, amounts payable by COM – home consumers may be paid by their relatives resident abroad. These amounts will be so small that one may not indulge in such practices for saving 5% tax. And if somebody does resort to such practice, it may be ignored as insignificant activity.

12. Note:

Brick & mortar Business: The principle that "**the market constitutes SEP** and the amounts received constitute tax base" can be applied to digitalised business as well as to **all other businesses**. However, applying this principle to all businesses would require consideration of more factors and a separate paper. In the current paper, our focus is on E-commerce or Digitalised business. Hence, we are not considering other business incomes.

13. Digital tax on data:

13.1 In the digital business, data is extremely valuable. 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 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.

An analogy may be drawn from **goodwill**. A businessman accumulates goodwill – which is an intangible asset. The goodwill is not stored anywhere and may not be registered anywhere. And yet, for tax purposes, goodwill shall be deemed to be located in the Country of Market. Similarly, the data shall be considered to be situated in the country to which the data pertains.

13.2 **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 @ 5% 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.

13.3 Data Security: There have been serious investigations by Governments of USA and UK on the activities by digital corporations. 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.

Data Security & Privacy: SEP: There have been serious allegations of political interference on some of the largest digital corporations. Hence, several Governments around the world are considering legislation for data safety and privacy. One of the provisions being considered is that all such digital corporations will have to store the data within the geographical boundaries of the COM. They will not be allowed to store data outside the COM. They may appoint their own branch or subsidiary; or outsource the function of maintaining data. The entity collecting, storing, processing the data will become the SEP of the digital corporation. We propose that the SEP 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 5% tax, the net amount can be remitted by the SEP abroad.

In India, the **Central Board of Indirect Taxes & Customs** (CBITC) 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.

Once a digital corporation is required to store data within the COM, it may have to set up either a branch or a subsidiary to collect, process, store and safeguard the data. This function can be assigned to a third party as outsourcing of business functions. Whosoever performs the function of

collecting, processing, storing and safeguarding the data shall be considered as the **SEP of the digital corporation**.

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 to file return and declare global revenue earned by the digital corporation out of data pertaining to the COM. After computing total tax liability @ 5%; and after deducting tax withheld by residents of COM; the balance tax will be paid by the digital corporation to the Government of COM. This tax paid to COM should be available as set off against the tax liability in COR.

13.4 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 are not considered as digital business are illustrated below.

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 @ 5%.

13.5 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 5% of revenue or that the digital corporation has

incurred losses; it will have to comply with procedures described in paragraph (10) above.

14. 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. For details, please see paragraph No. (10) above.

(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. For a clarification of this statement please see paragraph No. (4) above.

First Part of the Paper completed.

Next Page – Part II – Comments on OECD/ G20 PCD

Part II Comments on OECD/ G20 Public Consultation Document (PCD):

Chapter 1 Page 23. OECD/ G20 Questions: Para 87.
Our comments on "Marketing Intangibles" and "User Contribution and SEP proposals presented in OECD/ G20 PCD.

1. Litigation:

These proposals involve several **subjective** estimates & formulae. Within a tax payer corporation group, different associated enterprises can have different opinions on attribution of profits. There can be many differences of opinions between tax payers & tax collectors. And there will be no objective guidance to resolve the differences. It will result into **avoidable litigation**.

2. Dynamic Business; Stagnant Tax Laws:

Several different technologies keep growing at a fast pace. These technologies then converge and give **new products** which were not imagined before a few years. This process develops **new business models** which were not imagined earlier.

Today, several businesses can do business in several countries without residence & without PE. Tomorrow there will be many more such businesses. Technology & business are dynamic.

However, tax laws have been stagnant. A big gap has arisen between the real market and the tax law.

Complicated methods of attributing profits will not work. For the Countries of Market, a simple & efficient method needs to be developed. Residual Profit Split method etc. will not be practical in this dynamic world.

3. Most important **considerations** for a new method of taxation for –

(i) Considering Nexus; and (ii) Allocating tax base should be:

(a) The system should be practical, simple & objective for compliance as well as administration and **should not cause litigation.**

(b) Should be **fair to** COR, COS & COM.

All three proposals in the OECD/ G20 PCD do not pass these tests.

4. Best approach would be a low tax withholding rate as a final rate.

5. Observation: China has blocked U.S. Digital Corporations from doing business in China. Hence, China does not have COR Vs. COS conflict.

OECD/ G20 PCD Page 29. Paragraph 110.
Our comments on Anti- Base Erosion Proposal:

1. Tax Havens:

OECD/ G20 Public Consultation Document suggests an elaborate provision in paragraph 3 on pages 24 to 29. It is apprehended that digital corporations may avoid their digital taxes by resorting to several planning procedures despite BEPS. Hence, it is suggested that provisions similar to GILTI and BEAT may be introduced under the OECD Model as well as in the domestic tax laws.

General View:

Existing International Taxation with Transfer Pricing, GAAR, BEPS, GILTI & BEAT is extremely complicated and prohibitively costly for compliance. This proposal will increase the complications & cost of compliance & administration. Worldwide governments look at large corporations avoiding taxes within the four corners of law. Then governments legislate anti-avoidance provisions making the law complicated. At the OECD stage, drafts are made to give wider powers to tax officers in assessment of incomes. Then the governments make drastic penal & prosecution provisions. Together, they give rise to terrible harassment by tax officers. The honest tax payers bear maximum brunt of these laws. Tax payer protection laws have limited effect.

US tax consultants complain that the GILTI and BEAT provisions incorporated in US tax law have not yet stabilised. Many tax consultants find it difficult to understand these provisions. The corporations may find it difficult to comply with the law. The existing unpredictability of final tax assessment together with high cost of compliance is unacceptable. Why complicate the tax law further?

Another issue is that the GILTI and BEAT provisions are targeted towards protecting the COR and COS taxes. There is little protection for COM. These proposals may not help COM.

COM can avoid complicating its tax law by making a simple tax provision: Flat digital tax rate (say 5%) on Revenue Realised from COM - as a final tax. **No amount of tax planning can escape taxation in such simple legal provision.**

2,3,4 - Drop all these proposals.

5. Best approach to reduce complexity, ensure early tax certainty (predictability) and to avoid multi-jurisdictional disputes would be –

Flat digital tax rate (say 5%) on Revenue Realised from COM - as a final tax. The COR to give credit for tax paid in COM.

Comments Completed.

We thank OECD/G20 group for offering us this opportunity to study the subject and present our views on the same.

For Rashmin Sanghvi & Associates,
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