ADVANCE DIPLOMA IN CORPORATE TAXATION - NALSAR LAW UNIVERSITY, HYDERABAD

TAXATION OF CORPORATES IN DIGITALISED ECONOMY, BEPS ACTION PLAN

Adv. (CA) Kinjal Bhuta

5th December, 2023.

What is BEPS?

- Base erosion and profit shifting (BEPS) refers to tax planning strategies used by multinational enterprises that exploit gaps and mismatches in tax rules to avoid paying tax.
- Working together within **OECD/G20 Inclusive Framework on BEPS**, over 140 countries and jurisdictions are collaborating on the implementation of 15 measures to tackle tax avoidance, improve the coherence of international tax rules and ensure a more transparent tax environment.

What is BEPS?

- Three important phenomena facilitated by digitalisation – scale without mass, reliance on intangible assets, and the centrality of data – pose serious challenges to elements of the foundations of the global tax system.
- On one hand, the emergence of new and often intangible value drivers have revolutionised entire sectors creating new business models while continuously eroding the need for physical proximity to target markets.
- On the other hand, new technologies have facilitated tax avoidance through the shifting of profits by multinational enterprises (MNEs) to low or no tax jurisdictions.

Digital Economy

- Digital economies generally refer to economies based on digital technologies, and not merely limited to e-commerce or buying, selling and facilitating sale of goods on the Internet.
- The digital economy differs from a traditional economy because of its reliance on digital technology, online transactions and its transformative effect on traditional industries.
- Digital innovations such as the internet of things, artificial intelligence (AI), virtual reality, blockchain and autonomous vehicles all play a part in creating a digital economy.

Digital Economy

- Due to the virtual nature of business conducted by these digital technology companies, tax loopholes were invariably created, preventing many countries from collecting taxes on profits from such companies.
- Unlike traditional companies, whose profits are taxed at value creation, digital technology companies conduct most transactions electronically. This makes it difficult to capture where value is created, what it is, and how to measure it.
- Companies are taxed through *permanent establishment* rules, which are largely based on physical presence. So, while digital technology companies operate virtually, their profits are taxed only in the state where they have a physical establishment.

Major Challenges of a Digital Economy

1. Characterization of Income:

- Income may be characterized as dividend, royalty, FTS or business based on countries and based on DTAAs.
- Differences in definitions and qualifying factors
- Impact on tax cost
- Increased risk of Litigation
- Huge risk of the business getting classified as a permanent establishment (PE) in India.

Major Challenges of a Digital Economy

2. Classification of Permanent Establishment:

- A non-resident company is taxed at the rate of 40 percent on its business income, if it has a PE/business connection in India. However, due to intangible nature of a business, it is getting difficult to determine the permanent establishment of a company.
- To determine the existence of a permanent establishment
- Virtual PE's in India: Unilateral Approach
- Expansion of scope of business connection

Major Challenges of a Digital Economy

3. Attribution on Allocation of Taxation Rights:

- Breakdown of income and its approach concerning jurisdiction
- Resident-based taxation approach
- Source-based taxation approach

Major Challenges of a Digital Economy

4. Identity Verification:

In cyberspace, identification about transacting parties is difficult to be determined and this created a chaos for tax enforcement authorities to identify resident or non-residents regard to business opportunities.

- Techniques used for display of digitized information
- Webpage formed by using various locations
- No similarity between physical and logical locations
- Verification of identity

Major Challenges of a Digital Economy

5. Cybercrime:

- Loss of Evidence
- Data of any other person used for fraud
- Easy to destroy crucial data
- Data or information about a person from another location and in another country is difficult to trace.

Major Challenges of a Digital Economy

6. Tax Avoidance:

- When tax payers use existing law, double tax avoidance agreements & tax havens for not paying taxes, it is called **Tax Avoidance**.
- Tax haven Governments
- Convergence of technologies
- Concepts like - "company is a separate legal entity"

Major Challenges of a Digital Economy

6. Tax Avoidance:

- Treaty Shopping.
- Inappropriate application of very old legal concepts/principles
- modern communication technologies

Major Challenges of a Digital Economy

7. Transfer Pricing:

- It is difficult for tax authorities to audit transfer pricing transactions between the entities of MNCs resulting them to allocate their valuable assets to affiliates in low tax rate jurisdiction.
- Transferring profits to other countries, having less or no tax.
- Lack of Transparency
- Main problem- Intangibles, as they have high mobility nature.

Recommendation of BEPS

- Indian Government had appointed a **High Powered Committee** to make recommendations on **Digital taxation**. The committee presented its report in **year, 2001**.
- **OECD** had appointed a committee (TAG) to study Digital Taxation and make recommendations. **In the year 2005**, the Committee presented its report.
- The committee concluded that "There is no alternative taxing rule (i) which is superior to existing rules; and (ii) which is widely acceptable. Hence no changes may be made in existing tax treaty rules."

Recommendation of BEPS

- In the year 2008, the countries that were more into being Country of Residence (COR) accepted that the MNCs and GCs were avoiding and evading taxes to unacceptable extents.
- Hence, the G20 and OECD together decided to come out with new rules for international taxation.
- **In the year 2013,** OECD reversed its stand and accepted that "The Existing rules of International Taxation are inadequate".
- Thus, G20 and OECD together started the BEPS Programme to curb tax avoidance.

Action Plan 1

- BEPS Action Plan 1 recognizes that tax on income of foreign entities may be imposed by implementing virtual PE mechanism. However, it emphasizes that such implementation should be through bilateral negotiations with treaty partners.
- Some of the issues and solutions have been reproduced here:

Action Plan 1

Issues:

- Recent, rapid, and expansive digital transformation has had deep economic and societal impacts resulting in significant changes, which has sparked global debates.
- The tax implications are wide-ranging affecting both direct and indirect taxation, broader tax policy issues, and tax administration.
- At the center of the debate is whether international income tax rules, developed in a "brick-and-mortar" economic environment more than a century ago, remain fit for purpose in the modern global economy.

Action Plan 1

<u>Solution:</u>

- Members of the OECD/G20 Inclusive Framework on BEPS have been dedicated to finding a comprehensive, consensus-based solution to the two challenges arising from digitalization.
- Convened public consultations engaging key stakeholders including governments, businesses, civil society, academia, and the wider public welcoming a broad array of opinions on the matter to help us chart a path forward.
- Economic analyses and impact assessments
- Dedicated significant resources and attached substantial political imperative

Current Measures for Digital Economy in India:

1. Equalization Levy:

- Introduced by way of Finance Act, 2016
- Levy is 6% of the consideration received or receivable for any specified services
- Levied on resident payer
- Applicable on transactions which have a consideration of more than Rs. 1,00,000/-
- The transactions must be between an Indian resident or NR having a PE in India (Resident), and a NR service provider not having a PE in India (Non-Resident).
- Online advertisement, any provision for digital advertising space or any other facility or service for online advertising and extended to all digital businesses.

Current Measures for Digital Economy in India:

2. Significant Economic Presence:

- SEP was defined to mean any transaction in respect of any goods, services or property carried out by a non-resident in India including provision of download of data or software in India if the aggregate of payments arising from such transaction or transactions during the previous year exceeds the amount as may be prescribed. It further expands the definition of business connection such that a non-resident would be deemed to have a SEP in India if it carries out any of the following:

Current Measures for Digital Economy in India:

- transaction in respect of any goods in India above a specified value, including digital goods; or
- transaction in respect of any services in India above a specified value, including digital services; or
- transaction in respect of any property in India above a specified value, including download of data or software; or
- systematic and continuous solicitation of business from India from prescribed number of users through digital means; or
- systematic and continuous engagement with prescribed number of users through digital means.

Current Measures for Digital Economy in India:

Rule 11UD has been reproduced here as under:

"Thresholds for the purposes of significant economic presence.

- ***11UD***. *(1) For the purposes of clause (a) of Explanation 2A to clause (i) of sub-section (1) of section 9, the amount of aggregate of payments arising from transaction or transactions in respect of any goods, services or property carried out by a non-resident with any person in India, including provision of download of data or software in India during the previous year, shall be two crore rupees;*
- *(2) For the purposes of clause (b) of Explanation 2A to clause (i) of sub-section (1) of section 9, the number of users with whom systematic and continuous business activities are solicited or who are engaged in interaction shall be three lakhs."*

Current Measures for Digital Economy in India:

3. Adoption of MLI:

- India adopted the MLI in 2017 as a consequence of which amendments to India's existing DTAA network with respect to the expansion of the definition of PE are expected to come into force in the near future.
- The MLI target specific situations to take advantages of auxiliary activities exemption to avoid the certain creation of PE in the country.
- no guarantee of effective source taxation of digital income
- Bilateral approach

Current Measures for Digital Economy in India:

4. Taxation of Share Premium on Investments:

- Huge differences in valuations of companies having intellectual property and intangibles.
- Multiple subjective factors considered in valuation like cash flows projections and growth rates.
- Taxation of investments into such companies at high valuation impacts the growth of industry.
- If the consideration at which shares are issued is more than the FMV , such excess taxable as income from other sources u/s. 56(2)(viib) read with Rule 11UA.

Current Measures for Digital Economy in India:

5. Tax Collection at Source obligation for E-Commerce operators:

- Applicable to all e-commerce operators
- E- commerce operators means "any person who owns, operates or manages digital or electronic facility or platform for electronic commerce".
- E-commerce has been defined as "supply of goods or services or both, including digital products over digital or electronic network"
- E-commerce operators are mandatorily required to collect and pay GST (by way of TCS) on behalf of the suppliers at the prescribed rate of the net value of taxable supplies of goods or services made through it, within 10 days from the end of the month and furnish a monthly statement of outward supplies.

OECD Report on Digitisation Tax Challenges

- March 2018- The OECD/G20 Inclusive Framework on BEPS has been working on the issue, delivering an interim report.
- May 2019- Programme of work adopted
- The Programme of Work outlined proposals in two pillars that could form the basis for a multilateral consensus-based solution.
- The OECD Secretariat would undertake an economic impact assessment of the proposals to ensure that all members of the Inclusive Framework could be kept fully informed of the economic and tax revenue impact of key decisions relating to the proposals

Way Forward

- The CBDT has released a discussion paper on Profit Attribution of Business Profits.
- An equalization levy is a tariff and is not based on ability to pay, and it is only applicable to non-resident companies.
- The potential for double taxation of the SEP test can create friction in international commerce.
- The temptation to apply special taxes to tech giants right now will be strong, given the path India has adopted, when they may be more profitable than the rest of the global economy.
- Over the course of time, an all-inclusive, comprehensive, impartial policy should be the choice for digital taxation.


Q&A

Thank You !!!

CA. Kinjal Bhuta

+91 9920159601

kinjalbhuta@gmail.com

https://goo.gl/maps/EmnKkB9wSGe2V7R1A