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Growing Digital Cross Border Transactions - International Efforts for an Efficient Taxation System

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We live in a world where change is the only constant. There are two developments in international trade area which have revolutionized the way business is carried out and have made tax policymakers, tax managers and tax advisors keep on going back to drawing board to update their understanding and take course corrections measure. These developments are – emergence of multinational enterprise (MNE) as prime movers of international trade and digitalisation of economy. Both are driven by revolutionary developments in technology making movement of all factors of production and the products easier and faster. There is global convergence on the view that MNEs can erode tax bases of countries either by applying artificial tax arrangements or by shifting profits to convenient tax jurisdictions. International organisations like the Organisation for Economic Cooperation and Development (OECD), the United Nations (UN) and G-20 are coming together to plug loopholes in tax laws and tax treaties to avoid Base Erosion and Profit Shifting (BEPS) and develop a tax system which may provide certainty to taxpayers as well as protect revenues of countries. In this article we have discussed growing digitalization of economies and collaborative efforts of international communities to face the challenges posed by digital economies.

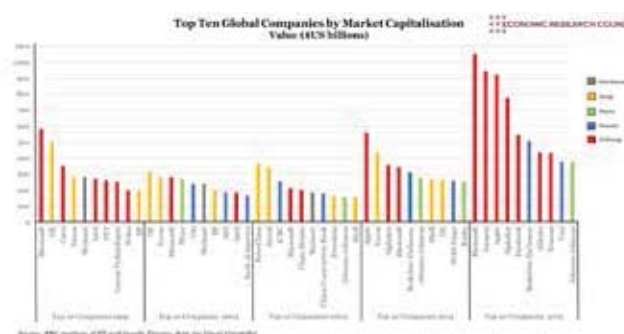
Emergence of MNEs as a major player in international trade

Various factors which have contributed to the growth of MNEs include availability of vast global market, wider availability and capability to use funds and trained manpower, arbitrage on labour costs, greater access to various natural resources and raw materials, higher level of efficiency in production, etc. It is interesting to mention that from a few hundreds in 1945 the number of MNEs grew to 100,000 with 900,000 foreign affiliates in 2010. The golden period of growth of MNEs was 1990 - 2016. During this period their assets grew 25 folds to USD 112 trillion, while sales rose 7 folds to USD 37.5 trillion. Further, the value of

exports by foreign affiliates of MNEs quadrupled to USD 6.8 trillion and the total number of employees quadrupled to 82 million. It is estimated that 50% of international trade takes place among the companies in MNE groups.¹

Growth of Digital Economy

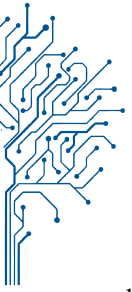
In recent times the profile of MNEs has undergone significant change. The brick-and-mortar companies have now come to be replaced by digital companies.. The graph below tells the story of emergence of digital companies in the last 20 years as dominant companies on the basis of market capitalisation:



The story of emergence of technology companies to the top is a story of growth of digital economy. There are many ways of defining the term “Digital economy”. Normally, it is understood as an economy where business is conducted through the Internet and World Wide Web. The Internet has grown and diffused rapidly across the globe, bringing significant benefits to economies and societies. Another definition of “digital economy” is that “it implies the global network of economic activities, processes, transactions and interactions among people, businesses, devices, etc. which is supported by Information and Communication Technology (ICT).”²

With increasing interconnectedness, a dynamic and innovative e-commerce marketplace has developed, consumers have been playing a more active role and an economy of

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sharing has emerged. The sharing economy can bring important benefits such as making efficient use of finite resources and developing new economic opportunities both to those doing the sharing and the platforms that connect them.

The digital economy touches all aspects of lives, including the way people interact, the economic landscape, the skills needed to get a good job, and even political decision-making. The OECD noted that it is “difficult to ring fence the digital economy from the rest of the economy for tax purposes” since the use of digital technologies has increased in traditional sectors as well. Therefore, the OECD has adopted a broad and inclusive definition for the digital economy consisting of a range of digital and tangible goods and services, including inter alia smartphones, tablets, computers, telecommunication digital content, availability of user data, cloud-based services, the Internet of Things, virtual currencies, advanced robotics, 3D printing, and peer to peer sharing of goods and services through the internet.

The COVID-19 pandemic had a dramatic impact on Internet traffic, as most activities increasingly took place online. As countries faced repeated lock-down, closure of offices, schools and places of recreation and businesses, dependence on online-services increased several folds in the last couple of years. Work-from-home has become the new normal way of working. TeleGeography has found that global internet bandwidth increased by 29% in 2021, bringing it back to “normal” levels compared to 2020’s COVID-driven levels of 34%. It also referred to a statement by Anahí Rebatta, senior analyst at TeleGeography that “(O)n a global scale, we’re seeing a whole range of new internet-enabled devices, growing broadband penetration in developing markets, higher broadband access rates, and even more bandwidth-intensive applications”.³

The evolution of cross-border digital economy calls for unconventional economic thinking and policy analysis. The Policy responses also need to take into account the blurring

of the boundaries between sectors, as well as increased difficulties of enforcing national laws and regulations with respect to cross-border trade in digital services and products. The tax policymakers have to move away from century old concepts of taxation to deal with the new developments in business brought in by digitalization.

Countries are rethinking how taxation rights should be allocated to prevent possibilities for under-taxation of major digital transactions in the fast-evolving digital economy. It is being appreciated that there may be a mismatch between locations where economic activities leading to profits take place and where those profits are currently being taxed. The primary claim of all countries, particularly developing countries is that as they are mainly markets for global digital platforms, and their users contribute significantly to the generation of value and profits, they should have the right to tax such profits. Under the auspices of the OECD, different options are being reviewed with the goal of reaching consensus on a solution in the beginning of 2020s. As the tax landscape evolves in the coming years, it is essential to ensure wide and more inclusive participation of developing countries in international discussions on taxation of the digital economy.

Indian Digital Economy

Digitalization affects different countries in different ways, and individual governments require policy space to regulate the digital economy in order to fulfil various legitimate public policy objectives.

As per one study, the number of online shoppers in India in 2016 was 149.4 million, which increased to 273.4 million in 2020 and is likely to exceed 500 million by 2022.⁴ “India is one of the largest and fastest-growing markets for digital consumers, with 560 million internet subscribers in 2018, second only to China. . Indian mobile data users consume 8.3 gigabytes (GB) of data each month on average, compared with 5.5 GB for mobile users in China and somewhere





in the range of 8.0 to 8.5 GB in South Korea, an advanced digital economy”⁵. Various estimates indicate that by 2025, India will be the largest mobile market in the world. “With over 560 million internet users, India is the second largest online market in the world, ranked only behind China. It was estimated that by 2023, there would be over 650 million internet users the country. Despite the large base of internet users, the internet penetration rate in the country stood at around 50 percent in 2020. This meant that around half of the 1.37 billion Indians had access to internet that year. There has been a consistent increase in internet accessibility compared to just five years ago, when the internet penetration rate was around 27 percent.”⁶

Challenges in taxing digital economy

In digital economy business may be conducted without regard to national boundaries and may dissolve the link between an income-producing activity and a specific location. It may not be incorrect to say that in many cases business in digital domain does not seem to occur in any physical location but may take place in the nebulous world of “cyberspace”. Persons carrying on business in digital domain could be located anywhere in the world. The entrepreneurs across the world have been quick to evolve their business to take advantage of the changes. They are adopting new models that rely more on digital and telecommunication network, do not require physical presence, and derive substantial value from data collected and transmitted. These new business models have created new challenges for policy makers, particularly tax policy makers. The OECD in their report issued in July 2021⁷ identified two problems in the existing international tax system which are based on agreements made in the 1920s and are enshrined in the global network of bilateral tax treaties. The first is, the existing rules which provide that “the profits of a foreign

company can only be taxed in another country where the foreign company has a physical presence”. The second problem is that “most countries only tax domestic business income of their MNEs, but not foreign income, on the assumption that foreign business profits will be taxed where they are earned”.

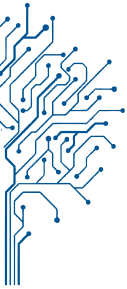
There is unanimity on the view that a global solution must be found at the earliest to avoid trade war and prevent uncertainty that could impact trade and investment. The OECD estimates that such a situation may cost the global economy up to 1% of global GDP and hamper from the Covid-19 crisis. The OECD estimates corporate tax avoidance costs anywhere from USD 100 – 240 billion annually, or from 4 – 10% of global corporate income tax revenue.⁸ The worse sufferers are developing countries as compared to advanced economies as they tend to rely more heavily on corporate income taxes. Consequently, to tax digital economy many countries are taking unilateral actions.

Efforts to frame an internationally acceptable system to tax Cross-border Digital Transactions

In general, countries that have adopted new measures to tax the digital economy seek a larger allocation of taxing rights to the ‘sources state’ where the consumer market is located, arguing that MNEs conduct their business without a physical presence in those locations. In 2015 the BEPS Action Plan 1, the Task Force on Digital Economy (TFDE) suggested three possible actions, without recommending either:

- (i) a new Nexus in the form of a significant economic presence,
- (ii) a withholding tax on certain types of digital transactions, and
- (iii) an equalisation levy.





In OECD, discussions continued to find an internationally acceptable solution for taxing digital economy. In the beginning, USA had been avoiding being part of resolution on digital taxation, though it has been taking several steps to tax digital economy and protect its tax base. Such measures include Base Erosion Anti-Abuse Tax (BEAT), Global Intangible Low-taxed Income (GILTI), etc. Appreciating the fact that the MNEs in digital economy were not paying appropriate tax even in their home country, the President of USA argued for implementing Global Minimum Tax of 15% to be paid by MNEs.

Subsequently, on 5 July 2021, 131 member countries and jurisdictions of OECD came out with a possible solution consisting of a new two-pillar plan. The core purpose of this plan is to ensure that large MNEs pay tax where they operate and earn profits. Thereafter, OECD/G-20 continued discussion on giving the shape to the two pillar approach which would have maximum acceptance.

On 8 October 2021 a statement was released that the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (IF) have agreed a two-pillar approach to address the tax challenges arising from the digitalisation of the economy.

The salient features of this statement are given below:

Pillar One: Aims to ensure a fairer distribution of profits and taxing rights among countries with respect to largest MNEs.

The new Pillar One scheme will cover MNEs (called ‘in-scope MNEs’) whose global turnover exceeds € 20 billion and profitability above 10% (i.e. profit before tax/revenue). This threshold is to be reduced to € 10 billion contingent on successful implementation including tax certainty. The approach is to be reviewed beginning seven years after the agreement comes into force and is to be completed within one year. It defines a new special-purpose Nexus rule whereby Amount A would be allocated to a market jurisdiction where the in-scope MNE derives at least € 1 million in revenue from that jurisdiction. For a smaller jurisdiction

with GDP lower than € 40 billion, the revenue threshold will be set at € 250,000.

So far as allocation of profits to market jurisdictions is concerned, the process will consist of two stages: first, residual profits, defined as profits in excess of 10% of revenue will be determined; second, 20-30% of such amount will be allocated to the market jurisdiction with nexus using a revenue-based allocation key.

Any double taxation is proposed to be relieved using either the exemption or credit method. To reduce tax controversies, it is agreed that disputes relating to Amount A will be solved in a mandatory and binding manner, without delaying the substantive dispute prevention and resolution mechanism.

To avoid any tax competition, it was agreed that the Multilateral Convention (MLC) will require all parties to remove all Digital Services Taxes and other relevant similar measures with respect to all companies, and to commit not to introduce such measures in the future.

The MLC through which Amount A is implemented is likely to be signed in 2022 and to come into effect in 2023.

So far as Amount B is concerned, “the application of the arm’s length principle to in-country baseline and distribution activities will be simplified and streamlined, with a particular focus on the need of low-capacity countries. This work will be completed by the end of 2022.”⁹

Pillar Two: It seeks to protect the tax bases of countries and puts a floor on tax competition on corporate income tax. It consists of two limbs - the first limb consists of the concept of minimum taxation to enable countries to protect their tax bases. It introduces Global anti-Base Erosion (GloBE) Rules which consists of: (i) an Income Inclusion Rule (IIR), which imposes top-up tax on a parent entity in respect of the low taxed income of a constituent entity; and (ii) an Undertaxed Payment Rule (UTPR), which denies deductions or requires an equivalent adjustment to the extent the low tax income of a constituent entity is not subject to tax under an IIR. The other limb of Part Two is a treaty-based



rule (the Subject to Tax Rule (STTR)) that allows source jurisdictions to impose limited source taxation on certain related party payments subject to tax below a minimum rate. The STTR will be creditable as a covered tax under the GloBE rules.

On 20 December 2021 the OECD published “*Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)*”. The report delineates the scope and sets out the operative provisions and definitions of the GloBE Rules. The implementation is scheduled in 2022. Explaining the goal of the GloBE Rules, the report says: “The GloBE Rules provide for a co-ordinated system of taxation intended to ensure large MNE groups pay a minimum level of tax on the income arising in each of the jurisdictions where they operate. It does so by imposing a top-up tax on profits arising in a jurisdiction whenever the effective tax rate, determined on a jurisdictional basis, is below the minimum rate.”¹⁰

The GloBE rules will apply to MNEs that meet the 750 million euros revenue threshold as determined under BEPS Action 13 (country by country reporting). The global minimum tax (GMT) rate used for purposes of the IIR and UTPR will be 15%. The OECD in FAQ on GloBE Rules¹¹ clarified the salient features as below:

- Once the number of countries joining the GloBE rules reaches a critical mass the MNEs will pay a minimum level of tax on the income they earn in each jurisdiction.
- If the country of ultimate parent does not apply the Income Inclusion Rule (IIR) then another parent down in the chain must apply IIR. If even this does not result in the income of the MNE Group being subject to tax at the 15% minimum rate, the further backstop of the “UTPR” kicks in, which ensures the payment of the minimum tax through a denial of deduction or similar

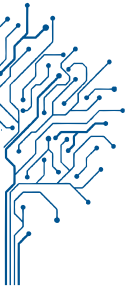
mechanism in all the countries where the MNE has a presence.

- The GloBE Rules are not mandatory, but those jurisdictions that adopt the rule will apply in a consistent manner.
- With a minimum effective tax rate of 15%, the GloBE Rules are expected to generate around USD 150 billion in additional global tax revenue each year.
- The Rules provide a transition rule to take into account losses that have been incurred prior to the effective date of the rules.
- The GloBE Rules have been designed to keep the administrative and compliance costs minimum.
- Commentary to the GloBE Rules will be released in early 2022 which will provide guidance on the interpretation of the global minimum tax rules.
- Stakeholder input will be sought in the development of the GloBE Implementation Framework.
- A model treaty provision to give effect to the Subject To Tax Rule (“STTR”) under Pillar Two will be developed and the model treaty provision will be supplemented by commentary that explains the purpose and the operation of the STTR. A multilateral instrument will be developed by the IF by mid-2022 to facilitate the swift and consistent implementation of the STTR in relevant bilateral treaties.

The above arrangement seeks to achieve the following goals¹²:

- Discourage MNEs to shift their profits to more tax friendly locations.
- Ensure uniform corporate tax regime throughout the world.





- Prevent the unilateral imposition of domestic tax

Parallel to the developments mentioned above, USA has been entering into agreements with countries which had implemented unilateral measures to tax digital economy. On 21 October 2021 the Office of the United State Department of Treasury reached an agreement with Austria, France, Italy, Spain, and the United Kingdom regarding the treatment of Digital Services Taxes (DSTs) during the interim period prior to full settlement of Pillar 1 of the OECD agreement. Under the agreement, in defined circumstances, DST liability that US companies accrue during the interim period will be credited against future income taxes accrued under Pillar 1 under the OECD agreement. In return, the US agreed to terminate the proposed additional duties on goods from the said countries. This agreement is known as “the Unilateral Measures Compromise”. Subsequently, on 22 November 2021 the US and Turkey, agreed to apply the same terms with respect to Turkey’s DST.

EU’s Proposed Directive for Implementation of Model GloBE Rules

On 22 December 2021 the EU issued Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union. It highlighted the fact that as the European Union (EU) “with a Single Market is a closely integrated economy, it is important to ensure that the two-Pillar agreement is implemented in a coherent and consistent way across Member States. The Directive implements the GloBE Rules only. The STTR is naturally suited to be addressed in bilateral tax treaties.

The Directive underlines the fact that “as multinational groups are usually present in several EU Member States and the GloBE Model Rules have a cross-border dimension, it is essential that no disparities arise in the operation of the rules, for example, in the method for computing the effective tax rate or top-up tax liability”. Further, it is critical to adopt a solution which should work for the internal

transactions among the EU countries.

Development in India

India has agreed to the two-pillar approach. As per Press Release dated July 2, 2021 and subsequent announcements by the Ministry of Finance, Government of India, India is in favour of a consensus solution which is simple to implement and comply, provided the solution result in allocation of meaningful and sustainable revenue to market jurisdictions, particularly for developing and emerging economies.

India and US reached an agreement to settle differences relating to the 2% Equalisation Levy imposed by India on e-commerce operators. The settlement is, as reported, broadly on the lines of the Unilateral Measures Compromise mentioned above.¹³ India will continue to impose the levy till March 31, 2024, or till the implementation of Pillar 1 of the OECD agreement on taxing digital transactions.

Once the OECD agreement rolls out, the 2% equalisation levy imposed by India will have to be withdrawn and will have to provide credit to the concerned companies against taxes accrued under Pillar 1 of the OECD agreement.

So far as India is concerned, it may be too early to say whether the New Two Pillar approach will give more revenue than the Equalisation Levy. However, as the revenue collected under Equalisation Levy is a very small part of the total tax revenue, in the interest of harmonious approach in taxing Digital Economy, India may accept the new approach. The actual challenge for India would be in dealing with the companies which may not be covered under the new approach – should the existing approach be continued, or the new approach be applied to those companies, also. For the latter, introducing proper domestic legislation and making changes in DTAAAs through the MLI route would have to be explored.

Challenges

Globally, stakeholders are examining the proposed new Two-Pillar approach not only from technical perspective,



but also from administrative perspectives. In their letter of 6th January 2022, “Business at OECD (BIAC)” highlighted two technical issues and mentioned that the Model Rules may prove an administrative and compliance struggle for many tax administrations and taxpayers, particularly given that the timeframe is very short.¹⁴

Hence, the agreed framework may have to face certain challenges, such as:

- Countries will have to give up their sovereign right of the countries to fix tax rates.
- The 15% rate may be more for some countries and less for others.
- Most important, it may be a challenge to have it adopted by all countries. Failure to bring big economies on board will turn the whole apple-cart.

Conclusion

While growth of MNEs and digital economy has made paradigm changes to the way business are conducted, tax policy makers across the globe are facing challenges in protecting their tax bases. Revolutionary changes in technology are becoming part of life in matters of months if not weeks. These are forcing our ways of living, behaving, and

earning income. Geographical boundaries are vanishing for conducting cross-border transactions in digital economy. Efforts to tax digital economy forced countries to take unilateral measures leading to multiple taxation and connected uncertainty for MNEs. International organisations like OECD and G-20 have been concerned about the impact and extent of Base Erosion by Profit Shifting (BEPS) and have been making efforts to reach a solution with maximum acceptability. The latest in the series of efforts is the new Two Pillar approach.

Implementing the new two-Pillar approach is likely to face serious challenges. Global acceptability will be the most significant challenge, followed by the complexity of the suggested computation methodology. The guideline for implementing the new approach is quite complex and would not be easy to be implemented by many developing economies. This may force them to look for easily implementable solution to tax digital economy. This must be avoided to ensure that there is no double/multiple taxation or no taxation. Further, countries which had implemented unilateral measures will compare the collection under both systems. Significant reduction in revenue due to the proposed scheme will discourage them to move to the new Two Pillar approach.

