

Amicus Alert: Recent Developments in the space of Digital Taxation

July 30, 2021

Introduction:

There has been a widespread agreement for some time that the international tax system needs reform to address the digitalisation of the global economy. Under the current international tax rules, multinational enterprises (“MNEs”) generally pay corporate income tax where they are established rather than where consumers or users are located.

The last decade witnessed many developments in the area of digital taxation. Discussions were conducted and proposals were considered both at an international level and at a domestic level.

This alert provides a brief summary of these developments along with key takeaways for MNEs.

Institutional Developments:

It is clear that taxation of digital economy is in one of the prime concerns within the international tax community and both the OECD and UN have made their recommendations.

OECD:-

In September 2013, the G20 Leaders endorsed the ambitious and comprehensive BEPS Action Plan, developed with OECD members. Addressing tax challenges raised by digitalisation has been the top priority for the OECD/G20 Inclusive Framework (“IF”)¹, since its inception.

Below is the timeline of developments within the solutions advanced by OECD in order to tackle taxation of digital economy:

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Oct, 2015

- OECD releases its Final Report on Action 1 identifying main difficulties posed by digitalisation of economy in the application of existing international tax rules and considers several options to address these difficulties. The options included: (i) Modification of PE rules, (ii) New withholding tax on digital transactions, and (iii) An "equalisation levy".

March, 2018

- OECD releases an Interim Report and discusses interim measures that countries could implement.

Jan, 2019

- OECD releases a Policy Note, introducing a "Two-pillared Approach" where: (i) Pillar 1 will address the broader challenges of digitalised economy, and (ii) Pillar 2 will address remaining BEPS issues.

May, 2019

- OECD released a Public Consultation Document and proposed three models for revising Profit allocation and Nexus rules under Pillar 1, and a Global Anti-base erosion proposal to address the continued risk of profit shifting under Pillar 2.

Nov, 2019

- OECD proposed a "Unified Approach" under Pillar 1 which is built on the significant commonalities identified in the three proposals forwarded in the Public Consultation Document.

Oct, 2020

- OECD released Blueprints of Pillar 1 & Pillar 2 reflecting the views on key policy features, principles and parameters, and identifies remaining political and technical issues where differences of views remain to be bridged,

July, 2021

- OECD releases a Statement that the significant majority of countries constituting the IF has agreed on a two-pillar solution to address the tax challenges arising from the digitalisation of the economy.

Statement on a Two-Pillar Solution:

The latest statement released on July 2021² sets out an agreement among members jurisdictions of the “IF” on the two-pillar solution to address the tax challenges arising from the digitalisation of the economy. A detailed implementation plan together with remaining issues will be finalised by October 2021.

OECD (2021), Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy, 1 July 2021, OECD, Paris, <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf>

The agreed key components of each Pillar are described below:

PILLAR 1 (addressing the allocation of taxing rights between jurisdiction):

- **Scope:-** MNEs with global revenue more than **20 billion euros** and profitability rate greater than **10%** would be considered in-scope³. Further, extractive and financial service sector have been carved out from the scope of Pillar One. Interestingly, the previous notion of covering only automated digital services (“ADS”) and consumer facing businesses (“CFB”) has been done away with.

2. OECD (2021), Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy, 1 July 2021, OECD, Paris, <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf>

3. The global revenue threshold would be reduced to 10 billion euros going forward.

- **Nexus:-** Nexus will be established by the revenue derived by an in-scope MNE from a jurisdiction. In general, **1 million euros** revenue from a jurisdiction has been agreed threshold for establishing nexus, for smaller jurisdictions (GDP below 40 billion euros) the revenue threshold has been reduced to **250,000 euro**.
- **Quantum of allocation:-** **20-30%** of the profits exceeding 10% margin threshold will be available for redistribution within market jurisdiction.
- **Tax Base:-** This will be determined on basis of financial accounting income (with few adjustments) and provision for carry forward of losses will also be present.
- **Implementation:-** The Pillar One proposal would be implemented through a multilateral instrument and will come into effect in 2023.

Pillar 2 (provide jurisdictions with a right to "tax back" where other jurisdictions have not exercised their primary taxing rights, or the payment is otherwise subject to low levels of effective taxation):

- **Overall design:-**
 - two interlocking domestic rules (the Global anti-Base Erosion Rules (“**GloBE**”) rules): (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; and
 - 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.
- **Scope:-** The GloBE rules will apply to MNEs that meet the **750 million euros** threshold as determined under BEPS Action13 (country by country reporting). Countries are, however, free to apply the IIR to MNEs headquartered in their country even if they do not meet the threshold. Further, Government entities, international organisations, non-profit organisations, pension funds or investment funds that are Ultimate Parent Entities(UPE) of an MNE Group or any holding vehicles used by such entities, organisations or funds are not subject to the GloBE rules.

- **ETR Calculation:-** GloBE rules will be applicable using an effective tax rate test that is calculated on a jurisdictional basis and tax base will be determined according to financial accounting income (with agreed adjustments). Top up taxes will not be imposed if the earnings are distributed within 3-4 years and are taxed at or above the minimum rate.
- **Minimum Rate:-** The minimum rate for the purposes of the IIR and UTPR will be at least **15%**. Further, the minimum rate for STTR will be from **7.5% to 9%**.
- **Implementation:-** The implementation plan for Pillar Two will be brought into law in 2022 and will be effective from 2023.

United Nations:-

The United Nations concurrently introduced an alternative approach to tax keeping in mind that the proposal should allocate reasonable share of taxes to market jurisdiction and should not be complex to implement .

In April, 2021 the UN introduced a new article, **Article 12B⁴**, in UN Model DTC to tax “income from automated digital services” which requires foreign providers of automated digital services to pay income tax at source by means of either:

UN Committee of Experts on International Tax Cooperation in Tax Matters (2021), 22nd Session, Tax Consequences of the Digitalised Economy-issues of relevance for Developing Countries, Co-Coordinator’s Report, E/C.18/2021/CRP 1.

4. UN Committee of Experts on International Tax Cooperation in Tax Matters (2021), 22nd Session, Tax Consequences of the Digitalised Economy-issues of relevance for Developing Countries, Co-Coordinator’s Report, E/C.18/2021/CRP 1.

- A withholding tax on gross income (rate to be negotiated between contracting States), or
- A withholding tax on qualified profits (net income) from automated digital services pursuant to an apportionment formula.

In its bid to simplify the implementation, the UN proposal does not require any threshold such as PE, fixed base, or minimum period of presence as a condition for taxation.

Developments in India:

India has been proactive in its approach to tax income from digital means. India was one of the first countries which introduced a new “**equalisation levy**” to tax revenue from “advertising services” in 2016, at the rate of **6%**. The scope of this levy was expanded in 2020, to tax revenue from e-commerce supply or services and the tax rate was set at **2%**.

Further, in 2018, India introduced the concept of “**significant economic presence**” (“SEP”) under its domestic tax code in order to bring income of non-residents operating in the digital space within the ambit of India-sourced income. Though the provisions remained inoperative till 2021, the Government has notified the relevant thresholds for non-residents to constitute SEP in India, and will come into force from 1st April 2022.

Taxpayers will continue to benefit from the tax treaties applicable to them due to the restrictive “Permanent Establishment” definition contained in them as it will override the definition of ‘business connection’ under the Indian Income Tax Act, 1961⁵.

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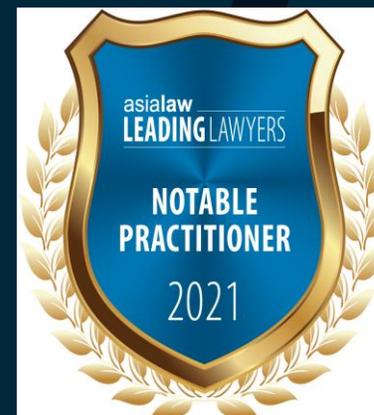
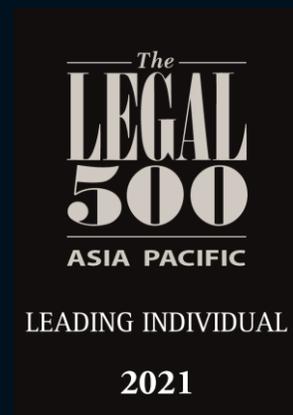
Although, the UN proposal would be incapable of covering multi-jurisdictional situations of profit allocation of the global revenue of multinational enterprises across multiple market jurisdiction, it still remains a viable option in case the OECD proposal fails to get a consensus.

Taxpayers in India should be wary of the future implications of the equalisation levy. Despite that the agreement on two-pillared approach provides for implementation of Pillar One proposals must include a commitment from members of IF to withdraw Digital Service Taxes (such as India's equalisation levy) and not adopt such measures in the future, it is still unclear whether India will roll back this levy.

ABOUT AMICUS

Amicus is legal and tax consulting firm with focus on corporate finance, re- structuring, private equity, international taxation, transfer pricing and goods and services tax. The Firm's tax team also represents clients in assessments and litigation including Tax Tribunal and Higher Courts.

The Firm focuses on providing efficient, effective, solution-oriented advice and representation based on specialist knowledge and experience. Amicus' boutique tax practice has been consistently been ranked as a leading practice by Legal 500, Asia Law and World Tax (ITR).





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