ASSESSING THE ADEQUACY OF INTERNATIONAL TAXATION LAWS IN THE ERA OF DIGITAL ECONOMY

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ABSTRACT

The digital economy has changed the global economy and raised fundamental challenges about whether the existing structure of international tax can capture the creation of value through digital transactions. Existing tax structures, which are focused on residence, source, and permanent establishment (PE) as bases for taxation, are insufficient to adequately capture the value of digital transactions. People and businesses alike are connected globally from jurisdictions where large multinational enterprises (MNEs) like Google, Amazon, Meta, Netflix, and others derive significant revenue without the same maintenance of a physical presence in the jurisdiction, which has caused extreme base erosion and profit shifting. This paper assesses if existing international taxation laws shaped by the OECD and the UN Model Conventions, the BEPS initiatives, and emerging initiatives such as the OECD Two-Pillar Solution, are adequate to address the issues of the digital economy. This sectors analysis primarily looks at unilateral actions undertaken by India to capture income from the digital economy, such as the Equalisation Levy and a presence through the definition of Significant Economic Presence or SEP, but also raises questions about the doctrinal issues raised by unilateral action, distributive justice concerns, as well comparative approaches to unilateral actions and principal approaches in India and internationally. While the treatment of digital MNEs through unilateral actions by some jurisdictions surprised many, the road towards a digital solutions has made incremental change; however, the existing regime remains inadequate to protect developing countries' interests. In conclusion, we suggest a more equitable, consensus-driven, inclusive framework that upholds source-based taxation and overall integrity in the digital economy.

INTRODUCTION

Taxation has always been based on two main principles, residence and source. Residence taxation establishes jurisdiction to the country in which the taxpayer is resident, while source taxation allows a country to tax income derived from a source in its jurisdiction[1]. These principles are put into effect through the "permanent establishment" test, which presumes the existence of a physical presence is necessary for meaningful business activity[2]. However, in today's digital world where cross-border commerce may happen in the blink of an eye, a reliance on physical nexus is becoming untenable. Major companies like Netflix, Google and Meta are able to carry on business in jurisdictions, generate substantial revenue, and commercially use user data without any tangible business presence[3].

This mismatch between the structure of modern commerce, and the structure of international taxation has caused significant base erosion and profit shifting (BEPS). The Organisation for Economic Co-operation and Development (OECD) estimates that governments lose USD 100–240 billion every year because of profit shifting by multinationals[4]. The loss of corporate tax revenue disproportionately impacts developing countries, who rely on corporate tax revenue to fund public infrastructure and welfare. Against this backdrop, the principal research question of this paper is whether the international taxation regime is capable of capturing value in a digital economy. In addressing this question, the article undertakes a doctrinal examination of statutes, case law, and international policy instruments, alongside critical and justice-oriented engagement. The Indian approach, both legislative and judicial, is used as a case study to illuminate broader global tensions.

THE DIGITAL ECONOMY AND THE CHALLENGE TO INTERNATIONAL

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[1] Michael Lang, Introduction to the Law of Double Taxation Conventions (Linde 2013) 12.
[2] OECD, Model Tax Convention on Income and on Capital: Condensed Version (OECD Publishing 2017) Art 5.
[3] Allison Christians, 'Taxing the Digital Economy' (2018) 20 Fla Tax Rev 55, 60.
[4] OECD, Measuring and Monitoring BEPS, Action 11 – 2015 Final Report (OECD Publishing 2015) 15.

TAXATION

There are three areas in which the digital economy is very different from the traditional commerce. First, the digital economy allows for scale without the need for mass; businesses with minimal physical assets are able to operate across multiple jurisdictions[5]. Second, the digital economy is driven by intangibles such as intellectual property, algorithms, and data, which create challenges for tax valuation. For instance, Google can generate billions of dollars of advertising revenue from the population of India, while having no office, employees, or taxable presence in India[6]. Similarly, streaming services such as Netflix, only require internet access and the consumption of local data to generate their income and, go untaxed under traditional treaty models. Third, the digital economy allows for significant user engagement, as users both create value from their data and contribute to the value chain through the effects of engagement and network effects. In essence, these areas that the digital economy could trade internationally allow for difficulties in relation to the permanent establishment or threshold test.

Judicial methodologies have struggled accordingly. In Vodafone International Holdings B.V. v. Union of India (2012) 6 SCC 613, the Supreme Court[7] of the outcome allied the notion that indirect transfers under existing law could not be taxed and made direct amendments to the Income Tax Act, 1961, retrospectively. In Formula One World Championship Ltd. V. Commissioner of Income Tax (2017) 394 ITR 80 (SC)[8], the Court ruled that even the arrangement initially of a Formula One Grand Prix event would satisfy a fixed place permanent establishment. These decisions highlight the tension between an outdated framework and the evolving nature of digital commerce.

EXISTING FRAMEWORK OF INTERNATIONAL TAXATION

International taxation has largely been moulded by bilateral Double Taxation Avoidance Agreements (DTAAs) to restrict either jurisdiction from taxing the same income twice[9]. The DTAAs are usually based on either the OECD Model Tax Convention (OECD MTC) or the UN Model Double Taxation Convention (UN MTC). The OECD MTC is primarily drafted to

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[5] Yariv Brauner, 'Taxing the Digital Economy Post-BEPS' (2017) 16 FJIL 2, 8.
[6] Jinyan Li, 'Protecting the Tax Base in the Digital Economy' (2018) 72 Bull Intl Taxn 4, 201.
[7] Vodafone International Holdings BV v Union of India (2012) 6 SCC 613 (SC).
[8] Formula One World Championship Ltd v Commissioner of Income Tax (2017) 394 ITR 80 (SC).
[9] Reuven S Avi-Yonah, 'International Tax as International Law' (2007) 57 Tax L Rev 483, 486.

reflect the interests of developed, capital-exporting states in residence-based taxation[10]. While the UN MTC is fundamentally based on similar principles to the OECD MTC, it leans towards diluting residence-based taxation in favour of source-based taxation, thereby, affording more advantages to states that are developing countries[11]. During negotiations, regardless of which model is being used, both models relied on the simplicity of the notion of permanent establishment (PE), which is primarily a physical presence-based test. The digital economy creates significant problems to determine how value can be created when there are no tangible assets or employees based in the source state. Because of this reliance on physical presence, these model tax conventions are outdated.

The OECD acknowledged the ineffectiveness of dealing with taxation in the digital economy when it launched the Base Erosion and Profit Shifting (BEPS) Action Plan in 2013[12]. The BEPS Action Plan was in response to aggressive tax avoidance strategies that exploited different domestic tax rules and different domestic tax rules and treaties. The 1st Action of BEPS directly confronted addressing the challenges brought about by the digital economy. However, instead of endorsing a single uniform answer, it offered three options: the introduction of an equalisation levy, the existing significant economic presence (SEP) test from Pillar 1, and some form of withholding tax on certain digital transactions. There was not global agreement on any of these three options, largely due to divisions between developed and developing states. The Multilateral Instrument (MLI), which was adopted in 2017, and which represented a new way to amend thousands of treaties at the same time to reduce treaty abuse, did not fundamentally re-conceptualise nexus as it exists for digital transactions[13]. Therefore, although there have been some small advances, the still-existing reliance on physical presence or nexus remains one of the weaknesses of the international tax regime.

GLOBAL RESPONSES: OECD, UN, AND STATE MEASURES

The OECD/G20 Inclusive Framework has taken the most ambitious response, known as the Two-Pillar Solution, which was announced in 2021[14]. Pillar One re-allocates a portion of

[10] OECD, Model Tax Convention on Income and on Capital (n 2) Commentary to Art 1.
[11] United Nations, United Nations Model Double Taxation Convention between Developed and Developing Countries (2017) Preface.
[12] OECD, Action Plan on Base Erosion and Profit Shifting (OECD Publishing 2013) 13.
[13] OECD, Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (2017) OECD Doc No. C(2017)119.
[14] OECD, Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy (OECD Publishing, 8 October 2021).

residual profit of the largest Multinational Enterprises to market jurisdictions without regard to physical presence. Pillar Two creates a minimum corporate tax rate of 15% across the globe to discourage profit shifting to low tax jurisdictions[15]. While this Framework represents innovation, it is limited in nature. Pillar One is limited to enterprises with gross receipts globally of more than EUR 20 billion and a profit rate of over 10%, which would exclude a significant number of digital businesses altogether. Additionally, it is so complex that it creates challenges for compliance in developing countries.

The United Nations Committeee of Experts on International Cooperation in Tax Matters has taken a different approach. In 2021, the Committee proposed an Article 12B which focused on automated digital services[16]. Article 12B would allow source jurisdictions to apply a withholding tax on the revenues from digital services. India and other developing countries endorsed Article 12B as a simpler and fairer alternative to the OECD reallocation formula. Article 12B did not gain sufficient traction in part due to opposition from developed jurisdictions.

Unilateral measures continue to proliferate. Examples include the European Union considering a revenue based Digital Services Tax (DST) of 3% based on revenue generated from targeted advertising and online platforms[17]. In addition, developed countries made political objections to the DST stating that, it discriminated against American technology companies. Domestically, the United States introduced mechanisms such as the Global Intangible Low Taxed Income (GILTI) and the Base Erosion and Anti-Abuse Tax (BEAT) through the 2017 Tax Cuts and Jobs Act[18]. While these measures protect U.S. revenues, they do little to facilitate fairer international allocation.

THE INDIAN PERSPECTIVE

India has taken a leading role in the issue of digital taxation. The 2016 Equalisation Levy imposed a 6 per cent levy on payments for online advertising made to non-resident companies[19]. This was broadened in 2020 through Equalisation Levy 2.0, which imposed a 2

[15] OECD, Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two) (OECD Publishing 2021).
[16] UN Tax Committee, Article 12B: Proposal for Taxation of Income from Automated Digital Services (2021).
[17] European Commission, Proposal for a Council Directive on the Common System of a Digital Services Tax COM(2018) 148 final.
[18] US, Tax Cuts and Jobs Act 2017 Pub L No 115-97, 131 Stat 2054.
[19] Finance Act 2016, s 163–180.

per cent tax on consideration received by non-resident e-commerce operators for supplies or services provided to Indian customers[20]. SEPs were introduced by way of the amendments made on the Finance Act 2018 and amended in 2020 to expand the definition of "business connection" to include a digital presence[21]. SEP thresholds were framed in relation to revenue and user engagement though it is still uncertain how these thresholds would be implemented in practice. Many judicial decisions have given more clarity to these provisions too. In Google India Pvt. Ltd. V. Commissioner of Income Tax (2019), the Karnataka High Court held that the payments made for online advertising were taxable as "royalty"[22].Though controversial, this decision signified the willingness of the judiciary to reinterpret existing classifications and categories on this issue based on a digital context and reality.

There have been disputes with this new regime. The USTR categorised India's equalisation levy as discriminatory which caused diplomatic angst[23]. Nevertheless, it is clear given revenue potential of these tax measures, India would continue to assert source-based taxing rights while positioning itself as a leading voice among developing countries in global tax negotiations.

CRITICAL AND JUSTICE-ORIENTED ENGAGEMENT

The discussion surrounding digital taxation is more than a discussion of legal doctrine or a narrow technical definition of nexus; it is fundamentally about distributive justice. The allocation of taxing rights determines how the benefits of globalisation and digitalisation are shared among states[24]. Developed countries, that host the majority of digital multinationals like Google, Amazon, and Meta, have historically accepted residence-based taxation ('i.e., the right to tax profits where a corporation is legally domiciled) as part of the international taxonomy, hence their fiscal interests. In contrast, developing countries where user markets share commonalities and where the value is increasingly created through consumer participation, generally contest this narrative and advocate for more robust source-based taxation rights. The friction between these two taxation operates reflects a more profound structural inequality in the global governance of taxation, where historically governance has constructed rules to

[20] Finance Act 2020, s 165A.
[21] Finance Act 2018, s 9(1)(i) Income-tax Act 1961 (as amended).
[22] Google India Pvt Ltd v Commissioner of Income Tax (2019) 414 ITR 318 (Karn HC).
[23] Office of the US Trade Representative, Section 301 Investigation Report on India's Digital Services Tax (January 2021).
[24] Tsilly Dagan, International Tax Policy: Between Competition and Cooperation (CUP 2018) 67.

favour the Global North.

For developing countries, the implications of ineffective taxation rules cannot be understated[25]. Without effective digital taxation regimes, the escape of wealth from market jurisdictions results in massive leakages of much-needed revenue to their fiscal revenues. In the case of developing countries, losing this type of revenue undermines their fiscal capacity to fund as share — scheme for welfare; and public services like education and public healthcare. The social and societal impact of this situation is exacerbated for women and marginalised communities, as these groups more heavily rely on no-fee, publicly funded services. Therefore, failing to obtain value in the digital economy not only increases fiscal deficits but also worsens social inequality; hence, global tax reform is an alignment of justice and efficiency.

The OECD's Two-Pillar Solution is trying to address these inequalities by reallocating some taxing rights under Pillar One and limiting profit shifting through Pillar Two. Nevertheless, its narrow application scope and complexity could lock in the control of developed states while allowing developing countries closer to limited revenue gains. Without the application of fairer approaches, like the United Nations', and their Article 12B proposal for withholding taxes on automated digital services, any global tax reform could continue to be asymmetric and entrench inequality in the digital age.

COMPARATIVE AND CONTEMPORARY INSIGHTS

The international approach to taxing the digital economy has been inconsistent and disjointed, representing the competing priorities of developed and developing countries. The adoption of digital business models at such a rapid pace has created a fundamental conflict in the international tax law, as developed countries – home to digital multinationals – prefer residence-based taxation to protect their domestic multinationals. Moreover, developing nations are demanding source-based taxation to access the revenue from expanding user markets. In the absence of agreement, multiple institutional, regional and unilateral solutions have been adopted. The OECD, United Nations, European Union, United States, and countries such as India all have different solutions. Collectively, they demonstrate the ingenuity and

[25] Sol Picciotto, 'Problems of Transfer Pricing and Corporate Taxation in the Digital Economy' (2018) 4 ICTD WP 1, 15.

ineffectiveness of the current laws and illustrate the need for global cooperation.

In 2021, the OECD/G20 Inclusive Framework announced a Two-Pillar Solution to international tax that represented the most groundbreaking attempt to modernize the international tax regime[26]. Pillar One proposes to allocate a portion of the residual profit of the largest multinational enterprises to the market jurisdiction of the business and would do so regardless of physical presence in a social medium. It is a monumental shift from the reliance on permanent establishment (which could be said to be an anachronistic due to the digital age), relying on the notion of tangible presence in the jurisdiction. However, the scope of Pillar One is very narrow. It applies only to companies with global turnover exceeding EUR 20 billion and profitability of more than ten per cent, which means many profitable but relatively smaller digital companies will be excluded. The re-allocation formula is complex, and would require significant administrative and technical capacity that many developing countries do not have. Pillar Two introduces a global minimum corporate tax rate of 15 per cent with the stated goals of fighting transfer mispricing to low-tax jurisdictions. While this proposal addresses the issue of tax havens, its benefits are predominantly for developed residence jurisdictions, and there are few benefits to expanding source-based rights for market states like India. The OECD model is therefore an advancement, but it does not overcome structural problems.

The United Nations Committeee of Experts on International Cooperation in Tax Matters has however made progress with a relatively simple and more equitable proposal[27]. In 2021, it adopted Article 12B into its model convention, that allows for source jurisdictions to impose withholding tax on income from automated digital services. This is a simple proposal, that is administratively simple and meets the needs of developing countries relying largely on corporate tax revenue. Countries like India and Nigeria have been strong supporters of this proposal because they see it as a way for them to capture revenues generated from taxing electronic transactions and to secure sustainable revenues going forward. By comparison, OECD countries have resisted this idea because they are concerned that the proposal would negatively affect their resident multinationals. The difference between the OECD and UN positions highlights a more general structural divide in global governance, where the OECD

[26] OECD, Two-Pillar Solution Statement (n 14).
[27] UN, Model Double Taxation Convention (n 11) Art 12B (2021 update).

seeks to manage stability and the interests of developed countries, while the UN governance trajectory aims to advance notions of equity and distributive justice for the Global South.

To date, regional initiatives have also emerged. Most notably, the European Union Digital Services Tax (DST)[28]. The critical distinction between the DST and the OECD residential taxes is that the EU initially considered a three per cent tax imposed on revenue made from targeted advertising, selling goods and services through online marketplaces, and monetising users' data. Unlike the OECD-based calculation of profit, the DST tax is based on gross revenue, which is a much better reflection of the levels of revenue generated by companies carrying out business in digital formats, especially since profit can be easily transferred out of the jurisdiction. The DST proposal faced swift opposition from the United States contending that it directly targeted US based tech giants—like Google, Apple, and Amazon. The Trump administration even went so far as to threaten tariff retaliation on EU exports, forcing the EU to reconsider any timeline for implementing a DST. The EU experience demonstrates the promise of regional innovation, but also the risk of worsening trade disputes when unilateral or regional actions take the place of coordinated multilateral frameworks.

The United States has largely opted out of multilateral solutions and settled instead for unilateral domestic reforms. The Tax Cuts and Jobs Act 2017 instituted mechanisms like Global Intangible Low Taxed Income (GILTI) and the Base Erosion and Anti-Abuse Tax (BEAT)[29]. GILTI tacks U.S. taxes onto the intangible income of controlled foreign corporations, even if that income is earned outside the U.S. BEAT imposes taxes on deductible payments made to foreign related parties, preventing the erosion of the U.S. tax base. The intent of these measures is to preserve American revenues and deter multinationals from the U.S. shifting profits out of the U.S. However, these reforms accomplish nothing at all towards improving the fair global allocation of taxing rights. They are acts of unilateralism disguised as domestic reform, evidencing the challenges of coming to a global consensus when powerful states favour national interests over collective solutions.

In the case of India, we see a somewhat different type of assertive unilateralism. Through the Equalisation Levy that was first introduced in 2016 and enshrined into legislation in 2020, and the Significant Economic Presence (SEP) rule, India was able to tax digital transactions that

[28] European Commission, Proposal on Digital Services Tax (n 17).
[29] US, Tax Cuts and Jobs Act 2017 (n 18) s 14201–14222.

involved Indian users, in the absence of physical presence[30]. While these initiatives have generated valuable revenue and enhanced India's position in negotiations at the multilateral level, they have also caused considerable controversy. The United States has called India's charge "discriminatory" and has threatened retaliatory tariffs. Also, there is still a risk of double taxation in situations where unilateral measures intersect already-existing treaty provisions. Thus, India's experience underscores both the imperative to protect tax bases in the digital era, and the risks of taking unilateral measures outside a harmonized international framework.

When synthesized, these comparative experiences illustrate three contemporary patterns. First, developed states, and thus OECD members, are opting for incremental reforms which suit their existing system, even though a large segment of digital revenues is not captured. Second, developing countries, backed by the UN and/or unilateral measures, are seeking more comprehensive reforms to maintain their source-based rights. Third, even if regional and unilateral experiments are novel, their continued use can undermine the international tax system and could lead to trade disputes. The contemporary landscape is one of pluralism without harmony. Competing versions of models can co-exist OECD's Two-Pillar Solution, UN's Article 12B, EU's DST, US domestic measures, and unilateral levies in India are all tensions with one another. This plurality provokes a level of uncertainty and unpredictability that is foundational to international tax law. For taxpayers, it increases compliance costs and the risk of double taxation. For states, it creates the possibility of trade wars and diplomatic friction. Ultimately, the comparative picture underscores the inadequacy of the current regime: without a unified, equitable, and consensus-based framework, digital economy taxation will remain unstable, fragmented, and deeply inequitable.

CONCLUSION

The landscape of international taxation has been evolving while not adapting to the realities of the digital economy. We have moved from a reliance on having a physical presence with the permanent establishment / taxable presence test that is now outdated. To be fair the OECD's BEPS project and the Multilateral Instrument (MLI) closed some loopholes but did nothing to resolve the inherent structural flaws of digital taxation. The OECD/G20 Two-Pillar Solution is no better, progress was made, but it is overly complicated and exclusive; in the guise of multilateralism. Unilateral anti-avoidance tax laws, like India's Equalisation Levy, show the

[30] Finance Act 2016 and Finance Act 2020 (n 19, n 20).

potential and risks of responding unilaterally, but they are also indicative of how nations can challenge the global consensus around international taxation.

In order for the international taxation laws to be enough for the digital age of economy, there needs to be a reform paradigm that is equitable, simple, and inclusive. Equity, simplicity, and inclusion means expanding Pillar One into all forms of taxation and introducing a UN Article 12B based taxing regime. There needs to be clarification of nexus rules for significant economic presence and we need to separate corporate taxation outcomes away from the political economy and corruption, to ensure that developing country concerns are put first and not hidden behind the dialogue of global negotiations. The International tax framework will continue to remain inadequate and biased if reform does not follow the path of equity, simplicity, and inclusion. Inevitably, we would further entrench injustice as the taxation of developing countries worsens, and we further propagate the structural imbalance in the allocation of tax revenues within a digital global economy.

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