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Digital Taxation- A Virtual Reality

By: Rachana Khandelwal, MST

Digitalization has brought revolutionary changes in the way businesses operate. It has created opportunities to reshape the existing business models through the use of technology, allowing businesses to establish a virtual presence on a global platform. Corporate giants such as Google, Apple, Facebook and Amazon (referred as GAFAM) operate globally without the need for significant physical resources. Their operations are essentially driven by intangibles, data, users, user created content, sophisticated algorithms and data analytics. For example, consumers no longer need to buy a DVD to watch a movie; they can digitally rent/buy the movie using digital services.

The exponential growth in digital commerce has challenged the current international tax framework, which is primarily based on the concept of a fixed place of business. These tax laws have become unsuitable and inadequate for the dynamic business models of the digital era.

Under Article 7 of the Organization for Economic Co-operation and Development (OECD) Model, a company conducting operations in a non-resident country is liable to tax only if it has a permanent establishment (PE) in that country.¹ Further, a PE is defined as a fixed place of business through which business operations are conducted wholly or partially.² There are other aspects to consider the taxing rights, however it largely means a right to tax the profits of a corporation in a non-resident country is created only if it has a PE conducting business operations.

Digitalization allows corporations to remotely participate in the economic activities of a country such as online retailing, advertising, gathering data, interacting with users without having any tangible assets in that country. The profits of such corporations go untaxed resulting in revenue loss to the Exchequer.

The European Commission indicated in its March 2018 report that on an average digital companies such as Google, Apple, Facebook, Amazon and Microsoft pay effective tax rate of 9.5% as compared to 23.2% paid by traditional businesses.³ The tax paid by Alphabet Inc. (Google) as a share of their revenues outside the EU is between 6% and 9%, whereas in the EU

¹ OECD, Articles of the Model Convention with Respect to Taxes on Income and on Capital, November 2017 available at <https://www.oecd.org/ctp/treaties/articles-model-tax-convention-2017.pdf>.

² Ibid. Article 5.

³ European Commission, Questions and Answers on a Fair and Efficient Tax System in the EU for the Digital Single Market, 2018 available at https://ec.europa.eu/commission/presscorner/detail/en/MEMO_18_2141.

this ratio is only 0.36% to 0.82%.⁴ This is primarily due to the three distinct attributes of highly digitalized business model identified by the OECD⁵ coupled with a clever tax planning structure.

Attributes of Highly Digitalized Business Models

i) Scale without Mass

Digitalization allows corporations to reach out to international customers across different countries without establishing a physical presence in these countries. In addition, digital corporations have spread their business operations across different taxable jurisdictions for desirable tax benefits, thus reducing their overall effective tax liability and maximizing profits. For example, a corporation involved in selling digital subscription services headquartered in the Cayman Islands catering to customers in the UK, can have R&D operations in the United States and a sales division in Luxembourg.

ii) Reliance on Intangible Assets

Intangible assets play a substantial role in a digitized business model. Sophisticated algorithms, software, copyrights, brand, patents, trademarks are critical components. Intangibles are mobile assets, which can be easily set-up in a low/no tax jurisdiction while providing services in a high tax jurisdiction. Using remote technologies, businesses manage, control and use intangibles located outside a tax jurisdiction. For example, a digital content streaming provider having customers in Asia can have IP rights and servers located in Ireland.

iii) Data and User Participation

Users contribute content and data to digital companies in the form of surveys, search history, sharing or liking a page on multi-sided digital platforms. Multisided platforms such as Facebook offers free service/product to users in exchange for their personal information. This user-data is collected and analyzed to improve, research or develop new products or services, thus creating an economic value to the company. Furthermore, the data collected is monetized by selling it for targeted online advertisements.

Broader Tax Challenges in Digital Economy

⁴ Paul Tang & Henri Bussink, PvdA Europa, EU Tax Revenue Loss from Google and Facebook, 2017

<https://paultang.nl/wp-content/uploads/2018/03/EU-Tax-Revenue-Loss-from-Google-and-Facebook-2.pdf>.

⁵ OECD, Tax Challenges Arising from Digitalization – Interim Report 2018, pp 51-57, available at <http://www.oecd.org/ctp/tax-challenges-arising-from-digitalisation-interim-report-9789264293083>.

The key challenges posed due to the above-mentioned attributes of digitalization are nexus and value creation.⁶

Nexus (Where to Tax?)

The current cross-border tax rules broadly indicate that a right to tax arises based on the location of a business establishment. In the digital era, buying and selling of goods/services takes place online through intermediating platforms, which requires little to no physical presence in the country of operation. For example, a buyer from the US is able to buy a cell phone case from Alibaba, an online marketplace established in China directing its delivery to India.

The economic presence of digitalized business models has shifted the underlying principle of taxation i.e from taxing the source country where the corporations are located to taxing the destination country where the user resides.

Value Creation (What to Tax?)

Intangibles, digital infrastructure and technology allows businesses to access a wide range of user data across the globe seamlessly. User participation in digitalized businesses such as social media platforms is an important aspect of data collection and value creation. The data sourced from users becomes a business input resulting into profits for the corporation. For example, a business collects a wide range of information from the users in the UK through the search engine it offers. This information is analyzed and sold to advertising companies, while the advertising contracts are signed, and payments are made to its subsidiary located in a low-tax jurisdiction such as Ireland. In this case, the value is created in the UK, however the profits are taxed at a significantly lower rate in Ireland. In such cases, the tax jurisdiction of the data collected through user participation is difficult to determine.⁷

Taxing the Digital Economy

The OECD's Task Force on the Digital Economy (TFDE) analyzed the concerns and considered a few options such as "alternatives to the existing permanent establishment (PE) threshold based on a "significant economic presence", the imposition of a new withholding tax on certain types of digital transactions, and the introduction of a separate "equalisation levy".⁸

⁶European Commission, A Fair and Efficient Tax System in the European Union for the Digital Single Market, 2017 available at https://ec.europa.eu/taxation_customs/sites/taxation/files/communication_taxation_digital_single_market_en.pdf.

⁷ Ibid.

⁸ OECD, Tax Challenges Arising from Digitalisation– Interim Report 2018, available at <https://www.oecd-ilibrary.org/docserver/9789264293083-en.pdf?expires=1576022433&id=id&accname=guest&checksum=7CC657D807D4870DEF42947C22AD6FE8>.

Significant Economic Presence intends to establish a nexus wherein corporations have digital taxable presence remotely through network, data, user participation and online commercial activities. At the EU level, significant digital presence is determined using quantitative thresholds such as annual revenue, number of users and business contracts signed for digital services.

Withholding Tax is a tax at source for payments on digital products and services, where the services are provided. This is being done by broadening the definition of passive income such as royalties, fees for technical services by including payment for certain digital products and services.

Equalization Levy is a tax on gross value of payments made for digital services. It is calculated based on the revenue of a corporation than its profits. It aims at the destination of supply of digital products/services. This levy is applicable to both residents and non-residents suppliers, thus creating a level playing field in the economy.

European Union (EU)- Digital Services Tax (DST)

The EU proposed a digital services tax of 3% on certain taxable services provided by multinational corporations. Taxable Services includes i) digital advertising targeted at users, ii) Multi-sided digital interfaces to users referred to as “intermediation services”, which allows users to find other users and interact with them and the transmission of data collected about users and generated from such users’ activities on digital interfaces.⁹

The interim proposal states that DST would only apply to companies with total annual worldwide revenues of more than €750 million and EU revenues of more than €50 million.

Unilateral Measures

While the EU, the OECD & the G20 countries are working on a multilateral solution for digital taxation, some countries have taken unilateral steps to tax the digital economy. Countries which have implemented/announced the digital services tax include¹⁰-

⁹ European Commission, Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services, March 2018 available at https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_common_system_digital_services_tax_2_1032018_en.pdf.

¹⁰ Elka Asen, Tax Foundation, Announced, Proposed, and Implemented Digital Services Taxes in Europe, October 2019 available at <https://taxfoundation.org/digital-taxes-europe-2019/>.

Country	Tax	Tax %	Scope
Austria* (with effect from January 2020)	Online Advertisement Tax	5 %	Online Advertisement.
France*	GAFA Tax (named after Google, Apple Facebook & Amazon)	2%	Digital interface services and targeted advertising services.
Hungary*	Advertisement Tax	7.5%	Advertisement Revenue.
India	Equalization Levy	6%	Withholding tax on payments for online advertising. ¹¹
Italy* (with effect from January 2020)	Web Tax	3%	Digital interface of advertising targeted at users, transmission of user generated data, Multi sided business model allowing exchange of goods or services.

*EU Countries

Conclusion

Governments and organizations such as the OECD and the European Union are striving hard to achieve a symmetry between the revenue generated and taxes paid by making necessary changes to the existing international tax laws, and by closing tax loopholes. The expansion of the digital economy has allowed corporates to explore global tax systems, thus creating a

¹¹ Tax Insights from International Tax Services, PWC, India introduces new equalization levy on online advertising revenue, June 2016 available at <https://www.pwc.com/us/en/services/tax/library/insights/india-introduces-new-equalization-levy-on-online-advertising-rev.html>.

mismatch between revenue and the actual taxes paid. The unilateral measures adopted by countries to establish a fair and square tax system by targeting highly profitable digital companies have certain advantages such as neutrality and competitiveness. However, it also raises compliance issues, possibility of tax avoidance and inefficiencies. This is particularly true in the case of the equalization levy. In case of taxes based on turnover such as levied by France, the threshold of revenue is high, which is at the center of political debate and is believed to be specifically targeted towards the US corporate giants such as GAFA.¹²

Another debatable issue is the value creation aspect of digital economy. The OECD and the US have taken the position that user-created value is not just exclusive to digital companies. Traditional corporations such as healthcare industry also depend on user-generated inputs to develop products. However, the EU thinks otherwise and wants to exercise taxing rights based on the value derived from the users in the EU.¹³ The OECD and the G20 countries are attempting to reach a consensus based holistic solution by the year 2020. This is an exciting time for the world of taxation as digital economy evolves and reforms the existing international tax code.

¹² Office of the United States Trade Representative, Report on France's Digital Services Tax Prepared in the Investigation under Section 301 of the Trade Act of 1974, December 2019, available at

https://ustr.gov/sites/default/files/Report_On_France%27s_Digital_Services_Tax.pdf.

¹³ European Commission, A Fair and Efficient Tax System in the European Union for the Digital Single Market, 2017 available at

https://ec.europa.eu/taxation_customs/sites/taxation/files/communication_taxation_digital_single_market_en.pdf.