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Addressing Tax Challenges of Digitalization

Exploring multilateralism as the way ahead for India

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By **Gouri Puri**, Partner, Shardul Amarchand Mangaldas & Co.
and **Kinshuk Jha**, Associate Professor and Executive Director,
Centre for Comparative & International Taxation, Jindal Global Law School

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Mr. Ameya Kunte (Founder, Globeview Advisors LLP)
Dr. Benard Schneider (Senior Lecturer in International Tax Law, Queen Mary University of London)
Dr. Dhruv Janssen-Sangahvi (Co-Head International Tax & International Tax Litigation, Nishith Desai Associates)
Ms. Mansi Kedia (Research Fellow, Indian Council for International Economy Relation)
Mr. Meyya Nagappan (Leader, Digital Tax and Social Finance, Nishith Desai Associates)
Mr. Mukesh Butani (Managing Partner, BMR Legal Advocates)
Dr. Nigam Nuggehalli, (Registrar, National Law School of India University Bengaluru)
Mr. Rohinton Sidhwa (Partner, Deloitte Haskins & Sells)
Mr. Subhomoy Bhattacharjee (Adjunct Faculty, Jindal School of Journalism and Communication & Consulting Editor, Business Standard)
Dr. Vikram Chand (Professor of Law, Tax Policy Center, University of Lausanne)

About the authors

Gouri Puri, Partner, Shardul Amarchand Mangaldas & Co.

Gouri Puri is a Partner in the tax practice at Shardul Amarchand Mangaldas & Co. Gouri works closely on international tax planning matters and digital taxation. She has over ten years' experience advising prominent multinationals on tax aspects of mergers and acquisitions, investment structures, establishment of funds, private capital arrangements and corporate restructurings. Gouri is actively involved in various thought leadership initiatives and policy advocacy through her collaboration with industry chambers, business and legal media.

Gouri holds a master's degree in taxation laws from Harvard Law School, where she was the Dean's Scholar for the Seminar on Current Issues in Tax Law, Policy and Practice. Gouri is admitted to the New York State Bar and Bar Council of India.

Kinshuk Jha, Associate Professor and Executive Director, Centre for Comparative & International Taxation, Jindal Global Law School

Kinshuk Jha is an Associate Professor and Executive Director, Centre for Comparative and International Taxation (CCIT), Jindal Global Law School (JGLS). He pursued his LLM in Europe between 2009-11, with a full scholarship from the European Commission. He then practiced for a couple of years dealing with Transfer Pricing and International Taxation matters in Pune. Since 2013, he has been teaching domestic and international taxation to both, undergraduate and postgraduate, students at JGLS. He has been involved in several academic projects, ranging from innovations at the level of higher secondary education in India, where he co-authored the first Legal Studies textbook for CBSE, to being part of an expert panel at the recent USTR Section 301 investigations of India's Digital Services Tax. His work focuses on taxpayer rights, anti-abuse provisions and digital taxation. He has recently published a book 'Taxpayer Rights: Deciphering the Indian Charter', with Mr. Mukesh Butani.

Research Team

Rahul Yadav, Principal Associate, Shardul Amarchand Mangaldas & Co.
Kriti Chawla, Assistant Professor, Jindal Global Law School
Ritesh Bajaj, Assistant Lecturer, Jindal Global Law School

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Introduction

India (and the world) is at an important crossroads for determining the future for addressing tax challenges of digitalization. In the last year, three key paths have emerged. First, is Organization for Economic Co-operation and Development's ("**OECD**") multilateral solution, which was recently backed by 134 countries (including India) that looks to reallocate taxing rights to market jurisdictions for highly profitable multinational enterprises ("**MNEs**") (with the package deal of a global minimum tax). OECD's fine print on the implementation plan is expected in October, 2021. Second, there is a digital services tax ("**DST**") (equalization levy), a domestic tax law measure, that has been implemented by several countries pending international consensus. These taxes have been the subject matter of debate under the Office of the United States Trade Representative ("**USTR**") investigations and have led to US imposing trade sanctions on several countries (including India). Finally, there is United Nation's ("**UN**") Article 12B that recommends a withholding tax on gross basis for just automated digital services ("**ADS**"). The UN proposal is primarily a bilateral solution, which is limited in scope and has implementation related challenges.

Over the years, India has emerged as a key voice in the international tax debate, spearheading developing countries' source and market based taxation rights (examples include India's source rules for taxation of indirect transfers and expansion of withholding taxes to fee for technical services under India's tax treaty network). Through its participation in the G20 and OECD's Base Erosion and Profit Shifting ("**BEPS**") initiative, India has committed to a multilateral approach for securing a fairer, stable and non-discriminatory international tax policy regime for developing nations. In its Press Release of July 1, 2021, the Ministry of Finance, Government of India, stated that India was in favour of a consensus based solution, provided it is simple to implement and allocates meaningful revenues to market jurisdictions.

In this context, much has been written about the niceties of OECD's Pillar One and its overall impact on Indian revenues, which is indeed at the heart of this debate. However, there have been few deliberations around other political, economic and strategic considerations that India needs to pragmatically weigh in and balance as she decides which path to choose. These factors are also important considering India occupies a unique position in this international tax debate as an emerging economy that sits somewhere in between the small developing nations and the developed countries. As India agrees to walk the line, this paper evaluates the multilateral consensus-based approach in light of such political, economic and strategic considerations.

Benefits of a multilateral approach for businesses and its impact on Indian policymaking

OECD's July 1st "Statement on a Two-Pillar Solution to Address the Tax Challenges arising from the Digitalization of the Economy" implicitly recounts the benefits that the multilateral approach has for businesses. [2]

First, a multilateral approach would effectively eliminate multiple taxation for businesses. This has been a key concern with respect to DSTs where different countries are competing to tax the same revenues, without any corresponding mechanism in place to alleviate the impact of multiple taxation. Therefore, DSTs, being an increased cost of doing business, ultimately impact the purchasers of taxable goods and services and possibly downstream consumers.[3] DSTs may increase prices in affected markets, decrease quantity supplied, and reduce investment in these sectors.[4]

Second, OECD's multilateral approach taxes corporate profits and not revenues. This will allow businesses to deduct their costs on research and development, intellectual property, infrastructure, employees, marketing, etc., and pay taxes on their true profits. In comparison, a gross basis tax on revenues (which is the mainstay of DSTs and UN's Article 12B proposal) could yield high or double taxation outcomes inconsistent with a businesses' profitability and penalize start-ups and small companies[5]. This in turn is likely to dis-incentivize innovation and cross-border flows to markets that follow gross basis taxation. Further, any disproportionate increase in business costs because of gross based taxation, may result in businesses' shifting such costs onto consumers.

Third, the multilateral approach offers a common tax framework and streamlined compliances through a uniform set of standards. Grappling with varied rules and compliances under disjointed DSTs (and even bilateral taxes in case UN's Article 12B were to be implemented) will add significantly to compliance costs of businesses. Businesses (that deal in billions of online transactions) will need to re-position and re-engineer internal processes and their financial reporting approaches across multitude of non-uniform DSTs and bilaterally negotiated taxes. This has been aptly described as a deadweight loss created because of a non-uniform approach[6].

Fourth, OECD's multilateral approach will lend tax certainty to businesses through a "common dispute prevention and resolution mechanism, which will avoid double taxation for Amount A, including all issues related to Amount A (e.g., transfer pricing and business profits disputes), in a mandatory and binding manner".[7]

This offers businesses more certainty than litigating DST disputes under different domestic rules and administrative procedures. Moreover, the existing dispute resolution mechanism (mutual agreement procedure) under the bilateral tax treaty framework is already unable to cope with growing international tax disputes and offer businesses and governments tax certainty.[8]

The benefits that businesses will reap from a multilateral approach and by avoiding the inefficiencies and costs of DSTs (and even bilaterally imposed taxes) will facilitate cross border flow of investment, goods and services, which is ultimately the aim of an international tax system.

More particularly, from India's standpoint, the benefits that businesses will gain from a multilateral solution are relevant to its policymaking for reasons discussed below.

Tax certainty, cross border investment and impact on Indian economy

India recently withdrew 2012's retrospective amendments relating to taxation of capital gains arising from in- direct transfers. Admittedly, such taxes were withdrawn to restore foreign investors' confidence in the fairness and certainty of India's tax regime. Few would dispute the fact that tax certainty is key to attract foreign direct investment inflows.[9] Tax policy should be investor and business friendly, induce trust, promote fair competition and innovation and minimize financial risk and uncertainty. In the context of withdrawal of the 2012 retroactive amendments, Revenue Secretary, Mr. Tarun Bajaj recently commented, "*Investors were cautious of coming into India and this decision does help us to actually clarify on that provision to the investor community .... For a sovereign which has a budget of more than INR 30 lakh crores, an amount of INR 5000-10,000 crores is not that important. What is important is your commitment, what is important your word.*"[10]

Sarralde, Hadelwang, Hentze and *Monkam*[11] note that domestic and foreign investments are affected by frequent changes in tax legislation and inconsistent and sometimes coercive implementation practices in tax administrations have negative repercussions on investment risk assessments and investment financing and therefore economic growth. From an investor's perspective, reliable and stable tax policies and a predictable behaviour of tax administrations are important factors for doing business in a country. Thus, tax certainty is crucial to stimulate economic growth and job opportunities.

International cooperation can contribute to strengthening tax certainty. To this end, (amongst other things) they recommend aligning domestic rules and practices with international standards and bilateral treaties as a key measure to increase simplicity and transparency for both MNEs and governments.[12] In this light, India's commitment to the multilateral solution will help in promoting tax certainty in India as follows.

First, India's commitment to a multilateral solution will *signal to foreign investors* India's willingness to adopt internationally agreed standards that foster tax certainty for businesses and, increase the predictability and stability of its tax system.

Second, following a uniform tax system with streamlined compliances and common dispute resolution will bring more clarity and policy coherence in how India addresses tax challenges to digitalization

and implements these rules. In comparison, having several disjointed DSTs or bilaterally negotiated taxes that are implemented with no international cooperation can cause significant uncertainty for both MNEs and governments.

Third, India has off-late made several changes its domestic tax policy (such as rationalization of corporate tax rates) to improve its tax competiveness. While the Indian Government has made some commendable efforts to bring clarity and coherence in its international tax policy, multilateralism and international cooperation will facilitate in driving that change.

Impact on Indian small and medium businesses ("SMBs") and consumers

Given that EL is not creditable overseas and entails compliances costs, several players have passed on the increased cost of doing business to consumers.[13] Increase in prices of goods and services impact all consumers, including SMBs[14] and start-ups[15]. Central Board of Direct Taxes' ("**CBDT**") draft report on profit attribution to permanent establishments noted that, "*if a market jurisdiction is unable to collect tax from the non-resident suppliers, it would be forced to collect all the taxes required from the domestic taxpayers, which in turn would reduce the ability of consumers to pay, reduce their competitiveness, hurt economic growth and the aggregate demand, resulting in a vicious cycle, which will adversely affect all stakeholders including the foreign enterprises doing business therein*." A DST, which is not designed as an income tax, could create similar results for consumers and the Indian economy. Therefore, DSTs may not be an optimum solution in the long run when compared with a tax on business profits, which alleviates double taxation (as is proposed by Pillar One).

Impact on Indian start-ups and unicorns

India is emerging as a hot bed for home-grown tech start-ups. It is now also a producer and not just a consumer of technology. In just a span of few months, several Indian unicorns have announced initial public offerings. Mr. Amitabh Kant, CEO of NITI Aayog recently commented that digitization has provided an impetus

to the start-up ecosystem in India and IPOs will drive the country's start-up revolution.[16] Starts-ups are key for job creation, retention of skilled workforce, innovation and attracting foreign investment. Their growing importance for the Indian economy cannot be overemphasized.[17]

Many of these start-ups and unicorns are eyeing foreign markets and are building their global user base. Ed-tech giant Byju's is aiming to become one of the largest players in the space in the US, with a target to hit revenues of USD 1 billion in the next three years.[18] Similarly, Ola, Swiggy, Practo, Wittyfeed have all expanded their businesses to foreign markets in the last two years.[19] Moreover, Indian gaming companies are looking to penetrate foreign markets.[20] This is because while Indian markets bring users, they are tougher to monetize. Even smaller home-grown start-ups are trying to capture high paying markets like the US, UK, Canada, Singapore, Dubai, and Australia given that Indian market is already overcrowded.[21] Reportedly, for smaller start-ups entering foreign markets, that offer them higher prices, has become key to their survival. Similarly, there has been a recent growth in India's B2C e-commerce exports by medium and small enterprises.[22] Moreover, India's exports in the information technology sector have been very significant to the economy.[23]

Foreign DSTs could equally burden Indian medium and small enterprises and start-ups, which are foraying into foreign markets, with the same problems and stall their growth. India therefore has an interest in protecting its start-up and tech ecosystem that has a growing global user base from foreign DSTs. A multilateral solution will be key to stop the proliferations of DSTs globally. The tax policy that India frames today as an emerging economy will also impact her future as an exporter of digital goods and services and therefore, it is important to evaluate both sides of the coin.

India's international trade relations and the economy

Trade, taxes and investment are intricately linked. The world has a long history of tax driven trade disputes. [24] The proliferation of DSTs absent a multilateral consensus on addressing tax challenges of digitalization can trigger a global trade war.

In response to DSTs (and in some cases proposed DSTs), US launched USTR 301 investigations against France, India, Italy, Turkey, Austria, Spain, United Kingdom, Czech Republic, European Union and Indonesia[25]. Broadly, the mainstay of these investigations was that DST's were inconsistent with international tax norms, applied to revenues and not business profits, were discriminatory and unreasonably burdened US based companies.[26] As some of these investigations concluded, US imposed additional tariffs on certain goods from India, Austria, Spain Turkey, United Kingdom, and Italy[27]. US retaliatory tariffs would be up to 25 percent *ad valorem* on an aggregate level of trade, that would collect duties on goods of such countries, in the range of the amount of DST that such country is expected to collect from U.S. companies. Put simply, and in the context of India, USTR tariffs seek to counteract the estimated value of the DST payable by U.S.-based company groups to India, which it estimates as approximately USD 55 million per year[28]. At present, US has suspended these tariff actions as it remains "committed to reaching a consensus on international tax issues through the OECD and

G20 processes"[29]. USTR noted that the suspension is to provide time for the multilateral negotiations to continue to make progress while maintaining the option of imposing tariffs under Section 301 if warranted in the future.

Trade disputes are not a one-way street. If multilateral consensus does not materialize, US's trade sanctions are likely to be met by retaliatory measures from countries that are facing these sanctions. For instance, India had also responded to USTR Section 301 investigations last year.[30] To add to the possible issues, DSTs vary in their scope and application and there is a lack of symmetry. There is no reciprocity in DSTs. Even amongst countries that are levying DSTs, conflicts may arise if certain DSTs are seen as being excessive or overreaching in comparison to others. Several experts have predicted the inevitability of a trade war absent a multilateral consensus based approach[31]. Pascal Saint-Amans, Director of the OECD's Center for Tax Policy and Administration commented that "Absent a multilateral solution, there is a serious risk of unilateral measures being taken, and these measures may trigger sanctions or trade tensions."

A trade war can result in a sharp decline in bilateral trade, higher prices for consumers and trade diversion effects (increased imports from countries not directly involved in the trade war). It also compromises the stability of the economy and future growth.[32]

As an emerging economy, foreign trade and investment is key to India's sustained economic growth. According to the CII-EY survey on "FDI in India – Now, Next and Beyond, Reforms and Opportunities", "India can expect to attract USD 120 billion to USD 160 billion of FDI annually by 2025 if it manages to increase the FDI to GDP ratio between 3% to 4% range by 2025. This can aid in bringing back India's GDP growth rate to 7%-8% range."[33] The Indian economy (like the rest of the world) is recovering from a COVID-19 induced slowdown. In a recent article, Mr. Amitabh Kant from NITI Aayog stated that India's economy could only recover through international trade and a strong focus on exports. More specifically, he added that "strong and coordinated policy action, across all levels of governments, is needed to realize this opportunity. Fiscal space is constrained, so is private consumption and investment. Exports must be the cylinder on which growth is fired for the foreseeable future."[34]

In 2018-19, India had a trade surplus of USD 16.85 billion with US, which had emerged as its top trading partner.[35] Notably, India is also currently in the midst of trade negotiations with the US. An official from the Ministry of Commerce recently commented that digital taxes was one of the stumbling blocks during the trade negotiations between the two countries. He added that the success of a "global treaty" will pave way for fresh negotiations.[36] India's commitment to a multilateral solution may also facilitate India's ongoing trade deals with other allies, such as UK, US and EU.[37] On the other hand a trade war or a decline in international trade relations could be a major setback for businesses, investments flows and the Indian economy, which is eyeing a USD 1 trillion target for exports by 2025.[38] An efficient tax system should not distort macroeconomic outcomes.[39]

OECD's multilateral solution and India's strategic tax policy considerations

Alongside securing revenues, there are other key tax policy considerations at stake for India that may be more effectively addressed by a multilateral consensus through OECD led Two Pillar Solution.

Recognition of market jurisdictions' right to tax beyond digitalization

India occupies a strategic position in the world trade order, in view of its huge market. A billion plus populace and emergence of a large middle class has put India on the world trade map and with private consumption steadily growing over the last few decades, Indian markets have remained an attractive destination for cross- border supply of goods and services. In this light, India's policy stance for international tax reforms that allocate fair and equitable share of taxes to market jurisdictions transcends beyond digitalization, as discussed below.

CBDT's draft report on profit attribution to Permanent Establishments ("**PE**") ("**Report**")[40] advocates a shift from the FAR approach on the basis that FAR does not consider the contribution of demand side factors (and hence market jurisdictions) in the business profits of a foreign enterprise. Notably, CBDT's call for a change in the profit allocation methodology, that recognizes market jurisdictions' right to tax based on demand side factors, is not limited to digitalized businesses but applies to all foreign businesses.[41] Similarly, the expansive scope of the 2% equalization levy ("**EL**"), is not limited to ADS, but can possibly cover a wide range of online transactions in sale of goods or provision of services with the Indian consumer base. Even the tax base for EL taxes the gross merchandise value and not just the revenues of the intermediary in case of foreign suppliers. Similarly, India's 'significant economic presence test' (which was recently introduced under India's source rules to tax foreign enterprises that engage with the Indian market remotely) does not restrict its scope to ADS.[42] Therefore, India's policy to assert taxation rights as a market jurisdiction and to reform the existing international tax system is broad and more neutral.

The recognition of a market jurisdiction's right to tax across all foreign businesses and not just digitalized business is a massive shift in international tax policy norms, which is not possible absent a multilateral consensus. Countries with narrower DSTs may in due course raise concerns around the scope of India's EL as being expansive or overreaching. Even the policy rationale of European countries that have introduced limited DSTs may not be aligned with that of India. They are unlikely to agree to any bilateral arrangement that deviates from the FAR approach for non-digital businesses. OECD's Pillar One is a key first step that recognizes that profits of all businesses (as against just ADS or CFB[43]) should be re-allocated to market jurisdictions because of the contribution of demand side factors. In this light, Pillar One better sub serves India's tax policy agenda in the long run. DSTs will not be able to reposition the entire international tax framework for market economies that necessarily requires multilateral consensus. International cooperation and momentum are important to realize policy changes that require the buy in of other nations. For instance, OECD's BEPS project plausibly paved way for India to finally re-negotiate its tax treaties with Singapore and Mauritius. Accordingly, the multilateral solution goes much beyond addressing a fiscal problem. There is indeed value in building consensus and getting the principles that allocate a profit share to market jurisdictions inserted in the international tax system.

OECD offers a package deal for global minimum tax

OECD's multilateral solution comes with the package deal of a global minimum tax of 15 per cent and the subject to tax (STT) rule. STT has the potential to plug tax abuse by MNEs in India. Global minimum tax can also deter tax driven outbound investments[44] and migration of Indian start-ups to offshore jurisdictions, which is an important consideration for an emerging economy. In the past five years, India has in any case moved away from a tax incentive based income tax regime and has rationalized its corporate tax rates. This move will also reduce tax competition amongst nations as a means to attract investment. Tax Justice Network has estimated that India is losing more than USD 10 billion in revenues each year owing to global tax abuse.[45] The Tax Justice Network estimates that India will gain at least USD 4 billion from a global minimum tax.[46]

Administration and enforcement of EL

As discussed above, India's EL is wide in scope in comparison to several of its DST counterparts levied by other countries. It can potentially cover several online transactions in goods and services contracted with the Indian market. Moreover, EL applies to the gross merchandise value and not just revenues retained by foreign intermediaries (where foreign suppliers are involved). It also has a relatively low monetary threshold and covers a wide variety of foreign suppliers.

Currently, 2% EL primarily relies on self–reporting and disclosures by foreign enterprises (that may not have Indian presence) for administering and enforcing the levy. While identification of prominent players may be easy for checking compliances, there will be a host of foreign businesses that are possibly transacting with Indian consumers and come under the scanner of EL but go unnoticed. The integrity and equity of any tax is largely driven by its enforcement. In the world of cross-border transactions, multilateralism has become key to the enforcement and administration of taxes, as is evidenced by growing tax information exchange agreements, common reporting standards, tax recovery assistance provisions.[47] Therefore, enforcing 2% EL and following through on compliances without international cooperation may prove to be challenging. On the other hand, saddling Indian consumers with withholding tax or representative assessee like obligations may not be an effective and practicable solution to administration and enforcement concerns.

Concerns surrounding UN's Article 12B

UN's Article 12B looks to offer a simpler solution by allowing market jurisdictions to levy a withholding tax on the gross amount of ADS income. It also gives foreign enterprises the option to elect a net income approach to taxation under a pre-set formula. Considering that Article 12B is modelled on the taxation of passive incomes (such as royalties, interest, dividends, etc.) under the current tax treaty network, it certainly is more familiar in comparison to OECD's Pillar One approach. Moreover, the inclusion of routine profits in UN's net income approach has also found favour with developing countries.

From a practical standpoint, however, the UN approach's Achilles heel is that it relies on a bilateral approach to amend India's existing double tax avoidance agreements. The UN approach therefore seems impracticable absent the political will of India's key tax treaty partners to come on-board. Amending tax treaties with countries, which are not the key exporters of capital, goods and services to India will not yield any significant revenue for India nor will it address the present imbalance in the international tax system, which is a multilateral issue[48]. It is practically difficult to allocate taxing rights between competing market jurisdictions through a bilateral mechanism absent a global scientific basis to do so.

Moreover, some commentators have also questioned the purported benefits of the UN's approach for developing countries, as follows.[49]

First, the UN approach only taxes ADS and hence ring fences the digital economy. Digitalization implies that all businesses can, with or without the benefit of local physical operations, participate in an active and sustained manner in the economic life of any market jurisdiction. Hence, designing a global tax reform that is based on sector-specific definitions may not be a long term solution. A system that is more neutral in its foundational rules will best be able to accommodate evolving business models. In comparison, OECD's Pillar One approach covers a much broader tax base and recognizes market jurisdiction's right to tax business profits of all multinationals (subject to revenue thresholds) because of the contribution of demand side factors. In this sense, OECD's Pillar One approach recognizes market jurisdiction's right to tax and captures revenues more widely (this is more consistent with India's policy stance).

Second, UN's net income approach is currently underdeveloped and unclear in terms of the manner in which the profit allocation formula should be applied to the entity or group's business profits and the resolution of disputes emanating therefrom. It still has to address all the related problems like group financials, segmentation of in-scope business, and interaction of consolidated financial accounts with taxable profits, elimination of double taxation, dispute prevention and resolution, which the Inclusive Framework is currently grappling with.[50]

Third, the simplistic revenue sourcing rules under the UN proposal accord taxation rights to the source country where the payer of goods or services is resident. This would mean that in situations where a non-resident pays for an advertisement that is targeted to Indian users, India would not get any taxing rights (such situations are presently taxed under India's 2%

EL). On the other hand, Pillar One would recognize market jurisdiction's taxing rights under its detailed revenue sourcing rules.

Finally, the UN solution does seem simple when it comes to its implementation and enforcement. However, re- negotiating bilateral tax treaties on a non-uniform basis with several countries would be a long and cumbersome exercise. Moreover, given that Article 12B is limited in scope, there will always be concerns around the co- existence of DSTs alongside Article 12B, creating more tax uncertainty. Therefore, the simplicity that the UN solution offers may be outweighed by its challenges. In comparison, a multilateral solution will provide a normative focal point needed to avoid divergences in the international tax arena.

Even from the perspective of businesses, taxation on a gross basis (as proposed under Article 12B) do not consider the significant expenditure incurred by ADS providers and may result in a tax outflow that is disproportionate to the business profits they derive from markets. On the other hand, a net profit-based approach which requires computing "qualified profits" in accordance with laws of each country raises administrative difficulties and significant compliance costs, that may leave businesses with no choice but to forcefully opt for gross based taxation.

Conclusion

Admittedly, India's preferred approach for addressing the tax challenge of digitalization was G24's proposal to amend the definition of PEs to include significant economic presence, and thereafter allocate profits based on a fractional apportionment method (that factored in sales).[51] However, achieving this outcome was not possible without a consensus amongst all nations. Against this backdrop, India opted in for OECD's unified approach. In the interim, EL was launched as a makeshift tax and India's source rules were amended to include significant economic presence test as a policy statement.

Much water has flowed under the bridge since the G24 proposal. India is a leading member of the Inclusive Framework and is actively and vocally shaping Pillar 1 negotiations alongside the OECD countries. India has once again reiterated its commitment to the consensus-based solution set out in OECD's July 1st statement. From an Indian standpoint, there are some positive developments in OCED's July 1 statement, namely, coverage of all MNEs (as against just ADS or CFBs) under the new profit allocation rules (subject to revenue thresholds), US dropping the safe harbor demand and coming to the table, abandonment of plus factors under the nexus rules and limited use of segmentation.[52] However, there are several key open points that will finally determine India's buy-in, such as the percentage of residual profits that Pillar Ones ultimately allocates to market jurisdictions (this is currently pitted to be in the range of 20%-30%) and its impact on Indian revenues. As a large emerging market, India may stand to gain much more than small developing nations[53]. Moreover, any comparison between EL revenues and Pillar One revenues, should, on the balance, factor in the combined revenue potential of Pillar One and Pillar Two and the macroeconomic costs of trade conflict and set back in foreign investment. There are also design features that will inform India's decision. For example, on profit alloca tion India favors an escalated approach where the share of profit to be given to the market jurisdiction goes up as the profit margin goes up. India is also looking for share in the deemed routine profits. On the other hand, India has expressed openness in having a common unified approach to tax compliances for MNEs and dispute prevention and resolution.[54]

While the jury is not out pending the fine print and the impact of Pillar One on Indian revenues is still unknown, this paper attempts to demonstrate that there are other critical strategic, political and economic considerations from an Indian standpoint that impact its decision making. These include reforming the present international tax framework for market jurisdictions, bolstering India's international trade relations and foreign investment, promoting tax certainty, and protecting interests of Indian tech companies that are cultivating a global user base for better monetization. Safe to say, the balance of convenience lies in favor of having a multilateral solution rather than not having one.[55]

Endnotes

1 *The paper should not be seen as any formal statement, view or expression by any of the experts (or their organizations), who have participated in the closed room technical sessions.*

2 OECD, Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalization of the Economy, available at 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 (as seen on August 23, 2021).

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