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PIXELS AND PROFITS: RETHINKING TAX POLICY FOR THE BORDERLESS DIGITAL ECONOMY

S. Chandralekha [1], S. Dharani [2], S. Aruna [3]

[1] Assistant professor, Vel Tech Rangarajan, Dr. Sagunthala R. and D. Institute of Science and Technology, School of Law, Chennai, Tamil Nadu, India
[2] Assistant professor, Mother Teresa Law College, Pudukkottai, Tamil Nadu, India
[3] Assistant professor, Vel Tech Rangarajan, Dr. Sagunthala R. and D. Institute of Science and Technology, School of Law, Chennai, Tamil Nadu, India

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ABSTRACT

India's digital economy has grown rapidly in recent years due to greater internet use, mobile technology, and many startups. As more people and businesses go online, traditional tax sysstems are struggling to keep up.

New types of online services—like e-commerce, digital ads, cloud storage, and online content—are making money across borders, often without a physical presence. This creates confusion about where and how these businesses should be taxed.

In the 2022–2023 budget, the Indian government introduced a 30% tax on virtual digital assets (like cryptocurrencies).

Globally, countries like the UK and France also started taxing big tech companies to ensure they pay taxes in the countries where they operate.

This article highlights how current international tax rules are outdated and need urgent changes. Right now, many rules are based on physical presence in a country, which doesn't work well for digital businesses. Some companies avoid taxes by shifting profits to countries with low tax rates. These practices need to be revised to apply digital taxes fairly.

The article explains what the digital economy is and how Indian tax laws are falling behind new digital trends. It also discusses the need for international agreement on key tax rules so that all countries can apply similar and fair laws.

The author uses existing studies to explore these issues and suggests how tax laws can be improved to bring the digital economy into the mainstream and make it more transparent. Finally, the article offers possible solutions to better tax digital businesses and technologies.

Keywords: Taxation, Digital Economy, Income, Permanent Establishment, Equalization Levy, Significant Economic Presence

1. INTRODUCTION

The current international tax rules have failed to keep up with how the digital economy works today. These rules were not updated to cover digital goods and services properly.

The digital economy is mostly made up of large multinational tech companies—often called "FAANG" (Facebook, Apple, Amazon, Netflix, and Google)—that provide services over the internet. These companies earn huge profits but

often avoid paying taxes in countries like India because they don't have a physical office there[1]. It is simply the digital companies which make up the digital economy.[2]

These digital companies operate online, using large amounts of data, and because Indian tax laws don't clearly define how to tax such companies, they often escape taxation. Also, current international tax laws mostly apply only to Non-Resident Indians (NRIs), not these global tech firms.

This article discusses these problems—why current laws don't work, how much they cover, and possible solutions. In the end, it will suggest ways to improve tax laws so digital companies can be taxed fairly.

2. TAXATION CHALLENGES IN THE DIGITAL ECONOMY

2.1. DIGITAL ECONOMY

The term "digital economy" refers to an economy that is based on digital computing technologies and involves the use of digital media of various types. Although, the digital economy is often confused with e-commerce, in reality, digital economy is a very wide term including a variety of software, internet platforms, applications, Internet of things, online advertising, cloud computing, crypto currencies, advanced robotics, electronic business processes, e wallets and online payment services, etc. apart from e-commerce transactions.

According to (ILO, 2018), the term digital economy refers to economic activities conducted over the Internet, utilizing digital information and knowledge as fundamental components in the production, marketing, and distribution of goods and services. It involves processes enabled by the Internet, mobile networks, and information technologies, facilitating new forms of commerce and interaction." Digitalization has penetrated many activities, and, indeed, almost the entire economy could be included in the "digital economy" (IMF, 2018). As technology increasingly permeates our daily lives and economic activities, distinguishing between the digital and non-digital economy becomes more challenging. The integration of online tools and platforms into various sectors blurs the lines between traditional and digital economic activities (APEC, 2019).

2.2. DIGITAL ECONOMY IN INDIA

The digital economy continues to make impressive advances across the globe and India is among the leaders in this space.

The landmark event of demonetization of currency in India in November 2016 saw a spur in the use of internet banking, plastic money, and e-wallets to make cashless payments. This was followed by the introduction of the Goods and Services Tax ("G.S.T.") in July 2017, which mandates that all records and documentation are to be updated on the online portal.

Based on press reports, the Economic Affairs Secretary of India expects that the digital economy in India may cross the USD 1 trillion mark by the year 2022 and may even constitute half of the total economy by 2030.

2.3. TAXATION CHALLENGES IN THE DIGITAL ECONOMY

With the increasing advances in digitization across various industries around the globe, there has been a significant increase in online transactions in the past few years, especially e-commerce transactions. In a borderless digital economy, it is possible to target a large volume of consumers and to undertake business activities in a foreign jurisdiction without establishing a place of business or a physical presence. As a result, tax administrations in most countries have not been able to keep pace with the advances of digitization and several difficulties can arise in the taxation of the digital economy, more so in the case of cross-border transactions. The important task that awaits completion by tax authorities is the adoption, on a global basis, of an acceptable method of allocating taxing rights among various jurisdictions involved in a digital transaction.

[1] Silvia Amaro & Karen Tso, US Tech Firms like Apple and Amazon Are Posing a 'Huge' Tax Challenge for France, CNBC, https://www.cnbc.com/2017/10/06/apple-amazon-techfirmsare-a-tax-challenge-for-france.html (quoting Bruno Le Maire, the French finance minister, referring to GAFAs), last seen 02/04/24.

[2] Fair Taxation of the Digital Economy, EUROPEAN COMMISSION, https:// ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy-en, Last visited Oct. 12, 2024.

2.4. TAXATION CHALLENGES IN THE DIGITAL ECONOMY FROM AN INDIA PERSPECTIVE

As per the provisions of the Indian tax law, non-residents are subject to tax only in respect of the income received in India or income sourced in India. Generally, business income of non-resident entities is taxed in India only if where a business connection or Permanent Establishment ("P.E.") exists in India. If sufficient connection of a P.E. exists, net business income of non-residents are taxable at the base rate of 40% in case of corporate entities and at 30% in case of non-corporate entities. However, if the income of the non-resident is in the nature of specific items of income such as royalties, fees for technical services, capital gains, or interest, specific rates of gross basis tax are applicable.

Since the digital model of business is quite different from traditional business and there is greater reliance on the use of intangibles, it is not easy to determine whether a foreign entity has a sufficient business connection or P.E. in another country by applying the existing tests under the domestic tax law or tax treaties. In fact, this is not a problem unique to India; tax authorities in most countries are grappling with this issue, France and Italy have adopted legislation, and proposals have been floated by the European Commission.

3. CHARACTERIZATION OF INCOME

Characterization of Income means deciding what type of income it is—this matters because different types are taxed differently.

Under Section 9 of the **Income Tax Act, 1961**, income earned by Non-Resident Indians (NRIs) in India is mainly classified into three types:

1) **Business Income**[3]
2) **Royalty**[4]
3) **Fees for Technical Services**[5]

This classification is very important when it comes to taxing digital services.

- If digital income is treated as **royalty** or **fees for technical services**, and the NRI has no business setup (called a "Permanent Establishment" or PE) in India, then the tax rate is just **10%**.
- But if the same income is treated as **business income** and the NRI **does** have a PE in India, then the tax is much higher—**40%**.

The big challenge with the digital economy is deciding **how to classify the income** from digital services—whether it counts as business income, royalty, or something else—because this decides how much tax must be paid.

1) The first problem is that whether these commissions be taxed as **business income** or as **fees for technical services**?

Example Case – *eBay International AG v. Deputy Director of Income Tax*[6]:

In this case, the Income Tax Appellate Tribunal (ITAT) said that the **user fees** eBay collected **do not count as "fees for technical or managerial services"** under Section 9 of the Income Tax Act.

Why Because eBay is just a **platform** where buyers and sellers meet. It does **not directly take part in making the sale happen**. So, the court decided that eBay's commissions are **not taxable** as fees for technical or managerial services. eBay was just helping to manage customer orders, and that alone was **not enough** to treat the income as taxable under that category.

2) Second Issue in Taxing the Digital Economy:

How should subscription fees earned by digital companies be taxed? Should they be treated as **business income** or as **royalty**?

[3] S. 9(i), Income Tax Act, 1961.
[4] Explanation 2 in S. 9(1)(vi), Income Tax Act, 1961.
[5] 5 Explanation 2 in S. 9(1)(vii), Income Tax Act, 1961.
[6] eBay International AG v. Deputy Director of Income Tax (IT), ITA No.6784/M/2010.

There have been many court cases with **different opinions** on this, which has created confusion. Here are a few examples:

1) ***Dun and Bradstreet Espana Case*****:**[7]

The court said that if a company just gives access to public reports or services already available to everyone, then **subscription fees are not royalty**. So, in this case, the fee was **not taxed as royalty**.

2) b***CIT v. Wipro Limited*****[8]:**

The Karnataka High Court said that if someone has **control over a database**, even if it includes public documents, then payments for using that database **should be treated as royalty**, not business income.

3) ***Cargo Community Case*****[9]:**

Here, the court ruled that subscription fees paid to use a web portal hosted in Singapore **count as royalty payments**.

3.1. FINAL POINT

These cases show that courts and tribunals **disagree** on whether subscription fees are **business income or royalty**. This leads to **confusion and uncertainty** because the tax law does not clearly explain i.e., lack of legislative clarity as how to classify such income for digital companies.

4. ESTABLISHMENT OF PERMANENT ESTABLISHMENT(PE) IN INDIA

After deciding what type of income it is (like business income or royalty), the **next important step** in digital taxation is to check whether the company has a **"business connection" in India**—because only then can the income be taxed in India.

4.1. THE ISSUE WITH PE

Many digital companies rely on things like **patents, copyrights, brand names, and digital platforms** to run their business. These companies can choose to set up their offices anywhere in the world—often in countries with **low or no taxes**—even if they earn money from Indian customers.

Example – Uber India:

Uber India said it's just a **support platform** that collects payments and sends the money to its parent company, **Uber BV** in the Netherlands. Uber BV gets tax benefits there[10]. So, even though Indian users pay for Uber's services[11], most of the income is sent abroad and may not be taxed in India.

4.2. THE REASON TO BE CONSIDERED

Digital platforms (like **Meta or other FAANG companies**) can earn **huge amounts of money from Indian users**, even if:

- They have **no office** in India
- They don't have **servers** in India

Since Indian tax laws can't easily reach companies **outside India**, these companies often **don't get taxed here**, even though they make money from Indian users.

[7] In Re: Dun and Bradstreet Espana, S.A., (2005) 193 CTR (AAR) 9.
[8] CIT v. Wipro Limited, [2013] 355 ITR 284 (KAR).
[9] In Re Cargo Community, (2007)208 CTR (AAR) 184.
[10] Radhakrishnan Rawal, The Taxation of PEs: An International Perspective, (2nd ed., 2006).
[11] Uber India Services Limited v. JCIT, 10039/JCIT(TDS)(OSD)-2(3)/2018-19.

4.3. FINAL POINT

If there is **no clear business connection in India**, it becomes **very difficult to tax** these digital companies under Indian law.

5. ATTRIBUTING PROFIT TO PERMANENT ESTABLISHMENT (PE)

If a **Non-Resident Indian (NRI)** has a **Permanent Establishment (PE)** in India (like a branch, office, or server), then the next step is to **figure out how much of the profit should be taxed in India**. But this is **not clear** when it comes to digital businesses[12].

5.1. INTERNATIONAL LAW ABOUT PE

According to **Article 7 of the OECD model**, a PE should be treated like a **separate business** when calculating profits. That means it should be compared to how an independent company would operate with others to set fair prices for transactions.

5.2. THE PROBLEM WITH DIGITAL COMPANIES

Let's take **Amazon.in** as an example. When you buy a shirt from Amazon.in, you don't know **where the server is located**—it could be anywhere in the world. If Amazon's PE is just its **server**, that makes it hard to:

- Identify the work done on that server
- Calculate the profit made from that work
- Assign the correct tax on that profit

So, **it's difficult to know how much profit to tax in India** if the server (PE) is in a different country and doesn't have people managing it daily. Hence currently there is a need to look at the alternative options which have to be taken into account to attribute profits to digital PE.[13]

6. INDIAN LAW AND SUPREME COURT VIEW

- **Rule 10** of the Income Tax Rules says profits can be estimated based on the **turnover** (revenue) made in India by a foreign company.
- The **Supreme Court (in Morgan Stanley case)**[14] said that the **transfer pricing principle** should be used to calculate profits for the PE.

7. MEANING OF TRANSFER PRICING

Imagine a **father sells a house to his son at a discount**. But if he sells the same house to a stranger, the price would be higher. For tax purposes, the law says the father must be taxed **as if he sold it to a stranger**—at the full market price.

This is called the **arm's-length principle**—and it's used to stop businesses from manipulating prices between related companies to avoid taxes[15].

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[12] Lina Spinosa & Vikram Chand, A Long-Term Solution for Taxing Digital Business Models: Should the Permanent Establishment Definition be Modified to Resolve the Issue or Should the Focus be on a Shared Taxing Rights Mechanism? 46 Intertax 476,494 (2018), https://www.kluwerlawonline.com/abstract.php?area=Journals&id=TAXI2018052, last seen on 14/09/2024.

[13] Asaf Harpaz, Taxation of the Digital Economy: Adapting a Twentieth-Century Tax System to a Twenty-First-Century Economy, 46 Yale Journal of International Law 57 (2021) http://hdl.handle.net/20.500.13051/6747.

[14] DIT v. Morgan Stanley & Co, (2007) 292 ITR 416 (SC).

[15] Andres Baez Moreno & Yariv Brauner, Taxing the Digital Economy Post BEPS…Seriously, 58 Social Science Research Network 19,16 (2019) https://dx.doi.org/10.2139/ssrn.3347503 last seen on 11/04/2024.

There is still **no clear rule** on how to assign or tax profits made by **digital companies through their PEs**, especially when those PEs are **just servers or online platforms**. So, tax authorities struggle to **fairly tax income from the digital economy**.

8. UNILATERAL MEASURES TAKEN BY INDIA

India has taken **its own steps** (called **unilateral measures**) to deal with taxing the digital economy. These steps were based on suggestions made by the **Akhilesh Ranjan Committee**, which studied how to tax **e-commerce** and **digital businesses**.

Some of the suggestions made by the committee are now **outdated**, but **many of the key ideas are still useful** and form the basis of the steps India has taken on its own to **tax digital companies** operating in the country.

1) Equalization Levy

The **Equalization Levy (EL)** is a type of **tax introduced by India** to make sure that **foreign digital companies** (like Facebook or Google) pay tax **just like Indian companies** when they earn money from Indian users.

- It was started **in 2016**, **before GST** was launched.
- The **main idea** was to **level the playing field** between **Indian companies** and **foreign companies** doing business **online in India**.
- This tax is **6%** and is applied on payments made to **non-resident (foreign) companies** for certain **online services**, like:
- **Online advertising**
- **Running online platforms for ads**
- If the foreign company **does not have an office or permanent setup in India (PE)**, then the Indian business **must deduct the tax** (EL) before paying them.
- But if the foreign company **has a proper office or setup (PE) in India**, this tax is **not applied**.

Important note: The government only taxed **some types** of digital services, like advertising, and **missed many other areas** of the growing digital economy. So, the scope of the Equalization Levy was **limited**, and **didn't fully capture** the **essence of the digital economy**[16].

2) Significant Economic Presence (SEP)

1) The **Indian government introduced SEP in 2018** to **tax foreign digital companies** that **earn money from Indian users**, even if they **don't have an office** in India.
2) **What is SEP?**

It means a **foreign company is doing enough business in India** to be taxed here. This happens when:

- The company sells goods or services to Indian customers, and the **payment crosses ₹20 million** (2 crores).
- Or, the company **regularly interacts with a large number of Indian users**, even if no money is directly charged.

3) How is SEP calculated?

All payments received from India for the company's goods or services are added up.

4) The law also said if a company is:

- **Doing business regularly in India**
- **Has agreements signed in India**
- **Or provides services in India**

[16] Report of Ad Hoc Group of Experts on International Cooperation in Tax Matters: Eighth Meeting, United Nations, Official Record, (Department of Economic and Social Affairs) ST/ESA/258 (New York, 1998) 4 [18] available at http://www.un.org/esa/ffd/tax/overview.htm last seen on 04/05/2024.

— then it may have a **business connection**, making it liable for tax.

8.1. PROBLEM WITH THE LAW

1) The **term "user" wasn't clearly defined**. A user could be:
   - Someone just **viewing content**
   - Someone **clicking on ads**
   - Or a **subscriber**
2) This causes **confusion**, especially for companies like **Facebook, YouTube, or Instagram**, where users don't pay, but their **activity (clicks and views)** helps the company **earn money through ads**.
3) Since "user" is not clearly defined, **tax authorities can't easily track or tax these companies**, even though they're making **huge profits from Indian users**[17].

9. WAY FORWARD

Countries around the world need to **come together and have discussions** to decide a **common definition** of **Equalization Levy**. Right now, every country is making its own rules (called **unilateral measures**), which is creating confusion and might lead to **double taxation** (when the same income is taxed twice in two countries). So, it's important to **rethink and expand** the scope of this tax **together**, not separately.

The concept of **Significant Economic Presence (SEP)** also needs to be **updated and made clearer**. The government should give a **clear definition of "user"**, because currently it is not clear whether a user means a viewer, a clicker, or a subscriber. Different examples and detailed models should be used to explain this better in the law.

Also, the **Income Tax authorities should write clear rules** on:

- How to **classify income** (like whether it's royalty, business income, etc.)
- How to **assign profits** to different types of income
- How to **tax companies whose servers are located in other countries** but still earn money from Indian users

9.1. THE AUTHORS ALSO GIVE THE FOLLOWING SUGGESTIONS

1) The Government of India should **not keep relying only on new laws** to handle the taxation of the digital economy. Instead, it should create a **new independent expert body** — like SEBI (for securities) or CCI (for competition) — to **advise the government** on digital economy issues. This body can also have **some minor powers** to make rules and oversee digital platforms.
2) The Government should also **set up research centres** that study the digital economy and **help integrate it** smoothly into the larger Indian economy. These centres can also guide how to **properly tax** this growing area.

10. CONCLUSION

India has already taken some steps on its own to tax digital companies, but the **digital economy is growing faster than the law can adapt**. Because of this, there is now a **big gap in regulation**, which needs to be **urgently fixed**. Right now, people and companies are taxed based on **either the local Indian tax law (the Income Tax Act)** or **the tax treaties India has signed with other countries (called DTAAs – Double Taxation Avoidance Agreements)**. Whichever rule benefits the taxpayer more is applied.

India has also introduced some **voluntary tax measures** like the **Equalization Levy** (also called the **"Google tax"**) and tried to **expand the definition of "business connection"** to include digital companies. But these steps **do not really**

[17] Committee of Experts on International Cooperation in Tax Matters, 30 October 30, 2006 - 3 November 3, 2006, United Nations, Official Report, Report of the Second Session 7 [26] available at http://www.un.org/ga/search/view_doc.asp?symbol=E/C.18/2006/10(SUPP)&Lang=E accessed 04/03/2024.

help much in bringing in more investors, increasing tax collections, or making a big difference unless **international tax agreements are also updated at the same time**.

To fix this, there's a focus on creating something called a **Multilateral Instrument (MLI)**. This is part of the **OECD's BEPS Action Plan 15** (BEPS stands for **Base Erosion and Profit Shifting**, which means trying to stop tax avoidance by shifting profits to low-tax countries). The **MLI is meant to help countries update their tax treaties together**, but not all countries may sign it, because it doesn't adjust for each country's unique agreements. So, **some concerns of countries about the MLI must be addressed**.

Once the **MLI is signed and tax treaties are updated**, the **Equalization Levy** (Google Tax) may **have to be reviewed**, because keeping both the levy and treaty-based taxes might **lead to double taxation** (taxing the same income twice in different ways).

Also, the rules about **Significant Economic Presence (SEP)** use many technical terms. If these terms were more **clearly explained and defined**, it would help reduce confusion and **prevent future legal disputes**.