Digital Services Tax

This article is based on "Digital Services Tax: Not about India vs US" which was published in The Indian Express on 25/01/2021. It talks about the rationale and concerns associated with the digital services tax.

Recently, the United States Trade Representative (USTR) published a report concluding that the 2% digital services tax (DST) introduced by the Indian government (by the 2020 Finance Act) discriminates against US businesses and contravenes settled principles of international tax law.

The DST is aimed at ensuring that non-resident, digital service providers pay their fair share of tax on revenues generated in the Indian digital market. India's 2% DST is levied on revenues generated from digital services offered in India, including digital platform services, digital content sales, and data-related services.

As the digital economy is increasingly becoming a separate sector of the economy itself, developed countries like the US (where the majority of digital service providers come from) must understand that it would be now difficult to ring-fence the digital economy from the rest of the economy for tax purposes.

Note:

- India was one of the first countries in the world to introduce a **6% equalization levy** in 2016, but the levy was restricted to online advertisement services (commonly known as "digital advertising taxes" or "DATs").
- In March 2020, it expanded the scope of the existing equalization levy to a range of digital services that includes e-commerce platforms. Any payment made by non-residents in connection with an Indian user will now attract a 2% levy.

Concerns Raised by USTR & Counterclaim

- The USTR conducted an investigation under section 301 of the US Trade Act, 1974, which authorizes it to appropriately respond to a foreign country's action that is discriminatory and negatively affects US commerce.
- The USTR report found the DST to be discriminatory on **two counts**.
  - First, it states that the DST discriminates against US digital businesses because it specifically **excludes from its ambit domestic (Indian) digital businesses**.
  - Second, according to the report, the DST does not extend to identical services provided by non-digital service providers.
- However, India clarified that the DST itself in no way discriminates based on the size of operations or nationality.
  - It may predominantly appear that DST is applicable to US companies because the market for digital services is dominated by US-based firms.
  - Further, any company that has a permanent residence in India is excluded since it is already subject to tax in India.

Rationale of DST

Prolonged International Tax Law Negotiation: The agenda to reform international tax law so that digital companies are taxed where economic activities are carried out was formally framed within the OECD's base erosion and profit shifting program.

  - However, seven years since its inception, it is still a work in progress.
  - Due to this, countries are worried that they might cede their right to tax incomes. Therefore, many countries have either proposed or implemented a digital services tax.

Note:

Base erosion and profit shifting (BEPS) refers to tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations.

- **Changing International Economic Order:** The proliferation of digital service taxes (DSTs) is a symptom of the changing international economic order.

  Countries such as India which provide large markets for digital corporations seek a greater right to tax incomes.
- **Asymmetrical Digital Power:** The taxation of the digitaliized economy turned out to be a relatively contentious issue because there is a huge asymmetry in digital service providers and consumers.
  - Further, a redistribution of taxing rights can have significant revenue implications for countries like India and the US. This makes a consensus-based solution harder to achieve.
  - Thus, countries claim that the exponential increase of the digital economy and the digitalization of the traditional economy require the adoption of new tax rules.

Associated Concerns With DST

- **Eventually Burdening Digital Consumers:** Experts suggest that DST can be passed on to consumers. While the Indian customer may not pay this as a tax, this could mean higher prices, contrary to the claim that it taxes the company.
- **Retaliatory Tariffs:** The USTR investigations could pose a threat of retaliatory tariffs, as similar tariffs were imposed by the US on France.
    - Further, it could turn into a **digital trade war-like scenario** and could harm India's Information and communication technology industry.
- **Double Taxation:** This was severely criticized by many countries as a unilateral measure that would result in double taxation.

Way Forward

- **New Model of Digital Taxation:** The core problem that the international tax reform seeks to address is that digital corporations, unlike their brick-and-mortar counterparts, can operate in a market without a physical presence.
    - Therefore, taxing in a particular jurisdiction may not augur well with the growth of the digital economy.
    - To overcome this challenge, countries suggested that a new basis to tax, say, the number of users in a country, could address the challenge to some extent.
    - The EU and India were among the advocates of this approach.
- **Expediting Multilateral Negotiations:** While the digital economy and its implications continue to evolve, the multilateral solution at the level of the OECD must be expedited.
    - Moreover, it would also require political consensus on multiple issues, including sensitive matters such as setting up of an alternative dispute resolution process comparable to arbitration.

Conclusion

As countries calibrate their response to competing demands for sovereignty to tax, DST is an interim alternative outside tax treaties. It possesses the advantage of taxing incomes that currently escape tax and creates space to negotiate a final, overarching solution to this conundrum.

Drishti Mains Question

As countries calibrate their response to the growing implications of the digital economy, Digital Services Tax is an interim alternative outside tax treaties. Discuss.

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This editorial is based on "Changing climate" published in The Indian Express on January 25th, 2020. Now watch this on our Youtube channel.