Summer, 2021
Vol. XIII, No. 1

Trade, Law *and* Development

Trade and Technology: Rebooting Global Trade for the Digital Millennium

FOREWORD

Shifting Sands: Taking Stock of an Extraordinary Year

EDITORIAL

Gautami Govindrajan & Ayushi Singh, *Curb Your Enthusiasm: The WTO E-Commerce Negotiations and the Developing World*

ARTICLES

Mira Burri, *Digital Transformation: Heralding in a New Era for International Trade Law*

James J. Nedumpara, *Skirmishes over Digital Service Taxes: The Perils and Systemic Costs of Section 301 Actions*

Craig Atkinson & Nicholás Schubert, *Augmenting MSME Participation in Trade with Policy Digitalisation Efforts: Chile's Contribution to 'An Internet of Rules'*

Gabriele Gagliani, *Techno-Economic Governance in the 21st Century: Converging Models for WIPO and the WTO?*

Marta Soprana, *The Digital Economy Partnership Agreement (DEPA): Assessing the Significance of the New Trade Agreement on the Block*

ISSN: 0976 - 2329
eISSN: 0975 - 3346

TL
&D

Trade, Law *and* Development

Vol. 13, No. 1 2021

PATRON

Hon'ble Prof. Poonam Saxena

FACULTY-IN-CHARGE

Rosmy Joan

EDITORS-IN-CHIEF

Amogh Pareek *Gautami Govindrajan*

EDITORS

Ayushi Singh (SENIOR CONTENT) *Sahil Verma* (MANAGING) *Abilash V.* (TECHNICAL)

Abhinav Srivastav *Anjali Sasikumar* *Sukanya V.*

Suvam Kumar *Tania Gupta*

ASSOCIATE EDITORS

Aastha Asthana *Malaika Shivalkar* *Neerali Nanda*

Nishant Sharma *Pranav Karwa* *Rashmi John*

Shlok Patwa *Swikruti Nayak*

COPY EDITORS

Akshita Saxena *Ananya Awasthi* *Anushka Mathur*

Jahnavi Srivastava *Maulik Khurana* *Nidhi Lakhotia*

Ria Chaudhary *Vidhi Damani* *Yashvi Hora*

CONSULTING EDITORS

Ali Amerjee *Aman* *Dishi Bhomawat*

Manu Sanan *Meghana Sharafudeen* *Prateek Bhattacharya*

Shashank P. Kumar

BOARD OF ADVISORS

B. S. Chimni *Daniel Magraw* *Glenn Wiser*

Jagdish Bhagwati *M. Sornarajah* *Raj Bhala*

Ricardo Ramírez Hernández *Vaughan Lowe* *W. Michael Reisman*

Published by

The Registrar, National Law University, Jodhpur

ISSN : 0976-2329 | eISSN : 0975-3346

Trade, Law *and* Development

James J. Nedumpara, *Skirmishes over Digital Service Taxes: The Perils and Systemic Costs of Section 301 Actions*
13(1) TRADE L. & DEV. 63 (2021)

SKIRMISHES OVER DIGITAL SERVICE TAXES: THE PERILS AND SYSTEMIC COSTS OF SECTION 301 ACTIONS

JAMES J. NEDUMPARA*

The growth in today's digital economy has presented numerous tax challenges. Corporate taxation is traditionally built on the notion of physical 'permanent establishment' or tangible locational nexus. In a digital economy, services can be rendered everywhere from anywhere. Who should get the first "bite at the apple"? While several countries have adopted a digital service tax to tax revenue or locational rent attributable to market country or the value-creating jurisdiction, these approaches have been fiercely resisted with countries such as the United States pursuing unilateral Section 301 actions. This article explores the complexities of this debate and examines in particular the risks in pursuing unilateral retaliations against legitimate attempts at taxing value creation in this digital economy. In examining this issue, the article discusses the various proposals debated at the Organisation for Economic Co-operation and Development (OECD).

TABLE OF CONTENTS

I. INTRODUCTION: WELCOME TO THE DIGITAL WORLD
II. TAXATION IN A DIGITAL ECONOMY
   A. WHO SHOULD GET THE FIRST "BITE AT THE APPLE"?
   B. INDIA'S EQUALISATION LEVY – ASSERTING THE RIGHT OF THE MARKET COUNTRY
III. DIGITAL SERVICE TAXES AND SECTION 301 PROCEEDINGS
IV. OECD INITIATIVES: THE WAY FORWARD
   A. OECD PILLAR ONE INITIATIVE
   B. SIGNIFICANT ECONOMIC PRESENCE
V. CONCLUSION

* Professor and Head, Centre for Trade and Investment Law, Indian Institute of Foreign Trade, Ministry of Commerce and Industry. Email: headctil[at]iift.edu.
The views expressed in this article are personal and should not be attributed to his institution or the Government. The author thanks Trishna Menon, Anushka Mathur and Swikruti Nayak for their assistance on this article.

I. INTRODUCTION: WELCOME TO THE DIGITAL WORLD

The global economy is rapidly transforming into a digital economy. Digital companies are perhaps some of the biggest companies in terms of market capitalisation or are the most profitable.[1] This is largely because, most digital companies rely on the ability to provide wide-ranging services remotely without having a physical presence in the jurisdiction where their customers are located.

The fast-growing digital economy has thrown up several new challenges, including issues related to the jurisdiction of countries to tax either certain types of transactions, activities or income. In the context of multi-national enterprises (MNEs), the general understanding is that profits should be taxed in a jurisdiction where the MNE's businesses are located. This assumption is based on the 20th century tax rules which were developed for conventional brick-and-mortar businesses. However, a number of modern-day digital companies provide services in the nature of software, data transmission, streaming, online advertisements, digital interface (online intermediation), payment processing, internet-based telecommunication, social networking platforms, etc., from remote locations. Accordingly, some of these high-tech companies, valued at a trillion dollars and larger in economic size than some middle-income countries, may not actually require physical presence in a specific jurisdiction to deliver their services.

Digital companies can provide most of their services without leaving their home jurisdictions, where most of their technologies and intellectual property rights (IPRs) reside. Most of these digital companies work on the basis of a two-sided or multi-sided business model.[2] A two-sided digital platform is one that allows users on one side of a transaction to interact with users on other sides, including through the purchase of goods and services. Digital platforms exist since there is a need for an intermediary to match the supply and demand sides of the platform in an efficient and effective manner. Just to give an example, LinkedIn is a popular professional networking service. It provides a platform for information exchange

---

[1] *Global Top 100 companies by market capitalisation*, PWC (May, 2021), https://www.pwc.com/gx/en/audit-services/publications/assets/pwc-global-top-100-companies-2021.pdf.

[2] Jean-Charles Rochet & Jean Tirole have roughly defined two-sided markets as *"markets in which one or several platforms enable interactions between end-users, and try to get the two (or multiple) sides 'on board' by appropriately charging each side. That is, platforms court each side while attempting to make, or at least not lose, money overall." See* Jean- Charles Rochet & Jean Tirole, *Two-Sided Market: A Progress Report*, 27 RAND J. Econ., 645 (2006). *See also*, Wei Cui, *The Digital Service Tax: A Conceptual Defence* (Allard School of Law at the University of British Columbia, Working Paper, 2019), https://commons.allard.ubc.ca/cgi/viewcontent.cgi?article=1469&context=fac_pubs [hereinafter Wei].

between two distinct user groups (individuals and employers) that provide each other with the economic benefits of a larger network. In this case, the user derives value for the services received and, in the process, creates network value to the platform provider. The web of these transactions creates network and scale effects when another user makes the service more valuable for every other user.

Digital companies often charge little or no money from users for online services, but collect critical data; in turn, the large audience of the digital platform is highly attractive to online sellers for targeted advertisements and promotional services. Most of the digital companies have a proprietary algorithm that allows them to offer enhanced and focused search results. Importantly, much of the content of the digital platform is delivered, directly or indirectly, by the user of the platform. In other words, the success of the platform depends upon the sustained engagement of users, which allows MNEs to gather significant chunks of data through intensive monitoring and the active involvement of users. Accordingly, most of the revenue or rent collected by global tech-companies is derived from countries where 'value creation' has taken place or where the users contribute to the value of the digital network. It is pertinent to mention here that a number of modern businesses are gathering data from customers, since customer feedback, inputs, and sale lists are valuable for all categories of businesses. Furthermore, the advent of the Internet of Things (IoT) increasingly allows companies to put sensors into their products and gather valuable information on use, performance, effectiveness and other critical aspects of the products. This in turn has increased the value of the final product as well as the associated IPRs, and has enabled these companies to focus more on maintenance, service, and product improvement.

It has been increasingly recognised that the network effects of digital platforms create market power without significant marginal cost, as the only major cost is developing, servicing and maintaining the digital platform.[3] Moreover, digital services can be delivered from multiple countries and sources at the same time.[4] Importantly, the digital dominance and the consequent revenue accrue to the company primarily on account of the user base and the associated network effects.

In this article, the countries from which digital enterprises source their revenue and create value are referred to as 'market countries'. Digital enterprises have a cross-jurisdictional presence and a predominant reliance on intangible assets, especially

[3] Org. Econ. Corp. & Dev., Public Consultation Document: Addressing the Tax Challenges of the Digitization of the Economy, OECD/G20 Base Erosion and Profit Shifting Project (2019), https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf [hereinafter OECD Public Consultation Document].

[4] Wei, *supra* note 2.

IPRs. The users of these platforms create value by producing content for the platform or by generating data that digital companies can sell or use in order to generate revenue. The value creation arises from the access to data relating to a particular market country, user participation (for example, posting on Facebook or other social media platforms) and the synergies with IPRs, for instance.[5] However, it is important to point out the extent to which value creation can differ, depending on the nature of the service. To illustrate, while users add value to a platform by sharing content or posting comments as in the case of Facebook, the scope of value creation may be different in the context of platforms that provide audio-visual content such as Netflix or Spotify. In other words, in case of certain digital interfaces or intermediation, the user participation may be so active that it can lead to 'co-production' of value, while in certain other cases, the user participation may be passive or negligible.

While the taxation of digital companies remains a difficult area to grapple with and not amenable to easy solutions, a number of digital firms have amassed unsurpassed wealth in the last two decades. In addition, the growth of technology also enabled digital firms to save tax by moving to low-tax jurisdictions. This also led to the phenomenon of a number of digital companies paying extremely low global taxes, which eventually lead to the "aggregation of 'stateless income'".[6] Sometimes, this is referred to as double non-taxation.[7] Well-accepted international taxation norms create difficulties in reaching the business income of enterprises that are strictly not resident or have no physical presence in the jurisdiction that has provided the economic basis for the income. To explain, traditionally, the source country where the income or business is generated has the primary right to tax income on a net income basis, whereas the resident country where the effective management takes place, also has the right to tax this income, provided a credit for the foreign source income is given.[8] However, in the absence of physical nexus in the digital economy, the market jurisdiction will have difficulty in applying a withholding tax on income attributable to the market jurisdiction. In addition to this, some reputed digital companies often operate from tax havens or low-tax jurisdictions, thus accentuating the pitfalls in the conventional taxation norms. At the heart of this controversy is the taxing power of countries to target the revenue or the rent collected by digital companies which provide services beyond their

[5] Wei, *supra* note 2.
[6] Edward D. Kleinbard, *The Lessons of Stateless Income,* 65 TAX L. REV. 99 (2011).
[7] Daniel N. Shavio, *Fixing U.S. International Taxation*, 9 JERUSALEM REV. OF LEGAL STUD. 116, 117 (2014), https://web.law.columbia.edu/sites/default/files/microsites/law-theory-workshop/files/DShaviro.pdf.
[8] REUVEN S. AVI-YONAH, ADVANCED INTRODUCTION TO INTERNATIONAL TAX LAW 8-9 (Edward Elgar, 2d ed, 2019).

'home' jurisdictions.[9] This saga continues with the focus of the discussion for an appropriate tax framework shifting from international forums to domestic jurisdictions and vice versa. While multilateral talks are progressing, unilateral measures are flourishing even leading to tit-for-tat measures.

The purpose of this article is to highlight the unique challenges present at this moment in taxing value creation in the digital economy. It highlights the difficulties in using traditional tools such as income tax in ensuring a fair allocation of taxes. The article proceeds, in Section II, to examine the efforts taken by certain countries, especially India, in taxing the digital economy and how such approaches have faced resistance. Section III of the article addresses the pitfalls in using unilateral trade actions, particularly Section 301 of the United States Trade Act, 1974 (Trade Act of 1974), in disciplining the use of digital services taxes. Finally, the article examines the cooperative efforts at the OECD in finding a multilateral solution to this problem.

II. TAXATION IN A DIGITAL ECONOMY

The current framework of tax laws, especially direct tax laws, is not well-suited to address the challenges posed by the digital economy. The 19th and 20th century laws were designed for classic 'brick-and-mortar' business models. For example, most income tax laws are based on the concept of a permanent establishment (PE). The source of the income is based on the existence of the PE and reflects the principle that 'until an enterprise of one State has a PE in another State, it should not properly be regarded as participating in the economic life of that other State to such an extent that the other State should have taxing rights on its profits'.[10] To reiterate, the concept of PE has always been linked to physical presence, for example, having an office, factory, project site, store, outlet, employees, or some kind of a material or physical existence.

The concept of PE incidentally requires two distinct thresholds: (1) a fixed place of business, and if no such fixed place of business can be found, (2) a person who acts on behalf of the entity and habitually exercises its authority.[11] In relation to digital service, one of the debated questions has been whether online presence

---

[9] Wolfgang Schon, *One Answer to Why and How to Tax the Digital Economy* (Max Planck Institute for Tax Law and Public Finance Working Paper No. 2019–10, 2019).

[10] ORG. ECON. CORP. & DEV., ADDRESSING THE TAX CHALLENGES OF THE DIGITIZATION OF THE ECONOMY, ACTION 1: 2014 DELIVERABLE, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT, 39 (2014), https://www.oecd.org/ctp/addressing-the-tax-challenges-of-the-digital-economy-9789264218789-en.htm.

[11] *Id.*

through a website can be equated to having a PE. The OECD Commentary to the Model Tax Treaty on Income and on Capital, 2010 (OECD Commentary) referred to a website as merely a combination of software and electronic data.[12] However, it states that the hosting of a website in a particular country through the help of certain devices, equipment, etc., could be a reasonable basis for a 'fixed place of business'.[13] The OECD Commentary also noted that if the enterprise carrying on business through a website has the server at its disposal, for example, through owning or leasing of the server, the place where the server is located could constitute a PE.[14] This is almost akin to a "deemed PE" in view of the presence of the server.[15] The concept of "service PE" is another useful tool to subject service providers who have no other physical presence to income/corporate tax.

However, in a digital economy, traditional tax concepts have their own limitations. Resultantly, a number of countries felt that introducing a new tax rather than modifying a conventional income tax would be the desirable solution.

A. Who should get the first "bite at the apple"?

The view that MNEs which derive their income from foreign jurisdictions need to pay their fair share of taxes is based on equitable grounds, the need for addressing distributive iniquities, and also on economic reasoning. Non-resident digital companies have market power which they can use to extract rent from the users of digital platforms. However, value creation in the market jurisdiction is still not considered as an organising principle of taxation even at the OECD,[16] while there has been a renewed effort to accord value creating jurisdictions taxing rights over revenue attributed to such jurisdictions. The quest, therefore, is to find out an appropriate form of taxation that has efficiency gains and is the least distortive among the comparable alternatives.

Most of the economists have used the concept of "economic rents" in examining the power of governments to extend their taxing power to digital transactions. According to a standard definition in Economics dictionaries, "rent" is a "payment to a factor of production in excess of the amount required to induce that factor

---

[12] Org. Econ. Corp. & Dev., *Commentary on Article 5: Concerning the Definition of Permanent Establishment, in* MODEL TAX CONVENTION ON INCOME AND CAPITAL, ¶42.2 (2010), https://www.oecd.org/berlin/publikationen/43324465.pdf [hereinafter OECD Commentary on PE].
[13] *Id.*; *see also*, Income Tax Officer v. Right Florists Pvt. Ltd., [2013] 143 ITD 445 (Kol), [hereinafter ITO v. Right Florists] ¶15.
[14] OECD Commentary on PE, *supra* note 12, ¶42.3.
[15] *Id.*, ¶32.
[16] OECD Public Consultation Document, *supra* note 3, at 6.

into production process."[17] Revenues in excess of short run marginal costs are "rents", whereas revenues up to the level of long-run marginal costs are "quasi-rents". According to Bankman *et al.*, quasi-rents differ from rents in the sense that they require investment under what can be considered competitive market conditions.[18] In the views of Wei and Hasimzade, digital platforms earn substantial rent from particular locations and can be subject to taxation the same way countries levy royalties, rent taxes or corporate income tax on natural resource extraction.[19] According to Bankman *et al.*, taxation limited to true economic rents is non-distortive in contrast to other forms of taxation that comes with efficiency losses.[20] Tax scholar, Reuven Avi-Yonah is also of the view that governments need revenue and that taxation of MNE revenue may be good enough to simply capture "rent" which can avoid distortion in global economic activities.[21] Typically, digital MNEs enjoy significant economy of scale which can limit the number of market players and, in turn, can lead to occupying market power. These MNEs realise rent from location specific assets or intangibles. Based on this logic, digital service taxes (DST) are levied on rent realised by digital platforms from specific locations.

In the past few years, several countries have taken different approaches to address this problem. Some European countries including Austria, France, Hungary, Italy, Poland, Spain, Tukey, and the United Kingdom (UK) have enacted DSTs.[22] Others like India[23] and Australia[24] have introduced or proposed *sui generis* forms of taxation such as equalisation levy, revenue apportionment or the diverted profit tax (DPT). The DPT seeks to target companies that design contrived arrangements between connected entities to divert profits from a particular jurisdiction. It was originally designed to address structures like Google's Double Irish Dutch Sandwich.[25] Another alternative is a destination-based cash flow tax.[26] The purpose

---

[17] Armen A. Alchian, *Rent*, *in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS 11552 (Steven N. Durlauf & Lawrence E. Blume eds., 2018).
[18] *See* Joseph Bankman et al., *Collecting the Rent: The Global Battle to Capture MNE Profits*, 72 TAX L. REV. 197 (2020).
[19] Wei Cui & Nigar Hashimzade, *The Digital Services Tax as a Tax on Location-Specific Rent* (Allard School of Law at the University of British Columbia, Working Paper, 2019), https://commons.allard.ubc.ca/cgi/viewcontent.cgi?article=1512&context=fac_pubs.
[20] Bankman, *supra* note 18, at 8.
[21] Reuven S. Avi-Yonah, *A Positive Dialectic: BEPS and The United States*, 114 AJIL UNBOUND 255 (2020).
[22] Elke Asen, *What European OECD Countries Are Doing about Digital Services Taxes*, TAX FOUNDATION (May 25, 2021), https://taxfoundation.org/digital-tax-europe-2020/.
[23] Equalisation Levy Rules, 2016, S.O. 1905(E) (May 27, 2016).
[24] Digital Profits Tax Act 2017 (Cth).
[25] Avi-Yonah, *supra* note 8, at 59.
[26] Australian Government, the Treasury, *Digital Economy and Australia's Corporate Tax System* 22 (Treasury Discussion Paper, Oct., 2018),

is to broadly allocate taxing rights over profits or rent attributable to value created by users of digital platforms. Although these taxes can be broadly brought under the category of DST, their character and nature differ vastly.[27] While some forms of DST are akin to income taxes, others veer closer to consumption taxes. In certain cases, the DST can neither be a tax on income nor a tax on consumption.

Digital taxation can be either on business income/profits or on digital transactions. Interestingly, there is a two-decade long discussion on the imposition of customs duty on e-commerce transactions at the World Trade Organization (WTO). There is an existing moratorium[28] on imposition of customs duty which is getting periodic extensions.[29] However, imposition of customs duty is a relatively minor issue when compared to the taxation of gross revenue or transactions of e-commerce companies attributable to a market jurisdiction.

Another alternative is to impose certain transaction or consumption taxes in the nature of valued-added taxes (VAT) on services rendered. Indonesia in particular, has pioneered this model.[30] Indonesia's electronic transaction tax targets cross-border digital transactions. However, the imposition of VAT cannot be selective and has to be across the board and will have to be applied to domestic enterprises as well. Non-discrimination in taxation or other forms of treatment is a key principle of the General Agreement on Trade in Services (GATS).[31] Any kind of discriminatory transaction-based taxation based on size thresholds could potentially be inconsistent with international commitments unless justified by one

---

https://treasury.gov.au/sites/default/files/2019-03/c2018-t306182-discussion-paper-1.pdf.

[27] ORG. ECON. CORP. & DEV., TAX CHALLENGES ARISING FROM DIGITALISATION – INTERIM REPORT 2018: INCLUSIVE FRAMEWORK ON BEPS, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT (2018), https://www.oecd.org/ctp/tax-challenges-arising-from-digitalisation-interim-report-9789264293083-en.htm. [hereinafter OECD Interim Report of 2018].

[28] World Trade Organization, Ministerial Declaration of 20 May 1998, WTO Doc. WT/MIN(98)/DEC/2 (1998). This WTO 1998 Declaration on Global Electronic Commerce, stated that "Members will continue their current practice of not imposing customs duties on electronic transmissions." This language has been replicated in subsequent decisions renewing the moratorium.

[29] *See* LEILA CHOUKROUNE & JAMES J. NEDUMPARA, INTERNATIONAL ECONOMIC LAW: TEXT, CASES AND MATERIALS 749- 750 (2021).

[30] *See* Government of Indonesia, Ministry of Finance, Government Regulation in Lieu of Law, Law No. 1 Year 2020 on State Finance Policy and Financial System Stability for Handling (Mar. 31, 2020), https://perpajakan.ddtc.co.id/peraturan-pajak/read/perpu-1-tahun-2020.

[31] General Agreement on Trade in Services art. XVII, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, 1869 U.N.T.S. 183.

of the general exceptions under the GATS.[32] It is also important to note that in a two-sided business model, the users are not often charged a fee for the use of the digital content. For example, digital companies such as Google and Facebook do not charge any user fee (other than subscription fee for some premium services) for access to their platforms. In addition, even if there are payments, the digital companies will be passing on the taxes to the consumers, who will find the end-user based digital services burdensome. Moreover, a VAT type consumption tax is likely to capture only specific transactions leading to shrinking of tax base. To restate, a consumption tax will be the least suited if the purpose of the tax is to extract the economic rent or quasi-rent from the MNEs attributable to specific locations.

B. India's Equalisation Levy – Asserting the right of the market country

In the above background, India is one of the first jurisdictions that imposed a type of DST mainly with a view to provide a level playing field to domestic firms. Section 165 of the Finance Act, 2016 introduced the concept of 'Equalisation Levy'. This initial 6% levy was on the gross consideration in relation to online advertisements and related services paid by Indian service recipients to a non-resident that did not have a PE in India.[33] The immediate trigger for the introduction of the equalisation levy was the Indian Revenue Department's loss in the *Rights Florists* case,[34] where the Income Tax Appellate Tribunal, Kolkata Bench ruled that payments made by Indian residents to digital companies such as Google and Yahoo for advertisement services targeted at the Indian market could not be taxed since these digital companies did not have a PE in India. The Appellate Tribunal noted that "[t]here is nothing on record to demonstrate or suggest that the online advertising revenues generated in India were supported by, serviced by, or connected with an entity based in India".[35] A similar view was expressed by the Income Tax Appellate Tribunal in *Yahoo India Private Ltd v. DCIT, Mumbai*, where the Mumbai Bench held that the assessee was not liable to deduct tax at the source for a payment made to Yahoo Holdings (Hong Kong) Ltd.[36] In light of the above, Section 165 provided that, if a non-resident person receives consideration for providing services of online advertisement, any provision for digital advertising space or any other facility or service for the purpose of online advertisement from a resident Indian or non-resident having a PE in India, then this transaction is subject to equalisation levy at the rate of 6%, subject to a minimum threshold limit

---

[32] *Id.*, art. XIV.

[33] The Finance Act, 2016, No. 28, Acts of Parliament, 2016 §165 [hereinafter the Finance Act of 2016, §165].

[34] ITO v. Right Florists, *supra* note 13.

[35] *Id.*, ¶21.

[36] Yahoo India Pvt. Ltd. v. DCIT, Mumbai, ITA No. 506/Mum/2008 (June 24, 2011).

of Rs. 1 lakh for aggregate payment during the year by each payee.[37] It further provided that if the payer fails to deduct, or deducted but failed to deposit the equalisation levy, then the expenditure will not be allowed as a deduction under Section 40(a)(ib) of the Income Tax Act, 1961 while computing the total income.[38]
India introduced certain changes to Equalisation Levy in the Finance Act, 2020.[39] While the 2016 equalisation levy was on business-to-business transactions, the 2020 amendment includes in its coverage, business-to-customer transactions as well. To be precise, from April 1, 2020 onwards, the scope of equalisation levy has been expanded to include a 2% levy on all online sale of goods or services into India by non-resident e-commerce operators. For the purpose of this levy, an 'e-commerce operator' is defined as a non-resident who owns, operates or manages digital or electronic facility or platform for online sale of goods or online provision of services or both.[40] 'E-commerce supply or services' means: (i) online sales of goods owned by the e-commerce operator; or (ii) online provision of services provided by the e-commerce operator; or (iii) online sale of goods or provision of services or both facilitated by the e-commerce operator; or, (iv) any combination of the above.[41] In other words, India's equalisation levy brings within its ambit, revenue generated from a broad and sweeping range of digital services including digital platform services, digital content services, data-related services, software-as-a-service and other categories of services. Equalisation levy will not apply where the sales, turnover, or gross receipts are less than Rs. 20 million during the financial year. Nor will it apply where non-resident e-commerce operators have PEs in India and provide e-commerce supply or services that are effectively connected to those establishments.

The 2020 amendment does not discriminate against companies based on their foreign residence, as it applies equally to all non-resident e-commerce operators not having a PE in India. Importantly, the equalisation levy is not considered as a taxation on income. Therefore, consideration (i.e., the payment) subject to equalisation levy is not subject to tax withholding.

III. DIGITAL SERVICE TAXES AND SECTION 301 PROCEEDINGS

The Trump Administration initiated retaliation on DSTs imposed by several European and Asian countries under the infamous Section 301 of the Trade Act of 1974. Section 301 proceedings under the Trade Act of 1974 are unilateral actions and have a controversial existence. It is actually not a single section, rather, under

---

[37] The Finance Act of 2016, §165, *supra* note 33.
[38] *Id.*
[39] The Finance Act, 2020, No. 12, Acts of Parliament, 2020.
[40] *Id.*, §164(ca).
[41] *Id.*, §164(cb).

Title III of the Trade Act of 1974, Sections 301 – 310 are codified and are collectively titled as "Relief from Unfair Trade Practices."[42] Section 301 formally establishes a procedure whereby persons can petition the United States (US) government to redress specific foreign barriers on trade.[43] In the past, the US has aggressively used unilateral actions under Section 301 to force countries to eliminate trade barriers and open up their markets to American goods and services. However, the imposition of punitive duties has been declared as WTO-inconsistent for their explicit breach of WTO obligations.[44]

Section 301 remedies have a fairly broad scope. If the United States Trade Representative (USTR) finds that the act, policy, or practice of a foreign country falls within any of the three actionable categories, it may, in response: (i) suspend, withdraw, or prevent the application of benefits of trade agreement concessions; (ii) impose duties, fees, or other import restrictions on the goods or services of the foreign country; (iii) enter into binding agreements that commit the foreign country to eliminate or phase out the offending conduct or to provide compensatory trade benefits; or (iv) restrict or deny the issuance of service sector authorisations to supply services in some sectors in the US.[45]

Section 301 actions are the embodiment of unilateralism. It is a self-help mechanism enabling the US to assert its rights as a sovereign actor.[46] Section 301 actions are premised on the ground that these measures are discriminatory against US firms. It is common knowledge that some of the largest digital companies come from a small group of countries. Naturally, any effort to tax their revenues

---

[42] Trade Act, 19 U.S.C. §§2411 – 2420 (1974) [hereinafter Trade Act of 1974].

[43] KEVIN. C. KENNEDY, INTERNATIONAL TRADE REGULATION: READINGS, CASES, NOTES AND PROBLEMS 754 (2009).

[44] Panel Report, *United States — Sections 301-310 of the Trade Act of 1974*, WTO Doc. WT/DS 152/R (adopted Jan. 27, 2000) [hereinafter *United States — Sections 301*]. In light of the statement made by the United States before the Panel that it would render determinations under Section 304 only in conformity with its WTO obligations, the Panel ruled in favour of its consistency with the United States' obligations under the WTO in respect of Section 301 of the Trade Act. In the recent Panel Report, *US — Tariff Measures on Certain Goods from China,* WTO Doc. WT/DS 544/R (adopted September 15, 2020), China initiated dispute settlement proceeding against the United States in response to USTR's action imposing additional tariffs on Chinese imports pursuant to a Section 301 investigation into Chinese acts, policies, and practices pertaining to technology transfer, intellectual property, and innovation. The Panel in this case held that the tariffs imposed by United States against Chinese goods were inconsistent with United States' WTO obligations. This case did not examine the unilateral nature of Section 301 actions.

[45] *See* Trade Act of 1974, *supra* note 42, §2411(c)(1)(A) – (D).

[46] Jared R. Silverman, *Multilateral Resolution over Unilateral Action: Adjudicating the Use of Section 301 before the WTO*, 17(3) U. PA. J. INT'L L. (1996), 232, at 233.

by market countries often attracts the criticism that these countries are targeting or inordinately impacting digital companies of a certain jurisdiction.[47] While the criticism is at best a logical fallacy, the US put Section 301 to good use to either pressurise or discourage countries from imposing DSTs or similar measures.

In relation to digital taxes, the first of the US' Section 301 actions was on the French DST, initiated in 2019.[48] In December 2019, the USTR concluded that the French DST discriminated against major US companies and that it was inconsistent with the prevailing international tax principles.[49] Subsequently, actions were initiated against the UK, Turkey, Austria, India, etc. The other four DST investigations (of Brazil, the Czech Republic, the EU, and Indonesia) were terminated because these jurisdictions had not adopted or implemented the DSTs under consideration.[50] In many ways, the purpose of these investigations was mainly to shield US digital companies from the proliferation of DSTs.[51]

The trouble with Section 301 proceedings is that there are statutory deadlines. If one examines the procedural history of Section 301, it is beyond doubt that Section 301 actions have morphed from a "diplomatic and relatively flexible tool" for ensuring market access, to a "rigid, and inflexible trade remedy measure".[52] Section 301 actions also emphatically reflect the trade policy priorities of the US Administration. It is no surprise, that in all Section 301 proceedings, the USTR has found that the foreign DST measures were against international tax principles and recommended retaliatory actions.

---

[47] Andres B. Schwarzenberg, Congressional Research Service, *Section 301 Investigations: Foreign Digital Services Taxes (DSTs)* (Mar. 1, 2021), https://crsreports.congress.gov/product/pdf/IF/IF11564.

[48] Office of the United States Trade Representative, Notice of Action in the Section 301 Investigation of France's Digital Services Tax, 85 Fed. Reg. 43292 (July 16, 2020), https://www.govinfo.gov/content/pkg/FR-2020-07-16/pdf/2020-15312.pdf.

[49] Office of the United States Trade Representative, Notice of Determination and Request for Comments Concerning Action Pursuant to Section 301: France's Digital Services Tax, 84 Fed. Reg. 66956 (Dec. 6, 2019), https://www.govinfo.gov/content/pkg/FR-2019-12-06/pdf/2019-26325.pdf [hereinafter France's DST Notice 2019].

[50] Office of the United States Trade Representative, Status Update on Digital Service Tax Investigations of Brazil, the Czech Republic, the European Union, and Indonesia (Jan. 13, 2021), https://ustr.gov/issue-areas/enforcement/section-301-investigations/section-301-digital-services-taxes.

[51] Peter A. Barnes & H. David Rosenbloom, *Digital Services Taxes: How Did We Get Into This Mess?,* 97 TAX NOTES INT'L 1255 (2020); Robert Goulder, *Rethinking the Taboo: Do DSTs Deserve Their Bad Rap?,* TAX NOTES INT'L. (May 8, 2020) https://www.taxnotes.com/opinions/rethinking-taboo-do-dsts-deserve-their-bad-rap/2020/05/08/2chjs.

[52] Silverman, *supra* note 46, at 247.

While many global initiatives are afoot, the proliferation of Section 301 investigations provides a recipe for tit-for-tat trade retaliations. As mentioned earlier, the US initiated Section 301 investigations on France' DST which was introduced in 2018.[53] The US' allegation was that the French DST was unreasonable and discriminatory against US-based tech companies and inconsistent with various international agreements. The US proposed countermeasures in the nature of additional duties of up to 100% on select French products.[54] According to the latest reports, France had agreed to suspend the collection of the DST until December 2020 in exchange for the US agreeing to postpone retaliatory tariffs on French goods.[55]

As the WTO Panel observed in *US — Section 301*, a threat of Section 301 actions from an economically powerful Member can cause serious damage to the other WTO Members and possibly, disrupt the market place. In this case, the threat of 301 is tantamount to "actually using the stick".[56] While a number of countries have either delayed or suspended DST actions, these measures are likely to be a temporary truce unless backed with credible proposals to recognise the right of market countries.

IV. OECD INITIATIVES: THE WAY FORWARD

The taxation of the digital economy has been a difficult issue on which international cooperation has been diffused and scattered.[57] There are several global initiatives in formulating a conceptual framework for digital tax, including those from the OECD and the G20. The OECD in its 2013 – 2016 Base-Erosion and Profit Shifting (BEPS) project,[58] and in its public consultation document (OECD Public Consultation document),[59] sought coordinated global action towards adopting a principle that MNEs report profits where value creation has

---

[53] *See* Office of the United States Trade Representative, Section 301 investigations, https://ustr.gov/issue-areas/enforcement/section-301-investigations.
[54] France's DST Notice 2019, *supra* note 49.
[55] Office of the United States Trade Representative, Notice of Modification of Section 301 Action: Investigation of France's Digital Services Tax, 86 Fed. Reg. 2479 (Jan. 12, 2021), https://www.govinfo.gov/content/pkg/FR-2021-01-12/pdf/2021-00425.pdf.
[56] *United States — Sections 301*, *supra* note 44, ¶7.89.
[57] Alan O. Sykes, *Introduction to the Symposium on Ruth Mason, "The Transformation of International Tax*", 114 AJIL UNBOUND 252 (2020).
[58] Organisation for Economic Corporation & Development, OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting, International collaboration to end tax avoidance,
https://www.oecd.org/tax/beps/#:~:text=The%20Inclusive%20Framework%20on%20Base,the%20OECD%20%2F%20G20%20BEPS%20Package.
[59] OECD Public Consultation Document, *supra* note 3.

taken place. Action Plan 1 of OCED's BEPS project was to address digital taxation.[60] In the G20 meeting at St. Petersburg in 2013, the leaders affirmed that profits should be taxed where the e-commerce companies derive their value from.[61] In 2018, the OECD issued an interim report (OECD Interim Report of 2018) with a suggestion to have a consensus based final report by 2020.[62] Three options viz., (i) significant economic presence;[63] (ii) withholding tax on digital transactions; and (iii) equalisation levy, were identified which a country may choose to adopt in its domestic tax laws, subject to bilateral tax treaties, to address the tax disparity between foreign and domestic business.[64]

The OECD Interim Report of 2018 provides details about the design and implementation of a variety of country measures that are potentially relevant to digitalisation, notably those relating to the broader direct tax challenges identified in the OECD BEPS Action 1 Report, 2015 (OECD/G20 Report of 2015).[65] The various *ad hoc*, un-coordinated and unilateral actions have been grouped into four categories as under:

1. alternative applications of the PE threshold;
2. withholding taxes;
3. turnover taxes; and
4. specific regimes targeting large MNEs.[66]

The OECD Interim Report of 2018 identifies that certain design features are common to some of these unilateral and un-coordinated actions.[67] Most of these actions aim at protecting and/or expanding the tax base in the country where the customers or users are located.

---

[60] ORG. ECON. CORP. & DEV., ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1 - 2015 FINAL REPORT (Oct. 5, 2015), https://www.oecd-ilibrary.org/docserver/9789264241046-en.pdf?expires=1627036711&id=id&accname=guest&checksum=5690E187483A46F4068E848EAF262E7C [hereinafter OECD/G20 Report of 2015].

[61] G20 Leaders' Declaration, St. Petersburg, Russia (Sept. 6, 2013) ¶50, http://www.g20.utoronto.ca/2013/Saint_Petersburg_Declaration_ENG.pdf.

[62] OECD Interim Report of 2018, *supra* note 27.

[63] In 2018, India amended the definition of "Business Connections" under Section 9 of the Income Tax Act, 1961 to include the principle of 'Significant Economic Presence'. *See* the Finance Act, 2018, No. 13, Acts of Parliament, 2018 [hereinafter Finance Act, 2018].

[64] OECD/G20 Report of 2015, *supra* note 60, at 13.

[65] *Id.*, at 97–129.

[66] OECD Interim Report of 2018, *supra* note 27, at 135–147.

[67] *Id.*, at 159.

Importantly, the report states that there is discontent among some countries with the taxation outcomes produced by the current international income tax system.[68] In many areas there are fundamental differences between the US and other countries imposing DSTs. The USTR has consistently taken the view that taxation on gross revenue is a violation of the OECD Model Tax Convention. According to the US, taxation is admissible only on "business profits" or other income streams such as interest, dividends, royalties and capital gains.[69] According to this view, DST based on gross revenue is against the basic architecture and the organising principles of the international tax system. While the focus is not to ring-fence the digital economy, the fact that business models in digital economies are constantly evolving indicates that a consensus-based outcome will be far more difficult to achieve and implement, than initially envisaged.

A. OECD Pillar One Initiative

The Pillar One initiatives of the OECD Blueprints to 'Address the Tax Challenges Arising from the Digitalisation of the Economy' are still under process and recognises the challenges posed by the digital economy.[70] From a neutral point of view and considering the status quo, the Pillar One initiative can be adverse to the interests of the US, being the resident country of some of the world's biggest digital companies. However, considering the rising tide of DSTs across jurisdictions and the compelling case for recognising the taxing rights of the market countries, the US may have to acknowledge the importance of replacing the current concept of PE with the new "nexus" rule which can incorporate the "significant digital presence" concept, discussed below. However, the US still has important stakes in minimising the amount allocated to source jurisdictions and strengthening the dispute settlement provisions. While repudiating the authority of market countries in taxing the revenue attributable to customer jurisdiction is unlikely to mollify the proponents of DST, the US can still keep the impact minimal by suggesting a fair tax allocation/apportionment formula or criteria. The Inclusive Framework under the OECD will have to address concerns relating to a fair allocation of profits in the next few months.

B. Significant Economic Presence

While discussing the options to address the broader direct tax challenges associated with the digital economy, the OECD/G20 Report of 2015 discussed "significant

[68] *Id.*

[69] Office of the United States Trade Representative, Section 301 Investigation, Report on the United Kingdom's Digital Service Tax, Section B.1, p. 18 (Jan. 13, 2021).

[70] ORG. ECON. CORP. & DEV., TAX CHALLENGES ARISING FROM DIGITALISATION – REPORT ON PILLAR ONE BLUEPRINT: INCLUSIVE FRAMEWORK ON BEPS (2020).

economic presence" (SEP) as a tool to establish taxable presence of a non-resident enterprise.[71] The meaning of SEP is not very clear. According to the OECD Public Consultation document, in order to create a nexus between the foreign entity and the revenues generated in the relevant country, the digital and economic means will not be sufficient.[72] There is a suggestion that alongside digital presence, other factors such as the existence of a user base or billing and collection in local currency; after-sales services, repairs or maintenance or other support services, the responsibility for the final delivery of goods to customers, etc could be considered.[73]

Several jurisdictions are introducing the concept of SEP. In March 2018, the European Council had proposed two directives for reforming international taxation by introducing the concept of SEP.[74] This is considered as an attempt to ringfence the digital economy and establish new nexus rules. Similarly, the Indian government amended the Income Tax Act, 1961 in 2018 to provide for an SEP (to supplement physical presence) as a nexus to tax business profits of a non-resident company.[75] However, an amendment of this nature in the domestic tax law is ineffective for all practical purposes in the absence of a corresponding change to tax treaties. Tax treaties usually override provisions of the domestic tax law and thus, negotiating the inclusion of such a change, especially in tax treaties with countries such as the US, is next to impossible. No wonder, the DST is conceived as a tax not on income, but on revenue, and has been carefully devised to fall outside the scope of tax treaties.

V. CONCLUSION

---

[71] OECD/G20 Report of 2015, *supra* note 60, at 107.

[72] OECD Public Consultation Document, *supra* note 3, ¶51.

[73] *Id.*

[74] Proposed Council Directive on laying down rules relating to the corporate taxation of a significant digital presence, COM (2018) 147 final (Mar. 21, 2018); Proposed Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services, COM (2018) 148 final (Mar. 21, 2018).

[75] The new insertion provides that SEP will be considered "business connection" in India and it means:

> (a) transaction in respect of any goods, services or property carried out by a non-resident with any person in India including provision of download of data or software in India, if the aggregate of payments arising from such transaction or transactions during the previous year exceeds such amount as may be prescribed; or
>
> (b) systematic and continuous soliciting of business activities or engaging in interaction with such number of users in India, as may be prescribed.

See Finance Act, 2018, *supra* note 63.

Finding a solution to the disagreement concerning the imposition of DST and the unilateral determination of trade retaliation will be the key concern for the global business community. It is well accepted that current notions of physical PE are not well-suited for the modern economy, especially in relation to the taxation of business income of digital companies. Taxing digital companies based on destination-based indirect or consumption taxes also has its own limitations. In a COVID-19 wrecked global economy, avenues for revenue mobilisation have substantially shrunk; government budgets are under severe stress and income inequalities have risen sharply. There is a compelling case for a market country or the value-creating jurisdiction to tax the income or rent attributable to the market or to a particular location. In the meantime, hybrid forms of taxation such as the DST or equalisation levies can be adopted as *ad hoc* tax measures, provided such measures are adopted in good faith and as interim mechanisms.

The Biden Administrations' decision to not implement the retaliatory measures for a period of 180 days is a welcoming decision.[76] The OECD discussions under the Inclusive Framework on Base Erosion and Profit Shifting have already shown good promise in yielding an outcome on the allocation of business income to market countries, based on the presumption of a virtual PE, SEP, or some other tax principle. A digital tax anchored on a virtual PE or SEP can be based on the gross revenue, turnover, sales or some other indicator or formulary apportionment. In short, the US will have to tone down their resistance to taxing gross revenue. Taxation of the revenue of the digital companies as business profits is ridden with conceptual and practical challenges and may entail amendments to double taxation avoidance agreements. However, the use of retaliatory measures will be the last thing the global economy wants during these challenging times.

[76] Office of the United States Trade Representative, *USTR Announces, and Immediately Suspends, Tariffs in Section 301 Digital Services Taxes Investigations* (Feb. 6, 2021), https://ustr.gov/about-us/policy-offices/press-office/press-releases/2021/june/ustr-announces-and-immediately-suspends-tariffs-section-301-digital-services-taxes-investigations.