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India and recent updates on the OECD/G20 Inclusive Framework's Two-Pillar Approach
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The Organisation for Economic Co-operation and Development (OECD)/Group of Twenty (G20) Inclusive Framework in its January 2020 Statement has affirmed the commitment to arrive at a consensus-based solution to the tax challenges arising out of digitalization of the economy by the end of 2020 and take forward the on-going discussion on the two-pillar approach. This article examines some of the key issues in the Statement for developing countries, such as the scope, new nexus rules, role of accounting standards and proposed source rules. India's proposal on profit attribution through a two-factor apportionment using employees and assets is mentioned as a potential option for country-wise thresholds in the new nexus.

Pillars One and Two are the two approaches adopted by the Inclusive Framework/Group of Twenty (G20) in order to tackle the tax related challenges arising out of digitalization. From a developing country's perspective in general and India's perspective in particular, the formulation of policy and the implementation of the final solution is of considerable importance. This is due to the fact that digitalization has spawned a new era in modern economic thought. With large user bases getting connected rapidly through high-speed information networks, legacy concepts on which conventional taxation theory was based are being rendered obsolete. In this background, we look at how well multilateral tax policy has caught up with the thunderous pace of financial/technological innovation and an update on the January 2020 Statement by the Organisation for Economic Co-operation and Development (OECD)/G20 Inclusive Framework on the Two-Pillar Approach.

The Ottawa Oversight

Since the 1998 Ottawa report on *Electronic Commerce: Taxation Framework Conditions*[1], there have been several attempts by the OECD to tackle the Base Erosion and Profit Shifting (BEPS) issues and other broad tax challenges arising from digital proliferation in the global economy. Our understanding of the effects of digitalization on the economy in general and on taxation in particular has evolved over the last two decades.

[1] OECD, Ottawa report on Electronic Commerce: Taxation Framework Conditions (1998).

Looking at the 1998 report, it is not surprising how the faith and notions held 22 years ago in respect of taxation and digitalization have experienced an utter and absolute volte-face. It is difficult not to refer to the now legendary and prophetic Moore's law[2] at this juncture. Gordon Moore, the co-founder of Intel, in 1965, forecasted that the number of transistors on a chip of a quarter-square inch size doubles every two years.[3] From about 2,000 in 1965, we now stand at roughly 18 billion transistors on a single chip. Our understanding of the impacts of technology on economy and taxation has also been as dramatic, but unfortunately with awkward twists and disturbing U-turns.

Consider the most critical and significant conclusions of the 1998 Report[4]:

a. The most important takeaway from technology is that it offers revenue authorities new opportunities to improve tax-payer service.
b. Principles which guide governments in relation to conventional commerce should also guide them in relation to electronic commerce. New legislation, if any, should be intended to assist in the application of the existing taxation principles.
c. New legislation, if any, should be structured to maintain fiscal sovereignty of countries.
d. Business decisions should be motivated by economic rather than tax considerations.
e. Examine the application of the principles of Harmful Tax Competition work to electronic commerce.

In the last three decades or so, technology's impact on international taxation principles has been so profound, intense and far-reaching that, with the benefit of hindsight, the conclusions of the 1998 report now appear paradoxical.

Consider each of the above proposals in the present scenario. Improving tax-payer services is a non-entity on the top short- or long-term strategies of the OECD/G20 at this point in time. Time and again, it has been established that principles guiding governments in the last 100 years in conventional commerce have been rendered obsolete now. Fiscal sovereignty of countries is sufficiently eroded, under the two-pillar approach's proposed global minimum tax, centralized checks and binding dispute prevention. Adjectives like "financial curse"[5], "scourge"[6], "Capitalism's Achilles' Heel"[7] and "blood bankers"[8] have been used to describe the tax considerations that have driven businesses in the last century. Multiple decades of work on harmful tax competition have been only marginally successful in controlling the proliferation of preferential regimes which has now led to the proposal of Pillar Two.

The issue with *incrementalism*

In effect, none of the recommendations/suggestions of the Ottawa taxation framework have stood the test of time. An overarching theme governs the recommendations in the 1998 report. This is the suggestion that digitalization is a standalone concept that only modifies, customizes

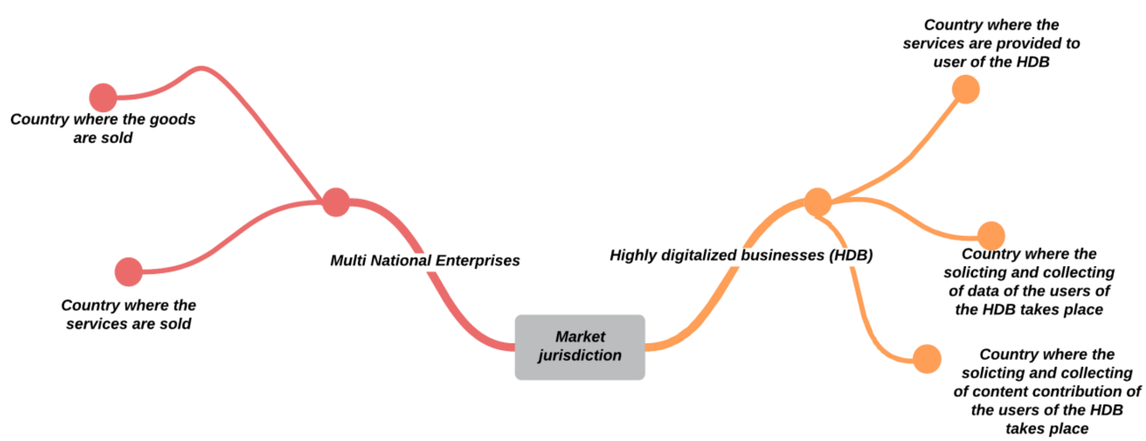
[2] Gordon E. Moore, "Cramming more components onto integrated circuits", *Electronics*, Volume 38, Number 8, April 19, 1965.
[3] Moore's Law is widely considered to have closely predicted the evolution of chip manufacturing technology and the physics involved. In 2017, about 18 billion transistors were found on high-end commercially available chips.
[4] OECD, Ottawa report on Electronic Commerce: Taxation Framework Conditions (1998).
[5] Nicholas Shaxson, *The Finance Curse: How Global Finance is Making Us All Poorer* (Bodley Head, 2018).
[6] Gabriel Zucman, *The Hidden Wealth of Nations: The Scourge of Tax Havens* (University of Chicago Press, 2016).
[7] Raymond W. Baker, *Capitalism's Achilles' Heel: Dirty Money and How to Renew the Free-Market System* (John Wiley & Sons, 2005).
[8] James S. Henry, *The Blood Bankers: Tales from the Global Underground Economy* (New York, Four Walls Eight Windows, 2003).

or reworks the existing commercial frameworks. In reality, digitalization has replaced existing structures instead of modifying them. A complete swap has taken place. Incremental and supplementary changes to the existing system can only bring superficial and cursory improvements to the existing imbalance in taxing rights. The Two-Pillar Approach is yet another incremental measure in redressing the stresses in the existing rules.

Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach

During its 8th Session during 29th – 30th January 2020, the Inclusive Framework (IF) on BEPS comprising 137 countries of the G20 and the OECD including India, released a statement[9], affirming the commitment to arrive at a consensus-based solution to the tax challenges arising out of digitalization by the end of 2020 and take forward the on-going discussion on the two pillars. Certain crucial improvements have been made to the unified approach over the last iteration.

Quite significantly, the term "market jurisdiction" has been defined for the first time. A pictorial representation of the definition is shown below.



Perhaps the biggest positive decision taken in the direction of creating a more equitable system is the inclusion of location where Multinational Enterprises (MNEs) sell tangible goods, directly or indirectly in the definition of the phrase "market jurisdiction". This is in stark contrast to the earlier statements where remote sale was of primary significance. The reference to direct/indirect sale of tangible goods did not come without any riders. It has been stated that mere sale will not create a new nexus without sustained interaction in the market and that further work shall be done to decide the factors which shall indicate, in addition to sales, the creation of a nexus.

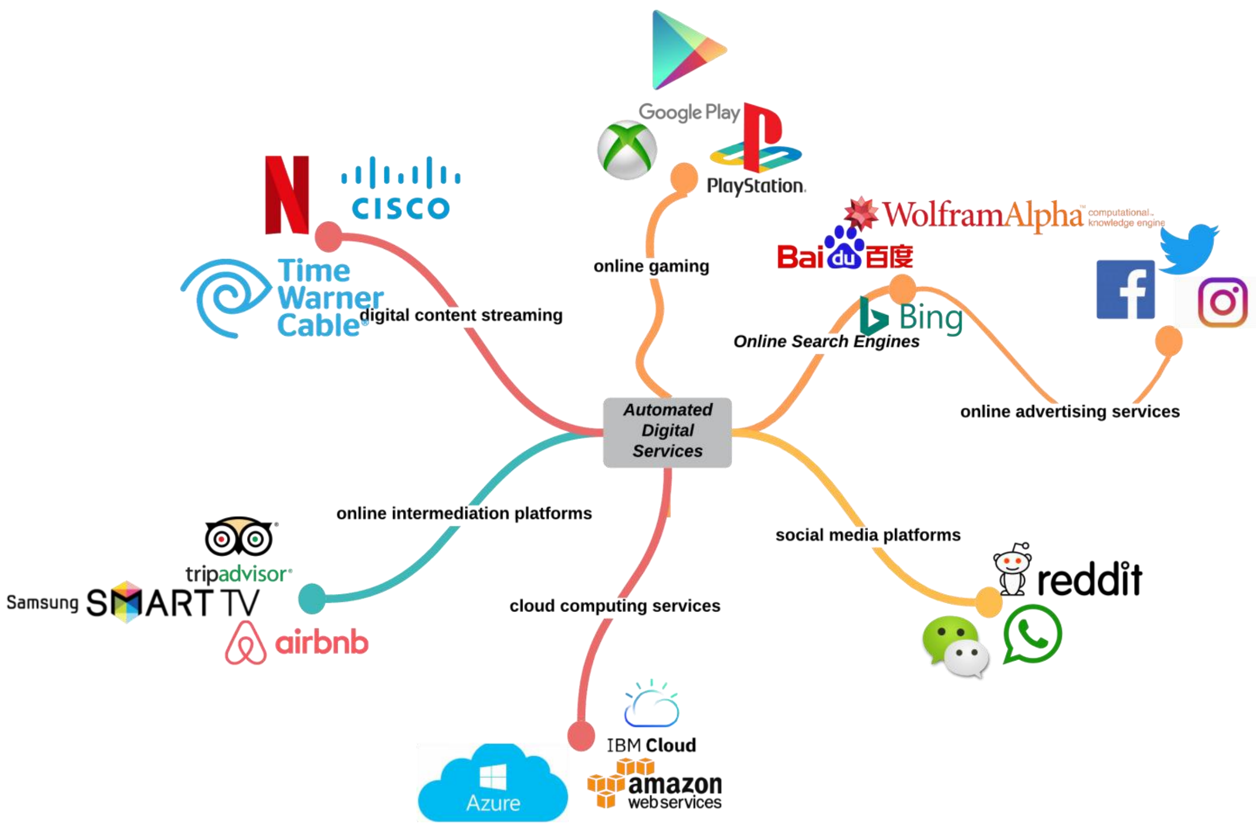
The OECD does not need to look further than India's Profit Attribution Report[10] to ascertain the conditions that in addition to sales would determine an entity's sustained interaction. India's Central Board of Direct Taxes (CBDT) has already, after an elaborate, meticulous and

[9] https://www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf, retrieved on 2nd February 2020.
[10] Report of the Committee to Examine the issues related to Profit Attribution to Permanent Establishment (PE) in India and Amendment of Rule 10 of Income-tax Rules, 1962 (2019, April). Proposal For Amendment Of Rules For Profit Attribution To Permanent Establishment. Retrieved from www.incometaxindia.gov.in.

exhaustive study, identified the two factors of employees and assets that determine the apportionment of profits derived from India. Since setting of thresholds has been the last-word in the OECD's recent work, country-wise thresholds of employees and assets might be the next logical step to include indirect and direct sale of tangible goods within the new nexus.

Automated Digital Services

In addition to the definition of market jurisdiction, automated digital services has been added to the list of income generating activities in addition to consumer facing businesses. These services have been inclusively defined as well. An illustrative diagram of entities covered by the definition is shown here.



The diagram is purely illustrative with companies indicated above operating in more than one category of business.

While financial services have been excluded from the nexus on account of prudential regulation in the market jurisdiction, there are digital wallet services, crypto currency wallet services, money transfer services, online book-keeping services and spending-linked privilege services which offer financial services to individual customers from outside the market jurisdiction without significant regulatory oversight. These may have to be considered by the Inclusive Framework for inclusion in the nexus.

Of Timing and Eyeballs

An important observation made in the statement is with respect to differences in accounting standards of different countries. It has been stated that the most important difference is in respect of when an income is treated as accrued or when an expense is treated as incurred in different jurisdictions. This is most importantly in reference to rates of depreciation, amortization, carry forward of losses and deferment of income disclosure. It is stated that, over the long term, most accounting standards converge to a more-or-less agreeable figure but due to timing issues, yearly income offered in different countries will be substantially different.

While this is only one of the many areas of divergence between accounting standards of countries, this too is not insignificant. The reason why most countries have withholding taxes is to ensure taxes are collected in time, throughout the year to match the government's expenditures throughout the year. If OECD's argument in respect of long-term accurateness of accounting systems is true, most countries would not have had the concept of depreciation at all, the sole purpose of which is to reflect a fairly average picture of the affairs of the business instead of yawning losses in the first five years and monstrous profits in the next five.

An interesting perspective was considered in the statement. It stated that, for online advertising, the rules under the Unified Approach shall deem revenue to arise in the jurisdiction where the advertising has been viewed instead of where the advertising has been purchased. What this means, from plain reading is that, if a hypothetical company selling Darjeeling Tea from India pays INR 100,000 to Google to improve its visibility on its search engine and the advertisement is seen/clicked substantially in the United Kingdom, as per the proposed rules, the income derived by Google from the sale of advertising space shall be deemed to arise in the United Kingdom. This perspective if extended to other kinds of automatic digital services, will probably negate and counter most assumptions that developing countries might be harboring under economic analysis of the two Pillars.

In this background, it is extremely crucial to ensure an effective participation of all members of the Inclusive Framework, including small and developing economies on the ongoing dialogue in respect of the two-pillar approach so that an exercise of independent economic analysis is initiated in all developing market economies. Developing and market economies should also make an effort to discuss and engage on these discussions at multilateral forums so that newer perspectives come into light.

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