

Taxation of Digital Economy - A Study



The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

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Basic draft of this publication was prepared by CA. Sanjay Kumar Agarwal

First Edition : February, 2026

Committee/Department : Committee on International Taxation

Email : citax@icai.in

Website : www.icai.org

Price : ₹ 310/-

ISBN : 978-93-47892-01-1

Published by : The Publication & CDS Directorate on behalf of
The Institute of Chartered Accountants of
India, ICAI Bhawan, Post Box No. 7100,
Indraprastha Marg, New Delhi - 110 002.

Printed by :

Foreword

Taxation has always been an integral pillar of economic policy, yet its role has never been more contested or consequential than in the face of today's digital disruption – a transformation that is compelling tax systems worldwide to fundamentally reconsider the nexus between economic value and taxing rights. In recent years, the rapid digitalisation of economies across the world has created unprecedented challenges and opportunities for tax systems, both domestically and internationally. As digital business models transcend traditional geographic boundaries, conventional tax rules are being re-examined to ensure fairness, efficiency, and revenue adequacy in the digital age.

The Committee on International Taxation of ICAI is committed to advancing knowledge and providing thought leadership in key areas of taxation that impact economic growth, cross-border commerce, and public policy. This publication titled ***"Taxation of Digital Economy – A Study"*** brought out by the committee provides comprehensive analysis of the evolving tax frameworks affecting digital businesses, with particular emphasis on India's multifaceted response – including Significant Economic Presence provisions and India's commitment under the global Two-Pillar solution – and the principles of sovereignty and fairness that underpin them.

I appreciate the efforts of **CA. Sanjay Kumar Agarwal, Chairman; CA. Chandrashekhar Vasant Chitale, Vice-Chairman and all the members of the Committee on International Taxation** for bringing out this Publication.

I am confident that this publication will serve as a valuable and practical reference for professionals in navigating this important aspect of international taxation.

Place: New Delhi
Date: 6th February, 2026

CA. Charanjot Singh Nanda
President, ICAI

Preface

The global economic landscape stands at a critical juncture. Digital technologies have enabled businesses to generate substantial revenues and profits in jurisdictions where they have no physical presence – a phenomenon termed as 'scale without mass'. This has rendered the traditional Permanent Establishment test, which has governed international tax allocation for nearly a century, increasingly inadequate. Digital platforms, data-driven business models and virtual services have reshaped traditional commercial activities, challenged established tax principles and prompted reconsideration of long-standing tax doctrines. In this context, a rigorous understanding of the interplay between digitalisation and taxation has become indispensable for modern tax administrations, policymakers, and advisory professionals.

“Taxation of Digital Economy – A Study” seeks to examine the multidimensional aspects of taxation in the digital era through the lens of India's evolving policy response - notably Significant Economic Presence (SEP), and India's participation in the OECD's Two-Pillar Solution. The objective of this study is to provide a comprehensive, well-researched, and accessible analysis of how digitalisation affects tax policy, tax compliance, and international tax cooperation. This publication examines current tax frameworks, emerging proposals for digital taxation, and the strategic considerations for jurisdictions seeking to adapt their tax systems to digital business realities.

This study is structured to benefit a wide audience — from seasoned tax professionals and corporate tax heads to students and researchers of taxation. The chapter-wise discussions address the foundational concepts, legal interpretations, international tax policy developments, and selected case studies thereby offering practical perspectives alongside the deeper theoretical and doctrinal analysis necessary for sophisticated advisory and policymaking work.

We express our deep gratitude to CA. Charanjot Singh Nanda, President, ICAI and CA. Prasanna Kumar D, Vice-President, ICAI, for their strategic guidance and continued encouragement for the Committee's work.

We sincerely acknowledge the dedicated contributions of CA. Piyush Bafna, CA. Pushpendra Dixit, CA. Nidhi Goyal, CA. Ashwani Rastogi, CA. Shree Lakshmi Valli, CA. Chintan Vajani, CA. Mahima Jain for undertaking the meticulous revision of this edition. We also place on record our appreciation for the critical insights and review by Mr. S.P. Singh (Ex-IRS), who has played a foundational role in shaping India's transfer pricing and international tax policy landscape. His input has significantly enhanced the analytical depth and policy orientation of the publication.

Our special thanks go to all Committee members: CA. Vishnu Kumar Agarwal, CA. Jay Ajit Chhaira, CA. Piyush Sohanrajji Chhajer, CA. Arpit Jagdish Kabra, CA. Umesh Ramnarayan Sharma, CA. Babu Abraham Kallivayalil, CA. Sridhar Muppala, CA. Ravi Kumar Patwa, CA. Rajendra Kumar P, CA. Gyan Chandra Misra, CA. Pankaj Shah, CA. (Dr.) Anuj Goyal, CA. Satish Kumar Gupta, CA. Hans Raj Chugh, CA. Pramod Jain and CA. Rajesh Sharma for their valuable involvement and support.

We also acknowledge the efforts made by Mr. Ashish Bhansali, Secretary, CA. Aparna Chauhan, Assistant Secretary, CA. Prachi Jain, Project Associate, CA. Saloni Sharma, CA. Professional, CA. Manish Goyal, CA. Professional for their technical and administrative assistance in bringing out this publication well in time.

We hope this revised and enhanced edition will deepen your understanding of taxation in digital economy, serving as a valuable guide for professionals navigating an increasingly globalized economy.

Place: New Delhi

Date: 6th February, 2026

CA. Sanjay Kumar Agarwal

Chairman

Committee on International Taxation, ICAI

CA. Chandrashekhar Vasant Chitale

Vice Chairman

Committee on International Taxation, ICAI

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1. The Growing Importance of Digital Transaction

Digitalisation is no longer a peripheral feature of the global economy; it is increasingly its organising principle. The rapid growth of digital transactions worldwide and in India, and the corresponding rise of digital enterprises to the top of global corporate rankings, underline why a dedicated framework for taxation of digital transactions is now a structural necessity rather than a marginal refinement.

1.1 Scale of the digital shift

The global digital economy is estimated at about 15 per cent of world GDP in 2024, or roughly USD 16 trillion of a USD 108 trillion global economy in 2024 and is likely to grow to 17% of global GDP by 2028. Across OECD countries, the ICT sector has grown at roughly three times the pace of the overall economy over the last decade, signalling a sustained reallocation of value creation towards digital activities. The World Economic Forum estimates that more than two-thirds of new value creation over the next decade could come from digitally enabled platforms.¹

India reflects this trend in an even more striking form. The digital economy already contributes about 11.7 per cent of India's GDP (INR 31.64 lakh crore in 2022-23) and is projected to reach about 20 per cent of gross value added by 2029-30, overtaking traditional sectors such as agriculture and manufacturing. Digital payments illustrate the speed of change: UPI volumes have risen from just over 1,000 crore transactions in 2019 to more than 17,000 crore in calendar year 2024, with the value of UPI payments

¹ "Global Digital Economy Rep[ort] – 2025" by Roger Stukhoff, <https://www.idc-a.org/insights> (accessed in January 2026); and "The Global Digital Economy will reach \$16.5 Trillion and capture 17% of Global GDP By 2028" by Michael O'Grady, <https://www.forrester.com/blogs> (accessed January 2026)

increasing from about INR 18.4 lakh crore to nearly INR 247 lakh crore over the same period.²

1.2 From “old economy” champions to digital giants

The corporate landscape has been transformed accordingly. In the late 20th century, the world’s largest listed companies were dominated by oil, automobile and consumer goods majors; technology firms made only an occasional appearance in the top tier. By 2024, technology and digital-platform companies account for the majority of the top global corporations by market capitalisation, with the so-called “Big Tech” or “Magnificent Seven” group alone reaching an aggregate valuation of over USD 20 trillion by Q3 2025.³

Where once energy, industrial and consumer staples groups such as Exxon, General Electric or Philip Morris symbolised economic leadership, they have largely been displaced at the top by enterprises whose core assets are algorithms, data, software and platforms. This transition from tangible, asset-heavy business models to highly scalable, intangible-driven digital models lies at the heart of the contemporary debate on allocation of taxing rights.

2. The Digital Economy and the Tax Challenge

The international taxation framework stands at a critical inflection point. For much of the past century, taxing rights were premised on the assumption that meaningful economic activity required physical presence, with source countries permitted to tax business profits only where a non-resident maintained a permanent establishment. Rooted in the League of Nations conventions and refined through the OECD Model Tax Convention, this approach functioned effectively in the industrial era, offering clarity, predictability, and manageable dispute resolution.

The digital economy has fundamentally disrupted this paradigm. Enterprises can now generate substantial revenues and achieve scale in jurisdictions without any physical presence, a phenomenon often described as “scale

² “Future Ready: India’s Digital Economy to Contribute One-Fifth of National Income by 2029-30” Ministry of Electronics & IT, Government of India, <https://www.pib.gov.in/PressRelease> (accessed in January 2026)

³ “The Magnificent Seven: U.S. Big Tech Market Cap Boom (2000 – Q3 2025)” by Soltani, <https://www.voroniapp.com/markets> (accessed in January 2026)

without mass.” Under traditional rules, such businesses remain largely outside the tax net of market jurisdictions despite significant user participation and consumption. This disconnect between economic reality and tax law has contributed to erosion of tax bases, particularly in developing countries, while domestic businesses remain fully taxable, creating competitive distortions and undermining the perceived legitimacy of the tax system.

3. The Evolution of India's Response

India was among the first nations to recognize this challenge and act decisively. The Finance Act 2016 introduced the Equalisation Levy—a targeted surcharge on online advertising services. Unlike traditional income taxes, it was structured as a tax on gross consideration, cleverly sidestepping constraints of India's Double Taxation Avoidance Agreements and asserting that nations have the right to tax value creation occurring within their borders.

The Finance Act 2020 dramatically expanded the Levy to 2% on e-commerce supplies and services, bringing virtually every major digital platform within the Indian tax net. Though internationally contentious and viewed as discriminatory by developed nations, these unilateral measures became a powerful catalyst for global negotiations, demonstrating that multilateral solutions were necessary to prevent widespread adoption of conflicting national measures.

India implemented Significant Economic Presence (SEP) rules, effective April 1, 2022, introducing a new "business connection" nexus based on economic presence rather than physical location. The amendment to the Income Tax Act, 1961, established specific criteria that trigger tax obligations for non-resident enterprises engaging significantly with the Indian market, reflecting the principle that value is created where the users are served.

4. The Global Context: Convergence and Fragmentation

India's legislative initiatives emerged against a global effort to reconfigure international taxation for the digital economy. Although the OECD's BEPS project recognised these challenges, it failed to achieve consensus, and the 2015 Action 1 Report offered only a menu of unilateral options such as digital

services taxes and economic nexus rules. This impasse led many countries to adopt divergent national measures, resulting in fragmented and overlapping digital tax regimes.

A turning point came in October 2021 with the OECD/G20 Two-Pillar Solution, representing a negotiated compromise. Pillar One reallocates a portion of residual profits of the largest multinational enterprises to market jurisdictions, while Pillar Two introduces a global minimum tax of 15 per cent. In line with this framework, India sunset its Equalisation Levy through amendments enacted in 2024 and 2025. Nevertheless, India has retained the Significant Economic Presence provisions under domestic law, reflecting its policy position that taxing rights should align with economic activity, subject to treaty constraints.

5. The Structural Imperative: Why Digital Taxation Matters

The taxation of digital transactions transcends technical compliance and revenue collection; it engages fundamental principles of fiscal sovereignty and economic fairness. From a revenue perspective, digital commerce constitutes one of the fastest-growing segments of global trade. Platform economies, Software-as-a-Service, streaming media, online advertising, e-learning, and fintech models generate substantial cross-border flows, with significant value creation occurring in countries like India. Yet absent new taxing rights, this value escapes source-country taxation.

From a fairness perspective, the current framework creates competitive imbalance. Domestic enterprises face full corporate income taxation, while foreign competitors serving identical customers through digital means may face no source-country income tax. This distortion favours incumbent foreign players and stifles domestic innovation. From a fiscal capacity perspective, digital taxation directly impacts developing countries' public finance. Low tax-to-GDP ratios limit resources for health, education, and infrastructure investment. The digital economy offers an opportunity to broaden the tax base without increasing rates. Lost revenue opportunities have material consequences for public services and infrastructure development.

From a systemic legitimacy perspective, perceived unfairness of preferential treatment for foreign digital enterprises erodes public confidence in the tax system. When foreign technology companies pay minimal tax while domestic

competitors face substantial obligations, the system's coherence and legitimacy are compromised, creating political pressures for protectionism and economic nationalism.

It is against this complex backdrop that the taxation of digital transactions assumes paramount importance. The frameworks, principles, and provisions discussed in the chapters that follow are not abstract legal constructs. They represent concrete efforts by India and the global community to rebalance taxing rights, to ensure fair taxation, and to align tax law with economic reality.

6. The Scope and Structure of This Publication

This publication addresses the principal issues arising from the taxation of digital transactions in India. It is grounded in current law, including the amendments introduced by the Finance Act 2025, and reflects the state of administrative and judicial interpretation as of the time of publication.

The subsequent chapters are organized as follows:

Chapter 2: Significant Economic Presence

The chapter traces SEP's evolution from BEPS Action 1 origins through introduction via Finance Act 2018, deferral in 2020, and operationalization under Rule 11UD. It provides comprehensive analysis of the statutory definition under Explanation 2A to Section 9(1)(i), including triggering thresholds and transaction scope. It analyses the scope and interpretation of SEP, covering transaction-based and user-based tests, the interaction between SEP and tax treaty protections, and the circumstances in which SEP becomes effective in the absence of treaty relief. The chapter also highlights key interpretational ambiguities, compliance challenges, and the unresolved issue of profit attribution, underscoring the potential for litigation and the need for greater clarity to ensure certainty and fairness in the application of SEP.

Chapter 3: Practical Issues Emerging from the Two-Pillar Approach

This chapter examines challenges relating to scope determination, revenue sourcing, profit allocation, compliance obligations, dispute prevention and resolution mechanisms, and coordination between domestic law and treaty-based frameworks. The chapter highlights complexities in data availability, segmentation of accounts, interaction with existing transfer pricing rules, and

administrative capacity constraints, especially in developing economies. It underscores the risk that, notwithstanding conceptual consensus, implementation frictions may dilute the effectiveness of the Two-Pillar approach. It addresses five critical implementation challenges arising from Pillar Two's GloBE rules: (1) selecting appropriate financial statements for ETR computations across different accounting standards (GAAP, IND AS, IFRS) and ensuring consistency; (2) treating opening brought-forward tax losses in transition years, including situations where deferred tax assets are not recognized; (3) whether Permanent Establishments must maintain separate financial statements for income and tax attribution; (4) accounting disclosure requirements under IAS 12 amendments versus IND AS 12; and (5) whether US BEAT taxes qualify as "covered taxes." The chapter examines ETR calculation complexities including substance-based income exclusion (SBIE), jurisdictional blending, and IIR/UTPR interplay. India-specific challenges include impact on tax incentives, transfer pricing adjustments, and administrative burdens in tracing MNE data across multiple jurisdictions.

Chapter 4: Permanent Establishment in Digital Economy

This chapter provides a comprehensive analysis of the concept of Permanent Establishment in the digital economy. The PE concept's traditional reliance on physical presence has become inadequate in the digital economy, creating "scale without mass" challenges. This chapter traces the global response through BEPS Action 1 (which diagnosed the problem but deadlocked) and Action 7 (reinforcing PE through anti-avoidance rules targeting commissionaire arrangements, preparatory/auxiliary exceptions, and anti-fragmentation—incorporated into India's treaty network via the Multilateral Instrument). The chapter analyses India's legislative response through SEP provisions and judicial evolution establishing the "pervasive control" doctrine, allowing courts to find PE based on functional control rather than formal ownership. The chapter analyses some of the important tax rulings. It examines India's emerging dual-track nexus framework—Pillar One for Super-MNEs and aggressive judicial PE determination for others—and practical implications for e-commerce, cloud computing, captive centres, and digital business models.

Chapter 5: OECD vs. UN Approaches to Taxation of the Digital Economy

This chapter contrasts the OECD's consensus-driven Two-Pillar Solution with the UN's simpler Article 12B framework on Automated Digital Services. The OECD approach reallocates only 25% of residual profits of approximately 100 Super-MNEs through complex formulary mechanisms requiring multilateral convention ratification, while UN Article 12B grants withholding tax rights (3-4%) on all digital service providers via simpler bilateral amendments. The chapter evaluates the relative merits of each approach from the perspective of developed and developing countries, examining whether the UN framework offers a more source-oriented and pragmatic solution for market jurisdictions such as India. It also considers the implications of divergent global standards on treaty negotiations and international tax coherence.

Chapter 6: Unilateral and Multilateral Measures on Digital Taxation

Chapter 7 examines unilateral and multilateral measures adopted by countries to tax the digital economy in the absence of a comprehensive global consensus. The chapter analyses instruments such as digital services taxes, equalisation levies, withholding taxes, and domestic nexus rules, alongside multilateral initiatives under the OECD and UN frameworks. It evaluates India's use of unilateral measures as both revenue tools and strategic levers in international negotiations, and assesses the risks of fragmentation, double taxation, and trade disputes arising from overlapping regimes. The chapter concludes by highlighting the need for coordinated multilateral solutions to ensure certainty, fairness, and stability in digital taxation.

Chapter 7: Taxation of Virtual Digital Assets including Cryptocurrencies / Crypto-assets

The chapter traces the evolution of India's approach to VDAs, culminating in the statutory recognition and taxation regime introduced through amendments to the Income-tax Act, including the special charging provisions, flat tax rates, denial of set-off and carry-forward of losses, and withholding obligations. It analyses key conceptual challenges such as classification of VDAs, characterisation of income (investment versus business), valuation issues, cross-border transactions, and enforcement difficulties arising from decentralisation and anonymity. The chapter also discusses the interaction between VDA taxation and international tax principles, regulatory

developments, compliance obligations, and policy concerns, highlighting the tensions between revenue mobilisation, market regulation, and technological innovation in the rapidly evolving crypto-asset ecosystem.

7. The Intended Audience and Approach

This publication is intended for tax professionals—chartered accountants, advocate, tax consultants, and in-house counsel—who advise multinational enterprises and Indian businesses on the tax implications of digital transactions. It is also relevant to tax administrators, policymakers, and academics seeking to understand the evolving contours of India's digital taxation regime.

The treatment throughout seeks to balance accessibility with precision. Complex statutory language is explained in plain terms, but without sacrificing technical accuracy. Case studies and illustrative examples are provided to illuminate the practical application of principles that might otherwise remain abstract.

A recurring theme throughout the publication is the importance of clarity and certainty in tax law. The digital economy is characterized by rapid change, by business models that blur traditional boundaries, and by technologies that outpace regulatory adaptation. Tax law, by contrast, requires stability and clarity to be effective. When statutory provisions are ambiguous or rules are missing—as is the case with profit attribution under SEP—they create uncertainty that burdens both taxpayers and administrators. This publication aims to highlight these gaps while also offering practical frameworks for navigating current uncertainties.

The ultimate goal is not merely to catalogue rules and procedures, but to equip professionals with a deep understanding of the principles underlying digital taxation in India, the challenges and opportunities they present, and the likely trajectory of legal and administrative development in this rapidly evolving field. The chapters that follow provide both the legal foundations and the practical guidance necessary to do so.

8. Conclusion

The taxation of digital transactions represents one of the most significant and complex challenges facing the global tax system. For India, the challenge is particularly acute: a nation with a massive and rapidly growing digital

economy, enormous fiscal pressures, and a strong commitment to ensuring that foreign digital enterprises contribute fairly to the Indian tax base. The frameworks and rules discussed in this publication are India's multifaceted response to this challenge.

These responses—Significant Economic Presence, the Equalisation Levy (now largely sunset), commitments under the Two-Pillar Solution—do not constitute a perfect or permanent solution. They are, rather, pragmatic measures reflecting India's assessment of its immediate needs, its negotiating leverage in global forums, and its commitment to the principles of sovereignty and fairness in international taxation.

As the digital economy continues to evolve, and as the global consensus on digital taxation continues to develop, these frameworks will inevitably be refined, amended, and supplemented. The chapters that follow provide a comprehensive analysis of the current state of the law and the conceptual foundations upon which future refinements will be built. For tax professionals and policymakers alike, a nuanced understanding of these provisions is essential to advising clients, formulating policy, and contributing to the ongoing global conversation about the future of international taxation in the digital age.

Significant Economic Presence

1. Introduction and Background

1.1. Evolution of International Taxation and Challenges in the Digital Economy

The foundations of international taxation, built nearly a century ago, were designed for an era of physical trade, tangible assets, and brick-and-mortar businesses. The “1920s compromise” allocated taxing rights on active business income to the source country and passive income to the residence country, with the **permanent establishment (PE)** concept—requiring physical presence—at its core. Codified in early German law and later refined through OECD model conventions, this framework worked well until the digital revolution. Today’s digital economy, driven by intangibles, user data, and multi-sided business models, allows companies like Google, Amazon, Meta, and Netflix to earn significant revenues across borders without local presence, exposing the inadequacy of existing tax rules and creating the global “digital economy tax challenge.”

1.2. Rationale for SEP: Addressing Limitations of Traditional Rules

The traditional requirement of physical presence has become increasingly inadequate in addressing the realities of modern business operations. The existing nexus rules, which were designed for a pre-digital age, create several fundamental problems:

- **Misalignment with Value Creation:** Digital businesses can create significant value in market jurisdictions through user engagement, data collection, and network effects without any physical presence. Traditional rules fail to recognize this value creation, leading to a disconnect between where economic activity occurs and where profits are taxed.
- **Base Erosion and Profit Shifting (BEPS) Opportunities:** The mobility of intangibles, users, and business functions in the digital economy creates opportunities for multinational enterprises to shift

Significant Economic Presence

profits to low-tax jurisdictions while generating substantial income from high-tax markets. The decreased need for local personnel and flexibility in choosing server locations exacerbate these opportunities.

- **Competitive Distortions:** The physical presence requirement creates unequal treatment between digital and traditional businesses. While traditional businesses with physical operations are subject to taxation in market or source jurisdictions, digital businesses providing similar services can avoid such taxation, creating competitive imbalances.
- **Revenue Loss for Market Jurisdictions:** Countries where digital businesses have substantial user bases and generate significant revenues often cannot tax these profits under traditional rules, leading to erosion of their tax bases.

The concept of Significant Economic Presence (SEP) emerged as a response to these limitations. SEP represents a paradigm shift from physical nexus to economic nexus, recognizing that businesses can have a significant economic presence in a jurisdiction without physical presence. This concept acknowledges that in the digital economy, value creation often occurs through interaction with users, collection of data, and provision of services through digital platforms.

India became a pioneer in this area, introducing SEP provisions through the Finance Act 2018. The SEP concept broadens the definition of 'business connection' under Section 9 of the Income Tax Act, 1961, to include situations where non-residents have significant economic presence in India without physical presence.

1.3. Global Context: OECD BEPS Action Plan 1 and Other International Efforts

The OECD's Base Erosion and Profit Shifting (BEPS) initiative, launched in 2013, marked global recognition of the tax challenges of the digital economy. Action 1 highlighted how companies could participate deeply in foreign markets without triggering tax under existing rules. The 2015 Action 1 Report acknowledged these challenges but found it impossible to ring-fence the digital economy, instead calling for consensus-based solutions. Renewed G20 mandates led to the OECD's 2018 Interim Report and the Two-Pillar Solution: **Pillar One** reallocates taxing rights to market jurisdictions, while **Pillar Two** sets a global minimum tax. It may be interesting to note that

Action Plan 1 of the OECD BEPS Project suggested three alternatives to address digital economy tax challenges: a new nexus rule based on Significant Economic Presence (SEP), a withholding tax on certain digital transactions, and an equalisation levy.

2. Definition and Scope of Significant Economic Presence

2.1. Evolution of SEP Provisions in India

The rise of the digital economy disrupted traditional tax principles, particularly the long-established reliance on physical presence for creating a taxable nexus. Responding to this global shift, India was one of the first countries to legislate a digital nexus concept under domestic tax law through the notion of Significant Economic Presence (SEP).

2.1.1. Finance Act, 2018: SEP Introduced

India introduced the concept of SEP via Explanation 2A to Section 9(1)(i) through the **Finance Act, 2018**, effective from **Assessment Year 2019–20**. The Memorandum to the Finance Bill, 2018 explained the rationale for introduction of the provision. It highlighted that the traditional tax rules relied on a non-resident's physical presence to establish tax obligations in a country. With digital advancements, businesses can now interact with foreign markets remotely, sidestepping physical presence and, thus, source-based taxation. The Memorandum recognised the adverse effect on the revenue of the country by eroding the source country's right to tax profits earned from its economy. The Memorandum refers to actions by the OECD reflected in BEPS Action Plan 1 which proposed a new nexus rule based on "significant economic presence," determined by sustained, purposeful digital engagement and revenue generated. In view of these facts, India proposed to amend its tax laws to recognize significant economic presence as constituting a "business connection," ensuring digital businesses are brought within the tax net.

This explanation fundamentally expanded India's ability to tax non-residents by decoupling nexus from physical presence and linking it to **digital engagement** or **economic thresholds** in India.

However, CBDT circular¹ explaining provisions of the Finance Act 2018 has clarified that –

“Therefore, if any transactions or activities are carried out by a non-resident in India beyond a threshold as may be prescribed, then such non-resident taxpayer would be liable to tax in India irrespective of its physical presence. In this connection, it is also clarified that unless corresponding modifications to PE rules are made in the DTAA, the cross border business profits will continue to be taxed as per the existing treaty rules.”

2.1.2. Finance Act, 2020: Deferral of Applicability

Although originally intended to take effect from FY 2018-19, the SEP provisions were never operationalized due to the lack of prescribed thresholds. Further, the SEP provisions introduced by the Finance Act 2018 were omitted by the Finance Act, 2020 before it came into effect.

In its place, new *Explanation 2A* to Section 9(1)(i) of Income-tax Act, 1961 (hereinafter referred to as “the Act”) was inserted to take effect from 01 April 2022. Further, the **Finance Act, 2020** deferred their applicability to **Assessment Year 2022-23 onwards** considering ongoing multilateral negotiations at the OECD. The Memorandum to the Finance Bill 2020 explained:

“Therefore, for the purposes of determining SEP of a non-resident in India, threshold for the aggregate amount of payments arising from the specified transactions and for the number of users were required to be prescribed in the Rules. However, since discussion on this issue is still going on in G20-OECD BEPS project, these numbers have not been notified yet. G20-OECD report is expected by the end of December 2020. In the circumstances, it is proposed to defer the applicability of SEP to starting from assessment year 2022-23. Certain drafting changes have also been made while deferring the proposal. The current SEP provisions shall be omitted from assessment year 2021-22 and the new provisions will take effect from 1st April, 2022 and will, accordingly, apply in relation to the assessment year 2022-23 and subsequent assessment years.”

At the same time, Finance Act 2020 which made newly substituted SEP provisions effective from AY 2022-23 onwards made some significant changes to the language of Explanation 2A, which is tabulated as under –

¹ Circular 8 of 2018 having F. No. 370142/07/2018-TPL

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Clause	Finance Act, 2018	Finance Act, 2020 (w.e.f. 1-4-2022)	Nature of Change
Opening Phrase	“it is hereby clarified”	“it is hereby declared”	The shift from “clarified” to “declared” suggests the government intended to emphasize this as a new statutory rule, rather than merely interpret an existing one. This could be relevant in interpreting legislative intent.
Clause (a)	“carried out by a non-resident in India”	“carried out by a non-resident with any person in India ”	Expanded scope –The phrase “carried out with any person in India” reflects a deliberate expansion of the scope beyond territorial boundaries. A transaction could now be deemed to create SEP even if executed outside India, so long as it involves an Indian party.
Clause (b)	“with such number of users as may be prescribed, in India through digital means ”	“with such number of users in India , as may be prescribed”	Dropping “through digital means” in clause (b) potentially brings in non-digital systematic engagement, although interpretationally, it may still lean toward digital, based on legislative intent and context.

Significant Economic Presence

The seminal commentary of Sampath Iyengar² contextualizes SEP as a strategic legislative move aimed not just at immediate taxation, but as a precursor to treaty negotiations. It observes that India's push to embed SEP into domestic law, even before global consensus, was indicative of a larger vision: to protect source-country taxing rights in a digitized world. The commentary highlights:

“The concept of 'significant economic presence' as a nexus for income to be taxed in India was first introduced in the Act by Finance Act, 2018 ... The intention of bringing in the concept of SEP in the domestic law is to enable India to negotiate for inclusion of this new nexus rule in the Double Taxation Avoidance Agreements.”

2.1.3. Rule 11UD Thresholds

Further, via Notification No. 41/2021 dated 3 May 2021 Rule 11UD³ was introduced which operationalised the regime from FY 2021–22 onwards by prescribing quantitative thresholds pertaining to payments and user interactions as under –

Thresholds for the purposes of significant economic presence.

11UD. (1) *For the purposes of clause (a) of Explanation 2A to clause (i) of sub-section (1) of section 9, the amount of aggregate of payments arising from transaction or transactions 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 during the previous year, shall be two crore rupees.*

(2) *For the purposes of clause (b) of Explanation 2A to clause (i) of sub-section (1) of section 9, the number of users with whom systematic and continuous business activities are solicited or who are engaged in interaction shall be three lakhs.*

2.1.4. Budget 2025: Carve-Out for Export-Oriented Purchases under SEP

In the Finance Bill 2025, India made a key amendment to Explanation 2A—the provision defining Significant Economic Presence (SEP) to ensure “**mere purchase of goods in India for export**” does not constitute an SEP trigger.

² Sampath Iyengar's Commentary on Explanation 2A to section 9 (13th Edition 2022)

³ Inserted by the IT (Thirteenth Amdt.) Rules, 2021, w.e.f. 1-4-2022.

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This clarification, effective from **1 April 2026** (i.e., Assessment Year 2026–27 onward), formally excludes such export-only procurement activities from the nexus test.

Key Aspects of the Amendment:

A. Alignment with "Business Connection": This amendment aligns the scope of SEP with the long-standing concept of "business connection" under Section 9(1)(i) of the Income Tax Act. The traditional understanding of a business connection has always carved out an exception for procurement activities in India that are solely for export purposes. This move brings consistency and predictability to India's tax framework.

B. Addressing Industry Concerns: The introduction of SEP provisions had raised concerns that foreign companies, which only use India as a sourcing hub for their global supply chains, could be inadvertently brought into the Indian tax net. This amendment directly addresses these concerns, providing much-needed relief to export-oriented businesses and reinforcing India's position as a reliable sourcing destination.

While this carve-out is a welcome and necessary step, it also highlights the need for ongoing refinement of the SEP provisions. The digital economy is complex and dynamic, and tax laws must evolve to keep pace. The current amendment is a positive development, but further clarifications and adjustments may be required to prevent the SEP provisions from having unintended consequences and to ensure that they are applied in a fair and equitable manner.

This carve-out realigns SEP's applicability with the traditional notion of "business connection" under Section 9(1)(i) of the Act, where mere imports or consumption of goods in India, would not ordinarily create taxable nexus. By shielding purely export-driven procurement from being construed as SEP, the amendment calibrates the law to protect global supply and trading chains from undue tax liabilities in India.

2.2. Statutory Framework and Interpretation of Explanation 2A

Explanation 2A to Section 9(1)(i) of the Act provides that for the purposes of the section, SEP of a non-resident in India shall constitute "business connection," and specifies two distinct yet alternative tests for the determination of SEP:

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- (a) **Transaction-based test:** Any transaction in respect of any goods, services, or property—including mere digital delivery or provision of software/data—between a non-resident and any person in India, where the *aggregate payments* arising from such transactions in the prior year exceed the prescribed threshold; or
- (b) **User-based test:** Systematic and continuous soliciting of business activities or engagement with such number of users in India (through digital means) as may be prescribed.

Importantly, SEP is in **addition to** the pre-existing rules concerning “business connection” and the dependent agent rules; it does not supplant them but rather complements them.

2.3. “any transactions” – meaning

Rooted in the OECD’s BEPS Action Plan 1, the SEP provision under Explanation 2A to Section 9(1)(i) was introduced by the Finance Act, 2018, to capture income arising from digital transactions even where no physical presence existed. The original language emphasized interaction “in India” and, notably for the user-based limb, specified that such interaction should occur “through digital means.”

However, the Finance Act, 2020, brought about significant changes that have since shaped the interpretational landscape. Most notably, the revised version (effective from 1 April 2022) expanded the scope of clause (a) by substituting “carried out by a non-resident in India” with “carried out by a non-resident with any person in India,” and clause (b) was revised to remove the qualifier “through digital means.” These changes, though subtle in phrasing, materially broadened the potential application of SEP.

This brings us to the ongoing debate: how broad is the scope of SEP in practice?

The Narrow Interpretation: A Digital-Only View

One school of thought holds that the SEP provision should be read narrowly to apply only to inherently digital transactions. This view draws support from the doctrine of *ejusdem generis*, arguing that since SEP was conceptualized to address challenges of the digital economy and includes a user-based test, the term “any transaction” in clause (a) should also be limited to digital contexts. Under this view, merely using digital communication (like emails or

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videoconferencing) in a traditional transaction, such as the sale of physical machinery, would not suffice. The digital component must be central, not incidental.

The Broad Interpretation: A Literal and All-Encompassing View

Conversely, the broader view insists on a plain and literal reading of the statutory language. Since neither clause (a) nor clause (b), in their current form, expressly limits applicability to digital transactions, this interpretation argues that all commercial interactions - digital or otherwise, fall within the SEP net, provided they meet the prescribed thresholds. The deliberate omission of the phrase “through digital means” in the 2020 amendment is seen as a legislative signal: the scope of SEP is meant to transcend the digital economy.

Under this broader view, the sale of machinery to an Indian entity regardless of how the deal was communicated would be relevant for SEP threshold calculations. This interpretation supports a uniform standard based purely on economic substance and the location of counterparties.

While the narrow interpretation is more aligned with SEP’s conceptual origins, the amendments in the Finance Act, 2020, point unmistakably toward a legislative intent to widen the regime’s scope. The change from “in India” to “with any person in India” in clause (a) reflects a move away from territorial limitations. Similarly, the removal of the “digital means” qualifier from clause (b) dilutes the original focus on digital presence.

To date, there is no administrative guidance or judicial ruling definitively resolving this interpretational divide. This has placed non-resident taxpayers in a challenging position caught between the risk of litigation under a narrow interpretation and the burden of over-compliance under a broad one.

Given the language refinements in 2020 and the absence of limiting words in the current statute, the broad interpretation is increasingly seen as the safer and more defensible position from a compliance perspective. Nonetheless, clarity from the Central Board of Direct Taxes (CBDT) would be a welcome step to bring certainty to cross-border business structuring in the digital and traditional economies alike.

2.4. Applicability: Persons and Transactions Covered

2.4.1. Persons to Whom SEP Applies

The provision is plainly drafted to catch **non-resident persons**—regardless of whether they have a physical Permanent Establishment (“PE”) or enjoy the benefit of a tax treaty. While SEP is unambiguously part of Indian domestic law, its application to treaty-protected non-residents is significantly limited. Where a Double Taxation Avoidance Agreement (“DTAA”) subsists, treaty provisions (particularly PE articles) may override domestic nexus unless the treaty itself is amended to recognize SEP-like economic nexus. This means non-treaty non-residents and treaty residents lacking PE protection are potentially within the full sweep of the SEP regime.

2.4.2. Transaction-Based Test

The CBDT has notified⁴ the following threshold under Rule 11UD: Aggregate payments from India exceeding INR 20 million in a financial year constitute a significant economic presence.

The transactions included are defined broadly and encompass:

- Sale and purchase of goods, services, or property—regardless of whether physical or digital means are used;
- Provision, download, or access to data or software (for example, in-app purchases or SaaS models);
- Online streaming or provisioning of e-content (audio, video, etc.);
- Digital advertising, cloud and IT services, e-learning, online gaming, and analogous digital interfaces.

The threshold is intentionally set at a level aimed at capturing significant digital business, but its scope is such as to potentially extend to traditional cross-border trade conducted electronically.

2.4.3. User-Based Test

Rule 11UD further prescribes that where a non-resident engages (systematically and continuously) with more than 300,000 users in India through digital or automated means in a year, SEP will be deemed to arise.

⁴ Notification no. 41 of 2021

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Covered activities include soliciting business through apps, websites, digital marketplaces, or any internet-based interface.

2.4.4. Consequences and Compliance Mandate

Where SEP is established:

- The non-resident is deemed to have a “business connection” in India under Section 9(1)(i), rendering such income attributable to the Indian operations taxable in India.
- Indian residents making specified payments to such non-residents must deduct tax at source under Section 195, necessitating compliance structures in cross-border transactions.
- Non-residents with SEP must obtain a Permanent Account Number (PAN), file tax returns in India, and maintain documentation justifying profit attribution.

It is emphasized that while SEP is intended as an anti-avoidance and modernization measure for the digital economy, its textual breadth can sweep in high-value traditional trade or isolated large deals executed via digital communication. The interplay between SEP, other business connection rules, and treaty relief is likely to give rise to interpretative wrangles and increased litigation, particularly in the absence of authoritative judicial exposition or detailed administrative guidance by the CBDT.

3. Treaty Law vs. Domestic Law: SEP and Permanent Establishment

3.1. Conflict between Domestic SEP Rules and International Tax Treaties

Under Section 9(1)(i) of the Income-tax Act, 1961, business connection traditionally required physical presence or dependent agents in India. SEP, via Explanation 2A, creates an economic nexus, an economic criteria alone (INR 20 million revenue or 300,000 users) suffice for SEP, equating SEP to business connection. Domestic law thus deems SEP-triggering non-residents taxable in India, even without a PE under treaty.

However, Section 90(2) of the Income Tax Act stipulates that when a DTAA exists, the more beneficial rule (treaty or domestic) applies. All of India's >90 DTAA's follow the PE definition (fixed place of business; dependent agent;

service PE etc.) for business profit taxation, which still hinges on physical presence. Consequently, treaty-protected non-residents meeting SEP thresholds but lacking fulfilment of a treaty PE conditions cannot be taxed in India under SEP, because treaty PE definitions “override” SEP as domestic law.

3.2. When Treaty Protection Overrides SEP

The “beneficial bargain” rule (Section 90(2)) allows non-residents to choose treaty or domestic law. For digital-only businesses from treaty countries:

- If no treaty PE exists, treaty protection applies, and SEP income is not taxable in India despite crossing SEP thresholds.
- Treaty PE definitions have not been updated to include digital-economy nexus or user-based criteria, so digital SEPs fall outside treaty PE.
- SEP thus remains ineffective for treaty taxpayers.

3.3. Treaty Override vs. Domestic Sovereignty:

The introduction of Significant Economic Presence (SEP) reflects India’s sovereign power to define nexus rules under domestic law. By deeming digital presence as sufficient to create a “business connection” under Explanation 2A to Section 9(1)(i), India has unilaterally expanded its taxing rights.

However, international obligations constrain this sovereignty. Article 27 of the Vienna Convention on the Law of Treaties makes clear that domestic law cannot override treaty commitments. Thus, where a Double Taxation Avoidance Agreement (DTAA) requires a permanent establishment (PE) for taxing business income, the SEP provision cannot displace that standard.

The result is a dual regime. SEP applies effectively in non-treaty situations or where treaty benefits are unavailable. But for residents of treaty jurisdictions, SEP has little effect unless the treaty itself is renegotiated to include such nexus. In practice, SEP operates as a treaty-gap filler, underscoring the divide between India’s unilateral legislative power and its binding treaty obligations.

3.4. Applicability of SEP Where Treaty Protection is Unavailable:

The effectiveness of India's Significant Economic Presence (SEP) rule must always be assessed in the context of tax treaties. For taxpayers resident in a jurisdiction with which India has a Double Taxation Avoidance Agreement (DTAA), SEP alone does not create taxing rights unless the treaty itself is amended to include such a nexus. However, there are several situations where treaty protection may not be accessible, in which case the domestic SEP provision operates in full force.

One such situation arises from challenges in establishing tax residency. Treaty benefits are extended only to a resident of the contracting state, as defined in Article 4 of the OECD and UN Model Conventions. If a taxpayer cannot establish residency, whether due to hybrid mismatch arrangements that leave it dual resident or stateless for treaty purposes, or due to inability to meet local residence requirements in the treaty partner country, it cannot invoke the DTAA. Practical difficulties can also arise, such as failure to obtain or furnish a Tax Residency Certificate (TRC) or supporting documentation under Section 90(4) and 90(5) of the Income-tax Act, which may prevent access to treaty relief. In such cases, the Indian Revenue might disregard treaty claims and apply domestic law, including SEP, to tax the income.

Another situation involves limitation of benefits clauses embedded in several modern treaties. If a non-resident fails to satisfy the limitation of benefits conditions, such as the requirement of sufficient business substance in its home jurisdiction, treaty protection may be denied. In such cases, SEP ensures that India retains a domestic legal basis to tax business income attributable to the significant economic presence.

SEP also becomes particularly relevant where the taxpayer is located in a jurisdiction with which India has not concluded a tax treaty. In the absence of a DTAA, there is no requirement for India to restrict its taxing rights to physical permanent establishments. Here, the SEP rule operates as a primary nexus test, allowing India to assert source-based taxation on revenues arising from digital transactions with Indian users.

In this way, SEP serves as a backstop provision, ensuring that India can tax non-residents engaging substantially with its market even if treaty protection is unavailable or inaccessible. This makes it an important safeguard in a

global tax environment marked by increasing hybrid structures, disputes over tax residency, and the practical challenges taxpayers face in substantiating treaty eligibility.

3.5. Applicability of SEP Where GAAR is Invoked:

The introduction of SEP raises another complex question in the Indian context: how it operates alongside the General Anti-Avoidance Rules (GAAR) contained in Chapter X-A of the Income-tax Act. GAAR empowers the Indian Revenue to disregard arrangements that are found to be “impermissible avoidance arrangements,” including those lacking commercial substance or those entered into with the main purpose of obtaining a tax benefit.

Where GAAR is invoked, treaty protections themselves may be curtailed. The jurisprudence around GAAR indicates that its overriding effect is not limited to domestic law but may extend to situations where a taxpayer seeks to rely on treaty provisions. This stems from the principle that treaties are intended to prevent double taxation, not to facilitate double non-taxation or aggressive avoidance. In such circumstances, once GAAR is applied, a taxpayer may find that its carefully structured claim to treaty protection collapses, leaving only the domestic law basis for taxation. At that point, India’s SEP provisions would apply to determine nexus and source-based taxing rights.

The NUJS Law Review article by Dhruva Gandhi and Gaurav Bhawnani (2017)⁵ provides a detailed exploration of this issue. The authors argue that GAAR, by design, was intended to override even treaty provisions where arrangements are found to be abusive. They caution, however, that this raises important constitutional questions about the sanctity of India’s treaty commitments and the need to strike a balance between anti-avoidance imperatives and international obligations. Their analysis shows that while GAAR strengthens India’s position against treaty shopping and artificial avoidance, it also blurs the boundary between permissible treaty planning and impermissible avoidance.

Applied to SEP, this reasoning means that where a taxpayer seeks to shield itself from India’s domestic nexus expansion by relying on treaty-based permanent establishment tests, GAAR could potentially neutralize the

⁵ https://nujslawreview.org/wp-content/uploads/2017/06/10-2-Dhruva-Gandhi-Gaurav-Bhawnani-%E2%80%93-GAAR-to-Override-DTAAs_-Can-the-Constitution-or-Limitation-of-Benefits-Clauses-Prevent-this-Menace.pdf

structure if it is found to be designed primarily to avoid SEP-based taxation. For instance, routing digital transactions through low-substance entities in treaty jurisdictions may be disregarded under GAAR, thereby restoring India's ability to invoke SEP under domestic law.

Thus, the interplay between GAAR and SEP demonstrates a cautionary approach. While treaties ordinarily restrict the application of SEP, GAAR ensures that treaty protection cannot be invoked to support abusive or artificial arrangements. This combination reinforces India's taxing rights over digital economy transactions while also aligning with the broader global principle that anti-avoidance rules are integral to the proper functioning of both domestic law and international tax treaties.

3.6. Future Outlook: International Negotiations and Unified Approaches

3.6.1. OECD Pillar One⁶

The **OECD's Pillar One "Amount A"** seeks to reallocate taxing rights to market jurisdictions absent physical presence. Under a **Multilateral Convention (MLC)**, Amount A will override PE thresholds in DTAAAs by amending treaties multilaterally.

- **Scope:** Applies to very large MNEs ($\geq$ €20 billion global turnover; $>$ 10% profit margin), reallocating a portion of residual profits to market countries based on revenue-sourcing rules.
- **Dispute Resolution:** Binding dispute-mechanism and mutual-agreement procedures (MAP), addressing cross-border uncertainties and treaty conflicts.
- **Entry into Force:** Requires ratification by 30+ jurisdictions representing $\geq$ 60% of in-scope MNE profits; US ratification pivotal (486/1000 points).

3.6.2. Multilateral Instrument (BEPS MLI)

The **BEPS Multilateral Instrument (MLI)** modifies existing DTAAAs (Actions 2–14) to implement anti-treaty-abuse and PE-avoidance measures without renegotiating each bilateral treaty. However, SEP-style digital nexus rules are

⁶ https://oecdpillars.com/pillar_one/pillar-one-summary-2/

not part of the MLI minimum standards; digital-economy treatment remains outside current MLI scope.

3.6.3. Unilateral Measures Pending Consensus

In absence of Pillar One implementation, India and other jurisdictions continue interim measures (DSTs, EL, SEP) on a **patchwork basis**, creating compliance complexity for global businesses.

- **International Consensus Essential:** Only a binding multilateral treaty (Pillar One MLC or future MLI update) can harmonize digital-economy nexus rules across treaties to validate SEP-type provisions. Unilateral SEP will remain toothless for treaty taxpayers.
- **Risk of Fragmentation:** Divergent timelines and opt-out choices in Pillar One MLC risk inconsistent adoption, undermining unified digital tax framework and perpetuating non taxation/dispute potential.
- **Developing-vs-Developed Country Divide:** Differing interests may slow consensus; developing countries (India, Brazil) push for broader inclusion of digital nexus, while some OECD members resist expanding PE definitions.

3.7. The Interplay and Potential Impact of UN Article 12B⁷:

With delays in OECD's Pillar One, the UN has proposed **Article 12B** in its Model Tax Convention to address income from **Automated Digital Services (ADS)** such as online advertising, cloud computing, gaming, and social media.

Article 12B grants source countries a new taxing right through two mechanisms:

1. **Gross-basis withholding tax** on ADS payments, at modest negotiated rates (around 3–4%).

⁷ <https://www.pwc.com/gx/en/tax/newsletters/tax-policy-bulletin/assets/pwc-un-tax-committee-adopts-article-12b.pdf> & Báez Moreno, Andrés, Because not always B comes after A: Critical Reflections on the new Article 12B of the UN Model Tax Convention on Automated Digital Services (September 14, 2021). Available at SSRN: <https://ssrn.com/abstract=3923508>

2. **Optional net-basis taxation**, where 30% of ADS profits are deemed taxable in the source country at regular corporate tax rates.

This framework offers a simpler, source-oriented alternative to the OECD approach, particularly attractive for developing countries.

Domestic SEP rules represent a necessary but incomplete adaptation of nexus to the digital economy. Treaty PE definitions still prevail for treaty-protected non-residents, negating SEP's application. The future of digital taxation hinges on international treaties not unilateral domestic law particularly the OECD Pillar One multilateral convention to amend PE rules and reallocate residual profits to market jurisdictions. Until then, India's SEP will capture only non-treaty entities, leaving treaty-protected digital businesses largely untaxed under domestic law.

4. Triggers and Thresholds for Establishing Significant Economic Presence

The SEP regime in India employs two alternative tests – A. revenue-based and B. user-based, either of which, if met, creates a “business connection” in India and subjects the non-resident's India-attributable profits to Indian tax.

4.1. Revenue-Based Threshold

A. Under Rule 11UD, SEP arises if aggregate payments by Indian residents to a non-resident for “specified transactions” exceed INR 20 million in a financial year.

B. “Specified transactions” encompass:

- Sale or purchase of goods, services, or property.
- Download or provision of data or software.
- Online advertising and marketing services.
- Streaming or download of e-content (audio, video).
- Cloud-based services, e-learning, gaming, and other digital offerings.

4.2. Critical Issues:

4.2.1. Scope Expansion through “Any Person in India”

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One of the most debated aspects of the amended Explanation 2A is its reference to transactions carried out by a non-resident “with any person in India.” At first glance, this drafting appears innocuous, but its implications are far-reaching. By adopting this formulation, the provision no longer restricts SEP to transactions with Indian users in the digital economy but extends to dealings with any Indian counterparty, whether individual, corporate, or institutional.

The practical effect of this expansion is that traditional trade and procurement arrangements—for example, an overseas supplier selling raw materials to an Indian manufacturer could theoretically fall within the scope of SEP if the value of such purchases exceeds the prescribed revenue threshold. This is a significant departure from the original policy intent. The OECD’s BEPS Action 1 Report, which inspired the SEP concept, was primarily concerned with addressing taxation challenges of the digital economy, where value is created through user participation, data exploitation, and cross-border digital interactions without physical presence. Extending SEP to conventional cross-border trade runs the risk of ensnaring businesses that were never the intended targets of the rule.

This broader sweep creates substantial compliance burdens for both taxpayers and the tax administration. Non-residents engaged in simple trading relationships with India may be forced into complex determinations of whether they meet SEP thresholds and whether any part of their income is attributable to India. For resident purchasers, the situation is equally burdensome, as it may trigger withholding obligations under Section 195, with the attendant risks of disallowance, interest, and penalty for non-compliance.

4.2.2. Currency Fluctuations and INR Conversion

The SEP threshold for transactions with Indian users is expressed in Indian rupees. However, most non-resident enterprises transact in foreign currencies, whether in USD, EUR, GBP, or other denominations. This raises the practical question of which exchange rate should be applied when converting revenues into INR for threshold testing.

One approach is to apply the **spot rate** prevailing on the date of each invoice or receipt. This method ensures accuracy in reflecting the true rupee value at the time of transaction but creates significant administrative complexity when thousands of small digital transactions are involved. Alternatively, a taxpayer

could use an **average exchange rate** for the financial year, which is easier to administer and aligns with common accounting practices. Yet, this method may distort threshold determinations where exchange rates fluctuate materially during the year, potentially pulling some taxpayers above or below the INR 20 million benchmark depending on the averaging method used.

In the absence of explicit guidance from the CBDT, different taxpayers may adopt different approaches, increasing the risk of inconsistency and litigation. The treatment of exchange rates thus remains a significant compliance uncertainty.

4.2.3. Gross vs. Net Revenue Recognition

A second issue arises in identifying whether the SEP threshold should be measured on a **gross revenue basis** or a **net revenue basis** after adjustments for discounts, sales returns, refunds, cancellations, and platform commissions etc..

If interpreted strictly as **gross receipts**, then every rupee billed, even if later refunded or written off, would count toward the INR 20 million threshold. This broad reading would push more non-residents into the SEP net but would not reflect their actual economic receipts from Indian customers.

On the other hand, a **net receipts approach** would exclude refunds, rebates, chargebacks, and intermediary commissions etc., measuring only what the non-resident ultimately retains as revenue. This interpretation is more consistent with the concept of “income attributable” to SEP activities but is harder to administer in practice, particularly where intermediaries such as app stores or payment processors are involved.

The ambiguity between these two approaches is likely to create disputes, especially for subscription-based businesses where free trials, discounts, or cancellations are common. Absent guidance, taxpayers face the risk that the revenue they consider below the threshold may be recalculated by tax authorities on a gross basis, triggering SEP and potential tax exposure.

4.2.4. Timing of Revenue Recognition

Different accounting standards (IFRS vs US GAAP) may recognize revenues at different points in time. Subscription models, milestone payments, and bundled contracts all create timing mismatches that could push taxpayers above or below the INR 20 million threshold in a given year. Unless uniform

accounting rules are prescribed, taxpayers and tax authorities may arrive at conflicting figures.

4.3. User-Based Threshold

SEP arises if a non-resident “systematically and continuously” solicits business activities or interacts with at least 300,000 Indian users in a financial year.

4.4. Critical Issues

4.4.1. Definition Ambiguity

The phrase “**systematic and continuous soliciting**” is a cornerstone of the user-based test for Significant Economic Presence (SEP), yet its lack of a legal definition in either the Income-tax Act or the Rules creates significant uncertainty for non-resident businesses. This ambiguity forces taxpayers and tax authorities to interpret two highly subjective terms, leaving the threshold for creating a tax nexus in India open to wide-ranging and potentially conflicting interpretations.

The phrase “**systematic and continuous soliciting**” is a cornerstone of the user-based test for Significant Economic Presence (SEP), yet its lack of a legal definition in either the Income-tax Act or the Rules creates significant uncertainty for non-resident businesses. This ambiguity forces taxpayers and tax authorities to interpret two highly subjective terms, leaving the threshold for creating a tax nexus in India open to wide-ranging and potentially conflicting interpretations.

The Meaning of “Systematic”

The term “**systematic**” implies that the business activities are not random, accidental, or isolated. It suggests a deliberate and methodical approach to engaging with the Indian market. However, the lack of a clear definition raises several critical questions:

- **What constitutes a “system”?** Does this refer to a planned marketing strategy, the use of algorithms to target Indian users, or the establishment of digital infrastructure (like local payment gateways or a country-specific website) to serve the Indian market?
- **Intent vs. Outcome:** Is the test met if a company's global marketing campaign happens to be successful in India, even if it wasn't the

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primary target? Or does it require a clear, documented intention to pursue the Indian market specifically?

- **Scale and Scope:** How extensive must the plan be? A single, well-planned advertising campaign could be considered "systematic," but it is unclear if that alone is sufficient to meet this criterion.

Without guidance, it is difficult for a business to know if its routine market development activities cross the line from incidental to "systematic."

The Meaning of "Continuous"

The term "**continuous**" suggests that the soliciting or engagement must be ongoing over a period and not a one-off event. It points to a sustained business interaction in India. The ambiguity here revolves around duration and consistency:

- **What is the required time frame?** The law does not specify a duration. Does an activity need to persist for the entire financial year, a majority of the year, or a certain number of months to be considered "continuous"?
- **What about intermittent or seasonal activity?** Many businesses, particularly in e-commerce, engage in heavy, planned marketing around specific holidays or seasons (e.g., Independence Day, Diwali). This activity is systematic but may not be continuous throughout the year. It is unclear how such periodic but regular engagement would be treated.
- **"Passive" vs. "Active" Continuity:** Does the continuous availability of a global website or application to Indian users count as "continuous" engagement, even if active soliciting (like advertising) is infrequent?

The Combined Challenge and Its Consequences

The law requires the activity to be both **systematic and continuous**, creating a high but undefined standard. The primary consequences of this definitional ambiguity are:

- **Significant Uncertainty for Businesses:** Non-resident companies are unable to determine with certainty whether their standard international business practices will trigger a taxable presence in India. This makes tax planning and risk assessment incredibly difficult.

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- **High Potential for Litigation:** In the absence of clear rules, the interpretation of this phrase is left to the discretion of tax officers. This subjectivity inevitably leads to disputes, as what one officer considers systematic and continuous, another may not. The burden of proof then falls on the taxpayer to defend their position in a lengthy and costly litigation process.

Ultimately, without clear administrative guidance from the CBDT or a binding judicial precedent, the phrase "systematic and continuous soliciting" remains a major source of interpretative risk within the SEP framework.

4.4.2. User Count and Tracking

The law requires a non-resident to have 300,000 or more users in India but critically fails to define the term "user". This omission creates a significant measurement problem, as a user could be quantified in several ways:

- **By Account:** Counting registered accounts is problematic. It doesn't distinguish between a person with multiple accounts and multiple individuals. It also fails to differentiate between **active users** who generate value and **dormant accounts** that have been inactive for years.
- **By Device:** A single individual may access a service from a laptop, smartphone, and tablet. Counting each device as a separate user would artificially inflate the user count, misrepresenting the actual number of unique individuals engaged.
- **By IP Address:** Using IP addresses as a proxy is highly unreliable. Internet Service Providers often assign dynamic IPs, meaning a single user can have multiple IP addresses over time.
- **By Unique Individual:** While this may be the most accurate metric, it is also the most difficult for a business to track and prove definitively, raising significant data privacy and technological hurdles.

This lack of a standardized metric forces businesses to choose a methodology and then defend it against potential challenges from tax authorities, creating substantial compliance uncertainty.

The user-based test for India's Significant Economic Presence (SEP) is particularly challenging due to its ambiguity. The core difficulties lie in accurately quantifying who counts as a "user," precisely identifying their

location in an era of borderless technology, and applying a single, rigid standard to diverse and complex business models.

4.4.3. Quantifying "Unique Users"

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- **By Device:** A single individual may access a service from a laptop, smartphone, and tablet. Counting each device as a separate user would artificially inflate the user count, misrepresenting the actual number of unique individuals engaged.
- **By IP Address:** Using IP addresses as a proxy is highly unreliable. Internet Service Providers often assign dynamic IPs, meaning a single user can have multiple IP addresses over time.
- **By Unique Individual:** While this is the most accurate metric, it is also the most difficult for a business to track and prove definitively, raising significant data privacy and technological hurdles.

This lack of a standardized metric forces businesses to choose a methodology and then defend it against potential challenges from tax authorities, creating substantial compliance uncertainty.

4.4.4. Identifying an Indian "Location"

The requirement to identify users **"in India"** is a significant challenge in a digital world where geographic borders are fluid. Technology that empowers users also makes their location difficult to verify with certainty.

- **VPNs and Proxies:** The widespread use of **Virtual Private Networks (VPNs)** and proxies is a major obstacle. These tools are specifically designed to mask a user's true geographic location by routing their traffic through servers in other countries. A business has no reliable way to determine if a user appearing to be from another country is actually an Indian user employing a VPN.

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- **Multi-Device and Inconsistent Data:** A single user often interacts with a service across multiple devices. Their smartphone might have location services enabled, providing a clear data point, while their desktop browser does not. This results in inconsistent and incomplete location data for the same individual, making a definitive count difficult.
- **Global Travelers:** The rule doesn't clarify how to treat Indian residents who are temporarily traveling abroad or foreign nationals temporarily in India. It is unclear if a user's location is determined by their residency or their physical location at the moment of interaction.

The burden of accurately identifying the location of 300,000 users, despite these technological obfuscations, is placed entirely on the non-resident company.

4.4.5. Common Application of Threshold Across Business Models

A one-size-fits-all user threshold is a rigid mechanism that fails to apply equitably across diverse sectors and business models. It can lead to unfair outcomes by creating a tax nexus that is disconnected from actual economic value creation.

- **Freemium and Ad-Supported Models:** Businesses like streaming services, news portals, or software providers may offer free services to a very large user base in India while generating minimal or no direct revenue from them. Under the user test, these companies could easily cross the 300,000-user threshold and be deemed to have a taxable presence, even if their economic engagement is negligible. This creates a disproportionate compliance burden relative to the value derived.
- **High-Value, Low-User Models:** Conversely, a company providing high-value specialized B2B software could earn substantial revenue in India from a very small number of corporate clients (e.g., a few hundred users). This business would *not* trigger the user-based test, even though its economic presence and profitability are far more "significant" than a freemium service with millions of non-monetized users.
- **Platform Economies:** For e-marketplaces, it remains unclear whether "users" include buyers, sellers, or both. An inequitable application

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could either double-count participants or miss a key segment of the platform's value chain.

This uniform standard can create false positives (triggering SEP for businesses with low economic value) and false negatives (missing businesses with high economic value), undermining the goal of fairly taxing an enterprise's true economic presence.

4.5. Types of Transactions Covered

Transaction Category	Description	Analysis
Sale/purchase of goods	Cross-border sale or purchase of tangible goods	The inclusion of tangible goods could significantly broaden the scope of SEP beyond its original intent of taxing the digital economy. These risks capturing traditional import/export trade, which is typically governed by existing customs duties and tax treaty principles related to permanent establishments. It creates ambiguity by extending a digital tax concept to conventional cross-border commerce, potentially leading to jurisdictional conflicts and double taxation.
Sale/provision of services	Digital or offline professional, technical, consulting,	The broad definition of "services" is a key concern. Without clear

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Transaction Category	Description	Analysis
	and marketing services	delineation between digital and offline services, the provision could inadvertently ensnare conventional, non-digital cross-border services (e.g., on-site consulting or repair). This lack of specificity risks creating uncertainty and could subject businesses with no significant digital link to India to SEP-related compliance and taxation, contrary to the provision's underlying policy.
Download/provision of data or software	SaaS, licensed software downloads, data analytics services	While this category is central to the digital economy, a major point of contention arises from the characterization of Software-as-a-Service (SaaS). Disputes frequently occur over whether providing access to cloud-hosted software constitutes a "download" (potentially a royalty) or a "service." This ambiguity is critical, as

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Transaction Category	Description	Analysis
		the tax treatment under domestic law and tax treaties can differ significantly, leading to litigation and uncertainty.
Online advertising and marketing	Ad impression sales, affiliate marketing, targeted ad services	These transactions are a core target of digital taxation frameworks. The main issue in the Indian context is the historical overlap with the Equalisation Levy (EL) on online advertising services. This creates a risk of double taxation where the same income could be subject to both EL and income tax via SEP. While the abolition of the EL from April 1, 2025, is expected to resolve this, a clear mechanism to prevent double taxation is essential for earlier period.
Streaming or download of e-content (audio/video)	OTT platform subscriptions, pay-per-view content downloads	A platform with a large number of non-paying or low-value subscribers could breach a user-based threshold without

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Transaction Category	Description	Analysis
		generating substantial revenue, leading to a disproportionate compliance burden. Therefore, specific carve-outs and clear, value-based thresholds (e.g., minimum revenue from subscriptions or transactions) are crucial to ensure the rules target only those foreign enterprises that have a genuinely significant economic engagement and to avoid inadvertently penalizing smaller or niche content providers.
Other digital transactions (cloud, gaming, e-learning)	Cloud hosting, virtual events, online courses, in-game purchases	This category correctly focuses on modern digital activities. The primary risk is the absence of clear, value-based thresholds. For instance, in gaming or e-learning, a large number of "free users" or low-value in-game purchases could trigger user-based SEP thresholds without corresponding

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Transaction Category	Description	Analysis
		significant revenue. This could create a tax liability for foreign companies that is disproportionate to the actual economic value derived from India, highlighting the need for a robust revenue threshold to complement user metrics.

While India's dual threshold SEP model ambitiously extends taxing rights to digital and even non-digital activities, it raises significant concerns over scope, administrative complexity, and potential treaty conflicts. Calibration of thresholds, clear definitions (especially for user-based triggers), and profit-attribution guidance are vital to balance revenue objectives with certainty and fairness for non-resident enterprises.

5. Link with “Business Connection” and Attribution of Profits

The single most significant and debilitating challenge in India's SEP regime is the complete absence of rules for attributing profits. While the law meticulously defines a new nexus for taxation, it provides no statutory mechanism to quantify the income that becomes taxable once that nexus is established. This has created a legally precarious situation for non-residents.

5.1. The Current Impasse: A Nexus without a Method for Quantification

As of August 2025, a non-resident may find that it has a SEP in India under Rule 11UD and is therefore, required to disclose this in its tax return. However, it is left with no prescribed methodology to compute the profits attributable to that SEP. This legislative void means that any income calculation is based on estimation and is highly susceptible to challenge by tax authorities. The past experience with profit attribution for traditional PEs,

which has been a hotbed of litigation due to diverse and subjective methodologies employed by tax officers, serves as a stark reminder. Without clear rules, the SEP regime risks becoming a catalyst for a new and even more complex wave of tax disputes.

5.2. BEPS Action 1 and Profit Attribution Options⁸

One of the most pressing concerns in operationalizing a Significant Economic Presence (SEP) nexus rule is determining how much profit should be attributed to such a presence. The OECD, in its BEPS Action 1 Final Report, recognized this complexity and devoted Section 7.6.2 to exploring potential solutions. It acknowledged that traditional function, asset, and risk-based profit attribution models are not suited for business models lacking physical presence like those captured under SEP. This led to an exploration of alternative methods.

A. Adjustments to Existing Rules:

The OECD first explored whether existing rules could be adapted, for example, by attributing automated digital functions or even considering user engagement as a proxy for performing business functions. However, this would involve significant theoretical leaps and would diverge materially from the arm's length principle that underpins current standards.

B. Bargaining or Game-Theoretic Models:

Inspired by joint venture profit-sharing analogies, this approach suggested allocating profits based on what an independent market country might have 'bargained for' had it been a party to the commercial arrangement. This was conceptually creative but difficult to operationalize and far removed from established norms.

C. Fractional Apportionment:

Another option was to treat the multinational enterprise (MNE) as a single unit, and apportion global profits using a formulaic method based on indicators like sales, user base, or digital footprint. While potentially effective, the OECD noted that this would be a departure from prevailing international practice, which emphasizes separate entity accounting. Moreover, it could

⁸ ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY – © OECD
2015 – para 7.6.2

produce inconsistent outcomes between digital SEP-based taxation and traditional PE-based taxation.

D. Modified Deemed Profit Methods:

As a more pragmatic alternative, the OECD explored presumptive profit approaches, similar to those used in sectors like insurance. Under this, a fixed profit margin (based on industry or transaction types) could be applied to revenues attributable to the SEP. While administratively simpler, these methods raise concerns about inflexibility, fairness, and the potential to over-tax digital businesses that may have low margins or be loss-making.

5.3. Analysis of the 2019 CBDT Committee Draft Report on Profit Attribution to PE⁹

The only substantive insight into the Indian government's thinking on this issue comes from a draft report released for public consultation by a CBDT-appointed committee in April 2019. Although these recommendations have not been notified and have no legal force, they provide some guiding principles that may eventually shape Indian policy.

- **India's Rejection of the OECD's AOA and Insistence on "Demand-Side" Factors:** The report documents India's consistent and trenchant opposition to the OECD's Authorized OECD Approach (AOA) for profit attribution. The AOA is primarily based on a Functions, Assets, and Risks (FAR) analysis, which India argues is a "pure supply approach" that only rewards the jurisdiction where the supply chain and economic activities are located. India's counter-position is that business profits are a function of both supply and demand, and therefore the market jurisdiction—which contributes demand, customers, and data—deserves a share of the tax base. The report strongly advocates for a "mixed approach" that gives weight to these "demand-side" factors.³⁵
- **A Critique of the Proposed Four-Factor Formula (Sales, Manpower, Assets, and 'Users'):** The committee proposed a complex formulary apportionment method. For traditional PEs, it suggested a three-factor formula giving weight to Sales, Manpower (employees and wages), and Assets. For digital businesses and SEPs, it went a step further, proposing a groundbreaking four-factor formula that introduces

⁹ Proposal No. F. No. 500/ 33 / 2017 – FTD.1 dated 18th April 2019

'Users' as a fourth factor, explicitly recognizing their role in value creation. The proposed weightages were nuanced: for digital models with low or medium user intensity, 'Users' would have a 10% weight, while for high-intensity models, this would increase to 20%, with the weight of other factors adjusted accordingly.

- **The Deemed Profitability:** Perhaps the most controversial element of the draft report is the proposal for determining the "profits derived from India" which form the base for apportionment. The committee suggested this should be the higher of two amounts: (a) revenue derived from India multiplied by the enterprise's global operational profit margin, or (b) a deemed profitability of 2% of the revenue derived from India. This 2% flat rate is designed to ensure that India receives some tax revenue even if the multinational enterprise is globally unprofitable or has a very low profit margin.

5.4. Attribution Rules: Taxing Only SEP-Attributable Income

Explanation 2A (second proviso) provides that taxation will be restricted to income attributable to SEP activities:

"Only so much of income as is attributable to the transactions or activities referred to in clause (a) or (b) of Explanation 2A shall be deemed to accrue or arise in India."

Income Attribution Requirement

- Income from a non-resident's overall global operations is not taxable but only revenue directly linked to SEP transactions/users.
- This mirrors traditional PE profit attribution but differs in lacking detailed guidance on methodology.

Absence of Clear Methodology

- Neither the Act nor CBDT rules specify how to allocate costs, expenses, or profits to SEP-triggering activities.
- BEPS Action 1 considered options (bargaining-model, fractional apportionment, deemed-profit), but India has not adopted any.
- The result is greater administrative discretion to tax authorities and litigation risk over what portion of global profits India may tax.

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Limiting tax to SEP-attributable income is conceptually fair, but absent standardized attribution rules, non-residents face unpredictable tax exposures. Silence on methodology creates a “black hole” of uncertainty thereby undermining SEP’s objective of legal clarity and predictability. Without clear guidance or safe harbours, SEP may devolve into aggressive unilateral assessments.

5.5. Comparison with Equalisation Levy and Overlap

Though Equalization Levy in all forms are now abolished in India from 01 April 2025, however for the earlier periods it may be applicable and hence, for the purpose of completeness, the same is discussed.

India’s Equalisation Levy (EL), introduced in 2016 and expanded in 2020, targets specified digital transactions (6% on ad services, 2% on e-commerce) under a separate statute. However, income taxed under EL is exempt from income tax (Section 10(50)) to avoid double taxation.

Feature	Significant Economic Presence (SEP)	Equalisation Levy (EL)
Legal Basis	Explanation 2A to Section 9(1)(i), Income-tax Act	Separate Chapter in the Finance Act
Nexus Test	Economic nexus (INR 20 million or 300,000 users)	Transaction-specific digital services
Tax Base	Income attributable to SEP transactions	Gross consideration for specified digital services
Tax Rate	On net income ($\geq 40\%$)	6% (ads), 2% (e-commerce)
Treaty Impact	Tax treaty PE definitions prevail over SEP for treaty-eligible non-residents	EL applies even if treaty PE exists
Overlap Handling	SEP-taxable income exempts EL items if EL applies	Income taxed under EL exempt from SEP income tax

Overlap and Interaction:

- Where both SEP and EL could apply to identical digital transactions, **EL** takes priority: income subject to EL is **exempt** from SEP taxation under Section 10(50).
- This hierarchy renders SEP thresholds largely academic for covered EL transactions, calling into question the practical relevance of SEP for many digital players.
- EL's narrower scope and exemption mechanism, however, leave non-advertising and non-e-commerce digital transactions fully exposed to SEP at higher rates, creating uneven treatment across digital business models.
- Further, abolition of EL from 01 April 2025 makes SEP's sweep wider.

The coexistence of SEP and EL creates complexity and potential distortions:

- **Administrative Burden:** Taxpayers were required to navigate two parallel regimes, identify applicable regime per transaction, and track overlapping coverage to claim exemptions.
- **Competitive Distortions:** EL applies only to a subset (ads, e-commerce), while SEP captures a broader range of transactions—leading to unlevel playing fields among digital businesses.
- **Threshold Irrelevance:** EL's primacy can render SEP thresholds academic for core digital transactions, undermining the policy rationale for SEP's introduction.

5.6. The six-year-long delay in finalizing and notifying these attribution rules is not accidental. It is a direct consequence of the ongoing, slow-moving global negotiations at the OECD/G20 Inclusive Framework on Pillar One, which seeks to establish a new multilateral framework for allocating taxing rights. India, a key player in these negotiations, appears to be in a "wait-and-see" mode. Finalizing its domestic attribution rules now would be premature and risky; if the eventual Pillar One consensus differs significantly, India would be forced to amend its domestic law again. This strategic patience, however, comes at the cost of prolonged and damaging uncertainty for taxpayers, who are caught between a legally effective nexus and a non-existent attribution mechanism.

6. Global Developments and Comparisons

6.1. Emerging International Trends in SEP and Related Measures

While India has taken a pioneering step by introducing Significant Economic Presence (SEP) into its domestic law, it is by no means alone in this endeavour. Other jurisdictions especially in emerging markets are also embracing SEP or SEP-like measures to assert taxing rights over non-resident digital businesses operating without a physical presence. These countries recognize the limitations of traditional nexus rules and are proactively designing frameworks to capture value generated within their economies. Whether through formal SEP provisions, digital services taxes, or withholding mechanisms on cross-border digital transactions, the common thread is a strategic shift toward **ensuring source-based taxation in the digital era**. The following comparative overview highlights how select countries are addressing similar challenges, offering insight into the broader global movement toward redefining tax nexus and profit attribution for the digital economy.

6.2. SEP Provisions in Other Countries

A. Nigeria: SEP Codified with Administrative Precision¹⁰

Nigeria enacted the Companies Income Tax (Significant Economic Presence) Order, 2020, establishing a statutory SEP regime with clearly defined thresholds and triggers. The SEP nexus is activated when a non-resident earns more than NGN 25 million (roughly USD 32,800) from digital services in Nigeria. In addition to turnover thresholds, other indicators such as the use of a “.ng” domain, a Nigerian-registered website, or localised engagement (pricing in Naira or offering domestic payment options) can signal purposeful and sustained interaction with Nigerian users.

The Nigerian Federal Inland Revenue Service (FIRS) has also prescribed a deemed profit attribution mechanism, allowing a 6% profit margin to be assumed on the turnover attributable to SEP. Notably, Nigeria imposes corporate income tax on such profits and a 10% final withholding tax on

¹⁰ [https://assets.kpmg.com/content/dam/kpmg/ng/pdf/tax/kpmg-in-nigeria-fgn-issues-cit-\(significant-economic-presence\)-order-2020.pdf](https://assets.kpmg.com/content/dam/kpmg/ng/pdf/tax/kpmg-in-nigeria-fgn-issues-cit-(significant-economic-presence)-order-2020.pdf)

specific technical, consultancy, and professional services rendered by non-residents, thereby combining elements of net and gross-based taxation.

B. Pakistan: A Hybrid Model of Levies and Withholding¹¹

Pakistan's digital tax strategy has evolved through a series of levies and withholding taxes, even without a formal SEP clause in the traditional sense. In its FY 2025-26 budget, Pakistan introduced a 2% Digital Transactions Proceeds Levy on domestic online sales of goods and services, with banks and couriers designated as withholding agents—a model that relies heavily on third-party enforcement.

Moreover, since 1 July 2018, a 5% final withholding tax applies to payments made to non-residents for various offshore digital services ranging from advertising and website hosting to e-commerce facilitation and data processing. Importantly, this tax is not contingent on the existence of a PE, mirroring the unilateral thrust of India's SEP rule. However, Pakistan's model raises compliance burdens for intermediaries, and in the absence of clear treaty relief mechanisms, risks double taxation and jurisdictional overlaps, particularly with provincial-level sales taxes.

6.3. Digital Services Tax

The emergence of Digital Services Taxes (DSTs) around the world reflects a common goal among countries to capture revenue from digital businesses that engage with users and earn substantial income in market jurisdictions without maintaining a traditional physical presence.

Among early adopters, Italy¹² stands out for implementing a DST that imposes 3% levy on gross revenues derived from specified digital activities conducted within its territory. This regime was introduced under Article 1, paragraphs 35 to 50 of Law 145 of 2018 and came into effect on the first of January 2020. The tax applies to both resident and non-resident entities, regardless of whether they maintain a permanent establishment in Italy. Following the 2025 Budget Law, the DST no longer requires a minimum Italian revenue threshold, although the global turnover threshold remains fixed at 750 million euros. The tax is triggered by activities such as online advertising targeted at Italian users, intermediation services provided through

¹¹ <https://www.vatcalc.com/pakistan/pakistan-couriers-and-payment-providers-e-commerce-2-tax/>

¹² <https://www.winston.com/en/insights-news/digital-services-taxes-in-uk-and-france>

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multi-sided digital platforms that facilitate transactions among users, and the sale or transmission of data collected from Italian users.

The United Kingdom¹³ has introduced its own DST at a rate of 2%, which applies to revenues from social media platforms, search engines, and online marketplaces. This tax is levied on companies with more than 500 million pounds in global revenue, of which at least 25 million pounds must be generated from UK users.

Similarly, France has implemented a three percent DST that applies to revenues derived from digital interfaces, advertising services, and monetization of user data, provided the taxpayer exceeds 750 million euros in global turnover and earns at least 25 million euros from French sources.

Despite their shared objective, these DSTs differ widely in their design, scope, and thresholds. This variance complicates global compliance and raises significant concerns about investment distortions and the risk of double taxation in the absence of a unified international framework such as the OECD's Pillar One.

6.4. Withholding Taxes

Another approach seen internationally is the use of withholding taxes on digital transactions. These are designed as simple source-based tax collection mechanisms. Pakistan's model is a prominent example, where since July 2018, a 5% final withholding tax applies to payments made to non-residents for offshore digital services. While this method expands the tax net without requiring the existence of a permanent establishment, it effectively taxes gross payments without regard to the actual profitability of the service provider. This creates compliance challenges and imposes administrative burdens on banks and other intermediaries responsible for withholding and remittance.

These unilateral measures including SEP rules, DSTs, Equalisation Levies, and withholding taxes reflect a shared urgency among source countries to secure taxing rights over digital value creation. However, the lack of international coordination has resulted in a fragmented landscape marked by inconsistent thresholds, overlapping tax bases, and varied profit attribution methods. This patchwork of rules not only burdens global digital businesses

¹³ <https://www.vatcalc.com/global/digital-services-taxes-dst-global-tracker/>

with multiple compliance obligations but also heightens the risk of double taxation. Until a binding multilateral consensus is achieved through mechanisms such as the OECD's Pillar One, the digital tax landscape will remain disjointed. Harmonization of definitions, alignment of economic thresholds, and development of treaty-based safe harbors are critical to ensuring fairness, reducing disputes, and maintaining the coherence of the global tax architecture in the digital era.

7. Operational and Compliance Aspects

7.1. Registration and Tax Return Filing

7.1.1. Registration Requirements

Once Significant Economic Presence is established, a non-resident is deemed to have a “business connection” in India and must register under the Income-tax Act, 1961:

- **Permanent Account Number (PAN):** Mandatory to file returns or claim treaty relief.
- **Tax Deduction Account Number (TAN):** Required only if the non-resident becomes a withholding agent (e.g., making payments to third parties) or if it has employees in India.

7.1.2. Return-Filing Obligations

Non-residents having SEP must file ITR. Further, returns must report SEP income, including: the total payments received from India, number of Indian users (if user-based SEP), and profits attributable to SEP.

7.1.3. Audit and Assessment

- **Tax Audit:** If turnover from Indian operations exceeds INR 100 million (INR 20 million for certain professionals), the non-resident must appoint a chartered accountant for tax audit under Section 44AB and file the audit report within due date.
- **Assessment and Scrutiny:** Non-residents with SEP can be subjected to scrutiny assessments (Section 143(2)), which can lead to detailed examinations of digital transaction records, user analytics, and profit-attribution calculations.

7.2. Data and Documentation Burdens

Non-residents must maintain detailed records:

- Transaction logs, payment details, and user-base analytics by geography.
- Allocation keys for shared costs (R&D, IT infrastructure) between global and India operations.
- Documentation justifying chosen attribution methodology, including economic analyses and internal board minutes.

7.3. Withholding Obligations

7.3.1. Resident Pay-Out Obligations

Under Section 195 of the Income-tax Act, any person responsible for paying to a non-resident any sum chargeable to tax under the Act is required to deduct tax at source at the time of payment or credit, whichever is earlier. Once SEP is invoked as a domestic nexus, Indian residents making payments to such non-residents may fall within this withholding net.

7.3.2. Obligations of Resident Payers

Resident payers must approach withholding obligations with caution. The applicable rate depends on whether the non-resident can successfully invoke treaty protection. If treaty benefits are available and a permanent establishment threshold has not been met, no tax may be required to be withheld. Conversely, if treaty benefits are denied or unavailable, withholding must occur at the rates prescribed under domestic law, which typically range between ten and forty percent depending on the character of the income and the applicable surcharge and cess.

In practical terms, compliance requires resident payers to obtain a valid Tax Deduction and Collection Account Number (TAN), compute the tax deductible, and deposit the withheld amount with the government within the stipulated timelines. The payer must also file the appropriate forms—most notably Form 15CA (a declaration of remittance details) and Form 15CB (a certificate from a chartered accountant in certain cases). These procedural requirements are intended to ensure transparency in cross-border payments, but they also impose significant administrative burdens on Indian businesses,

particularly smaller enterprises engaging with foreign digital service providers.

7.3.3. Consequences of Non-Compliance

The law prescribes stringent consequences where tax is not withheld or remitted. First, Section 40(a)(i) provides that any payment made to a non-resident without the requisite tax deduction is not deductible in computing the payer's taxable income. This means that the Indian resident loses the ability to claim the expense for tax purposes, resulting in a higher effective tax liability.

Second, under Section 201(1), the resident payer is deemed to be an assessee in default and becomes personally liable for the tax that should have been deducted, together with interest at one percent per month from the date on which deduction was required until the date on which it is actually made good. This interest provision can create a significant financial burden if non-compliance continues over a long period.

Third, penal consequences may also follow. Under Section 271C, the failure to deduct tax can result in a penalty equal to the amount of tax that should have been withheld. In addition, prosecution under Section 276B may be initiated in extreme cases of willful default.

7.3.4. Critical Issues:

The imposition of withholding tax obligations on Indian residents making payments to non-residents deemed to have a Significant Economic Presence creates a host of practical and legal complexities.

First, when multiple payers are involved, such as online platforms that intermediate between service providers and end users, identifying the appropriate deductor and the precise scope of withholding becomes complicated. For example, a digital platform might facilitate subscription payments, advertising fees, and royalty-like charges simultaneously. The question arises whether the platform itself, the end user, or both, bear the primary obligation to withhold under Section 195. This multiplicity risks duplication of compliance or, conversely, gaps where no party withholds due to ambiguity.

Second, there is a lack of clarity on the base on which withholding is to be applied. Section 195 requires deduction on "any sum chargeable under the provisions of the Act." In the context of SEP, only that portion of income

attributable to the significant economic presence is deemed to accrue in India. However, at the stage of payment, the payer often has no mechanism to determine the precise attributable profit portion, since such attribution requires a detailed functional and economic analysis of the non-resident enterprise's global operations. In practice, this leads payers to deduct tax on the **gross amount of payment**, which can significantly exceed the ultimate taxable income of the non-resident. This can create cash flow burdens, results in excess withholding, and forces non-residents into lengthy refund procedures.

Finally, the policy rationale of imposing withholding in SEP contexts is itself problematic. Withholding presumes a level of certainty regarding the income's chargeability and quantum, but SEP introduces a novel and indeterminate nexus concept where the exact amount of income attributable to India cannot be known at the payment stage. This disconnects between legal principle and administrative practice increases the likelihood of disputes, excess tax collection, and eventual refunds, undermining the efficiency of the withholding system.

8. Case Studies and Illustrative Examples

8.1. Case Study 1: Import of Goods by a Non-Resident without Treaty Protection

Scenario

CaymanCo, a company incorporated in the Cayman Islands, sells industrial machinery worth INR 28 million to Indian buyers during a financial year. The sales are executed through email correspondence and an online catalogue. Goods are shipped directly from the Cayman Islands. CaymanCo does not maintain an office, warehouse, or employees in India.

Application of SEP Provisions

Since the INR 20 million revenue threshold is crossed, CaymanCo is deemed to have a Significant Economic Presence in India. This creates a domestic law business connection under section 9(1)(i), even though CaymanCo does not have a physical presence in India. As there is no DTAA between India and the Cayman Islands, treaty protection is unavailable. Consequently, the income attributable to these transactions is taxable in India.

Interpretative Challenges:

Nature of Transactions:

The case involves traditional import of machinery, where CaymanCo sells goods to Indian buyers through digital correspondence. While the mode of communication is digital, the business itself is not inherently digital in nature. The original policy intent of SEP, inspired by the OECD's BEPS Action 1 report, was to address the challenges of taxing the digital economy where value is created through user participation, data exploitation, and sustained virtual engagement. Applying SEP to conventional import transactions risks stretching the concept far beyond its intended focus.

From a doctrinal perspective, such cases are more appropriately examined under the traditional "business connection" tests laid down in section 9(1)(i) and interpreted by Indian courts. Historically, the jurisprudence has treated mere purchase of goods for export or straightforward import transactions as insufficient to create a business connection in India, unless there is continuity of activity, an element of agency, or operations carried out in India. Subjecting pure import arrangements to SEP simply because the revenue threshold is met ignores this well-settled framework and undermines the distinction between conventional trade and digital nexus.

Attribution of Profits:

Even if a business connection is established, the attribution of profits remains unresolved. CaymanCo undertakes all substantive functions such as design, production, and logistics outside India. The only link to India is the customer base. Without attribution rules or safe harbors, determining how much of CaymanCo's global profit can fairly be taxed in India remains uncertain.

8.2. Case Study 2: Licensing of Intellectual Property in a Non-Treaty Context

Scenario

CaySoft, a company incorporated in the Bermuda, grants an Indian mobile phone manufacturer the right to use its proprietary mobile operating system. In consideration, CaySoft charges a royalty of INR 35 million during a financial year. The company has no office, branch, or personnel in India.

Application of SEP Provisions:

Since the royalty receipts exceed the INR 20 million threshold, CaySoft is deemed to have a Significant Economic Presence in India under Explanation 2A. This creates a domestic law “business connection,” bringing the royalty income within India’s tax net. As India has no DTAA with the Bermuda, CaySoft cannot rely on treaty protection. Its Indian tax liability must therefore be determined solely under domestic provisions.

Nature of Transactions:

The transaction involves the licensing of intellectual property, an area already covered under section 9(1)(vi) of the Income-tax Act, which taxes royalties accruing or arising in India. Traditionally, royalty taxation does not require the physical presence of the licensor in India, and the right to tax is secured at the point of payment by the Indian licensee. In such cases, invoking SEP is arguably unnecessary. The traditional royalty framework would have sufficed, suggesting that SEP adds duplication rather than clarity.

This example highlights the **overlap between SEP and the existing royalty regime**. While SEP would technically be triggered once the INR 20 million threshold is met, the long-standing royalty provisions already bring such income within India’s tax ambit. The case illustrates the risk of duplication and interpretational uncertainty when SEP is applied to income streams that are already covered by specific charging sections.

8.3. Case Study 3: Subscription-Based Digital Services and Profit Attribution

Scenario

MonStream, a company incorporated in Monaco (a jurisdiction with which India has no DTAA), operates a global video streaming platform. Its subscribers span across Europe, Asia, and North America. In a given financial year, MonStream earns INR 50 million in subscription revenue from Indian users alone. The platform’s technology infrastructure, research and development, and content acquisition are all managed and financed outside India. MonStream does not maintain an office or employees in India.

Application of SEP Provisions

Since MonStream’s Indian subscription revenues exceed the prescribed INR 20 million threshold, the company is deemed to have a Significant Economic

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Presence in India. This creates a domestic “business connection,” allowing India to assert taxing rights over the income “attributable” to its Indian activities. In the absence of a tax treaty with Monaco, MonStream cannot claim treaty protection and must rely solely on domestic law.

Nature of Transactions

The case involves a quintessential digital business model. Unlike traditional import or royalty arrangements, MonStream derives revenue directly from Indian users who subscribe to its platform. The value is generated not only through technological infrastructure and global content rights but also from the **network effects** and **user engagement** within India. At the same time, the overwhelming majority of costs, assets, and functions that produce this revenue are located outside India. This sharpens the unresolved question of how profits are to be allocated when SEP is triggered.

Issues and Challenges

1. Attribution of Global Profits

Although INR 50 million of revenue is linked to Indian users, the income must still be restricted to the portion “attributable” to Indian operations. Since MonStream carries out no substantive functions or risk-bearing activity in India, one view is that only a narrow margin—akin to a marketing or distribution return—should be taxed. Another possible approach, consistent with OECD BEPS Action 1 discussions, is to attribute a portion of global residual profits to the Indian market based on factors such as user share, subscription revenue proportion, or data value. This difference in approaches can lead to significantly different tax outcomes.

2. Overlap with Other Jurisdictions

MonStream’s business spans multiple countries, many of which may assert taxing rights under their own SEP-like or digital tax rules. If each jurisdiction attributes a portion of global profits without a harmonized formula, there is a real risk of double or even multiple taxation. Without a treaty to resolve allocation conflicts, MonStream is exposed to overlapping claims that reduce certainty and efficiency.

3. Administrative Practicality

For resident Indian payers, the challenge is compounded by withholding obligations. Subscription fees are collected through Indian banks or digital

wallets, which may be treated as responsible for withholding under section 195. These intermediaries cannot reasonably determine what portion of the revenue represents the “attributable income” of MonStream in India. In practice, this leads to withholding on the gross revenue, creating cash flow strain for MonStream and requiring refund claims through the Indian system.

This case study highlights the core weakness of SEP in practice: the difficulty of attributing profits to India when global business operations are highly integrated and costs are incurred offshore.

8.4. Case Study 4: User-Based SEP Thresholds and the Challenge of Identifying Unique Indian Users

Scenario

USStream, a company incorporated in the United States, operates a global music streaming service. The company charges subscription fees through international payment gateways, with most payments denominated in USD. USStream’s analytics indicate significant activity from India, but subscriber details are pooled globally. In a given financial year, revenues linked to India are estimated at INR 15 million.

Although the United States has a DTAA with India, USStream is unable to furnish a valid Tax Residency Certificate (TRC) and supporting documents as required under section 90(4) and 90(5) of the Income-tax Act. As a result, treaty protection is not available, and domestic SEP rules apply.

Application of SEP Provisions

Under Explanation 2A, SEP can be triggered either by revenue thresholds or by systematic and continuous interaction with users in India. In this case, the INR 15 million subscription revenue suggests that the revenue threshold is not crossed. However, given the nature of the business, it is possible that the user-based test may independently trigger SEP.

Nature of Transactions:

USStream’s business depends on the engagement of Indian users, but identifying the **location and number of unique users** is fraught with difficulties. Users pay through global payment gateways such as PayPal or Stripe, where billing addresses may not reliably indicate physical location. Some users also access the platform using VPN services, masking their Indian IP addresses. This raises the practical question of whether SEP

thresholds should be tested on the basis of billing information, IP address, device data, or other proxies.

Issues and Challenges

1. Counting Unique Users

The statute refers to “such number of users in India as may be prescribed,” but in practice, platforms often face difficulty distinguishing between unique users and multiple accounts, especially when users employ VPNs or international payment methods. Should multiple accounts linked to one device count as one user or several? Without clear rules, both over-counting and under-counting are possible, leading to disputes with tax authorities.

2. Location of Users

User location is central to SEP attribution, yet digital footprints are notoriously ambiguous. VPNs can disguise location, global payment gateways may reflect offshore billing details, and some subscribers may consume content in India while paying through an account registered abroad. If user presence is uncertain, SEP attribution risks becoming arbitrary.

3. Absence of Treaty Relief

Had USStream been able to furnish a TRC, it could have relied on the India-US DTAA, which does not yet recognize SEP as a nexus. Without a TRC, treaty relief is unavailable, and the company is fully exposed to domestic law. This demonstrates the importance of documentation in cross-border tax planning: a procedural lapse effectively subjects USStream to a more onerous tax regime.

8.5. Case Study 5: SEP and Transfer Pricing — Sales within a Multinational Group

Scenario

LiechTech, a company incorporated in Liechtenstein (a jurisdiction with which India has no DTAA), manufactures high-end electronic components. All of its Indian sales are made exclusively to its wholly owned Indian subsidiary, IndiTech Pvt. Ltd., which assembles and markets finished products in India.

In the relevant financial year, LiechTech earns INR 45 million from sales to IndiTech. The transactions are cross-border, but pricing has been documented and tested under India’s transfer pricing provisions. The

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Transfer Pricing Officer accepts that the prices are consistent with the arm's length principle (ALP).

Application of SEP Provisions

Since LiechTech's sales to India exceed the INR 20 million threshold, it is deemed to have a Significant Economic Presence in India. In the absence of a tax treaty, this creates a domestic law business connection, making its Indian-sourced income taxable under section 9(1)(i).

Nature of Transactions

Unlike cases involving unrelated third parties, here all transactions are between associated enterprises and already subject to rigorous transfer pricing analysis. Transfer pricing ensures that IndiTech pays an arm's length price for the components, thereby allocating a fair share of profits to India through the subsidiary. Invoking SEP in parallel raises the question of whether further attribution is necessary when the transactions have already been benchmarked under TP.

Issues and Challenges

1. Overlap of Frameworks

Transfer Pricing provisions allocate profits between associated enterprises based on the arm's length principle, while SEP seeks to deem income attributable to India by virtue of significant economic presence. When TP has already tested the pricing, applying SEP risks double counting or unnecessary duplication.

2. Attribution Beyond ALP?

If LiechTech is deemed to have an SEP, should India tax more than what is already captured through TP adjustments? From a conceptual standpoint, SEP is about nexus, while TP is about quantification. Yet in practice, TP benchmarking ensures that the Indian subsidiary's profits reflect a fair share of group earnings. Taxing LiechTech again under SEP could result in **economic double taxation** unless carefully reconciled.

3. Domestic Law vs OECD Standards

Generally under Dependent Agent PE, when a foreign enterprise sells only to its related subsidiary at ALP, the profits attributable to the market jurisdiction are already recognized in the subsidiary's taxable income. SEP, however,

expands domestic nexus rules without specifying how it interacts with transfer pricing. This creates uncertainty about whether India can still assert taxing rights over the non-resident parent in addition to taxing the subsidiary.

4. Compliance Burden without Incremental Revenue

For businesses like LiechTech, where TP compliance already exists and transactions are verified as arm's length, SEP does not generate incremental revenue for the tax administration but imposes additional compliance costs and risks of litigation.

This case study highlights the interplay between SEP and transfer pricing provisions.

8.6. Case Study 6: Online News Platforms, Free Users, and Attribution of Non-Monetary Contributions

Scenario

NewsNet, a digital news provider incorporated in the UK, runs a global online platform with a significant readership in India. In a given financial year, it earns INR 18 million from paid subscriptions sold to only 500 Indian readers. In addition, its website attracts 400,000 unique Indian users, many of whom access the site for free or through ad-supported models. The company has no office, bureau, or journalists in India, and all content is created and managed outside the country. Further, assume that it is not eligible for India-UK DTAA.

Application of SEP Provisions

Although subscription revenue from India falls below the INR 20 million threshold, NewsNet crosses the user-based threshold of 300,000 Indian users. By virtue of this test, the company is deemed to have a Significant Economic Presence in India, creating a domestic law business connection under section 9(1)(i).

Nature of Transactions

Unlike traditional subscription-based businesses, online news platforms often rely on a hybrid model where some users pay for content while a larger portion consume content free of charge but are monetized through targeted advertising. This creates complexity in applying SEP, since "user presence" extends beyond paying customers to include free readers whose contribution is indirect but still commercially valuable.

Issues and Challenges

1. User Locality Verification

The first challenge lies in establishing the location of users. Online readership can be highly mobile, with users accessing content through virtual private networks (VPNs), international roaming, or global internet gateways. Determining whether a user is genuinely “in India” for the purposes of the threshold test is therefore difficult. Should IP addresses alone be decisive, or should billing information and device data also be considered?

2. Attribution of Subscription Revenue

For the INR 18 million subscription revenue, attribution is relatively straightforward. These payments are clearly sourced from 500 Indian customers. However, they fall below the revenue threshold. SEP is triggered only because of the user-based test, which pulls into question how much of the company’s global profits can be attributed to India in light of this digital footprint.

3. Non-Monetary User Contributions

The real complexity arises in valuing the contributions of non-paying users. Free and ad-supported readers provide significant commercial value by generating traffic, clicks, and data that can be monetized globally through advertising networks. But how should this indirect value be split between jurisdictions? Should India claim attribution based on the sheer number of Indian readers, or should attribution be tied only to advertising revenues demonstrably linked to Indian impressions?

By treating free users as equivalent to paying users for SEP purposes, India’s law captures businesses that may have little or no revenue from the Indian market. On the one hand, the large Indian user base undeniably contributes to the platform’s global value. On the other hand, taxation without actual Indian revenues risks double counting, since the advertising revenues may be recognized and taxed in another jurisdiction under consolidated contracts.

This case highlights the unique attribution challenges for ad-supported and free-user models, which dominate much of the digital economy.

8.7. Case Study 7: Cross-Border Platform Commissions and SEP Attribution

Scenario

Francemart, a company incorporated in France, operates a global online marketplace. The platform connects Indian buyers with sellers located worldwide, facilitating e-commerce transactions across multiple product categories. For its intermediation services, Francemart charges commissions on completed transactions. In a given financial year, the company earns INR 23 million in commissions attributable to Indian users. It is assumed that Francemart is not eligible for India-France DTAA since Francemart is fiscally transparent entity.

Application of SEP Provisions

Since Francemart's commission income from India exceeds the INR 20 million threshold, the company is deemed to have a Significant Economic Presence in India. This creates a domestic business connection under section 9(1)(i), requiring Francemart to comply with Indian tax obligations, including registration, profit attribution, and filing of tax returns.

Nature of Transactions

Francemart operates a two-sided platform where both buyers and sellers contribute to the creation of value. Indian residents participate both as buyers purchasing from foreign sellers and as sellers supplying to foreign customers. The platform's revenue is generated primarily through commission fees, but significant additional value may also be created through user data collection, targeted advertising, and analytics services offered to vendors.

Issues and Challenges

1. Apportioning Buyer-Side and Seller-Side Revenue

A critical issue in applying SEP is identifying whether the INR 23 million commission revenue is solely attributable to Indian buyers, or whether Indian sellers also contribute to the value creation. For example, if an Indian buyer purchases from a foreign seller, the commission could arguably be attributed to the Indian market. Conversely, if a foreign buyer purchases from an Indian seller, should part of the commission also be considered Indian-sourced? The two-sided nature of the platform complicates clear attribution.

2. Revenue versus Data Value

Platforms like Francemart often derive material value not only from transaction-based commissions but also from the collection of user data, which can be monetized through analytics, targeted advertising, and vendor services. This raises the question of whether India can claim taxing rights over global profits linked to Indian user data, even if the direct commission revenue is relatively modest. Distinguishing between the commission income and the data-derived value is conceptually challenging but central to determining what portion of profits should be attributed to SEP in India.

This case illustrates the complexities of applying SEP to two-sided digital marketplaces, where value is generated simultaneously from multiple categories of users.

8.8. Case Study 8: Capital Gains on Sale of Shares to Indian Residents and the Impact of GAAR

Scenario

ChinaCap, an investment firm incorporated in China, holds shares in an unlisted Indian company. During the financial year, it sells the shares directly to an Indian resident buyer for a gain of INR 300 million. The transaction is executed digitally, with no office, employees, or physical presence of ChinaCap in India.

Although India and China have a DTAA, the Indian Revenue authorities invoke **General Anti-Avoidance Rules (GAAR)**, alleging that ChinaCap's holding structure was created primarily to obtain treaty benefits. As a result, treaty protection is denied, and taxation is determined solely under Indian domestic law.

Application of SEP Provisions

At first glance, one might question whether SEP is triggered, since capital gains are not explicitly the type of "business income" SEP was intended to cover. However, on a literal reading, the sale of shares could fall within "transactions in respect of property with any person in India," thereby invoking SEP.

Nevertheless, the more coherent interpretation is that **capital gains taxation under section 45 and section 9(1)(i)** already applies, and SEP does not need to be invoked. SEP was conceived for taxing cross-border **business**

profits in the digital economy, not for recharacterizing capital gains, which have a self-contained statutory framework.

Nature of Transactions

The case raises a doctrinal question: is the sale of shares “business income” (to which SEP applies) or “capital income” (covered under the capital gains regime)? Indian law has long treated capital gains as a separate head of income, distinct from profits of business. Therefore, even where the counterparty is an Indian resident, SEP should not override the capital gains provisions.

Issues and Challenges

1. SEP vs Capital Gains

If tax authorities attempt to apply SEP, they risk duplicating or conflicting with capital gains taxation. SEP’s purpose was never to subsume other heads of income but to extend the scope of “business connection.” Capital gains provisions already provide for taxation when shares of an Indian company are transferred, irrespective of residence of the seller.

2. Effect of GAAR

The invocation of GAAR is critical here. Since GAAR denies treaty protection in cases of abuse, the India-China DTAA cannot be relied upon. ChinaCap’s gain is therefore taxed entirely under Indian domestic law. This demonstrates that GAAR serves as a powerful backstop to ensure that taxpayers cannot use treaty structures to escape Indian tax. SEP in this case is largely irrelevant, because the capital gains regime independently provides for taxability.

3. Digital Execution and User Nexus

If the transaction is executed digitally, for example through an Indian stock exchange or online trading platform, authorities may be tempted to characterize it as an SEP-triggering transaction. This stretches SEP beyond its intent and conflates capital market transactions with business connections. Judicial clarification will likely be required if such arguments are pursued.

This case highlights the **interaction between SEP, capital gains, and GAAR.**

8.9. Case Study 9: E-Commerce Marketplace with Mixed Transactions

Facts

ShopEase, a company incorporated in the British Virgin Islands (a jurisdiction with which India has no DTAA), operates a global e-commerce marketplace. The platform enables vendors located in the British Virgin Islands to sell goods directly to Indian consumers. In the financial year 2024–25, Indian buyers make aggregate payments of INR 180 million to ShopEase vendors via the platform. The marketplace charges a 10 percent commission on gross goods value, yielding INR 18 million in platform fees, while the underlying gross sales amount to approximately INR 180 million. ShopEase has a registered Indian user base of 20,000 accounts.

Application of SEP Provisions

Under Explanation 2A, a Significant Economic Presence arises if either the revenue threshold or the user threshold is crossed. Here, the **revenue test** may not be satisfied, if only net commission income is considered as aggregate payments which is only INR 18 million which falls below the INR 20 million benchmark. Further, the **user test** is also met, since ShopEase has only 20,000 Indian users. Accordingly, SEP is deemed to exist, creating a domestic law business connection in India.

Nature of Transactions

ShopEase's direct revenue comes in the form of commissions on vendor sales, while the total gross value of goods traded through the platform far exceeds its own reported income. The SEP framework must grapple with whether taxation should be based on the commission revenue earned by ShopEase or on the full gross merchandise value transacted through the platform.

Issues and Challenges

1. Platform Fees versus Gross Sales

The statute refers to “payments arising from transactions in respect of goods, services, or property carried out by a non-resident with any person in India.” A literal reading could suggest that the entire INR 180 million gross sales value constitutes “payments arising from transactions in respect of goods with Indian buyers.” However, ShopEase itself only earns INR 18 million in

platform fees. If the gross sales are taken as the relevant metric, SEP would be triggered at a much higher level of exposure than intended, potentially inflating the tax base far beyond the company's actual income.

2. Commission Attribution

Even if SEP is established, the principle of attribution requires that only the profits of the non-resident attributable to India are taxable. In this case, attribution should logically be restricted to the INR 18 million platform commissions, adjusted for related expenses. However, Indian authorities could argue that the gross sales value provides the relevant measure of SEP nexus and therefore serves as a basis for attributing profits. This approach risks double taxation, since the vendors themselves may also be taxable on their profits from Indian sales in their home country.

3. Withholding Complications

Indian buyers or payment intermediaries processing transactions may face uncertainty about withholding obligations under section 195. Should withholding apply only on the commission fee portion received by ShopEase, or on the gross payments routed through the platform? Absent clear guidance, Indian customers may over-withhold, complicating vendor payouts and creating disputes.

This case underscores the tension between the **breadth of the SEP nexus test** and the principle of **profit attribution**. While SEP is established on the strength of the user base, the taxable base is uncertain. If limited to commissions, the exposure is manageable, but if expanded to gross sales, India's assessments could substantially exceed ShopEase's actual economic profits. The risk of over-withholding by Indian customers can add further complexity.

Conclusion: Lessons from SEP Case Studies

The case studies examined across different business models reveal the wide-ranging implications and unresolved challenges of India's Significant Economic Presence (SEP) provisions. While SEP was introduced to modernize nexus rules for the digital economy, its application in practice often goes well beyond that narrow intent.

First, the examples demonstrate the **breadth of SEP's drafting**. The phrase "any person in India" and the inclusion of both revenue and user-based thresholds mean that SEP can capture not only digital businesses but also

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traditional imports, intra-group sales, and marketplace transactions. These risks blurring the distinction between digital economy nexus and conventional trade, leading to potential overreach.

Second, the case studies highlight the **tension between SEP and existing income categories**. Royalties, capital gains, and transfer pricing transactions are already governed by specific statutory regimes. Applying SEP in parallel raises risks of duplication and double taxation. The recurring question is whether SEP adds any incremental value where dedicated charging provisions already exist.

Third, the user-based threshold examples bring out the **practical difficulties of attribution**. Counting unique Indian users, distinguishing paying from free accounts, and valuing non-monetary contributions such as user data are all fraught with ambiguity. These issues underline the gap between the conceptual design of SEP and its operational feasibility in a digital economy dominated by free and ad-supported services.

Fourth, the marketplace and commission models show the **uncertainty in defining the taxable base**. Should SEP thresholds be tested on gross transaction values or on the platform's net commission income? Should attribution extend to user data monetization in addition to direct revenue? Without clear rules, platforms face the risk of inflated tax assessments and withholding disputes.

Fifth, the case studies demonstrate the **interplay of SEP with treaty and anti-avoidance frameworks**. Where tax treaties apply, SEP has little effect unless renegotiated into the treaty text. However, where treaty protection is unavailable either because the jurisdiction has no treaty with India, or because GAAR or documentation lapses deny access, SEP operates as a powerful domestic nexus rule. This underscores its role as a backstop, filling treaty gaps rather than overriding them.

Finally, the case studies collectively reveal the **policy tension in SEP's design**. On one hand, SEP reflects India's determination to secure source-based taxation in the digital economy. On the other hand, the provision's breadth, lack of attribution rules, and overlap with existing tax regimes create legal uncertainty, compliance burdens, and risks of double taxation. Unless clarified through legislation, administrative guidance, or judicial interpretation, these ambiguities may generate disputes.

Practical Issues Emerging from the Two-Pillar Approach

1. Introduction

In recent years, India's international tax framework has witnessed significant reforms aimed at aligning with evolving global standards and addressing the challenges posed by the digitalised economy. A notable development in this regard has been the withdrawal of the Equalisation Levy regime, which previously applied to specified digital services and e-commerce operators. This withdrawal marks a strategic policy shift as India moves towards the implementation of international consensus-based solutions, including the OECD-led Two-Pillar Approach, particularly Pillar One, which addresses the reallocation of taxing rights for large multinational enterprises.

Simultaneously, the Indian government has taken several legislative and administrative measures to enhance transparency, curb base erosion, and prevent profit shifting. These include refinements in the scope of Significant Economic Presence (SEP), expanded reporting obligations under Master File and Country-by-Country Reporting (CbCR), and alignment of domestic law with key BEPS Action Plans. The introduction of General Anti-Avoidance Rules (GAAR), coupled with a re-examination of tax treaty benefits under the Principal Purpose Test (PPT), further reflects India's commitment to robust source-based taxation while maintaining coherence with global tax norms.

Together, these developments underscore a comprehensive transition in India's approach to international taxation—from unilateral digital tax measures to multilateral frameworks grounded in cooperation, certainty, and administrative efficiency.

BEPS 2.0 signifies a substantial paradigm shift within the realm of international taxation. Pillar One proposes a reallocation of taxing rights based on market jurisdiction for large multinational enterprises engaged in automated digital services and consumer-facing businesses, while Pillar Two introduces a globally coordinated minimum effective corporate tax rate of 15%. The adoption of the dual-pillar resolution constitutes a seminal juncture, aiming to modernize longstanding international tax rules and address

challenges arising from digitalisation and globalisation. Entities domiciled in India with international footprints, as well as foreign entities with economic presence in India, must carefully assess the implications, including potential incremental tax exposure and enhanced compliance obligations. .

2. Challenges

With the rise of digital commerce, multinational enterprises have been able to derive significant revenues from jurisdictions without establishing a physical presence, thereby avoiding taxation in countries where their consumers are located. Under the existing international tax framework, such income is generally characterised as "business income" and remains taxable only in the country of residence, provided a permanent establishment (PE) exists in the market jurisdiction. In the absence of such a PE, the source country is effectively denied taxing rights, leading to substantial base erosion.

Recognising this challenge, governments globally — including India — have taken unilateral and multilateral measures to address the taxability of digital economy transactions. India has already amended Section 9 of the Income-tax Act to expand its source rules through the concept of Significant Economic Presence, though comprehensive treaty-based solutions are still awaited. The central policy concern for governments is the fair and effective allocation of taxing rights over profits derived by global corporations across jurisdictions.

For taxpayers, however, key concerns remain: (i) the avoidance of double taxation, and (ii) the need for certainty and clarity in the application of tax laws. This book seeks to explore and present a framework that balances both sets of interests through legally sound and administratively feasible measures.

Requirements of a Digital Taxation System that will encourage the technical commercial revolution and will not hamper it:

- (i) The digital taxation system should be absolutely **simple, efficient and dynamic**. It should not bother the digital corporations and the users with burdensome compliance and threats of penalty and prosecution from a hundred different countries. Such a system can be called "**Future Ready**".
- (ii) The **digital corporations** also have to understand and accept the fact that they will have to pay a digital tax in every country from where they

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earn revenue. Their hugely complex tax planning will be demolished and ignored. If they avoid taxation, they will face consequences in the Countries of Market. If they pay up the tax, they can do business & grow.

- (iii) All the **Countries of Market** (COM) have to state clearly to COR and OECD that they (COMs) have a clear right to tax digital profits. They will tax the profits and any attempt at avoiding COM tax is only hampering technological revolution and finalisation of objective of BEPS Action One.

There are **three major challenges** in taxing digitalised commerce:

- (i) Determining the **Scope of income** that should be covered within the digital taxation.
- (ii) Determining **Nexus** - PE/SEP for establishing “Right to Tax”.
- (iii) **Attributing** taxable profits to the Country of Market. In other words, recognising the COMs’ “**Right to Tax**” digital commerce profits.

The concept of taxing the digital economy has undergone a notable evolution in recent international tax discourse. Initially, the focus was confined to the “digitalised economy”, referring predominantly to businesses providing fully digital or automated services—such as online advertising, streaming platforms, and digital marketplaces. However, the scope has now been broadened to include “Consumer-Facing Businesses” (CFBs)—entities that engage directly with individual consumers across jurisdictions without a physical presence, such as e-retailers, social media companies, and app-based service providers.

While this shift is significant, it overlooks a substantial component of the digital economy—Business-to-Business (B2B) digital commerce. Many multinational enterprises offer digital services or platforms exclusively to other businesses, including enterprise software, cloud computing, data analytics, and financial technology services. These services generate considerable revenue from market jurisdictions without triggering taxability under traditional permanent establishment thresholds or the emerging consumer-facing criteria.

Given their economic footprint, it is imperative that B2B digital transactions are not excluded from the scope of digital taxation merely because they do not interface directly with end consumers. A balanced and inclusive

framework must therefore also bring B2B digital commerce within the fold of digital tax policies to ensure fairness, neutrality, and integrity in the allocation of taxing rights.

3. Suggestions for improvement of taxation system

Multinational Corporations (MNCs), through sophisticated tax planning strategies, have been able to shift profits across jurisdictions to minimise their overall tax liability, often without aligning such outcomes with genuine economic activity. In response, international organisations such as G-20 and the OECD have developed the Base Erosion and Profit Shifting (BEPS) Action Plans to counteract such tax avoidance practices. While these efforts are well-intentioned and necessary, the implementation of complex anti-avoidance measures—especially those involving subjective Transfer Pricing rules—has made tax laws increasingly intricate and open to multiple interpretations. This legal ambiguity fuels costly and prolonged litigation, burdening both taxpayers and tax authorities. Moreover, an overly aggressive global adoption of BEPS provisions may inadvertently stifle cross-border trade and economic cooperation. There is a pressing need to strike a balance between ensuring that MNCs pay their fair share of taxes and maintaining a tax framework that is administratively simple, predictable, and globally consistent. A possible way forward lies in replacing complex profit attribution mechanisms under the current system with more transparent alternatives—such as a combination of Significant Economic Presence (SEP) and Withholding Tax (WHT) models—that reduce tax evasion while preserving the ease of compliance and facilitating global commerce.

It is against this backdrop of aggressive tax avoidance by MNCs and the complexity of current anti-avoidance regimes that the international tax community has turned its focus to the Two-Pillar solution proposed under the OECD/G20 Inclusive Framework. The Two-Pillar Approach represents a paradigm shift in the allocation of taxing rights and the setting of minimum standards to curb base erosion. Pillar One seeks to re-allocate a portion of residual profits of large multinational enterprises to market jurisdictions, irrespective of physical presence, while Pillar Two aims to ensure that such enterprises pay a minimum level of tax, regardless of where they are headquartered or operate. While these measures are an attempt to create a more equitable and modern international tax architecture, their complexity,

implementation challenges, and potential overlap with existing frameworks such as SEP and WHT, raise important questions. It is crucial to evaluate whether the Two-Pillar Approach strikes the right balance between fairness, administrability, and global economic efficiency—especially for developing countries striving to secure their fair share of tax without imposing undue compliance burdens on cross-border business activity.

4. Pillar One of the OECD's BEPS 2.0

Pillar One of the OECD/G20 Inclusive Framework represents a major reform in international taxation, aiming to address the tax challenges arising from digitalisation and the globalisation of business models. It departs from the traditional requirement of physical presence and instead reallocates taxing rights over a portion of residual profits of large and highly profitable Multinational Enterprises (MNEs) to the jurisdictions where their consumers or users are located. Pillar One comprises three key components: Amount A, which reallocates a share of residual profits of MNEs with global revenue exceeding EUR 20 billion and profitability above 10% to market jurisdictions; Amount B, which standardises and simplifies remuneration for baseline marketing and distribution functions; and Amount C provides Tax Certainty Framework designed to provide binding dispute prevention and resolution mechanisms to reduce tax uncertainty.

While conceptually sound in addressing profit allocation in a digital economy, Pillar One introduces significant administrative and legal complexities. These include the technical challenges in computing residual profits, establishing new nexus rules, preventing double taxation, managing coordination among multiple jurisdictions, and ensuring consistency with existing domestic and treaty-based rules. For developing countries in particular, the compliance burden and need for institutional capacity to implement and administer such rules remain major concerns.

4.1. Amount A

Amount A under Pillar One introduces a new taxing right for market jurisdictions, irrespective of physical presence. As mentioned earlier, it applies to large Multinational Enterprises (MNEs) with global revenue above EUR 20 billion and profitability exceeding 10%. A portion of the MNE's residual profit—defined as profit above the 10% threshold—is reallocated to market jurisdictions using a formulary approach. The share reallocated is

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fixed at 25% of the residual profit. Amount A operates outside traditional transfer pricing rules and is not linked to the performance of local entities. The approach requires a multilateral convention to ensure coordinated implementation and dispute resolution. Safe harbours and exclusions exist, including for extractive industries and regulated financial services. It aims to address the tax challenges of digitalisation by recognising the value created by user participation and market engagement. However, it necessitates complex revenue sourcing, profit segmentation, and elimination of double taxation across jurisdictions.

Implementing Amount A under Pillar One framework in India presents several practical challenges due to the complexity of India's tax system, the nature of global businesses, and the evolving international tax rules. These are discussed hereunder:

1. Determining the Allocation of profit to Market Jurisdictions
 - Revenue Sourcing: One of the central features of Amount A is the allocation of a portion of an MNE's profit to market jurisdictions based on factors such as revenue, sales, or the presence of user. In India accurately determining the source of revenue can be complex, particularly for businesses operating in the digital economy. Where it may be difficult to attribute revenue to a particular jurisdiction.
 - Digital Economy: Many multinational digital companies (e.g. tech platforms, e-commerce) derive significant revenue from Indian users but do not have a physical presence in the country. For instance, an online streaming service or a digital marketplace may have to a large user base in India, but they do not operate from physical premises. Determining how to allocate revenue generated by India user for the purpose of Amount A can be challenging, as traditional rules of revenue sourcing may not apply effectively.
 - Challenges in Identifying Market contribution: For some industries, particularly digital services or goods with a global customer base, distinguishing between sales driven by local economic activity versus those driven by global marketing or business function become difficult.
2. Revenue Threshold and Size Criteria
 - Threshold for Application: Under Amount A only large multinational enterprises (MNE's) with certain threshold of global revenue are

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subject to reallocation (e.g. global turnover above €20 billion and profitability above 10 per cent). Determining whether a company qualifies for the rules can be challenging, especially for businesses with complex structures, multiple subsidiaries, or intricate cross-border transactions. In India, determining whether an MNE qualifies for Amount A requires detailed financial reporting across jurisdictions.

- Consolidation of Financials: MNEs with multiple subsidiaries and business segments might need to consolidate their global financial for the purpose of determine whether the company revenue exceeds the threshold for applying Amount A. This process can involve complex cross-border tax filings and may requires extensive adjustments for intercompany transactions.
3. Implementing the Allocations Formula for Profit Reallocation
- Profit Allocation Mechanism Amount A involves a complex formula to allocate a portion of the profits to market jurisdictions based on sales or other indicators of economic activity. The formula considers various factors such as the volume of sales or user engagement in jurisdiction. In India, MNEs may find it difficult to apply this allocation formula effectively due to the need for detailed, accurate data about sales, users or economic activities in the Indian market.
 - Determining “Significant Economic Presence” One of the challenges in India, especially for digital businesses, is determining what constitutes a significant economic presence in the country for purposes of reallocation. While sales may be used as an indicator, there are other factors to consider, such as the number of user or the value created in the market. This creates significant administrative complexity in reporting and ensure compliance.
4. Complexity in Compliance and Documentation
- Transfer Pricing Documentation Under Pillar One, India would need to develop new documentation and compliance requirements to ensure that companies apply the Amount A rules correctly. This includes demonstrating how profits have been reallocated to market jurisdiction based on the economic activities in those jurisdictions. For businesses with a large volume of cross-border transaction, this documentation process could be extremely complex.

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- **Audit and Disputes:** India's tax authorities may face challenges when auditing MNE's on their Amount A calculations. The complexity of applying the profit reallocation formula may lead to disagreements on the methodology and assumptions used. This could result in lengthy audits, disputes, and potential adjustments in tax assessments. Taxpayers may need to provide substantial data and documentation to support their profit allocation decisions, increasing complex burdens.
5. **Uncertainty Regarding Application and Tax Rates**
- **Uncertainty Around Tax Rates:** India's corporate tax rates and local tax policies may not align with the OECD's reallocation framework. For instance, certain sectors, such as the technology sector or start-ups, may benefit from tax incentives, which may impact the overall tax liability related to the reallocated profits. The implementation of Amount A requires careful consideration of the local tax rates to avoid tax distortions or inequities.
6. **Multinational Business Model in India**
- **Business Models and Supply Chains:** MNE often have complex supply chains that involve various subsidiaries in India. Amount A requires the allocation of profits to market jurisdictions, which may affect how income is reported and taxed within India. For instance, businesses engaged in online sales may generate revenue in India without having a physical presence. This can complicate the profit allocation to the market jurisdictions, especially when there are multiple jurisdictions involved in the MNEs supply chain.
 - **Foreign Tech companies;** (e.g. streaming platforms, online gaming) that generate substantial revenue from Indian customers but have no physical presence in India will need to determine the portion of their profits attributable to the Indian market. Indian subsidiaries of MNEs might not directly engage in sales functions but could still be involved in marketing or customer support, adding complexity to determining the appropriate reallocation.
7. **Administrative burden on the tax authorities to track and ensure compliance with Amount A's provisions.**

4.2. Amount B

Amount B is intended to simplify the application of transfer pricing rules for routine activities such as distribution, marketing, or other routine services. Its primary objective is to introduce a standardized methodologies that reduces the administrative burden on multinational enterprises (MNEs) and tax authorities. By prescribing fixed returns for qualifying activities, Amount B seeks to ensure that arm's length remuneration for routine functions is allocated consistently to local entities. This approach enhances predictability and reduces subjectivity in the determination of transfer prices for commonly performed functions. As a result, Amount B is expected to contribute to the simplification of transfer pricing compliance, promote tax certainty, and minimise the risk of disputes in cross-border transactions involving standardised business operations.

Let's look at an example where Amount B applies to a holding subsidiary in a multinational enterprise(MNE) context. A holding subsidiary typically holds shares in other subsidiaries and may not perform active distribution or marketing activities, but it still might perform certain administrative or routine functions that require a fixed return under Amount B.

Example : Global Holding Co. and its Subsidiary in Country X

Background:-

- Global Holding Co. (a multinational enterprise) is headquartered in Country A and operates in multiple countries through its various subsidiaries.
- Global Holding Co. own a holding subsidiary in Country X, called Subsidiary X. which primarily hold shares in the group's operating companies in Country Y and Country Z.
- Subsidiary X does not perform active distribution, marketing, or manufacturing activities. Its main function is to manage the group's investments in the operating companies and handle intercompany financing and strategic decisions for those subsidiaries.
- Country X's tax authorities and the OECD would apply Amount B to determine a routine return for Subsidiary X's activities related to holding managing investments.

Step-1: Routine Function of Holding Subsidiary

Under Amount B, Subsidiary X is considered to be performing a routine function associated with holding assets, collecting dividends, and managing financial investments. These types of activities typically generate a fixed return under the OECD guidelines.

Subsidiary X might also manage some of the group's intellectual property rights or provide administrative services to the subsidiaries in Country Y and Country Z. However, it doesn't engage in active sales, distribution, or other value-adding activities that would involve a higher profit margin.

- Routine Return Set by Amount B:
The fixed return is often a simplified percentage of the income or revenue generated by the holding subsidiary's activities.
- For example, Amount B might determine that Subsidiary X is entitled to a 5% return on the assets or equity that it manages.

Step-2: Calculate the Return for Subsidiary X. Assume Subsidiary X has total managed assets worth \$500 million. Therefore, the routine return for Subsidiary X would be: $5\% \times \$500 \text{ million} = \25 million .

So, Subsidiary X would earn \$25 million as its routine return for managing its investment under Amount B.

Step-3: Taxation in Country X

- The \$25 million return earned by Subsidiary X will be subject to the corporate tax rate in Country X.

Summary: In this case, Amount B would result in Subsidiary X earning a \$25 million fixed return for managing the assets. This routine income will be taxed in Country X at the local tax rate.

Below are some of the key challenges in India:

1. Determining a fixed return percentage that aligns with India's existing transfer pricing framework.
2. Classifying routine vs. non-routine activities especially in sectors with mixed activities like distribution and innovation.
3. Adapting global standards to local conditions, particularly in industries with varied tax treatment and specific regulatory considerations.

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4. Data collection and documentation issues related to identifying and supporting routine functions.
5. Potential for tax disputes regarding the application of the fixed return methodology.
6. Tax rate differences and alignment with India's corporate tax regime.

These challenges highlight the complexity of implementing Amount B in India and the need for careful consideration of local rules, business operations, and tax authority interpretation when applying the OECD's BEPS 2.0 framework.

Conclusion: Developing countries (like India) are likely to see more revenue gains under Pillar 1 of the Convention. This is because Pillar 1 aims to allocate a portion of the profits of multinational enterprises to the countries where they have market activity, even if they do not have a physical presence in those countries. Developing countries often have a large and growing digital market, but they may not have the resources to enforce their tax laws or to negotiate bilateral tax treaties with other countries. The Convention provides a multilateral solution that allows developing countries to participate in the allocation of profits and taxes, which could result in significant revenue gains for those countries. However, the exact amount of revenue gains will depend on a variety of factors, including the size and structure of the multinational enterprises, the countries in which they operate, and the nature of their digital services.

The Economic Impact Assessment shows that there are several special provisions for developing countries.

- *For jurisdictions with GDP under USD 40 billion, which includes all low-income jurisdictions in the Inclusive Framework, the nexus threshold to receive Amount A is lowered from EUR 1 million to EUR 250,000. This change increases the share of low-income (and middle income) jurisdictions that are able to receive allocated profit under Amount A due to the nexus threshold.*
- *The de minimis provisions largely exempt small and lower income jurisdictions from the obligation to provide double tax relief. Taken together, these provisions play a significant role in increasing low-income Inclusive Framework member revenue estimates from Amount A.*

4.3. Disadvantage to the developing countries from Pillar One implementation:

1. **Limited Ability to Capture Tax Revenue from Digital Economy:** Amount A primarily reallocates profits to market jurisdictions based on factors like user participation or sales in a jurisdiction, which can often favour larger developed economies. For example, if an MNE generate significant revenue in a developing country without physical presence, it may not receive a sufficient share of the reallocated profit under new rules.
2. **Risk of losing Tax Revenue to Developed Countries:** The profit reallocation mechanism under Pillar One is formula-based and might disproportionately benefit developed countries that have a large user base, advanced infrastructure, and a well-established presence of global digital businesses. This could result in the loss of taxing rights for developing countries that may have local consumers or market but do not have significant share of the overall global profit of MNEs.
3. **MNEs could artificial shifting profits to low tax jurisdictions or using mechanisms like intangible asset planning to reduce the amount allocated to developing countries.**
4. **Potential for Double Taxation or Jurisdictional Disputes,** The formula for reallocation may lead to double taxation or disputes between market jurisdictions and source jurisdictions (where the company is based). Since Pillar One reallocates taxing rights, countries could end up taxing the same profits, especially if the rules not properly coordinated.

While Pillar One aims to address the tax challenges posed by digitalization, it carries significant potential drawbacks for developing countries, particularly in terms of lost tax revenue, increased administrative burden, and limited control over their tax systems.

4.4. Pillar Two of OECD BEPS 2.0

The Pillar Two framework under the OECD's Base Erosion and Profit Shifting (BEPS) 2.0 initiative introduces a Global Minimum Tax of 15% on large multinational enterprises (MNEs) with annual revenues exceeding €750 million. It aims to prevent profit shifting to low-tax jurisdictions.

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Summary of Key Insights:

1. Income Inclusion Rule (IIR): The top-up tax is charged at the parent entity level.
2. Undertaxed Payments Rule (UTPR): Imposes tax if the IIR is not applied.
3. Blending Issues: Taxes are assessed globally or jurisdictionally to prevent artificial tax reductions.

It is important to note that if the DMT (Domestic Minimum Tax) is implemented by Indian Revenue authorities, it may not result in a real tax benefit as the companies incorporated and / or functioning in India are already paying taxes higher than that arrived at by applying the GloBE Rules. However, India would be able to collect under IIR or UTPR for countries that are not part of the OECD Inclusive Framework for example Bangladesh where Indian MNEs already have presence.

How IIR Could Be Refined:

1. Improved Deferral Mechanism: Allow deferral of top-up taxes where future tax adjustments (e.g., deferred tax liabilities) would raise the ETR.
2. Recognition of Broader Tax Concepts: Include withholding taxes, tax credits, and other indirect taxes in the ETR calculation.
3. Safe Harbor for Loss-Making Entities: Exempt loss-making subsidiaries from IIR application until profits normalize.

Furthermore, as the IIR and UTPR allocates taxing rights to other jurisdictions, it is likely that maximum jurisdictions will incorporate the QDMTT¹ mechanism and ask MNEs to pay global minimum taxes into their jurisdiction only. In case the DMT is adopted, there might be no collection of extra tax revenue in any of the jurisdictions where the parent entity or IPE is established. This may result in a low collection of revenue for India.

¹ The Qualified Domestic Minimum Top-Up Tax (QDMTT) is a domestic-level tax mechanism that allows a country to collect the top-up tax on the low-taxed profits of multinational enterprises (MNEs) before the taxing rights shift to another country under the Pillar Two rules. It ensures tax revenue stays within the source country rather than being collected by the parent jurisdiction.

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With the implementation of Pillar Two, Revenue Authorities in India need to develop a robust system to trace and maintain data of MNEs.

This may also require free flow of financial information among various jurisdiction in which MNEs operate or have presence. Multiple data source points need to be identified for collecting independent information and their integration with existing data. This entails a detailed exercise and an upgradation of the existing methodology adopted to detect cases of non-compliances. The rules of Pillar Two are still evolving and incorporation of these rules into the existing complex tax structure would be a challenging task for Indian Revenue Authorities.

The Income Inclusion Rule (IIR), a core part of the Pillar Two framework, ensures that profits in low-tax jurisdictions (LTJs) are subject to a minimum tax of 15%. However, if a subsidiary in an LTJ has an Effective Tax Rate (ETR) below this threshold, certain challenges or "faults" in the IIR mechanism could arise.

Challenges faced in all five application steps and through a country-by-country approach: It is to be ensured that an effective minimum taxation of 15% is achieved in each jurisdiction in which one or more group companies and / or permanent establishments are located.

1. The first step is to identify the constituent entities of the group covered by Pillar Two and their role in the minimum taxation (e.g. UPE, Partially owned Parent Entity (PoPE), Intermediated Parent Entity (IPE), Minority owned Parent Entity, Permanent Establishment, Transparent Company, Joint Venture, etc.).
2. The qualifying income or loss for each constituent entity is then determined based on the profit or loss for the year in accordance with the consolidated accounting standard, making Pillar Two-specific adjustments.
3. In the third step, the "covered taxes" of each constituent entity are determined, also by making certain adjustments (in particular taking into account deferred taxes). In the next step, the effective tax rate (ETR) per jurisdiction is calculated by setting the sum of the adjusted covered taxes of all constituent entities in relation to the sum of the qualifying income of all constituent entities for each jurisdiction.

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4. The jurisdiction's ETR is then compared with the minimum tax rate of 15% and the top-up tax is calculated, which ensures the minimum tax rate of 15%.
5. When determining the top-up tax, the so-called substance-based income exclusion must be taken into account, which reduces the low-taxed income accordingly.

4.5. Challenges with the substance-based income exclusion (SBIE) under Pillar Two

Example: Manufacturing Subsidiary in a Low-Tax Jurisdiction

Scenario A:

A global pharmaceutical company has a manufacturing subsidiary in Country X, a low-tax jurisdiction with a 5% corporate tax rate. The subsidiary:

- Employs 500 workers.
- Owns a factory and equipment worth \$50 million.
- Generates \$100 million in annual income.

Application of SBIE:

The SBIE allows the company to exclude a percentage of income tied to tangible assets and payroll from the Global Anti-Base Erosion (GloBE) rules' minimum effective tax rate (15%). For instance:

Assume SBIE permits 5% of tangible assets and 10% of payroll to be excluded.

If payroll costs are \$20 million annually, the exclusion would be:

Tangible assets: 5% of \$50 million = \$2.5 million.

Payroll: 10% of \$20 million = \$2 million.

Total SBIE exclusion = \$4.5 million.

Thus, \$4.5 million of income is excluded from Pillar Two's minimum tax calculation.

4.6. Potential issues and practical implications:

4.6.1. Complexity in Calculation and Compliance

Complexity: Calculating the effective tax rate across multiple jurisdictions is complex. It requires blending local taxes, timing differences, and permanent differences under accounting and tax rules.

Example: A subsidiary in an LTJ (Low Tax Jurisdiction) reports \$100M in profits but utilizes deferred tax liabilities (e.g., accelerated depreciation). The calculated ETR could appear artificially low, even though over time it may exceed 15%.

Impact:

The parent company may be required to pay a top-up tax prematurely under IIR rules.

It increases compliance burdens due to continuous recalculations.

4.6.2. Mismatch Between Local Tax Systems and GloBE Rules

Complexity: Differences in local tax base definitions and global GloBE tax base lead to mismatches.

Example: A subsidiary in an LTJ pays withholding taxes on dividends, which do not count toward the local ETR under GloBE rules.

Impact:

The subsidiary's ETR falls below 15%, triggering a top-up tax under IIR, even though the overall tax burden (if withholding taxes were included) would exceed 15%.

4.6.3. Loss-Making Entities Impacting IIR

Complexity: If a subsidiary in an LTJ incurs losses, its ETR appears artificially low.

Example:

Year 1: Subsidiary earns \$0, with tax losses carried forward.

Year 2: Subsidiary earns \$10M profit and pays \$1M tax (10% ETR due to prior losses).

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Impact:

The losses make it appear as though the subsidiary's ETR is below 15%, triggering an unnecessary top-up tax, which contradicts the intent of the rule.

4.6.4. Double Taxation Risks

Complexity: IIR can result in double taxation if LTJ's tax authority later imposes back taxes.

Example:

A subsidiary in an LTJ reports \$100M profit, taxed at 5% (ETR = 5%).

Parent company pays the 10% top-up tax (to meet 15%) under IIR.

Later, the LTJ imposes an audit adjustment, raising the local tax to 10%.

Impact:

The parent has already paid the top-up tax, and now the subsidiary faces additional tax exposure, creating a double taxation scenario.

4.6.5. Application of Tax Incentives and Credits

Complexity: Certain tax credits (e.g., R&D credits or investment incentives) might not count toward the ETR under GloBE rules.

Example: An LTJ grants tax credits reducing effective tax, resulting in an apparent ETR of 10%.

Impact:

Despite legitimate tax planning, the IIR may apply a top-up tax to bring the ETR to 15%, discouraging use of such incentives.

The implementation of Pillar Two—the Global Minimum Tax (GMT) of 15% under the OECD's BEPS 2.0 framework—has significant implications for developing countries. While its primary aim is to curb profit shifting to low-tax jurisdictions, its effects on developing economies are nuanced and multifaceted.

4.7. Positive Impacts on Developing Countries

4.7.1. Increased Revenue Potential through Top-Up Taxes:

Opportunity: Developing countries may benefit if they align their tax rates closer to the 15% minimum, capturing more revenue locally instead of losing it to other jurisdictions under the Income Inclusion Rule (IIR).

Example: A multinational with a subsidiary in a developing country paying 10% corporate tax will face a top-up tax of 5% under Pillar Two. Developing countries could adjust tax rates to capture this gap.

4.7.2. Reduced Base Erosion and Profit Shifting (BEPS):

Benefit: The GMT reduces incentives for MNEs to shift profits to low-tax jurisdictions, which could lead to more stable and predictable tax revenues in developing countries.

Outcome: Retaining more taxable income locally may bolster the domestic tax base.

4.7.3. Level Playing Field for Tax Competition:

Advantage: With a 15% global floor, harmful tax competition between countries to offer ultra-low tax rates will diminish, potentially benefiting developing countries that lack resources to compete in tax incentives.

4.8. Challenges and Risks for Developing Countries

4.8.1. Potential Loss of Competitive Advantage:

Challenge: Many developing countries rely on low tax rates and tax incentives (e.g., tax holidays, free zones) to attract foreign direct investment (FDI). The 15% minimum may undermine this strategy.

Impact: These countries may struggle to attract or retain MNEs that previously sought tax-efficient structures.

4.8.2. Limited Capacity for Implementation and Compliance:

Issue: Developing countries often face administrative challenges in implementing complex international tax rules.

Example: The calculation of Effective Tax Rates (ETR) under GloBE rules involves sophisticated adjustments, which may overwhelm under-resourced tax administrations.

4.8.3. Top-Up Tax Collected by Parent Jurisdictions:

Risk: If a developing country levies a tax rate below 15%, the top-up tax may be collected by the parent company's home country (usually a developed country) under the IIR, resulting in a loss of potential tax revenue for the developing country.

4.8.4. Impact on Investment Incentives:

Concern: Incentives like R&D tax credits, accelerated depreciation, or tax holidays may no longer provide the desired benefit if they lower the ETR below 15%.

Example: A country offering a 10-year tax holiday could see MNEs facing top-up taxes elsewhere, reducing the attractiveness of such incentives.

4.9. Strategic Responses for Developing Countries

4.9.1. Adopt Qualified Domestic Minimum Top-Up Tax (QDMTT):

Solution: Developing countries can introduce a QDMTT, allowing them to collect the top-up tax locally instead of allowing it to flow to other jurisdictions.

Benefit: Ensures that any tax shortfall to reach the 15% GMT is collected by the host country.

4.9.2. Reform Tax Incentive Structures:

Action: Shift from offering tax holidays to more targeted, measurable incentives that align with the global tax framework (e.g., infrastructure development credits or employment-based incentives).

4.9.3. Enhance Administrative Capacity:

Recommendation: Invest in tax administration capacity-building to effectively implement and monitor the complex rules under Pillar Two.

International Support: Seek technical assistance from international bodies like the OECD, IMF, or regional tax organizations.

4.9.4. Regional Cooperation:

Approach: Engage in regional collaboration to negotiate collectively with MNEs or harmonize tax policies, reducing harmful tax competition.

4.10. Practical Issues in Pillar Two

4.10.1. Issue 1: Financial Statements to be used for Pillar Two Computations

Brief Background

- Financial Accounts prescribes that financial statements that are used for preparing the consolidated financial statements of the group (prior to any consolidation adjustments eliminating intra-group transactions) is required to be considered.
- However, if it is not practicable to use the financial statements for consolidation, then another set of financial statements can be used if such financial statements are:
 1. prepared using the Indian GAAP Accounting Standard or an IND AS (Accounting Standard), for which Indian GAAP necessary modification to adopt BEPS recommendation has to be adopted.
 2. Information is reliable and
 3. In case there is a permanent difference exceeding Euro 1 million arising on account of use of an accounting standard different from the UPE's accounting standard, then such difference should be conformed by the UPE's accounting standard.
- Further, the accounting standard used for preparing consolidated financial statements should also be Acceptable Financial Accounting Standard or an Authorised Financial Accounting Standard.

4.10.2. Issue 2: Treatment of opening brought forward tax losses in the Transition Year

Brief Background

- In case an entity has recorded a tax loss during the fiscal year prior to Transition Year, the brought forward tax losses would be eligible to be set off against the taxable income arising in the Transitional Year or subsequent years, under the local tax law of that jurisdiction. This would result in a low tax liability in future. Hence, the entity would generally recognize a deferred tax asset ("DTA") in its books which would be reversed in the year in which such losses are utilized.

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- Pillar Two law provides for Transition Rules wherein, such opening deferred tax assets recognized on brought forward tax losses is eligible to be considered as part of the computation of adjusted covered taxes in the year in which such tax loss is utilized.

Practical Issue

- However, in certain situations, entities do not recognize a deferred tax asset on brought forward tax losses, due to valuation allowance or accounting adjustments. In such cases, there are no opening deferred tax attributed recorded in the financial statements in the Transition Year.

4.10.3. Issue 3: Whether PE are required to maintain separate FS

Brief Background

- The Pillar Two Law recognizes a permanent establishment (“PE”) as a separate constituent entity under the computation of Net GloBE Income, Adjusted Covered Taxes and ETR (%). In order to undertake separate computations of a PE, the income and taxes that are attributable to a PE shall be reallocated to it from the Main Entity. The income and taxes attributable to the PE can be identified from the financial statements prepared for the PE.

Practical Issue

- However, in certain situations, separate financial statements are not prepared for a PE. In such case, the MNE group relies on the internal management accounts prepared for the PE to identify the income and taxes attributable to a PE.

Key Consideration

- Whether separate financial statements are required to be prepared for a PE on account of Pillar Two Law.

4.10.4. Issue 4: Accounting Disclosures

Brief Background

- IAS 12 has passed an amendment which will require entities to provide a disclosure related to the impact of Pillar Two under current taxes and provide a disclosure to mention that mandatory temporary exception has been availed for deferred taxes.

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- A similar disclosure requirement is not yet implemented for IND AS 12.

Practical Issue

- In case of Indian HQ MNEs, whether disclosure would be required in the consolidated financial statements, while consolidating an entity that has provided a disclosure under IAS 12.

4.10.5. Issue 5: BEAT and Similar Taxes

Brief Background

- Pillar Two Law provides that covered taxes include the following:
 1. Taxes recorded in the financial accounts of a Constituent Entity with respect to its income or profits or its share of the income or profits of a Constituent Entity in which it owns an Ownership Interest;
 2. Taxes on distributed profits, deemed profit distributions, and non-business expenses imposed under an Eligible Distribution Tax System;
 3. Taxes imposed in lieu of a generally applicable corporate income tax; and
 4. Taxes levied by reference to retained earnings and corporate equity, including a Tax on multiple components based on income and equity.
- Entities in the USA are required to pay tax which is meant to prevent foreign and domestic corporations operating in the United States from avoiding domestic tax liability by shifting profits out of the United States called BEAT Taxes. Such taxes are imposed in addition to the normal corporate tax in the USA.

Practical Issue

- Whether BEAT Tax can be considered as covered taxes under Pillar Two Law.

4.10.6. Other Issues

- Impact on IFSC
- Transfer pricing Adjustments
- Implication on M&A activity
- Tax Exemption/Benefit regimes will have limited relevance

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- Impact on payments to associated enterprises (STTR Rule)
- Errors in CBCR/Financial Statements
- Impact on Qualified Refundable Tax Credits (QRTCs)
- Additional Compliance Burden (GIR + QDMTT)
- CBCR Safe Harbour have little to do with CBCR

4.11. Industries Most Affected in India

4.11.1. Information Technology (IT) & IT-Enabled Services (ITES):

Context: India's IT sector, including giants like TCS, Infosys, and Wipro, operates globally with subsidiaries in low-tax jurisdictions (e.g., Ireland or the UAE).

Impact:

Subsidiaries in low-tax jurisdictions may trigger a top-up tax under Pillar Two.

Tax optimization strategies such as using tax-efficient jurisdictions for IP holding or services may be curtailed.

Response: IT companies may need to restructure global operations to align with the 15% minimum tax.

4.11.2. Pharmaceuticals & Biotechnology:

Context: Major players like Sun Pharma, Dr. Reddy's, and Cipla have significant overseas operations and benefit from tax incentives for R&D in India and abroad.

Impact:

Indian subsidiaries in low-tax countries or those enjoying R&D tax credits may fall below the 15% ETR.

Tax holidays in Special Economic Zones (SEZs) could face challenges under the GloBE rules.

Response: Companies may need to re-evaluate the use of international R&D hubs or adopt Qualified Domestic Minimum Top-Up Taxes (QDMTT).

4.11.3. Manufacturing & Special Economic Zones (SEZs):

Context: India offers tax holidays and other incentives in SEZs to attract manufacturing investments under initiatives like Make in India.

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Impact:

Companies with ETRs below 15% due to tax holidays may face top-up tax obligations in their parent jurisdictions.

This could diminish the attractiveness of SEZs for global MNEs.

Response: India may consider redesigning SEZ incentives or implementing QDMTTs to capture potential top-up taxes locally.

4.11.4. Financial Services:

Context: Indian banks and financial institutions with global operations (e.g., State Bank of India, ICICI) might operate in jurisdictions with lower tax rates.

Impact:

Revenue earned in offshore financial centres (OFCs) could face scrutiny under the IIR or Undertaxed Payments Rule (UTPR).

Response: Financial institutions may need to enhance compliance mechanisms for reporting and tax alignment.

4.11.5. E-Commerce & Digital Economy:

Context: Companies like Flipkart (owned by Walmart) and Amazon India are part of global structures.

Impact:

E-commerce businesses operating through jurisdictions with lower ETRs will be impacted by the minimum tax requirement.

Response: Multinationals may shift structures to comply with India's tax rates and avoid additional tax liabilities.

4.12. Impact on Indian MNEs

India being a member of the Inclusive Framework, is expected to incorporate the GloBE Rules into its domestic law. In the interim budget, announced on 1st February 2024, there were no policy announcements on the implementation of the GloBE Rules in India. For appreciating the impact let us assume that the rules are introduced in 2026.

1. **Application of Pillar Two to Indian MNEs:** Since the GloBE Rules may have come into effect (say, from 1st February 2026) in other jurisdictions where Indian headquartered MNE groups have presence,

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such MNE groups will be required to comply with the GloBE Rules even if India has not implemented the rules for that period.

2. **Disclosure:** Indian MNE groups will have to provide for top-up tax in the books of account, if applicable, in their financial statements for the year ended 31st March 2026, if India introduces the law.

Benefit of tax incentives in India would be limited: In-scope MNE groups availing tax incentives such as IFSC unit will need to evaluate the overall tax impact in India, pursuant to the Pillar Two Globe Rules. However, a group having non IFSC presence along with a unit in IFSC, may be able to benefit from the jurisdictional blending at India level.

4.13. Conclusion

The Pillar Two framework presents both opportunities and challenges for developing countries. While it can help curb BEPS and stabilize tax revenues, it also risks undermining traditional tax incentives and FDI strategies. To maximize benefits, developing countries should focus on implementing a Qualified Domestic Minimum Tax (QDMTT), revising incentive structures, and enhancing administrative capacity. International cooperation and technical support will be crucial in ensuring that these nations can effectively navigate the new global tax landscape.

Pillar Two's Impact on Indian Industries: Context and Implications

The OECD's Pillar Two framework—introducing a Global Minimum Tax (GMT) of 15%—is set to impact Indian industries, especially multinational enterprises (MNEs) operating in or through India. While it targets large MNEs with consolidated revenues exceeding €750 million, its influence will ripple across key sectors due to India's tax policies, incentives, and global business integration.

Chapter 4

Permanent Establishment in Digital Economy

1: Introduction - The 'Scale Without Mass'¹ Conundrum

1.1. The Foundational Concept

For the better part of a century, the international tax order has been built upon a foundational bedrock: the concept of Permanent Establishment (PE). First articulated in rudimentary form by the League of Nations and later codified in Article 5 of the OECD and UN Model Tax Conventions, the PE concept serves as the primary "nexus" or threshold. It is the gold standard that a source country must establish to gain the right to tax the business profits of a non-resident enterprise.

This traditional PE concept is, at its core, a creature of a "brick-and-mortar" economy. Under Article 7 (Business Profits) of the model treaties, a country may only tax the profits of a foreign enterprise if that enterprise carries on its business through a PE situated therein. The definition of this PE, found in Article 5, is overwhelmingly physical. It rests on Four conceptual pillars:

¹This phrase was popularised by Erik Brynjolfsson and Others in "Scale without Mass: Business Process Replication and Industry Dynamics", <https://www.frbsf.org/wp-content/uploads/brynjolfsson.pdf> (accessed in December 2025).

However, OECD used this phrase in BRIEF ON THE TAX CHALLENGES ARISING FROM DIGITALISATION: INTERIM REPORT 2018; The most direct reference to this phrase is in paragraph 11 where the report says: "The Interim Report also identifies three characteristics that are frequently observed in certain highly digitalised business models: scale without mass, heavy reliance on intangible assets, and the role of data and user participation, including network effects."

In context of Permanent Establishment this phrase is used by Andrés Felipe Ramírez Ocampo in "Scale without Mass: Permanent Establishments in the Digital Economy". [OCAMPO, Andrés Felipe Ramírez. Scale without Mass: Permanent Establishments in the Digital Economy. Revista Direito Tributário Internacional Atual nº 5. ano 3. p. 13-23. São Paulo: IBDT, 1º semestre 2019]

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1. **Physicality:** There must be a "fixed place of business," such as a factory, an office, a branch, a mine, or a place of management.
2. **Business:** Business should be carried on from such fixed place.
3. **Permanence:** This presence cannot be merely fleeting; it must have a degree of temporal permanence.
4. **Disposal:** The enterprise must have the place "at its disposal," implying a degree of control or right of use.

Unless this physical threshold was met—or the enterprise had a dependent agent who is habitually concluding contracts or securing orders etc. on its behalf—the profits of the foreign enterprise were exclusively taxable in its country of residence. This framework, logical for the industrial age, was fundamentally inadequate for the digital revolution.²

1.2. The Digital Wrench

The proliferation of the digital economy has driven a wedge between the place of value creation and the location of physical presence. Modern multinational enterprises (MNEs) operating digitized business models—from e-commerce platforms and streaming services to Software-as-a-Service (SaaS), cloud computing, social media networks, and algorithm-based online advertising—can become deeply embedded in the economic life of a country without any physical presence or of the traditional markers of a PE.

These business models shatter the traditional framework:

- They generate substantial revenue from a jurisdiction by remotely engaging with a massive user base, collecting and monetizing their data, and delivering digital goods and services directly via the internet.
- Their most valuable assets are intangible: source code, proprietary algorithms, user data, and global brand recognition.
- Their physical infrastructure is often limited to servers, which may be located in low-tax jurisdictions and, crucially, are often owned and operated by third-party Internet Service Providers (ISPs), thereby failing the "disposal" test for a PE.

² It is interesting to note that the concept of PE has not been abandoned in digital economy. In fact, BEPS Action 7 and subsequent jurisprudence have significantly adapted, rather than replaced, the PE standard.

1.3. The Core Challenge: 'Scale Without Mass'

This phenomenon is aptly described as "**scale without mass**." A digital enterprise can achieve immense **scale** (in users, revenue, and market share) in a jurisdiction with almost zero physical **mass** (in assets, offices, or personnel).

This disconnect creates two profound challenges for the existing tax rules:

1. **Base Erosion:** It allows lack of effective taxation and profit shifting which may result in avoidance of taxation in the source country (due to no PE) and is often shifted from the residence country to a low-tax or no-tax jurisdiction.
2. **Competitive Imbalance:** It creates a profound distortion in the market. A domestic, "brick-and-mortar" business (like a local bookstore or media company) is fully subject to corporate tax, while its non-resident digital competitor (an e-commerce platform or streaming service) selling to the same customers may pay no income tax on its profits.

The central question for policymakers became: If the PE concept is the "what" and "where" of taxation, what happens when the "where" is everywhere and nowhere at once?

1.4. The Path Forward

The global response to this digital PE conundrum has been evolving rapidly from uncoordinated unilateral measures to a complex, consensus-driven global framework. This chapter traces this evolution with a specific focus on India's position. The international approach to nexus is now bifurcating into a "dual-track" system. For the world's largest MNEs, a new taxing right based on market sales (Pillar 1) will soon apply. However, for the vast majority of all other MNEs, the traditional PE concept is far from obsolete. On the contrary, it is being aggressively re-interpreted and re-armed by tax authorities as well as by judiciaries. As will be inferred, recent landmark rulings, particularly in India, are now finding nexus through principles of "pervasive control," signalling a significant, substance-based expansion of the PE concept.

2. The BEPS Project's Initial Response (Actions 1 & 7)

When the G20 leaders and the Organisation for Economic Co-operation and Development (OECD) launched the Base Erosion and Profit Shifting (BEPS) Project in 2013, they were responding to a global wave of public and political demand for an effective taxation system minimising shifting of profits by MNEs thereby eroding tax bases of countries. The "scale without mass" phenomenon, discussed in Part 1, had become a glaring symbol of a 1920s tax system failing in a 21st-century economy. At the heart of this systemic failure was the digital challenge.

It was no surprise, therefore, that the very first item on the 15-point BEPS Action Plan was **Action 1: Address the Tax Challenges of the Digital Economy**. This was, by far, the most ambitious and contentious part of the entire project. While other Actions aimed to patch leaks in the existing international tax framework (e.g., treaty abuse, transfer pricing, hybrid mismatches), Action 1 implicitly asked a fundamental question: Are the foundational concepts of nexus (Permanent Establishment) and profit allocation (the Arm's Length Principle) still fit for effective taxation?

Answering this question proved impossible in the initial 2013-2015 BEPS timeline. The 2015 Final Report on Action 1 did not deliver a new global standard. Instead, it delivered a brilliant diagnosis of the problem, a controversial conclusion that the digital economy could not be "ring-fenced," and a "menu of options" for countries to consider. This failure of consensus directly led to the rise of unilateral measures (like India's EL and SEP, discussed in subsequent part) and ultimately necessitated the creation of the new "Pillar 1" project.

However, the BEPS project attacked the PE problem on a second, more tactical front: **Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status**. If Action 1 was a strategic debate about *replacing* the PE concept, Action 7 was a tactical operation to *reinforce* it. It aimed to plug the most widely abused loopholes in the existing Article 5 definition that MNEs, particularly in the digital and services sectors, used to avoid a taxable presence.

This part will analyse these two parallels, and often contradictory, streams of work. It will first explore the diagnosis and deadlock of Action 1, and second,

detail the highly technical and legally impactful changes of Action 7, which, through the Multilateral Instrument (MLI), have now become part of treaty network in India.

2.1. BEPS Action 1: Diagnosis, Deadlock, and Divergence

The 2015 Final Report on Action 1, "Addressing the Tax Challenges of the Digital Economy," is one of the most significant documents in modern tax history, primarily for what it failed to do. It was tasked to solve the digital tax puzzle but concluded that no consensus on a solution was possible at that time.

2.1.1. The "Ring-Fencing" Conclusion

The report's most foundational (and controversial) conclusion was that it would be "difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes." The Task Force on the Digital Economy (TFDE) concluded that the digital economy was increasingly *becoming* the economy itself. E-commerce was simply the new form of commerce; cloud computing was the new form of IT infrastructure; digital advertising was the new form of advertising.

This conclusion, detailed in the **OECD (2015), *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report***, had significant impact: creating a special set of "digital tax" rules for only "digital companies" would be unworkable, inequitable, and would become obsolete as "traditional" businesses (like automotive or manufacturing) became fully digitized.

Instead, the report concluded that the BEPS challenges exacerbated by the digital economy should be tackled by the *other* BEPS Actions, particularly the new rules on Controlled Foreign Corporations (CFCs), transfer pricing (aligning profit with value creation), and, most notably, the anti-PE-avoidance rules in Action 7.

2.1.2. The Diagnosis: Key Features of the Digital Economy

While the report shied away from a unique solution, it provided a clear-eyed diagnosis of *why* the digital economy breaks the old rules. It identified several key features³:

³ *Action 1 - 2015 Final Report*, Chapter 5

1. **Mobility:** This was identified as the most central feature.
 - *Mobility of Intangibles:* MNEs can easily locate high-value intangibles (algorithms, source code, patents etc.) in low-tax jurisdictions, even if they were developed elsewhere and are exploited globally.
 - *Mobility of Users:* The user base is global and often provides value (data, content) from a jurisdiction where the MNE has no presence.
 - *Mobility of Business Functions:* Functions like data processing, server hosting, and customer support can be centralized in strategic locations, far from the markets they serve.
2. **Reliance on Data (Data and User Contribution):** The report highlighted the rise of business models that collect and monetize "big data" from users. This raised complex questions about value creation. Is a user browsing a "free" social media platform actually "working" for the platform by creating data? If so, how should that value be measured, and should it create a right to tax in the user's jurisdiction?⁴.
3. **Network Effects:** This describes business models (e.g., social media, marketplaces) where the value of the service increases with the number of users. A new user joining the platform creates a positive externality, making the platform more valuable for all other users. The report acknowledged this "user-created value" but struggled with how to tax it.
4. **Multi-sided Business Models:** This refers to platforms that serve two distinct sets of customers, often creating value by connecting them. The classic example is a search engine, which provides "free" services to users while selling high-value advertising space (targeted using the users' data) to businesses. This model allows an MNE to have a massive economic nexus with users in one country (e.g., India) while its only paying customers (advertisers) are billed from another (e.g., Ireland).

⁴ Action 1 - 2015 Final Report, Paras. 200-205

2.1.3. The Deadlock: A "Menu of Options"

Because the 100+ countries in the BEPS project could not agree on a single standard to address these challenges, the 2015 Final Report concluded by presenting three potential "options" that countries could consider introducing. This "menu" was a formal acknowledgment of the lack of consensus.⁵

- **Option 1: The Significant Economic Presence (SEP) Nexus:**

This was the most radical option, as it proposed a new nexus for income tax that was not dependent on physical presence. The report suggested that an SEP could be established if a non-resident enterprise had a "significant economic presence in another country on the basis of factors that have a material connection to that country."⁶

The proposed factors to determine this "material connection" included:

- A **revenue-based factor** (e.g., generating revenue above a certain threshold from transactions in that country).
- A **digital-based factor** (e.g., number of active users, data collected, volume of digital contracts).
- A combination of the two.

This proposal, while not adopted as a global standard, was seized upon by several countries, most notably India, which, as discussed in subsequent part of this chapter, introduced it into its domestic law.

- **Option 2: A Withholding Tax (WHT) on Digital Transactions:**

This option proposed a new, gross-basis final withholding tax on payments made by residents of a country to a non-resident for the supply of digital goods or services. The logic was that it would be relatively simple to administer (the payer would withhold) and would capture revenue that was otherwise escaping the tax net. However, the report also noted its significant downsides: it taxes gross revenue, not net profit; it could be a blunt instrument; and it could lead to tax cascading and disputes over characterization.⁷

⁵ Action 1 - 2015 Final Report, Chapter 9

⁶ Action 1 - 2015 Final Report, Para. 280

⁷ Action 1 - 2015 Final Report, Paras. 306-324

- **Option 3: The Equalisation Levy:**

This was, in many ways, the most disruptive option. The report proposed a new tax, levied on the gross consideration for certain digital services, which would be structured to exist outside the scope of income tax treaties. (Source: Action 1 - 2015 Final Report, Paras. 325-345).

By not being a "tax on income or profits" (as defined in Article 2 of most DTAAAs), it would not be constrained by the PE threshold in Article 5 or the business profits rules in Article 7. This was a direct, unilateral tool to "equalise" the tax burden between digital and non-digital businesses. Again, India was the first and most prominent country to adopt this option, introducing its Equalisation Levy in 2016.

2.1.4. The 2018 Interim Report and the Great Divergence

The 2015 report's failure to find a solution, and the subsequent "menu" of options, led to a wave of the very unilateralism the BEPS project was designed to prevent. Countries began implementing their own Digital Services Tax ('DSTs') and Equalisation Levies, leading to international trade tensions.

The OECD's **2018 Interim Report, *Tax Challenges Arising from Digitalisation***, documented the predictable chaos. This report is critical because it formally acknowledges the deep and fundamental disagreement between countries, which it grouped into three "diverging" camps:

1. **The "Fundamental Change" Camp (India, UK, France, etc.):** This group of countries (largely capital-importing, market jurisdictions) "take the view that the [scale without mass] issue... requires a solution that goes beyond the existing framework." They argued that user contributions and market data created value and that this value *must* be taxed in the market jurisdiction, even without a physical presence. This camp strongly supported a new nexus like the SEP.⁸
2. **The "Existing Framework is Sufficient" Camp (USA, etc.):** This group (largely capital-exporting, home to many digital MNEs) "are of the view that the existing rules, reinforced by the BEPS measures... are sufficient to address the tax challenges." They argued that the new

⁸ 2018 *Interim Report*, Chapter 1, Para. 1.18

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BEPS rules on transfer pricing (Actions 8-10) and PE avoidance (Action 7) should be given time to work, and that the "user contribution" concept was "not a useful or relevant concept for tax purposes."⁹

3. **The "Wait and See" Camp:** A third, smaller group of countries remained unconvinced by both arguments and preferred to wait and assess the impact of the BEPS measures.

This documented deadlock was the end of the line for Action 1. It proved that the digital nexus problem could not be solved within the existing BEPS framework. This failure was the direct catalyst for the OECD's new, more ambitious project: the "Two-Pillar Solution," with Pillar 1 (discussed in Part 6) being the direct successor to the failed Action 1.

2.2. BEPS Action 7: Fortifying the Traditional PE

While the high-level debate of Action 1 raged on, the technical experts on Action 7 were engaged in a different, more practical fight: "Preventing the Artificial Avoidance of Permanent Establishment Status."

This action was not about creating a new nexus; it was about stopping MNEs from *artificially* structuring their operations to *avoid* the existing one. The **OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report***, introduced three major changes to Article 5 of the OECD Model Tax Convention, all of which were aggressively adopted by India.

2.2.1. Change 1: Commissionaire Arrangements (Article 5(5) & 5(6))

This change targeted the most common structure used by MNEs (especially in tech and pharma) to sell into a market without a PE: the commissionaire or "dependent agent" arrangement.

- **The Old Problem:** The pre-BEPS Article 5(5) only created a Dependent Agent PE (DAPE) if a person in the source country "has, and habitually exercises... an authority to conclude contracts *in the name of* the enterprise."
- **The Abusive Structure:** MNEs exploited this *de jure* (i.e. form) legal test. A non-resident principal (e.g., "MNE Ireland") would set up a

⁹ 2018 *Interim Report*, Chapter 1, Para. 1.22

subsidiary in India ("IndiaCo"). IndiaCo would employ a full sales team that would find customers, market the product, and negotiate every material detail of the contract. However, at the final moment, the contract would be sent to Ireland for a "formal" signature or "rubber stamp."

- MNE Ireland would claim it had no PE, as IndiaCo never "concluded contracts in its name."
- IndiaCo would claim it was a separate legal entity, merely a "low-risk distributor" or "commission agent," and would pay tax in India only on its small, cost-plus service fee, while the high-value "risk-bearing" profit from the sale was booked in Ireland.
- **The BEPS Solution (New Article 5(5)):** Action 7 completely rewrote the rule, shifting it from a *de jure* (form) test to a *de facto* (substance) test. The new Article 5(5) states that a DAPE is created where a person..."...habitually concludes contracts, or **habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification** by the enterprise..."¹⁰

This new standard has drastically lowered the threshold. It no longer matters who *legally signs* the contract. It only matters who does the substantive work of "playing the principal role" (i.e., the sales negotiation) that *leads to* the contract's conclusion. This change was specifically designed to capture the modern sales force operating through a commissionaire or subsidiary models.

- **Tightening the "Independent Agent" Carve-Out (New Article 5(6)):**
 - **The Old Problem:** MNEs would argue their subsidiary (like IndiaCo) was an "agent of independent status" (under the old Art. 5(6)) and therefore exempt, even if it was a dependent agent.
 - **The BEPS Solution:** Action 7 added a "closely related enterprises" test. The new Article 5(6) states that an agent is *not* independent if it "acts exclusively or almost exclusively on

¹⁰ Action 7 - 2015 Final Report, Para. 12; OECD Model Tax Convention (2017), Art. 5(5)

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behalf of one or more enterprises to which it is closely related."¹¹

- This means an Indian subsidiary that *only* works for its foreign parent can no longer claim to be an "independent agent" and will be tested under the new, easier-to-meet DAPE rule in Article 5(5).

2.2.2. Change 2: The "Preparatory or Auxiliary" Exceptions (Article 5(4))

This change targeted the artificial use of a list of "exempt" activities in Article 5(4).

- **The Old Problem:** Article 5(4) provided that certain activities were *deemed* not to be a PE, even if conducted from a fixed place, because they were "preparatory or auxiliary" (P&A). The list included:
 - using facilities *solely* for storage, display, or delivery of goods;
 - maintaining a stock of goods *solely* for storage, display, or delivery;
 - maintaining a fixed place *solely* for purchasing goods or collecting information.
- **The Abusive Structure:** MNEs, particularly in e-commerce, exploited this. An e-commerce giant could lease a massive, 1-million-square-foot "fulfilment centre" in India, employ thousands of staff, and run its entire in-country logistics from that site. It would then claim this was merely a "warehouse" for "storage, display, or delivery" under Article 5(4)(a) and (b) and was therefore exempt from being a PE.¹²

The problem was that what is "auxiliary" for a 1950s manufacturer (a small shed to store spare parts) is a core and essential business function for a 2020s e-commerce company.
- **The BEPS Solution (New Article 5(4)):** Action 7 attacked this by adding a new "gatekeeper" condition. The new rule states that the exemptions in Article 5(4) (a) to (d) *only apply if* the overall activity of the fixed place of business..."...is of a **preparatory or auxiliary**

¹¹ Action 7 - 2015 Final Report, Para. 16

¹² Action 7 - 2015 Final Report, Para. 26, citing this exact example

character."¹³

This seemingly small change is revolutionary. It moves the test from a simple "list-checking" exercise to a substantive "core function" analysis. Now, an e-commerce company cannot simply claim the "warehouse" exception. It must first prove that its warehouse operation is *actually* "preparatory or auxiliary" to its *entire* business. For a business whose entire value proposition is logistics and rapid delivery, this test is impossible to meet. This change effectively makes large, core-function fulfilment centres taxable as PEs.

2.2.3. Change 3: The Anti-Fragmentation Rule (New Article 5(4.1))

This final change was designed to stop MNEs from "salami-slicing"¹⁴ their operations to avoid the P&A test.

- **The Old Problem:** An MNE could "fragment" a cohesive business operation into multiple, small, legal entities or offices.
 - *Example:* An MNE sets up two offices in India. Office A *only* does purchasing (exempt under old 5(4)(d)). Office B *only* does storage (exempt under old 5(4)(a)). Together, they form a cohesive supply-chain operation, but because they are separate "fixed places" (or even separate companies), they each claim preparatory or auxiliary exemption.
- **The BEPS Solution (New Article 5(4.1))¹⁵:** The new "anti-fragmentation" rule prevents this. It states that the P&A exceptions in Article 5(4) will *not* apply to a fixed place if the MNE (or a closely related enterprise) carries on activities at *another* place in the same country, and...
 1. That other place *constitutes a PE*; OR

¹³ Action 7 - 2015 Final Report, Para. 28; OECD Model Tax Convention (2017), Art. 5(4)

¹⁴ The process of gradually reducing the size of something by a series of small incremental steps.

¹⁵ Action 7 - 2015 Final Report, Paras. 37-39; OECD Model Tax Convention (2017), Art. 5(4.1)

2. The **overall activity resulting from the combination** of functions at the two places is *not* of a preparatory or auxiliary character.

This rule forces tax authorities to look at the *combined, holistic* business functions of the MNE and its related parties within a country, not just the isolated activities of a single office.

2.3. The Multilateral Instrument (MLI): The Delivery Mechanism

These powerful new rules in Action 7 were just recommendations. They would have no legal effect until they were written into the 3,000+ bilateral tax treaties in existence—a process that would take decades.

To solve this, the BEPS project delivered its most innovative creation: **Action 15, the Multilateral Convention to Implement Tax Treaty Related Measures (the "MLI")**.

The MLI is a "super-treaty with feet in existing treaty." It allows countries to sign one document and, in that document, declare which of their existing tax treaties (called "Covered Tax Agreements" or CTAs) they wish to modify, and which BEPS provisions they wish to adopt. When two countries (e.g., India and France) both sign the MLI, list each other's treaty as a CTA, and "opt-in" for the same BEPS provision (e.g., the new DAPE rule), the MLI *automatically and simultaneously* modifies their bilateral treaty.

India's Aggressive Adoption:

India has been a strong proponent of the MLI and took has taken a very aggressive stance, opting in to almost all the key anti-abuse provisions. (Source: Press Information Bureau, Govt. of India, 02 July 2019). Specifically, India adopted:

- **Article 12 (DAPE) of MLI:** The new "principal role" test for commissionaire arrangements.
- **Article 13 (P&A) of MLI:** Both the new "core function" test (Art. 13(2)) and the anti-fragmentation rule (Art. 13(4)).

The MLI entered into force for India on October 1, 2019, and its provisions began to legally modify India's tax treaties from F.Y. 2020-21 onwards. This means that, for dozens of India's key treaty partners (like France, Japan, the

UK, Singapore, Netherlands etc.), the *legal definition of PE is now the new, stronger BEPS Action 7 definition*.

This has, in turn, created a new generation of litigation. As seen in recent 2025 tribunal rulings like ***Kosi Aviation Leasing Ltd. v. ACIT (ITAT Delhi)***¹⁶ and ***Sky High Appeal XLIII Leasing Company Ltd. v. ACIT (ITAT Mumbai)***¹⁷, taxpayers are now challenging the *technical enforceability* of the MLI based on Supreme Court decision in MFN decision in the case of *Assessing Officer (International Taxation) v. Nestle SA*¹⁸. They argue that the MLI's provisions (in that case, the Principal Purpose Test or "PPT") cannot be applied without a specific, separate notification under Section 90(1) of the Income-tax Act to amend each DTAA.¹⁹ While the tribunals have (as of late 2025) sided with the taxpayer on this technical ground holding that MLI cannot apply without separate notification, the matter is far from settled and is indicative of the new, complex legal battles created by the MLI's implementation.

2.4. Conclusion: A Fractured Legacy

The initial BEPS project's response to the digital PE challenge lacked cohesive approach.

On one hand, **Action 1's mandate was diagnostic and consensus-building, in which it failed to achieve agreed approach**. The 2015 Final Report and 2018 Interim Report stand as testaments to a global conflict between market countries (like India) demanding a new, economic nexus and capital-exporting countries (like the US) defending the existing framework. This deadlock achieved nothing but the formalization of "diverging views" and, in doing so, provided the very justification for the unilateralism (the EL and SEP) that it was meant to prevent. The failure of Action 1 is the direct "parent" of the Pillar 1 project.

¹⁶ ITA 994/DEL/2025, dated 30-9-2025

¹⁷ [2025] 177 taxmann.com 579 (Mumbai - Trib.) [13-08-2025]/ IT Appeal Nos. 1122, 1106, 1198, 1157, 1108, 1156 and 1155 (Mum) of 2025

¹⁸ [2023] 155 taxmann.com 384/[2024] 296 Taxman 580/[2023] 458 ITR 756 (SC)

¹⁹ It may be clarified that issues in litigation has been on requirement of notification for MFN clause and not on the articles 12/13 per se.

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On the other hand, **Action 7** was a quiet, tactical success. It methodically dismantled the most common legal structures used to *artificially* avoid the physical PE. Through the MLI, these new, tougher rules are now the law.

This dual legacy set the stage for the chaotic and complex landscape we see today. It created a two-front war for tax authorities in India:

1. **The Legislative/Political Front (Post-Action 1):** Armed with the "options" from Action 1, India's legislature created its own unilateral weapons (EL and SEP), as discussed in the next Part.
2. **The Judicial/Legal Front (Post-Action 7):** Armed with the new MLI-strengthened Article 5, India's tax authorities began launching a new wave of PE assessments, forcing the judiciary to test the boundaries of these new rules, as well as the fundamental "substance" of the PE concept itself, as will be seen in Part 4.

3. India's Unilateral Path – The EL & SEP Era

The failure of the BEPS project to deliver a consensus on a new taxable nexus (as detailed in Part 2) was a significant turning point. For major market jurisdictions like India, which saw a rapidly growing digital user base generating immense value for foreign MNEs, the "wait and see" approach was not a viable option. Armed with the "menu of options" presented in the 2015 Action 1 Final Report, India's legislature did not hesitate. It launched a bold, two-pronged unilateral strategy to tax the digital economy, running in parallel with its efforts to strengthen the traditional PE definition via the MLI.

This strategy involved two distinct and structurally different measures:

1. **The Equalisation Levy (EL):** A new, conceptually an indirect tax designed to *bypass* the PE threshold in tax treaties.
2. **The Significant Economic Presence (SEP):** A new, direct tax nexus designed to *expand* the domestic law definition of "business connection," with the long-term goal of integrating it into tax treaties.

3.1. The Equalisation Levy (EL) 2016 & 2020

The Equalisation Levy was India's first and most direct response. It was a clear adoption of "Option 3" from the Action 1 report. The legislative brilliance of the EL lay in its structure: it was introduced by the **Finance Act, 2016**, not

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as an amendment to the Income-tax Act, 1961, but as a separate, standalone tax in Chapter VIII of the Act.

This design was a deliberate and strategic manoeuvre to avoid India's DTAA obligations. The levy is on gross consideration, not on net income. By not being a "tax on income" (as covered by Article 2 of most treaties), India's position was that the levy was not a "covered tax." Therefore, the PE threshold in Article 5 and the profit allocation rules in Article 7 of the treaties simply did not apply.

3.1.1. The 2016 Levy (EL 1.0)

The initial 2016 levy (Section 165, Finance Act, 2016) was narrowly focused.

- **Rate:** 6% on the gross consideration.
- **Scope:** Applied only to payments received by a non-resident (without a PE in India) from an Indian resident (or a non-resident's PE in India) for specified services, primarily **online advertising and related services**.
- **Collection:** It was a withholding tax, with the liability to deduct and remit the tax placed on the Indian payer.

This was immediately dubbed the "Google Tax," as its primary targets were the revenues of foreign digital advertising giants.

3.1.2. The 2020 Expansion (EL 2.0)

The **Finance Act, 2020**, dramatically and suddenly expanded the EL's scope (by introducing Section 165A), transforming it from a niche levy into a sweeping Digital Services Tax (DST).

- **Rate:** 2% on the gross consideration.
- **Scope:** This new levy applied to a non-resident "e-commerce operator" for "e-commerce supply or services" made, provided, or facilitated to the Indian market.
- **Payer:** Unlike EL 1.0, the liability to pay this tax was placed directly on the non-resident e-commerce operator.

The scope of "e-commerce operator" and "e-commerce supply or services" was made exceptionally broad. The levy is triggered if the non-resident operator makes sales to:

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1. A person resident in India;
2. A person who buys such goods or services using an Indian IP address;
3. A non-resident, in specified circumstances (such as the sale of data collected from Indian users or the sale of ads targeting Indian users).

This expansion, enacted with retrospective effect from April 1, 2020, brought virtually every major foreign B2C and B2B digital platform—marketplaces, SaaS providers, streaming services, data processors—into the Indian tax net, provided their annual revenue from India exceeded the threshold of INR 20 million(i.e. Rs 2 Crores).

3.1.3. International Fallout and the "Grand Bargain"

The 2020 expansion triggered immediate international condemnation, particularly from the United States. In January 2021, the **United States Trade Representative (USTR)** concluded its Section 301 investigation, finding India's EL (along with other similar DSTs) to be "discriminatory" against U.S. companies and "inconsistent with prevailing principles of international taxation."²⁰ The USTR threatened retaliatory tariffs, leading to a protracted political standoff.

This standoff made the EL a powerful bargaining chip for India in the renewed multilateral negotiations on the "Two-Pillar Solution." The EL's existence was a clear and present "stick" that incentivized the global community to agree on a multilateral "carrot."

The "grand bargain" was finally struck as part of the Pillar 1 agreement, which requires all signatory countries to withdraw their unilateral DSTs. In the **Finance (No. 2) Act, 2024**, India introduced a sunset clause for the 2% EL (Section 165A), stating it shall not apply to consideration received on or after August 1, 2024. The subsequent **Finance Act, 2025**, has introduced a similar sunset for the 6% EL (Section 165), to be effective from April 1, 2025.

These amendments signal India's commitment to the global Pillar 1 framework. However, the withdrawal is implicitly and practically contingent on the successful implementation of the Pillar 1. Should the Pillar 1 process fail to be implemented globally, it is almost certain that these sunset clauses would be revisited.

²⁰ <https://ustr.gov/sites/default/files/enforcement/301Investigations/Report%20on%20India%E2%80%99s%20Digital%20Services%20Tax.pdf>

3.2. Significant Economic Presence (SEP)

India's second unilateral measure, the Significant Economic Presence (SEP), was a fundamentally different strategic tool. It was not a treaty bypass; it was a direct challenge to the traditional PE concept itself.

First introduced by the **Finance Act, 2018**, the SEP concept was a direct legislative adoption of "Option 1" (the new nexus) from the 2015 BEPS Action 1 report. This provision amended the **Income-tax Act, 1961**, expanding the definition of "business connection" in Section 9(1)(i) to include an SEP.

This topic is discussed in great detail in a separate Chapter of this book. Please refer the same. However, the same is briefly discussed hereunder.

The amendment states that a non-resident will be deemed to have a "business connection" in India, *irrespective of whether it has a physical presence in India*, if it meets certain thresholds. After a delay (to await global consensus), the CBDT finally notified these thresholds, making the provision effective from A.Y. 2022-23.

As per **CBDT Notification No. 41 of 2021 (dated May 3, 2021)**, an SEP is triggered if the non-resident, in a previous year, meets *either* of the following conditions:

1. **Revenue Threshold:** The aggregate of payments arising from transactions in respect of goods, services, or property with any person in India exceeds **INR 20 million** (approx. USD 240,000).
2. **User Threshold:** The non-resident "systematically and continuously solicits" its business or "engages in interaction" with **300,000 users** in India.

The SEP provision is remarkably broad, with a low revenue threshold that could capture even small to medium-sized non-resident enterprises, including non-digital ones.

3.2.1. The Treaty Override: SEP's "Fatal Flaw"

Despite its broad domestic scope, the SEP concept has had a very limited practical impact. This is due to the foundational principle of tax treaty supremacy, codified in **Section 90(2) of the Income-tax Act, 1961**.

Section 90(2) allows an assessee to apply the provisions of a Double Taxation Avoidance Agreement (DTAA) if they are more beneficial than the

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provisions of the domestic Act. This principle has been repeatedly upheld by the Supreme Court, most notably in ***Union of India v. Azadi Bachao Andolan*** (2003)²¹.

The conflict is clear:

- India's domestic law (Section 9) now says a non-resident can have a taxable "business connection" (an SEP) without a physical presence.
- However, India's DTAA's (e.g., with the USA, UK, Singapore, Netherlands, etc.) still define a PE based on the traditional physical presence criteria in Article 5. Article 7 (Business Profits) of these treaties states that India can only tax the business profits of a non-resident if they are attributable to a PE *as defined in that treaty*.
- Since the DTAA's physical PE definition is more beneficial to the taxpayer than the domestic law's economic SEP definition, the treaty provisions override.

Therefore, any non-resident eligible to claim benefits under a DTAA (which is the vast majority of foreign MNEs) is currently shielded from the SEP provisions.

3.2.2. The Strategic Purpose of SEP

Given its ineffectiveness against treaty-resident MNEs, the SEP's purpose was never primarily about immediate tax collection. Instead, it served two key strategic goals:

1. **Taxing Non-Treaty Jurisdictions:** SEP is fully effective for non-residents based in jurisdictions with which India does not have a DTAA (e.g., many "tax havens").
2. **A Powerful Negotiating Tool:** Its primary function was to be a clear and public statement of India's legislative policy. It signalled to the world, and to all of India's treaty partners, that India would no longer accept the physical presence-based PE standard. This provision was designed to be the "ask" in all future bilateral treaty negotiations and, more importantly, to demonstrate India's non-negotiable demand for a market-based taxing right in the multilateral Pillar 1 negotiations.

²¹ Union of India v. Azadi Bachao Andolan [2003] 132 Taxman 373/263 ITR 706 (SC)

In summary, the EL was the short-term, pragmatic "tax-grabber" designed to bypass treaties. The SEP was the long-term, "policy-setter" designed to challenge and, eventually, change those same treaties. Both measures, while viewed as aggressive and unilateral, were instrumental in forcing the global consensus that the traditional PE concept was no longer sufficient for the digital age.

4. The New PE Battleground – Indian Judicial Developments

While India's legislature was creating new unilateral weapons in the form of the Equalisation Levy and Significant Economic Presence (as detailed in Part 3), a parallel and equally consequential battle was being waged by the Revenue in judicial forums. This battle was not about creating new laws but about aggressively re-interpreting the *existing* PE definition in India's tax treaties, long before the MLI (discussed in earlier part of this chapter) took full effect.

This judicial front has become the most critical arena for defining the future of PE in India. The period from 2017 to 2025 has been marked by a clear judicial trend: a deliberate shift away from a formalistic, legal-text-based interpretation of PE towards a "substance-over-form" doctrine. This evolution culminated in two landmark Supreme Court decisions that have fundamentally reshaped the PE landscape.

This Part will trace this judicial evolution, from the foundational "disposal test" laid down in the *Formula One* case to the 2025 "pervasive control" doctrine established in the *Hyatt International* ruling. It will then analyze the profound impact of this new, substance-based jurisprudence on digital and digitized business models, examining the new risks and the remaining judicial safe harbours.

4.1. The Landmark Precedent: Formula One World Championship

The first major tremor that signalled this judicial shift was the Supreme Court's 2017 landmark ruling in ***Formula One World Championship Ltd. v. Commissioner of Income Tax***²². This case, while concerning a physical

²² (2017) 394 ITR 80 (SC)

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sporting event, established the foundational principles that would later be applied to less tangible business models.

4.1.1. Facts of the Case

The case involved Formula One World Championship (FOWC), a UK-based company, which held the commercial rights for the F1 Grand Prix. FOWC entered into a Race Promotion Contract (RPC) with Jaypee Sports International Ltd. (Jaypee), an Indian company, which gave Jaypee the right to host, stage, and promote the F1 race at the Buddh International Circuit in Noida. FOWC received substantial consideration from Jaypee for these rights. The core question was whether FOWC had a fixed place PE in India (i.e., the circuit) under Article 5 of the India-UK DTAA.

4.1.2. The Dispute: Presence vs. Possession

FOWC argued it had no fixed place PE. Its contentions were primarily:

1. **No Fixed Place:** The circuit was owned, developed, and controlled by Jaypee, not FOWC.
2. **No Disposal:** FOWC had no legal ownership, lease, or right of possession over the circuit. It merely had access to the circuit, as granted by Jaypee, to conduct the race.
3. **No Permanence:** FOWC's presence in India was extremely limited, lasting only for the duration of the event (a few weeks, including setup) and the race itself (a few days). This, it argued, was "temporary" and "fleeting," failing the permanence test.

The Revenue countered that FOWC's business was the event, and it exercised complete and unfettered functional control over the circuit during that period, making it a fixed place of business.

4.1.3. The Supreme Court's Ruling:

The Supreme Court, in a seminal judgment, ruled in favour of the Revenue, holding that FOWC did have a fixed place PE in India. The Court's reasoning established critical principles:

1. **The "Disposal" Test Redefined:** The Court, relying heavily on the OECD Commentary and the commentaries of Klaus Vogel, definitively held that "disposal" does not require legal ownership or a formal lease. The test is whether the enterprise has the premises "at its disposal" in

a functional sense—that is, a *right of use* and *control* over the premises to conduct its core business. The Court found that during the event, FOWC and its affiliates (like Formula One Management, or FOM) had complete control over the circuit. They exercised dominion over the track, the pits, the paddock, the media centre, and team areas, excluding even Jaypee's personnel from certain areas. This functional control, not legal title, satisfied the "disposal" test.

2. **The "Permanence" Test Re-contextualized:** The Court rejected the argument that "temporary" presence negates a PE. It held that permanence must be viewed in the context of the specific business. For a business that is inherently moving from place to place, like a racing circuit or a concert tour, the business *is* the event. The Court held that the presence of FOWC at the circuit was not "fleeting" or "accidental"; it was a planned, recurring event at a fixed geographical location. The "permanence" test was met because the circuit was at FOWC's disposal for the *entire duration required* to conduct its business in India.
3. **Stability, Productivity, and Dependence:** The Court emphasized that the PE must exhibit three characteristics: stability (a distinct place, not temporary in the context of the business), productivity (the place through which the core business is carried on), and dependence (the enterprise is dependent on that place for its revenue-generating activity). FOWC's core business of conducting the race was wholly dependent on and productive through the Buddh Circuit, which was at its disposal for a stable period.

4.1.4. Implication of Formula One

The Formula One ruling was the first major judicial statement in India that "substance over form" would be the governing principle in PE disputes. It established that functional control could trump legal form (like lease deeds or ownership titles) in determining the existence of a fixed place PE. This ruling opened the door for the Revenue to look through complex contractual arrangements and assess the economic reality of control—a principle that would be taken to its logical conclusion eight years later in the Hyatt case.

4.2. The 2025 Watershed: Supreme Court in *Hyatt International*

If *Formula One* opened the door, the Supreme Court's judgment in *Hyatt International Southwest Asia Ltd. v. ADIT*²³, blew the door off its hinges. This ruling dramatically expanded the "substance-over-form" principle by establishing the "**pervasive control**" doctrine—a test with profound and immediate implications for digitized business models, service MNEs, and any company operating in India through a complex web of agreements.

4.2.1. Relevant Facts

The case involved Hyatt International Southwest Asia Ltd. ("Hyatt"), an entity tax resident in the UAE. Hyatt had entered into a "Strategic Oversight Services Agreement" (SOSA) with Asian Hotels Ltd. (AHL), the Indian owner of the Hyatt Regency hotels in Delhi and Mumbai. A separate entity, Hyatt India Pvt. Ltd., had a separate "Hotel Operating Services Agreement" (HOSA) for day-to-day management.

Hyatt (UAE) filed nil tax returns, claiming it had no PE in India under Article 5 of the India-UAE DTAA. Its contentions were:

1. **No Fixed Place:** It had no office, branch, or property in India.
2. **No Disposal:** The hotels were owned by AHL, not Hyatt (UAE). It had no exclusive possession or designated space.
3. **No Business in India:** Its role was purely "advisory" and "consultancy," rendered from Dubai. Day-to-day operations were by Hyatt India.
4. **No Service PE:** Any employee visits were intermittent and did not meet the 9-month threshold for a Service PE under the treaty's specific clause (Art. 5(2)(i)).

4.2.3 Pervasive Control Doctrine

The Supreme Court, upholding the Delhi High Court's findings, rejected every one of these arguments. It "looked through" the formal bifurcation of the SOSA and HOSA, finding that in substance, Hyatt (UAE) exercised

²³(Civil Appeal Nos. 9766-9773 of 2025)/[2025] 176 taxmann.com 783 (SC)/[2025] 306 Taxman 241 (SC)/ [2025] 478 ITR 238 (SC)[24-07-2025]

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"pervasive and enforceable control" over the entire hotel operation, effectively making the hotel premises its own fixed place of business.

The Court found this "pervasive control" manifested in several ways:

- **Operational Control:** The SOSA granted Hyatt (UAE) rights that went far beyond mere "advice." It had the authority to:
 - Appoint and supervise key personnel, including the General Manager.
 - Govern human resource policies, procurement policies, and operational protocols.
 - Manage and control the hotel's operational bank accounts.
 - Station its own employees or affiliates' employees at the hotel *without* the owner's approval.
- **Strategic Control:** Hyatt (UAE) was not just a consultant; it was an "active, ongoing participant" in the core business. It held ultimate authority over branding, marketing, service standards, and quality assurance. The Court found Hyatt India was, in effect, acting as an instrument to execute the policies and standards dictated by Hyatt (UAE).
- **Financial Integration:** Hyatt (UAE)'s remuneration was not a fixed advisory fee. It was calculated as a percentage of room revenue and, crucially, a percentage of the "cumulative gross operating profit" (GOP). This, the Court held, linked Hyatt (UAE)'s income directly to the hotel's performance and demonstrated its role as an active commercial participant, not a passive advisor. [5]
- **The *Formula One* Principle Applied:** Building directly on its *Formula One* precedent, the Supreme Court held that the test is not whether a formal right of use of premises is granted, but whether, in substance, the premises were 'at the disposal' of the enterprise and were used for conducting the core business functions of such enterprise. Exclusive possession is not essential; temporary or shared use of space is sufficient, provided, business is carried on through that space.

The 20-year term of the SOSA easily satisfied the "stability" and "permanence" tests. The Court concluded that Hyatt (UAE) was carrying on *its own business* (of brand and hotel management) *through*

a fixed place (the hotel premises) that was at its functional disposal via "pervasive control."

4.2.4. Applying *Hyatt* to Digital and Digitized Models: The Core Argument

The *Hyatt* ruling is a watershed because its "pervasive control" doctrine provides the Revenue with a powerful new tool to attack the "scale without mass" problem *without* relying on the (treaty-blocked) SEP provisions. The doctrine shifts the PE focus from *physical possession* (which digital companies lack) to *functional control* (which they possess in abundance).²⁴

This new doctrine creates significant, direct PE exposure for a wide range of modern business models:

A. Contract R&D and ITES/BPO Arrangements

- **The Risk (Post-*Hyatt*):** The *Hyatt* doctrine poses a direct threat to the common "captive" BPO/R&D/ITES model. A non-resident parent (e.g., in the USA) that sets up an Indian subsidiary to perform services (like software development or back-office support) can no longer rely on the separate legal entity status as a complete shield. If the parent exercises "pervasive control" over the Indian subsidiary's operations—dictating projects, controlling budgets, appointing key managers, integrating IT systems, and making key operational decisions—the Revenue can now argue that the Indian subsidiary's office is, in substance, "at the disposal" of the US parent, making it a fixed place PE of the parent. This decision may give rise to litigation in respect of other features of digital economy, such as server infrastructure.
- **The Shield (Judicial Limitations):** This risk is, however, heavily mitigated by a strong line of taxpayer-friendly rulings from the Supreme Court itself, which *Hyatt* did not overrule.
 - ***DIT v. E-Funds IT Solutions Inc.***²⁵: The Supreme Court held that an Indian subsidiary providing back-office support services *only* to its US parent (which in turn served US clients) did not

²⁴ However, it is clarified that courts in India, conceptually, still presupposes a fixed place of business in India and expands the "at the disposal" test; it does not eliminate Article 5(1)'s fixed-place requirement or create a pure "virtual" PE doctrine.

²⁵ (2017) 399 ITR 34 (SC)

create a fixed place PE. The parent had no right of use or control over the Indian premises. The Court explicitly stated that "outsourcing" work to a subsidiary does not, by itself, create a PE.

- ***ADIT v. Morgan Stanley & Co. Inc.***²⁶: The SC held that while "stewardship" activities (monitoring the investment) by the parent do not create a PE, employees of the parent who are "deputed" to the Indian subsidiary and perform services for the parent *can* create a Service PE.
- ***Concentrix CVG Customer Management Group Inc. v. ACIT***²⁷: In a recent application of these principles, the ITAT held that a captive BPO unit in India was *not* a PE. The key factors were: (1) The Indian subsidiary operated independently and bore its own entrepreneurial risk; (2) The parent's employees only performed "stewardship" functions, not core business; and (3) The subsidiary was remunerated at arm's length.

The line between *Hyatt's* "pervasive operational control" (which creates a PE) and *Morgan Stanley's* "stewardship" (which does not) is now the central battleground for captive service centres.

B. Digital Platforms (Servers & Infrastructure Control)

- The Risk (Post-Hyatt): This is where the Hyatt doctrine has its most direct digital application. Consider a foreign social media or e-commerce MNE that has an Indian subsidiary. The subsidiary may legally lease data centre space or servers in India. However, the foreign parent, from abroad, exercises 100% functional control over this infrastructure. The parent's algorithms run on these servers, its code dictates their operation, and its remote technical staff control them.

Post-Hyatt, the Revenue can argue that "pervasive control" over this digital infrastructure (servers, data centres) makes those physical assets a fixed place PE of the foreign parent, as they are, in substance, "at its disposal" for conducting its core business.

²⁶ (2007) 292 ITR 416 (SC)

²⁷ [2025] 179 taxmann.com 38 (Delhi - Trib.)([30-09-2025])

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- The "Virtual PE" Fallacy: It is critical to distinguish the Hyatt PE from the "virtual PE" concept. In *Clifford Chance Pte Ltd. v. ACIT*²⁸, the Revenue argued for a "virtual service PE" under the India-Singapore DTAA, claiming services rendered remotely into India should create a PE. The ITAT emphatically rejected this, holding that a Service PE (under that treaty) requires the physical presence of employees in India for a stipulated duration.

However, this ruling does not protect digital businesses from the Hyatt doctrine. Clifford Chance rejected a Service PE (Art. 5(6)) based on no physical presence. Hyatt confirms a Fixed Place PE (Art. 5(1)) based on control over physical assets (like servers or premises), even without legal possession.

C. Cloud Computing and SaaS Models

- The Risk (Post-Hyatt): The Hyatt ruling reframes the entire cloud computing debate. The old debate was about characterization: are payments for cloud services "royalties" for the "use of equipment"?

Multiple rulings²⁹ have held that payments for cloud or data centre services are not royalty, as the customer has no "control, possession, or dominion" over the underlying equipment; they are merely receiving a service.

However, Hyatt shifts the question. The question is no longer whether the customer has a PE, but whether the cloud provider's foreign parent has a PE by exercising "pervasive control" over the local data centre infrastructure (whether owned by a subsidiary or a third party) to deliver its core business.

D. Franchise and Management Agreements

- **The Risk (Post-Hyatt):** The *Hyatt* case was, at its heart, a hotel management/franchise dispute. The ruling applies directly to any franchise model where the foreign franchisor's rights exceed mere

²⁸ *Clifford Chance PTE Ltd. vs. ACIT* [2024] 160 *taxmann.com* 424 (Delhi - Trib.) [14-03-2024]

²⁹ *Commissioner of Income-tax, International Taxation -1 vs. Amazon Web Services, Inc* - [2025] 174 *taxmann.com* 1188 (Delhi), *Rackspace, US Inc vs. Deputy Commissioner of Income-tax (International Taxation), Mumbai* [2020] 113 *taxmann.com* 382 (Mumbai) [28-11-2019], *Rackspace, US Inc. vs. Deputy Commissioner of Income Tax, International Taxation 4(1)(1), Mumbai* [2021] 124 *taxmann.com* 92 (Mumbai - Trib.) [29-01-2021]

brand protection. If the franchisor dictates operational procedures, controls procurement, manages finances, or otherwise exercises "pervasive control" over the Indian franchisee's business, the Revenue can argue that the franchisee's premises are a fixed place PE of the franchisor.

- **The Shield (Judicial Limits):** In an 2018 ITAT ruling³⁰, a franchisee was held *not* to create a DAPE because it acted in its own name, profits belonged to it, and it lacked contracting authority. However, *Hyatt* was a *fixed place* PE case, not a DAPE case. The "pervasive control" test for a fixed place PE is a new and more potent threat to these models than the DAPE rules.

4.3. Other Key ITAT and High Court Rulings (2018-2025)

The *Hyatt* and *Formula One* rulings do not exist in a vacuum. The lower courts have been simultaneously shaping the PE landscape, creating a complex mosaic of rulings.

4.3.1. The Characterization Battle: Royalty vs. Business Income

This battle is central, as it determines whether income can be taxed (as royalty/FTS) regardless of a PE, or only if a PE exists (as business profits).

- Google India: The AdWords Saga

The taxation of online advertising revenue has been highly contentious. In *Google Ireland Ltd. v. DCIT* (Bangalore ITAT, 2018)³¹, the ITAT initially held that payments from Google India to Google Ireland for AdWords program distribution rights were royalties. The Tribunal held Google India was not a simple reseller but a licensee of Google Ireland's IP, and the payments involved the "use of" patented technology and confidential data.

This decision caused an uproar. However, after the Karnataka High Court³² set it aside, the ITAT reversed its position in 2022³³. In the new ruling, the

³⁰ *Deputy Commissioner of Income-tax, (IT)-2(1)(2), Mumbai vs. Dominos Pizza International Franchising Inc.* [2018] 94 taxmann.com 296 (Mumbai)/[2018] 171 ITD 321 (Mumbai)/[2018] 193 TTJ 963 (Mumbai)[18-05-2018]

³¹ [2017] 86 taxmann.com 237 (Bengaluru – Trib.)/[2017] 190 TTJ 409 (Bengaluru – Trib.)/[23-10-2017]

³² [2021] 127 taxmann.com 36/435 ITR 284 (Kar.)

³³ [2022] 143 taxmann.com 302/197 ITD 604 (Bangalore - Trib.)

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ITAT held that the payments were business profits, not royalty, and thus not taxable in India in the absence of a PE. This aligns with the long-standing view in cases like Yahoo India and Set Satellite. The introduction of the Equalisation Levy (as discussed in earlier part of this chapter) was a direct legislative response to tax this very income stream, assuming it was business income without a PE.

- CPPGROUP Services Ltd. v. DCIT (Delhi ITAT, 2025)³⁴

In a very recent and significant ruling, the ITAT addressed the "make available" test for Fees for Technical Services (FTS) under the India-UK DTAA. It held that IT development and non-IT support services provided by a UK entity to its Indian group company were not FTS because they did not "make available" any technical knowledge, skill, or process to the Indian entity, which could not apply the technology independently. This ruling is a crucial shield for MNEs, as it confirms that most digital services (SaaS, cloud, IT support) do not meet the restrictive "make available" test present in many of India's treaties.

4.3.2. The Subsidiary PE Shield: *Morgan Stanley* and its Progeny

The *Hyatt* doctrine's threat to captive subsidiaries is held in check by a powerful line of cases that form the "ALP safe harbour."

- ADIT v. E-Funds IT Solutions Inc.³⁵

This Supreme Court ruling is the cornerstone defence for India's BPO/ITES industry. The Court held that an Indian subsidiary providing back-office services to its US parent (which in turn served US clients) did not create a PE. The Court's key findings were:

1. **No Fixed Place PE:** The parent had no right of use or control over the Indian premises.
2. **No Service PE:** The services were not "furnished within India" to the parent's clients; they were rendered *in India for* the parent.

³⁴ [2025] 180 taxmann.com 296 (Delhi - Trib.)(04-11-2025]

³⁵ [2017] 86 taxmann.com 240 (SC)/[2017] 251 Taxman 280 (SC)/[2017] 399 ITR 34 (SC)/[2017] 298 CTR 505 (SC)[24-10-2017]

- Adobe Systems Inc. v. ADIT³⁶

This ruling strongly reaffirmed the Morgan Stanley principle in the modern era. The Revenue argued that Adobe India (an R&D subsidiary) was a PE of Adobe Ireland. The Delhi High Court held:

1. **No DAPE:** The Indian sub had no authority to conclude contracts.
2. **No Fixed Place PE:** The "disposal test" was not met.
3. **The ALP Safe Harbour:** Most importantly, the Court held that *even if* a PE was deemed to exist, the Indian subsidiary was already being remunerated at an arm's length price (ALP) for its functions. This ALP-based income was already taxed in India. Applying the *Morgan Stanley* principle, **no further profit** could be attributed to the foreign parent's alleged PE. This remains the most important defence for MNEs with captive Indian subsidiaries. This view was further reiterated in recent decision³⁷.

- CIT v. Samsung Electronics Co. Ltd. (Delhi HC, 2025)³⁸

In another very recent judgment, the Delhi High Court rejected the Revenue's attempt to create a PE for Samsung Korea. It held that seconded employees performing market research, data collection, and liaison activities were aligned with the Indian subsidiary's (Samsung India's) business, not the parent's. The Court stated, "Collection of market information, collation of data for development of products, market trend studies or exchange of information would not meet the qualifying benchmarks of a PE."

³⁶ Adobe Systems Incorporated vs. Assistant Director of Income-tax [2016] 69 taxmann.com 228 (Delhi)/[2016] 240 Taxman 353 (Delhi)/[2017] 292 CTR 407 (Delhi)[16-05-2016]

³⁷ Commissioner of Income-tax (International Taxation) vs. Adobe Systems Software Ireland Ltd. [2025] 171 taxmann.com 168 (Delhi)[23-01-2025]

³⁸ Principal Commissioner of Income-tax, International Taxation vs. Samsung Electronics Co. Ltd. [2025] 170 taxmann.com 417 (Delhi)/[2025] 303 Taxman 212 (Delhi)/[2025] 478 ITR 271 (Delhi)[15-01-2025]

4.4. Synthesis: The New Dual-Track PE Landscape

The Indian judicial landscape for PE, especially after 2017, has become remarkably complex. The judiciary has, in effect, created a two-track system for PE analysis that mirrors the global legislative (Pillar 1) and tactical (BEPS Action 7) developments.

Several key themes are now clear:

1. **Substance Over Form is the New Norm:** The Supreme Court in *Formula One* and *Hyatt* has emphatically declared that the era of relying on legal formalities is over. Tax authorities and courts will look *through* contracts, intercompany agreements, and legal structures to determine the economic reality of an arrangement.
2. **"Pervasive Control" is the New Fixed Place PE:** The *Hyatt* doctrine is the Revenue's new weapon. It *lowers the bar* for the "disposal" test in Article 5(1). "Pervasive control" (operational, strategic, financial) over *any* physical premises—be it a hotel, an office, or a data centre—can, in substance, make that premises a fixed place PE of the non-resident, even without any legal possession. This is the single greatest PE risk for MNEs in India today.
3. **A Judicial Dichotomy on "Virtual" Presence:** The Indian judiciary has created a critical split.
 - **Virtual Service PE is REJECTED:** As seen in *Clifford Chance* (*supra*), the ITAT has rejected the idea that remote digital services can create a *Service PE* (e.g., under Art. 5(2) or 5(6)) in the absence of a specific treaty clause. Physical presence of *people* remains the threshold.
 - **Pervasive Fixed Place PE is ACCEPTED:** In *Hyatt* (*supra*), Supreme Court has, in effect, created a PE based on "virtual" (i.e., remote) *control* over *physical* assets. This is the new, more sophisticated line of attack.
4. **The ALP Safe Harbour Remains the Strongest Shield:** The *Morgan Stanley / E-Funds / Adobe* line of cases remains the taxpayer's most robust defense. The principle that *no further profits* should be attributed to a PE if the Indian subsidiary has already been taxed on a

full arm's-length remuneration for its functions is a sound and judicially-backed position.

The Unresolved Tension:

The future of PE litigation in India will revolve around the collision of these two judicial doctrines. The key unresolved question is: Will the Hyatt "pervasive control" doctrine be used to defeat the Morgan Stanley/Adobe "ALP" defence?

Revenue is now likely to argue that "pervasive control" means the foreign parent is performing "significant people functions" (SPFs) and assuming key risks *in* India (using the sub's premises as its PE). Therefore, they will argue, the ALP paid to the subsidiary as a "low-risk" captive is *insufficient*, and a *separate*, much larger "residual" or "entrepreneurial" profit must be attributed to the parent's *own* PE.

For digital businesses, the message from the Indian judiciary is clear: The era of simple, form-based tax planning is over. The substance of control and the economic reality of the functions performed within India are now the determinative factors for establishing a Permanent Establishment.

5. Global Judicial & Legislative Approaches

India's unilateral measures and its aggressive judicial re-interpretation of Permanent Establishment (PE) did not occur in a vacuum. They were part of a period of global tax anarchy, a direct consequence of the BEPS Action 1 project's failure to deliver a consensus in 2015. With the traditional PE nexus shattered by digitization, and no global replacement in sight, nations were left to fend for themselves.

This period, roughly from 2016 to 2024, was characterized by profound fragmentation. The world's major economies, facing the same "scale without mass" problem, pursued radically different solutions based on their economic structures and legal traditions.

- The **United States**, home to most digital MNEs, focused on defending the existing framework internationally while strengthening its *own* global tax rules (e.g., GILTI) and using trade policy as a weapon against the unilateral measures of others.

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- The **European Union**, advocating for a harmonized digital tax, failed to achieve internal consensus, leading its member states (like France and Italy) to launch their own Digital Services Taxes (DSTs).
- The **United Kingdom** forged a "third way," creating the Diverted Profits Tax (DPT), a sophisticated anti-avoidance tool designed to function as a "synthetic PE."
- **Emerging economies** like Brazil, China, and Indonesia abandoned OECD norms, relying on expanded withholding tax regimes, aggressive PE enforcement, and new domestic laws creating a non-physical "economic presence" nexus.

This Part analyzes the divergent paths taken by these prominent jurisdictions. Understanding this global fragmentation is essential to appreciating *why* the multilateral Pillar 1 solution became an absolute economic and political necessity, and how India's own judicial path (as seen in Part 4) compares to that of its global peers.

5.1. The United States: Defending the Framework

The US position has been the most significant counter-force to the global push for new digital tax rules. As the home jurisdiction for the majority of the world's largest digital MNEs (e.g., Apple, Google, Meta, Amazon, Microsoft), its domestic and foreign policy has been aimed at protecting its tax base and defending the primacy of the "physical presence" standard, at least until a multilateral solution on its terms (Pillar 1) could be agreed.

5.1.1. The *Wayfair* Earthquake: A Domestic Revolution

While US *international* tax policy resisted economic nexus, its *domestic* tax jurisprudence underwent a revolution. The landmark Supreme Court case, ***South Dakota v. Wayfair, Inc.***³⁹, fundamentally altered the US nexus landscape, and its tremors were felt globally.

- **The Old Rule (*Quill*):** For over 25 years, US states were bound by the 1992 Supreme Court ruling in *Quill Corp. v. North Dakota*. *Quill* held that under the US Constitution's Commerce Clause, a state could *not* force a business to collect its sales tax unless the business had a "physical presence" (e.g., an office, warehouse, or employees) in that

³⁹ 585 U.S. 162 (2018), Accessed at https://www.supremecourt.gov/opinions/17pdf/17-494_j4el.pdf

state. Conceptually, this "physical presence" standard for *sales tax* may have relevance to the "physical presence" PE standard, the decision is yet to be tested in connection of foreign income-tax economic nexus.

- **The *Wayfair* Ruling:** The Supreme Court in *Wayfair* explicitly overturned *Quill*, calling its physical presence rule "unsound and incorrect" in the modern e-commerce age. The Court held that a business could have a "substantial nexus" with a state based on a "significant economic presence," even without a single physical asset. South Dakota's law, which triggered nexus for remote sellers with more than \$100,000 in sales or 200 transactions in the state, was held to be constitutional.
- **Global Implications:** The *Wayfair* decision was a powerful intellectual weapon for market countries like India.
 1. **It Shattered the "Physical Presence" Dogma:** The highest court in the US, the world's largest capital exporter, had declared that a "physical presence" test was an archaic relic in the age of e-commerce. This gave immense political and jurisprudential cover to countries seeking to replace the PE standard.
 2. **It Legitimized "Economic Nexus":** It provided a clear precedent for a nexus based on a simple sales revenue threshold. This directly mirrored the "SEP" concept proposed in the BEPS Action 1 report and later adopted by India (as discussed in Part 3).

While *Wayfair* was a *sales tax* case, its impact on the *income tax* debate was undeniable. It severely weakened the US's moral and legal arguments against other countries adopting their own economic nexus standards for corporate income tax.

5.1.2. The USTR Section 301 Investigations: Wielding the Trade Weapon

If *Wayfair* was the domestic legal development, the primary *foreign policy* tool used by the US was the Section 301 investigation, wielded by the United States Trade Representative (USTR).

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As countries like France, Italy, the UK, and (most broadly) India began rolling out their unilateral DSTs and Equalisation Levies (as detailed in earlier part of this chapter), the US launched a series of investigations. The USTR's position, outlined in its **January 2021 report on India's Equalisation Levy**, was that these taxes were "actionable" and "discriminatory" for three main reasons:

1. **Discriminatory in Nature:** The USTR argued that the levies were "facially discriminatory" as they overwhelmingly targeted US-based tech MNEs.
2. **Inconsistent with Tax Principles:** By taxing gross revenue, not net income, and by applying outside the treaty framework, they were "inconsistent with prevailing principles of international taxation."
3. **Burdensome on US Commerce:** The levies were found to create a significant burden on US companies.

The USTR threatened retaliatory tariffs of up to 25% on goods from these countries. This "tax-for-tariffs" trade war, particularly the one held in suspense against India, became the primary political motivation for all parties to find a multilateral solution. The US used its trade power to *force* other countries to the negotiating table for Pillar 1, the core promise of which was the complete withdrawal and prohibition of all such unilateral DSTs and Equalisation Levies.

5.2. The European Union: A Failure of Unanimity

The European Union, as a massive, unified market bloc, faced the same digital tax challenges. However, its efforts to create a harmonized EU-wide solution repeatedly failed due to the competing interests of its own member states.

5.2.1. The Failed 2018 Directives

In March 2018, the European Commission (EC) proposed a two-pronged legislative package to tax the digital economy, mirroring the BEPS Action 1 "options": [4]

1. **The "Significant Digital Presence" (SDP) Directive (Long-Term Solution):** This was a proposal for a "digital PE." It would have allowed member states to tax the profits of a digital firm if it had a "Significant Digital Presence" in their jurisdiction, *even with no physical*

presence. The SDP nexus would be triggered by exceeding thresholds of:

- €7 million in annual revenues in the member state; or
- 100,000 users in the member state; or
- 3,000 business contracts for digital services.

This was, in essence, a regional version of the SEP concept.

2. **The interim Digital Services Tax (DST) (Short-Term Solution):** This was a proposed 3% tax on gross revenues from certain digital activities (e.g., selling online advertising, digital intermediary activities) where user participation was key.

Both proposals were ultimately *defeated*. Under EU law, tax measures require a unanimous vote of all member states. A small group of low-tax and/or digitally-exporting nations, notably **Ireland, Sweden, and Denmark**, vetoed the proposals. They argued that such measures would harm innovation, invite US retaliation, and that the only viable solution was a global one negotiated at the OECD level.

5.2.2. The Rise of National DSTs and Judicial Divergence

This failure of EU-wide action prompted a wave of uncoordinated, national-level DSTs, as member states like France, Italy, Spain, and Austria implemented their own "French-style" DSTs, all of which became targets of the USTR's Section 301 investigations.

On the judicial front, EU member states (pre-MLI) struggled to apply the traditional PE rules, often with results that contrasted sharply with India's approach.

- The Google Ireland Case (France)⁴⁰:

In a landmark 2017 ruling, the French Supreme Administrative Court (Conseil d'État) held that Google Ireland, which received all advertising revenue from French customers, did not have a PE in

⁴⁰ <https://www.internationaltaxreview.com/article/2a68rfy5bw2ycq1rcvqj5/french-appeals-court-upholds-google-pe-decision>, affirmed in *France vs. Google*, April 2019, Administrative Court of Appeal, Case N° 17PA03065 (accessed at <https://tpguidelines.com/france-vs-google-april-2019-administrative-court-of-appeal-case-n-17pa03065/>)

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France.

- **Facts:** Google France, a subsidiary of Google Ireland, acted as a "commissionnaire" and performed marketing and sales support. However, all contracts with French advertisers were "formally" concluded by Google Ireland.
- **The Ruling:** The French court, applying a strict *de jure* (legal form) interpretation of the pre-BEPS Article 5(5), held that Google France had no authority to "conclude contracts." It rejected the Revenue's argument that Google France's employees were, in substance, the "real sales force." The court also found no fixed place PE, as Google France's premises were not "at the disposal" of Google Ireland.
- **Contrast with India:** This ruling is the *direct opposite* of the "substance-over-form" approach taken by the Indian Supreme Court in *Formula One* and *Hyatt*. While the Indian judiciary was willing to find a PE based on *functional control*, the French court (at that time) stuck to a formalistic test that MNEs could easily structure around. This case is a prime example of *why* the BEPS Action 7 (anti-commissionnaire) rules were created.

- The Valueclick Case (France)⁴¹:

In this case, the Supreme Administrative Court had to decide whether an Irish group company had created a French PE through the activities of employees of its French affiliate. The factual matrix was rich: French employees negotiated commercial terms, shaped contractual clauses, ran local advertising programmes, and even appeared to customers as if they were representatives of the Irish entity. For customers, the Irish and French entities were indistinguishable.

The lower Administrative Court had earlier downplayed these elements, holding that a PE could arise only if the French employees were *legally empowered* to bind the Irish company. Since the Irish entity formally approved every contract and the French team lacked

⁴¹ France vs Valueclick Ltd. Dec 2020, Administrative Court of Appeal (CAA), Case No 420174 accessed at <https://tpcases.com/france-vs-valueclick-ltd-dec-2020-supreme-administrative-court-case-no-420174/>

express authority to conclude contracts, the Administrative Court found no PE.

The Supreme Administrative Court took a more substance-driven view and overturned this reasoning. It held that the French company possessed the human and technical resources necessary to *enable* the Irish enterprise to operate in France in a self-standing manner—resources sufficient to decide upon concluding contracts and to make the Irish company's service offering effectively autonomous in France. Crucially, physical infrastructure like data centres was not determinative; the real test was whether the French affiliate's people and processes functionally allowed the Irish company to serve advertisers independently.

This signalled a shift in French jurisprudence even before the MLI took full effect, moving it closer to a substance-based analysis.

5.3. The United Kingdom: The Diverted Profits Tax (DPT)⁴²

The UK, frustrated by both OECD gridlock and EU inaction, adopted a unique and highly effective unilateral measure: the **Diverted Profits Tax (DPT)**, introduced in 2015.

The DPT is not a DST. It is not a gross-basis tax. It is a new corporate tax, levied at a high rate (initially 25%, raised to 31% from April 2023 to remain 6% above the main 25% corporate tax rate). Its brilliance lies in its design as a "super-tax" that *targets the specific BEPS structures* used to avoid a PE.

The DPT applies in two main scenarios:

1. **The "Artificial PE Avoidance" Rule (Sec. 86, Finance Act 2015):**
This rule targets the *Google-style* commissionaire structures. It applies where:
 - A foreign company carries on activity in the UK *in connection with* sales to UK customers.
 - A "UK person" (like a subsidiary) performs functions designed to *avoid* the foreign company having a UK PE.

⁴² <https://www.gov.uk/hmrc-internal-manuals/international-manual/intm489500>

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- The setup is designed to avoid UK tax.

When triggered, the DPT taxes the foreign company as if it had a PE in the UK. It is, in effect, a legislative PE that bypasses the treaty definition.

2. **The "Insufficient Economic Substance" Rule:** This targets MNEs that create artificial, low-substance entities in low-tax jurisdictions to divert profits from the UK (e.g., through IP royalty payments).
 - **Success and Impact:** The DPT has been immensely successful, not primarily through direct assessments, but as a "nudge" tax. The high 31% rate, combined with procedural hurdles (e.g., tax must be paid upfront before appeal), creates a massive incentive for MNEs to "voluntarily" restructure their operations to be compliant.
 - Following the DPT's introduction, major MNEs like **Google, Meta, and Amazon** publicly announced that they would stop booking their UK sales through Ireland and would begin booking them in the UK, paying UK corporation tax. The DPT effectively *forced* them to unwind their PE avoidance structures, achieving the same goal as BEPS Action 7 through a powerful unilateral deterrent. The UK also has a 2% DST (from 2020), which it has pledged to remove upon implementation of Pillar 1, however the negotiations are still going on.

5.4. Emerging Economies: A Different Toolkit

Emerging economies, often sceptical of OECD-led reforms they felt were dominated by developed nations, adopted their own aggressive tactics.

5.4.1. Brazil: The Withholding Tax (WHT) Approach

Brazil's tax system is complex and largely non-compliant with OECD norms (Brazil is not yet an OECD member but it is an OECD accession candidate).

- **WHT on Technical Services:** Brazil characterizes most payments for digital services, software, and technical assistance not as "business profits," but as "royalties" or "fees for technical services," which are subject to a **domestic gross withholding tax** (typically 15-25%).

- **CIDE Levy⁴³:** In addition to income tax, Brazil levies a separate "Contribution for Intervention in the Economic Domain" (CIDE) at 10% on payments for royalties, licenses, and technical services.
- **Result:** By characterizing digital payments as taxable on a gross WHT basis, Brazil ensures it gets a "first bite" of the tax revenue, regardless of whether a non-resident has a physical PE. This "source taxation" model, while creating risks of double taxation, has been its long-standing answer to the digital tax problem.

5.4.2. China: Aggressive PE Enforcement

China has adopted a two-pronged approach: actively participating in the Pillar 1/2 negotiations while simultaneously expanding its domestic enforcement of traditional PE rules.

- **Broad Service PE:** China's tax treaties often include a broad "Service PE" provision (based on the UN Model), which is triggered by the presence of employees in the country for 6 months in any 12-month period. The State Taxation Administration (STA) has been known to enforce this aggressively, particularly in the engineering, construction, and high-tech sectors.
- **Aggressive Agency PE:** Long before BEPS Action 7, Chinese tax authorities challenged commissionaire structures. In well-known audit cases, the STA aggregated the activities of multiple related entities to find a *de facto* agency, arguing that the local subsidiary was the "real" sales force.⁴⁴

5.4.3. Indonesia: The "Significant Economic Presence" Law

Indonesia, like India, has been a vocal proponent of market-based taxation and has taken aggressive unilateral steps.

- **Aggressive Audits:** The Indonesian Directorate General of Taxes (DGT) is renowned for its aggressive PE audits, often asserting PEs based on a handful of employee visits or a broad interpretation of "supervisory" activities, leading to numerous high-profile disputes.

⁴³ <https://www.lexology.com/library/detail.aspx?g=61f8dc51-83b5-4c0b-8c61-672e68ca9923>

⁴⁴ <https://www.internationaltaxreview.com/article/2a68rfy5bw2ycq1wn6ad5/two-tax-enforcement-cases-highlight-pe-risk-in-china>

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- **Law No. 2/2020:** In 2020, in response to the COVID-19 pandemic and the surge in digital services, Indonesia passed a law that mirrors India's dual-track approach:

Income Tax based on "Significant Economic Presence": The law empowers the government to tax non-resident PPMSEs that have a "Significant Economic Presence" in Indonesia. This SEP can be triggered by gross revenue, user traffic, or other factors. The law states that this will either be enforced by deeming a PE *or* by applying a final withholding tax on the gross transaction value.

Indonesia's law is a clear unilateral assertion of an economic nexus, justified by the failure of the old treaty rules.

5.5. A Trend in Retreat? The Case of Canada

The era of unilateralism, which began after 2015, is now showing clear signs of receding in anticipation of the multilateral solution. The case of **Canada** is the most recent and prominent example.

Canada had proposed its own DST, set to be effective from January 1, 2024, and apply retroactively to 2022. This tax, like the UK and French versions, was a 3% gross revenue tax on large digital MNEs.

However, after years of intense political pressure from the US (including threats of USTR Section 301 tariffs) and significant progress on the Pillar 1 Multilateral Convention (MLC), the Canadian government announced in its 2024 and 2025 Budgets and policy statements⁴⁵ that it would rescind and not proceed with its proposed DST.

This policy reversal is a clear illustration of the "grand bargain" at the heart of the global digital tax debate. The unilateral measures (like India's EL & SEP, France's DST, and Indonesia's SEP law) were the *threats* that forced the world, especially the US, to the negotiating table. The *promise* of Pillar 1 is the removal of these fragmented, trade-war-inducing taxes in favour of a single, multilateral system. The retreat of Canada's DST is the first major sign of that bargain being honoured, setting a strong precedent for other nations—including India—to follow suit as the Pillar 1 MLC moves towards ratification.

⁴⁵ <https://www.canada.ca/en/department-finance/news/2025/06/canada-rescinds-digital-services-tax-to-advance-broader-trade-negotiations-with-the-united-states.html>

6: The Multilateral Solution and its Interaction with PE

The global fragmentation and escalating trade tensions detailed in Part 5 created an unsustainable environment for both MNEs and tax administrations. The aggressive unilateralism of market jurisdictions (like India, France, and Indonesia) and the defensive trade threats from capital-exporting nations (primarily the United States) forced all parties back to the OECD/G20 Inclusive Framework to finalize a comprehensive, multilateral solution.

The result was the "Two-Pillar Solution," a historic global agreement that fundamentally rewrites the rules of international taxation.

As this solution is the subject of dedicated chapters in this publication, this Part will not explore its complex mechanics in detail. Instead, it will provide a brief overview focused exclusively on one critical point: **the interaction of Pillars 1 and 2 with the traditional and evolving concept of Permanent Establishment.**

A common misconception is that this new solution makes the PE concept obsolete. The reality is precisely the opposite. The multilateral framework *relies* on the PE concept and, in many ways, *increases the stakes* of PE determination for the vast majority of MNEs.

6.1. Pillar 1: Re-allocating Taxing Rights

Pillar 1 is the direct answer to the "scale without mass" problem. It is a "nexus-and-profit-allocation" solution that applies *only* to the largest and most profitable MNEs (generally, those with global turnover above €20 billion and profitability above 10%).

6.1.1. Amount A: The New Taxing Right (Nexus without PE)

The core of Pillar 1 is "Amount A." This is an entirely new taxing right that allows market jurisdictions (like India) to tax a formulaic share of an MNE's residual profits.

- **PE Interaction:** Amount A's nexus is based on a *revenue sourcing* threshold, completely bypassing the physical presence test of Article 5 (Permanent Establishment). It is a "nexus-over-the-top" solution.

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- **The "Grand Bargain":** The political price for this new taxing right is the "grand bargain" discussed in Part 5: all signatory countries must withdraw their Digital Services Taxes (DSTs) and other unilateral measures (like India's Equalisation Levy) and agree not to introduce new ones.

6.1.2. Amount B, ALP, and the MDPSH: The Co-existence with PE

This is the most critical point: Pillar 1 does not replace the existing PE framework. For the MNEs in scope, the traditional rules of Articles 5 (PE) and 7 (Business Profits) will continue to apply for all their "routine" in-country activities.

The framework is designed to *co-exist* with the existing PE rules to prevent double taxation, primarily through the **Marketing and Distribution Profits Safe Harbour (MDPSH)**.

- **The Problem:** What happens when India, under its *Hyatt* "pervasive control" doctrine (discussed in Part 4), *already* deems a non-resident MNE to have a PE and attributes significant profit to it? If Amount A is then *also* allocated to India, the same in-country market profit could be taxed twice.
- **The Solution (MDPSH):** The MDPSH is, in essence, a credit mechanism. It provides a fixed, "safe harbour" return for routine marketing and distribution activities already being performed and taxed in the market jurisdiction (whether by a subsidiary or a PE). This "safe harbour" amount, which is already taxed in India under the traditional PE/ALP rules, is then *credited against* the new Amount A allocation, ensuring that only the *excess* residual profit (if any) is taxed under the new formulaic right.
- **The Implication:** The MDPSH makes the determination of a PE *more* important, as it becomes the baseline for calculating the offset against the new Amount A liability.

(For a detailed analysis of Amount A mechanics, profit allocation, and the MDPSH, see **Chapter [***]** of this book.)

6.2. Pillar 2: The Global Minimum Tax (GloBE)

Pillar 2, or the "GloBE" rules, is not a new nexus rule; it is a "top-up tax." Its objective is to ensure that all in-scope MNEs (those with revenue over €750 million) pay a minimum effective tax rate (ETR) of 15% on their profits *in every jurisdiction where they operate*.

Pillar 2 interacts with the PE concept in three critical ways:

1. **PE as a Jurisdictional Locator:** The entire GloBE calculation is based on determining an MNE's ETR on a "jurisdictional basis." The PE concept is the primary mechanism used by the GloBE rules to determine *where* income is located. If an MNE has a PE in Country A, the profits attributable to that PE are allocated to Country A for the 15% ETR test. Therefore, correctly identifying the existence of a PE is a *prerequisite* for the Pillar 2 calculations.
2. **A Backstop to PE Avoidance:** Pillar 2 acts as a powerful deterrent against classic PE avoidance. In a pre-Pillar 2 world, an MNE might use a "commissionnaire" structure (as discussed in earlier part of this chapter) to avoid a PE in high-tax India and book the "stateless" sales profit in a 0% tax haven. Under Pillar 2, this strategy fails. Even if the MNE successfully avoids an Indian PE, the "stateless" profits booked in the 0% jurisdiction will be identified, and another group entity (e.g., the ultimate parent) will be forced to pay a "top-up tax" of 15% on those profits. GloBE works on jurisdictional accounting profit, so "avoiding" a PE may not prevent a top-up tax under Pillar 2, thereby limiting the tax payoff of PE-avoidance structures.
3. **The Subject to Tax Rule (STTR):** The STTR is a specific, treaty-based component of Pillar 2 that *directly* interacts with the PE framework. It is a "treaty override" provision that applies to certain "at-risk" payments between connected parties (e.g., interest, royalties) where the payment is taxed below a minimum rate (9%) in the recipient's jurisdiction. The STTR allows the *source* country (like India) to "top up" the withholding tax on that payment *before* the DTAA applies, even if the recipient has no PE in India. It is, in effect, a limited, gross-basis taxing right that applies where a combination of a low tax rate and the absence of a PE would otherwise lead to base erosion.

In conclusion, the multilateral solution does not make PE irrelevant. Pillar 1 (Amount A) creates a new, separate nexus for a small number of mega-MNEs, but it relies on existing PE principles (via the MDPSH) to prevent double taxation. Pillar 2 (GloBE) uses the PE definition as a fundamental sorting mechanism to allocate income to jurisdictions and acts as a potent backstop against the very PE avoidance schemes that MNEs have used for decades.

*(For a full discussion of the GloBE rules, the Income Inclusion Rule (IIR), the Undertaxed Profits Rule (UTPR), and the STTR, see **Chapter [***]** of this book.)*

7. What Lies Ahead – The Future of PE in India

The preceding parts of this chapter have traced a long and convoluted journey. We began with the traditional "physical presence" concept of PE, a 20th-century relic designed for a brick-and-mortar world. We saw how the digital economy's "scale without mass" phenomenon rendered this concept obsolete, leading to the BEPS project. That project, in turn, failed to achieve consensus on a new digital tax, instead offering a "menu of options" and a set of rules to strengthen the existing, physical PE definition via BEPS Action 7.

This failure at the global level to arrive at an agreed solution triggered a decade of tax anarchy.

- India, as a prominent market jurisdiction, moved unilaterally, first with its Equalisation Levy (EL) and then with the (largely dormant) concept of Significant Economic Presence (SEP).
- Concurrently, India's tax authorities and, more importantly, its judiciary, began an aggressive re-interpretation of the *existing* PE definition. This judicial path, created a new, powerful "substance-over-form" doctrine, evolving from the "disposal test" in the Supreme Court's 2017 *Formula One* ruling to the "pervasive control" doctrine in its 2025 *Hyatt International* watershed judgment.
- This unilateral and judicial aggression in India was mirrored by global fragmentation, with the US, UK, EU, and emerging markets all pursuing different, conflicting strategies.

- This chaos finally forced the world back to the negotiating table, resulting in the Two-Pillar Solution, a "grand bargain" where market jurisdictions would repeal their unilateral taxes in exchange for a new, formulaic taxing right (Amount A) for the world's largest MNEs.

We have now arrived at a critical inflexion point. With the multilateral solution on the verge of implementation, and India's Supreme Court having just handed down a landmark new PE precedent in Hyatt (*supra*), what is the future of Permanent Establishment for digitized businesses in India?

7.1. The Misconception of PE's Obsolescence

A common narrative following the announcement of the Two-Pillar Solution was that it signalled the "death of the PE." The new nexus of Pillar 1's Amount A, based on revenue sourcing, was seen as the replacement for the archaic "physical presence" test. This interpretation is fundamentally incorrect.

The concept of Permanent Establishment is not dead; in fact, its relevance has been reinforced and, for most companies, its risks have been amplified.

1. Pillar 1's Extremely Limited Scope

The first and most critical point is one of scope. The new taxing right of Amount A (as discussed in Part 6) is not a universal replacement for Article 5. It is a highly targeted solution designed to apply only to the largest and most profitable MNEs—those with global turnover exceeding €20 billion and profitability over 10%. This group is estimated to include only around 100 of the world's largest companies.

For the **99.9% of all other MNEs** operating cross-border—including thousands of highly digitized and profitable foreign companies with significant sales in India—Pillar 1 simply does not apply. For this vast majority of companies, the *only* gateway for India to tax their business profits remains the traditional PE concept as defined in Article 5 of India's DTAA's.

2. Pillar 2's Explicit Reliance on PE

As detailed in Part 6, the Pillar 2 (GloBE) rules are not a nexus-creating provision, but they explicitly rely on the PE concept to function. The entire GloBE calculation of a 15% effective tax rate (ETR) is performed on a "jurisdictional basis." The PE concept is the primary tool used to determine that basis.

The GloBE rules must identify where an MNE's profits are located to test their ETR. If a US MNE has a PE in India, the profits attributable to that PE are (in principle) allocated to the Indian jurisdiction for the ETR calculation. If the PE is located in a tax haven, its profits are allocated there. Therefore, a correct determination of the *existence* and *location* of a PE is a foundational prerequisite for the entire Pillar 2 system to operate. [1]

3. The Ongoing Relevance of PE for Pillar 1 (MDPSH)

Even for the ~100 MNEs within the scope of Pillar 1, the PE concept remains critical. As explained in Part 6, the Marketing and Distribution Profits Safe Harbour (MDPSH) is the mechanism that prevents double taxation. It acts as a "credit" for profits already taxed in the market jurisdiction via a local subsidiary or a PE under the traditional rules.

This creates a new, high-stakes incentive for these MNEs. To maximize their MDPSH "credit" and reduce their Amount A "top-up" tax, they will need to accurately identify their existing PEs and defend their profit attribution to them under the Arm's Length Principle (ALP). Thus, Pillar 1 does not end the PE debate; it reframes it as a critical component of the Amount A calculation.

For these reasons, the concept of Permanent Establishment will remain the central battleground for international tax in India for the foreseeable future.

7.2. India's Emerging "Dual-Track" Nexus Framework

The future of PE in India is best understood as a "dual-track" system, with two separate and distinct nexus regimes operating in parallel. A foreign MNE's PE risk profile in India is now entirely dependent on which track it falls into.

Track 1: The Multilateral Track (The "Pillar 1 Club")

- **Who it Applies To:** The ~100 largest MNEs in scope of Amount A.
- **The Nexus Rule:** The new, formulaic nexus based on **revenue sourcing**. If the MNE derives the requisite amount of revenue from India (e.g., €1 million), it is in scope, and Amount A will be allocated to India, *regardless* of any physical presence or PE.
- **The "Grand Bargain":** This track is contingent on the "grand bargain" at the heart of the global deal. To gain access to Amount A, India *must* repeal its unilateral measures. We are already seeing this in motion.

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- The **Finance (No. 2) Act, 2024**, inserted a "sunset clause" for the 2% Equalisation Levy on e-commerce operators (EL 2.0), making it inapplicable from August 1, 2024. [2]
- The Finance Bill, 2025, has reportedly proposed the full abolition of the 6% Equalisation Levy on digital advertising (EL 1.0) effective April 1, 2025. [3]

This demonstrates India's political commitment to honoring the multilateral agreement. For MNEs in this club, the primary PE analysis will be in the context of the MDPSH, as discussed above.

Track 2: The Judicial PE Track (The "99%,")

- **Who it Applies To:** All other MNEs, from medium-sized SaaS companies to large traditional industrial groups, that are *not* in scope of Pillar 1.
- **The Nexus Rule:** The traditional PE definition in **Article 5 of India's DTAAs**, as modified by the MLI (BEPS Action 7) and, most importantly, *as interpreted by the Indian judiciary*.
- **The New Weapon:** The primary tool for the Indian Revenue in this track will no longer be the (now-repealed) EL or the (treaty-blocked) SEP. The new weapon is the **"pervasive control" doctrine** established by the Supreme Court in its 2025 *Hyatt International* judgment.

For the vast majority of businesses, the future of digital taxation in India is not Pillar 1; it is the *Hyatt* doctrine.

7.3. The Future PE Battleground: *Hyatt* Control vs. *Adobe Safe Harbour*

For the "99%" on Track 2, all future PE disputes will centre on an inevitable and monumental collision between two competing judicial doctrines, both detailed in part of this chapter.

1. The Revenue's Sword: The *Hyatt* "Pervasive Control" Doctrine.

The Supreme Court's 2025 *Hyatt* ruling established that a non-resident could have a fixed place PE in India without legal possession or exclusive use of a premises, so long as it exercises "pervasive and enforceable control" over the operations, strategy, and finances of the

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business being conducted there. This "substance-over-form" test gives the Revenue a powerful tool to look through subsidiary arrangements.

2. The Taxpayer's Shield: The Morgan Stanley / Adobe "ALP Safe Harbour."

The Supreme Court in Morgan Stanley (2007) and the Delhi High Court in Adobe (2024) and Samsung (2025) have consistently upheld the principle that where an Indian subsidiary (or alleged PE) performs functions for its foreign parent, and that subsidiary is remunerated at an Arm's Length Price (ALP) for those functions (and pays full Indian tax on that ALP), no further profits can be attributed to the foreign parent's alleged PE.

The Inevitable Collision: A New Era of Attribution Disputes

The future PE battleground will be the direct confrontation between these two principles. The Revenue will no longer simply accept an ALP-based defence. The new line of attack will be far more sophisticated:

- **Revenue's Argument (Post-Hyatt):** The Revenue will use the *Hyatt* doctrine to assert that a non-resident parent's "pervasive control" over its Indian subsidiary means the parent *itself* has a fixed place PE in India (using the subsidiary's office). They will then argue that this PE is performing "significant people functions" (SPFs) and assuming key entrepreneurial risks (DEMPE functions).

Therefore, the Revenue will contend, the ALP paid to the subsidiary as a "low-risk" captive or service provider is *insufficient*. They will argue that the subsidiary's ALP only covers its *routine* functions, and that a *separate, additional entrepreneurial or residual profit* must be attributed to the *parent's own PE* (the one created by "pervasive control") under Article 7.

- **Taxpayer's Counter-Argument (Post-Adobe):** The taxpayer will argue that the *Adobe* and *E-Funds* rulings remain the binding precedent for attribution. They will contend that *all* functions performed in India, and *all* assets and risks in India, are already housed within the Indian subsidiary and have been fully remunerated at arm's length. They will argue that the *Hyatt* ruling (which was a hotel management case) does not overturn the *Morgan Stanley* attribution principle, and

that attempting to "attribute" a second layer of profit to a "control PE" is economically flawed and constitutes double taxation.

It appears that this collision between *Hyatt* control vs. *Adobe* ALP will be the most crucial legal question in Indian international tax for the next decade. Its outcome will determine the PE risk for all MNEs with captive service centres, R&D labs, and BPO operations in India.

7.4. Re-evaluating Digitized Business Models in the Post-Hyatt Era

This new, substance-based PE landscape requires a complete re-evaluation of the risks for common digitized business models.

A. Captive ITES, BPO, and R&D Centers

- **The Old Risk:** The primary risk was a Dependent Agent PE (DAPE) (if the sub concluded contracts) or a Service PE (if employees were seconded).
- **The New Risk (Post-Hyatt):** The risk is now a **Fixed Place PE** of the foreign parent. The Revenue will scrutinize the "pervasive control" a parent exercises. Do parent-company managers dictate projects, budgets, and HR? Are IT systems so deeply integrated that the parent has "control" over the Indian office? The line between permissible "stewardship" (per *Morgan Stanley*) and taxable "operational control" (per *Hyatt*) has become dangerously thin.

B. Cloud Computing (SaaS, IaaS, PaaS) and Data Centers

- **The Old Debate:** Is a cloud subscription payment a "royalty" for the "use of equipment"? As seen in earlier part of this chapter, Indian ITATs have generally held **no**, as the customer has no control or dominion over the server.
- **The New Debate (Post-Hyatt):** The *Hyatt* ruling flips the script. The question is not whether the *customer* has control. The question is whether the *foreign cloud provider* (e.g., AWS USA) exercises "pervasive control" over the *physical data centre* in India (whether owned by its Indian subsidiary or a third party).
- Since the foreign parent's software, algorithms, and global technical staff exercise 100% remote, functional control over the physical

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servers in India to deliver their core business, the Revenue can strongly argue *Hyatt*-based argument that these servers constitute a fixed place PE of the foreign parent. This is a massive, unresolved risk area.

C. E-commerce and Fulfilment Centres

- **The Old Strategy:** A foreign e-commerce MNE (e.g., Amazon) sells to Indian customers from its foreign entity. A separate Indian subsidiary (e.g., Amazon India) provides marketing and runs a "fulfilment centre." The foreign MNE would argue the warehouse is "preparatory or auxiliary" under Article 5(4) (though this argument weakened by BEPS Action 7, as seen earlier).
- **The New Risk (Post-*Hyatt*):** The Revenue can now largely bypass the "preparatory/auxiliary" debate. They can simply argue that the foreign MNE exercises "pervasive control" over the Indian fulfilment centre's operations—dictating inventory, logistics, and pricing—making the warehouse, in substance, a fixed place PE of the foreign MNE.

7.5. The Fading Relevance of India's Unilateral Measures

Given this new landscape, what is the future of the unilateral tools India created?

1. The End of the Equalisation Levy (EL)

The EL was a brilliant, but temporary, solution. It was a gross-basis tax enacted outside the Income-tax Act, 1961, which cleverly bypassed India's DTAA obligations. However, it was a blunt instrument that invited significant trade retaliation, particularly from the US (as seen in the USTR Section 301 reports).

As of 2025, the EL is being phased out. Its withdrawal is the explicit "quid pro quo" for India's participation in Pillar 1. Its legacy is that it successfully *forced* the world to a multilateral consensus, but it is not part of India's long-term tax arsenal.

2. The Future of Significant Economic Presence (SEP)

The SEP, unlike the EL, was an amendment to the Income-tax Act itself (Section 9(1)(i)). It was India's attempt to create a "digital PE" in domestic law, based on the BEPS Action 1 proposal.

However, as discussed earlier, the SEP has been a "paper tiger." Due to the operation of Section 90(2) of the Act, an assessee resident in a treaty partner country (e.g., USA, Singapore, Ireland etc.) can opt to be governed by the DTAA, if it is more beneficial. Since none of India's DTAA's contain an "SEP" clause, and all define PE based on *physical presence*, the SEP provision has been *legally overridden* by the treaty network.

So, what is its future?

- **A "Sleeping" Provision:** The SEP is effectively redundant for MNEs from treaty countries. It will remain on the statute books as a tool for the Revenue to tax MNEs from the few non-treaty jurisdictions (e.g., tax havens) that may meet the revenue or user thresholds.
- **A Failed Legislative Experiment:** The SEP's true purpose was not to collect tax (it was always blocked by treaties), but to act as a *threat* and a *political statement* to the OECD, demonstrating India's legislative intent to tax the digital economy.
- **The Judicial Path Won:** Ultimately, the Indian Supreme Court, through its "pervasive control" doctrine in *Hyatt*, has proven to be a far more effective and powerful tool for creating a "substance-based" digital nexus than the legislature's (failed) "economic-based" SEP. The *Hyatt* doctrine can bypass the physical presence test of Article 5(1) through *interpretation*, something the SEP (as a domestic law) could never do.

7.6. Concluding Thoughts: The Dawn of the "Substance" Era

The decade-long search for a "digital PE" in India has reached a fascinating stage. The journey has exposed the strengths and weaknesses of all three branches of government.

- The **Legislature** tried with the SEP but was checkmated by its own treaty obligations.
- The **Executive** tried with the Equalisation Levy but was checkmated by international trade policy and the need for a global compromise.
- It was the **Judiciary** that ultimately provided the most potent solution.

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The Supreme Court's "substance-over-form" transition, from *Formula One* to *Hyatt International*, has given the Indian Revenue a flexible and powerful domestic doctrine to find PE based on *economic reality and functional control*, rather than archaic notions of physical possession.

This leads to the new emerging landscape for PE in India in the coming years:

1. **For the ~100 largest MNEs:** A new, multilateral era of formulaic taxation under Pillar 1, with PE remaining relevant for calculating the MDPSH offset.
2. **For the 99%:** A new, contentious era of "judicial PE," where the *Hyatt* "pervasive control" doctrine could be the Revenue's primary weapon, and the *Adobe* "ALP safe harbour" should be the taxpayer's primary shield.

Far from being obsolete, the concept of Permanent Establishment has been revitalized. It has shed its 20th-century obsession with *physicality* and has been re-armed for the 21st century with the doctrine of *control*. The key question for any digitized business operating in India is no longer "Where is your office?" but "Where is your control?" On the answer to that question, billions in tax revenue will depend. The era of substance has truly begun.

OECD vs. UN Approaches to Taxation of the Digital Economy

1. Introduction – A Tale of Two Forums

1.1. The Context: A House Divided

For nearly a century, the international tax architecture was a monolithic structure, built on the consensus of the League of Nations¹ and maintained, largely, by the Organisation for Economic Co-operation and Development (OECD). This architecture relied on physical presence (Permanent Establishment) and the Arm's Length Principle (ALP) to allocate taxing rights. As detailed in the previous chapter, the digitalization of the economy shattered these foundational pillars, allowing multinational enterprises (MNEs) to achieve "scale without mass" and generate stateless income.

The initial global response in the form of the Base Erosion and Profit Shifting (BEPS) Project (2013-2015) was a unified effort to patch the leaks. However, on the specific issue of the *digital economy* (Action 1), the consensus fractured. The 2015 Final Report on Action 1 offered a diagnosis but no cure, presenting instead a "menu of options" (Equalisation Levy, Significant Economic Presence, Withholding Tax) that countries could adopt unilaterally.

This failure to agree on a single global standard triggered a decade of divergence. While the OECD rushed to construct a new consensus through the "Inclusive Framework" (leading to the Two-Pillar Solution), the United Nations (UN) Committee of Experts on International Cooperation in Tax Matters quietly but decisively charted a different course.

¹The work on international tax issues began in the early 1920s and involved a group of experts, which later became the Fiscal Committee of the League of Nations. This work produced the first model bilateral tax treaties in 1928, which served as the foundation for the later models. Subsequently the League of Nations developed Mexico Model (1943) and London Model (1946). After World War II, the work of the League of Nations was taken over by the United Nations, and subsequently the Organisation for European Economic Co-operation (OEEC), the predecessor to the OECD, developed its own model largely based on the London Model.

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By 2021, the world was presented with two distinct, and in many ways competing, visions for the future of digital taxation:

1. **The OECD Approach:** A complex, multilateral "re-allocation" of taxing rights for a small club of mega-MNEs (Pillar 1), combined with a global minimum corporate rate of 15% for MLEs with annual revenue exceeding €750 million.
2. **The UN Approach:** A simple, bilateral "source taxation" right on digital payments for *all* digital service providers (Article 12B).

This chapter analyzes this great divergence. It compares the technocratic complexity of the OECD's solution with the pragmatic simplicity of the UN's alternative, exploring why developing nations like India find themselves straddling both worlds.

1.2. The Philosophical Divide: Value Creation vs. Source Rule

To understand the technical differences between Pillar 1 and Article 12B, one must first appreciate the significant philosophical divide between the two bodies.

The OECD Ideology: "Value Creation" and Neutrality The OECD, historically representing capital-exporting nations (the "Global North"), has traditionally favoured *residence-based* taxation. Its solution to the digital challenge is rooted in the concept of "value creation." The OECD argues that digital MNEs create value not just through capital and labour (physical presence), but through "active user participation" and "marketing intangibles" in the market jurisdiction. Therefore, the OECD solution aims to *re-allocate* a portion of the "residual profit" (profit exceeding a routine return) to the market jurisdictions where users are located. This approach seeks to be "neutral"—avoiding gross-basis taxes that might stifle innovation—and "exclusive", aiming to replace all unilateral measures with a single global rule.

The UN Ideology: "Source Taxation" and Simplicity The UN Tax Committee, representing the interests of developing and capital-importing nations (the "Global South"), operates on a different premise: the primacy of *source-based* taxation. The UN view is that if a non-resident enterprise participates in the economic life of a country and derives income from it, that source country has a primary right to tax that income, regardless of physical presence or "residual" profits. The UN approach prioritizes "simplicity" and

"administrability." For developing nations with limited administrative capacity, complex formulas for allocating "residual profit" are unworkable. Instead, the UN favours bright-line rules—like Gross Withholding Taxes (WHT)—that are easy to enforce, harder to avoid, and guarantee revenue "from the first dollar" of income.

1.3. The Stakes for Developing Nations

The choice between these two approaches is not merely academic; it is a question of fiscal sovereignty and economic survival for developing nations.

- **The Revenue Stake:** Developing countries, including India, are net importers of intellectual property. A system that taxes only the "super-profits" of top 100 companies (like under OECD Pillar 1) may yield significantly less revenue than a system that taxes the gross payments made to *all* foreign digital providers (UN Article 12B).
- **The Capacity Stake:** Implementing Pillar 1 requires navigating a voluminous multilateral convention, participating in complex dispute resolution panels, and relying on financial data audited in foreign jurisdictions. Implementing the UN approach simply requires amending a treaty and enforcing a withholding tax code.
- **The Political Stake:** The OECD process has been criticized for being dominated by the G7/G20 agenda. The UN, with its "one country, one vote" structure, is increasingly seen as the more legitimate forum for setting global tax rules, a sentiment culminating in the historic 2023/2024 UN General Assembly resolutions to establish a binding "UN Framework Convention on International Tax Cooperation."

India occupies a unique position in this landscape. It is a key member of the G20 and the OECD Inclusive Framework, yet its sympathies and domestic policies (like the Equalisation Levy) are deeply aligned with the UN's source-based philosophy. As we explore the mechanics of both approaches, this tension—between India's global commitments and its national interests—will be a recurring theme.

2. The OECD Approach – The "Two-Pillar" Solution

The OECD's response to the digital challenge is undoubtedly the most ambitious rewriting of international tax rules in a century. After the deadlock

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of BEPS Action 1 (2015), the OECD/G20 Inclusive Framework on BEPS—a group expanded to include over 140 jurisdictions, including India—embarked on a new project to address the "Tax Challenges Arising from the Digitalisation of the Economy."

In **October 2021**, 137 jurisdictions agreed to a historic "Statement on a Two-Pillar Solution." This agreement was a political "grand bargain": market countries (like India) agreed to forego their unilateral digital taxes (like the Equalisation Levy) in exchange for a new, guaranteed taxing right over the world's largest MNEs (Pillar 1) and a global floor on tax competition (Pillar 2).

2.1. Pillar One: Re-allocation of Taxing Rights (Amount A)

Pillar One is the direct answer to the "scale without mass" problem. It creates a new taxing right, known as **Amount A**, which is allocated to market jurisdictions *independent* of the physical presence (PE) and Arm's Length Principle (ALP) rules.

2.1.1. Scope:

The "Winners" Circle: Unlike the UN approach (which targets "digital services"), Pillar One is not ring-fenced to the digital economy. However, its scope is extremely narrow in practice. It applies only to MNEs that meet two thresholds:

1. **Global Revenue:** Greater than **€20 billion** (eventually lowering to €10 billion).
2. **Profitability:** Profit Before Tax (PBT) margin greater than **10%**.

This scope captures roughly **100 of the world's largest and most profitable companies** (the "Super-MNEs"). It includes digital giants (Apple, Alphabet, Meta) but also consumer goods and pharma majors. Notably, **Regulated Financial Services** and **Extractive Industries** are explicitly excluded.

2.1.2. The New Nexus: Revenue Sourcing

For these in-scope MNEs, Pillar One creates a new "special purpose nexus." A market jurisdiction (e.g., India) gains the right to tax Amount A if the MNE derives at least **€1 million** in revenue from that jurisdiction (or €250,000 for smaller economies with GDP < €40 billion). Crucially, this revenue is

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determined by **Revenue Sourcing Rules** that trace sales to the end user, regardless of billing location. This bypasses the classic tax planning structure where sales to India are billed from Ireland or Singapore.

2.1.3. The Mechanism: The Three-Step Allocation

The calculation of Amount A is a formulary apportionment process:

- **Step 1: Determine Residual Profit.** Take the MNE's total adjusted profit and subtract a "routine" return of 10% of revenue. The remaining profit is the "residual" or "excess" profit.
- **Step 2: The Re-allocation Percentage. 25%** of this residual profit is allocated to the "Amount A pool."
- **Step 3: Allocation to Markets.** This pool is distributed among eligible market jurisdictions in proportion to the revenue sourced from each.

Example: An MNE has global revenue of €100 billion and profit of €20 billion (20% margin).

- Routine Profit (10%): €10 billion.
- Residual Profit: €10 billion (€20bn - €10bn).
- Amount A Pool (25%): **€2.5 billion**. If 5% of the MNE's sales are in India, India gets the right to tax 5% of that pool (€125 million) at its domestic corporate tax rate.

2.1.4. Amount B: The "consolation prize"?

While Amount A grabs the headlines, Pillar One also includes **Amount B**. This aims to simplify transfer pricing for "baseline marketing and distribution activities." It creates a fixed return (a standard arm's length remuneration) for local distributors. While intended to reduce disputes for developing countries, many (including India) have expressed concern that the proposed returns are too low and restrict their ability to tax local value addition.

2.2. Pillar Two: The Global Minimum Tax (GloBE)

While Pillar One addresses *where* tax is paid (nexus), Pillar Two addresses *how much* is paid (rate). It introduces the **Global Anti-Base Erosion (GloBE)** rules, which ensure that MNEs with revenue above **€750 million** pay a minimum effective tax rate (ETR) of **15%** in every jurisdiction they operate.

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Pillar Two consists of two interlocking rules:

1. **Income Inclusion Rule (IIR):** If a foreign subsidiary is taxed below 15% (e.g., in a zero-tax haven), the Ultimate Parent Entity's home country (e.g., the US) imposes a "top-up tax" on the parent to bring the rate up to 15%.
2. **Undertaxed Profits Rule (UTPR):** A backstop rule that allows other countries (like India) to deny deductions or impose tax if the parent jurisdiction fails to apply the IIR.

Relevance to the Debate: Pillar Two effectively kills the "tax haven" model. It reduces the incentive for MNEs to shift profits to low-tax jurisdictions because that profit will be taxed *somewhere* at 15%. For India, this is a double-edged sword: it stops base erosion, but it also limits India's ability to use tax incentives (like tax holidays) to attract FDI, as those incentives might be clawed back by the MNE's home country.

2.3. Critique of the OECD Approach

Despite the "consensus," the OECD approach faces fierce criticism, particularly from the Global South:

1. **Complexity:** The rules for calculating Amount A run into hundreds of pages, requiring complex segmentation, sourcing, and dispute resolution mechanisms that are beyond the capacity of many developing nations.
2. **Meagre Revenues:** Studies (e.g., by the South Centre² and Oxfam³) suggest that for many developing countries, the revenue from Amount A (after removing unilateral taxes like the EL) might be negligible or even negative. The 25% allocation of *only* residual profit is seen as too low.
3. **The "Grand Bargain" Cost:** The mandatory removal of unilateral measures (EL/DSTs) deprives countries of a simple, effective policy tool in exchange for an uncertain, complex share of a small pie.

² Accessed at https://www.southcentre.int/wp-content/uploads/2022/10/RP165_Evaluating-the-Impact-of-Pillars-One-and-Two_EN.pdf

³ Accessed at https://www.oxfamireland.org/sites/default/files/pillar_1_impact_assessment_v2_25jan2022.pdf

4. **Loss of Sovereignty:** The mandatory binding arbitration mechanism for disputes is constitutionally difficult for many nations, including India, to accept.

It was this dissatisfaction with the "OECD consensus" that paved the way for the resurgence of the United Nations in the tax arena.

3: The UN Approach – Article 12B (Automated Digital Services)

While the OECD was constructing the complex edifice of Pillar One, the United Nations Committee of Experts on International Cooperation in Tax Matters (UN Tax Committee) was quietly engineering a radically different solution. Driven by the frustration of developing nations who found the OECD proposals administratively unworkable and economically insufficient, the UN sought a solution that prioritized **simplicity**, **administrability**, and **source taxation**.

The result was the introduction of **Article 12B** into the **2021 UN Model Double Taxation Convention**. Unlike the OECD's "re-allocation" of residual profits, Article 12B creates a direct, gross-basis taxing right on payments for digital services.

Furthermore, this "soft law" model provision is rapidly evolving into a binding "hard law" instrument through the negotiations for the UN Framework Convention on International Tax Cooperation, marking the most significant shift in global tax governance since the League of Nations.

3.1. The 2021 UN Model Update: A New Tool for the Global South

The inclusion of Article 12B in the 2021 UN Model was a watershed moment. For decades, tax treaties had restricted source taxation of business profits to cases where a Permanent Establishment (PE) existed (Article 7). As digitization rendered the physical PE obsolete, developing countries—which are predominantly net importers of digital services—saw their tax bases erode.

Article 12B was designed to bypass the PE threshold entirely. It allows a country to tax income from **Automated Digital Services (ADS)** paid to a non-resident, simply because the income *arises* in that country.

Philosophical Underpinning:

The UN approach rejects the OECD's complex "value creation" metrics (user participation, marketing intangibles). Instead, it rests on a simpler economic rationale: Market Access. If a non-resident enterprise benefits from access to a country's market and digital infrastructure to earn revenue, that country has a sovereign right to tax that revenue at source, regardless of the enterprise's physical footprint or profitability.

3.2. The Core Mechanism: Gross-Basis Withholding Tax (WHT)

Article 12B consists of eight substantive paragraphs:

1. **Paragraph 1:** Establishes general residence-based taxation right
2. **Paragraph 2:** Grants limited source country withholding tax right on gross basis
3. **Paragraph 3:** Provides optional net basis taxation alternative
4. **Paragraph 4:** Defines "income from automated digital services"
5. **Paragraph 5:** Exclusion when permanent establishment exists
6. **Paragraph 6:** Source rules—when income "arises" in a jurisdiction
7. **Paragraph 7:** Clarification of when income does not arise in a jurisdiction
8. **Paragraph 8:** Beneficial owner requirement

The architecture of Article 12B is intentionally simple, mirroring the familiar mechanics of Article 12 (Royalties) and Article 12A (Fees for Technical Services).

3.2.1. The Charging Provision (Paragraph 2)

Article 12B(2) provides the primary taxing right. It states that income from automated digital services may be taxed in the Contracting State in which it arises (the Source State) according to its laws. However, if the beneficial owner is a resident of the other State, the tax is limited to a certain percentage of the gross amount of the payments.

- **The Rate:** The rate is left to be settled through bilateral negotiations. The UN Commentary suggests a "modest" rate (typically 3% to 4%) to

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prevent excessive taxation, though in practice, countries often push for higher rates (e.g., 10%) in domestic legislation.

- **The Trigger:** The tax is triggered by the *payment*, not by a profit allocation formula. This ensures revenue collection "from the first dollar."

3.2.2. The Scope: "Automated Digital Services" (ADS)

The definition of ADS in Article 12B(4) is both broad and precise. It covers any service provided on the Internet or an electronic network requiring minimal human involvement from the service provider.

Inclusions (The "Digital List"):

The Commentary explicitly includes:

1. Online advertising services.
2. Supply of user data.
3. Online search engines.
4. Online intermediation platforms (marketplaces).
5. Social media platforms.
6. Digital content services (streaming, e-books).
7. Online gaming.
8. Cloud computing services.
9. Standardized online teaching services.

Exclusions: Crucially, Article 12B excludes services that involve significant human intervention or provided through permanent establishment, preventing overreach:

- Customized professional services (like consulting, legal, engineering).
- Customized online teaching (like live tutoring).
- Services providing internet access (like ISPs).
- Online sale of physical goods.

This definition is significantly broader than Pillar One. While Pillar One captures only the ~100 largest MNEs, Article 12B captures **every** foreign

provider of ADS, from a tech giant down to a mid-sized app developer or a niche streaming service.

3.3. The "Net Income" Option: A Unique Safety Valve

A common critique of gross-basis taxes (like India's Equalisation Levy) is that they can tax loss-making companies. If a startup has a 2% profit margin but faces a 10% gross tax, the tax exceeds its total profit.

Article 12B addresses this head-on with a unique innovation in **Paragraph 3**. It grants the foreign taxpayer an **annual option** to be taxed on **net profits** instead of the gross withholding tax.

- **The Mechanism:** If the taxpayer opts for net taxation, the Source State (e.g., India) can tax only the "qualified profits" attributable to the ADS activities in that state.
- **The Formula:** Qualified Profits = Total Revenue from Source State × (Global Profitability Ratio of the ADS segment) × 30%.
- **The Logic:** This acts as a safety valve. Profitable tech giants will likely stick with the simple gross WHT (which acts as a final tax). However, low-margin or loss-making digital businesses can opt for the net basis to avoid excessive taxation. This feature provides the "neutrality" that critics argued unilateral measures lacked.

3.4. Administration: Simplicity as a Strategy

For developing countries, the strongest argument for Article 12B is administrative feasibility.

- **No Complex Audit:** Unlike Pillar One, which requires auditing global consolidated accounts and segmenting business lines (a task requiring immense capacity), Article 12B is a withholding tax. The compliance burden falls primarily on the *local payer* (B2B) or the payment gateway (B2C).
- **Immediate Revenue:** There is no waiting for a global "Amount A" pool to be calculated and distributed 18 months after the fiscal year ends. The tax is collected at the time of payment.
- **Treaty Compatibility:** Article 12B fits seamlessly into the existing bilateral treaty network. Countries can renegotiate specific treaties

(e.g., India-USA) to include it without waiting for a multilateral convention to be ratified by 100+ nations.

3.5. Latest developments

While Article 12B began as a "soft law" recommendation in 2021, the landscape in late 2025 has shifted dramatically. The failure of the OECD to implement Pillar One by its initial deadlines (and continued US resistance) spurred the UN to move from *models* to *conventions*.

3.5.1. The UN Framework Convention on International Tax Cooperation

Following the historic UN General Assembly resolution in late 2023, formal negotiations for a binding UN Framework Convention on International Tax Cooperation began in 2024. By November 2025, the Intergovernmental Negotiating Committee (INC) has held multiple sessions.

3.5.2. The "Early Protocol" on Cross-Border Services

In a significant development for digital taxation, the INC agreed in 2025 to prioritize two "Early Protocols"—binding agreements that countries can sign alongside the main framework.

One of these is the Protocol on Taxation of Income from Cross-Border Services.

- This protocol is essentially Article 12B "on steroids." It seeks to multilateralize the source taxation right for digital and automated services.
- **India's Stance:** India has been a vocal champion of this protocol. Having pioneered the concept with its domestic Equalisation Levy and Section 9(1)(vi) (royalty) expansions, India views this UN Protocol as the legitimate international legal basis for its source-based taxation of the digital economy.

3.5.3. Unilateral Adoption

While treaty updates take time, the spirit of Article 12B has already been adopted in domestic laws across the Global South.

- **Pakistan, Kenya, Nigeria, and Nepal** have introduced Digital Services Taxes or WHTs on digital fees that closely mirror the Article 12B definition.

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- **India** has effectively operationalized this approach through the expansion of "Royalty" (to include software/cloud) and the Equalisation Levy (though EL 2.0 is being phased out for Pillar 1, the underlying policy preference for source taxation remains).

In summary, the UN Approach represents the "Plan B" that is rapidly becoming "Plan A" for the developing world. It offers a simple, broad, and sovereign right to tax the digital economy at source, standing in stark contrast to the OECD's complex, narrow, and residence-weighted Pillar One.

4: Critical Comparison – Complexity vs. Certainty

Having practiced international taxation for nearly four decades, world has witnessed the evolution of the global tax architecture from the relatively stable consensus of the post-war era to the fractured landscape of today. In all that time, we have never encountered a divergence as stark—or as consequential—as the one between the OECD's Pillar One and the UN's Article 12B.

To the uninitiated, this may appear to be a technical dispute between two bureaucracies. It is not. It is a fundamental clash of legal philosophies.

- The **OECD approach** represents the pursuit of **theoretical purity**: a system attempting to achieve perfect neutrality and avoid double taxation through a mechanism of staggering complexity. This requires complex segmentation of business lines, revenue sourcing rules, and dispute resolution mechanisms that override domestic law. Though it tries to be perfectly economically neutral (taxing only "value created" by markets) it creates a compliance nightmare that few tax administrations outside the G7 are equipped to handle.

The **UN approach** represents the pursuit of **pragmatic certainty**: a system of "rough justice" that prioritizes administrability and revenue security over theoretical perfection.

For a developing country like India, the choice between these two is not just about tax policy; it is about the very capability of the state to enforce its sovereign rights. This section provides a critical, comparative analysis of these two models across four key dimensions.

4.1. Nexus: The Illusion of Precision vs. The Reality of Payment

The first and most profound difference lies in how the two systems identify the taxable link (nexus).

The OECD Pillar One: The "Revenue Sourcing" Quagmire

Pillar One abandons physical presence for a new test: Revenue Sourcing. A market jurisdiction gets taxing rights only if the MNE's revenue is "sourced" to that jurisdiction. This sounds simple but is administratively nightmarish.

- **The Challenge:** To apply this, an MNE must trace millions of transactions to the location of the *end user*. For a B2B cloud company selling to a reseller in Ireland who sells to a distributor in Singapore who serves a client in India, "tracing" the revenue to India requires peering through multiple layers of the supply chain.
- **The Data Gap:** MNEs often do not possess this granular end-user data. The Pillar One rules thus rely on a hierarchy of "reliable indicators" and "allocation keys."
- **The Critical Flaw:** From an auditor's perspective, this system is a "black box." An Indian Assessing Officer (AO) cannot independently verify the global revenue sourcing data of a US tech giant. They must rely on the audited data provided by the MNE. This creates a dependency that erodes fiscal sovereignty.

The UN Article 12B: The "Payer Residence" Certainty

In sharp contrast, Article 12B relies on the Residence of the Payer rule (Article 12B(6)).

- **The Rule:** If the person *making the payment* for the digital service is a resident of India (or a PE situated in India), the income arises in India.
- **The Advantage:** This follows the "money trail." The Indian tax authority knows exactly who the Indian payer is (they are the ones claiming the expense deduction). The nexus is established by a verifiable, domestic transaction (the payment), not by an unverifiable global algorithm.

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- **Conclusion:** For developing nations, the UN's "follow the money" approach provides hard certainty. The OECD's "trace the user" approach provides theoretical precision but practical unverifiability.

4.2. Allocation: The "Black Box" vs. the "Top Line"

Once nexus is established, how much tax is paid?

The OECD Pillar One: A Formulaic House of Cards:

The allocation mechanism of Amount A is a marvel of complexity. It requires:

1. **Consolidated Group Accounts:** Starting with financial statements (e.g., US GAAP or IFRS).
2. **Book-to-Tax Adjustments:** Dozens of adjustments to remove items like fines, pension liabilities, etc.
3. **Segmentation:** Breaking down the MNE's profits if it has "out of scope" divisions (e.g., AWS vs. Amazon Retail vs. Amazon Prime vs. Amazon Payments (financial services)).
4. **The Formula:** Applying the 10% routine / 25% residual split.
5. **The MDPSH Offset:** Calculating the Marketing and Distribution Profits Safe Harbour [shortly 'MDPSH'] to reduce the allocation.

Critique: This system creates a "Too Big to Audit" problem. No single tax authority (except perhaps the headquarters jurisdiction) has the capacity to audit this entire chain. For a country like India, the Amount A allocation will effectively be a number handed down from a global panel. If India disagrees with the segmentation or the routine profit calculation, its ability to challenge it is minimal. Furthermore, the allocation is based on *residual* profit. In a year where a tech giant invests heavily or faces a downturn, the "residual" profit may vanish, meaning India gets **zero** revenue, despite billions in local sales.

The UN Article 12B: The "First Dollar" Guarantee

Article 12B allocates taxing rights based on Gross Revenue.

- **The Mechanism:** If an Indian resident pays ₹100 to a foreign digital provider, and the WHT rate is 10%, India collects ₹10 immediately.
- **The Advantage:** This guarantees revenue **"from the first dollar."** It is independent of the MNE's global profitability, its transfer pricing

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structures, or its "residual" calculations. It is immune to base erosion strategies that shift costs to wipe out net profits.

- **The Critique (and Defense):** Critics argue this is "unfair" because it taxes revenue, not profit (a loss-making company still pays tax). This is a valid economic critique. However, Article 12B(3) solves this by offering the **Net Income Option**. If the gross tax is truly unfair, the MNE can *choose* to file a return and pay tax on qualified profits. This shifts the burden of proof to the taxpayer to demonstrate their profitability, rather than forcing the tax authority to disprove it.

4.3. Administration & Disputes: Sovereignty vs. Binding Arbitration

This is perhaps the most politically sensitive dimension.

The OECD Pillar One: The Loss of Audit Sovereignty

To make Pillar One work, the OECD has introduced a mandatory "Tax Certainty Framework."

- **The Mechanism:** Disputes over Amount A will not be settled by Indian courts or Indian AOs. They will be settled by a transnational **Review Panel** and **Determination Panel**.
- **The Implication:** If India believes it has been allocated too little Amount A, it cannot unilaterally raise a demand. It must submit to a binding global process. For a country like India, whose Parliament and Supreme Court have jealously guarded tax sovereignty (as seen in the *Azadi Bachao* and *Vodafone* sagas), submitting to binding international arbitration for corporate tax is a monumental, and perhaps unconstitutional, concession.

The UN Article 12B: Utilizing Existing Infrastructure

Article 12B requires no new global infrastructure.

- **Administration:** It uses the existing withholding tax [WHT] mechanism, which Indian revenue authorities have mastered over 60 years.
- **Disputes:** Disputes are handled through the existing Mutual Agreement Procedure (MAP) under Article 25. While the UN is working on improving dispute resolution, it does not force binding arbitration on

countries that do not want it. It respects the existing administrative and judicial hierarchy of the Source State.

4.4. The "Winner" for Developing Countries: A Revenue Reality Check

From a purely pragmatic standpoint, which system yields more revenue?

Multiple independent studies, including those by the **South Centre** and the **Oxford Centre for Business Taxation** (2021/2024) as referred above, have modelled the outcomes. The results are stark.

- **OECD Pillar One Scenario:** For most developing countries, the revenue from Amount A is minimal. Why? Because:

1. It applies to only ~100 companies.
2. It reallocates only 25% of excess profit.
3. Crucially, it requires the repeal of unilateral taxes (EL/DST).

Result: Many countries would actually lose revenue compared to their current unilateral measures. It is a "negative revenue trade."

- **UN Article 12B Scenario:**

1. It applies to **thousands** of digital companies (no €20bn threshold).
2. It taxes gross revenue at (e.g.) 10%.
3. It creates a broad, stable base.

Result: Even with a conservative WHT rate, Article 12B is projected to generate significantly higher and more stable revenue for developing nations than Pillar One.

Conclusion: The OECD's Pillar One is a masterpiece of diplomatic engineering, designed to save the face of the international tax system and prevent a trade war. But as a tax instrument, it is a "Rolls Royce engine in a go-kart"—over-engineered, fragile, and dependent on a level of global trust and cooperation that simply does not exist.

The UN's Article 12B is a "rugged utility vehicle." It is blunt, simple, and robust. It works in the mud and chaos of real-world tax administration. For a country like India, which has the market power to enforce source taxation

and the administrative fatigue of fighting transfer pricing wars, the UN approach is not just an alternative; it is the far more logical alignment with national interest.

5: India's Strategic Position – The "Dual-Track" Reality

In assessing the future direction of global digital taxation, it is essential to recognise India's distinctive and influential role. India remains the only major economy that has actively engaged with, contributed to, and operationalised elements from both the OECD and UN approaches, positioning it uniquely within the evolving international tax landscape.

For the past decade, India has effectively operated a **"Dual-Track" strategy**:

- **Track 1 (The Diplomatic Track):** Engaging constructively at the **OECD Inclusive Framework** to shape the multilateral consensus (Pillar One/Two), ensuring it recognizes the rights of market jurisdictions.
- **Track 2 (The Domestic/UN Track):** Aggressively implementing unilateral measures (Equalisation Levy, SEP) that mirror the **UN's source-based philosophy**, essentially creating a "Plan B" on the ground while negotiating "Plan A" at the high table.

This Part analyzes this strategic duality. It explores how India has managed to be both a "rule-maker" at the OECD and a "rebel leader" at the UN, and why its domestic laws effectively served as the "beta test" for the UN's Article 12B.

5.1. India at the OECD: The Reluctant Architect

India was not merely a passive rule-taker in the BEPS process. Unlike many developing nations that struggled to have their voices heard, India was a vocal and influential member of the Steering Group of the Inclusive Framework.

5.1.1. Shaping the "Unified Approach"

The very core concept of Pillar One—that "market jurisdictions" (where users are located) deserve a share of the profits—was a victory for India. In the early days of the debate (2018-2019), India, along with the G-24 group,

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aggressively pushed for the "Significant Economic Presence" (SEP) concept to be the basis of the new nexus.

While the final Pillar One rules (Amount A) did not adopt the full SEP model, they conceded the fundamental principle: nexus without physical presence. India can rightly claim credit for forcing the OECD to abandon the century-old "physical presence" dogma.

5.1.2. The Critique from Within

Based on various news items, articles in taxation journals and discussion in various forums, one draws inference that India's support for the final Pillar One package was, at best, grudging. India has consistently articulated three major critiques of the OECD solution, which align closely with the Global South's perspective:

1. **The "Peanuts" Problem (Quantum of Tax):** India has long argued that allocating only **25% of residual profit** (profit above 10%) is insufficient. India advocated for a system of "Fractional Apportionment" that would allocate a share of the *entire* global profit, not just the "super-profit." Under the current formula, if a tech giant has a 15% margin, only 1.25% of its total profit (25% of the 5% excess) is available for redistribution to *all* market countries combined. For a market of 1.4 billion users, this is seen as a pittance.
2. **The Complexity Barrier:** As noted earlier, India has repeatedly flagged the administrative unworkability of the revenue sourcing rules and the dispute resolution panels. India's tax administration, though sophisticated, is already overburdened. The prospect of suspending domestic audits in favour of a binding global panel decision is politically and administratively difficult.
3. **Amount B Disappointment:** India viewed Amount B (fixed returns for marketing and distribution) as a critical tool to reduce transfer pricing litigation. However, the final design of Amount B (released in 2024) was made "optional" for countries, largely due to Indian resistance against a mandatory cap that would limit its ability to tax higher margins for value-added distribution.

Thus, while India signed the "Two-Pillar Solution," it did so as a strategic compromise—a "Grand Bargain" to avoid a trade war with the US—rather than out of ideological conviction.

5.2. India at the UN: The Ideological Home

If the OECD is where India negotiates out of necessity, the UN is where it operates out of conviction. India's domestic tax policy has always been deeply aligned with the UN Model's preference for **Source Taxation**.

5.2.1. Domestic Laws as "Proof of Concept" for Article 12B

It is no coincidence that the UN's Article 12B (Automated Digital Services) looks remarkably similar to India's domestic measures. In many ways, India wrote the playbook that the UN later codified.

- **The Equalisation Levy (EL) vs. Article 12B:**
 - *Similarities:* Both are taxes on **gross consideration** (revenue). Both apply to specific lists of digital services (online ads, e-commerce). Both bypass the PE threshold. Both are collected (mostly) via withholding or reverse charge.
 - *The Connection:* When the UN Committee was drafting Article 12B in 2020-2021, India's successful implementation of the EL (since 2016) served as tangible proof that a gross-basis digital tax was administratively feasible and revenue-generative. India's experience debunked the OECD's warning that such taxes would "break the internet" or stifle investment.
- **Significant Economic Presence (SEP) vs. UN Nexus:**
 - India's domestic SEP rules (Section 9(1)(i)) define nexus based on a revenue threshold (INR 2 crores) or user base (300,000 users). This mirrors the UN's philosophy that *market participation* alone justifies taxation.
 - Leading Indian tax officials (e.g., Mr. Rajat Bansal) were key members of the UN Committee of Experts during the drafting of the 2021 Model. Their inputs ensured that the UN Model reflected the practical realities of tax administration in a large developing economy.

5.2.2. Championing the "Source" Cause

India has consistently used the UN forum to articulate the "demand-side" theory of value creation. India argues that the user is not just a consumer but a factor of production. Data provided by Indian users is the "raw material" for

digital giants. Just as a country taxing the extraction of oil (source taxation) is accepted, India argues it must be allowed to tax the extraction of data at source. The UN Model accepts this logic; the OECD Model (mostly) rejects it in favour of residence taxation.

5.3. The 2024/2025 Pivot: Leading the Global South

The years 2024 and 2025 marked a decisive shift in India's strategy. With the implementation of Pillar One not making much headway (due to US political paralysis) and the Pillar Two (GloBE) rules proving immensely complex, India pivoted strongly towards the UN.

5.3.1. Support for the UN Framework Convention

In late 2023, the UN General Assembly voted by a landslide (led by the African Group) to establish a binding UN Framework Convention on International Tax Cooperation. This was a direct challenge to the OECD's dominance.

- **The Vote:** The vote split the world. The US, UK, and EU voted *against* it. The Global South (Africa, Asia, Latin America) voted *for* it.
- **India's Stance:** India voted **in favour**. This was a critical signal. Despite being a G20 member and a key player at the OECD, India threw its weight behind the UN process. This signalled that India no longer viewed the OECD as the *exclusive* forum for setting global tax rules.

5.3.2. The Strategic Calculus

Why this pivot?

1. **Alternative Policy:** With the US ratification of Pillar One looking increasingly unlikely (requiring a 2/3rds Senate majority), India needs a "Plan B." A binding UN Convention that legalizes source-based digital taxation (like Article 12B) provides international legitimacy for India to keep or expand its domestic levies if Pillar One collapses.
2. **Leadership of the Global South:** As India positions itself as the "Voice of the Global South" (a key theme of its G20 Presidency), supporting the UN tax process aligns with its broader geopolitical goals of reforming multilateral institutions.

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3. **Revenue Security:** India realizes that the "complex certainty" of the OECD may yield less revenue than the "simple certainty" of the UN approach.

5.3.3. The Current Reality

As of late 2025, India is effectively riding two horses.

- It continues to prepare for Pillar Two implementation (likely via the Finance Bill 2026) to ensure it doesn't lose out on "top-up" taxes.
- It has provisionally agreed to withdraw the Equalisation Levy *if* Pillar One comes into force.
- *Simultaneously*, it is a lead negotiator in the UN Convention talks, pushing for a "Protocol on Digital Services" that would take the Article 12B approach to multilateral level.

This "Dual-Track" reality means that for tax professionals in India, the future is not a binary choice between OECD and UN. It will likely be a hybrid ecosystem where Pillar Two applies to the giants and UN-style source rules apply to the rest.

6: The Future – Convergence or Collision?

The international tax landscape is not moving towards the "stable" consensus promised by the OECD in 2021. Instead, it is moving towards a sign of historic collision. The "Great Divergence" between the OECD and UN approaches is no longer just a philosophical debate; it has hardened into a diplomatic and legal standoff.

The future of digital taxation will be determined by two competing timelines: the slow, agonizing closure (or miraculous survival) of the OECD's Pillar One, and the rapid, energetic rise of the UN Framework Convention.

6.1. The UN Framework Convention: From Soft Law to Hard Treaty

The most significant development of the mid-2020s is the formalization of the UN tax process. What began as non-binding "model" provisions (like Article 12B) has evolved into a mandate for a binding international treaty.

6.1.1. The Terms of Reference (ToR)

Following the landmark UN General Assembly resolutions of 2023 and 2024, the Ad Hoc Intergovernmental Committee finalized the Terms of Reference (ToR) for the new UN Framework Convention on International Tax Cooperation in early 2025.

Crucially, the ToR explicitly lists "taxation of the digitalized economy" and "taxation of cross-border services" as priority areas. This signals that the UN Convention will not merely replicate the OECD's work; it will offer an alternative legal basis for taxation, likely grounded in the source-based principles of Article 12B.

6.1.2. The Early Protocols

The UN strategy is to use "Early Protocols" to address urgent issues while the main framework is being negotiated. The proposed Protocol on Digital Services is expected to be a multilateral version of Article 12B.

Impact: If adopted, this Protocol would allow signatory nations (likely the G-77 and China block) to impose withholding taxes on digital services *without* renegotiating thousands of bilateral treaties. It would provide immediate international legal cover for domestic Digital Services Taxes (DSTs).

6.2. The Fate of Pillar One: The "Critical Mass" Problem

While the UN accelerates, the OECD's Pillar One is stalled in a dangerous limbo. The text of the **Multilateral Convention (MLC)** to Implement Amount A is ready, but its entry into force faces a nearly insurmountable hurdle: lack of universal acceptance.

- **The "Critical Mass" Threshold:** The MLC requires ratification by countries representing at least 600 "points" (roughly 60% of the in-scope MNEs' home jurisdictions) to enter into force.
- **The US Veto:** Since the vast majority of in-scope MNEs are US-headquartered, it is mathematically impossible for Pillar One to enter into force without US ratification.
- **The Political Reality:** Ratifying a tax treaty in the US requires a two-thirds majority in the Senate (67 votes). Given the domestic situation, this does not appear easy to be achieved.

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The Scenario of Failure:

If the US does not ratify Pillar One by the agreed deadlines (extended repeatedly through 2025), the "Grand Bargain" collapses.

- The ban on unilateral measures (DSTs/EL) lifts.
- Countries that "paused" their DSTs (like France, UK, Italy) will reactivate them.
- Countries that repealed them (like India, provisionally) will likely reinstate them or pivot fully to the UN Protocol.

6.3. Conclusion: The Era of Fragmentation

We are entering a period of profound uncertainty. The vision of a single, unified global tax system for the digital economy has failed to materialize. Instead, we are moving towards a bifurcated world:

1. **The "Pillar Two" World:** A global success story. The 15% minimum tax (GloBE) will likely become the universal standard, curbing tax competition and ending the "tax haven" model. This is the OECD's enduring legacy.
2. **The "Digital Nexus" Chaos:** A fragmented reality.
 - If Pillar One dies, the **Global North** may take actions to protect its tech giants.
 - The **Global South**, led by India, will coalesce around the **UN Convention and Article 12B**.

The Final Word:

The future of digital taxation in India will likely look less like the complex algebra of Amount A and more like the pragmatic simplicity of a Withholding Tax—authorized by domestic law, legitimized by the UN, and enforced at the source. The "Great Divergence" is not ending; it is just beginning.

References & Further Reading

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Chapter 6

Unilateral Measure and Multilateral Measure on Taxation of Digital Economy

1. Introduction

The existing framework on tax, double taxation and right to tax active income such as business income and passive income i.e. dividend, royalties, fee for technical services, interest, has been dealt with by international bilateral tax treaties.

A rapid evolution of the global economy, particularly the rise of the digital economy, has challenged the relevance of existing tax treaties. Traditional notions of economic presence and the allocation of taxing rights are increasingly inadequate in an era where businesses operate virtually across borders, creating substantial economic value without a physical presence. This shift has enabled companies to generate significant revenue in jurisdictions without being physically present, often resulting in tax base erosion and profit shifting. Consequently, there is a growing global effort to re-evaluate taxing rights to ensure a fair and equitable allocation of tax revenues.

2. Challenges posed by Digital Economy

The rapid evolution of the digital economy has fundamentally reshaped how businesses operate globally. This transformation has exposed significant gaps in traditional international tax frameworks, designed for an era of physical commerce. OECD in its report on BEPS Action Plan 1 has described key challenges posed by the digital economy includes:

2.1. Nexus

- **Traditional View:** Tax systems rely on physical presence to establish a taxable nexus.
- **Digital Disruption:** Businesses can generate significant income in jurisdictions without any physical footprint.

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- **Implication:** Countries struggle to assert taxing rights over digital enterprises operating remotely.

2.2. Data

- **Digital Reality:** Digital companies collect vast amounts of user data, which is monetized and contributes significantly to value creation.
- **Tax Challenge:** The challenge lies in determining how and where this data-driven value should be taxed.

2.3. Characterization of Income

- **Blurred Boundaries:** Digital business models blur the lines between different types of income (e.g., royalties, services, goods).
- **Tax Complexity** This hybrid nature complicates the application of existing tax treaties and domestic laws.

2.4. Cross-Jurisdictional Scale without mass

- **Phenomenon:** Companies can achieve significant market penetration and revenue in a country without physical infrastructure or employees.
- **Tax Implication:** This undermines the relevance of physical presence as a basis for taxation.

2.5. Heavy Reliance on Intangible Assets including IP

- **Core Assets:** Digital firms often depend on intellectual property (IP), algorithms, and brand value.
- **Tax Difficulty:** These assets are mobile and hard to value, making profit attribution complex.

2.6. User Participation

- **User Driven Value:** In some digital models (e.g., social media, online marketplaces), users contribute to value creation.
- **Tax Question:** The role of user-generated content and engagement raises questions about whether users' jurisdictions should have taxing rights.

The OECD in its 2015 report proposed following measures to address the direct tax challenges posed by digital economy

a. Modifications to the Nexus Rule

Significant Economic Presence (SEP): Introduce a new nexus based on digital presence, user base, and revenue generation, even without physical presence

Purpose: Allow countries to tax profits of digital businesses that have a meaningful economic foot print through digital means.

b. Withholding taxes

Expanded Scope: Apply withholding taxes on certain digital transactions such as downloads, streaming or cloud services

Goal: Ensure source countries can collect tax on payments made to foreign digital service providers.

c. Digital equalisation levy

- Concept: Impose a tax on digital transactions or revenues to equalize the tax burden between domestic and foreign digital businesses.
- Example: India later adopted this idea with its own Equalization Levy in 2016.

d. Profit Attribution to Significant Functions

- Focus on Intangibles: Improve methods for attributing profits to jurisdictions where key digital functions (like data collection or user engagement) occur.
- Challenge: Valuing and allocating profits from intangible assets like algorithms and user data.

e. Improved Transfer Pricing Rules

- Action 8–10 Alignment: Strengthen rules to ensure that transfer pricing outcomes align with value creation, especially for intangibles and risk allocation.
- Digital Relevance: Address manipulation of intra-group pricing for digital goods and services.

f. Multilateral Instrument (MLI)

- Framework: Develop a multilateral treaty mechanism to swiftly implement tax treaty changes across jurisdictions.
- Digital Impact: Facilitate coordinated responses to digital tax challenges without renegotiating bilateral treaties.

As tech giants generate substantial revenues across borders without local establishments, countries have sought new ways to claim their fair share of tax. This has led to two competing approaches: **unilateral measures** and **multilateral efforts**.

3. Unilateral Measures

The limitations of existing international tax rules in taxing digital enterprises, combined with slow progress and challenges in achieving consensus on OECD initiatives like BEPS Pillar One, led several countries to adopt unilateral measures.

Unilateral measures are tax policies adopted independently by countries in response to the limitations of existing international tax rules and the slow progress of multilateral reforms. These measures aim to ensure that digital companies pay a fair share of tax in the jurisdictions where they generate significant economic value.

However, there is still a risk of taxing the same income in multiple jurisdictions. This has also led to lack of consistency across countries increases compliance burdens for businesses.

India was the first to do so by introducing the Equalisation Levy in 2016, initially targeting only online digital advertising

Indian's Unilateral Approach

3.1. Equalisation Levy (“EL”)

The CBDT, recognizing the importance of addressing direct tax issues related to e-commerce transactions, constituted a committee to propose an approach to manage these challenges. After evaluating three options outlined in the report, a new nexus based on significant economic presence, a withholding tax on digital transactions, and the Equalisation Levy, the committee observed that the Equalisation Levy presented a simpler solution.

Unlike the first two options, it could be implemented under domestic law without requiring extensive amendments to multiple tax treaties.

While introducing the Equalisation Levy, the Finance Minister of India, in the 2016 Budget speech, provided the rationale as follows: "To tax income accruing to foreign e-commerce companies from India, it is proposed that any person making a payment exceeding ₹1 lakh in a year to a non-resident, who does not have a permanent establishment in India, as consideration for online advertisements, shall withhold tax at 6% of the gross amount paid, as an Equalisation Levy. The levy will apply only to B2B transactions."

Further, memorandum on Financial Bill 2016 provided following rational for introduction of Equalisation Levy

"With the expansion of information and communication technology, the supply and procurement of digital goods and services have undergone exponential expansion everywhere, including India. The digital economy is growing at ten per cent per year, significantly faster than the global economy as a whole.

Currently in the digital domain, business may be conducted without regard to national boundaries and may dissolve the link between an income-producing activity and a specific location. From a certain perspective, business in digital domain doesn't seem to occur in any physical location but instead takes place in the nebulous world of "cyberspace." Persons carrying business in digital domain could be located anywhere in the world. Entrepreneurs across the world have been quick to evolve their business to take advantage of these changes. It has also made it possible for the businesses to conduct themselves in ways that did not exist earlier, and given rise to new business models that rely more on digital and telecommunication network, do not require physical presence, and derives substantial value from data collected and transmitted from such networks.

These new business models have created new tax challenges. The typical direct tax issues relating to e-commerce are the difficulties of characterizing the nature of payment and establishing a nexus or link between a taxable transaction, activity and a taxing jurisdiction, the difficulty of locating the transaction, activity and identifying the taxpayer for income tax purposes. The digital business fundamentally challenges physical presence-based permanent establishment rules. If permanent establishment (PE) principles are to remain effective in the new economy, the fundamental PE components

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developed for the old economy i.e. place of business, location, and permanency must be reconciled with the new digital reality.

The Organization for Economic Co-operation and Development (OECD) has recommended, in Base Erosion and Profit Shifting (BEPS) project under Action Plan 1, several options to tackle the direct tax challenges which include modifying the existing Permanent Establishment (PE) rule to include that where an enterprise engaged in fully de-materialized digital activities would constitute a PE if it maintained a significant digital presence in another country's economy. It further recommended a virtual fixed place of business PE in the concept of PE i.e. creation of a PE when the enterprise maintains a website on a server of another enterprise located in a jurisdiction and carries on business through that website. It also recommended to impose of a final withholding tax on certain payments for digital goods or services provided by a foreign e-commerce provider or imposition of a equalisation levy on consideration for certain digital transactions received by a non-resident from a resident or from a non-resident having permanent establishment in other contracting state.

Considering the potential of new digital economy and the rapidly evolving nature of business operations it is found essential to address the challenges in terms of taxation of such digital transactions as mentioned above. In order to address these challenges, it is proposed to insert a new Chapter titled "Equalisation Levy" in the Finance Bill, to provide for an equalisation levy of 6% of the amount of consideration for specified services received or receivable by a non-resident not having permanent establishment ('PE') in India, from a resident in India who carries out business or profession, or from a non-resident having permanent establishment in India.

Further, in order to reduce burden of small players in the digital domain, it is also provided that no such levy shall be made if the aggregate amount of consideration for specified services received or receivable by a non-resident from a person resident in India or from a non-resident having a permanent establishment in India does not exceed one lakh rupees in any previous year."

Thus, India introduced the Equalisation Levy as a tax separate from the Income-tax Act to avoid issues related to relief under Double Taxation Treaties. Further, to prevent double taxation, an exemption under Section 10

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of the Act is provided for any income arising from specified services on which the Equalisation Levy is chargeable.

Subsequently, the Finance Act, 2020 expanded the scope of the Equalisation Levy, introducing a 2% levy on the amount of consideration received or receivable by an e-commerce operator for e-commerce supplies or services made, provided, or facilitated by it to person resident in India. Further, this expansion in 2020 was introduced at the time of enactment of the bill without referring the same in the budget speech or Finance Bill.

However, the total revenue collection from the Equalisation levy was meagre as compared to the overall tax collection of the country. The year wise collection pursuant to equalisation levy was provided by answer to a unstarred question no. 1332 in Rajya Sabha on 12th February 2021. The answer provided is as under:

(Value in Rs. Crores)		
S.No.	Financial Year	Equalization levy collected
01	2016-17	338.6
02	2017-18	589.4
03	2018-19	938.9
04	2019-20	1,136.5
05	2020-21 (up to 30.01.2021)	1,492.7

(Source: OLTAS)

Although the revenue generated from the Equalisation Levy has been relatively modest compared to overall tax collections, its implementation has been met with significant debate and controversy, particular introduction of Equalisation Levy in 2020 on E-Commerce Operators.

Repealed EL:

The Government of India has phased out the Equalisation Levy in a significant policy shift. Levy @ 2% levy on e-commerce transactions was abolished effective August 1, 2024, and the 6% levy on online advertising

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was discontinued from April 1, 2025. This strategic rollback was driven by several factors:

- **Alignment with OECD/G20 Framework:** India is a key member of the OECD/G20 Inclusive Framework, which has developed a two-pillar solution to address global tax challenges. The abolition of the EL signals India's commitment to implementing this multilateral consensus, particularly Pillar One, which deals with the reallocation of taxing rights.
- **Easing Trade Tensions:** The EL was a source of friction with several countries, notably the United States. The U.S. Trade Representative (USTR) had initiated Section 301 investigations, deeming the tax discriminatory against American tech giants and threatening retaliatory tariffs. Repealing the levy helps mitigate these trade disputes.
- **Reducing Compliance Burden:** The broad and sometimes ambiguous scope of the EL created significant compliance challenges for non-resident companies, particularly regarding the tracking of Indian IP addresses and the nuances of "facilitation" of sales.

3.2. Significant Economic Presence

With the repeal of the EL, the corresponding income exemption under Section 10(50) of the Income Tax Act has also been withdrawn. This paves the way for the taxation of non-residents under the Significant Economic Presence (SEP) provisions.

Introduced in 2018 and fully operationalized in 2021, recognising this paradigm shift in economy due to impact of digitalisation, India introduced the concept of Significant Economic Presence (SEP) into its Income-tax Act. The SEP regime creates a taxable nexus for non-residents in India even without a physical presence. The memorandum explaining provision of the Finance Bill provided following rational for the introduction of concept of SEP:

"The oranges upon the trees in California are not acquired wealth until they are picked, not even at that stage until they are packed, and not even at that stage until they are transported to the place where demand exists and until they are put where the consumer can use them. These stages, upto the point where wealth reached fruition, may be shared in by different territorial authorities." (excerpts from a report on double taxation submitted to League of Nations in early 1920s)

Taxation of business profits on the basis of economic allegiance has always been the underlying basis of existing international taxation rules. Economists gave primacy to the economic allegiance rather than physical location and made it clear that physical presence was important only to the extent it represented the economic location.

Ordinarily, as per the allocation of taxing rules under Article 7 of DTAAs, business profit of an enterprise is taxable in the country in which the taxpayer is a resident. If an enterprise carries on its business in another country through a 'Permanent Establishment' situated therein, such other country may also tax the business profits attributable to the 'Permanent Establishment'. For this purpose, 'Permanent Establishment' means a 'fixed place of business' through which the business of an enterprise is wholly or partly carried out provided that the business activities are not of preparatory or auxiliary in nature and such business activities are not carried out by a dependent agent.

For a long time, nexus based on physical presence was used as a proxy to regular economic allegiance of a non-resident. However, with the advancement in information and communication technology in the last few decades, new business models operating remotely through digital medium have emerged. Under these new business models, the non-resident enterprises interact with customers in another country without having any physical presence in that country resulting in avoidance of taxation in the source country. Therefore, the existing nexus rule based on physical presence do not hold good anymore for taxation of business profits in source country. As a result, the rights of the source country to tax business profits that are derived from its economy is unfairly and unreasonably eroded.

OECD under its BEPS Action Plan 1 addressed the tax challenges in a digital economy wherein it has discussed several options to tackle the direct tax challenges arising in digital businesses. One such option is a new nexus rule based on "significant economic presence". As per the Action Plan 1 Report, a non-resident enterprise would create a taxable presence in a country if it has a significant economic presence in that country on the basis of factors that have a purposeful and sustained interaction with the economy by the aid of technology and other automated tools. It further recommended that revenue factor may be used in combination with the aforesaid factors to determine 'significance economic presence'. The scope of existing provisions of clause

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(i) of sub-section (1) of section 9 is restrictive as it essentially provides for physical presence based nexus rule for taxation of business income of the non-resident in India. Explanation 2 to the said section which defines 'business connection' is also narrow in its scope since it limits the taxability of certain activities or transactions of non-resident to those carried out through a dependent agent. Therefore, emerging business models such as digitized businesses, which do not require physical presence of itself or any agent in India, is not covered within the scope of clause (i) of sub-section (1) of section 9 of the Act.

In view of the above, it is proposed to amend clause (i) of sub-section (1) of section 9 of the Act to provide that 'significant economic presence' in India shall also constitute 'business connection'."

The introduction of the SEP provision through the Finance Act 2018 was further modified in 2020. The 2020 amendment revised the wording in the definition by replacing the phrase "in India" with "with any person in India" and also omitted the words "through digital means." The memorandum explaining the provision was silent on these changes and simply stated that these changes would be effective from AY 2021-22.

Through these amendments the India has introduces two forms of SEPs in the Domestic tax laws. These are

- a. **Transaction based SEP** – i.e. linked based on the thresholds of Transaction in respect of any goods, services or property carried out by a non-resident with any person in India; and
- b. **Activity based SEP** – i.e. linked based on systematic and continuous soliciting of business activities or engaging in interaction with users in India

A non-resident is deemed to have a SEP in India if it meets either of the following conditions:

- a) **Revenue Threshold:** Transactions in respect of any goods, services, or property with any person in India, including the provision of downloading data or software, if the aggregate of payments arising from such transaction(s) during the previous year exceeds ₹2 crore.
- b) **User Threshold:** Systematic and continuous soliciting of business activities or engagement in interaction with 3 lakh or more users in India.

3.3. Implications of the Shift from EL to SEP:

- **Nature of tax:** Business income under the Income Tax Act.
- **Tax Base:** Net income (profits) attributable to Indian operations.
- **Tax Rate:** Corporate tax rate applicable to foreign companies (~40-42%, including surcharge & cess).
- **Treaty Benefits:** Available, subject to DTAA provisions (e.g., if no PE exists under the treaty).
- **Compliance:** Withholding tax (TDS) under Section 195 by the Indian payer on attributable income.

This transition marks a fundamental shift from a simple gross-basis turnover tax to a more complex net-basis income tax. While the tax rate under SEP is significantly higher, it applies to profits, not revenue, which may provide relief to low-margin businesses. However, the challenge now shifts to the robust determination and attribution of profits to the Indian SEP, a notoriously contentious area in international taxation.

3.4. Unilateral Measure by other countries

The OECD/G20 Inclusive Framework on BEPS, established in 2016 after the 2015 BEPS package, aimed to bring together over 110 jurisdictions to implement BEPS measures and address emerging tax challenges, including those posed by the digital economy. However, progress has been slow, with the initial timeline for a final report on the digital economy extended to 2020. However, till date consensus among countries remains elusive, primarily due to disagreements regarding the jurisdiction where value is created and where user bases are concentrated.

According to the Tax Foundation's April 2024 report "Digital Taxation around the world," East and Southeast Asia accounted for over 40% of global internet users in 2020, while generating 22% of information industry value. In contrast, North America, with only 12% of internet users, generated 40% of the value created in the information industries.

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Table 1. The Geographic Mismatch between Users and Digital Value Creation, 2020

Regions	Internet Users (Millions)	Share	Information Industries (Trade-In Value Added in Millions of U.S. Dollars)	Share
North America	433	12%	1,622,124	40%
Europe	607	16%	1,027,223	25%
East and Southeast Asia	1,534	41%	892,787	22%
South and Central America	360	10%	80,527	2%
Other Regions	817	22%	443,686	11%
World	3,751	100%	4,066,347	100%

Note: Information industries include publishing, audiovisual, broadcasting activities, telecommunications, computer programming, consultancy, and information services activities (industry codes: J58_60, J61, J62_63).

North America includes Canada, Mexico, and the United States; Europe includes Iceland, Norway, Switzerland, Russia, the United Kingdom, and the 27 Member States of the European Union; East and Southeast Asia includes Japan, Korea, Brunei, China, Hong Kong, Indonesia, Cambodia, Malaysia, Philippines, Singapore, Thailand, Chinese Taipei, and Vietnam; Other Regions include Australia, Israel, New Zealand, Turkey, India, Morocco, Saudi Arabia, South Africa, and Tunisia.

Source: Our World in Data, "Number of Internet Users by Country," accessed Apr. 10, 2024, <https://ourworldindata.org/grapher/number-of-internet-users-by-country>; and OECD, "Trade in Value Added (TiVA): Principal Indicators," accessed Apr. 10, 2024, https://stats.oecd.org/Index.aspx?DataSetCode=TIVA_2022_C1.

(Source: Tax Foundation's April 2024 report "Digital Taxation around the world")

Due to the slow pace of achieving global consensus on taxing the digital economy, many countries have introduced unilateral measures in their domestic laws to protect their tax base. These measures include Digital Services Taxes (DSTs), Equalisation Levies, Significant Economic Presence (SEP) rules, and withholding taxes on digital transactions. While such steps address immediate revenue concerns, they have led to increased complexity, risks of double taxation, and trade tensions, highlighting the need for a cohesive global solution.

The following table summarizes the unilateral measures adopted by various countries worldwide, excluding those implemented by India.

Effective From	Country	Type	Tax Rate	Scope	Rationale
12-04-2016	Israel	Digital PE	-	"Permanent establishment" exists if economic activities are conducted via the internet with conditions like adapting services to Israeli	Address rapid digital economy expansion.

Unilateral Measure and Multilateral Measure on Taxation ...

				customers and managing customer relations.	
01-01-2017	Taiwan	WHT	-	Payments to foreign providers for online advertisements and e-services (e.g., games, videos, music, and platform services).	-
01-07-2017	Hungary	DST	7.5% / 0%	Certain internet advertising services.	-
01-01-2018	Slovakia	WHT	5%	Payments to foreign digital platforms facilitating transport and lodging services in Slovakia without PE registration.	-
01-07-2018	Pakistan	WHT	5%	Offshore digital services, including online advertising, hosting, content distribution, and online sale facilities.	-
01-01-2019	France	DST	3%	Services enabling targeted advertising, digital intermediation, and user data transmission.	Restore fiscal justice and push for global taxation reforms.

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01-01-2019	Turkey	WHT	15%	Online advertising services.	-
13-05-2019	Malaysia	DST	6%	Digital services provided to Malaysian users.	-
01-01-2020	Austria	DST	5%	Online advertising targeted to Austrian users using IP or geolocation.	Interim solution for taxing digital giants.
01-01-2020	Italy	DST	3%	Revenue from targeted ads, multisided platforms facilitating user interaction, and user data transmission.	Tax revenue from digital multinationals benefiting from Italian users.
01-01-2020	Tunisia	DST	3%	Sale of computer applications and digital services by non-resident companies.	-
03-02-2020	Nigeria	SEP	-	Income exceeding NGN25m from streaming, data services, or goods/services through digital platforms; localised interaction through domain names or pricing in Naira.	-
01-03-	Turkey	DST	7.50%	Gross revenue	-

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2020				from digital advertising, content sales, and platform services.	
31-03-2020	Indonesia	Digital PE	-	Income tax on foreign digital entities with "significant economic presence"; otherwise, an electronic transaction tax applies.	Introduced under COVID-19 measures for economic stability.
01-04-2020	UK	DST	2%	Turnover of firms with worldwide revenues > £500m and > £25m from UK users.	Interim measure until global tax reform.
01-07-2020	Poland	DST	1.50%	Online advertising.	Tax digital giants.
01-01-2021	Kenya	DST	1.50%	Gross income from digital marketplace services.	-
01-01-2021	Paraguay	DST	4.50%	Revenues from foreign digital businesses in Paraguay.	-
16-01-2021	Spain	DST	3%	Targeted advertising, digital intermediation, and user data sales when devices are located in Spain.	Address tax value disconnect caused by digital services.

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17-02-2021	Portugal	DST	4% / 1%	Exhibition levy for ads on video-sharing platforms (4%); annual levy on video-on-demand providers (1%).	-
01-07-2022	Tanzania	DST	2%	Turnover of non-resident digital service providers.	Ensure taxable income from non-residents serving Tanzanian consumers.
17-07-2022	Nepal	DST	2%	Digital services delivered automatically through IT and internet platforms.	Prevent tax erosion via international platforms.
01-07-2023	Pakistan	Digital PE	-	Virtual business presence through online transactions irrespective of physical presence.	-
01-07-2023	Uganda	DST / WHT	5% / 15%	DST on income from digital services; WHT for non-registered entities providing digital services.	Increase tax revenue from digital economy.
01-01-2024	Denmark	DST	2% (3% surcharge)	Revenue from audio-visual media services; 3% surcharge for low investment in	Finance local content production (e.g., movies, series).

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				Danish content.	
01-01-2024	Sierra Leone	DST	1.50%	Turnover from digital/electronic transactions, including marketplaces, subscription media, software, and online betting.	-
01-01-2024	Colombia	DST / WHT	3% / 10%	DST on revenues from systematic interaction with Colombian users; WHT for non-registered digital service providers.	-
01-01-2024	France	Streaming Tax	1.20%	Revenue from streaming services via subscriptions and advertisements.	Fund the Centre national de la musique (CNM).
24-06-2024	Canada	DST	3%	Revenue from online marketplaces, ads, social media, and user data.	Prevent tax base erosion and delays in OECD Pillar 1 solution.
01-07-2024	Tanzania	DST	2%	Revenue from services via digital marketplaces (e.g., web hosting, software, music, films, games).	Tax non-resident suppliers targeting Tanzanian consumers.
01-07-2024	Pakistan	SEP	-	Significant economic presence	-

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				includes transactions exceeding thresholds or continuous digital interactions.	
16-07-2024	Nepal	Digital PE	-	PE exists with significant digital presence or 90+ days of transactions in Nepal involving data/services while maintaining offshore servers.	Prevent tax erosion via international platforms.

3.5. USA's Retaliatory Measure

Following France's adoption of the DST, the United States Trade Representative (USTR) opened a Section 301 investigation to assess whether the French DST unfairly discriminated against U.S. companies, notably tech giants like Google, Amazon, Facebook, and Apple. The investigation concluded that the French DST disproportionately targeted U.S. businesses, prompting the U.S. to threaten retaliatory tariffs on French exports. The scope of the investigation was later expanded to include DSTs imposed by Austria, India, Italy, the United Kingdom, and Canada.

Amid rising trade tensions, a truce was negotiated in October 2021 to align these unilateral measures with the OECD/G20 Inclusive Framework's Pillar One solution. Under the agreement, countries like France, Italy, Spain, and the UK committed to phasing out their DSTs once the Pillar One framework, which reallocates taxing rights for large multinational enterprises, was implemented. In return, the U.S. agreed to suspend retaliatory tariffs during the transitional period.

India also reached an agreement with the U.S., retaining its Equalisation Levy temporarily while committing to align with the global consensus under Pillar One upon its implementation. Similar agreements were reached with other countries that had adopted unilateral measures, highlighting the need

for international cooperation to mitigate trade disputes and establish a uniform approach to taxing the digital economy. In 2024, India has repealed the 2% Equalisation Levy on E-Commerce Operator thought implementation of Pillar One is not in sight in near future.

3.6. Impact of OECD / G20 Pillar One v/s DSTs on USA

Jane G. Gravelle, a Senior Specialist in Economic Policy at the Congressional Research Service (CRS)¹, authored a report titled "The OECD/G20 Pillar 1 and Digital Service Taxes: A Comparison" that analyses the effects of both approaches. The report concludes that Pillar 1 will increase taxes on U.S. firms, partially offset by foreign tax credits, leading to an estimated revenue loss. In contrast, DSTs are likely to be passed on to consumers, thereby primarily affecting the residents of the countries imposing these taxes. A summary of this report is provided verbatim below:

"If Congress chooses not to adopt Pillar 1 of the OECD/G20 proposal to allocate some taxing rights to market countries, digital services taxes (DSTs) will likely continue and proliferate. DSTs are taxes imposed by other countries on the revenue of large firms, and they are alleged to target U.S. multinationals that provide digital products. Adopting Pillar 1 would likely shift the right to tax some profits of these multinationals to market countries, increase U.S. firms' taxes, and lose U.S. revenue, but would reduce the number of DSTs. These two options (i.e., adopting or not adopting Pillar 1) have different economic consequences, which are relevant to this choice. In addition, not adopting Pillar 1 may trigger the imposition of retaliatory tariffs on imports from certain countries imposing DSTs that are currently on hold.

Pillar 1 would allocate 25% of the profits of large multinationals—defined as those with global revenues of \$20 billion or more and profit margins (profits as a percentage of revenue) over 10%—to market countries, referred to as Amount A. Under long-standing international rules as embodied in tax treaties, these profits are currently allocated to the country where the assets are held. Pillar 1 was originally aimed at digital companies that did not have a physical presence in some countries and was based on the argument that users create value. While this allocation rule was being considered by the

¹ CRS serves as nonpartisan shared staff to congressional committees and Members of Congress. It operates solely at the behest of and under the direction of Congress.

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Organisation for Economic Co-operation and Development (OECD), a number of countries enacted DSTs. These taxes vary, but can be imposed on advertising revenues of digital companies, sales in online markets, sales of data, and sales of digital products. Part of the Pillar 1 agreement is the removal of DSTs in certain countries. Other countries that retain or enact DSTs will be disallowed their share of Amount A.

Pillar 1 has since evolved to cover all industries (not just digital firms) with the exception of the financial and extractive industries. Therefore, it is no longer targeted only at digital firms with no physical presence, as first envisioned by the OECD, but is a general move to partial formulary apportionment based on sales, similar to sales taxes imposed by U.S. states. Unlike state formulary apportionment, however, Pillar 1 remains limited to large profitable firms.

Digital services taxes have proliferated. The United States Trade Representative (USTR) conducted studies of DSTs in France, and then subsequently in Austria, India, Italy, Spain, Turkey, and the United Kingdom, and determined that they discriminate against U.S. firms. Retaliatory tariffs were imposed for these countries, but suspended while Pillar 1 was being considered. Canada is now moving forward with a DST, and the USTR has determined its effects are similar to those of the other countries investigated.

Evidence suggests that both Pillar 1 and DSTs fall disproportionately on U.S. firms, which are responsible for between half and two-thirds of Amount A, while accounting for 37% of the profits of the 500 largest global companies. Although CRS was not able to locate a comprehensive study of the U.S. share of DSTs, the USTR analysis identified the focus on U.S. firms. For example, the USTR found that 75% of the French DST on advertising would be paid by two U.S. firms, Alphabet (formerly Google) and Meta (formerly Facebook). In the UK, 90% of the tax was paid by five firms who are likely largely or completely U.S. firms.

There were two justifications for Pillar 1 and for the DSTs that developed. The first was that these companies did not pay their fair share of international taxes. It can be argued, however, that Pillar 2, which applies a global minimum tax of 15%, addresses that issue, and that the issue has also been addressed by the U.S. minimum tax on global intangible low-taxed income, or GILTI. The second reason is the argument that users of digital products create value, which justifies assigning a share of profits to market countries.

This argument could be said to become moot after Pillar 1 was expanded to all firms, but it could also be argued that user value creation was never a valid argument in the first place, as users exchanged their contributions for benefits, such as free search engines.

The economic effects of the two options also differ. Pillar 1 will increase taxes on U.S. firms, which will in part be offset by foreign tax credits, so there is an estimated revenue loss. DSTs will be passed along to consumers and thereby largely fall on the residents of the countries imposing the taxes.”

4. Multilateral Measure

Multilateral measures aim to create a globally coordinated framework to ensure fair and effective taxation of multinational enterprises (MNEs), especially those operating in the digital space. These efforts seek to overcome the limitations of unilateral actions and prevent fragmentation, double taxation, and trade disputes.

The 2015 BEPS Action 1 Report recognized that the digitalization of the economy presented broader tax challenges beyond addressing base erosion and profit shifting (BEPS). These challenges primarily revolve around how to allocate taxing rights on income generated from cross-border activities in the digital age.

To address these challenges, the Task Force on the Digital Economy (TFDE) analysed three options: (i) a new "significant economic presence" test, (ii) a withholding tax on certain digital transactions, and (iii) an equalization levy. However, members of the Inclusive Framework have varying views on how digitalization should impact international tax rules.

Despite these divergences, members agree on the need to maintain a single set of relevant and coherent international tax rules. To this end, the Inclusive Framework is undertaking a comprehensive review of profit allocation and nexus rules to address the impact of digitalization. This work recognizes the limitations of traditional concepts like permanent establishment and the arm's-length principle in the digital age.

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The Inclusive Framework has emphasized several key principles:

- Any new rules should be based on net basis taxation, avoid double taxation, and be as simple as possible.
- Tax certainty and improved dispute prevention and resolution mechanisms are crucial.
- A level playing field must be ensured for all jurisdictions, regardless of size or development level.
- Compliance and administrative burdens should be minimized.

Subsequently, on 8th October 2021, nearly 140 countries from around the world rallied behind a historic overhaul of international corporate tax rules, marking a significant milestone in tax reform. The agreement reflects a collective effort to modernise taxation for the digital era and mitigate global tax competition through a 'two pillar' solution. Under Pillar One, the allocation of taxing rights on corporate profits between countries is being transformed, while Pillar Two establishes a minimum corporate tax floor of 15 % for multinational companies.

OECD's impact assessment of Pillar One and Pillar Two estimates that these measures could increase global corporate income tax (CIT) revenues by about USD 50-80 billion per year. Taking into account the combined effect of these reforms and the US GILTI regime, the total effect could represent USD 60-100 billion per year or up to around 4% of global CIT revenues. The exact gains could differ from these 'ex ante' estimates as they would depend on the final design and parameters of Pillar One and Pillar Two, the extent of their implementation, the nature and scale of reactions by MNEs and governments, and future economic developments.

Further detail on Pillar One and Pillar two has been dealt with in subsequent chapters.

4.1. OECD/G20 Inclusive Framework – Two-Pillar Solution

Pillar One: Reallocation of Profits and Nexus Rules

Objective: Allocate a portion of global profits of large MNEs to market jurisdictions where users and consumers are located.

Scope: Applies to MNEs with global turnover above €750 million and profitability above 10%.

Key Features:

- **Amount A:** New taxing right for market jurisdictions, regardless of physical presence.
- **Amount B:** Simplified fixed return for baseline marketing and distribution activities.
- **Removal of DSTs:** Countries adopting Pillar One must withdraw unilateral digital services taxes.

Pillar Two: Global Minimum Tax

Objective: Ensure large MNEs pay a minimum level of tax (15%) regardless of where they operate.

Key Rules:

- **Income Inclusion Rule (IIR):** Parent entities pay top-up tax if subsidiaries are taxed below minimum.
- **Undertaxed Payments Rule (UTPR):** Denies deductions or requires adjustments for low-taxed income.
- **Subject to Tax Rule (STTR):** Allows source countries to impose withholding tax on certain payments.

4.2. Multilateral Convention (MLC)

Purpose: Implement Pillar One uniformly across jurisdictions.

Mechanism: A single treaty instrument to override bilateral tax treaties and establish new nexus and allocation rules.

Status: Draft released in 2023; adoption expected in phases.

4.3. Benefits of Multilateral Measures

Consistency: Reduces tax uncertainty and compliance costs.

Fairness: Aligns taxing rights with value creation.

Stability: Prevents trade wars and retaliatory tariffs.

Inclusivity: Over 140 jurisdictions involved in the Inclusive Framework.

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- **Comparative Summary**

Feature	Unilateral Measures	Multilateral Measures
Approach	Country-specific	Consensus-based (OECD Inclusive Framework)
Examples	DSTs, SEP rules	Pillar One & Two
Scope	Revenue-based taxation	Profit-based reallocation
Implementation Speed	Immediate	Slow, complex negotiations
Risks	Trade disputes, double taxation	Political delays, enforcement challenges
Goal	Tax digital activity locally	Create a fair, global tax system

4.4. Conclusion

The digital economy's taxation remains a dynamic and contentious issue. While unilateral measures offer quick fixes, they risk global fragmentation. Multilateral cooperation, though slower, promises a more equitable and sustainable solution. Businesses must stay agile, as the landscape continues to evolve.

Taxation of Virtual Digital Asset including Crypto-currencies / Crypto-assets

1. Introduction

The emergence of Virtual Digital Asset ('VDA'), including cryptocurrencies, bitcoin, non-fungible tokens (NFTs), and other digital assets globally is evolution of technology, economic disruption and regulatory adaptation which has marked a significant impact on the global financial system. Cryptocurrencies allow peer-to-peer transactions without the need for banks, reducing costs and increasing speed.

These digital innovations are transforming how value are stored, transferred and even conceptualized, challenging the foundations of traditional financial institutions and regulatory framework. With the integration of digital assets into mainstream finance - through exchange traded funds (ETFs), futures and custody services - the boundaries between traditional and digital markets are becoming increasingly blurred, reshaping financial stability and market dynamics.

VDAs are not just financial instruments but introduce a paradigm shift. These have demanded a rethinking of monetary policy, regulation and economic participation including taxation system. Governments and policymakers across the globe are grappling with the complexities posed by the unique nature of these digital assets. The absence of universally accepted definitions, valuation methods, and compliance mechanisms has led to an inconsistent regulatory framework and tax landscape. These challenges become even harder to tackle because these transactions are often difficult to trace, making it tough to implement and enforce a tax and regulatory policy.

In India, the Reserve Bank of India imposed a banking ban on crypto transactions in April, 2018 which was later overturned by the Supreme Court in March 2020, reviving the industry. The term "virtual Digital Assets" was formally introduced by the Finance Act, 2022 imposing a 30% tax on VDA

gains and 1% TDS on transfers. This marked the first statutory recognition to VDAs, even though they were not granted the status of legal tender.

This chapter aims to explore the taxation of VDAs and cryptocurrencies using a three-pronged approach: (i) providing a high-level overview of the existing tax regime in India, (ii) identifying key issues and shortcomings in this framework, and (iii) offering actionable recommendations / policy reforms to address these challenges.

2. Existing Taxation Framework Surrounding VDAs INCLUDING Crypto-currencies / CRYPTO-ASSETS in India

Recent studies conducted by Nasscom and WazirX project that investments in cryptocurrencies by Indians could reach approximately \$241 million by 2030, driven by the exponential growth observed in the Indian cryptocurrency market in recent years. Notably, India currently holds the distinction of having the highest number of cryptocurrency owners globally, reflecting the increasing adoption of VDAs in the country¹.

The provisions on taxation of VDAs effective on or after April 1, 2022, establish a tax framework as outlined in the Finance Act, 2022.

The Income Tax Act 2025² further refined the framework, classifying VDAs which include any crypto-asset being a digital representation of value that relies on a cryptographically secured distributed ledger or a similar technology. The new law aims to modernize and simplify the tax framework while ensuring transparency and regulatory oversight in the digital asset space.

¹ On 11 September 2024, Reuter reported: India led the way in global adoption of cryptocurrencies for the second straight year as investors braved the country's tough regulatory stance and steep trading taxes, a report, opens new tab from blockchain analytics company Chainalysis showed on Wednesday.

The report, which tracks adoption across four sub-categories in 151 countries, showed India ranked high on usage of centralized exchange and decentralized finance assets from June 2023 to July 2024. [<https://www.reuters.com/technology>; (as accessed in September 2025)]

² The Income Tax Act, 2025 is a landmark overhaul of India's direct tax legislation, replacing the six-decade-old Income Tax Act of 1961. It was passed by Parliament in August 2025 and will come into effect from April 1, 2026.

2.1. Definition of VDA under the Income Tax Act?

An exclusive definition of VDA was introduced under the Income-tax Act, 1961 (the Act 1961), as a new clause (47A) in Section 2, which reads as follows:

“virtual digital asset” means—

- (a) *any information or code or number or token (not being Indian currency or foreign currency), generated through cryptographic means or otherwise, by whatever name called, providing a digital representation of value exchanged with or without consideration, with the promise or representation of having inherent value, or functions as a store of value or a unit of account including its use in any financial transaction or investment, but not limited to investment scheme; and can be transferred, stored or traded electronically;*
- (b) *a non-fungible token or any other token of similar nature, by whatever name called;*
- (c) *any other digital asset, as the Central Government may, by notification in the Official Gazette specify:*

Provided that the Central Government may, by notification in the Official Gazette, exclude any digital asset from the definition of virtual digital asset subject to such conditions as may be specified therein.”

Thus, the term Virtual Digital Asset is broadly defined to include cryptocurrencies, NFTs, and any other VDAs as may be notified by the Central Government. Interestingly, the definition also allows the Central Government to exclude specific digital assets from this classification. For instance, India's first digital currency, the Central Bank Digital Currency (CBDC), has been expressly excluded from the scope of VDAs.

Section 2(111) of the Income Tax Act 2025 (the Act 2025) provides the definition of VDA as under:

(111) *“virtual digital asset” means-*

- (a) *any information or code or number or token (not being Indian currency or foreign currency), generated through cryptographic*

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means or otherwise, called by any name, providing a digital representation of value exchanged with or without consideration, with the promise or representation of having inherent value, or functions as a store of value or a unit of account including its use in any financial transaction or investment, but not limited to investment scheme; and can be transferred, stored or traded electronically;

- (b) a non-fungible token or any other token of similar nature, by whatever name called; (c) any other digital asset, as the Central Government may, by notification, specify;*
- (d) any crypto-asset being a digital representation of value that relies on a cryptographically secured distributed ledger or a similar technology to validate and secure transactions, whether or not such asset is included in sub-clause (a) or (b) or (c), where,— (i) “non-fungible token” means such digital asset as the Central Government may, by notification, specify; (ii) the Central Government may, by notification, exclude any digital asset from this definition, subject to such conditions as specified therein;*

2.2. Legal Provisions Governing Taxation of VDAs in India

The provisions on taxation of VDA was first introduced in the Act 1961, through the Finance Act 2022. The relevant sections surrounding taxation of VDA are listed below:

- Section 2(47A): Defines 'Virtual Digital Asset.'
- Section 115BBH: Governs tax on income generated from transfer of VDAs.
- Section 194S: Covers Tax Deduction at Source (TDS) on transfer of VDAs.
- Section 56(2)(x): Includes VDAs within the definition of 'property' for the purpose of taxation.

Whereas the above provisions are correspondingly covered in the Income Tax Act 2025 (effective from 1st April 2026) which are given herein under:

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- Section 2(111A): Defines 'Virtual Digital Asset.'
- Section 194 : Governs tax on income generated from transfer of VDA.
- Section 393 (Sl. No. 8(vi) of the Table) : Covers Tax Deduction at Source (TDS) on transaction of transfer of VDA with some exception of no TDS at certain limit.
- Section 92(5)(f): Includes VDA within the definition of 'property' for the purpose of taxation.
- Section 285BAA³: Mandatory reporting obligations for crypto-asset transactions.

2.3. Applicable Tax Rates on VDA Transactions

Section 115BBH of the Act, 1961⁴ provides that income generated from transfer of VDAs during the fiscal year 2022-2023 onwards is subject to taxation at a flat rate of 30% (plus applicable surcharge and cess), irrespective of an individual's income slab. Notably, no deductions of any kind are allowed, except for the cost of acquisition—the original amount paid to purchase the digital asset. Expenses such as mining costs, transaction fees, or any other associated costs cannot be deducted from the taxable income. Additionally, the flat rate of 30% is applicable to any gains from trading, selling, or swapping VDA, irrespective of whether the income is treated as capital gains or business income.

2.4. TDS on transfer of VDA Transactions

To ensure better compliance and tracking of VDA transactions, section 194S of the Act, 1961⁵ mandates TDS of 1% tax on payments made for transfer of VDAs. This applies to transactions where the total value exceeds INR 10,000 in a financial year, or INR 50,000 in the case of specified persons⁶. The tax

³ **Section 285BA of the Act 1961** deals with the obligation to furnish statements of financial transactions or reportable accounts. While it's broader in scope, it laid the groundwork for more targeted reporting by Section 285BAA of the Act 2025.

⁴ corresponding Section 194 of the Act 2025

⁵ Corresponding section 393 of the Act 2025 (Sl. No. 8(vi) of the Table)

⁶ "specified person" means a person-

(a) being an individual or a Hindu undivided family, whose total sales, gross receipts or turnover from the business carried on by him or profession exercised by him does not exceed one crore rupees in case of business or fifty lakh rupees in case of profession,

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so deducted is required to be reported using Form 26Q for general taxpayers and Form 26QE for specified persons.

Illustration: Person A purchases a Bitcoin / part thereof for INR 10 Lakh and later sells it for INR 20 Lakh.

- The individual earns a profit of INR 10 Lakh, which is taxed at 30%.
- No deductions are permitted except for the initial investment of INR 10 Lakh.
- Since the transaction value exceeds INR 10,000, 1% TDS is applicable on the transaction and the buyer will be required to deduct INR 10,000.

3. Addressing Key Questions

- *Can an individual offset VDA losses against other income?*

As per Section 115BBH, losses incurred from VDAs cannot be offset against any other source of income. This includes business income, salary, capital gains from other investments, or even gains from VDAs. In other words, each transaction involving VDAs is treated as a standalone taxable event, and the losses are non-adjustable.

- *Are gifts of VDAs taxable?*

VDAs received as gifts are taxable in the hands of the recipient as 'income from other sources' at regular slab rates, if their value exceeds INR 50,000. However, the exceptions stated in sec. 56(2)(x)⁷ are also applicable to gift of VDAs. For instance, VDA received as gifts from relatives will be tax-exempt. Similarly, gifts received during special occasions such as weddings are exempt from tax.

- *How should VDAs be reported in Income Tax Returns (ITR)?*

For the assessment year 2023-24 onwards, the Income Tax Department has introduced a dedicated schedule in the Income Tax Return (ITR) forms for reporting income derived from VDAs. This new schedule, titled "Schedule

during the financial year immediately preceding the financial year in which such virtual digital asset is transferred;

(b) being an individual or a Hindu undivided family, not having any income under the head "Profits and gains of business or profession".

⁷ Section 92(5)(f) of the Act 2025

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VDA", is included in ITR-2 and ITR-3 forms and is designed to allow crypto investors to disclose their income from VDAs on a transaction-wise basis.

- *Can one claim exemption under sec. 54F in respect of any gain on sale of VDAs?*

Section 2(14) of the Act 1961 defines capital assets as "property of any kind" unless specifically excluded. Prior to 2022 this broad definition did not exclude cryptocurrencies. Consequently, gains from their transfer were generally considered as long term capital gains and taxpayer could in some cases claim exemption such as under section 54F by reinvesting the proceeds in a residential property. However, the Finance Act 2022 defined the term "Virtual Digital Asset" (VDA) and formally introduced a special regime under Section 115BBH. This provision levies a flat 30% tax on VDA transfers, prohibits set-off of losses, and disallows exemptions under sections such as 54F. The Finance Act, 2025 has continued with these rules without extending any relief to taxpayers, thereby maintaining the strict tax treatment of VDAs.

- *Is there any mandatory reporting obligation for VDA transactions in India*

Section **285BAA** of the Act 2025, lays down **mandatory reporting obligations** for crypto-asset transactions in India. This is a significant step toward tightening compliance and aligning with global standards like the OECD's **Crypto-Asset Reporting Framework (CARF)** endorsed by the G20.

4. Comparative Analysis of VDA Taxation Frameworks in Key Jurisdictions

This section provides a comparative analysis of the taxation frameworks for VDAs in major jurisdictions, including the United States, India, and the European Union (EU). As the cryptocurrency market continues to grow, governments around the world are developing unique tax frameworks to address the challenges posed by digital assets. Understanding these different approaches helps identify trends, challenges, and opportunities for reform in digital taxation.

4.1. United States of America ('USA')

The USA taxes cryptocurrency as either 'income' or 'capital gains' for tax purposes, following the IRS guidelines. The taxes levied on VDAs are separate for long term capital gains and short term capital gains. While short term capital gains are taxed as per an individual's Income tax bracket (which may be anywhere between 10% to 37%), long term gains may be taxed at a lower rate ranging between 0% to 20%. It is important to note that for NFTs deemed collectibles, there is a higher 28% tax on long-term gains.

4.2. Canada

Canada has emerged as a prominent destination for cryptocurrency mining, largely due to its abundant renewable energy resources and favourable economic environment. The country's vast hydroelectric power capacity, particularly in provinces like Quebec and British Columbia, offers a sustainable and cost-effective energy source for mining operations. This has attracted significant global investment, with billions of dollars flowing into the sector. Notably, the Toronto Stock Exchange (TSX) has seen a substantial number of Exchange-Traded Funds (ETFs) for Ethereum and Bitcoin, reflecting the growing interest and investment in the Canadian cryptocurrency market.

In terms of taxation, Canada treats cryptocurrencies as 'commodities'. Profits from cryptocurrency mining or staking are considered as business income and are subject to income-tax. The Canada Revenue Agency (CRA) requires miners to report their income and expenses related to mining activities. Where the gain on disposal of cryptocurrencies is treated as a Capital Gain, 50% thereof is taxable at the regular Federal and Provincial tax rates, which is advantageous compared to the taxation of other assets.

4.3. European Union ('EU')

The EU's approach to cryptocurrency taxation is decentralized, as individual member states set their own policies. However, there are efforts to standardize crypto taxation across the region. The European Union has introduced major initiatives to regulate and tax cryptocurrencies. The Markets in Crypto-Assets Regulation (MiCA), effective from December 2024, creates a comprehensive framework for issuers, exchanges, custodians, and stablecoins, focusing on licensing and investor protection. Complementing this, the DAC8 [Directive on Administrative Cooperation (tax transparency for

crypto-assets)] Directive⁸, aligned with the OECD's Crypto-Asset Reporting Framework (CARF), requires crypto-asset service providers to collect and share transaction data with tax authorities. Member States must implement DAC8 by December 2025, with reporting effective from 2026. Together, MiCA and DAC8 aim to ensure transparency, reduce tax evasion, and integrate digital assets more securely into Europe's financial system.

Most EU countries, including Germany, France, and Italy, impose capital gains tax on the sale of cryptocurrencies. Cryptocurrency is also generally exempt from VAT in most EU jurisdictions, recognizing them as a means of payment.

In the **Czech Republic**, the taxation of VDAs varies based on the nature of the activity. Profits derived by individual investors from the sale of VDAs are subject to a flat income tax rate of 15%. This rate aligns with the taxation of foreign currency transactions. However, businesses engaged in cryptocurrency activities are taxed at the corporate income tax rate of 19%. This rate applies to profits generated from business operations involving VDAs. Additionally, recent legislative amendments propose tax exemptions for individuals – for instance, income from the transfer of crypto-assets may be exempt from taxation if the holding period exceeds three years. Similarly, individuals are not required to report cryptocurrency transactions if the total annual income from such transactions does not exceed CZK 100,000 (approximately USD 4,200).

Denmark treats gains from VDAs as personal income, subject to the country's progressive tax rates. The bottom-bracket tax rate is 12.01%, applicable after accounting for personal allowances, whereas the top-bracket tax rate is 15% on income exceeding a specified threshold. A recent proposal suggests introducing a tax on unrealized capital gains from cryptocurrency (~42%), effective from January 1, 2026, along with loss-offset mechanisms and improved reporting. This remains under consideration.

Belgium's approach to VDA taxation is more nuanced and forward-looking and depends on the nature of the activity. Gains from the sale of VDAs are generally not taxable unless the activity is deemed 'speculative'. In such cases, capital gains are taxed at a rate of 33%. Individuals or entities

⁸ DAC8 is the eighth amendment of the Directive on Administrative Cooperation in Direct Taxation, focusing on the automatic exchange of information regarding crypto-assets among EU countries to combat tax fraud and evasion.

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engaged in professional trading of VDAs are considered to be conducting a business and are taxed accordingly. The taxation rate for business income ranges from 25% to 50%, depending on the level of income.

Germany encourages long-term, buy-and-hold investments in VDAs by imposing no taxes on cryptocurrencies held by residents for more than 12 months, irrespective of the value. VDAs are classified as private funds rather than legal tender. Corporations are required to pay capital gains taxes on VDAs.

4.4. Andorra

Andorra, with an economy committed to technological innovation, treats VDAs as an intangible fixed asset and has a favourable tax plan for Crypto investors. Capital gains tax is capped at 10% and set off and carry forward of losses is allowed for the next 5 years.

4.5. Australia

In the Australian Federal Budget for 2022-2023, the government clarified that digital currencies, such as Bitcoin, are excluded from 'foreign currency' treatment for tax purposes. This means that individuals and corporations are required to pay capital gains tax on VDAs at regular income tax rates, unless the gains exceed the exemption threshold. For corporations, 50% of the capital gains from VDAs held for more than a year are taxable at the corporate tax rate of 30%. The government permits the offsetting and carrying forward of losses in the case of VDAs.

The other countries which are tax free havens, i.e. UAE, Switzerland, Singapore offer zero capital gains tax for individuals.

As discussed earlier, to summarize, in the Indian context, the taxation of Virtual Digital Assets (VDAs) raises a number of significant concerns. The current framework, introduced through Section 115BBH of the Income-tax Act, imposes a flat tax rate of 30% on income arising from VDA transactions. Unlike most other categories of income, no deductions are permitted for expenses incurred, except for the cost of acquisition. This restrictive approach disregards the genuine costs borne by market participants and results in an inflated effective tax burden.

Further, the regime mandates a 1% tax deducted at source (TDS) on the transfer value of VDAs under Section 194S. While intended as a mechanism

to track transactions, the provision may create liquidity constraints, especially for high-frequency traders and exchanges, as it locks up capital and increases administrative overheads. Compounding this is the prohibition on setting off or carrying forward losses from VDA transactions. Losses from one transaction cannot be adjusted against gains from another, and they cannot be carried forward to future years. The absence of loss recognition runs counter to the principle of taxing “real income” and exposes investors to a disproportionately high liability even when their overall portfolio may be in deficit.

By contrast, several international jurisdictions have adopted more balanced approaches. For example, in the United States, crypto-assets are generally treated as property for tax purposes, and while gains are taxable, losses are also recognized for set-off within the capital gains framework. Similarly, countries within the European Union, under evolving frameworks like DAC8, are moving towards simplified and transparent reporting systems that combine revenue protection with investor clarity. These experiences suggest that taxation of VDAs can be structured in a way that secures revenue while also acknowledging market realities.

To position India as a global leader in VDA investment, a more forward-looking, balanced tax policy, coupled with a robust and well-defined regulatory framework, is essential. Such reforms would not only enhance the legitimacy of VDAs but also create a stable environment to attract investment. As the global landscape continues to evolve, it is imperative that India adopts a more proactive stance to stay competitive and leverage its potential to attract both domestic and international investors.

5. Challenges in Taxing VDA

The taxation of VDAs presents several challenges, particularly in India, where the regulatory landscape is still in its nascent stages. While the Indian government has made strides toward addressing the taxation of VDAs, numerous challenges persist, reflecting the complex and rapidly evolving nature of the cryptocurrency ecosystem. This section explores the key challenges faced in taxing VDAs .

5.1. Lack of Centralised Control and Regulatory Authority

The absence of a central authority and the pseudo-anonymous nature of cryptocurrency transactions make it difficult for tax administrations to track transactions and enforce compliance. This poses significant challenges for tax authorities in identifying taxpayers and their transactions, increasing the risk of tax evasion.

Presently, The Reserve Bank of India (RBI), the Ministry of Finance, and the Securities Exchange Board of India (SEBI) are the regulating authorities for cryptocurrency in India. The Ministry of Finance does play a central role in determining the tax framework for cryptocurrencies. However, the ministry's approach to cryptocurrency regulations appears more focused on mitigating illicit activities rather than fostering and encouraging cryptocurrency investment. This is evident from the introduction of the Travel Rule under the Prevention of Money Laundering Act (PMLA) in 2023, which aims to track and monitor cryptocurrency transactions for potential financial crimes.

SEBI's role remains advisory, but if crypto assets were to be classified as securities, SEBI would assume a major regulatory role in terms of licensing and compliance.

Crypto Bill 2021 (Cryptocurrency and Regulation of Official Digital Currency Bill, 2021) was due to be tabled during the Winter Session, 2021. The government postponed it on the argument that: any legislation on the subject can be effective only with significant international collaboration on evaluation of the risks and benefits and evolution of common taxonomy and standards.”⁹

Although the RBI banned cryptocurrency transactions in 2018, the Supreme Court lifted this ban in March 2020. The bill also proposes the creation of the Digital Currency Board of India (DCBI), which would oversee cryptocurrency regulation, alongside existing authorities like the RBI, the Ministry of Finance, and the Securities and Exchange Board of India (SEBI), each responsible for different regulatory aspects. However, the fate of this bill remains uncertain.

Recently

The Crypto-Systems Oversight, Innovation, and Strategy (COINS) Bill, 2025 introduced on 21st July 2025, has proposed a comprehensive regulatory

⁹ Answer by the Government to an Unstarred Question No. 2039 put in Lok Sabha for answer on 19.12.2022.

framework, including the creation of a specialised regulator called the Crypto Assets Regulatory Authority (CARA), legal protections for non-custodial asset storage, temporary relief for startups, rights for lawful anonymous transfers, and the establishment of strategic Bitcoin and cryptocurrency reserves.

5.2. Uncertainty Regarding Characterisation of VDAs

One of the foremost challenges in taxing VDAs in India is the ongoing regulatory uncertainty. The Indian government has yet to establish a comprehensive framework that clearly defines the legal status of VDAs, which complicates tax administration. Cryptocurrencies are currently treated as assets, but their tax treatment remains ambiguous, particularly with regard to how they should be classified—whether as commodities, currency, or property.

While most countries consider cryptocurrency as a form of property for tax purposes, there is still a lack of consensus on their categorisation, with some countries treating them as intangible assets, commodities, or financial instruments. This lack of clarity creates inconsistencies in tax treatment and regulatory interpretation across jurisdictions.

The majority of countries that have analysed the issue classify virtual currencies as 'intangible assets'. This is because they are non-physical assets that can be separated and transferred individually. Major accounting firms also propose classifying virtual currencies as 'intangible assets other than goodwill'. The International Financial Reporting Interpretations Committee (IFRIC) notes that virtual currencies meet the definition of an intangible asset as an 'identifiable non-monetary asset without physical substance'.

This lack of a common definition means that regulators and international standard-setting bodies tend to use their own terminology and definitions, resulting in different tax implications and regulatory interpretations across jurisdictions. This is further complicated by the fact that some countries have not yet issued guidance on how cryptocurrencies are classified.

5.3. Lack of Comprehensive Guidance

Many jurisdictions lack comprehensive guidance or legal frameworks for the tax treatment of VDAs and cryptocurrencies, resulting in inconsistent application of tax laws and creating uncertainty for taxpayers. The absence

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of a uniform approach across countries results in different classifications of assets and different tax implications.

As cryptocurrencies transcend national borders, the issue of jurisdictional taxation becomes increasingly complex. Many cryptocurrency investors in India engage in cross-border transactions, either through foreign exchanges or decentralized platforms.

High tax rates and the absence of a clear regulatory framework in India have led many investors to seek more favorable tax jurisdictions abroad. Countries like Singapore, Switzerland, and Portugal have established clearer and more investor-friendly taxation policies, which attract significant cryptocurrency investments from India.

Investors with exposure to foreign cryptocurrency markets also face the possibility of double taxation. While India has agreements to avoid double taxation with certain countries, the lack of clarity in crypto-related taxation could lead to complications in tax filing and the potential for double taxation on cryptocurrency income earned abroad.

5.4. Divergence in approach for taxation

VDA are possessed or held virtually and are international. Any crypto currency minted in one country can be traded in India and stored in wallet in another country. There is a challenge of cross border taxation, double taxation agreements and varied regulatory framework globally.

It is advisable to consider improvements for India's VDA tax regime and few suggestions are given below:

- Adopt a capital gains model similar to global standards i.e. long term and short term gains); Encourage long term holding and reduce speculative trading;
- Allow loss adjustments including related cost e.g. Expenses such as mining costs, transaction fees, or any other associated costs;
- To lower rate from 1% to 0.01%;
- To introduce lower threshold limits for 1% TDS;
- Consensus on characteristics of Income for taxation of VDA for cross border/DTAA;

- Clarity of VDA Characterisation will pave way for correct stance and applicable tax under GST Law

The countries like Singapore, UAE, Switzerland have zero capital gains tax and less regulated, which attracts investments into these countries. The Government of India should look for VDA as opportunity in potential of VDA in digital commerce, fintech etc.

5.5. Technological and Administrative Challenges

The increasing complexity of blockchain technology and the rapid evolution of cryptocurrency-related financial products present unique challenges for tax authorities in India. The decentralized nature of cryptocurrencies makes it difficult for the Indian tax authorities to monitor transactions and enforce compliance effectively.

Cryptocurrency transactions, especially those conducted through decentralized exchanges (DEXs) or peer-to-peer (P2P) networks, are inherently more difficult to track than traditional financial transactions. As a result, many investors may evade tax obligations, leading to a significant loss of potential revenue for the government.

The highly volatile nature of digital currencies poses significant challenges in determining their value for tax purposes. Fluctuations in value over short time frames, coupled with the lack of a uniform exchange rate, complicate the determination of taxable gains and losses. The lack of clear guidance on valuation methods further increases these difficulties.

Taxpayers may struggle to keep precise records of purchase and disposal prices over time, making it difficult to declare this information to the tax authorities through their tax returns. This is because it involves maintaining complex records of monetary flows and transaction dates and the lack of a clear translation into fiat currency in some cases can also complicate record-keeping. Due to this ambiguity, there is a serious risk that a substantial volume of transactions remains unreported.

The rapid evolution of technology also presents ongoing compliance challenges. New technologies and changes in mechanisms, may require reassessment of existing guidance. The tax implications of new types of virtual currencies, such as stablecoins, also need to be taken into account.

The lack of specialized knowledge and infrastructure to address the nuances of cryptocurrency taxation poses serious challenges. A significant investment in training, technology, and personnel is necessary to address the unique issues posed by VDAs and cryptocurrencies.

6. The Way Forward

In conclusion, India faces significant challenges in taxing VDAs and cryptocurrencies. These challenges stem from regulatory uncertainty, high tax rates, the absence of a cohesive legal framework, and the technical complexities associated with blockchain technology. For India to fully leverage its potential as a global hub for cryptocurrency investment and innovation, it is essential that the government implements a more progressive, clear, and investor-friendly tax regime. Only then will India be able to tap into the full potential of the cryptocurrency market, fostering both domestic and international investment.

Furthermore, the Government of India must recalibrate its approach to the application, acceptance, and regulation of VDAs in alignment with international standards. Corporate taxes play a crucial role in attracting investment, and the tax treatment of VDAs should not hinder the growth of this emerging sector. As VDAs transcend national borders and are rapidly gaining global acceptance, the current tax regime risks stifling the domestic market and curbing the vast potential of Indian investors.

A pragmatic way forward involves implementing a progressive tax structure with differentiated rates for short-term and long-term capital gains. India's current imposition of a TDS on VDA transactions is unique and acts as a significant deterrent to investors. If the TDS is meant to track transactions, a reduced rate, such as 0.01%, would suffice. Additionally, the complete prohibition on the set-off of losses is an overly stringent measure that undermines India's competitiveness in the VDA ecosystem.

To foster innovation and investment, India should closely monitor international developments in the area of policy, in general, and taxation policy in particular to ensure that India remains competitive. Albeit, these have to be done along with protection of revenue and fundamental fiscal mechanisms of the country.

