India needs an overhaul of its tax treaty policy

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Globally, countries are making a concerted effort to rein in the direct tax challenges posed by the digital economy. Some of this work is directly inspired by the recommendations set out by the OECD as part of its 15-point Action Plan to tackle base erosion and profit shifting.
The Indian government, too, introduced two key changes to its income tax regime to ensure that multinational corporations operating in the digital sector can no longer exploit the current international tax rules based on the traditional principles of 'source' and 'residence'.

First, India put in place a new tax nexus based on significant economic presence in section 9 of the Income Tax Act to enable taxation of business profits of foreign enterprises, regardless of whether the foreign enterprise has a physical or representative presence in India or not.

Second, a six percent equalization levy is in place to tax advertisement-related payments earned by digital companies from Indian advertising business.

In both cases, the idea is to bring foreign digital companies under the Indian tax net without the requirement for a physical place of business in India.

Measures such as the equalization levy are supposed to be temporary, interim measures to address tax challenges posed by the digital economy until a global consensus is reached. The OECD is currently working on a proposal and a final report in this area is due.

Pertinently, equalization levy could be bypassed in many ways, for instance, by establishing an Indian distributor and routing payments through that distributor.

And so far as the new tax nexus based on significant economic presence is concerned, the change means nothing unless it reflects in tax treaties. This is given that the Income Tax Act allows taxpayers to choose to apply the tax treaty if it is more beneficial to the taxpayer.

India's tax treaties generally restrict India's right to tax business profits of foreign businesses in the absence of a permanent establishment. The treaty definition of permanent establishment is so vague that a large number of treaty disputes revolve around this definition.

While India does incorporate the UN-recommended service permanent establishment article to tax services provided by foreign businesses, the way the article is drafted makes it prone to abuse.

For instance, for India to tax the income, the service provider has to come to India and stay in India for a stipulated period of time. This not only excludes those who provide services from abroad through digital means but also those who do not stay longer than the stipulated period of time.

What India needs, therefore, is a complete overhaul of its tax treaty policy. The concept of permanent establishment needs to be expanded. It is high time that India incorporates a digital nexus in its tax treaties to tax foreign businesses.

Perhaps, India should consider doing away with the concept of permanent establishment from tax treaties. A flat rate of tax would reap much better and consistent benefits in terms of tax revenues and would also provide certainty to foreign investors and reduce treaty disputes.

Any potential change to India's tax treaties is viewed as an inroad to foreign direct investment. This is far from true. There is no conclusive evidence to show that tax treaties stimulate inward investment into developing countries. On the contrary, there are studies to suggest that tax treaties have no direct, significant impact on foreign investment.

China, for instance, has started to pose a threat to the dominance of the OECD as the world tax organization and has begun to take a contrarian stand. China's rise as a powerful nation provides it a place where it can deviate from OECD norms and instead create a system that furthers the country's own interests.

India is well placed to follow the China example. India's working-age population will reach a billion plus in 2040s. Indian people want to spend more, and spend lavishly, and prefer foreign brands as well as services. With the government's push for its 'Make in India' scheme, manufacturing will be on the rise and Indian manufactured goods would be sold in foreign markets.

India would likely have an upper hand in the negotiations because companies would strive to get access to the Indian market and the fear of losing foreign investment or facing trade sanctions from foreign governments is completely misplaced.

The rules of international tax law that India follows today date back to the 1920s and were written by a closed group of developed countries part of the OECD club. As capital exporting nations, these countries wanted their investors to pay as little tax as possible in capital importing countries. Not surprisingly, an international tax system was developed that catered mostly to the rights and interests of developed countries and at the cost of developing countries.

The original residence and source rule, and subsequently the arm's length principle, suited the interests of developed countries. Developing countries were to either comply with the rules developed by the OECD or face trade and other sanctions.

There is no denying the fact that the international tax system has failed to keep pace with the changing dynamics of business and rapid digitalization. International tax law primarily governed by tax treaties entered into between two sovereign jurisdictions, are intended to avoid double taxation and provide certainty. India should drastically renegotiate its tax treaties and protect its tax base without compromising the underlying objectives of a tax treaty.