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The Taxation Method in Terms of the Digital Economy

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Abstract

Because of advancements in technology in recent years, the digital economy has experienced phenomenal expansion. Despite this, digital taxes have emerged as a serious worry, resulting in losses that amount to millions of dollars due to the PE rule for the usual tax rules. This article will delve deeper into the logic behind digital tax and common solutions to tackle this issue.

Keywords: digital tax, digital economy, international tax method

The digital economy has grown dramatically in recent years due to technological advancements. However, tax issues have become a significant concern as a result of the growth of digital sales, resulting in millions of dollars in losses.

The majority of digital market transactions involve intangible assets. Tax issues come from intangible assets such as data, the value of which is difficult to quantify when compared to physical items. For example, determining the tax income created by overseas advertising is difficult because no tangible commodities are produced throughout this process. Revenue authorities may have difficulty determining the location of chargeable advertising.

Additionally, the growth of e-payments has diversified the payment mechanism without physical presence, making it difficult for tax jurisdictions to classify this transaction. While traditional overseas sales require the collection of tariffs and the completion of royalty forms, internet purchases do not require customs clearance because they are transferred directly from the source to the consumer. As a result, enforcing VAT on online sales is rather difficult.

International company tax rules as they currently exist do not respond to the reality of the new global economy. The Internet enables businesses to supply markets and earn virtual profits without establishing a legal or physical presence on a local level. Bilateral tax treaties are founded on this notion to avoid double taxation in the global economy. As a result, the source country retains the ability to tax net income and collect withholding taxes. The resident nation may tax the payment with an obligation to offset double taxation through tax credits or exemptions in the source country. International tax law is silent on how corporations can benefit from another country's digital services without establishing a physical presence. Under the existing global tax regime, international enterprises without PE cannot apply taxes on their business profits.

Multinational enterprises (MNEs) frequently seek to lower their group's tax burden through aggressive tax planning that takes advantage of tax loopholes and mismatches in tax rules. They reallocate profits to avoid taxation or tax-free or low-tax nations with little business substance. These are known as Base Erosion and Profit Shifting (BEPS).

Transfer pricing is a widely utilized technique by multinational corporations and their subsidiaries to allocate profits to tax havens, particularly for intangible assets. Their digital products, like patents or intellectual property, are registered in low-tax jurisdictions to offset the group's tax liability. According to a survey conducted by the European Commission, international organizations pay 3.5 percent less in taxes than domestic businesses. Additionally, SMEs are disproportionately harmed because they pay a higher tax rate than large firms, resulting in unfair competition and a decline in tax income.

Certain technological companies frequently employ the Double Irish method to transfer their intangible assets to achieve double taxation and avoid withholding tax. For instance, Google has transferred over $75.4 billion in profits to take advantage of tax breaks. Ireland's government permits businesses to incorporate while maintaining their tax domicile in another country. This means that Google can store its intellectual property patents in companies physically located in the republic but not considered registered there. Google has chosen to establish an infinite number of businesses in Bermuda to avoid paying the US tax of 35%. BEPS can quickly result in monopolistic scenarios that are detrimental to innovative variety.

To address the concerns raised previously, possible solutions to the digital taxation conundrum are below.

In terms of laws, the 2015 final report placed a premium on the digital economy in terms of OECD action, identifying four BEPS solutions. For instance, it addresses the exceptions in the definition of the permanent establishment (PE) identity. New restrictions have been enacted to eliminate false agreements or arrangements that permit a company to conduct its core business in another country, such as selling goods and services, without establishing a permanent presence. For transfer pricing, the OECD/G20 BEPS initiative suggests revising its transfer pricing principles, but so far makes no mention of preventing transfers from abusing ex-ante pricing.

While international consensus on new taxing regulations has taken a long time to establish, numerous nations have enacted or proposed enacting a Digital Services Tax (DST). These rules include expanding what defines a permanent establishment to include digital businesses that do not have a physical presence in a jurisdiction, based on specified criteria such as involvement with local markets. However, there are particular implementation concerns. There are numerous disagreements on the scope of DST; it is unclear if just primary user data should be charged or whether any digital interaction should be considered. Different countries have varying definitions of tax bases, which can easily result in tax conflict.

Additionally, under the DST policy, double taxation must be resolved. Numerous governments choose DST as a transition policy prior to concluding international agreements. For example, Australia would impose a 5% tax on advertising, but the repeal of the DST would be conditional on the implementation of Pillar 1.

Under international tax law, a transitional phase exists between taxes based on the Arm's Length Principle and taxation based on formulary allocation. The OECD/G20 Inclusive Framework supports Pillar One. It proposes reallocating global non-routine revenues to market countries regardless of the existence of a PE. Pillar One grants market jurisdictions taxing authority over a portion of the residual profits made by MNE groups with a global annual revenue exceeding €20 billion and a profit margin of 10%.

Altering the laws governing nexus and profit allocation for corporations is the primary focus of the first pillar, which seeks to modernize the international tax system to accommodate the new economic paradigm. This necessitates expanding the taxing authority of market jurisdictions in which the corporation actively and regularly participates in the economy in order to accomplish this goal. The first pillar applies to all multinational corporations that have a gross revenue of more than € 20 billion. An adjusted Profit Before Tax (PBT) measure will be used to determine the tax base, and the consolidated financial statements will be reviewed to determine whether or not the business is eligible to submit a Pillar one application. Earnings made by multinational corporations can be broken down into two main categories: normal profits and residual profits. It is estimated that between 20 and 30 percent of the earnings from residuals are regarded to be amount A. In order to prevent double taxation, this amount will be distributed to the various market jurisdictions using a revenue-based allocation approach. The Pillar tax that was applied to digital services will be eliminated in stages. In the context of international tax law, there is a period of time that can be thought of as a transitional phase between taxation that is based on the Arm's Length Principle and taxation that is based on formulaic allocation.

Pillar two is composed of two overlapping domestic rules (Global anti-Base Erosion rules = GloBE rules) and a treaty-based rule aimed at mitigating base erosion caused by deductible intra-group payments.

According to BEPS Action 13, the requirements of GloBE will be applicable to multinational corporations that have annual revenues of more than 750 million euros. The purpose of the adoption of the Income Inclusion Rule (IIR) is to levy an additional tax on a parent company based on the low-taxed income of a component firm. This additional tax is subject to the split-ownership rule's shareholdings of less than 80 percent. When referring to the practice of restricting reductions or demanding an equivalent adjustment to the amount that a component entity's low-tax income is not taxed in accordance with an IIR, the term "UTPR" is used to describe the process. Both the Internal Revenue Rate (IIR) and the Unified Tax Rate (UTPR) will have a minimum tax rate of 15%. One of the regulations that are based on treaties is called the Subject to Tax Rule (STTR). This rule allows source jurisdictions to impose restricted source taxes on some connected payments that are already subject to tax at a rate that is lower than a specified minimum, which is currently 9 percent.

In terms of VAT, we need to consider two prominent situations. The reverse charge procedure should be used, under which the recipient business is responsible for VAT in the B2B situation. Commonly, the beneficiary is a firm or an individual who is not VAT registered for online business-to-consumer transactions. The foreign supplier must register for and impose VAT on paying the country of the final consumers. Global cooperation and the actual execution of such laws and principles are the remaining impediments in the digital economy.

In general, numerous efforts have been undertaken to address the tax charge concerns posed by digitalization. Pillar one was established to facilitate cross-border transactions without permanent establishments. Pillar two has successfully explored how to prevent the transfer of intangible assets to tax havens to achieve tax avoidance. There are specific mechanisms to levy VAT via internet transactions, such as the reverse charge scheme for B2B transactions and imposing foreign suppliers to pay the VAT during the B2C process.

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