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Prasanna S,

Chairman of Institute of Legal Education

No. 08, Arul Nagar, Seera Thoppu,

Maudhanda Kurichi, Srirangam,

Tiruchirappalli – 620102

Phone : +91 94896 71437 – info@iledu.in / Chairman@iledu.in



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DIGITAL ECONOMY AND TAXATION

AUTHOR – YATIN BANSAL, STUDENT AT AMITY LAW SCHOOL

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ABSTRACT

The rapid expansion of the digital economy has fundamentally altered global commerce, challenging traditional taxation frameworks that rely on physical presence and source-based taxation. Digital businesses, including multinational technology firms, operate across multiple jurisdictions without a significant physical footprint, making it difficult for tax authorities to allocate taxing rights effectively¹⁰⁷³. As a result, international tax laws have struggled to adapt to new business models, leading to concerns over tax avoidance, base erosion, and profit shifting (BEPS). In response, global institutions such as the Organisation for Economic Co-operation and Development (OECD) and the United Nations (UN) have introduced various initiatives, including the OECD's two-pillar solution, to address the challenges of taxing the digital economy¹⁰⁷⁴.

The OECD's two-pillar approach aims to establish new profit allocation rules and a global minimum tax rate, ensuring a more equitable distribution of tax revenues among jurisdictions. However, the implementation of digital services taxes (DSTs) by individual nations has sparked tensions, particularly between developed and developing economies, due to concerns over trade retaliation and compliance burdens¹⁰⁷⁵. Developing countries argue that current global tax reforms disproportionately benefit wealthier nations, limiting their ability to tax digital transactions effectively. As the digital economy continues to evolve, achieving a consensus on international taxation remains a complex yet critical task for ensuring tax fairness and economic stability¹⁰⁷⁶.

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¹⁰⁷³ OECD "Addressing the Tax Challenges Arising from the Digitalisation of the Economy", 2021

¹⁰⁷⁴ United Nations "Taxation of the Digital Economy: Options for Developing Countries", 2022

¹⁰⁷⁵ IMF "Corporate Taxation in the Global Digital Economy", 2020

¹⁰⁷⁶ European Commission "Digital Taxation in the EU: Policy Proposals and Challenges", 2021.

INTRODUCTION

The digital economy has reshaped global commerce, enabling businesses to operate beyond traditional borders without requiring a physical presence. Digital platforms, e-commerce, and data-driven services have grown exponentially, challenging the conventional tax systems designed for brick-and-mortar establishments. The reliance on intangible assets, user-generated value, and cross-border transactions complicates the allocation of taxing rights among jurisdictions. As a result, many countries have faced difficulties in ensuring that multinational enterprises (MNEs) pay their fair share of taxes¹⁰⁷⁷.

Historically, international tax law has been based on principles such as permanent establishment (PE) and source-based taxation, which grant tax rights to countries where businesses maintain a physical presence. However, digital businesses can generate substantial revenues from users in a country without a physical footprint, allowing them to shift profits to low-tax jurisdictions. This has led to concerns over base erosion and profit shifting (BEPS), where MNEs exploit tax loopholes to minimize their liabilities¹⁰⁷⁸. Governments and international organizations have recognized the need to reform tax laws to address these challenges and ensure fair taxation in the digital economy.

The Organisation for Economic Co-operation and Development (OECD) has played a central role in global tax reforms, particularly through its Base Erosion and Profit Shifting (BEPS) initiative. The OECD's two-pillar solution aims to redistribute taxing rights and establish a global minimum corporate tax rate to prevent profit shifting. Under Pillar One, market jurisdictions where significant revenue is generated would have the right to tax a portion of an MNE's profits, even if the company lacks a physical presence. Pillar Two introduces a 15% global

minimum tax to curb tax competition and reduce incentives for profit shifting¹⁰⁷⁹.

In parallel, some countries have implemented unilateral measures, such as Digital Services Taxes (DSTs), to tax revenues generated by digital activities like online advertising and data monetization. However, DSTs have sparked controversy, with some nations, particularly the United States, viewing them as discriminatory against their tech giants. The European Union and other regions have also explored comprehensive digital tax frameworks, further complicating the global tax landscape. The lack of consensus on digital taxation has led to trade tensions and legal disputes, highlighting the urgency of international cooperation¹⁰⁸⁰.

Developing countries face unique challenges in taxing the digital economy. Many of these nations are heavily reliant on corporate income tax, yet they struggle to tax digital transactions effectively due to limitations in legal frameworks and enforcement mechanisms. While the OECD's proposals offer a structured approach to digital taxation, some critics argue that they favour developed economies and do not adequately address the needs of emerging markets. The United Nations has proposed alternative frameworks to ensure a more equitable distribution of tax revenues to developing nations¹⁰⁸¹.

As the digital economy continues to evolve, international tax policy must adapt to new technological and business developments. Ensuring tax fairness while fostering innovation and economic growth remains a complex challenge¹⁰⁸². Governments must collaborate through multilateral agreements to develop sustainable taxation models that account for the realities of digital commerce. Achieving a global consensus on digital taxation will require balancing the interests of developed and

¹⁰⁷⁹ OECD, *Two-Pillar Solution to Address the Tax Challenges Arising from Digitalisation*, 2021

¹⁰⁸⁰ European Commission, *Digital Taxation in the EU: Policy Proposals and Challenges*, 2021

¹⁰⁸¹ United Nations, *Taxation of the Digital Economy: Options for Developing Countries*, 2022

¹⁰⁸² IMF, *Tax Policy for the Digitalizing Economy: Issues and Options*, 2020

¹⁰⁷⁷ Supra Note No 3

¹⁰⁷⁸ OECD, *Model Tax Convention on Income and Capital*, 2017

developing economies while minimizing tax disputes and trade conflicts.

Challenges in Taxing the Digital Economy

The rapid expansion of the digital economy has created significant challenges for international taxation, as traditional tax rules struggle to accommodate new business models. Digital firms, particularly multinational technology companies, can operate in multiple jurisdictions without a physical presence, making it difficult for tax authorities to assess and collect corporate taxes effectively. The reliance on outdated tax principles, such as permanent establishment (PE) and source-based taxation, has led to tax base erosion, profit shifting, and disputes among nations over the allocation of taxing rights¹⁰⁸³.

1. Lack of Physical Presence and Permanent Establishment Rules

A fundamental challenge in taxing digital businesses is the reliance on permanent establishment (PE) rules, which traditionally require a business to have a physical presence in a country before being subject to taxation. Digital companies, however, can generate substantial revenues from consumers in a jurisdiction without maintaining a local office, warehouse, or personnel. This creates an opportunity for companies to operate in high-tax countries while declaring profits in low-tax jurisdictions, reducing their overall tax liabilities¹⁰⁸⁴. Many countries argue that existing PE definitions must be revised to reflect digital value creation, but achieving a global consensus remains difficult.

2. Profit Shifting and Base Erosion

The digital economy has enabled multinational enterprises (MNEs) to shift profits strategically to low-tax jurisdictions through practices such as transfer pricing and intellectual property (IP) licensing. By locating intangible assets in tax havens, companies can report minimal taxable income in countries where they generate

significant revenue. According to the OECD, base erosion and profit shifting (BEPS) activities cost governments between \$100 billion and \$240 billion annually in lost tax revenues¹⁰⁸⁵. This has intensified calls for global tax reforms to prevent corporate tax avoidance and ensure that profits are taxed where economic activity occurs.

3. Challenges in Defining and Allocating Value Creation

A major point of contention in digital taxation is determining where value is created and how profits should be allocated among jurisdictions. Unlike traditional industries, where value creation is linked to physical production and sales, digital businesses derive value from user engagement, data collection, and platform interactions. Some countries argue that users contribute to a company's value by providing data and participating in digital networks, justifying a tax based on digital activity within their borders¹⁰⁸⁶. However, this approach challenges conventional tax principles, creating legal and administrative complexities.

4. Unilateral Digital Services Taxes (DSTs) and Trade Disputes

Due to the slow progress in international tax negotiations, several countries have implemented unilateral Digital Services Taxes (DSTs) to tax revenues from online activities such as digital advertising, e-commerce platforms, and data-driven services. While DSTs are seen as a temporary solution to capture tax revenues from digital giants, they have sparked trade disputes, particularly between the United States and European nations. The U.S. government has argued that DSTs disproportionately target American technology firms, leading to threats of retaliatory tariffs and further complicating multilateral tax negotiations¹⁰⁸⁷.

¹⁰⁸³ Supra Note No 3

¹⁰⁸⁴ G. Zucman, "The Hidden Wealth of Nations: The Scourge of Tax Havens", 2018

¹⁰⁸⁵ OECD, "Base Erosion and Profit Shifting (BEPS) Final Reports", 2021

¹⁰⁸⁶ Supra Note No 8

¹⁰⁸⁷ Supra Note No 9

5. Compliance and Administrative Challenges

Taxing the digital economy presents significant compliance and enforcement challenges, particularly for developing countries. Many tax authorities lack the technological capacity and regulatory infrastructure to monitor digital transactions effectively. Additionally, multinational corporations face legal uncertainties and increased compliance costs due to the fragmented nature of digital tax regulations worldwide¹⁰⁸⁸. The need for harmonized tax rules is crucial to reducing administrative burdens and ensuring fair taxation across jurisdictions.

6. Implementation Challenges in the OECD's Two-Pillar Solution

The OECD's two-pillar approach, designed to address digital taxation challenges, aims to allocate taxing rights more equitably (Pillar One) and establish a global minimum tax rate of 15% (Pillar Two). However, implementing these measures has proven difficult due to political disagreements, varying national interests, and technical complexities. Some countries, particularly developing economies, argue that the proposed framework disproportionately benefits developed nations, limiting their ability to tax digital companies operating within their borders¹⁰⁸⁹. As negotiations continue, concerns remain about enforcement mechanisms, revenue distribution, and the potential for loopholes.

7. The Role of Developing Countries in Digital Taxation

Developing nations face unique challenges in taxing the digital economy due to their limited tax enforcement capabilities and reliance on corporate income tax. Many digital companies generate substantial revenues from users in these countries but pay little or no taxes due to the absence of local subsidiaries or PE. The United Nations has proposed alternative taxation frameworks that would grant greater

taxing rights to source countries, but these proposals have yet to gain widespread international support¹⁰⁹⁰. Ensuring that global tax reforms address the needs of both developed and developing economies remains a critical challenge.

8. Future Prospects for International Digital Taxation

The future of digital taxation depends on international cooperation and the successful implementation of multilateral tax reforms. Countries must balance the need for fair taxation with economic competitiveness, ensuring that tax policies do not stifle digital innovation. While the OECD's two-pillar framework represents a significant step forward, ongoing discussions will determine whether a truly equitable and enforceable global tax system can be achieved. The digital economy will continue to evolve, requiring tax frameworks to remain adaptive and responsive to new technological and business developments¹⁰⁹¹.

International Tax Law and Digital Economy Reforms

The rise of the digital economy has exposed fundamental weaknesses in international tax law, particularly its reliance on outdated principles such as source-based taxation and permanent establishment. These traditional rules were designed for an industrial economy, where businesses operated within well-defined geographic boundaries. However, digital businesses can generate substantial profits from countries where they have no physical presence, making it difficult to allocate taxing rights effectively¹⁰⁹². This challenge has led to widespread tax avoidance practices, where multinational enterprises (MNEs) shift profits to low-tax jurisdictions, reducing their overall tax burden.

¹⁰⁸⁸ Supra Note No 7

¹⁰⁸⁹ IMF, "International Tax Coordination and Digital Business Models", 2022

¹⁰⁹⁰ G Zuckmen, "Tax Justice and the Global Digital Economy", 2019

¹⁰⁹¹ Tax Policy in a Digitalized World: Prospects for Reform, 2023

¹⁰⁹² Supra Note No 3

1. OECD's Two-Pillar Solution

To address these issues, the Organisation for Economic Co-operation and Development (OECD) introduced the two-pillar solution, which represents a significant reform in international tax law. Pillar One seeks to reallocate taxing rights to market jurisdictions where significant digital business activities occur, even in the absence of a physical presence. This reform targets highly profitable MNEs, requiring them to pay taxes based on revenue generation rather than corporate residence. Pillar Two establishes a global minimum tax rate of 15%, aiming to curb tax competition among countries and prevent profit shifting¹⁰⁹³.

2. Implementation Challenges of Global Tax Reforms

Despite broad international support, the implementation of these reforms faces multiple challenges. Political disagreements among nations, particularly between developed and developing economies, have slowed progress. Some countries argue that the reforms favour wealthier nations with large consumer bases while limiting the ability of developing countries to tax digital transactions occurring within their borders¹⁰⁹⁴. Additionally, the complexity of the two-pillar framework presents legal and administrative difficulties, requiring significant modifications to domestic tax laws.

3. Unilateral Tax Measures and Trade Disputes

The slow implementation of multilateral reforms has led several countries to introduce unilateral tax measures, such as Digital Services Taxes (DSTs), to capture revenue from digital companies. However, these measures have triggered trade tensions, particularly between the United States and European nations. The U.S. government has criticized DSTs as discriminatory against American tech giants, leading to the threat of retaliatory tariffs¹⁰⁹⁵. This situation highlights the urgent need for a

coordinated international tax framework to prevent fragmented regulations and trade conflicts.

4. Role of the United Nations in Digital Taxation

In response to concerns that the OECD's approach primarily benefits developed economies, the United Nations (UN) has proposed alternative taxation frameworks that would grant more taxing rights to source countries. The UN's proposals focus on increasing revenue-sharing mechanisms for developing nations, ensuring that digital businesses contribute fairly to the economies where they generate income¹⁰⁹⁶. However, these proposals have yet to gain widespread adoption, as many developed countries prefer the OECD-led approach.

5. Developing Countries and Capacity Constraints

Developing countries face unique challenges in adapting to digital tax reforms due to limited enforcement capabilities and technological constraints. Many of these nations lack the infrastructure to track digital transactions effectively, making it difficult to ensure tax compliance. The OECD and the UN have initiated capacity-building programs to assist developing economies in implementing digital tax measures, but progress has been slow¹⁰⁹⁷. Addressing these disparities is crucial to achieving a truly equitable international tax system.

6. The Future of Digital Taxation

As the digital economy continues to expand, tax laws must evolve to keep pace with new business models and technological innovations. Achieving a global consensus on digital taxation requires balancing the interests of developed and developing economies while minimizing economic distortions. Although the OECD's two-pillar solution represents a significant step forward, ongoing discussions will determine whether these reforms can be

¹⁰⁹³ OECD, "Two-Pillar Solution to Address the Tax Challenges Arising from Digitalisation", 2021

¹⁰⁹⁴ Supra Note No 9

¹⁰⁹⁵ OECD, "The Future of Digital Taxation: Global Challenges and Solutions", 2023

¹⁰⁹⁶ Supra Note No 18

¹⁰⁹⁷ Supra Note No 10

effectively implemented and enforced¹⁰⁹⁸. The future of digital taxation will depend on international cooperation, transparency, and the adaptability of legal frameworks to emerging economic realities.

Implications for Developing Economies

The taxation of the digital economy has significant implications for developing economies, many of which struggle with limited tax enforcement capabilities and revenue mobilization challenges. Digital businesses generate substantial income from consumers in developing countries, yet these nations often lack the legal and technological infrastructure to effectively tax such transactions. Since traditional tax frameworks are based on the concept of permanent establishment, developing nations find it difficult to claim their fair share of tax revenues from multinational digital corporations that operate remotely¹⁰⁹⁹. This has led to substantial revenue losses and increased reliance on indirect taxes, such as value-added taxes (VAT), which disproportionately impact lower-income populations.

1. Revenue Losses and Economic Inequality

The inability to effectively tax digital businesses exacerbates economic inequality, as governments in developing economies struggle to generate revenue for essential public services. With corporate tax bases shrinking due to profit shifting and tax avoidance strategies employed by multinational enterprises (MNEs), developing countries face significant fiscal constraints. The OECD estimates that global tax avoidance costs governments between \$100 billion and \$240 billion annually, with a disproportionate impact on low-income nations¹¹⁰⁰. Without an effective international tax framework, developing countries remain at a disadvantage, as they lack the economic

leverage to negotiate favourable tax agreements with large digital firms¹¹⁰¹.

2. The Need for International Cooperation and Policy Reforms

Developing countries have advocated for reforms that grant greater taxing rights to market jurisdictions, arguing that profits should be taxed where economic activity occurs. While the OECD's two-pillar solution is a step toward fairer global tax distribution, concerns remain that the proposed system still favours developed economies. The United Nations (UN) has proposed alternative taxation models, such as withholding taxes on digital transactions and simplified profit allocation rules, to enhance tax collection in developing countries. However, implementing such reforms requires strong international cooperation, as unilateral tax measures risk trade disputes and retaliatory actions from major economies¹¹⁰².

3. Capacity Constraints and Implementation Challenges

Even if new digital tax frameworks are adopted, many developing countries face significant capacity constraints in implementing them. Tax authorities in these nations often lack the technical expertise, digital infrastructure, and legal frameworks necessary to track online transactions effectively. The OECD and the UN have initiated capacity-building programs to assist developing economies in strengthening their tax administration, but progress has been slow. Without adequate resources and technological support, developing countries risk falling further behind in the global digital tax landscape¹¹⁰³.

CONCLUSION AND SUGGESTIONS

The rapid expansion of the digital economy has significantly disrupted traditional taxation principles, creating both opportunities and challenges for international tax law. The limitations of source-based taxation and

¹⁰⁹⁸ Supra Note No 19

¹⁰⁹⁹ OECD, "Model Tax Convention on Income and Capital", 2017

¹¹⁰⁰ Supra Note No 13

¹¹⁰¹ Supra Note No 17

¹¹⁰² Supra Note No 10

¹¹⁰³ United Nations, "Strengthening Tax Administration in Developing Countries", 2023

permanent establishment (PE) rules have allowed multinational enterprises (MNEs) to operate in multiple jurisdictions without paying their fair share of taxes. This has led to widespread tax avoidance, profit shifting, and revenue losses, particularly for developing economies. The need for comprehensive tax reforms has never been more pressing, as governments seek to adapt their tax systems to the realities of a digitalized global economy.

1. The Importance of International Cooperation

Given the cross-border nature of digital businesses, unilateral tax measures—such as Digital Services Taxes (DSTs)—have led to trade disputes and inconsistencies in taxation policies. A globally coordinated approach, such as the OECD’s two-pillar solution, represents a step toward resolving these challenges. However, achieving a fair and effective implementation of these reforms requires stronger international cooperation, with equitable consideration for both developed and developing economies.

2. Strengthening Global Tax Governance

A key challenge in digital taxation is the governance and enforcement of international tax rules. The OECD and the United Nations (UN) have played pivotal roles in shaping global tax policies, but concerns remain over whether developing countries have a meaningful voice in negotiations. Strengthening the role of international organizations in facilitating fair tax reforms, including the expansion of the UN’s role in digital taxation, could help ensure a more balanced global tax system.

3. Reforming Permanent Establishment and Profit Allocation Rules

Current tax treaties rely on outdated PE rules that fail to capture digital value creation. Tax reforms should focus on revising the definition of PE to include significant digital presence, ensuring that MNEs pay taxes where they generate economic value. Additionally, profit allocation rules should be adjusted to consider user participation, data monetization, and

digital interactions as key factors in determining taxable income.

4. Addressing the Needs of Developing Economies

Developing countries face unique challenges in taxing the digital economy, including limited administrative capacity and reliance on indirect taxation. To bridge this gap, international organizations and developed nations should support capacity-building programs that enhance tax enforcement capabilities in developing economies. Simplified tax mechanisms, such as withholding taxes on digital transactions, could also provide a practical solution for countries with limited tax enforcement infrastructure.

5. Ensuring Fair Distribution of Tax Revenues

While the OECD’s two-pillar solution aims to allocate taxing rights more fairly, concerns persist that the benefits will primarily favor developed economies with large consumer markets. Further negotiations should focus on ensuring that low-income countries receive a fair share of tax revenues from digital businesses operating within their borders. Alternative tax measures, such as revenue-based taxation models, could help address disparities in revenue distribution.

6. Reducing Compliance Burdens and Legal Uncertainty

Taxation of the digital economy introduces significant compliance challenges for both governments and businesses. The complexity of new tax regulations, including differing national policies, increases compliance costs and creates legal uncertainties for multinational companies. A harmonized global tax framework with clear and simplified rules would benefit both tax authorities and businesses by reducing administrative burdens and promoting tax certainty.

7. Adapting Tax Policies to Emerging Technologies

As digital technologies continue to evolve, international tax laws must remain flexible to address new business models and revenue streams. Emerging trends such as artificial intelligence, blockchain, and decentralized finance (DeFi) present new taxation challenges that require proactive policy adjustments. Governments should anticipate these developments and work towards adaptive tax frameworks that can accommodate future technological advancements.

8. Encouraging Compliance Through Incentives and Fair Regulations

Rather than solely focusing on enforcement and penalties, governments should also implement incentive-based tax policies to encourage voluntary compliance by digital businesses. Tax credits for companies that contribute to local economies, data-sharing agreements between tax authorities, and transparency measures can foster a more cooperative approach to digital taxation.

9. The Path Forward

The future of digital taxation depends on continued dialogue, cooperation, and compromise among nations. A truly effective international tax framework must balance economic interests while ensuring fairness and sustainability. While the OECD's two-pillar solution marks progress, further refinements and policy innovations are necessary to address the evolving nature of digital business models. By prioritizing inclusivity, transparency, and efficiency, global tax policymakers can create a system that benefits both developed and developing economies while maintaining the integrity of international taxation.