Taxation of digital economy, the EU DST and third (developing) countries

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Topics

Taxation digital economy and developing countries

Pillar 1/ UN/Unilateral approaches

DST and developing countries

EU DST and third (developing) countries

1. Taxation of digital economy

Business without physical presence, or limited physical presence?

- Without physical presence (no premises, no employees): No P.E., no tax
- With (some) limited physical presence: Office in the country, but IP owned by company headquartered abroad. e.g. Kenya Uber: Office (administrative support/cost plus) Payments made to headquarters, and remainder sent back to the Uber drivers (less 25% fee). No withholding tax on the 25%.

See M. NdajiwoThe Taxation of the Digitalised Economy: An African Study (Nigeria, Ghana, Senegal, Kenya, Rwanda, and Uganda). ICTD, June 2020. WP 107).

What type of business? Mainly B2C

- Highly digitalized business (broader scope e.g. digital manufacturing)
- Automated digital services provider (social media platforms, search engines, online marketplaces, online content providers, intermediation platforms)
- Also own local (with broad geographical scope) online marketplaces: Mercado libre (LA), Alibaba (Asia) and Jumia (Africa)

1. Taxation of digital economy and developing countries

- Headquarters of highly digitalized business in developed countries
- Limited taxing rights in developing countries (physical presence)
- If presence, limited taxation. Local subsidiary taxed on the remuneration paid by its parent company for providing support services (cost plus OECD TP Guidelines). Result limited margin of profit to developing countries.

Developing countries need to collect revenue of highly digitalized business, and this need has increased due to the need to recover from the COVID19 pandemic

Choices: Wait for multilateral consensus, to change their tax treaties or source (domestic) rules to introduce significant economic presence or to allow withholding taxation, or to introduce unilateral measures (DST, Equalization levy).

1. Taxation of digital economy and developing countries

Objectives

- No ring fencing of digital groups or activities
- Avoid double taxation
- Simplification in design, administration and compliance

Several proposals: OECD, UN, Unilateral and EU approach

- Additional tax burden for digital business
- More compliance, and less certainty
- Differences in tax base and tax rate.

2.1. Pillar 1 approach

- Started: OECD BEPS Action 1 and now Pillar 1 (even before e-commerce)
- Pillar One – the Re-allocation of taxing rights
  - Addresses the question of business presence and activities without physical presence;
  - Will determine where tax should be paid and on what basis;
  - Will determine what portion of profits could or should be taxed in the jurisdictions where customers and/or users are located.

Source: https://www.oecd.org/tax/beps/beps-actions/action1/

- February 2019 3 proposals (user participation, marketing intangible, significant economic presence). November 2019: OECD Secretariat Unified approach (Amounts A, B, and C)
- Role of the US decisive (participation (or not) in BEPS Action 1, introduction of marketing intangibles approach, safe harbour Amount A.

2.1. Pillar 1 approach

Pillar 1 Unified approach

- Focus on "consumer-facing businesses",
- New nexus, distinct and separate from the existing concept of the permanent establishment, which would ensure a company is taxable in a jurisdiction where its sales exceed a certain threshold even if it is not physically present in that market,
- Three tier-mechanism
  - Amount A: Residual profit,
  - Amount B: Fixed return to routine, distribution and marketing activities,
  - Amount C: To cover cases where there are more functions in the market jurisdiction that those accounted for under the local entity's baseline marketing and distribution functions and includes ways to solve tax disputes including mandatory binding arbitration.

2.1. Pillar 1 approach

Concerns for developing countries

- Waiting for consensus (now not only G20 and BEPS IF but also G7)
- Amount A would include a formulary apportionment and thus it deviates from ALP and OECD TP Guidelines which developing countries have been required to follow.
- Significant economic presence (G24 proposal) was dismissed in unified approach
- Changes to tax treaties and introduction of mandatory binding arbitration (difficult to accept due to experiences by developing countries in investment arbitration)
- Meantime some countries introducing digital service tax (no income tax, but turnover tax, and therefore, not relying on changes to tax treaties)
- UN discussion art. 12B Automated digital services which also requires changes to tax treaties.
- See also briefing African Union https://au.int/sites/default/files/newsevents/workingdocuments/39572-wd-briefing_paper_on_global_tax_debate_for_1st_extraordinary_stc.pdf

2.2. UN approach

New Article 12B – INCOME FROM AUTOMATED DIGITAL SERVICES (2021 UN Model)

Taxing right

Allocation of taxing rights between residence taxation and source taxation in the absence of physical presence

Automated digital services

Any service provided on the Internet or another electronic network, in either case requiring minimal human involvement from the service provider. It includes especially:-Online advertising services;-Supply of user data;-Online search engines;-Online intermediation platform services;-Social media platforms;-Digital content services; -Online gaming;-Cloud computing services; and Standardized online teaching services.

Rate

Withholding tax gross amount of the income (% subject to bilateral negotiations) or

30% of the net income of automated digital services - Where the enterprise belongs to a multinational enterprise group, the option for net basis taxation is subject to availability of information to the source jurisdiction about the profitability ratio of the automated digital services business segment or of the group as a whole

https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2021-04/CITCM%2022%20CRP.1_Digitalization%206%20April%202021.pdf

2.2. UN approach

Concerns for developing countries

- Waiting for consensus (now not only G20 and BEPS IF but also G7)
- Changes to tax treaties to introduce the UN art.12B Model. In practice, it takes time and bargain negotiation with developed countries
- Withholding tax (gross) due to limited administrative capacity of developing (source) country. Need for a simple, reliable and efficient method to enforce tax imposed on income from automated digital services derived by non-residents.
- However, net basis taxation is possible but subject availability of information to the source jurisdiction about the profitability ratio of the automated digital services business segment or of the group as a whole.
- It does not require any particular threshold, such as a permanent establishment, fixed base, or minimum period of presence, in a Contracting State as a condition for the taxation of income from automated digital services. However, the use of countries of DST may result in two different systems one in tax treaty and another one in unilateral rules .
- Work ATAF in digital services tax (DST), which may reduce the impact of the UN approach.
- Would India and China include the new art. 12bUN in their tax treaties?

2.3. Unilateral approaches

Equalization Levy in India

- 2016: 6% tax on business-to-business transactions in the digital advertising space
- 2020 Broadened to all non-resident e-commerce operators defined as providers of digital platforms making or facilitating the sale of goods or provision of services. Rate 2% of consideration received or receivable for e-commerce supply or services made or provided or facilitated on or after the 1st day of April, 2020.

This amendment expands the scope of Equalisation Levy to any online sale or provision of services or their facilitation.

Diverted profit tax

Diverted profit tax in Australia and the United Kingdom. The diverted profit tax aims to tackle corporate tax structures used by MNEs to avoid paying taxes in a specific country by shifting the profit to another country with a lower tax rate.

2.3. Unilateral approaches

Significant economic presence (SEP) Nigeria

2019 Finance Act: Non-resident company providing digital, technical, management, consultancy or professional services would be deemed to have a taxable presence in Nigeria if they have a significant economic presence and profit can be attributed to the business activity carried out in Nigeria.

2020 Order to provide guidance on the definition of Significant Economic Presence (SEP), in relation to taxation of income derived from Nigeria by foreign companies.

Also in other countries (e.g. Israel, Indonesia)

2.3. Unilateral approaches

Foreign Company deemed to have an SEP in Nigeria if (2020 Order)

Category 1 – Use of digital platforms

- Where in an assessment year, such foreign company derives gross income equal to or greater than N25,000,000 (or its equivalence in other currencies), from any of the following activities (or combination thereof):
  - ✓ Streaming, or downloading services of digital contents to any person in Nigeria
  - ✓ Transmission of data collected about Nigerian users, which has been generated from such user's activities on a digital interface, including a website or mobile application
  - ✓ Provision of goods or services directly or indirectly to Nigerians through digital platforms
  - ✓ Provision of intermediation services through digital platforms that link suppliers and customers in Nigeria

Category 2 – Use of a Nigerian domain name/registration of a website in Nigeria

- A foreign company that uses a Nigerian domain name (.ng) or registers a website address in Nigeria, will be deemed to have a SEP in Nigeria.

Category 3 – Purposeful and sustained interaction

- Where a foreign company has a purposeful and sustained interaction with persons in Nigeria by customizing its digital platform to target persons in Nigeria or reflecting the prices of its products, services or options of billing or payment in Naira, such foreign company will be deemed to have a SEP in Nigeria.

2.3. Unilateral approaches

Withholding tax mainly in Latin American countries

- Argentina (Buenos Aires) 5% WHT on online content supplier
- Peru: 3% WHT on digital services provided by non-residents in Peru and accessed via the internet and used in Peru
- Uruguay: 12% WHT levied on payments made for digital services (rendered via the internet, technology platforms, software apps and similar means) supplied by non-resident to customers located in Uruguay

- Also in Paraguay, Mexico, Pakistan, Philippines, Thailand.
- See comparison A. Oguttu. A Critique from a Developing Country Perspective of the Proposals to Tax the Digital Economy. November 2020.

2.3. Unilateral approaches

Concerns for developing countries

- Waiting for consensus (now not only G20 and BEPS IF but also G7)

- Differences in approaches among countries and regions see https://tax.kpmg.us/content/dam/tax/en/pdfs/2021/digitalized-economy-taxation-developments-summary.pdf p.5.

- Unilateral rules and tax treaties

- Administrability and resources from tax administration

2.4. DST and developing countries

- Not an income tax (no tax treaty relief, but it could be regarded as business expense in the country of residence)
- Reference to the consideration paid (gross-turnover) and not the net profit.
- Levied: Supply of a certain defined categories of e-services and imposed on the parties to the supply without reference to the particular economic or tax position of the supplier
- Charged at a fixed rate, calculated by reference to the consideration paid by those services
- Not creditable or eligible for any other type of relief against income tax.
- DST to be paid in addition to a country's income tax charge.
- US investigations trade representative regarding DST could lead to tariffs being imposed on the countries export to the US.

See ATAF Policy Brief June 2020
https://events.ataftax.org/index.php?page=documents&func=view&document_id=61

2.4. DST and developing countries

DIGITAL SERVICE TAX

Benefits

- Way to collect tax revenue (also during the COVID19 pandemic)
- Relatively simple to calculate and administer compared to income tax
- It improves fairness tax systems (MNE's pay taxes) which can contribute to voluntary compliance

- Introduced in developed and emerging countries (Australia, Brazil, Czech Republic, India, Indonesia, Italy, Spain, Turkey, UK) and few African countries (e.g. Kenya)
- Some countries as interim measure, while consensus is reached? But would that be the case?
- Some countries wait for consensus

2.4. DST and developing countries

DIGITAL SERVICE TAX :KENYA (Finance Act and Regulations)

- Taxation on income accrued in or derived from Kenya from provision of services through a digital marketplace
- 1.5% on gross transaction value.
- A ”**digital marketplace**” means a “platform that enables the direct interaction between buyers and sellers of goods and services through electronic means.
- Digital services include: a)downloadable digital content such as mobile applications; b)over-the-top services including streaming television shows, music or podcasts; c)sale or licensing of, or any other form of monetising data collected about Kenyan users; d)provision of a digital marketplace; e)subscription-based media including news; f)electronic data management including website hosting and cloud storage services; g)electronic booking or ticketing services; h)provision of search engine services; i)online distance training or e-learning; and j)any other service provided through a digital marketplace.
- Differences between residents/non-residents with or without PE.
- Offset (with PE) or final tax (without PE)/ simplified registration (without PE) or update registration (PE)

https://www.pwc.com/ke/en/assets/pdf/tax-alert-income-tax-digital-service-tax-regulations-2020.pdf

2.5. Discussion

See Digital Taxes and Trade in Services in Globalization and Digitalization - Interconnections Between Taxation, Trade and Investment (10th of June)

https://www.youtube.com/watch?v=UoNiK3dhwpA (from 8.20 min.)

Pros/Cons of the proposals

What would be in your view the best proposal for developing countries?

Are there any other solutions for taxation of digital economy? And if so which solutions?

Digital service as interim solution and becoming permanent?

2.6. EU DST and third (developing) countries

Unilateral EU countries DST

- Additional resources
- Differences in the tax base and tax rate
- Some countries as interim measure waiting for consensus
- Turnover taxes do not take profitability into account- thus disproportionate taxation and consumers may directly bear the added costs imposed by DST measures through higher fees/prices.

EU

EU Directive 2018

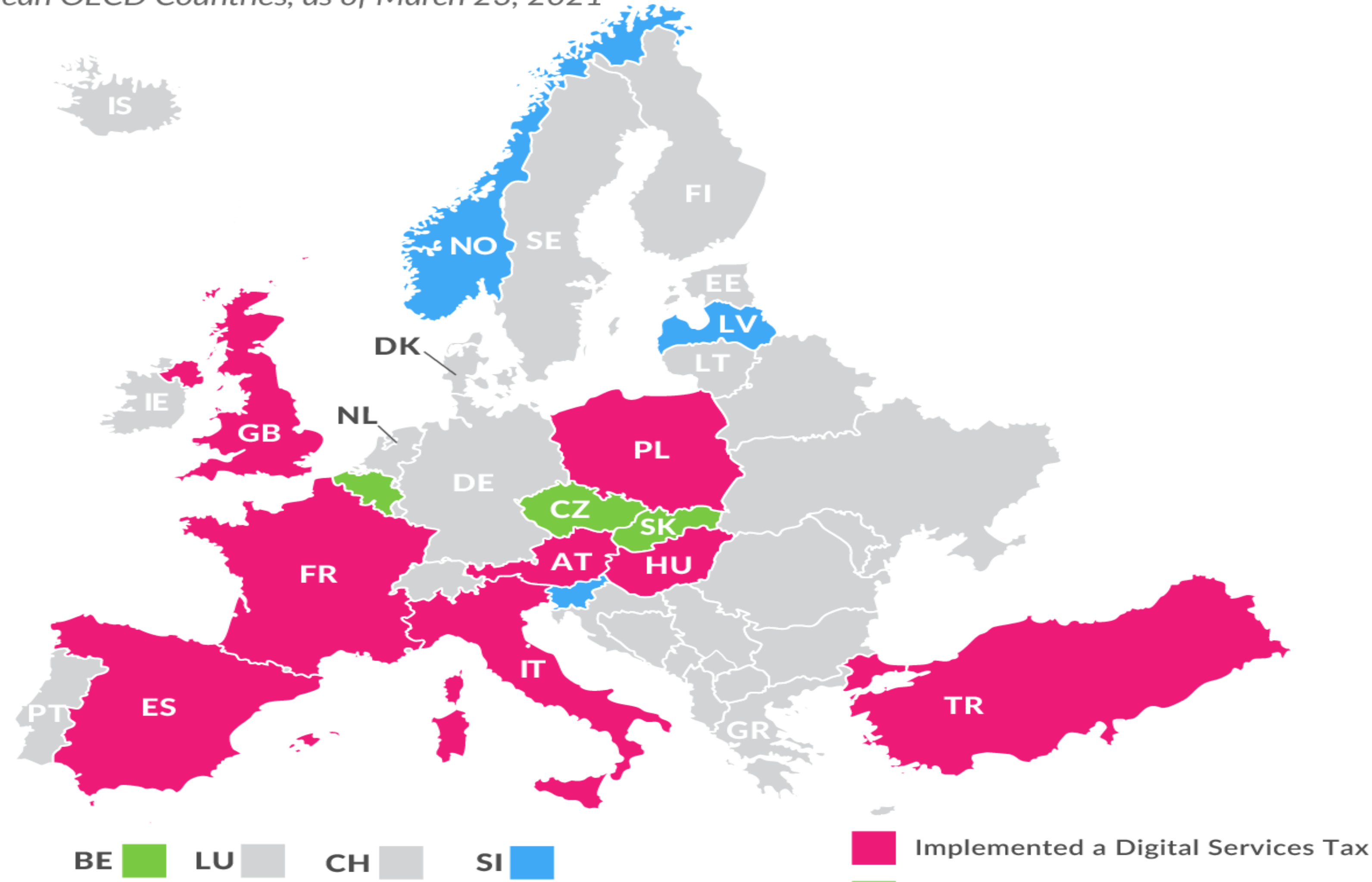
3% DST on gross revenue – EU users and threshold EUR 750 million

2021 EU Digital Levy see https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12836-A-fair-&-competitive-digital-economy-digital-levy_en

Roadmap, public consultation (with feedback), adoption by the Commission second quarter of 2021.

Digital Services Taxes in Europe

Announced, Proposed, and Implemented Digital Services Taxes (DSTs) in European OECD Countries, as of March 23, 2021



Source: KPMG, "Taxation of the Digitalized Economy: Developments summary."

2.6. EU DST and third (developing) countries

EU Digital levy

EU Commission: Shaping Europe's Digital Future and Fair Taxation

A proposal compatible with the OECD

- A corporate income tax top-up to be applied to all companies conducting certain digital activities in the EU
- A tax on revenues created by certain digital activities conducted in the EU
- A tax on digital transactions conducted business-to-business (B2B) in the EU

To keep in mind

Scope and definition of digital activities or companies subject to digital levy

Relation with the EU and MsT obligations including DTC and also WTO compliant

Fairness considerations: SMEs, digital companies with a dominant/weak position

What is different from the EU 2018 Directive?

A proposal as an add-on to any OECD Pillar 1 framework

Ottawa principles: regarding e-commerce: neutrality, efficiency, certainty and simplicity, effectiveness and (see AmCham Feedback)

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