Taxation of the Digital Economy: One problem, many solutions and the potential of forum shopping

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Topics

- Taxation of the digital economy
- Multilateral approaches
- Unilateral approaches
- Regional Approaches
- Challenges

ONE PROBLEM

1. Taxation of the 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 but also B2B

- 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 the digital economy

- 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 the digital economy

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

MANY SOLUTIONS

1.1. Pillar 1 Approach

- Started: OECD BEPS Action 1 and now Pillar 1
- 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.

1.1. Pillar 1 Approach

OECD-BEPS INCLUSIVE FRAMEWORK STATEMENT OCTOBER 2021.

- Pillar 1 and Pillar 2 as a package deal
- 2021 US proposal for a minimum tax, adopted G7
- Thereafter OECD-BEPS Inclusive Framework Statement October 2021 adopted by G20 in November 2021. 137 jurisdictions of the 141 BEPS Inclusive Framework (Nigeria, Kenya, Sri-Lanka and Pakistan).

TO KEEP IN MIND

- Multilateral Convention to be open for signature in 2022, and in force as of 2023.
- Multilateral Convention will require all parties to remove **all Digital Services Taxes and other relevant similar measures** with respect to all companies, and to commit not to introduce such measures in the future.

1.2. 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

1.2. 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. What happens if no or very limited tax treaties.
- 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. 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. 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. Unilateral approaches

Withholding tax

- 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. 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. Unilateral approaches

Digital Services Tax

- 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. Unilateral approaches

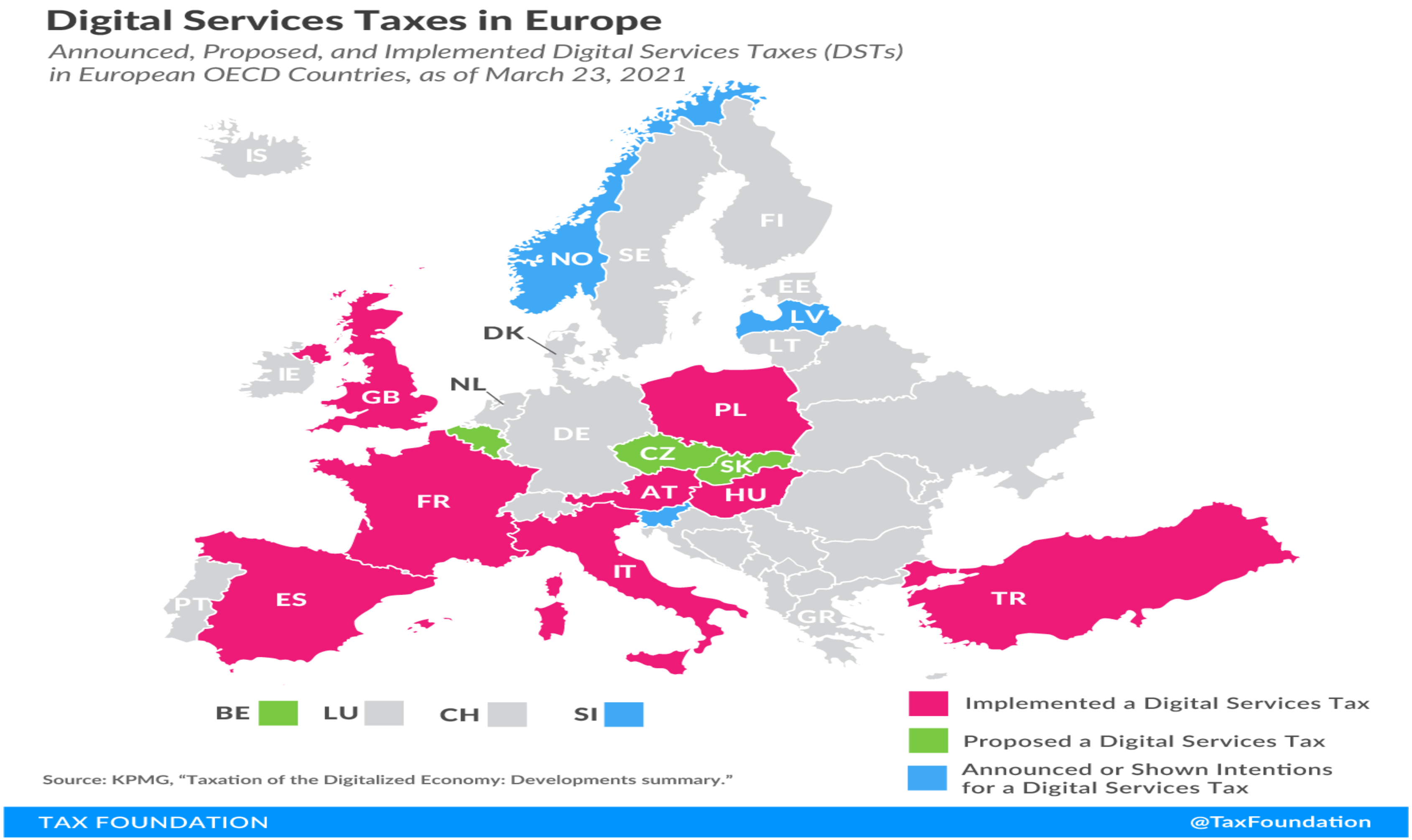
Digital Services Tax

Benefits

- Way to collect tax revenue (also during the COVID19 pandemic). However, according to Digitalization and Taxation in Asia (IMF 2021) small revenue effects (p. viii).
- 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
- Statement October 2021 still needs a Multilateral Convention, and countries need to agree to remove all DSTs or similar related measures.

2. Unilateral approaches



2. Unilateral approaches

Value Added Tax (see Digitalization and Taxation in Asia (IMF 2021 p. 43-50)

VAT on digital transactions does not involve any fundamental rethink of taxing rights, but rather the development of a mechanism to give effect to the destination principle in the case of digital transactions.

The VAT is a tax on consumption imposed commonly on the destination principle, which means that the taxing right is commonly located at destination or the place of consumption.

Challenges on tax design and collection: Categories of import of digital delivered services and goods

- Digital services provided directly to final customers/consumers (e.g. movies, music, accounting services)- Requires self assessment VAT – unenforceable obligation in practice.
- Imported services provided to business. VAT reversed charge. The domestic business to account for the VAT on the imported service.
- Goods supplied by foreign based sellers. De minimis threshold for low-value consignments.

Now advances in promotion of digital entrepreneurship. Equal VAT playing field for domestic provides of digital services and goods and non-resident competitors. Both liable for the same VAT.

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 services tax as interim solution and becoming permanent?

3. Regional Approaches

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 (Proposals)

2018 Fair Taxation of the Digital Economy

- Digital Service Tax (Interim Tax) 3% DST on gross revenue – EU users and threshold EUR 750 million
- Significant economic (digital) presence (Long term)

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. No yet adopted in light of discussions at the OECD –BEPS Inclusive Framework

3. Regional Approaches

EU Digital levy

- EU Commission: Shaping Europe's Digital Future and Fair Taxation
- Need to obtain revenue to overcome the COVID19 crisis

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 double tax conventions and also WTO compliant
- Fairness considerations: SMEs, digital companies with a dominant/weak position

What is different from the EU 2018 Directive proposals?

A proposal as an add-on to any OECD Pillar 1 framework. The Commission has also proposed (COM(2021) 570 final to amend the Own Resources Decision so that the following revenue would be allocated to the EU budget:

15% of the share of the residual profits from multinationals that would be re-allocated to EU Member States under the recent OECD/G20 agreement on a re-allocation of taxing rights ("Pillar One").

Forum Shopping

4. Challenges

While the discussion at global level is about **taxing highly digitalized business and to prevent the use of unilateral measures** (e.g. digital tax), developing countries and international organizations (e.g. UN, UNCTAD ESCAP) are also focusing on:

(i) the **benefits of digital trade**, (ii) the **challenges and opportunities for countries that digital trade present** and (iii) **how to achieve SDGs** (equality, regional partnerships for development). Examples:

- UNCTAD initiative trade for all,
- For Asia and the Pacific: the United Nations ESCAP Digital Economy and Inclusive Trade,
- For Latin America: the 2018 Report Approaches to the Digital Economy from the Development Bank of Latin America, and
- For Africa: the Nairobi Manifesto in the Africa e-commerce week to empower African economies in the digital era.

These initiatives promote regional approaches to foster inclusive trade, inclusive business and inclusive markets. There should be a balance between taxation and promotion of digital trade. This is also true for African countries.

4. Challenges

Challenges of developing countries are for instance

- to compete with developed markets,
- to get access to consumer data, and
- to develop strategies for e-commerce with coordination between tax, trade, investment and development (infrastructure, etc).

Some of the opportunities are

- to increase revenue by levying taxes for highly digitalized business,
- to introduce tax incentives to promote e-commerce activities and regional app to share consumer data,
- to develop online tool to boost intra-regional trade (e.g. Mercado libre: the largest online marketplace in Latin America).

However, attention should be given to the content of the proposals, and whether the proposals fit or not the reality of the countries.

Priorities development of internet connection, digital infrastructure, digital entrepeneurship.

THIS IS ALSO TRUE for most of the African countries

4. Challenges

Use of tax incentives to enhance digital trade Examples

- tax holidays for companies incorporated in the country setting up an e-commerce platform (Mauritius),
- tax holidays for income generated from e-commerce activities (Nigeria, Kazakhstan)
- tax rebates (Northern Mariana Islands)
- the use of a free trade zone benefits for e-commerce (i.e. Cross-border e-commerce pilot zone in China).

However, the use of these tax incentives should also be part of a national e-commerce strategy to ensure that digital economy brings inclusive and sustainable development to developing countries. This is also true in the case of most African countries.

Pillar 2 to be discussed in workshop of 16 March 2022.

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