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Taxation in Digital Economy

Santiago Diaz de Sarralde 9 April, 2018

The **Interim Report of the OECD Task Force on the Digital Economy**, released on march 15th 2018, summarizes the works[1] already done on this topic following the tax challenges identified in the 2015 BEPS Action 1 Report, the implementation and impact of the BEPS package in this area, the uncoordinated and unilateral actions adopted in a number of countries and considerations for the design of interim measures while a broader consensus is reached.

International income tax system rule is based since the 1920s on the "origin of wealth" principle. Traditionally, the factors creating value were relatively immobile and required intensive use of labour and tangible assets, justifying **generally taxation at "residence" states** (source taxation was applied only by virtue of separate distributive rules to income and capital gains derived from immovable property, dividends, interest and royalties -withholding taxes-). The **nexus (or Permanent Establishment) rule** – "fixed place of business" or "dependent agent"- complements this principle in the case of non-resident enterprises performing a sufficient level of economic activity in a jurisdiction (the mere export of goods by a foreign enterprise not produced or distributed through a local facility would fall out of this definition and, consequently, be free of income taxation) and **profit allocation rules, based on the "arm´s length principle"**, guide the determination of the profits that will be subjected to taxation in every jurisdiction implied in cross-border Multinational Enterprises' activities.

Indirect consumption taxes on cross-border transactions follow the "destination principle" (as opposed to the origin): no tax (VAT) is levied on exports and the associated input tax is refunded to the exporting business (this is often called "free of VAT" or "zero-rated"), while imports are taxed on the same basis and at the same rates as domestic supplies. Problems arise concerning export of services or low value goods, but the traditional physical exports (the bulk of total in the past) were ok with this solution.

These principles for international taxation were complemented with **bilateral tax treaties and multilateral trade agreements** in order to avoid double-taxation and promote commerce.

Technological advances and economic globalization have transformed business models. Value creation is becoming less and less dependent on the physical presence of people or property, intangibles are becoming more and more important and the place of taxation blurred**, calling the effectiveness of traditional international taxation rules into question, especially concerning highly digitalised businesses even if affecting the rest of the economy, due to the difficulties ring-fencing the digital economy.**

The measures of BEPS package are already having an impact trying to face these challenges through Action 7 (prevent the artificial avoidance of permanent establishment (PE) status), Actions 8-10 (assure that transfer pricing outcomes are in line with value creation), Action 3 (strengthen Controlled Foreign Company (CFC) rules), Action 5 (tackle harmful tax practices) and Action 6 (prevent treaty abuse) and the new guidelines and implementation mechanisms relating to Value Added Tax (VAT) that were agreed under Action 1 to level the playing field between domestic and foreign suppliers. **Nevertheless, more efforts need to be made in the specific field of digital businesses to avoid the risks associated with unilateral actions due to the lack of agreement in**

this area.

Relevant Tax Policy Developments in the taxation of international digital economy

Unilateral actions (planned or in force) are grouped in the Interim Report into four categories: (i) **alternative applications of the PE threshold** (diluting the requirements for permanence and physical location, establishing a "digital presence"; Slovak Republic, Israel, India, Saudi Arabia) ; (ii**)** **withholding taxes** (as happened previously with passive income; Greece, The Philippines; United Kingdom; Brazil, Thailand, India) (iii) **turnover taxes** (aimed to restore a level playing field, in the way of equalisation levies; India, Italy, Hungary, France, European Union) and (iv) **specific regimes targeting large MNEs** (United Kingdom; Australia; Italy; United States).

This broad catalogue of national measures show clearly the **lack of consensus** facing digital economy challenges on international taxation and the **need to coordinate efforts** to, on the one hand, offer an **answer to the complaints** of double no-taxation emerged with new business models and not covered by already developed BEPS actions, and, on the other, avoid the **possible adverse consequences** of uncoordinated actions on tax and commercial, treaties investment, innovation, growth, compliance and administration costs and welfare.

Next steps

OECD Inclusive Framework plans to work toward a consensus-based solution by 2020, with an update on progress in 2019. Recent G20 Meeting in Buenos Aires, March 2012, have shown that much more work is needed to reach a consensus both from the political and the academic point of view.

Meanwhile, non-global activity in this area continues. On 21 March 2018, the European Commission proposed **new rules to ensure that digital business activities are taxed i**n a fair and growth-friendly way in the EU. The Commission has made two legislative proposals: The first initiative aims to reform corporate tax rules so that profits are registered and taxed where businesses have significant interaction with users through digital channels. This forms the Commission's preferred long-term solution and would enable Member States to tax profits that are generated in their territory, even if a company does not have a physical presence there. The second proposal responds to calls from several Member States for an interim tax on revenues which covers the main digital activities that currently escape tax altogether in the EU. Worth to mention also are the components of **USA tax reform** linked to taxation of intangibles (GILTI -Global Intangible Low-Taxed Income-; FDII -Foreign-Derived Intangible Income-; BEAT -Base Erosion and Anti-Abuse Tax-).

In our opinion, this kind of initiatives clearly show that **short-term efforts to foster consensus are essential**. **Digital economy requires an update of nexus rules** to expand their definition from physical presence, protect markets from monopoly tendencies reinforced by the network economies that characterised new business models and gather new data on economic activity to prevent new forms of informal economy derived from the use of platforms to connect individuals and the transformation of traditional working relationships.

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[1] This overview is based on the Interim Report.

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