Taxation of Digital Economy in Peru

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A little background

International taxation is a tricky business. Taxpayers that perform international transactions are more than often thrown into the difficult issue of double taxation. The way in which different countries consider that they have jurisdiction to apply taxes on the outcome of certain international operations is at least problematic. At its worst, these difficulties can potentially turn around the decision of entering business in certain jurisdictions, if the overall taxes make said businesses economically unattractive.

Traditionally, there are two allocation of taxing rights rules: residence and source. Under the residence rule, a country has the right to tax all operations generated by those who, under local legislation, are deemed resident for tax purposes. On the other hand, under the source rule a country may tax all operations carried out within its borders not being relevant the personal conditions of he who carries the activity.

Due to the current international taxation rules, it is amazingly easy to find situations in which both of them collide generating as stated, double taxation conflicts. Therefore, questions may arise such as: why can´t the different nations around the globe adopt a uniform system of taxation? Answer to such kind of questions are difficult and may take pages and pages of theoretical explanations but, to make the story short, not all countries are the same, and it is a matter of convenience.

As a rule, developing countries are capital importers. Not having enough wealth to carry out certain kind of activities, they require foreign companies to invest within their borders. Developed countries have that wealth and, looking for investment opportunities, place their capital in the country that offers the best conditions possible to ensure a satisfying return.

Having developing countries the necessity to import investment, they are more likely to apply taxes on a source criterion (for the activities carried on within its borders). Developed countries are most likely to apply the residence criterion, since their residents are the ones performing the above-mentioned investments.

In the modern world, new questions arise since due to the new technologies, the criteria described before may not be enough to determine if certain operations should be taxed or not in certain jurisdictions. In the following lines we will presenting the situation of digital economy taxation in Peru and where possible, offer solutions where necessary.

Digital economy and Income Tax in Peru

As stated before, developing countries usually use the source system to determine if a specific operation is going to be taxed or not according to local legislation. Peru is not an exception to the rule. Pursuant to Section 6 of the Peruvian Income Tax Law, non-resident individuals and corporations are taxed on their Peruvian source income. For such purposes, Section 9 of the said Law establishes that the following activities, generate Peruvian source income:

- Any income related to real state property when such property is located in Peru.

- Any income related to inventory sold in Peru, including the transfer of any right related to such inventory.
- Interest and any other income generated from investment activities when capital is used in Peru o when the payor of the interest is a Peruvian resident.
- Dividends coming from a Peruvian corporation.
- Income generated from civil, commercial, and business activities carried out in Peruvian territory.
- Salaries, wages, and pension plan payments received for activities performed in Peruvian territory.
- Income generated from stock and debt instruments sales when said stock or debt instruments where issued by a Peruvian corporation.

At this point, the list above details several Peruvian based operations which is consistent with up until this point we have stated. Being a developing country, and a capital importer, Peru uses a source criterion to define which operations are taxed for Peruvian Income Tax purposes.

It was until the 2003 Peruvian Income Tax Law amendment that said long used criterion was broke by adding the following operations to the list of those that generate Peruvian Source Income:

- Technical assistance services used in the Peruvian territory.
- Income derived from providing digital services via internet or any other web application when said services are economically used or consumed in Peru.

It was clear then that due to the massification of the internet, certain services that would usually require presence in Peru (thus, generating Peruvian source income under traditional regulation) could then be provided from outside the country. Not wanting to lose revenues, in 2003 the Peruvian government enacted Legislative Decree No. 945 which included income generated from services described in the list of Peruvian source income.

Section 4-A (b) of the Peruvian Income Tax Law regulations further detailed those services that would be considered digital services under Peruvian Income Tax Law. In general, Peruvian Law considers as Digital Services any services

that can only be provided through the internet (such as hosting, data warehousing, application hosting, web site hosting, online consulting services). Those services generate Peruvian Sourced Income, if used or consumed in Peru. In other words, if they produce an economic benefit in Peru or are paid from Peru.

The legislation described has generated a problematic situation for taxation purposes which has not yet been resolved. Back in 2003, Peru was the only South American Country that taxed income received from activities performed by foreign individuals (or corporations) outside Peru. This constituted a violation of the economic allegiance doctrine described before when detailing residence and source criteria for allocating the right to tax income.

It must be noted that the legislation described somewhat backfired. Suppliers of digital services usually do not allow their Peruvian clients to perform any withholding on their fees (of course they cannot be blamed if after all the Peruvian government asks an individual to pay taxes for an activity that has nothing to do with Peru). Peruvian clients, having to pay the withholding tax from their own pockets, end with cost overruns that in addition are not deductible under Peruvian Income Tax Law.

And what about VAT?

Peruvian VAT is a whole different situation. At the core of the Peruvian VAT Law lies the territoriality principle. Being VAT a consumption tax, Peruvian Law only taxes activities that suppose consumption in Peru. This is valid for goods and services.

To that extent, Sections 1 to 4 of the Peruvian VAT Law establish that when a non-resident entity (individual or corporation) provides services that are consumed in Peruvian territory, the burden of the tax should be put in the Peruvian client.

Then in this case, the problem in Peru is not one of who is the taxpayer but one of how to find said taxpayer and make him comply. Take simple services used on a day to day basis such as movie or music streaming. Under the Peruvian

VAT Law such services should be burdened with VAT which should be paid by their users. Would every individual comply?

Peru lacks legislation that enables its government to collect taxes as described before. Other South American countries, a little more advanced in these issues, have enacted provisions that make credit card companies and banks, collect VAT on digital operations by charging them on their clients' accounts.

Is the treatment described correct?

Certainly, Peruvian legislation is far from perfect let alone complete. Nonetheless some advances have been made regarding the economic impact of digital economy.

Regarding the Peruvian Income Tax, legislation must be amended to repair the negative effects that the legislation has created as described before. Similar cases related to credit or insurance services received from tax-heaven resident companies have been resolved by allowing deduction on the third-party assumed tax. Not a great solution but it gives the resident user an opportunity to recover the cost overrun created.

For VAT purposes, a more practical approach must be taken. It is necessary to implement legislation that allows the government to collect taxes that currently are off the scope of the Peruvian Tax Administration.

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