Roadmap to the digital tax debate for developing countries

By:

Sebastian Duenas

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Introduction

International taxation started its development a little after WWII. The first draft of an international tax treaty was published by the OECD in the 60´s when only a few treaties were signed. International tax systems slowly evolved in time, but they reached a peak before including rules to address digital businesses. The creation of internet in the 1960´s allowed the evolution of commerce, but no one ever thought that the world will see the digitalization of businesses as it is today. In the 1990´s the internet was introduced as a tool available to people in their homes. By 2015, the fast evolution of digital businesses combined with the lack of legal developments to keep with the pace of the advancements of technology were a concern for the world leaders.

In the early 2000´s digital businesses grew at an unusual speed. This evolution triggered the discussions on how to tax the digital economy. Moreover, in the current crisis people were pushed to change the way they work, the way to

acquire goods and services, and started to understand that the development of businesses is necessary on the digital environment. Under this new reality the international tax discussion nowadays is focused on the design of a new formula to tax multinational companies that are doing business online without necessarily having a presence in all the countries that sales are made.

The international tax discussion of digital taxes started by the Organization for Economic Cooperation and Development (OECD) with the base erosion and profit shifting project (BEPS). Some developing countries have joined the OECD on its initiative but some other have not demonstrated interested on the topic. In the current situation, developing countries must participate on the discussion of taxing the digital economy to be able to develop legislation that allows them to create a playing filed that makes them attractive for investors and allows them to collect a fair share of taxes derived from this part of the economy.

This article reviews the policy advancements on digital taxation, the individual initiatives that some developed countries have enacted, and considers some recommendations for developing countries to address future changes. It also contains a brief analysis of the Ecuadorian VAT reform for digital services and other possible options that need to be considered by the country.

The Digital Taxes Initiative

When the OECD BEPS Project[1] started a few years ago, the world was not completely sure about how important digital taxation was going to be in a few years' time. Digitalization was an ongoing matter that was not a top priority for governments. Developing countries were even less worried about this because the revenues derived from the digital economy were small in relation to those that came from the brick and mortar companies. With the evolution of technology, many digital business models nowadays do not require physical presence in countries where they have sales. They can reach their customers through remote sales and service platforms. The lack of a physical establishment allows digital service companies to escape from taxation creating a perceived sense of inequality among countries.

Business models that are part of the discussion include social media

companies, e-commerce marketplaces, cloud services, and web-based services platforms have all motivated targeted tax policies. The BEPS project was a still work-in-progress when the OECD understood that BEPS Action 1, was not having the impact that was expected. The recommendations contained in Action 1 were not implemented by the OECD members. The initial aim of BEPS Action 1 was to update the international tax framework to include digital economy under the international tax rules, that were created for companies not operating online but under different conditions.

For this reason, in 2017 the organization started a new project, BEPS 2.0. This second part was created to address the digital economy directly and to provide the world with a stronger base for digital taxation. Other reasons for the creation of the project included that the EU issued a proposal for a digital taxation among EU member countries, as individual country initiatives for digital taxes had become more widespread.

Except for the OECD, by 2017 no other international organization focused its attention on digital taxation to find a common solution. This gave the organization the necessary leverage to capture the world's attention. With a few months on the run, the OECD managed to convene some of the world's best tax professionals to discuss the proposals and the create guidelines for digital taxation. Furthermore, the OECD gathered more attention by allowing non-member countries to participate in the discussion by creating the inclusive framework (a group of no OECD members countries that are willing to implement the BEPS project) to implement BEPS on non-member countries.

There have been some bumps in the road with the project, and in the meantime some countries have decided to enact unilateral measures (e.g., digital services taxes "DST" or a tax on gross income upon a determined national and worldwide threshold that applies to companies that provide specific digital services; it results in an economic effect similar to what tariffs cause with imported goods) to tax digital businesses. Unilateral measures have not stopped the work that the OECD has been doing. The first phase of BEPS 2.0 is planned to end by 2021.

Developing Countries

The OECD has 36 members, that have been involved in the digital taxation discussion since it all started in 2014. The lack of agreement and the different strategies taken by non-OECD countries, as well as other OECD members have added complications to outcome that was initially expected. Countries that are not OECD members for purposes of the implementation of BEPS 2.0 can be divided in two categories: i) those that are part of the inclusive framework (i.e., a group created by the OECD to let non-member countries participate in the discussion), and ii) a group of 19 or 20 other countries that are not part of the framework; hence they have not participated in the discussions and probably do not have considered any advancements regarding digital taxation.

Out of this small group of 19 to 20 countries, it can be predicted that in the foreseeable future those countries will be in a different situation than those that are part of the discussion. The lack of participation means that even if there is no agreement on BEPS 2.0, those countries are not gaining experience to understand what can be done to progress towards implementing digital taxes.

Ecuador VAT Reform

One example is Ecuador, a developing country that is not part of the OECD nor of the inclusive framework. Ecuador has addressed digital taxation on its own by enacting a tax reform to include digital services and the fees derived from goods transferred on digital platforms as taxable with value added tax (VAT) at a rate of 12%.

In Ecuador, VAT has a broad taxable base. Ecuadorian VAT generally taxes goods transferred at any part of the value chain, and all the services that are provided in the country. There are goods and services that are considered necessary and that are specifically excluded from VAT to make VAT a little less regressive. Before the reform, digital services and goods transferred on digital platforms were not exempt from VAT, then the specific inclusion made by the reform was passed because clarification was required.

In practice, Ecuadorian digital services providers were collecting VAT on their revenue streams based on the general idea that their services were not specifically excluded from VAT. Ecuadorian digital services providers applied

VAT to their services disregarding the fact that the services were digitally provided. Moreover, due to the lack of a specific rule, non-Ecuadorian digital services providers were not collecting VAT on the services provided in the country. Since foreign providers do not have a physical presence in Ecuador, the Ecuadorian Internal Revenue Service (IRS) was not able to collect VAT from them.

This disparity made Ecuadorian digital services more expensive than those provided by foreign digital services providers. Not to speak about the difficulties that Ecuadorian digital services providers encounter at the moment to charge, collect, and remit VAT due to a lack of applicable procedures for their specific business patterns.

It can't be said that the tax reform was specifically focused on solving the disparity between Ecuadorian and non-Ecuadorian digital services providers, but rather it seems that it was focused on increasing tax revenue. So that, in December 2019 the Government and the National Assembly (i.e., Congress) approved Public Law RL-2019-2021-051, known as the Organic Law of Tax Simplification and Progressivity, to specifically address the VAT treatment of digital services and online transferred goods. The reform specifically included both categories as taxable for VAT starting on September 2020.

The taxable categories include, i) one for imported digital services, in this case VAT is assessed upon the payment by an Ecuadorian resident or an Ecuadorian permanent establishment of a non-resident for imported digital services, and ii) a second category for digital services exclusively for services that involve the delivery and transportation of physical goods, in this case VAT applies to the commission charged by the digital platform that provides the service.

The only relevant change included with tax reform was that for the first time since VAT was created, the tax includes non-resident aliens as taxpayers (i.e., a foreign company that is a digital service provider in Ecuador). For the purposes of collection, the reform gives faculties to the IRS to create a register for foreign providers, specifically for those that are not domiciled in the country or that do not have a permanent establishment. The reform also instructs that once the register is created by the IRS, if a service provider is not registered, there would

be no legal consequences and the obligation to withhold the tax is transferred to the financial institutions that intermediate the payment.

Finally, if any of fact patterns mentioned is not applicable when a payment is made, the client (i.e., final consumer) is the one directly obliged to pay the tax . It seems that the changes incorporated into the Ecuadorian legislation were made to facilitate the work to be done by the tax administration in order to collect the VAT. The obligations derived from its enactment were transferred to the various parties involved in the transactions. The immediate effect of the reform is that the cost of goods transferred digitally, will increase, affecting customers directly because of a higher final price in the various categories. Some companies have already emailed their customers to show them the effects of the VAT on the price of their services.

Ecuador did not discuss any other initiatives for taxing the digital economy, therefore the limited tax reform changes did not consider progress made around the world. It is a necessity, not only for Ecuador, but for all other countries to be involved with the evolution of the taxation of the digital economy, in order to advance the legislation. It is not fair to criticize any governmental initiative without pointing out possible options that may be considered to get up to speed on the taxation of the digital economy, and how to implement new laws to facilitate the collection of a fair share of taxes from online businesses, while avoiding the enactment of laws that create a distorted business environment thereby discouraging those companies from investing in a particular country.

Possible Alternatives

Many developed countries have opted to enact unilateral digital service taxes this has led to several discussions and unilateral responses from other countries. As an example, the United States (US) started investigations to stop the spread of this unilateral taxes and has achieved the postponement of its application (i.e., France Digital Service Tax), and is trying to convince the United Kingdom (UK) to withdraw the already enacted DST considering that this countries are negotiating a free trade agreement.

On the contrary, developing countries generally do not have a strong position to negotiate with other countries in terms of taxation. But also, specifically regarding digital taxes, developing countries may not have all relevant pieces (knowledge and manpower in their tax administrations) to design appropriate legislation to take advantage of the digital economy.

A first impediment one that is not tax-related; is that developing countries have a technology barrier that has prevented them to have as much online services or products as developed countries.

Ecuador for example, needs to invest on infrastructure to allow their citizens to have access to digital services to begin with. It is considered that 80% of the Ecuadorian population have access to internet something that may not be that accurate, however, a majority of the users as well as the best quality of internet services are located in main cities (e.g., Quito and Guayaquil), while there are many other locations that have poor quality of internet service or even no access to it.

A population with access to quality internet services is key for the development of the digital economy and the consequent tax collection. Furthermore, national and foreign investors need to have the appropriate technological infrastructure to be able to provide a variety of digital products, as well as to generate technology and compete with them by advancing the digital economy.

From the tax perspective, the Ecuadorian government should give some consideration to joining the international tax debate on this matter. By taking action the Government will gain a perspective of the available options, to be part of this changing environment of tax transformation and technology investments.

Understanding digital services providers' needs, is the cornerstone of any developing Government plan to attract investors to develop the digital economy. By no means the enactment of unilateral measures should be considered the solution, therefore, not only Ecuador but other developing countries need to consider all the available options. Some of the digital taxation proposals that are out to be considered include:

- The application of the corporate income tax to the digital economy. The majority of the world leaders in the digital business are domiciled in developed countries. Most of these entities do not even have a permanent establishment in developing countries, although they provide services in these countries. Therefore, for developing countries, there is no way to tax those companies.
- To include their officials in the inclusive framework and the discussions derived from the OECD BEPS 2.0 project. For Ecuador, as well of other developing countries, being part of the discussion and the potential consensus among all the participants can make a difference.
- To consider a fractional apportionment method[2] to give the country greater taxing rights in the digital economy.
- While dividing the search for consensus is not a good option for digital services taxes, to participate on discussions regarding the implementation of a Digital Services Tax may give developing countries the tools required to address an appropriate tax.
- To impose custom duties to electronic transmissions[3]. This can have consequences with the World Trade Organization and a possible cascading effect,[4] that need to be discussed before considering them as an option.
- Countries may follow the United Nations (UN) Tax Committee proposal. The UN approach consists on the inclusion of an article in the double tax treaties to tax automated digital services. The proposal gives a country the right to source and tax cross-border payments via a withholding tax on gross income or an apportionment formula on net income.

A detailed study of the current policy discussions is the key for choosing a solution, if any will be implemented. A unilateral solution is not an option because, that will lead to more chaos, and will probably make developing countries less attractive to digital service providers as to other investors.

The key takeaways from the discussion on how to move forward on this topic from the perspective of developing countries can be resumed in: i) the necessity of investing in infrastructure that allows the development of digital businesses, ii) the will of developing countries governments to put the necessary efforts to participate on the discussions and gain experience to implement a solution, iii) the necessity of an international consensus to

implement the solution.

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[1] The BEPS Action Plan started as a project to design a framework to secure government revenues by ensuring that profits are taxed in the jurisdiction where the economic activities generating such profits are performed and where value is created.

[2] The method proposes the allocation of profit of digital businesses to a jurisdiction by establishing that the business has a sustained and significant economic presence there with sales exceeding a threshold amount. After that revenue is attributed to the digital permanent establishment based on the local customers' digital usage of the business.

[3] Customs on duties on electronic transmissions are tariffs that increase the price of imported services according to the policy objectives of the government that imposes them, the idea of custom duties is to protect the internal market from external competitors.

[4] In the case of Ecuador to impose tariffs on electronic transmissions will directly affect the taxable base for those transmissions, base that is considered to calculate VAT. Then electronic transmissions will increase their prices to final customers as a consequence of the application of custom duties.

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