Is income taxation of foreign digital goods and services in the market state compatible with current international principles on the attribution of tax jurisdiction?

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The Argentine 2017 proposed income tax amendment: A misstep averted just before reaching the edge of the cliff

1. Background

1.1. International context

The post-BEPS international tax scenario shows a rough, agitated transition towards a much more inter-nation equitable system where, progressively but within uncertain time contours, the states' national tax base is expected to be better protected against erosion and profit-shifting manipulations, as well as engrossed by a share of a greater world income basis resulting from the BEPS process' final grasp on previously nontaxable income.[1]

The international tax system is not yet stable and particularly in the area of stateless income manifestations (e.g., digital economy yields)[2] –absent a conclusive guidance within the income tax coming from the 2015 Report on Action 1– countries have showed themselves eager to grasp additional income fiercely competing with each other, and using innovative tax tools (special levies outside the income tax), aimed at bypassing well settled international income tax principles and DTA's obligations on the taxation of business income (examples abound, U.K. And Australian DPT, Indian equalization tax, EU Finance Ministers´ proposal on a gross turnover tax on digital companies. Italian equalization proposal).

Even a new trend within the income tax –consisting of stretching domestic source rules to accommodate taxation of business income derived from foreign source activities carried out by nonresidents– might spread, thus giving raise to extraterritorial taxation; recent amendments in Uruguay are a good example.[3] A draft rule finally not maintained in the text of the bill sent to Congress by the Argentine Executive Branch on November 15, last, was going in the same direction.

The Uruguayan experiment and the Argentine last minute aborted proposal demonstrates, once more, the urgent need for G20/OECD to head up the path forward on the taxation of digital economy income, giving a univocal direction under which countries may consistently align. The revised outcome on Action 1, expected to be issued in April 2018, it is a unique occasion for a timely response to the current lack of definition and the anarchic and massive irruption of emerging economies in the digital economy field.[4]

1.2. Argentine domestic law

The Argentine income tax law (ITL) asserts tax jurisdiction on residence and source. Residents are taxed on a worldwide income tax basis (articles 1 and 127, ITL) while non-resident aliens, whether individuals or legal entities having no presence in Argentina (i.e., a branch or, more generally, a permanent establishment or PE), are only taxable on Argentine source income, as defined by ITL and its implementing regulations (articles 1, 5, 6 to 13, 93, and accompanying implementing regulations).

Income from goods sold from abroad is foreign source in its entirely (article 8, ITL);

similarly, income from services carried out outside Argentina is sourced where the services are performed, in accordance with articles 5 and 127, ITL, and, hence, is not subject to the Argentine tax jurisdiction in the hands of non-resident taxpayers (accord. Article 1, ITL).

In connection with the taxation of non-residents, the principle of source plays a crucial role in allowing the exercise of tax jurisdiction and in defining taxable income, to such an extent that income from activities (e.g., the rendering of services) performed abroad in their entirely by non-residents are beyond the reach of the argentine tax jurisdiction; and that is so regardless of the fact that such services may be destined to customers, clients or end-users residing in Argentina. This last fact is alien to the assessment of source under ITL but for two exceptional cases: i) technical, financial or similar advice rendered from abroad under article 12, ITL, and ii) cinematographic films, radio or TV broadcasting or other means of video or sound transmission from abroad under article 13, ITL, provided that they are economically utilized in Argentina (i.e., used in a business by the resident service recipient).

This understanding is shared by the tax agency (AFIP) in cases concerning digital economy services rendered from abroad to end-users residing in Argentina: The residence of the users in Argentina (i.e., the existence of a local market) might not be deemed an income producing event nor a succedaneum of local activity deployed by a non-resident taxpayer in the context of ITL.

These technical legal concepts –identification of the source with the place where the income producing activity is deployed and the dissociation of the tax jurisdiction with the place of residence of the service recipient– are not only textual and clearly incorporated in ITL, but are of longstanding and almost universal application within OECD/G20 countries.

The operation of a digital platform also renders business income under treaty law and scholars' opinions. Regarding online advertising it has been sustained that the characterization of the activity is undoubtedly the provision of a service; an online advertiser hires and pays for advertising services (display of its advertisements among a particular audience of the Website) and not for the use of intangible assets developed by the site operator, e.g., database of users of the site.[5]

In similar terms, the Argentine tax agency has held that the nature of the activity may not be embrangled with the technological means through which the service is provided.

1.3. OECD MC, BEPS and beyond

OECD has undoubtedly characterized income from digital services as business income under article 7, OECD Model Convention (OECD MC). In the report to Working Party No. 1 of the Committee of Fiscal Affairs, produced by the technical advisory Group on the conventional characterization of electronic commerce payments,[6] all members of the Group unanimously agreed that payments for advertising services constitute business income under article 7, and not royalties under art. 12, regardless of the treaty wording variations of this last article.

This position has been maintained and invariably affirmed in other OECD's documents issued in later years. Thus, the TAG (Technical Advisory Group) 2005 report,[7] where in relation to the question of the place where corporate earnings originate (where it is their source) concluded that they must be deemed originating in the location where the factors that allow the company to get its income are located, thus rejecting the suggestion that the mere fact that a country provides the market towards the goods or services of the company are destined might allow this country to claim tax jurisdiction over any share of the business income on the basis of that single circumstance.

The content of the changes to the comments to article 5, OECD MC (2003) confirmed that the location of the servers could, under certain circumstances, constitute an EP, while expressly rejected a Website in the source country could constitute an EP.

The changes included in 2013 to the comments on article 12 of the OECD MC, at the same time, clarified the delimitation between the application of articles 7 and 12 in the context of new e-commerce business models and addressed cases of difficult apprehension and classification. The same paragraphs were included in the comments to article 12 of the UN Model Tax Convention (UN MC) – paragraphs 12 to 16-. The significance of these clarifications lies on the fact that none of them even slightly touch the issue of payments for online advertising; and this is so precisely because there is no room for doubt on the inclusion of that income within the scope of article 7 (business income); advertising income lacks any elements that might allowed that income to be characterized as royalties under article 12, OECD MC.

Insofar as the issue of digital economy income is concerned, the Final Report on Action 1 of the OECD/G20 BEPS Action plan, issued in October 2015, did not innovate on the traditional paradigms of residence, source and characterization; and, in fact, Annex A referred to and confirmed all the documents expressly mentioned in the preceding paragraphs where it was clearly supported the characterization of digital services as business income. In addition, it remains open and without definition the discussion on whether, under certain digital economy business models, tax jurisdiction on the overall income could or should, to a certain extent, be attributed to the market jurisdiction; and in fact, the Report did not support modifying the traditional paradigms of residence and source to accommodate that possibility. It is also well known that the Final Report on Action 1 did not adopt any recommendation whatsoever concerning taxation of income arising from the different manifestations of the digital economy; it only mentioned and meagerly described three possible, certainly innovative and highly controversial, venues, none of which has had widespread acceptance internationally [digital PE, tax withholding, and equalization tax].

1.4. Post BEPS national experiments on the taxation of digital economy's yields

Controversial domestic experiments and proposal in countries like the U.K, Australia, New Zealand, India, Indonesia, Turkey, Israel, and the recent EU proposal for a gross turnover tax on digital companies has determined OECD to attempt regaining control on the digital taxation area by speeding up a revision process originally expected by 2020. To that end, the Task Force on the Digital Economy (TFDE) sought public comments on key issues identified in a request for inputs related to the tax challenges[8] raised by digitization and the potential options to address these challenges, and held a public consultation meeting at the University of California, Berkeley on November 1st, last;[9] these new efforts are aimed at issuing a revised (interim) report considering inputs from stakeholders by April 2018.

Although OECD/G20's objectives at this stage may be much modest than arriving to a definitive solution on the taxation of digital economy, one would ideally expect that the hand-off, and optionality policies underlying the 2015 Report on Action 1 be replaced by the adoption of a uniform criteria on the attribution of income tax jurisdiction. Although it is premature to ascertain what would be the path chosen, whether to boost residence or source taxation on digital economy income, or even resorting to new paradigms such as destination based corporate income taxation, it is quite clear that the traditional inter-nation equilibrium between residence and source countries on business income will be shaken. Meanwhile, it is highly advisable not to adopt interim domestic solutions which, at last, might place a country in a competitive disadvantage vis-à-vis other G20 countries aligned with the revised outcome on Action 1.

2. 2017 Argentine tax reform: Taxation of digital services

The following rule ("the proposal") was included in previous versions the tax bill sent by the Executive Branch to Congress on November 15, 2017:

(First article added after article 13, ITL)

"Article … (I) .- *It is presumed, without admitting proof to the contrary, that FIFTY PER CENT (50%) of the price paid for digital services provided through the Internet or any adaptation or modification of the protocols platforms or technology used by the Internet or another network through which equivalent services are provided, constitutes net gain of Argentine source, when the service is economically used in the country. The regulations will establish the scope of the referred supplies."*

Since the proposal was highly inconvenient for policy, legal and technical reasons, The Ministry of finance decided to abort it before sending the bill to Congress.

By taxing foreign digital services, the proposal would have contravened ITL source rules on services rendered from abroad by non-residents having no PE presence in Argentina, and solid OECD guidance disallowing to peg source to the residence country of consumers, users or service recipients without any additional economic link between the foreign services provider and said jurisdiction.

Besides, the proposal would have created unfounded inequalities on the provision of services from abroad, artificially grounded on the way such services are put at the disposal of users or consumers; for example, under the proposal, advertising in the foreign press (e.g., in the New York Times or El Pais) would have remained untaxed, while advertising in a foreign platform would have been taxed.

Even though the proposal was aimed at reaching B2B services only, Argentine tax jurisdiction on services digitally provided from abroad remained unwarranted despite the fact that the Argentine recipient would have been allowed to deduct the correlative expense as connected with taxable income; in other words, and going back to the advertising example, if deduction by the Argentine counterparty were enough to justify taxation of the foreign provider as if it were obtaining Argentine source income, advertising in the traditional foreign press should have been similarly reached by the proposal and it was not.

The proposal would have generated double taxation. In effect, an isolated –not shared by most trading partner countries– taxation on digital economy's yields at source would have not allowed crediting the tax so imposed in the home country; this is so because according to international recognized rules, service income is sourced where the activity takes place, and the foreign tax credit is limited to taxes paid on foreign source income under the residence country's legislation. Similarly, taxable income under the proposal would not have been considered foreign source in exemption countries.

The proposal would have also contravened Argentine treaty obligations under current DTAs and the MLI (Multilateral Instrument) signed by Argentina on June 7, last.[10] Under all these agreements business income is exclusively allocated to the residence country unless the foreign enterprise has a PE in the source country and the income is attributable to the latter.

Bearing that in mind, the proposal would have also created significant differences between treaty and non-treaty countries, thus inadvertedly promoting a possible migration of foreign digital players towards treaty-partner countries, a move which could have made the new piece of legislation useless in terms of positive revenue effect.

Besides, pending the revised outcome of Action 1, BEPS, by April 2018, adopting a premature decision on a unilateral basis following a more than a decade old and highly controversial legislation in LatAm, as intended, might have implied taking serious risks of going in the opposite direction of most OECD/G20 countries.

From a different perspective, it is not clear why digital services would have been taxable while digital good would have not.

Finally, going to the text of the proposal itself, it is worth noting that a central definition (i.e., that of *digital services*) would have been left empty and conditioned upon the regulations' final elaboration, in what appeared to be an undesirable sort of *blank* taxable event. Queries also aroused in connection with the intended scope of digital services: were digital services just those of an automated nature that require no substantial labor force to be rendered? Was the rule aimed at reaching services that by its own nature might have been rendered inside Argentina but for the service provider's decision to migrate servers outside Argentina? In other words, would foreign labor-based digital services have remained untaxed in line with domestic and treaty general source provisions? On the contrary, were digital services of all type rendered by a foreign provider through the internet taxable? If that were the case, where was the dividing line: could even a foreign accounting or legal advice rendered by mail to an Argentine client have felt within the scope of taxable digital services? Just an extreme example of the many uncertainties the proposal would have created if maintained in the text of the bill sent for Congressional consideration.

3. Final comment

Until the taxation of the digital economy is reassessed, national conflicting experiments will be repeated once and again, without a meaningful, solid, and uniform conceptual basis, and, consequently, with grave consequences to the industry players in terms of multiple layers of taxation.

Moreover, should the present lack of definition be maintained for long, tax anarchy will continue to spread with unilateral diverging measures and countermeasures, highly damaging to digital players, flows and yields, consumers, and tax administrations that embark in an endless tax competition.

[1] Teijeiro, *A call for a Sustainable Response to the taxation of Digital Economy within the International Income Tax System,* Kluwer international Tax Blog, October 17, 2017.

[2] In an article published in 2015, I alerted on the instability of the current world tax scenario, based on a number of different but confluent circumstances including, *inter alia*, potential inter-country tax imbalances coming from a perceived intention of governments to grasp as much income from border-less activities as possible –such as the various manifestations on the digital economy– whether at residence or at customers' jurisdictions (accord., Teijeiro, *Opening the Pandora's Box in the International Tax Field (First Part),* Tax Planning International

Review, volume 42, #4 April 2015, p. 4 ss). See also, tax Sovereignty in the BEPS Era, Rocha-Christians eds., Wolters Kluwer, Series in International Taxation 60, 2017; Chapter 6, Teijeiro, *Jurisdictional Excesses in BEPS Times: National Appropriation of an Enhanced Global Tax basis*.

[3] See Ramirez, La Experiencia Uruguaya en Materia de Impuesto a la Renta en el Marco de la Economía Digital, work prepared for seminar 1, IX IFA LatAm Congress, Buenos Aires, May 31-June 2, 2017

[4] Id. note 1, above.

[5] Kim A., L. Neumann, Netser I. and Fuller J., *Character and Source of Income from Internet Business Activities.*

[6] Technical Advisory Group on Treaty Characterization of Electronic Commerce Payments, February 1, 2001.

[7] Technical Advisory Group, *Treaty Rules and E-Commerce: Taxing Business Profits in the New Economy.*

[8] www.oecd.org/…/tax-challenges-digitalisation-part-2-comments-on-request-for-input-2017.pdf

[9] https://www.youtube.com/watch?v=pDmxwlkJkDQ, https://www.youtube.com/watch?v=PcJMt75wDgM

[10] See Teijeiro*, MLI minimum standards on treaty shopping and mutual agreement procedure. LATAM countries' position,* July 3, 2017.