Market access based income tax on cross-border digital trades: A second best for the LATAM Region?

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The OECD's BEPS 2.0 project is currently navigating turbulent waters partly because of the unexpected Covid19 crisis and its impact on state budgets and the need for additional revenues, and partly because of internal tensions and conflicts within OECD dominant group of industrialized countries, the 140-member-state inclusive framework, and the business community. Disagreements include (but are not limited to) the ring-fencing of the digital economy taxation (an idea that China and The US strongly oppose), and the allocation of taxing powers to market jurisdictions under Pillar I of the OECD Unified Approach.

In fact, OECD delayed(1) from July to October 2020 the target to reach a unified digital tax solution, and Pascal Saint-Amans (Director of the Center of Tax Policy and Administration) recently recognized that, insofar as Pillar I is concerned, amid the alignment of stakeholders' interest, the final outcome might be reached by stages over a process which would last until 2021.(2)

This postponement is not good news for a process that, although developed under a tightening timeframe thus far, widens the window to unilateral state experiences fueled by budget constraints and increased political pressures in a covid19 context. A number of emerging economies –particularly the biggest players in the LATAM region– had previously delayed any legislative action in this area until the 2020 final OECD outcome whose occurrence is now fatally delayed until next year.(3)

Unfortunately, in this context, one may not envisage but a "rebellion in the farm" greater than ever, with leading countries and emerging economies as well trying to apprehend the digital economy's yields and income under the various policy lines already on the menu or even under newly developed, more or less creatively designed, tax tools.

In my view, this trend will certainly deepen outside Europe during the second semester of 2020, unless a harmonized OECD solution to market countries' genuine, equitable appetites start to be sought shortly, balancing the theoretical adherence to value creation concepts coming from the economic science, on one hand, and the bargaining aspect dictated by the political science, on the other hand, and, hence, allowing a revenue-satisfying outcome to emerging markets to be reached.

So far the national administrations of emerging economies perceive that, in allocating direct taxing rights over the new economy, OECD is excessively pegged to a theoretical economic approach and lacks the political flexibility needed to arrive at a satisfactory outcome that genuinely contemplates the national interest of market states; or, even worse, that in the re-slicing of the greater pie coming from the direct taxation of income derived from the digital businesses, the central economies influence the OECD to follow a path that would change nothing (or almost nothing) in terms of allocation of taxing powers to markets, while adding simultaneously extreme complexity to the administration of the system, far beyond the capacity of emerging countries' tax administrations. That perception has significantly grown as from the release of the OECD Unified Approach, and, besides, is on the very basis of the apparently unstoppable proliferation of diversified national tax tools designed to cope with the lack of an equitable, uniform, and harmonized income tax solution.

Individual countries have been exploring domestic direct tax measures on the cross-border trade of digital goods and services for a while, and this trend grows lately since the massive shift to digital commerce during Covid19 times clearly shows the need of grasping tax revenues from profitable segments in this sector of the economy.(4) In this sense, observers concur that a key current trend to consider is (i) the extent to which large consumer markets in emerging Latin American or Asian economies turn towards passing unilateral tax solutions alien to the OECD Unified Approach, and (ii) their willingness to deactivate them in the future if the OECD ever reaches an agreeable, harmonized solution.

A global picture of unilateral initiatives developed in the area of direct taxation on the digital economy (including special levies outside the income tax system that work or were aimed at working as a proxy to the income tax) shows at least two different groups of measures classified on the basis of their fiscal efficiency.

A first group made of levies that have not been fully efficient fiscal wise, either because they fail to apprehend the digital businesses altogether, or because of other reasons, such as the lack of practical application or limited scope. These include: (i) the traditional PE concept, as updated by BEPS Final Recommendation on Action 7, subsequently reflected in the OECD MC 2017 and the MLI, which In terms of efficiency to catch income arising from the digital economy has proved to be useless;(5) (ii) the diverted profits tax or DPT (United Kingdom,(6) Australia) which, in practice, served more as a menace to force transfer pricing adjustments in the income tax than as a revenue tool in itself;(7) and (iii) the 2016 equalization tax (India), whose taxable matter was originally limited to cross-border advertising services.(8)

A second group of unilateral experiences include the economic significance presence or digital PE in the market state (regulated, among others, in Malaysia, Turkey, Israel, and Slovak Republic),(9) and (ii) the digital service tax or DST approved in Italy, and France,(10) following the 2018 European Commission (EC) Initiative,(11) and the pending approval in Spain, the United Kingdom, Poland, Austria, Portugal and the Czech Republic. O——————————————————————————n the same track, the EC has recently proposed to revive the DST at the European level if there is no agreement at the OECD this year.(12)

Besides all of the above, some Latin American countries have resorted to the application of somehow innovative source rules that confer income tax jurisdiction to the country where the service recipient, customer or client is situated, regardless of the place where the service or good provider performs its activities, i.e., even in the case in which the foreign provider's sole nexus to the taxing jurisdiction is precisely the residence of the service recipient, customer or client. These are the cases under the domestic tax laws in force in Peru (pre-BEPS legislation) and Uruguay (post-BEPS legislation). A similar proposal was discussed in Argentina in 2017, but the proposed provision was eliminated from the bill by the Executive Branch right before the bill of what was later the 2017 tax reform (Law 27,430) were sent to Congress for consideration.(13)

The lack of a final, timely, harmonized OECD solution to the direct taxation of the digital economy(14) opens chances for the Latin American innovative source rules on income from the digital economy to be reconsidered within certain premises and conditions; thus, arriving at what would be a sort of market-access based income tax, limited to ring-fenced highly digitalized cross-border B2B businesses.

The first query would be whether the sole residence in the market jurisdiction of the service recipient, customer, or client might be deemed as a sufficient *nexus* for the income of the foreign digital seller or service provider to fall within the taxing powers of that jurisdiction. Since business customers tend to be immobile (fixed in a given jurisdiction) even for highly digitalized, mobile, foreign providers, and on the premise that there is no income without sales, the taxing right of the market jurisdiction on the income derived therein by a foreign seller or service provider appears to be at least as justifiable as are other acceptable connections- under international tax law.(15) Moreover, conventional international tax law has already receipted the payer residence as a legitimate connection.(16)

Under Argentine tax law, there are already contemplated two cases where the residence of the service recipient control the taxation of certain targeted cross-border services: (i) technical, financial or similar advice rendered from abroad under article 13, of the income Tax la (ITL), and (ii) exploitation of cinematographic films, radio or TV broadcasting, or other means of video or sound projection, reproduction, transmission and/or diffusion from abroad under article 14, ITL, provided that they are economically utilized in Argentina (i.e., used in a business by the resident service recipient).(17)

The tax should be applied through a withholding at source to be made by the resident buyer or service recipient on a presumed net income basis to be determined, thus facilitating administration and control in the market jurisdiction. This presumption system (widely utilized in Latin American legislation for other types of cross-border income) should be fair enough as to recognize that value creation also depends on other factors located outside the market jurisdiction, and to allow the foreign seller or service provider residing in a tax-credit country to offset the withholding at home as long as its tax legislation is adapted to that end.(18)

This was the mechanism utilized by the proposed text designed by the Argentine Executive branch on occasion of the 2017 tax reform; the proposal (first article to be incorporated after article 13 of what was then the text of ITL, read as follows:

"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."

Of course this is just a mere example, and the above text is perfectible in many ways.

The proposal would require ring-fencing digital business income not to collide with the tax treatment afforded under domestic law to the importation of goods and services from abroad generally (which may or may not be similarly taxable), but there would be no reasons to distinguish between cross-border provision of digital goods and services.

From another perspective, a market-access based income tax on digital goods and services should be contemplated in existing double tax treaties via the MLI. Otherwise the adoption of such a proposal exclusively in the internal laws of market jurisdictions would create significant differences between treaty and non-treaty partner-countries, thus promoting a migration of foreign digital players towards treaty-partner countries, a move that could make the innovation useless in terms of positive revenue effect for the market jurisdiction.

The OECD-G20 group of countries has been lined up for a while behind rather different premises to solve the elusive problem of reaching consensus over the direct taxation of the digital economy; and the tax world is anxiously waiting for a final harmonized outcome that contemplates the genuine interest of market states; That would be a triumph of tax multilateralism and the end of the tax chaos that otherwise might seriously jeopardize international digital commerce for decades. This is a reality that might make any speculations on an alternate plan, *per se*, a futile effort.

However, the complexities in terms of political agreements and technical solutions are such at the OECD level nowadays , that the potential absence of a timely, final agreement, opens the window to a second best, a coordination of unilateral state responses patterned after market access based income taxation; i.e., a coordination of market States' taxing powers within the income tax system, that it is by far superior to the proliferation of an archaic DST without an incorporated system to avoid multiple layers of taxation.

If that idea becomes suitable in case no agreement is reached at the OECD level on the current premises, efforts should be made to implement market access based income tax on cross-border digital economy income on a wide geographical basis, i.e., in LATAM, at least adding up major economies grouped in Mercosur and Pacific alliance trade blocs. By contrast, a unilateral, isolated attempt will damage the taxing jurisdiction vis-à-vis competing markets.

[1] Gottlieb, Ali, *Pandemic Delays Global Agreement on Digital Tax to Fall*, Daily tax Report: International, May 4, 2020, Bloomberg Tax https://news.bloombergtax.com/daily-tax-report-international/pandemic-delays-global-agreement-on-digital-tax-rewrite-to-fall The OECD may hold the previously scheduled July meeting virtually because of the coronavirus, but will not deliver the digital tax plan by then, Pascal Saint-Amans, Director of the OECD's Center for Tax Policy and Administration, said on the OECD webcast of May 4, last. He added that countries will meet in October–either physically or virtually– to complete negotiations, but the reasonable expectation here is that it may be a staged process on at least some of the aspects particularly concerning Pillar I, so that full implementation details would be decided in 2021.

[2] Amaro, CNBC, Europe News, May 25, 2020, *Europe could target Silicon Valley with taxes to help it rebound from the coronavirus-fueled recession* https://www.cnbc.com/2020/05/25/coronavirus-why-the-crisis-might-mean-higher-taxes-on-silicon-valley.html?__source=sharebar|linkedin&par=rebshaar

[3] The OECD/G20 Inclusive Framework on BEPS` document dated May 29, 2019, *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalization of the Economy* (https://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf) recognized that if the Inclusive Framework would not deliver a comprehensive consensus-based solution within the agreed G20 time frame, i.e. by the end of 2020, there was a risk that more jurisdictions will adopt uncoordinated unilateral tax measures, thus increasing significantly the risk of growing compliance burdens, multiple taxation and uncertainty in the international scene.

[4] Id. 2, above

[5] Highly digitalized businesses do not need to maintain a traditional physical presence in market countries since they mostly rely on remote functions and automated processes, and whenever support and marketing functions are required in relevant markets, these functions are entrusted to related entities in the jurisdiction that are remunerated on a cost-plus basis, and do not *per se* entail a PE risk; unless in jurisdictions where related entities are not deemed a PE, as it is generally the case but for certain Spanish case law, including the decisions of the *Tribunal Superior* in re *Roche* (2012) and *Dell* (2016).

[6] For a description of the UK DPT see Teijeiro. *Once more on a short-of-expectation BEPS outcome and the erratic domestication of a weak guidance: The case of the digital economy*, Kluwer International Tax Blog, August 29 2016

[7] The French DPT approved by the end of 2016 was declared unconstitutional shortly thereafter: Constitutional Council, December 29, 2016, Decision 2016-744 DC.

[8] This last tax, however, has been revamped and widened in scope recently, to become a general tax on the foreign provision of digital goods and services on the internet, as reported in Jain, Nagappan, Agarwalla, *India Equalization Levy Expanded—a Surprise Move! (Part 1),* Daily Tax Report: International, May 29, 2020, Bloomberg Tax https://news.bloombergtax.com/daily-tax-report-international/india-equalization-levy-expanded-a-surprisme-ove-part-1

[9] This approach, where allocation of the taxable basis is made under a formulary approach, had been contemplated as an alternate harmonized approach in the OECD Policy Note and the March 2019 Document, basically with the endorsement of Colombia and India, but later vanished from the OECD Unified Approach under Pillar I, as released by the OECD Secretariat in October 2019 (https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf) This document focused exclusively on the user participation (for highly digitalized businesses) and market intangible (for highly digitalized and other consumer-oriented businesses) approaches; these are a couple of alternatives which observers from emerging economies have qualified as detrimental to the interest of this group of countries since they would not significantly alter the allocation of revenues to market states. While discussing the marketing intangibles approach at the OECDIFA Panel of the 2019 London IFA Congress, Amy Roberti (Global Director of Taxes of Procter & Gamble) recognized that the appropriation of residual income based on marketing intangibles would modify almost nothing for a company like Procter & Gamble, since its market intangibles were mostly developed and are located in the US.

[10] The effective application of the French DST has been postponed to 2021

[11] See Teijeiro, *Are We Finally Coming into Terms on the Taxation of the Digitalized Economy? A View from a LATAM Perspective,* Kluwer International Tax Blog, June 28, 2019. For countries' reasons to resort to non-income levies rather than to the income tax system, see Teijeiro, *A call for a Sustainable Response to the taxation of Digital Economy within the International Income Tax System*, Kluwer International Tax Blog, October 5, 2017,

[12] See 2, above. See, also, Gardner, *New EU Tax Proposals Later if OECD Talks Fail, Top Official Says*, Daily Tax Report: International, May 28, 2020, Bloomberg Tax https://news.bloombergtax.com/daily-tax-report-international/new-eu-tax-proposals-later-if-oecd-talks-fail-top-official-says Bunn, *EU: The Next Generation, The Tax Foundation, May 27, 2020 https://taxfoundation.org/eu-budget-proposal-next-generation/#.XtBJc8YXWX0.linkedin* EY Tax News Alert, *European Commission publishes proposal for recovery plan and adjusts 2020 Work Programme* https://globaltaxnews.ey.com/news/2020-5790-european-commission-publishes-proposal-for-recovery-plan-and-adjusts-2020-work-programme

[13] For a critical appraisal of these source rules under the traditional source concept, see Teijeiro, *Is income taxation of foreign digital goods and services in the market state compatible with current international principles on the attribution of tax jurisdiction,* Kluwer International Tax Blog, November 22, 2017

[14] As well as of the lack of a competitive challenging proposal as it could have been a global trend following the adoption of a destination-based corporate income tax by the US patterned after the guidelines of the Treasury White Paper released in 2016 (see Teijeiro. *Is the US DBCFT proposal the beginning of the end for the traditional residence-source paradigm?* Kluwer International Tax Blog, February 24, 2017.

[15] In fact, the legislation of LATAM countries such as Mexico, Brazil, and Peru contemplate cases in which the tax is applied where the payer is located.

[16] As recently as 2017, the UN Model has introduced amendments to the allocation of taxing rights for technical services to the jurisdiction of the payer (see article 12A, paragraph 5, UNM (2017).

[17] Id. note 13, above. Articles 13 and 14, ITL, text ordered by Decree 814/19 (former articles 12 and 13, ITL).

[18] The legislation of both tax-credit or exemption residence countries should be reconciled so as to consider the digital business income taxable in the market jurisdiction as sourced outside the home country.