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Are We Finally Coming into Terms on the Taxation of the Digitalized Economy? A View from a LATAM Perspective

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A. Where are we? A worldwide and LATAM picture

A current worldwide picture of unilateral initiatives developed on the direct taxation of the digitalized economy includes at least the following paths:[1] (i) the traditional PE concept, as updated by BEPS Final Recommendation on Action 7, and subsequently reflected in the OECD MC 2017 and the MLI; (ii) the diverted profits tax or DPT; (iii) the equalization tax; (iv) the digital service tax or DST; and (v) the significant economic presence or digital PE, with its progeny under the Policy Note and the Public Consultation Document issued by the OECD in January and March, 2019, respectively, i.e. the user participation and the marketing intangibles sub-alternatives.

Besides, some Latin American countries have resorted to the application of peculiar, somehow distorting, source rules which confer income tax jurisdiction to the country where the 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 customer or client. These are the cases under the domestic law in force in Peru (pre-BEPS legislation) and Uruguay (post-BEPS legislation).[2] A similar proposal was discussed in Argentina in 2017, but the provision was eliminated by the Executive Branch before the bill of what was later the 2017 tax reform (Law 27,430) was sent to Congress for consideration.[3]

In terms of efficiency to catch income arising from the various business models of the digital economy, the traditional PE concept has proved to be useless; and this is so because highly digitalized businesses do not need to maintain a bricks & mortar presence in market counties since they mostly rely on remote functions and automated processes. Moreover, whenever support and marketing functions are required in the market (as in the case of most relevant markets), these functions are entrusted to related entities in the jurisdiction remunerated on a cost-plus basis, which do not *per se* entail any PE risks.[4]

Based on the foregoing, the amendments to article 5, OECD MC (2017) and corresponding provisions of the MLI, coming from BEPS Action 7 on the negative list (article 5, par. 4) and agent PE rules – commissioners, exclusive independent agents – (art. 5, par. 5 and 6) have limited, if any, influence on the digital economy sector. Besides, at least based on initial reactions, changes to article 5 are expected to be implemented in a relatively low number on bilateral relationships under the MLI.

The UK DPT[5] was conceived and designed as a separate levy from the corporate income tax, whose objective was reaching multinational entities (MNEs) that market digital goods and services in the jurisdiction, and utilize artificial structures that lack substance, either to avoid a PE or to erode the tax basis of an entity in the jurisdiction. Under a sort of *open* taxable event, DPT applies under the fiction that there is a PE in the jurisdiction, or that the income in the UK attributable to a subsidiary therein would have been higher by application of the transfer pricing guidelines. Instead of being effectively applied, DPT has mostly served as a dissuasive tool to force transfer pricing adjustment in the income tax. A similar levy has been applied in Australia. A French DPT approved by the end of 2016 was declared unconstitutional shortly thereafter[6] as it was deemed to violate the constitutional principle of reserve, according to which the law must set forth the tax base, the tax rate and the form of application of taxes generally, and DPT, as it had been designed, lacked those characteristics. Since DPT in other civil law countries – like most LATAM countries – would have encountered similar troubles, it has not been proposed as an option to tax digital economy´s yields in the region.

The equalization tax in India consisted of a 6% levy on payments to non-residents for the provision of online B2B advertising services to be withheld by Indian service recipients.[7] It is a special levy that substitute the income tax and is applied on a legal fiction since payments from India to foreign advertising providers are deemed a proxy of actual activity carried out in India by the non-resident beneficiaries of the payments. In other words, the equalization tax is an extraterritorial or *ultra vires* income tax disguised as a special levy. Like the DPT, the equalization tax does not allow crediting against the corporate income tax in the taxpayers' home country, so that both levies potentially originate cascade taxation in the international field.

DST was first proposed by the European Commission as an interim solution to the taxation of the digital economy by a EU Proposal for a Council Directive released in March 2018;[8] though the Directive is still pending and the approval has been postponed this year for lack of the required agreement among EU Member States. Meanwhile, unilateral proposals for a DST (including a more limited digital advertising tax) proliferated all over Europe. In Italy, a 3% DST on the value of B2C services to be withheld by Italian residents was approved last year, and it is to be implemented during 2019 after complementary regulations are issued.

Approval of similar DST initiatives is pending in France, Spain and the UK. The French initiative (the so called GAFA tax) – currently subject to Parliament's approval – consists of a 3% levy on gross receipts coming from advertising services, websites, and the resale of users' data, obtained in France by non-resident service providers whose global and French invoicing exceeds EUR 750 million, and EUR 25 million, respectively. Similarly, the Spanish proposal which would need to be resent to Parliament after the change in government, consists of a 3% on gross receipts from advertising services, online services in the sharing economy sector, and the sale of users' data, by non-resident service providers whose invoicing level exceed the global and domestic thresholds set in EUR 750 million and EUR 3 million, respectively. The UK's DST is a levy which would apply from 2020 and to be revised in 2025, at a rate of 2% on gross receipts derived by non-resident entities managing search engines, social networks and online markets whose global and UK invoicing exceed GBP 500 million and GBP 25 million, respectively. The most recent European DST proposals include those under consideration in Austria, the Czech Republic, Poland, and Portugal.

In Latin America, DST proposals have been discussed in Chile and Mexico. The initiative in Chile consisted of a 10% on gross sales proposed by the Pineda's administration in the second half of

2018. The initiative appears now to have been abandoned and replaced by an amendment to the general 19% VAT addressed to cover digital services rendered from outside Chile.[9] In Mexico, the initiative originated in Parliament is still in a precarious form since some technical aspects need to be re-addressed. The levy appears to be patterned after the European proposal, but the tax basis would be net income instead of gross turnover. Moreover, quite surprisingly, taxpayers are limited to domestic entities and PE of foreign entities in Mexico, leaving outside the scope of application foreign entities rendering digital services across the border and without a Mexican presence. Finally, it is queried whether this proposal has some chance to be approved in a foreseeable future since it came from an opposition party and, reportedly, the current administration of Mr Lopez Obrador took office with the promise not to raise taxes during the fist three years of government.

In accordance with the Final Report on BEPS Action 1 (2015)[10], a non-resident enterprise has a significant economic presence based on factors that evidence a meaningful and sustained interaction with the economy of that country via technology and other automated tools. In turn, a presence of that sustained interaction comes from a combination of (i) a revenue-based factor, i.e. transactions with in-country customers over a pre-set threshold; (ii) digital factors, such as local domain name, local digital platform and local payment options; and (iii) user-based factors, including monthly active users, regular online contract conclusions, and volume of data collected.[11]

The significant economic presence test for nexus has not lost vitality nowadays and, in fact, it is kept and an alternate global solution in the OECD Policy Note, and under Pillar 1 of the Public Consultation Document released on March 6, 2019.[12] Insofar as the attribution of income to the market state in case a significant economic presence therein is verified, this last document is inclined to apply a formulary approach based on sales, assets, and personnel, complemented by a withholding tax as a collecting tool, as long as it does not originate double or multiple taxation.

The significant economic presence test has been applied extensively in unilateral experiences around the world, including pre-BEPS initiatives like that of Malaysia (2013), and post-BEPS domestic statutory amendments in Turkey and Israel (both in 2016), the Slovak Republic (2017), Kuwait and Saudi Arabia, and the Indian proposal that is expected to come into effect this year.

No PE legislation in the LATAM region has included the concept of significant economic presence yet, and though the concept still carries application queries, particularly concerning attribution rules, there are reasons to believe that this is an attractive policy option to emerging economies in LATAM, that might even think of it as a new rule to assert jurisdiction in the international field not only on highly digitalized businesses but on other sectors of the economy as well.

Meanwhile, the OECD document released last March 2019 presented two sub-alternatives to measure value, and hence income, attributable to market jurisdictions which to some extent function as proxies to the significant economic presence: (i) the user participation proposal, exclusively addressed to highly digitalized businesses, which are then ring-fenced against one of the main objectives of Action 1 of the G20-BEPS Action Plan, and (ii) the marketing intangibles proposal, which would be applicable on a same foot to highly digitalized and other businesses.

The user participation proposal would imply resorting to a new nexus based on the value created by highly digitalized businesses through the development of an active user base, data requirements and content contributions from users. It would imply changing current nexus rules, and the new income attribution would only apply to social media platforms, search engines and online markers.

Income to be attributed to the users' jurisdictions would be calculated through a non-routine or split residual income approach, i.e. a complex mechanism hardly administrable by tax authorities of emerging economies in LATAM and elsewhere.

The remaining sub-alternative takes into consideration the connection between marketing intangibles and market jurisdictions, and, on that basis, the proposal would imply modifying transfer pricing and treaty rules to require that marketing intangibles and associated risks be attributed to market jurisdictions. It would also imply modifying conventional rules to allow market jurisdictions to levy income from marketing intangibles even in cases where the entity does not have a taxable presence there.

For emerging economies in LATAM, the marketing intangibles option is more attractive than the user participation proposal as a new nexus rule for two reasons: (i) it would apply to highly digitalized and other businesses, and (ii) it would assert market jurisdiction states' right to tax, regardless of the existence of a taxable (physical) presence in the jurisdiction. When it comes to the consideration of the income allocation rule to market states, however, the marketing intangibles proposal emerges as a squalid version of the significant economic presence test and it could be viewed as detrimental to the emerging economies' legitimate aspirations as market states.

B. Where are we headed?

The OECD/G20 Inclusive Framework on BEPS` last document dated May 29, 2019, *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy*,**[13]** started recognizing that if the Inclusive Framework does not deliver a comprehensive consensus-based solution within the agreed G20 time frame, i.e. by the end of 2020, there is 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.

Based on that context, it restates the ambitious 2020 timeline for finalizing a consensus-based solution among the 129 members of the Inclusive framework.

Chapter II of the document focuses on the allocation of taxing rights (Pillar One), and describes the different technical issues that need to be resolved to undertake a coherent and concurrent revision of the profit allocation and nexus rules, while Chapter III focuses on remaining BEPS issues (Pillar Two) and describes the work to be undertaken in the development of a global anti-base erosion (GloBE) proposal that would provide jurisdictions with a right to "tax back" where other jurisdictions have not exercised their primary taxing rights, or the payments are otherwise subject to low levels of effective taxation.

Under Pillar One, the three proposals coming from the Policy Note and the March document (namely significant economic presence, user participation and marketing intangibles) are reiterated as possible paths to develop a consensus-based solution on how taxing rights on income generated from cross-border activities in the digital age should be allocated among countries.

These proposals have common policy objectives which consist of (i) contemplating the existence of a nexus in the absence of physical presence, (ii) using the total profit of a business, and (iii) contemplating the use of simplifying conventions to reduce compliance costs and disputes. However, they also have important differences, including but not limited to the scope of the reallocation of taxing rights to the market jurisdictions in situations where value is created by a business through participation in that jurisdiction.

Within this framework, technical issues that need to be resolved under the program are grouped into three building blocks: (i) different approaches to determine the amount of profits subject to the new taxing right and the allocation of those profits among the jurisdictions; (ii) the design of a new nexus rule that would capture a novel concept of business presence in a market jurisdiction not constrained by a physical presence requirement; and (iii) different instruments to ensure full implementation and efficient administration of the new taxing rights, including the effective elimination of double taxation and resolution of tax disputes.

As regards the issues highlighted in (i) of the preceding paragraph, i.e. approaches for profit allocation, the focus of the program is on modified residual profit split, fractional apportionment, distribution based, business line and regional segmentation, carve-outs, and how to deal with losses. As regards nexus (point (ii) of the preceding paragraph), focus is on developing a concept of remote taxable presence, changing article 5 OECD MC (PE clause) or incorporating a new, separate concept; as well as thresholds to be used to target significant economic involvement with market jurisdictions.

C. 2020 and beyond: What is next for Latin America

Due to an increasing political pressure and the tax administrations' desire to grasp income from the new economy to finance ever increasing public needs while keeping balanced national budgets, agitated parliamentary times are to be expected in the region as from next year. However, what can be expected in terms of technical tools to reach that objective will mostly depend on the OECD outcome in terms of timing and substance.

If the OECD does not reach consensus on a uniform multilateral response by the end of 2020, (i) unilateral, misaligned responses will proliferate all over the region, and (ii) DST-like levies and/or massification of distorting source rules in the income tax system (similar to those already existing in Peru and Uruguay) are to expected.

If, instead, a uniform multilateral response is reached within the OECD inclusive framework, unilateral measures will be unwind, and major emerging economies in the region – including OECD member states like Chile, Colombia, and Mexico, and prospect member states like Argentina, Brazil, Peru and Costa Rica – will most probably align and lead a conforming trend in the direct taxation field. Of course, this process will widespread only if in the previous process towards consensus within the OECD inclusive framework, the region speaks with one voice in terms of its aspirations on nexus and allocation of income, and the outcome comforts to it. If, on the contrary, the outcome is viewed somehow detrimental to those aspirations, some dispersion in the domestic LATAM legislative responses is still possible.

END NOTES

[1] This picture includes special levies outside the income tax system applied on different tax basis, such as gross turnover, but that works or are aimed at working as a proxy to the income tax.

[2] For a critical appraisal of these source rules, particularly referred to the Uruguayan legislation, 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,

http://kluwertaxblog.com/2017/11/22/income-taxation-foreign-digital-goods-services-market-state-compatible-current-international-principles-attribution-tax-jurisdiction/

[3] See footnote 1, above, particularly at point 2.

[4] Unless in jurisdictions where related entities are not deemed a PE (this is generally the case but for certain Spanish case law, including the decisions of the Tribunal Superior in re Roche (2012) and Dell (2016)).

[5] 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, http://kluwertaxblog.com/2016/08/29/once-more-on-a-short-of-expectation-beps-outcome-and-the-erratic-domestication-of-a-weak-guidance-the-case-of-the-digital-economy/

[6] Constitutional Council, December 29, 2016, Decision 2016-744 DC.

[7] For a critical appraisal see Teijeiro, 'Detecting clouds before the Post-BEPS storm becomes uncontrolled', Kluwer International Tax Blog, March 30 2016, http://kluwertaxblog.com/2016/03/30/detecting-clouds-before-the-post-beps-storm-becomes-uncontrolled/

[8] Reasons to resort to special (no income) levies are various, including (i) an apparent OECD/G20 blessing coming from the optionality contemplated in the outcome of the 2015 Report on Action 1, (ii) collection's easiness; (iii) the need to prevent collision with obligations undertaken under tax treaties, and (iv) the central economies' failure to assume themselves as market jurisdictions, a condition which for the first time in almost a century align them with emerging (source) economies. In this scenario, instead of recognizing income tax jurisdiction to market countries generally, either through a digital PE or another concept dissociated from the bricks & mortar economy, and even assuming the risk of altering the current jurisdictional balance between residence and source countries, central economies (particularly EU countries) have been inclined to adopt a somehow schizophrenic behavior – against their own long-term interest in the digitized era – consisting of proposing or adopting special non-income levies that leave the income tax inter-nation balance apparently unaffected. 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, http://kluwertaxblog.com/2017/10/05/call-sustainable-response-taxation-digital-economy-within-international-income-tax-system/

[9] VAT legislation in LATAM on cross-border digital economy transactions following BEPS recommendations has been already passed in Argentina, Colombia, Costa Rica and Uruguay.

[10] For further reference see Teijeiro, The BEPS Project Lacks Comprehensive Definition on the Taxation of Digital Economy in Market Jurisdictions', Kluwer International Tax Blog, October 24 2015, http://kluwertaxblog.com/2015/10/24/the-beps-project-lacks-comprehensive-definition-on-the-taxation-of-digital-economy-in-market-jurisdictions/

[11] The 2015 Report on Action 1 contains the following example: a non-resident enterprise (i) generates gross revenue above the threshold (ii) from transactions with in-country customers

concluded electronically (iii) through a localized digital platform (iv) where the customer is required to have a personalized account and utilize the local payment options offered on the site to execute the purchase, it could be deemed that there is a link between the revenue generated from that country and the digital and/or used based factors evidencing a significant economic presence in that country.

[12] https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf

The significant economic presence text is the taxation mechanism in the market jurisdiction favored by the International Bureau of Fiscal Documentation's written document submitted to OECD on March 6, 2019, and co-authored by Pasquale Pistone, Joao Nogueira, and Betty Andrade.

[13] 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

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