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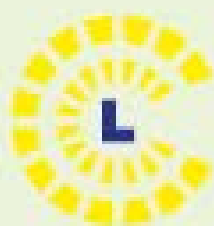
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**TAXATION AND THE
DIGITAL ECONOMY**







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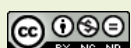
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PRESENTATION

Advances in technology have driven forward the globalization of the economy, with extremely important effects that would have been unimaginable just a few decades ago. The development of this globalized economy has paved the way for new economic models in the world, models that break away from the traditional paradigm and set the foundations for necessary agreements on the taxation of international operations.

It can be observed that activities on electronic service platforms, which are no longer restricted to a single territory but rather can be offered at a global level, do not fit the concept of a permanent establishment and, as such, they do not fall in line with the taxation requirements associated to this concept.

Moreover, with these services, we have seen the rise of unfair competition that undermines many traditional activities, such as advertising, for instance. In addition, with the intervention of intermediaries in such cases, the profits of professionals and the corresponding tax bases are reduced, a phenomenon that has been notable in sectors such as hotel bookings and taxis, to name just a couple.

Furthermore, all this leads to a considerable reduction in revenues from taxes on company profits in many States and, as a result, it is necessary to define new international taxation regulations adapted to the digital economy.

One of the strategic objectives of the Comité de Integración Latino Europa-América (CILEA) is to take an active part in the international debate that has arisen around the digital economy.

The professionals who comprise the CILEA have in-depth knowledge of the world of companies and their obligations. Moreover, our professional practice is underpinned by ethics and a commitment to the public interest.

By aligning our objectives and knowledge with the needs of the companies that we advise, in this report, we put forward a number of reflections and proposals that we are confident can help improve regulation and reduce inequalities.



Philippe Arraou
Report Coordinator



Gustavo Gil Gil
Chairman of the CILEA

BACKGROUND



In 2017, the Comité de Integración Latino Europa-América (CILEA) conducted a survey among its members, asking whether their countries had specific regulations on the taxation of electronic commerce, both in terms of direct and indirect taxes, applicable to B2B (Business-to-Business) and B2C (Business-to-Consumer) for transactions of goods and services.

Eleven countries took part in the survey (Bolivia, Brazil, Colombia, Ecuador, France, Guatemala, Italy, Peru, Romania, Spain and Uruguay) and their responses were unanimous: no country has specific regulations for electronic commerce. Economic operations on the Internet are subject to taxes in just the same way as any other operation.

In this report, we summarize the results obtained in relation to the kinds of taxes: indirect (generally VAT) and direct (corporate tax and income tax).

Indirect tax (VAT)

VAT on B2B operations between entities subject to this tax, whether the operation involves goods or services, is paid in the destination country or, in other words, the customer's country, in either of the following ways:

- During the import procedures, to be paid along with other taxes
- Reverse charging the customer with payment by the taxpayer (as occurs in the European Union)

VAT on B2C operations or, in other words, sales to consumers who are not subject to this tax, is payable in the destination country, which rules out the possibility of selling it more cheaply by applying a lower tax rate.

Payment of VAT on sales to consumers by companies located in foreign countries is managed in different ways between:

- Countries in the Americas, where the (foreign) seller sells without VAT and the customer pays their own country's VAT when they dispatch the import;
- European countries, where the foreign company has to register with the Tax Authority of its customer's country to apply that country's VAT and pay it to the State, on the condition that the sales volume exceeds a threshold of 35,000 euros. Below this threshold, the VAT of the country of origin applies. As there are few differences in terms of VAT rates between the Member States of the European Union, this tax does not generate a competition issue with respect to the customer. In Europe, they are experimenting with a new system known as the Mini One-Stop Shop (MOSS), for the payment of VAT on services sold within the Union, to simplify management and prevent the need for every company to register in every State.

It can be concluded that international regulations on indirect taxation adapt well to electronic commerce by applying the tax of the destination country, so that the good or service sold in the country by a foreign company is taxed at the same rate as if it were sold by a company in the country.



No problems are perceived with respect to these regulations and, as such, it is considered that they can continue to work as they have done to date.

Direct tax (Corporate Tax or Income Tax)

The regulations on direct taxation are different.

Each country has bilateral agreements in place with other countries to avoid double taxation and to define the regulations with respect to the country in which the tax has to be paid.

The international regulatory system designed by the OECD almost always applies: a foreign company pays tax in the country in which it sells its goods or services on the condition that it has a permanent establishment in the country in question.

With respect to electronic commerce, this becomes problematic: there is no need to have a permanent establishment in other countries, with physical implementation or human resources, to sell and make profit.

Locating the headquarters of the operations in a country with low tax rates, or even in a tax haven with no taxation, within the framework of a perfectly legal arrangement, is very beneficial. However, there are two kinds of consequences:

- For the State in which the good or service is sold, no tax is collected, even though profit is generated.
- The local companies in the country face unfair competition and their activities gradually diminish until they are forced to close.

Therefore, the digital economy becomes an issue in significant and challenging areas of the world of international taxation planning due to the fact that the Internet causes a complete disconnection from the basic tax regulations.

As well as distance sales online, it raises the issue of the taxable event. The flows of wealth related to gathering and exploitation of the users' data are not aligned to the concept of territoriality or the location of assets of activities. The data collected from users is the main source of value creation in the digital economy. Digital information can be sold or leased to advertisers, which generates an extremely high source of revenue.

As long as this economic model is not covered by international tax regulations, digital companies will have the opportunity to assign the value generated to countries that apply low tax rates. Nowadays, in the battle to stop the erosion of the tax base and profit assignment, the OECD is striving to restrike the fiscal balance between States, aligning value creation with transfer pricing. However, this is no easy task due to a lack of tangible data.

In conclusion, it is imperative that new specific provisions are devised that deal with the taxation of the digital economy. CILEA aims to contribute towards this task by putting forward suggestions.

PROPOSAL FOR INTERNATIONAL REGULATION OF THE DIRECT TAXATION OF ELECTRONIC COMMERCE

The growth of the digital economy and electronic commerce is extremely significant and, as a result, it is becoming imperative that decisions are made in relation to the direct taxation of companies.

Based on their knowledge of companies and their obligations, and within the framework of their professional practice underpinned by ethics and a commitment to the public interest, the Public Accountants that form part of the international organization CILEA put forward constructive proposals to combat tax inequalities and achieve greater economic and social justice through taxation.

Nowadays, international tax regulations basically focus on indirect taxes and, although there may be room for improvement, there is the advantage that these regulations are in place and operative. In contrast, there is a considerable lack of tax harmonization in terms of direct taxes, particularly in relation to calculating and taxing company profits.

Due to the consequences of the 2008 financial crisis and the rise in fiscal optimization practices to the detriment of States, the OECD is promoting measures to combat fraud, tax evasion and harmful tax competition, which we consider timely yet insufficient.

We have seen how large multinationals (Google, Apple, Amazon) have been subject to massive monetary fines imposed by the European Union to compensate for taxes that have been evaded, thereby setting a precedent in case-law that enables us to tackle the lack of ambition or will of States in this respect.

Regardless of any individual analysis that we may conduct of these cases, it is clear that nobody can be satisfied with the method currently used. It generates great fiscal uncertainty, both for companies, which are faced with a situation of confusion and under threat from an eventual decision by a public authority, and for States, which cannot control the financial repercussions of the challenge to the national regulations.

Both companies and States need clear, stable and precise tax regulations. Moreover, the scandals in recent times have highlighted the urgent need for progress to be made in the modernization of international taxation.

The harmonization of the direct taxation of companies has not had a great deal of success to date and the repeated attempts to improve the situation tend to be fairly unfruitful. There are obvious difficulties involved in tackling the issue, such as the impact on the economies of States that take advantage of their low tax rates to attract large companies and generate employment, or the need to take each country's fiscal history into account, including an extremely diverse range of concepts. While these contexts that hinder decision-making to a large extent cannot be overlooked, neither can the situation continue without new international tax regulations, which are particularly becoming more urgent due to the tremendous growth of the digital economy. The benefits generated by this form of taxation are a source of inequality and injustice, which we consider unacceptable. The globalization of the economy cannot be built on such a foundation. Everybody should be able to take advantage of technology without it being to the detriment of others. In other words, the most desirable solution is to take measures that protect public interests at a global level and not only on a national scale.

Fair taxation requires us to devise new measures that affect territorial regulations, as they have to adapt to the development of international activities, the location of which is not always clear. With this in mind, we propose creating regulations adapted to the reality of the digital economy, to tax profits in the countries in which they are made, just as the OECD has tried to propose, but with little success to date due to opposition from certain strong countries.

Many people are still satisfied with regulations on the territoriality of tax on profits, although there may be certain questions pending. The regulations are based on the concept of a



permanent establishment, defined as the existence of a physical presence in a country throughout a complete cycle of production. The definition of permanent establishment is a close approximation to reality enables profits to be taxed in the country in which the value is generated, which everybody agrees is appropriate.

However, these regulations are obsolete for activities that generate profits that are not linked to a physical location of production, as is the case of electronic commerce or the dematerialization of a large number of services. Thanks to the Internet, there is no longer any need to have a permanent establishment in another country in order to carry out economic operations. It would therefore be logical to pay a tax in the country in which the profit is generated, so that the permanent establishment is taken into account.

International taxation agreements for avoiding double taxation are based on this basic principle: the place where the tax is payable is generally determined according to the nature of the activity and the revenue generated. Companies pay taxes in the place that they have a permanent establishment in the case of commercial activities, in the fixed premises from where the service is provided, in the location of the building in the case real estate rental income. Furthermore, certain specific revenues such as interests, royalties and copyright are taxed in the debtor's country.

With respect to this model, a new category of revenue can be identified, coming from online activities, dematerialized exchanges, intermediary operations and dematerialized services, so that they can be taxed in the State of consumption

How can we change the method of taxation applied to the digital economy?

Three taxation methods are proposed for digital operations:

1. Financial intermediaries

Retaining an amount of money at the time of payment, by way of direct taxation, is one method that is already applied in many countries around the world.

With this method, one advantage is the avoidance of reporting obligations for companies, as the tax is paid in the country using reporting forms presented to the Tax Authority.

In order to apply this method, the contribution of financial intermediaries is required, through which the payment for the purchase is made to the foreign company. They would withhold part of the payment and then pay it to the State. To ensure the efficiency of the system, these intermediaries would be jointly liable for the withholding.

This would obviously work for any form of payment, whether it be through traditional banks or online services of any kind, even cryptocurrencies (bitcoins) or compensation and exchange systems. Just a fixed tax rate would be required applicable to the turnover generated in the country: a flat tax. For example, with a tax rate of 28% on profit estimated at around 15% of the turnover, the flat rate would be 4.2%, rounded down to 4%.

This method has the advantage of being simple and easy to apply. It would have to be stipulated in the agreements between States to avoid it potentially being perceived as a penalty, in the case of its application as a unilateral decision by one country.

It is necessary to establish a tax credit in the seller company's country of residence (see below).

While it may be simple, this taxation method has a drawback particularly for people starting a business, as they do not generate a profit in the early stages, so paying tax on turnover may be a significant cost for startups and a restraint on international economic development.

2. Application of VAT regulations to direct taxes

In the same way as the previous taxation method, a flat tax could be applied, but managed directly by the companies, without involving financial intermediaries, by applying the concept of indirect taxation on international operations.

When the company's turnover exceeds a certain amount, as well as VAT in the destination country, a tax should be applied to profit, at a rate calculated in the way indicated above.

For instance, in the case of VAT, a turnover limit of 35,000 euros is applied in the large majority of the Member States of the European Union. Below this limit, the tax is paid in the country of origin and, above the limit, it is paid in the destination country.

Direct taxation could be applied in the same way. For example, if the VAT rate is 20%, a 4% supplement is added for the tax on profits, and the foreign company has to pay 24% of its turnover in the State in which it sells, without having a permanent establishment.

As in the case of the previous method, this method has the advantage of being very simple, but the drawback of penalizing companies in the early stages of international trade, particularly small firms. In their case, a real calculation of the tax base would be more suitable, but more complex, which would require a new definition of permanent establishment for such companies.

3. Digital Permanent Establishment

Maintaining the current regulatory framework and conserving the concept of permanent establishment, a new figure could be created for distance economic operations, that could be referred to as a "Digital Permanent Establishment".

The definition of this new permanent establishment could be established using new concepts and measures, such as the following indicators:

- bytes transferred in the country of consumption
- subscribers in the country
- pages visited
- personal data stored

When certain parameters are exceeded, the importance of the activity in the destination country could be ascertained, despite the company not having a physical presence there and not meeting the criteria for the current definition of a permanent establishment. These would be new criteria that enable the concept and existence of a "Digital Permanent Establishment" to be determined. This would involve purely technical concepts, which would enable the possibility of monitoring them, leading to a new relation between the Tax Authority and companies.

To avoid the problem of monitoring technical data, another simpler method could be using a company's level of turnover in the country, as described in the previous section, but without applying a flat tax. The difference is that the consequence of exceeding the limit would not be to pay a tax, but rather that the foreign company would be subject to the country's taxes, applying its accounting and fiscal regulations, and submitting valid tax reports, to calculate and pay the tax on real profits, as is now the case of permanent establishments.



Tax credit

Regardless of the method applied to collect a tax in the country of consumption, a tax credit would be generated for the company, to be applied to the tax on profits payable in its country of residence, in accordance with the regulations of the tax agreements in place to avoid double taxation. This requirement is essential to ensure the measure is successful, without penalizing companies.

Although the tax credit cannot be repaid in the country that collects it, space could be left for bilateral negotiations between States, which could allow for it through agreements in this respect.

CONCLUSIONS

Today's taxation structures are not adapted to the reality of the new dematerialized economy. It is no longer acceptable that traditional companies have to compete with new economic agents that benefit from low and even zero taxation, thanks to legal arrangements that are completely lawful. This is a case of unfair competition that companies are unable to fight in an economic way and which, moreover, impoverishes States and destroys jobs.

The response to this problem must be found at a higher international level, with a clear commitment from the international community, starting with the G20.

The Public Accounting profession and, in particular CILEA, offers its contribution, based on its knowledge of the issue, its observations working in the field, its commitment to the public interest and its heavy involvement in the transition to the digital economy.



Founded in 1997, the Comité de Integración Latino Europa-América (CILEA - the Latin Integration Committee of Europe and the Americas) is an association that brings together professional organizations in the fields of Economic and Accounting Sciences from Latin countries in Europe and the Americas, representing more than a million professionals as a whole.

The CILEA International Studies series was initiated in 2013, with the aim of systematically collating and disseminating the studies conducted by CILEA on issues of professional interest. The series includes research that generally covers technical aspects related to the work of professionals in SMEs in Latin countries, presenting comparative results. They also strive to develop and publicize CILEA's proposals with respect to issues that affect SMEs and small and medium professional firms that are not commonly subject to research at an international level.

The series does not aim to propose binding guidelines for the member countries, but rather to generate useful reflections and guidance for discussion and professional practice which can gradually contribute towards the regulation of these matters by the competent authorities.

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