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Taxing the Digital Economy to Fund the COVID-19 Response
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The COVID-19 pandemic has weakened global economic growth, raising pressures on revenue authorities to fund the fiscal stimulus necessary to contain the spread of the virus and provide income support to affected households. Accordingly, countries are taking national measures to tax the digital economy as highly digitalized businesses are seeing a rise in sales, subscribers and profits owing to the work from home lockdown measures. The three main policy responses undertaken are digital service taxes, nexus rules based on significant economic presence and withholding taxes on digital transactions. These are briefly summarized here and elaborated in detail in a forthcoming research paper by the South Centre Tax Initiative (SCTI).

La pandémie de COVID-19 a provoqué un fort ralentissement de la croissance économique mondiale, renforçant la pression sur les autorités fiscales qui doivent trouver les ressources permettant de financer la relance budgétaire nécessaire pour contenir la propagation du virus et de venir en aide aux ménages les plus touchés en leur garantissant un revenu. Dans cette optique, de nombreux pays prennent des mesures au niveau national pour taxer l'économie numérique, les entreprises fortement numérisées ayant vu leurs ventes, leurs abonnés et leurs bénéfices augmenter en raison des mesures de confinement, qui favorisent le travail à domicile. Trois types de mesures sont mises en place qui consistent en l'imposition de taxes sur les services numériques, l'élaboration de règles permettant d'établir un lien fiscal pour les entreprises numériques qui opère par l'intermédiaire d'une présence numérique significative et des retenues à la source sur les transactions numériques. Elles sont brièvement résumées ici et seront examinées en détail dans un prochain document de recherche de la SCTI (South Centre Tax Initiative).

La pandemia de COVID-19 ha debilitado el crecimiento económico mundial, con lo que han aumentado las presiones sobre las autoridades fiscales para que financien el estímulo fiscal necesario para contener la propagación del virus, y proporcionen apoyo a los ingresos de los hogares afectados. Por consiguiente, los países están adoptando medidas nacionales para cobrar impuestos sobre la economía digital, dado que las empresas altamente digitalizadas están experimentando un incremento en las ventas, los suscriptores y los beneficios debido a las medidas de trabajo a domicilio adoptadas a causa del confinamiento. Las tres principales políticas puestas en marcha en respuesta

a esta situación son los impuestos sobre los servicios digitales, las normas sobre un nexo en base a una presencia digital significativa, y las retenciones en origen sobre las transacciones digitales. Estas medidas, que se resumen aquí de forma breve, se explican con detenimiento en un documento de investigación que publicará próximamente la Iniciativa sobre Fiscalidad del Centro del Sur (SCTI, por sus siglas en inglés).

The COVID-19 pandemic is posing serious challenges for the world economy. The United Nations (UN) has estimated a decline in global gross domestic product (GDP) to 1.2% in 2020[1], instead of 2.5%, which was the pre-COVID expectation. The worst case scenario estimates a fall to 0.9%. The World Bank expects global GDP to fall by at least 2%[2], and the effects are unevenly distributed, with developing countries seeing a fall of 2.5% and industrial countries of 1.8%. Further, the detrimental effects of the pandemic are unevenly distributed in developing countries, especially those that are highly vulnerable to high-risk and short-term private debt, as well as the volatility of the markets.[3] Similarly, spillover effects of the early lockdown in Southeast Asia, plus the measures adopted in the rest of the world are expected to cause a dramatic drop on global foreign direct investment from -30% to -40% during 2020-2021.[4]

However all is not bleak and according to the UN, "a well-designed fiscal stimulus package, prioritizing health spending to contain the spread of the virus and providing income support to households most affected by the pandemic would help to minimize the likelihood of a deep economic recession."

This has increased the responsibility on revenue authorities who have to manage a tightrope walk – at one hand they need to give businesses support through expedited refunds and more time for compliance and filing returns; while on the other hand they nevertheless need to increase revenue collection to fund the fiscal stimulus.

Accordingly, there has been a rise in national measures on taxing the digital economy.[5] This is unsurprising given that highly digitalized businesses are seeing increased profits owing to work-from-home measures. Nasdaq, the US stock exchange that is dominated by tech firms, saw the price to earnings (P/E) ratio of the top 100 companies cross a 10-year average of 19 and increase to 28 in April, following the March crash in equity markets worldwide. The so-called FAANG companies (Facebook, Apple, Amazon, Netflix, Google) have all seen increased sales and subscribers post the lockdown, with the exception of Amazon which reported less profit than anticipated, though that was due to higher delivery costs, implying sales may have even gone up.[6] [7]

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1 See https://www.un.org/development/desa/dpad/publication/world-economic-situation-and-prospects-april-2020-briefing-no-136/.

2 See http://documents.worldbank.org/curated/en/295991586526445673/pdf/The-Potential-Impact-of-COVID-19-on-GDP-and-Trade-A-Preliminary-Assessment.pdf.

3 United Nations Conference on Trade and Development (UNCTAD), *From the Great Lockdown to the Great Meltdown: Developing Country Debt in the Time of Covid-19*, Trade and Development Report Update (April 2020).

4 UNCTAD, "Impact of the COVID-19 Pandemic on Global FDI and GVCs", Investment Trends Monitor, Special Issue (March 2020).

5 See https://www.bloomberg.com/news/articles/2020-05-03/a-26-trillion-pot-of-digital-gold-eyed-by-cash-hungry-nations.

6 See https://www.cnbc.com/2020/05/04/big-techs-earnings-prove-its-immune-to-the-coronavirus.html.

7 See https://www.cnbc.com/2020/04/30/amazon-amzn-q1-2020-earnings.html.

Hence, countries have ramped up measures to ensure these companies pay their fair share of taxes. While these have been condemned by some developed countries as “unilateral”, the fact remains that for Inclusive Framework (IF) members this is a right under international law which has been guaranteed under Chapter 7 of the Action 1 report of the Base Erosion and Profit Shifting (BEPS) project.[8] For those countries outside the IF – which includes half of Africa – the criticisms are invalid as they are not bound by the IF’s rules.

The South Centre Tax Initiative has a forthcoming research paper which documents in detail the policy measures taken by different countries in this regard. These measures can be grouped into three overall responses: (1) Digital Service Taxes (2) Significant Economic Presence (3) Withholding Taxes on Digital Transactions. A brief explanation of each response follows.

Digital Service Taxes (DSTs)

On 21 March 2018, the European Commission (EC) proposed new rules to ensure that digital business activities are taxed in a fair and growth-friendly way in the European Union (EU). The proposal laid down the ground for several measures subsequently adopted by an increasing number of countries, within and outside the EU. These measures consist of implementing a variation from 3% to 8% tax on revenues arising from the provision of digital services.[9]

The tax is to apply to digital services provided through digital interfaces, including advertisement, the provision of supplies, goods or services and the sale of user data generated from their activity in such digital interfaces. Two criteria are included to identify the firms or companies subject to the tax: (1) the total amount of worldwide revenues reported by the entity for the latest complete financial year for which a financial statement is available; (2) the total amount of revenues obtained by the entity within the country or jurisdiction during that financial year.

The amount of these criteria will depend on the economic context of each jurisdiction. The application of this tax follows the basis of user value creation, which implies that income generated domestically based on where the user is located should be taxed, whether or not a company has a permanent establishment in that country.

The countries applying or proposing the use of this approach include Austria, Belgium, Canada, Czech Republic, Denmark, France, Israel, Italy, Poland, Spain, Turkey and the United Kingdom.

[8] See https://www.oecd.org/tax/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report-9789264241046-en.htm.

[9] European Commission, Council Directive 2018/0073 (CNS), COM(2018) 148 Final (2018). Available from https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_common_system_digital_services_tax_21032018_en.pdf (accessed 05.03.2020).

Significant Economic Presence

This concept expands the definition of "business connection" to incorporate a new digital nexus to tax business profits of foreign businesses based on "significant economic presence" (SEP). In other words, nexus would exist even without physical presence. This would be determined using 'revenue generated on a sustained basis' as the basic factor, and in combination with one or more of the following factors would establish nexus: "(1) the existence of a user base and the associated data input; (2) the volume of digital content derived from the jurisdiction; (3) billing and collection in local currency or with a local form of payment; (4) the maintenance of a website in a local language; (5) responsibility for the final delivery of goods to customers or the provision by the enterprise of other support services such as after-sales service or repairs and maintenance; or (6) sustained marketing and sales promotion activities, either online or otherwise, to attract customers".[10]

The SEP was one of the three proposals considered by the Inclusive Framework for addressing the tax challenges arising from the digitalization of the economy and was put forth by the Group of Twenty-Four (G24). It was also mentioned in the Action 1 Report of BEPS as one of three original measures that could be adopted on taxing the digital economy and subsequently included in the EC's proposal as significant digital presence.

Countries which have adopted this measure are India, Indonesia, Israel and Nigeria.

India has gone a step further and proposed a fractional apportionment profit allocation method. This was part of the SEP proposal put forth by the G24 in the Inclusive Framework in early 2019. Profit would be allocated to the SEP through three successive steps: (1) defining a tax base to be divided (2) determining allocation keys to divide that base (3) weighting of these allocation keys.[11] The suggested tax base was the global profit rate of the multinational enterprise (MNE) group applied to the sales revenue in a particular jurisdiction. The allocation keys were Sales, Assets, Manpower and Users (SAMU), the last key applicable for those businesses for which users meaningfully contribute to the value creation process.

Withholding Taxes on Digital Transactions

In such an approach, countries have been expanding the definition of taxable income sourced from their country to include income generated from providing digital services. Withholding taxes (WHTs) are then imposed on such transactions. Countries have adopted different approaches to defining digital services, with most going for broad and all-encompassing definitions that cover almost any conceivable service delivered electronically or over the internet such as advertising, website maintenance, movies, music, games, data storage, processing, etc. Others take a narrower approach which is usually targeted at income from advertising.

This is accompanied by source rules which lay out the criteria under which the income will be deemed as derived from the jurisdiction. These typically include payment for the service being made by resident persons or permanent establishments (PEs) of a non-resident person and association with activities in that jurisdiction. The responsibility for withholding the tax tends to be either on the buyer directly or on the financial institution facilitating the transaction. Non-

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

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

resident digital businesses that do not have a PE in the jurisdiction are required to register for tax purposes, or authorize a representative to perform those duties.

Countries using this approach include Costa Rica, India, Kenya, Malaysia, Mexico, Pakistan, Slovakia, Turkey, Uruguay, Vietnam and Zimbabwe.

Hence, while discussions continue in the Organisation for Economic Co-operation and Development (OECD)'s Inclusive Framework on a two-pillar solution on taxing the digital economy, more and more countries are proceeding with national measures to address the urgent revenue requirements for funding the fiscal response to the COVID-19 pandemic. Nevertheless, efforts will persist with a multilateral solution within the Inclusive Framework. The July deadline for coming to a consensus on the key aspects of the two-pillar solution has now been pushed to October, hence it is important developing countries use the additional time to marshal forces and bolster their arguments.

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