Tax challenges of digital economy

Vanesa Casadas

The digital economy is changing the economic paradigm. This means that the previous rules and concepts that don't adapt to this new reality must be reconsidered. This new environment does have positive effects, such as more options for customers and greater competition. But it also comes with unintended consequences, such as lower tax collection or unfair conditions for local companies, given that the customers can acquire products and services from digital providers located abroad where they pay lower taxes.

The new business models and distribution channels imply that the traditional definition of direct and indirect taxes no longer applies in most cases, given that it isn't easy to determine which authority has jurisdiction. These gaps in international regulations reduce tax revenues and make it easier to send profits to tax havens. The OECD says this is called base erosion and profit shifting (BEPS) and it has prepared an action plan that revises tax regulations to reach a consensus on how to tackle the problem. Their conclusions show the need to redefine how direct and indirect taxes are set up, strictly adhering to the principles of consistency, neutrality, efficiency, certainty and simplicity, effectiveness and legitimacy, flexibility, compatibility and consensus.

Direct taxes are applied to the companies that reside in a given country. To determine where it should pay its taxes, they use the concept of permanent establishment (PE). The challenge lies in how to decide the location of a digital business for tax purposes. A good example of this is the typical mechanism used by global ecommerce companies through which an Internet provider has its main business in a country from where it issues its invoices, but it uses local warehouses to deliver products to its customers. Can that warehouse be considered a taxable nexus? These types of questions reveal the need for a new definition of the concept of PE, one which takes into account the new regulatory concerns that stem from the digital economy: nexus, data and types of revenues.

In the case of indirect taxes it is necessary to revise traditional concepts. One of the main issues on which consensus has been reached is that for digital services the tax location should be where the product or service is consumed. This situation opens up more questions, such as who is responsible for booking the tax obligations and which mechanisms can be used in terms of compliance and the payment of said obligations. In this regard, they are considering redefining the tax exemptions many countries apply to goods that aren't worth much in customs, given that the related administrative costs are higher than the amount to be collected. Until recently, it wasn't a big concern, but the ever greater use of ecommerce has revealed two important issues.

On one hand, it might be considered unfair competition to national providers. But on the other hand, VAT revenues have been hit hard and regulators are looking for new ways of improving tax collection at national borders by reducing costs. However, the biggest concern is that when intangible assets are delivered across borders, such as the sale of digital content or applications given that they don't enter the country through customs and can be sold directly to the final user without any national intermediaries. In this case, the OECD's guidelines on ecommerce recommend that the provider register, collect and send VAT according to the laws for the customer's region. This makes the process of selling abroad more complex, but it foments fair local competition.

In short, the digital economy is developing and new challenges will arise. In this environment, the regulators will find solutions that guarantee taxes are properly collected, while at the same time it foments new business models and more competition.