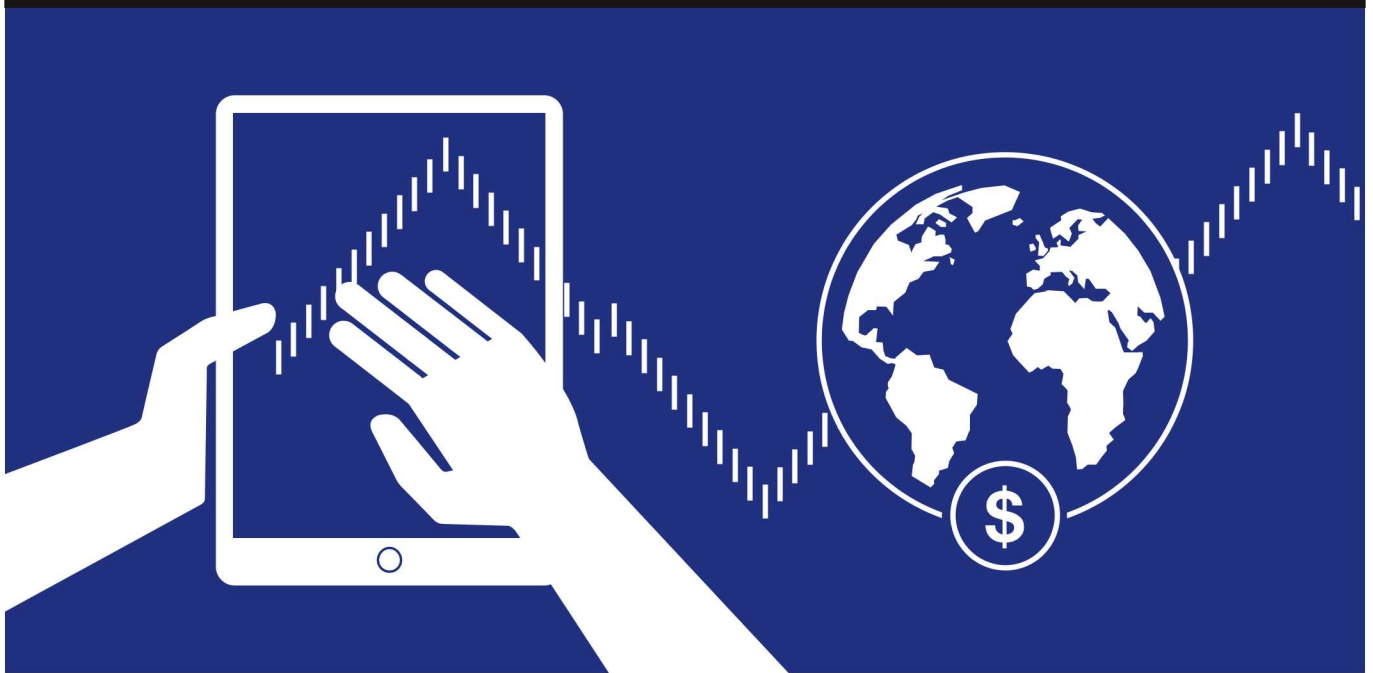


Taxing the Digital Economy

Progressive Taxation Briefing



What is the digital economy?

While we are all acutely aware of the increasing influence the digital economy plays in our lives, there is currently no widely accepted definition of what it actually is.¹ Some definitions refer to online platforms and activities that owe their existence to these platforms, but they are seen by some as too restrictive,² especially given the digital economy's continued growth and expansion.³ The OECD has noted that the digital economy is fast becoming the economy itself, meaning "it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes".⁴

For the purposes of this briefing, the digital economy is understood to be (but is not limited to):

- Trade in electronic transmissions including online delivery of software, music, e-books, films and video games.⁵
- Online platforms such as Google, Facebook and Amazon, platform-enabled services such as Uber and Airbnb, and suppliers of Information and Communication Technology (ICT) goods and services.⁶
- Mobile technology and applications including money transfer, borrowing and saving services.

The digital world has transformed the way people communicate, provide services, deliver goods and structure businesses. By allowing users to interact with each other and with businesses on remote platforms, it has made user engagement and customer data collection valuable products in themselves and changed how businesses advertise and market their products. The digitalisation of the economy has also introduced new and more complex business models and allowed companies to carry out business in countries where they do not have any physical presence.

What types of taxes apply to the digital economy?

The growth and transformation of the digital economy has had wide implications for indirect and direct taxes at national and global levels. This applies both to the ‘standard’ taxes applied broadly throughout the economy, such as Corporate Income Tax (CIT) and Value Added Tax (VAT), as well as any potential special taxes such as excise taxes on social media. Whilst all the developments in taxing the digital economy have implications for fair and progressive taxation and need to be addressed, some of the most pressing ones are considered below.

► **Corporate Income Tax (CIT):**

Digitalization of the economy has increased methods of accessing customers and, in many cases, wiped out the need for local staff and infrastructure. The link between business activity and the actual physical presence of a multinational corporation has further deteriorated, and it is now easier than ever to transfer and use intangible assets, such as software, across borders. These challenges, coupled with problems around the principle of treating companies within a multinational group as separate entities for the purpose of taxation,⁷ are now further exacerbating international corporate tax avoidance. The move towards the digital economy has also further complicated the question of dividing taxing rights between countries, with new questions arising around how value is created, for example in the case of platforms built on user participation. In the final report of Action 1 of the Base Erosion and Profit Shifting (BEPS) project, the OECD identified⁸ three main policy challenges relating to the digital economy:

- **Nexus** – this is the factor that connects a business to a jurisdiction for tax purposes, something that has traditionally been linked to physical presence. A lack of physical presence challenges the fundamental principles that regulate the taxing rights of countries.
- **Data** – the collection and use of various types of information has created significant value and new business models.
- **Characterisation** – new types of digital products and means of delivering services have created uncertainties for the classification of payments, with possible tax implications.

The OECD’s BEPS project, however, failed to come up with meaningful solutions to these – and other – challenges in international taxation.⁹ In response, in January 2019 the OECD/G20 Inclusive Framework on BEPS¹⁰ launched a process aimed at addressing some of the fundamental challenges and principles of the international tax framework, including the allocation of taxing rights.

This process focuses on two “pillars.” Pillar One focuses on the question of taxing rights and discusses the potential introduction of a “new taxing right”, which could factor in users and sales and not depend on physical presence. Pillar Two tries to deal with the remaining BEPS risks and tax competition by introducing a global minimum effective tax rate.¹¹ Some of the proposals under pillar one also include a partial or full move towards treating multinational companies as one entity for tax purposes and allocating profits between countries based on an agreed formula (“formulary apportionment”).¹² This could represent a meaningful change in the global approach to international taxation, and address the core challenges arising from the move to the digital economy. However, it remains to be seen whether the Inclusive Framework rises to the task. The final report is expected at the end of 2020.

► **Value Added Tax (VAT):**

Cross-border trade in goods and services has always created challenges for VAT/GST (Goods and Services Tax) systems, and the rise of e-commerce has only exacerbated these. Problems arise especially where private consumers acquire digital products (such as software or films), delivered from suppliers based abroad, who do not need any physical presence in the country of the consumer. Such goods and services risk being undertaxed and creating not only a revenue gap, but also unfair pressure on domestic suppliers who must charge the tax on their products.¹³ The problem has been highlighted many times, including by the OECD, which developed international VAT/GST guidelines proposing solutions such as shifting to a destination-based approach, which would give countries where consumers are based the right to tax products and services.¹⁴ More and more countries, including developing ones, are adopting measures to extend their VAT/GST systems to capture e-commerce from foreign suppliers.¹⁵

► **Excise and other special taxes:**

In an effort to raise additional revenues, governments have been looking to tax the telecommunications industry – and the most recent trend has been to initiate or raise excise taxes targeting mobile consumers.¹⁶ Excise taxes are levied

on specific goods, often on fuel or luxury goods such as alcohol or tobacco, and certain activities such as gambling. They are indirect, often levied at the point of production or sale, and included in the price of a product or activity. As well as raising revenue, excise taxes are often used to influence behaviour and realise wider social objectives on the grounds that higher prices tend to discourage consumption.¹⁷

In Uganda, the introduction of excise duty at 1% on the value of all mobile money transactions in 2018 sparked significant public outcry, as it made access to the service more expensive for a significant number of users, especially poor people. The worldwide trade body Groupe Spéciale Mobile Association (GSMA) estimated that around 100,000 mobile money agents saw earnings decline by 35% to 40%, and 300,000 went out of business completely.¹⁸ Customers shifted to use cash or agency banking, whilst others transferred smaller amounts via mobile money. Excise taxes on mobile money transfers have also been introduced in Kenya, Zimbabwe and Tanzania, and are, as of end-2019, being considered in Zambia.

In 2018, Uganda also introduced an excise Over the Top (OTT) services tax of 200 Ugandan shillings (Ushs) per person per day (around US\$0.05) on the use of social media. The OTT tax in Uganda was found to be regressive because of its impact on lower income earners by increasing the cost of connectivity.¹⁹ According to the Tax Justice Alliance in Uganda, the tax on social media services – which the government termed an effort to curb “gossip” or “idle talk”²⁰ – discouraged e-commerce and led to the violation of access to information and the internet, citizen participation, and freedom of expression and association.

In Benin, in 2018, the government attempted to introduce a social media tax, but due to public pressure they were forced to rescind.²¹ As of end-2019, Zambia is considering a similar tax, whilst Tanzania has already introduced a government licence fee for bloggers, and Kenya has introduced excise taxes on internet usage.²² Several countries in Asia, including Bangladesh, Pakistan and Nepal, also apply usage taxes.²³

► Tariffs:

The regulation of e-commerce tariffs has been part of the WTO agenda since the first moratorium on customs duties on electronic transmissions was introduced in 1998.²⁴ The moratorium prevented members from applying tariffs to electronic transmissions, including online deliveries of software, music, e-books, films and video games. Already, the moratorium has resulted in an estimated annual tariff revenue loss of over US\$5 billion for developing countries²⁵

The trade in electronic transmissions has since been rapidly growing and evolving.

Since July 2016, e-commerce has been one of the high priority issues being pushed by developed countries in talks at the World Trade Organization (WTO).²⁶ At the Davos World Economic Forum in 2019, several governments and their allies announced their intention to launch new negotiations on e-commerce, plurilateral negotiations that will take place at the WTO.²⁷ The re-writing of rules is strongly backed by some of the internet giants and could secure them free access to data, the ability to operate and profit in a country without physical or legal presence, and exclude them from local content requirements.²⁸ It may have serious implications for privacy, data protection and taxation, while failing to address the moratorium and related revenue loss.

Examples of good and bad uses of taxes on the digital economy

As indicated above, the introduction of the mobile money transfer tax in Uganda has already had implications for agents and users of the service, pushing individuals to either transfer less or opt out of the service altogether. Following Uganda's example rather closely in an effort to raise revenue in their own cash-crunched economy, in 2018 Zimbabwe introduced an intermediate money transaction tax of 2% on the value of every transaction above one Zimbabwean dollar.²⁹ With electronic transactions making up more than 96% of the total, the impact on Zimbabweans has been substantial.³⁰ Mobile money had significantly expanded financial inclusion in Zimbabwe;³¹ at end-2019, with vendors setting food prices 40% higher for mobile money as versus cash purchases, the tax has greatly exacerbated the extreme food security emergency in the country.³²

The ‘Over the Top Tax’ on social media services in Uganda has also been strongly criticised by civil society. Following its introduction, the cost of 1GB of mobile data jumped to nearly 40% of monthly income for the poorest Ugandans.³³ Whilst additional tax revenue may be raised, these taxes have clearly increased the cost of connection for all – particularly young people and women who were using these platforms to earn an income. It has been shown that the tax hit rural regions harder – where average incomes are lower – and increased barriers to connectivity, therefore contributing to the growing digital divide.³⁴

While discussions in the OECD Inclusive Framework on international taxation reform continue, several countries, including France, Austria, Hungary and India, have opted to introduce unilateral measures to address some of the tax challenges of the digital economy. Austria has announced the introduction of a tax aimed at digital advertising, while several other countries, including Canada and Uganda, are exploring options.³⁵ France's approach targets the largest digital companies in the country with a 3% tax on their gross revenue.³⁶ Hungary taxes digital advertising revenue at 7.5%, while in 2016 India introduced an 'equalisation levy', a withholding tax on payments made by Indian businesses to foreign digital advertisement providers. At the same time, India has put forward a strong proposal for a multilateral solution through the OECD Inclusive Framework process.³⁷

► **How can taxation of the digital economy be made more progressive?**

The main objective to achieve progressivity should be to ensure that companies in this sector are subject to the same taxes as other companies and that they are paying their fair share of them, especially in relation to corporate income taxes. A comprehensive reform of international corporate taxation with a shift to full formulary apportionment at its core is likely to be the only solution to really address the issue long-term. An effective minimum tax rate, if set at an appropriate level, could also make a significant difference,

especially for developing countries that are most affected by the race to the bottom in corporate tax rules and rates.

A greater measure of tax transparency is also required to better inform these discussions, as well as quantitative analysis of how the proposals are likely to affect individual tax jurisdictions and the extent to which it may shift the tax base of multinational corporations away from tax havens.³⁸

In the meantime, improving rules around taxable presence and applying special turnover-based taxes on digital companies to make up for the difference in their tax contributions are options worth considering, especially for developing countries.

At the same time, governments should refrain from introducing excise taxes to digital economy services, and focus instead on taxing the companies that are earning this income. An excise tax usually raises the total price that consumers pay for a product or activity and only very rarely reduces the business revenue available to a company. Since excise taxes are borne by consumers and usually flat-rated, they are inherently likely to be regressive.³⁹

And finally, while VAT is generally criticized for being regressive, failing to subject foreign e-commerce and digital products and services providers to VAT can put local companies at a serious disadvantage.⁴⁰ It might therefore be advisable for countries to adjust their VAT systems in this regard.

Recommendations

►► **Governments should:**

- *Support reform of international corporate taxation that addresses the context and needs of developing countries, including through supporting formulary apportionment and an ambitious minimum effective tax rate in the OECD Inclusive Framework discussions on digital taxation.*
- *Consider application of unilateral special taxes on digital companies based on turnover or income.*
- *Avoid excise and other consumer taxes that increase costs for consumers, especially those related to social media use and mobile money services.*
- *Consider revising VAT/GST systems to capture digital products and services from foreign providers.*
- *Refrain from participating in the WTO plurilateral e-commerce negotiations, and evaluate the potential impact of the proposals on their taxing rights and economies given the continuing transformation and growth of the digital economy.*

This is one of a series of briefings on Progressive Taxation published by ActionAid International beginning in October 2018. You can find them at <https://actionaid.org/publications/2018/progressive-taxation-briefings>

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<http://actionforglobaljustice.actionaid.org>

International Registration number: 27264198

Website: **www.actionaid.org**
Telephone: **+27 11 731 4500**
Fax: **+27 11 880 8082**
Email: **mailjhb@actionaid.org**

ActionAid International Secretariat,
Postnet Suite 248, Private Bag X31, Saxonwold 2132,
Johannesburg, South Africa.

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