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Trade and tax in a digital world

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Contents

Executive summary

The Hinrich Foundation series on Asia's digital economy has flagged a number of important issues for the trade agenda in the Asia Pacific region. One topic of rising importance is the connection between digital trade and taxation policies.

Fiscal pressures in the wake of pandemic spending have accelerated the quest to appropriately tax companies and purchases made in the digital or online environment.

Neither trade nor tax are new issues. What is new are the types of challenges that digital trade poses to revenue collection. As the digital economy has grown significantly, governments have watched with increasing dismay as taxes have not been collected from a steeply growing volume of transactions. Fiscal pressures in the wake of pandemic spending have accelerated the quest to appropriately tax companies and purchases made in the digital or online environment.

Until recently, trade experts could avoid most discussions about tax and tax experts could overlook trade implications of tax policies. Trade has typically been handled by trade and commerce ministries while tax is managed by finance ministries or central banks. Communication between the two sides, even in a domestic setting, can be limited. International opportunities for conversations between tax and trade are even more rare. The growing strength of the digital economy and new types of cross-border trade activities have eroded this previous division of labor. Increasingly, trade policies need to reflect changes in tax policies and vice versa.

The rise of the digital economy has complicated the traditional tax environment. Firms can be located anywhere and provide goods and services online to suppliers, vendors and customers without any need for a physical presence. The digital economy allows firms to scale up substantially at often minimal direct costs, creating a small set of super firms generating outsized profits. Such technology or digital firms present tempting targets for cash-strapped governments looking for revenue.

However, it is not just large firms that can take advantage of new ways to find customers. A vital aspect of the digital economy is how it enables even the smallest companies to engage in cross-border trade. Firms that might never have been tempted to trade outside their own villages are increasingly finding key markets halfway around the globe.

In short, there are at least three important ways that the digital economy has affected traditional tax systems: by allowing firms to compete in markets without a physical presence; by the proliferation of approaches, mostly used by large firms, to more carefully manage tax; and by the participation in cross-border trade by companies previously not engaged in such transactions.

Changes in tax policy to address these challenges run a significant risk of upending cross-border trade opportunities and burdening firms of all sizes with substantial new compliance costs. As tax and trade have been considered largely in silos, unintended consequences are likely to rise. This

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paper does not examine every element of cross-border tax policies. Instead, it highlights a range of direct and indirect tax applications to the digital economy that are important for trade. Absent global cooperation on the range of direct and indirect tax issues, an increasing number of governments are opting for domestic solutions that increase regulatory costs to trade.

While there have been important recent steps to move towards some more harmonized tax approaches, especially as part of the Inclusive Framework and OECD activities described more fully below, the implementation of coordinated tax changes has yet to begin. Furthermore, global consistency for some aspects of direct tax has not resolved continuing challenges in the indirect tax environment.

Governments have used a variety of tax policies as a tool in their arsenal of options to attract more foreign investment or to provide additional support to local firms. As yet, there are limited institutional mechanisms to address gaps in coverage and avoid duplication of efforts.

This paper highlights some of the current and upcoming issues of digital tax under both direct and indirect tax collection schemes. These tax frameworks have the potential to dramatically upend the expansion of digital trade around the world. Firms will have to navigate an increasingly complex environment that requires adherence to specific trade rules and regulations, and mastery of complicated tax regime requirements that may include VATs, customs duties, DSTs, withholding taxes, extra-territorial application of taxes on intangible assets, and transfer pricing mechanisms.

What may change is not only the payment of tax. Even the requirements for tax reporting could transform and lead to more regulatory divergence. The challenges for companies are significant. Much of this reporting burden is likely to land on firms that are intermediaries. While many digital intermediaries are large firms with resources to address compliance concerns, smaller firms play similar functions but with less capacity. Many MSMEs do not even realize that their businesses will be affected by such international tax policy changes, leaving them unable to respond or play a proactive role in shaping debates or to prepare themselves to manage growing complexity. Increasingly, firms will be asked to submit, on behalf of customers or clients, a wide and growing range of tax-related information on business sales to tax authorities.

The burden of managing such complexity will be substantial for the smallest firms who lack capacity and resources.

As always, the burden of managing such complexity will be substantial for the smallest firms who lack capacity and resources. While many of the tax changes noted in this paper may not directly apply to small firms, the indirect implications and trade changes are likely to continue to disproportionally affect MSMEs. The largest digital firms that currently support MSMEs may opt to make changes that can destroy the value of many smaller firms overnight. This will upend previous business models and could limit the ability of MSMEs to find overseas markets and customers.

Preface

This paper, written by the Asian Trade Centre, was generously supported by the Hinrich Foundation. It represents the third paper in a series for 2021 looking carefully at a range of digital trade issues that will be part of the trade agenda in Asia for 2021 and beyond. For more papers in the series, please see https://www.hinrichfoundation.com/global-trade/digital/.

The Asian Trade Centre, based in Singapore, works with governments and companies across Asia to create better trade policies.

The Hinrich Foundation is pleased to support research on digital trade and regulatory policies that will lead to faster, more inclusive economic growth in Asia.

Introduction

The digital economy is critical to ensuring continued economic growth and development across the Asia Pacific region.[1] The six large economies of Southeast Asia – Indonesia, Malaysia, Philippines, Singapore, Thailand and Vietnam – have enjoyed significant digital trade growth, increasing from 260 million internet users in 2015 to 400 million users in 2020.[2] A similar story of explosive digital growth can be told for every country in the region. The COVID-19 pandemic has only accelerated these trends.

As the *Asia Digital Economy Series* has noted in previous papers, a range of policy challenges lie ahead.[3] One topic of increasing importance is the connection between digital trade and taxation policies.

Neither trade nor tax are new issues. There have been tax implications arising from trade for decades. In fact, multinational firms running operations in multiple jurisdictions have deftly navigated the interplay between trade and tax. What is new are the types of challenges that digital trade poses to revenue collection.

Governments have watched with increasing dismay as taxes have not been collected from a steeply growing volume of transactions.

Tax systems based on traditional brick-and-mortar operations are less relevant in a world of rapidly expanding trade flows driven by business models that may not require an on-the-ground physical presence. As the digital economy has grown significantly, governments have watched with increasing dismay as taxes have not been collected from a steeply growing volume of transactions. Fiscal pressures in the wake of pandemic spending has accelerated efforts to appropriately tax companies and purchases made in the digital or online environment.

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Until recently, trade experts could avoid most discussions about tax policy and tax experts could overlook trade issues. Trade has typically been handled by trade and commerce ministries while tax is managed by finance ministries or central banks. Communication between the two sides, even in a domestic setting, can be limited. International opportunities for conversations between tax and trade are even more rare. The digital economy and new types of cross-border trade activities have eroded this previous division of labor between groups. Increasingly, trade policies need to reflect changes in tax policies and vice versa.

Most conversations about revised tax policies related to digital trade seem to focus more heavily on the digital elements, particularly around specific types of technology firms, and less on the trade aspects of managing complex issues in cross-border contexts. This paper is an attempt to look at changing tax systems from the perspective of trade, including trade rules and regulations. It also considers the implications of different types of revenue collection on the ability of firms to provide digitally delivered goods and services across borders. As with nearly all policies, the challenges of compliance with new regimes are likely to impact smaller firms in particular.

The likely impact of changing tax regimes on digital trade, particularly for micro, small and medium sized enterprises (MSMEs), is not well understood. This paper begins this conversation. Unless and until trade officials and experts become more deeply involved in tax policies and vice versa, there is a high risk of delivering unintended consequences and rupturing a promising avenue of future economic growth. The exponential growth of digital trade could slow significantly or even reverse for some markets if inappropriate tax policies are imposed without careful consideration of the consequences to trade.

Too many varieties of "tax" are frequently bundled together with terms used interchangeably despite significant differences.

One complication in unravelling the connections between tax and trade has been definitional. Too many varieties of "tax" are frequently bundled together, especially by the trade community, with terms used interchangeably despite significant differences. The bundling together of both direct and indirect types of taxation is particularly problematic. Each may have trade implications, but the impact may vary. Loose definitions complicate rather than clarify the discussion.

Clear challenges lie ahead in designing effective and appropriate policy responses.

This paper is intended to raise more questions than it answers. It does not cover every element related to digital tax and trade but focuses attention on important areas of likely overlap. The digital tax landscape is an emerging and evolving topic. Limited rules or regulations are in place at this time. Clear challenges lie ahead in designing effective and appropriate policy responses. The risks of incompatible policy frameworks across the Asia Pacific region cannot be discounted. Such regulatory fragmentation could destroy the promise of the digital economy and make it significantly harder for large and small firms across the region to participate in digital trade.

Traditional approaches to tax and trade

As with any field, experts have created an environment that can feel impenetrable to outsiders. The tax landscape is no different, which may partly explain why trade officials have limited exposure to tax issues. The jargon is different and complex and does not neatly coincide with the mental maps of most trade practitioners.[4] Tax has simply been outside the purview of trade for the most part, attended to different ministries or agencies in different policy tracks.

To simplify the key concepts relevant to digital trade and tax, it is worthwhile to review existing tax management systems that apply to cross-border trade transactions. This is not meant to be an exhaustive review, but some context is necessary to understand how adding layers of digital transactions has dramatically complicated tax structures.

In the pre-digital era, tax was applied largely to businesses having a physical presence or "permanent establishment".

In the pre-digital era, tax was applied largely to businesses having a physical presence or "permanent establishment" in different tax jurisdictions. Multinational companies (MNCs) tended to have operations in multiple locations with staff on the ground, buildings, factories, and other facilities. As tax rates and methods of determining tax vary around the world, MNCs grappled with managing diverse settings. Many governments engaged in experiments to gauge the impact of corporate tax cuts, for instance, in attracting inbound investment and achieving other desirable outcomes. Companies learned ways to limit their overall tax bill. An entire industry of firms and specialists emerged to leverage potential legal opportunities in trimming tax obligations.

Broadly speaking, there are two types of taxes: direct and indirect.

Broadly speaking, there are two types of taxes: direct and indirect. Direct taxes, as the name implies, are paid directly to the government. These include corporate tax, income tax, and property tax. Indirect taxes take several different forms. Essentially, indirect taxes are first collected by one entity or individual and then remitted or paid to the government. The most easily recognized forms of indirect tax are Value Added Taxes (VAT) or Goods and Services Taxes (GST), which shops, suppliers, or manufacturers collect from customers and then submit to the government.

Tariffs or duty payments fit under the definition of direct taxes. These are payments made directly to the government at the time of importation of goods at the border.[5] Customs departments are responsible for tariff collection and normally operate under the direction of the finance ministry. The use of duty payments on digital services or electronic transmissions would be different. They are an indirect tax because customs officials are not likely to directly collect the tax or duty payment on imported services or electronic transmissions.[6]

The digital economy has complicated the traditional tax environment.

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online to suppliers, vendors, and customers in places without any need for a physical presence. Firms can now scale substantially at often minimal direct costs, creating a small set of super firms generating outsized profits. Such technology or digital firms present tempting targets for cash-strapped governments looking for revenue.

However, smaller firms can also take advantage of new ways to find customers. A vital aspect of the digital economy is how it has enabled even the smallest companies to engage in cross-border trade. Firms that might never have been tempted to trade outside their own villages can now find key markets halfway around the globe. Tiny companies can behave more like multinational firms.

In short, the digital economy affects traditional tax systems in three ways: by allowing firms to compete in markets without a physical presence; by the proliferation of approaches, mostly used by large firms, to more carefully manage overall and local tax bills; and by allowing a greater variety of firms to participate in cross-border trade including MSMEs.

Direct tax

Base erosion and profit shifting (BEPS)

The digital economy's shifting corporate footprints have prompted concerns about whether MNCs pay a "fair" share of taxes as well as where they pay taxes.

The 2008 Global Financial Crisis led to renewed calls for addressing tax inconsistencies internationally. In response to growing government concerns about the ways in which multinational companies could exploit gaps in different tax regimes, the OECD prepared and managed the Base Erosion and Profit Shifting (BEPS) Project. More than 130 different economies are now part of the Inclusive Framework to develop a system of principles for domestic implementation and through tax treaties.[7] In the follow up to the 2015 BEPS Project, fifteen action items were organized under two distinct pillars.

The first pillar establishes new rules about the relationship between tax location and profit attribution. Essentially, this pillar addresses the question: "how much of a MNCs profits should be redistributed to markets and where?" Under the proposed changes, MNCs are to pay tax where they conduct "sustained and significant business."

While members agreed in early July 2021 on the need to reallocate profits and to enact a global minimum tax, the exact mechanisms for managing the processes remain under discussion.

The second pillar requires a global minimum tax to reduce incentives to shift profits to lower-tax jurisdictions. Despite sustained focus on both elements of the OECD/G20 agenda, key issues remain unresolved. While members agreed in early July 2021 on the need to reallocate profits in pillar one and to enact a global minimum tax, the exact mechanisms for managing the processes remain under discussion.[8]

The OECD Inclusive Framework process strives to encourage firms to fulfill tax obligations where sales revenue is generated while also allowing adjustments that reflect the relative profitability of the different enterprises within an MNC. Specific types of firms or products are not singled out for such treatment. To accomplish this objective, OECD members have suggested using quantitative thresholds and a formula for calculating global revenue and profit margins as well as sales revenue from particular market countries.

As might be expected in an agreement with many participants and significant revenue implications, progress has been difficult. Members have disagreed over different aspects of policy recommendations, definitional issues, and implications of alternatives. To compound the challenges of getting a deal done, all participating countries have promised that, once an agreement has been reached, it will be used as a single, globally applicable tax regime. Members will refrain from using "unilateral tax measures" for covered areas in the future.

Given that the OECD/Framework process is tackling some of the biggest challenges in the global tax regime, the BEPS project is not yet fully implemented.[9] In particular, the meeting of goalposts has been repeatedly postponed, with recent efforts to get to a conclusion hindered by the Covid-19 pandemic.

G7 member countries agreed in principle to a global corporate minimum tax rate of 15%.

The BEPS process took a significant step forward at the G7 talks in June 2021. Member countries agreed in principle to a global corporate minimum tax rate of 15%. Participants also endorsed for a proportion of the largest, most profitable MNCs to be taxed in locations where profits are generated.

The final communique read, in part: "We commit to reaching an equitable solution on the allocation of taxing rights, with market countries awarded taxing rights on at least 20% of profit exceeding a 10% margin for the largest and most profitable multinational enterprises. We will provide for appropriate coordination between the application of the new international tax rules and the removal of all digital services taxes, and other relevant similar measures, on all companies. We also commit to a global minimum tax of at least 15% on a country-by-country basis."[10]

Such an agreement in principle, however, does not mean that wrapping up the final package will be straightforward. The communique text highlights some of the issues ahead. Initially, many tech giants escaped inclusion due to a formulation that started at 10% profits. As such, many companies otherwise viewed as "unicorns" may not generate any profits at all or deliver significantly less than 10%. Even Amazon – often cited as the sort of firm a tax regime should include – does not clear this 10% threshold if viewed at the group level. The final deal, announced by the OECD in July 2021, stipulates that a company's profitable business units would be included despite its overall profit margin. As such, Amazon's lucrative Amazon Web Services appears to be included now.

Although some countries have stated[11] their opposition to the deal, 130 countries – including China, India, Germany, and France – agreed to a global tax regime for the world's 100 biggest companies, both digital and nondigital, with global annual revenue of US$20 billion or more.[12] Possible exemptions for the financial industry and manufacturing will undergo further negotiations until October.

As with any agreement, the devil is ultimately in the details of implementation. This includes continuing discussions around issues of scope, definitions of covered firms and activities, and how a tax base is defined. The G20 has called on the OECD to finalize the technical work in order for the framework to be approved in October 2021.[13] Once approved, it will take time for the final texts to be confirmed and legal scrubbing completed.

A final agreement could still face significant challenges obtaining domestic-level approval across a range of participating member states.

A final agreement could still face significant challenges obtaining domestic-level approval across a range of participating member states. The US Congress would have to approve changes in tax codes. Cyprus, to name just one EU member, has already expressed grave concerns about allowing the EU to endorse outcomes for taxation. Tax has been a member state competence within the EU. In addition, EU institutions are unlikely to negotiate on enabling legislative bills until 2023.[14]

Many Asian economies have been watching the developments with some concern. A significant number of Asian countries have relatively low corporate taxation rates in place as part of an overall strategy to attract business investment. It is unclear how existing policies will adjust to address or adapt to proposed changes.[15]

The BEPS process has focused on putting into place an agreement and the implementation framework for both pillars. However, there will be trade implications for some of the likely changes in direct tax.

Many of the largest digital platforms have provided a wide range of services for free. If corporate taxes increase, this practice may be less optimal. Paid services could also see rate or fee hikes for users as a means to offset new tax obligations. The exact scope and outline of possible trade implications are hard to confirm until the finalization of all details of the OECD and Inclusive Framework process.

Digital services taxes (DST)

With multilateral outcomes remaining elusive, some European governments moved ahead with local imposition of digital services taxes (DST).

The OECD project has ground on for more than a decade. As the process slowed, some European governments moved ahead with local imposition of digital services taxes (DST). They developed an overall scheme in 2018, although the application of DST was postponed pending outcomes from the OECD process, in itself originally slated to finish by 2020.[16] With multilateral outcomes remaining elusive, many governments intending to impose new digital services taxes have opted to forge ahead regardless of progress at the OECD. According to KPMG, 25 countries had enacted direct tax legislation by January 2021. An additional 20 countries had regulations pending.[17]

With multilateral outcomes remaining elusive, DSTs are an attempt to tax sales of digital services instead of profits.

The composition of DSTs varies. However, all pursue an approach whereby taxes are applied against the gross revenues of specific firms. A few countries have tried to accomplish the same objectives by adopting a gross-based withholding tax. In all, DSTs are an attempt to tax sales of digital services instead of profits. Typically, DSTs are not designed to capture all firm activities, but the activities of firms above a certain size. The activities are also distinguished by type. As such, this makes for a hybrid tax system, with aspects of direct tax (based on firm revenue) and indirect tax (sales of specific services in a market).

Even within Europe, the design of DSTs vary significantly. Austria and Hungary tax revenues derived from online advertising. France includes targeted advertising plus the provision of a digital interface and movement of data related to advertising. The rates also vary, from 0% (currently applied as a temporary measure) to 7.5% in Hungary and Turkey.[18]

Although differently titled, India has a similar form of DST already in place called the equalization levy (EL). The first version was introduced in 2016 and collected revenue for online advertising, provision of online advertising space, and related services. In 2020, the targets for the EL were expanded with the addition of non-resident e-commerce operators for e-commerce supply or services.

DSTs, particularly those enacted unilaterally, pose many challenges. This includes the high likelihood of double taxation, as firms can be subject to both DST and direct tax on exactly the same transaction or income. Normally, a dense web of taxation treaties may prevent such double tax application. However, the hybrid tax structure of DSTs is not yet captured in the same way.[19]

It remains unclear whether unilateral DSTs violate existing international trade rules.

It remains unclear whether unilateral DSTs violate existing international trade rules. The key trade principle of non-discrimination is at risk in the application of existing DST structures. Until a case is actually filed, it can be difficult to determine how a World Trade Organization (WTO) dispute settlement panel might rule on the issue.[20] However, there are several ways that such schemes could be found to run afoul of existing multilateral trade rules at the WTO. As former WTO Chief Economist Patrick Low notes, unilateral DSTs might be seen to be discriminatory for the following reasons. They lack deductibility rules as well as benchmarks that link taxes to different levels of profitability among taxable enterprises. They contain double taxation possibilities which affect only foreign suppliers. Lastly, they include specific application rules that apply DSTs based on firm size, product mix, or means of delivery of a service.[21]

Partly in response to concerns about discriminatory treatment, the United States launched a Section 301 case, alleging unfair trade practices, against France's digital services taxes in July 2019. The US found sufficient evidence of unfair trade practices six months later[22] and published a list of 63 tariff lines subject to duties up to 100%. The imposition of retaliatory tariffs was suspended by the US Trade Representative (USTR) twice, including in January 2021, to allow time for negotiated compromise.[23]

The application of such retaliatory tariffs would extend the disagreement over digital services taxes into significantly broader economic sectors.

The list of potential tariff targets reaches beyond technology products and includes steep tariff increases on a range of goods such as cheeses and wine. The application of such retaliatory tariffs would extend the disagreement over digital services taxes into significantly broader economic sectors and would likely lead to renewed bilateral complaints from entirely different types of stakeholders on both sides.

America did not only address possible digital discrimination by France. The United States subsequently launched Section 301 investigations for Austria, India, Italy, Spain, Turkey, and the United Kingdom. USTR found that the DST schemes in all six countries unfairly discriminated against American firms in early 2021. On June 2, 2021, USTR announced the imposition of tariffs against all six countries, although it also immediately suspended the application of tariffs for an additional 180 days to give time for the multilateral process spearheaded by the OECD to work.[24] Section 301 cases against four additional countries – Brazil, the Czech Republic, the European Union, and Indonesia – were suspended because these jurisdictions had not yet implemented the DSTs under consideration.

DSTs are likely to have trade implications. Depending on the scheme and thresholds, firms may reconsider which digital services are delivered into which markets. Many of the proposed or actual thresholds for collection of DST can be quite low. As such, many firms may be captured by the tax collection schemes.

As an example, the EU's original DST formulation applied to firms which either delivered more than €7 million in a member market, or counted more than 100,000 users or over 3,000 business contracts in a taxable year. As relative scale is easier to achieve through digital trade, even quite small companies can easily exceed one or more of these threshold categories and be eligible for direct tax payments to more than one EU member market.

Customs duties on e-commerce goods

Customs duties are direct taxes paid on goods transiting a border. To support smaller firms engaging in cross-border trade, many governments have waived the collection of customs duties – and often indirect VAT payments – for small size, small value shipments. While the levels of these "de minimis" waivers have varied,[25] the basic principle has been consistent. Firms are excluded from payment of customs duties and all associated customs paperwork on sales below the threshold.

Given the increasing importance of cross-border trade for e-commerce goods, many governments have scaled back on waivers for small size, small value shipments.

As the volume of e-commerce goods trade has increased, the volume and values of e-commerce goods have skyrocketed. Given the increasing importance of cross-border trade for e-commerce goods, many governments have scaled back or even eliminated the use of de minimis. As a result, more e-commerce goods and companies, particularly MSMEs, have faced direct taxation schemes through customs duties paid at the border. This includes all goods arriving in Australia, as the threshold was dropped from AU$1,000 to zero in July 2018. Australia also started to apply GST at the same time.[26] Singapore will start applying GST on goods above SG$400 on January 1, 2023.[27]

Income taxes in the digital economy

Digital technology has also altered another aspect of direct taxation – income taxes. The European Union is preparing to require digital platforms to report income earned through platform participants. The regulation will apply in January 2023. EU member states will also be mandated to share this information with one another, to ensure that firms and individuals earning income via platforms in a cross-border setting are paying taxes.[28]

Indirect taxes

Indirect taxes, as noted above, are taxes collected by firms on behalf of customers and then remitted or delivered to governments on behalf of these customers. The application of indirect tax schemes can be complicated in the cross-border context as customers are less likely to be registered as taxpayers in multiple jurisdictions. Firms that are required to collect and remit payments may also not be registered in every location where tax may need to be managed.

Value-added tax (VAT)

Most of the recent attention to digital tax changes has examined direct taxes, especially related to the OECD and Inclusive Framework process. Yet the use of indirect taxes in the digital economy has also proliferated. According to KPMG, 82 countries have enacted rules for digital indirect taxes, typically either a GST or VAT. Eleven more countries are considering the application of such tax regimes.[29]

To ensure greater consistency in the application of digital indirect taxes, in April 2017 the OECD released a set of recommended principles and mechanisms to address the challenges for collecting VAT on cross-border sales of digital products.[30] In July 2020, the OECD issued a new set of model rules for platform operators in the gig economy and sharing economy.[31]

Extension of such rules into the digital economy without a clear global framework has risked both under-taxation and trade distortion due to double taxation.

While 165 countries use a VAT system[32] for managing indirect taxes, the extension of such rules into the digital economy without a clear global framework has risked both under-taxation and trade distortion due to double taxation. The situation is most fraught for digital services trade.

As a broad-based consumption tax, the burden of paying VAT is meant to fall on household users, not businesses. It is a tax on the value added across a supply chain. Firms engaged in supply chain activities are responsible for controlling and collecting the tax and remitting the portion of tax on the margin – that is, the difference between the VAT on taxed inputs and the VAT on taxed outputs – to the relevant government tax authorities. The details of how this process takes place can be complicated, even for trade in goods. The challenges with a neutral application of VAT are compounded for services. Effective management of VAT systems in cross-border settings can be even more complex.[33]

Many of the countries that KPMG has flagged for having indirect GST or VAT policies in place do not follow the OECD guidelines. Of course, the guidelines are a set of recommended practices and not requirements under any sort of legal obligation. But they suggest that indirect tax policies applied to the digital space already vary and may continue to diverge in the future.

As with the application of direct tax schemes, the trade principle of non-discrimination may be eroded with the imposition of indirect tax schemes such as VAT or GST on companies in the digital economy. The cross-border nature of such transactions and the limited ability of firms to effectively collect and remit taxes to local tax jurisdictions can be exacerbated by a lack of domestic presence for firms to remit VAT or GST payments to the relevant authorities.

While many trade agreements explicitly outlaw the need for local presence[34] in order to provide services, the spread of indirect tax obligations may undermine these commitments. To ensure that proper VAT payments have been attributed to the firm, companies may need to have local tax identification or registration numbers in overseas markets. Such an obligation may constitute a local presence requirement.

Collecting cross-border VAT on digital services could be particularly problematic for smaller firms unable to register in overseas markets and effectively remit payments.

Collecting cross-border VAT on digital services could be particularly problematic for smaller firms unable to register in overseas markets and effectively remit payments, especially in local currencies, to local tax authorities.

Smaller services providers may not collect and remit VAT/GST themselves but instead rely on larger companies to provide these services.[35] For example, e-commerce and digital services platforms could collect VAT for purchases on behalf of companies. Alternatively, financial services firms like banks, credit card companies, or payment processing platforms might be tasked with managing tax payments. As many of the indirect taxation schemes are new or under development, particularly those related to VAT for digital services, it is not clear how indirect taxes might be paid. The impact of expanded collection on smaller firms is also not clear. If the compliance costs of collecting and remitting taxes becomes too high, platforms and other intermediaries may opt to stop carrying the services of some companies, especially the smallest firms. They may also halt the delivery of services into some markets.

VAT and GST rates vary considerably, with levels ranging from 5% to 25%. The range complicates the ability of firms to predict in advance the VAT to apply to their product prices in the final markets. The digital world allows customers to purchase goods and services from anywhere. Hence companies could find their price points severely impacted by alternative levels of VAT rates if they are unaware of the VAT variations that will apply to purchases in overseas markets. As a simple example, companies that have designed price points based on relatively lower VAT rates in their home market may be significantly disadvantaged in Europe, where VAT rates are typically higher.

Managing VAT is made more complex by the fact that some markets have differing rates of VAT within their own jurisdiction. For example, US states may apply additional taxes to purchases made within the United States, and many Canadian provinces use differing VAT rates.

Given the inconsistency in VAT schemes, companies in overseas jurisdictions may find themselves often inadvertently out of compliance with the tax regimes – perhaps in more than one market. Managing compliance and efficient payment of tax will add significant costs to firms. Tax has to be remitted in local currencies, which can also be tricky for firms to manage.

Firms may end up hiring local tax agents to manage more of the process, driving up costs.[36]

With the explosion of digital education, universities and colleges may be suddenly subject to GST/VAT on electronically supplied services (ESS).

For an illustration of the challenges in managing VAT proliferation on digital services, consider higher education services.[37] During the Covid-19 pandemic, millions of students were suddenly switched to online delivery of course content. While many governments have not applied GST/VAT to in person education services, online services can be treated differently. Many GST/VAT schemes are meant to apply to electronically supplied services (ESS). With the explosion of digital education, universities and colleges may be suddenly subject to GST/VAT on ESS. These rates can be up to 20% and application of the rates may depend on the location of the student. Given that Covid also disrupted travel, some students that were typically resident in one market could be physically located elsewhere during some or all of the course delivery period, with computer IP addresses that may be masked for security purposes.[38]

To qualify as a covered ESS, countries use differing definitions. In the UK, "live" lectures are exempt. In Spain, tax laws look to the mode of delivery – online content of any kind is online and therefore subject to tax as a covered ESS. To compound challenges for companies trying to comply with VAT requirements, some countries exempt some or all of education services from VAT payments. It is highly likely for a university or college to ultimately pay double VAT or GST on services for students in some markets, with limited ability to claim a refund for the overlapping amount of tax.

Calculating VAT on cross-border supply chains, especially for services, can be extremely challenging.

Many of the potential trade challenges that apply to DST schemes could impact cross-border VAT collection. VAT is meant to be collected on the value added at different stages in the production process. Calculating VAT on cross-border supply chains, especially for services, can be extremely challenging. As a result, some of the collection methods could end up discriminating against foreign firms. Double taxation – that is, the application of tax twice on the same service in different markets – is a serious issue for firms in the digital economy. Finally, many VAT schemes that apply to cross-border delivery could disadvantage particular firms or services, as they are often applied only to certain types of products or services or, as the education example illustrates, only applied to some types of services delivery methods.

Equalization levy

There are also new forms of indirect taxes that go beyond VAT, such as India's equalization levy (EL). As discussed earlier, the EL has similarities with DSTs. The levy amount is currently 6% and charged on "specified services," such as online advertisement and any provision for digital advertising space, or any other facility or service for the purpose of online advertisement.[39] Adjustments were finalized in 2020 to widen the scope of the EL with a newly added 2% rate. India's 2021 Finance Bill also proposes new amendments. The levy would be extended to include purchases of goods and services made through e-commerce operators by residents in India and by non-residents when targeted by advertising aimed at Indian residents. Individuals buying goods and services while using an Indian IP address could also be subject to the tax.

Customs duties on electronic transmissions

Another potential form of indirect taxation is the application of customs duties on electronic transmissions. Until now, the collection of such duties has been prohibited under a moratorium managed by the WTO. Duty collection has been suspended for electronic transmissions and the moratorium has been renewed approximately every two years since 1998.[40] The moratorium may be lifted during the next Ministerial Conference (MC12) in late 2021. Such action would allow members to begin to apply duties to electronic transmissions.

A discussion of what constitutes an "electronic transmission" is worthy of a separate report. Ultimately, countries appear to be considering the application of customs duties to all digital services or to subsets of digital services such as downloadable books, music, and software.[41] While the collection of duties on electronic transmissions, however defined, may fit into a direct taxation method, customs authorities are not yet in a position to physically collect and remit duties on inbound digital services. As a result, the imposition of such duties will likely be handled as an indirect tax. Firms, platforms, or financial services providers may be responsible for the collection of duties on cross-border delivery of digital services that will then be remitted to governments.

Indirect tax payments and data flows

Given delays in electronic payment processing, firms are likely to be paying tax ahead of payment receipt. For smaller firms, the cash flow implications could be significant.

Indirect taxes are payable regardless of profits for the firms. The payment is due the moment a customer makes a purchase, regardless of whether the payment has been received by the firm. Given delays in payment processing, noted in an earlier Hinrich Foundation report on electronic payments,[42] firms are likely to be paying tax ahead of payment receipt. For smaller firms, the cash flow implications could be significant.

As digital firms, especially services companies, deliver products directly to consumers, managing indirect taxes also means tracking tax payments on behalf of individual purchasers. Purchasers may not have a tax or VAT registration number beyond their own home market, and may not even have a clearly identifiable number domestically for payment of tax. This is true for many firms in developing country markets and certainly applies for individual consumers.

Firms cannot effectively and efficiently remit tax payments if they cannot move financial data or customer data across borders.

To manage the indirect tax requirements applicable to the delivery of digital goods and services, data will need to flow across borders. Firms cannot effectively and efficiently remit tax payments if they cannot move financial data or customer data across borders. To help reduce the costs of compliance, companies are likely to centralize tax operations in a limited number of jurisdictions. This may also require relevant data to be housed in different markets. Restrictions on the location of data hosting can dramatically impede the ability of firms to consolidate tax functions.

Definitional challenges

Taken as a whole, the digital economy comes with a wide range of definitional challenges. As much of digital trade cannot easily be seen or measured, it can be difficult to determine what ought to be captured and what should be excluded.

Tax policies to fit the digital era contain specific inconsistencies and issues. As noted above, some approaches are applied to more narrow sectors or applications, like paid online or digital advertising. Others are more expansive, including software downloads, books, or music. Many policies are less clear but appear to capture software as a service (SaaS) or other types of renewable services delivery, such as continuing maintenance contracts. These contracts apply to software upgrades and updates, and increasingly to manufactured products such as digital services tracking, monitoring of aircraft engine performance while in flight, or the operationalization of Internet of Things (IOT) services that may be managed across borders. New services, such as streaming or sharing services, could also be tricky to manage.

Governments have applied different thresholds to various types of digital taxation schemes. Some of these thresholds can be quite low. As a result, they target companies of smaller size. Some thresholds for tax payment requirements can be easily met by some companies across the tax year, even if the firm was not eligible for tax payments in previous years. As a result, many companies could get caught out by market changes that affect their tax requirements in different jurisdictions.

The cross-border applications of services taxes may conflict with existing trade agreement restrictions on local presence.

If the seller is in one jurisdiction, the platform provider is in another, and a paid advertiser is in a third market, who is meant to pay tax?

Many of the tax applications, even in the goods environment, can be extraordinarily complex. If the seller is in one jurisdiction, the platform provider is in another, and a paid advertiser is in a third market, who is meant to pay tax?

Ease of doing business

Paying tax in a domestic context can be a challenge. At a minimum, it requires firms to have a registered tax presence. The variation in ease of corporate registration for businesses is substantial. According to the World Bank's 2020 Ease of Doing Business report, starting a business varies significantly around the world, requiring anywhere between 1 to 18 different procedures that can require up to 100 days to complete. The findings are reproduced in Figure 1 below.

Even paying domestic tax can be difficult. According to the World Bank, managing tax payments can take from 49 hours per year to more than 12 times that amount. Obtaining a VAT refund might stretch to 55 weeks.

Digital trade may require more firms located around the world to manage significant inconsistencies in time, costs, and procedures.

Digital trade may require more firms located around the world to manage significant inconsistencies in time, costs, and procedures. The burden of successfully completing even a limited number of steps will be felt particularly by smaller companies.

Figure 1 – **Which economies set the best regulatory performance?**

Topic and indicator	Economy establishing best regulatory performance	Best regulatory performance	Worst regulatory performance
Starting a business			
Procedures (number)	Georgia; New Zealand	1	18
Time (days)	New Zealand	0.5	100
Cost (% of income per capita)	Rwanda; Slovenia	0.0	200.0
Minimum capital (% of income per capita)	Australia; Colombia; Mauritius	0.0	400.0
Paying taxes			
Payments (number per year)	Hong Kong	3	63
Time (hours per year)	Singapore	49	696
Total tax and contribution rate (% of profit)	Canada; Denmark; Singapore	26.1	84.0
Postfiling index (0-100)	No economy with both CIT and VAT has reached the best performance yet	100	0
Time to comply with VAT refund (hours)	Croatia; Republic of Korea; Netherlands	0	50
Time to obtain VAT refund (weeks)	Australia; Estronia	3.2	55
Time to comply with corporate income tax correction (hours)	Estoria; Lithuania; Portugal	1.5	56
Time to complete a corporate income tax correction (weeks)	Japan; Sweden; United States	0	32

Source: World Bank Doing Business 2020[43]

Institutional settings for managing tax and trade

The rise of the digital economy has put new pressures on both the tax and trade landscapes. While the two have intermingled for some time, the increasing number of taxes that apply to cross-border digital movement of goods and services have made clearly defined splits between tax and trade less relevant and applicable. Tax experts must consider the trade implications of changing tax rules. Trade experts can no longer ignore tax issues.

Institutional bodies for managing these issues can also better facilitate connections. The Asia Pacific Economic Cooperation (APEC) deserves appreciation for its early efforts to bring these two communities together. APEC launched, in 1993, a Finance Ministers Process, which now includes an APEC Finance Ministers Meeting and the Finance and Central Bank Deputies' Meeting (FCBDM). Although cooperation and consistent communication between APEC's trade and finance tracks are limited, the existence of parallel tracks provides an opportunity for increased cross-delivery of information and improved cooperation.

The Association of Southeast Asian Nations (ASEAN) also has a Finance Ministers and Central Bank Governors' Meeting (AFMGM) as part of the sustained set of meetings held every year across the region. ASEAN Finance Ministers also meet regularly with what are called the "+3" counterparts from China, Japan, and South Korea.

Within the AFMGM, there is an ASEAN Forum on Taxation (AFT) to work on tax-related impediments to regional economic integration. Much of the work has focused on creating bilateral agreements to avoid double taxation and to limit the potential for tax evasion. It should also be possible for the AFT to deliver workplans related to the taxation of digital trade and help ensure that ASEAN's efforts to achieve the ASEAN Economic Community (AEC) is supported and facilitated by consistent digital tax policies.

Asia is increasingly linked by a dense web of existing trade commitments, including bilateral and regional trade agreements, and a new set of "digital only" trade agreements.

Asia is increasingly linked by a dense web of existing trade commitments, including bilateral and regional trade agreements, and a new set of "digital only" trade agreements. While many of these FTAs and digital agreements have coverage of some aspects of digital trade and e-commerce, few make explicit reference to tax, even at the level of encouraging regulatory cooperation on digital tax elements.

Asia's two largest regional trade agreements briefly refer to tax. In the chapter on agreement exceptions, the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) has a section devoted to tax measures (Article 29.4).[44] The article repeatedly notes that the CPTPP may not apply to taxation measures and that tax trumps trade if a conflict arises between CPTPP and any tax convention. Article 29.6c explicitly references digital products, but the many caveats attached obscure what the provision actually delivers. CPTPP Article 14.3 permanently extends the mortarium on the collection of customs duties. The Regional Comprehensive Economic Partnership (RCEP) has a shorter section (Article 17.4) in the exceptions chapter to address tax. Like in the CPTPP, tax conventions prevail in RCEP; the agreement also references existing WTO provisions.[45] RCEP Article 12.11 references the WTO moratorium and notes that members may adjust future duty collection practices depending on possible WTO changes.

In the Digital Economy Partnership Agreement (DEPA) between Chile, New Zealand, and Singapore, the imposition of customs duties on electronic transmissions is prohibited. Paragraph 3.2.2 in the DEPA also states that internal taxes may be applied internally, provided they are imposed in a manner consistent with the agreement.[46] Article 15.5 does address tax. The most relevant section (15.5.2) clarifies that nothing in DEPA should apply to tax or taxation measures.

Going forward, it is increasingly important to consider the participation of tax regulators in trade integration conversations.

Going forward, it is increasingly important to consider the participation of tax regulators in trade integration conversations. Nearly every trade agreement has, at a minimum, a committee tasked with overseeing the FTA provisions. This committee might build in a review mechanism for unfolding tax policies applicable to trade – in particular, digital trade.

Currently, a global tax authority does not exist. That is why the OECD has taken the lead in the BEPS project, in order to help coordinate tax issues among the Inclusive Framework's 139 member governments. Given the growing connections between tax decisions and global trade commitments managed by the WTO, better coordination is critical. As many trade agreements allow tax conventions to prevail over trade provisions, it is important to reflect on the potential impact of tax policy on trade commitments.

Conclusions

This paper has highlighted some of the current and upcoming issues of digital tax under both direct and indirect tax collection schemes. These tax frameworks have the potential to dramatically upend the expansion of digital trade around the world. Firms will have to navigate an increasingly complex environment that requires adherence to specific trade rules and regulations, and mastery of complicated tax regime requirements. This may include VATs, customs duties, DSTs, withholding taxes, extra-territorial application of taxes on intangible assets, and transfer pricing mechanisms.

Many MSMEs do not even realize that their businesses will be affected by such international tax policy changes, leaving them unable to respond or play a proactive role in shaping debates.

What may change is not only the payment of tax. Even the requirements for tax reporting could transform and lead to more regulatory divergence. The challenges for companies are significant. Much of this reporting burden is likely to land on firms that are intermediaries. While many digital intermediaries are large firms with resources to address compliance concerns, smaller firms play similar functions but with less capacity. Many MSMEs do not even realize that their businesses will be affected by such international tax policy changes, leaving them unable to respond or play a proactive role in shaping debates or to prepare themselves to manage growing complexity. Increasingly, firms will be asked to submit, on behalf of customers or clients, a wide and growing range of tax-related information on business sales to tax authorities.

As always, the burden of managing such complexity will be substantial for the smallest firms who lack capacity and resources. While many of the tax changes noted in this paper may not directly apply to small firms, the indirect implications and trade changes are likely to continue to disproportionally affect MSMEs. The largest digital firms that currently support MSMEs may opt to make changes that can destroy the value of many smaller firms overnight. This will upend previous business models and limit the ability of MSMEs to find overseas markets and customers.

Allowing tax and trade issues to be addressed in a holistic manner can help ensure the delivery of rules and regulations that work better for all stakeholders.

Absent sustained dialogue and discussions between governments and the private sector, many proposed and planned changes in the tax landscape may have severe unintended consequences. Allowing tax and trade issues to be addressed in a holistic manner can help ensure the delivery of rules and regulations that work better for all stakeholders.

It would be ideal to craft a concrete series of proposals here to address this growing list of concerns, but the issues are too new and the level of capacity needed to tackle the interplay between tax and trade remains underdeveloped. This paper represents a first step – to increase the level of understanding, especially for the trade community, of many of the ongoing changes in tax that will have trade implications. As always, when engaging in dialogue, it will be critically important to consider varied stakeholder inputs, from large and small firms, to better grasp the challenges and opportunities ahead.

The tax and trade implications may also vary by levels of development, with differing responses likely from different communities. The Inclusive Framework process has brought together a wide range of member governments. Something similar will be needed for addressing the trade implications of tax policies and the reverse.

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Other papers in the Asia Digital Economy Series:

- Increasing access and interoperability of cross-border e-payments in Asia
- Digital trade in the Asia Pacific

Researcher bio: Dr. Deborah Elms

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Dr. Deborah Elms is the Founder and Executive Director of the Asian Trade Centre. The Asian Trade Centre works with governments and companies to design better trade policies for the region. Dr. Elms is also Vice Chair of the Asia Business Trade Association (ABTA) and sits on the International Technical Advisory Committee of the Global Trade Professionals Alliance and is Chair of the Working Group on Trade Policy and Law. She was also a senior fellow in the Singapore Ministry of Trade and Industry's Trade Academy.

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The Asian Trade Centre (ATC) is the regional thought leader, advocate and educator for trade in the Asia Pacific region and serves as the resource for trade-related activities in Asia. They are a team of trade policy and supply chain subject matter experts positioned to meet the trade related needs of businesses — small and large — and governments — regional and foreign — operating in the Asia-Pacific.

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— They design and conduct training and capacity building programs for government officials and companies throughout Asia on key aspects of trade policy.

ATC is also the Secretariat to the Asia Business Trade Association (ABTA) and the Asia Pacific MSME Trade Coalition (AMTC).

Endnotes

1. This paper largely focuses on the Asia-Pacific economies of Brunei, Cambodia, China, India, Indonesia, Japan, Laos, Malaysia, Myanmar, New Zealand, the Philippines, Singapore, South Korea, Thailand, and Vietnam.
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3. See https://www.hinrichfoundation.com/research/wp/digital/cross-payments-in-asia-deborah-elms/
4. The reverse, of course, is also true. The trade world likely appears to be just as complex for tax policy experts. This paper, however, is designed for trade rather than for tax.
5. As with most aspects of trade and taxes, of course, there can be variations. Goods that arrive in free trade zones, as an example, can be exempt from duty payments. In many markets, firms can claim back duties paid on goods that are later exported.
6. The World Customs Organization (WCO) has noted challenges for customs officials in collecting duties on e-commerce goods shipments as well as VAT or GST on physical goods. Duty collection for digital services by customs is likely to be an even larger problem as internal processes are not currently configured to do so. See, for example, “Ecommerce and revenue collection,” WCO, October 2015, at https://mag.wcoomd.org/magazine/wco-news-78/e-commerce-and-revenue-collection/ accessed June 28, 2021.
7. See, for example, https://www.oecd.org/tax/beps/background-brief-inclusive-framework-for-beps-implementation.pdf accessed May 26, 2021.
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15. See, for example, “G7 tax deal reverberates in Singapore and beyond,” Nikkei Asia, June 11, 2021, at: https://asia.nikkei.com/Economy/G-7-tax-deal-reverberates-in-Singapore-and-beyond-What-to-know accessed on June 28, 2021. The G20 grouping includes more Asian participants and the host government, Italy, has also invited additional Asian governments to attend, including Brunei as chair of ASEAN and New Zealand as current chair of APEC.
16. For more details on the EU scheme, see https://ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en accessed on June 8, 2021.
17. See Taxation of the digitized economy, KPMG, slide 5, Updated January 15, 2021, accessed at: https://tax.kpmg.us/content/dam/tax/en/pdfs/2020/digitalized-economy-taxation-developments-summary.pdf on June 2, 2021. Another new reference that captures the range

of digital tax activities is the Digital Policy Alert, which notes 36 different types of tax actions taken by a range of governments and sub-federal level entities in 2021. The Digital Policy Alert provides links to the full texts of various bills for review. See https://www.globaltradealert.org/digital_policy, accessed on June 8, 2021.

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28. See the EU directive at https://www.consilium.europa.eu/en/press/press-releases/2021/03/22/taxation-council-adopts-new-rules-to-strengthen-administrative-cooperation-and-include-sales-through-digital-platforms/ accessed on June 2, 2021. The OECD is reportedly considering updating its rules for reporting on the sharing and gig economies. See, for example, https://news.bloombergtax.com/daily-tax-report/oecd-gig-economy-tax-reporting-rules-may-expand-to-match-eus?context=article-related accessed on June 28, 2021.
29. See Taxation of the digitized economy, KPMG, slide 64, Updated January 15, 2021, accessed at: https://tax.kpmg.us/content/dam/tax/en/pdfs/2020/digitalized-economy-taxation-developments-summary.pdf on June 2, 2021.
30. See the recommendations at https://www.oecd.org/tax/consumption/international-vat-gst-guidelines-9789264271401-en.htm accessed June 2, 2021.
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32. The OECD definition of VAT or GST involves "a broad-based tax on final consumption collected from, but in principle not borne by, businesses through a staged collection process, whatever method is used for determining the tax liability (e.g. invoice-credit method or subtraction method)."
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