TAX CHALLENGES OF THE DIGITAL ECONOMY

3RD Version

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INTRODUCTION

This research is intended to analyze digital economy taxation, particularly in light of the criterion used for taxability derived from BEPS actions.

1. DIGITAL ECONOMY. CHARACTERIZATION, ECONOMIC AGENTS AND EXAMPLES OF TRANSACTIONS.

Briefly, we could define digital economy as the production of intangible goods and services based on communication, information and software technology, and the resulting transactions among different types of users.

Antonio Morales Martín lists the main characteristics assigned to digital economy by the OECD, within the framework of the BEPS Action 1. Those characteristics are:

- "Mobility in relation to intangibles, on which the digital economy relies heavily, in relation to users and in relation to business functions, as a consequence of the performance of an activity that does not necessarily require local personnel, and the flexibility to choose the location of servers and other resources".

- "The importance of data and the so-called *big data*, on which the digital economy rests".

- "Network effects derived from user participation, integration and synergies".

- "Multiple business models according to which suppliers and consumers can be located in different jurisdictions."

- "Trends towards monopoly or oligopoly."

- "Volatility, as a consequence of the ease to start up a business and the rapid technological evolution".

In digital economy, the following agents or stakeholders can be briefly identified:

a) The economic agent creating or developing the digital product (server[1], digital platform, email marketing[2] e-book, hotels and tickets search services, newspaper web page, etc.).

b) The economic agent supplying/selling the digital product mentioned above. It may be the same subject creating and/or developing the product.

[1] Server: "Software or application attending the queries of a client and returning a response according to the request, providing essential services within a network. When this software runs on computers exclusively dedicated, it is called "server". Depending on the service provided, there are several types of servers such as email server, database server, file server, web server and game server, among others". (https://infortelecom.es/blog/glosario/servidor/).

[2] Email Marketing: "Direct marketing and online communication technique based on sending emails massively to a list of contacts. Its content is usually mainly advertising but it is also used to build loyalty and maintain a stable and long-term relationship with customers or the public" (https://infortelecom.es/blog/glosario/email-marketing/).

c) The economic agent using the provision of the service to collect information from its users (big data[3]) for its subsequent analysis, utilizing or selling the results of this analysis, for the purposes of their use in other economic activities. This economic agent may coincide with the subject or subjects referred to in a) and/or b).

d) The economic agent using the digital goods (company, individual, final consumer).

It should also be pointed out that the provision of digital services may be carried out by the interposition of successive intermediary subjects, whether economically o legally related to each other or not.

As examples of digital economy transactions, we can mention:

- The provision of software, and its maintenance and updating service, rendered by one company to another of the same economic group.

- The provision of the digital information storage service.

- Online sale of tangible goods (e.g. household appliances).

- The provision of TV or entertainment services to individuals (such as online games, or the possibility of watching movies in smart devices).

- The provision of on-line health care consulting services delivered to individuals.

- The sale of an e-book.

PART II

2. OBSOLESCENCE OF TRADITIONAL LEGAL CONCEPTS FOR DIGITAL ECONOMY TAXABILITY

The advent of the digital economy has implied a great challenge for the traditional taxation criteria. In this regard, we find domestic legislation in institutions that, at the time of their creation, logically did not consider the particularities of this new economy. Since this new economy was established, both tax administrations, courts of law and taxpayers themselves have been compelled to apply the existing legislation to the new reality. This implied “forcing” the application of principles and concepts on the digital economy that were designed for the traditional economy.

In this regard, it is worth referring to the need for the physical presence of the taxpayer in the State jurisdiction intending to exercise taxing powers over the income, revenues or sales thereof. Considering these characteristics of the digital economy, the transactions said digital economy originates can occur in a jurisdiction without there being any physical presence in that jurisdiction. Subsequently, in the aforementioned attempt to “force” the application of tax legislation on the new reality, the concept of “virtual permanent establishment” has been created, which fails to contemplate the diversity of transactions the digital economy gives rise to.

[3] Big Data: "It refers not only to the storage of large amounts of data and information, but also to the tools and procedures used to find repetitive patterns in such data that allow their management and analysis" (https://infortelecom.es/blog/glosario/big-data/).

Consequently, there is a departure from the traditional requirement of physical presence of the subject obtaining the profit or income or whom conducts sales, both in legislation and in court decisions. In this regard, it is worth mentioning the relatively recent ruling of the United States Supreme Court in the case "South Dakota vs. Wayfair Inc.". In this ruling, the jurisprudential criterion with over 50 years of validity is set aside, by which the physical presence of the subject was required in order to consider this subject as a taxable person for the Sales Tax. The ruling established that the company, which conducts sales in the State of South Dakota only under the online modality, had to pay the tax regardless of the fact that in said State the company did not have facilities, employees, representatives, or any other manifestation of a physical presence. The ruling found that the standard of a physical presence is "defective and incorrect", imposing an arbitrary and formalistic distinction with respect to those who did have a physical presence in the jurisdiction[4]. In other words, with this ruling, the US Supreme Court enabled taxability in the jurisdiction where sales take place without the need for any physical presence on the part of the person conducting them.

Even though the case presented in the preceding paragraph shows the alignment of the courts of law with the new reality created by the digital economy, it is understood that tax laws and conventions to avoid international double taxation must carry out the necessary adaptations to address digital economy taxation, ruling out the method of "forcing" the application of institutions that do not fix its nature. These legislative adaptations and international treaties, which manifest the necessary changes in certain taxation principles, will allow the existence of a more equitable tax system which does not discriminate whether sales are conducted in a jurisdiction with a physical presence or by means of a digital platform. Likewise, the aforementioned alignment of domestic legislatures and international agreements will bring certainty to the taxability scope of transactions in the new digital economy, avoiding conflicts among states and, in addition, costs derived from the judicialization of problems regarding normative interpretation, both for tax administrations themselves, as well as for taxpayers.

3. PART III

BEPS ACTIONS AND TAXATION PRINCIPLE WHERE ACTIVITY IS DEVELOPED AND VALUE IS GENERATED. ITALIAN SCHOOL OF TAXING POWERS

3.1 TAX EVASION AND AVOIDANCE IN THE CONTEXT OF INTERNATIONAL TRANSACTIONS AND BEPS ACTIONS. TAXATION PRINCIPLE IN THE PLACE WHERE ACTIVITY IS DEVELOPED AND VALUE IS GENERATED.

Tax evasion and avoidance taking place within the framework of international transactions have led the international community, led by the OECD, at the behest of the G20, to focus on providing to the taxation field, in a global manner, concepts, guidelines and instruments that allow to overcome domestic legislations and actions of the different economic agents meaning erosion of the taxable base through the relocation of profits in different jurisdictions. To this end, the OECD has developed a body of analysis and

[4] See reference websites: www.iprofesional.com,"Hard blow to online sales giants in the United States: Why may a court decision issued in that country affect Argentina?", by Juan Manuel Vázquez (Master in Tax Law from Austral University and Georgetown University), 06/26/2018.
See court decision at: Http://ujs.sd.gov/uploads/sc/opinions/28160.pdf

guidelines, classified into 15 actions called the "Base Erosion and Profit Shifting Project" (BEPS).

BEPS Action 1 addresses the challenges posed by digital economy taxation, an aspect we will refer to in this work.

For the purposes of our study, it should be noted that one of the guiding principles of the BEPS criteria is to "…better align the location of taxable profits with the location of economic activities and value creation, …" In other words, BEPS Actions aim at ensuring that profits are taxed where economic activities take place and value is added.

Based on this guiding principle, we will focus on analyzing the generation of value in the framework of the digital economy, but we will first make reference to the generation of value in the traditional economy and then we will move on to analyzing the phenomenon in the context of the digital economy.

By traditional economy we mean the modality of production and commercialization of goods and services that has existed prior to the emergence of the digital economy and coexists with it.

3.2. BRIEF REFERENCE TO PROFIT TAXABILITY DOCTRINAL BASIS IN THE JURISDICTION WHERE VALUE IS GENERATED

The guiding principle adopted in the framework of BEPS Actions to tax the digital economy, in terms of profit taxability in the place where economic activities take place and value is added, finds doctrinal support in the Italian doctrine of taxing powers. We undertake this doctrinal approach to better understand the theoretical foundation of the taxability criterion.

In order to understand the doctrinal conception of taxing powers of the Italian School, it is necessary, first, to mention what was pointed out by Giuliani Fonrouge when stating that, when we refer to taxing powers, we are referring to the cause of the tax (Giuliani Fonrouge 1997: 511 and 527).

In other words, under this conception, in order to determine the States that have the taxing powers to levy cross-border transactions, we understand that it is necessary to find the cause that justifies the exercise of such powers.

Along these lines, we will refer to the Italian School and its justification for the State taxing powers, whose main advocates were Ranelleti, Griziotti and Vanoli.

In this sense, Ranelleti considers that "...a service, as generally understood, provided by the State to the society, is the first and mediate cause of the tax (Giuliani Fonrouge 1997: 512).

Giuliani Fonrouge can also be quoted again when referring to Vanoli's concept, "... the cause of the tax lies in the public activity, and how the individual sees in it a means to an end (satisfaction of certain needs), giving special relevance to the moment of the satisfaction of such needs as a consequence of the public activity: it is in this sense that Vanoli accepts Grizioti's criterion that the cause of the tax lies in the general and particular advantages that the State activity can provide to subjects" (Giuliani Fonrouge 1997: 516).

PART IV

VALUE GENERATION IN THE DIGITAL ECONOMY

Bearing in mind the criterion determined by BEPS Actions of levying profits in the place where activities are developed and value is added, it is necessary, first of all, to determine how value is generated in the framework of digital economy in order to analyze the digital economy taxability.

For this purpose and with the aim of carrying out a comparative analysis that facilitates the understanding of the subject, we will first deal with the goods and service value generation of the traditional economy, and then focus on the goods and service value generation of the digital economy.

4.1. GOODS AND SERVICE VALUE GENERATION IN TRADITIONAL ECONOMY

4.1.1 GOODS VALUE GENERATION IN TRADITIONAL ECONOMY

Firstly, we must bear in mind that when referring to them, we are referring to both tangible and intangible goods. An example of tangible goods (physical product) is an automobile, and of intangible goods is a drug product formulation.

For goods to have value, their existence and demand are necessary, even if this demand is potential. Goods without, at least potential, demand have no economic value.

Let's examine some examples.

A car is "complete", with "full existence", once its production is finished. It has full existence once its manufacture has been completed, regardless of whether it has already been purchased or not by the consumer. It has value because it already exists and because there is, at least, a potential demand for it.

It is worth clarifying that a specific demand for goods may have been manifested, even before or in the course of their production, but in the absence of a real demand, the existence of a potential demand has already generated the value of the goods. The potential demand already gives value to goods.

Similarly, a drug product formulation does exist since the inception of the formulation. It has value because it exists and has a potential demand (given by those pharmaceutical companies that would be interested in using it).

Goods are characterized for their capacity to have value by the mere existence of a potential demand. They may have real demand, even before being created or during manufacturing, but real demand is not essential for goods to have value once produced or created. Once goods are produced or created in traditional economy, the concurrence of its existence (tangible or intangible) and the existence of a demand, either potential or real, generates the value of goods.

The potential demand is essential for goods, either tangible or intangible, at least to have value.

Goods and their resulting value may exist even before the effective consumer "shows up". If the potential demand for the goods disappears, because it is out, it gets spoiled

or becomes obsolete, the value is lost, however nobody will deny the existence of the goods and their value at one point in time.

In summary, for goods value – either tangible or intangible, - to be generated in the traditional economy, the existence of the goods and their demand, at least a potential one, are necessary.

4.1.2 SERVICE VALUE GENERATION IN TRADITIONAL ECONOMY

Unlike goods, a service and its value only exist whenever there is an effective, concrete, and actual demand for the service; a potential demand is not enough for its existence as such. That is to say, services cannot have an existence before there is a concrete demand. Therefore, a service and its value are simultaneously generated.

Let´s take the example of a dentist who delivers a service: the service will exist only when the patient (client) appears and asks for it. There is the possibility of delivering a service for tooth decay treatment, which is given by the dentist´s skills (intangible goods) and all the physical assets and other services involved to that effect. But this potential is not the service itself, the service is fixing the tooth decay, which takes place when the above-mentioned potential "meets" or is matched with the patient's demand.

It should be noted that emphasizing the need of the existence of an effective demand to create the existence of a service should not dismiss the fact that -, as it emerges from the previous example -, the service needs to come into existence (and therefore there must be a value attached to it after being created); that is, the existence of a previous capacity, given by tangible and/or intangible goods, to provide the potential service.

4.2. VALUE GENERATION IN DIGITAL ECONOMY. "PRIMARY DIGITAL GOODS", "SECONDARY DIGITAL GOODS" AND DIGITAL SERVICES.

Given the characteristics of the goods and services existing in the digital economy framework, they can be classified as follows:

a) Primary digital goods
b) Secondary digital goods
c) Digital services

"Primary digital goods" are those digital goods that enable the provision of digital services, the transfer of secondary digital goods, the procurement of traditional services or the performance of transactions involving physical goods (tangible). Examples of primary digital goods are the digital platforms providing a language teaching service over the Internet, the app allowing you to "download" a graphic design software to a PC, the digital platform that makes purchasing a ticket or hotel services possible, or the one that allows you to rent a car or buy a machine.

"Primary digital goods", like goods (physical or intangible) in the traditional economy, have value for their mere existence in conjunction with a potential demand. For example: a digital platform for language teaching has existence (given by the software and hardware that are part of it) and value because it has a potential demand. The combination of both elements - existence and potential demand - gives value to the primary digital goods (digital platform for language teaching).

As for "secondary digital goods" and digital services, both require the existence of an effective, real, concrete demand for their creation and the generation of their value, that

is to say, their existence and value cannot be created from a potential demand, so they share the same characteristics as services in the traditional economy: the need of a real, and concrete demand.

In other words, “secondary digital goods” and “digital services” are "produced" when the capacity to transfer them and their effective demand get matched through the network.

Examples of “secondary digital goods” are films, e-books or software that can be "downloaded" from the web. In these cases, the possibility of having the digital goods (secondary) is potential, available when the consumer demands it. The "consumer's private copy" of the film, e-book, or software, only exists when it is demanded, “downloaded" from the network.

In the examples above, we find “primary digital goods”, consisting of the software giving access to the contents (films, e-books or software) to be downloaded from the network, and “secondary digital goods” that is, the intangible goods consisting of the particular film or software that has been downloaded from the network.

It should also be noted that secondary digital goods may become primary digital goods. For example, a software acquired through the web can be used to provide digital services over the Internet.

It is also relevant to consider another variant of the digital economy, which is the case of companies owning primary digital goods that in turn, may be users of other primary digital goods. An example of this is a company owning a website platform providing services to sell physical goods in a jurisdiction, but in order to deliver this service, it uses a software outsourced from a company located in another country.

In terms of examples of digital services, we can mention those rendered through platforms that provide information on physical goods and allow their commercialization, or provide different types of information such as weather information, flight schedules, online legal advice, etc.

From the above, we can conclude that “traditional services”, “digital services” and “secondary digital goods” share the same characteristic in terms of their existence and value, that is to say, it is necessary to combine the capacity to provide/transfer them on the one hand, and the effective verification of consumer demand on the other.

However, there is a difference between “traditional services” on the one side, and “secondary digital goods” and “digital services” on the other. “Traditional services”- as it has already been mentioned-in some cases, can only be delivered in the same jurisdiction where there is the capacity to provide them, while “secondary goods” and “digital services” always have the technical possibility of being consumed, demanded, in a jurisdiction different from where they are provided.

Examples:

- The dental service mentioned above can only be provided in the same jurisdiction from which it is provided (the jurisdiction where the dentist is providing the service and where patients are).
- On the other hand, some services can be provided from one jurisdiction and used in the same jurisdiction or in a different one. This would be the case of a laboratory that provides analysis services of mining samples. The laboratory may be in the same jurisdiction requesting the analysis, or the laboratory may be in one country and the company requesting the analysis in another.

- The service provided by a digital hotel booking platform can be used in the same jurisdiction where the company managing and updating such platform is located, or in a different country.

That is to say, some services belonging to the traditional economy can only be used in the same jurisdiction from which they are provided, **whereas there are services belonging to the traditional economy that have the possibility of being used in another country; the latter characteristic is shared between "secondary digital goods" and "digital services**".

When the dynamics of the effective consumer of secondary digital goods or digital services is multiplied, a set of real consumers called "secondary digital goods or service market» is obtained.

As a summary of what has been stated in this section, we can say that value is generated in different types of digital goods and services when goods or services acquire such a nature, that is, when they are created. Therefore, as described above, there is a difference in this respect between primary digital goods on the one hand, and secondary digital goods and digital services on the other. In the case of primary digital goods, although they may have, even before their creation, a specific demand giving them value, in its absence, a potential demand is enough to create such value. On the other hand, in the case of secondary digital goods and digital services, value is generated when there is an effective demand for them. For example: the digital platform (primary digital goods) already exists and has a value from the moment it has been created and has its potential demand, while in the case of secondary digital goods and the digital service offered by such platform, they come into existence and get value only when they are actually demanded. In other words, secondary digital goods or digital services acquire existence and value when being demanded by consumers.

PART V

TAXING POWERS IN DIGITAL ECONOMY

In this section, we will be dealing with the States that have taxing powers to levy transactions in the digital economy.

In order to do this, we will build on the intention expressed in the framework of BEPS Actions, in terms of ensuring "… that profits are levied wherever economic activities take place and value is added"[5]. Consequently, we will make use of the analysis carried out in the preceding Part 1 regarding how value is generated in digital economy.

Likewise, for the purposes of doctrinally establishing the taxing powers criterion from the place in which value is generated, we will make a very brief reference linking this criterion with the taxing powers criterion of the Italian School.

5.1 STATES MAKING TRANSNATIONAL DIGITAL ECONOMY POSSIBLE

Taking into account what was stated above regarding how value is generated in digital economy (Part IV), the taxability criterion for said economy being sought through BEPS (Part III, item 3) and the doctrine that is the ground for the latter (Part III, item 4), we will

[5] OECD/G20 Project on "Tax Base Erosion and Profit Shifting", "Explanatory note on Final Reports 2015", item 7.

next analyze the states with the taxing powers to levy income derived from the digital economy.

For this purpose, we must determine those States enabling value generation in the digital economy. In this regard, we can identify:

a) The State providing services and allowing the development, invention and subsequent provision, and/or maintenance and/or updating of intangible goods for the provision of the digital service, which for practical purposes, will be identified as the "Digital State" and its jurisdiction, "digital jurisdiction".

b) The State providing the services and allowing the development and existence of a market where the digital goods or service were and are sold/rendered, and which, for practical purposes, will be identified as "Market State", and its jurisdiction, "market jurisdiction".

In other words, on the one hand, there is the State with the services that gave rise to the conditions, "the environment", for the development of digital goods. For example, by providing or facilitating an educational system in which the professionals involved in such a development were trained (human capital), and/or by providing legal certainty for these purposes (protection of intellectual property rights), and/or by taking direct measures to promote the production of digital goods (e.g., several and different direct incentives, such as tax breaks, for the development of the software industry).

On the other hand, there is the State that, for example, has provided the service to create the conditions for the development of a market with the capacity to acquire and use digital goods, while providing legal certainty for that purpose.

Considering this classification, it is worth highlighting:

a) That, in the case of primary digital goods, it is the “digital State” that allows the invention and development of these goods and their maintenance and update.

b) That, in the case of digital services and secondary digital goods, both States allow the generation of revenues derived from them. The digital State has allowed the invention and allows the maintenance of the digital platform with the potential to generate digital secondary goods or a digital service when combined with the market, thus enabling the “market state”.

5.2 STATE TAXING POWERS ON INCOME DERIVED FROM THE SALE OR RENT OF PRIMARY DIGITAL GOODS.

As previously described, primary digital goods owe its existence exclusively to the digital state, so it is the digital state that has exclusive taxing power over the profits derived from their sale or rent.

An example of primary digital goods is the benefit obtained from the sale of a digital platform for language learning developed in a certain jurisdiction which can be exclusively levied by the state where it was developed.

Next, the taxing power authority of the states will be analyzed, in the case of the provision of primary digital goods, when the owner and the consumer are in different jurisdictions.

An example of this is software leasing. If the primary digital goods (software) are made available, managed and updated in the same jurisdiction where they are used by the lessor, logically, it is only one state that has the taxing powers to levy the income derived from the leasing.

If the software is made available from one jurisdiction and is used by a lessor located in another jurisdiction, we find ourselves in two states with taxing powers over the income generated by the leasing of primary digital goods. In this case, the transaction, location, and value arise from the interaction, conjunction, between the existence of the goods subject to leasing and the existence of a demand for that leasing. That is, we are faced here with a case in which there are two States that allow the leasing of the primary digital goods, and therefore the emergence of its value and the generation of profit derived from it. On the one hand, there is the State that created the environment for the development, maintenance and updating of the primary digital goods, and on the other hand, the State that created the environment for the existence of a subject with the capacity to be a lessor of the digital goods. We find ourselves with a case of double taxation, two states with taxing powers over the same income.

5.3 STATE TAXING POWERS ON INCOME DERIVED FROM THE SALE OR RENT OF SECONDARY DIGITAL GOODS OR DIGITAL SERVICES.

As it was seen in section 5.1, secondary digital goods and digital services owe their existence and value to both the "digital state" and the "market state".

As it has already been mentioned, the roles of these two States may take place simultaneously in a single jurisdiction. This would be the case of an entity that owns the digital platform and offers its services in the same market in which it is located (this market may be the only destination for its services, or, more likely, one of the many markets served by the digital platform).

However, it may happen that both States do not coincide or overlap, which would give rise to double taxation by both states regarding the profit/income derived for the sale or provision of such goods or services.

PART VI

6. INTERNATIONAL DOUBLE TAXATION IN DIGITAL ECONOMY

DOUBLE TAXATION FROM THE SAME NEXUS CRITERION

Up until now, the taxing theory has analyzed international double taxation arising from the existence of different connecting criteria that account for the exercise of the taxing power by more than one State regarding the same taxable person or event.

As an example of the above, we can mention two States that exercise their taxing powers over the same income, one over the jurisdictional nexus of residence and the other one over the jurisdictional nexus of the source. Another example would be the case of two States exercising their taxing powers, one over the jurisdictional nexus of the subject's residence and the other over the jurisdictional nexus of the subject's nationality.

In this regard, the solution adopted by most international conventions in order to avoid international double taxation is to choose residence as a criterion of jurisdictional nexus, granting up to a limit rate, the possibility of taxing income at the source.

The criterion to avoid international double taxation in the traditional economy outlined in the preceding paragraph has even been adopted in the highlighted case of cross-border services of the traditional economy, which value is generated, as we have seen, in the same way as the value of secondary digital goods and a digital service is generated.

However, in the case of secondary digital goods and digital services, double taxation is not verified in the application of two different jurisdictional nexuses, residence and source, but in the same jurisdictional criteria established by BEPS for the event, the place where economic activities take place and value is added.

In other words, the international double taxation that occurs in digital economy originates from the existence of two States having the same jurisdictional nexus with the taxable event (location of primary digital goods, and sale or location of secondary digital goods and digital services).

PART VII

TAX BASE DETERMINATION, DISTRIBUTION AMONG DIFFERENT STATES AND INCOME TAX COLLECTION IN DIGITAL ECONOMY

In this section of the document, we will analyze the tax base distribution of income tax between both States, as well as proposals for tax collection.

7.1 TAX BASE DETERMINATION AND PARAMETERS FOR DISTRIBUTION AMONG THE STATES.

The international double taxation of the digital economy described in item 10 implies the need to globally agree on parameters to distribute the tax base in question between the digital state and the market state.
Given the existence of this international double taxation, it is necessary to establish parameters to distribute the tax base between both states.

While both the Digital State and the Market State contribute with their interaction to generating the value of the digital economy, it is very difficult to determine the extent to which each State has contributed to generating the value. That is, it would be an arduous and debatable task to determine how much of the value originates in the potential to provide secondary digital goods[6] or digital service, and how much of the value originates in the demand for secondary digital goods or digital service. Besides, that fraction is likely to vary according to the particularities of the specific secondary digital goods or digital service. To the difficulty of the task can be added the cost and time it would take.

Therefore, the adoption of a practical solution, easy to understand, free of cost and easy to apply should be considered. In this sense, it would be appropriate to reach an international consensus on the distribution of the value of the tax base according to percentages. These percentages are not necessary to be fixed forever; a review of these percentages could be made over time according to emerging analysis parameters.

[6] As regards the Author's proposal about how to classify the goods and services in the digital economy, see the following link:
https://www.linkedin.com/posts/gabriel-sullivan-31b074178_how-value-is-generated-in-digital-ec-sullivan-activity-6585506884428541953-sMTT

As regards the taxable base, it should be the value of the income obtained by the owner of the primary digital goods (the supplier of the secondary digital goods or digital service). This can be identified as ¨Digital economy tax base¨(DETB).

As regards digital tax base value determination, it can be determined based on the financial statements of the subject providing the secondary digital goods or digital service, prepared in accordance with international accounting standards (example: IFRS).

As regards the digital economy tax base fraction (DETB) attributed to the Digital State, it can be identified as “digital tax base” (DTB) and the fraction attributed to the Market State can be described as “market tax base” (MTB).

In this regard, it should be considered that there is likely to be more than one market jurisdiction, and that even the digital jurisdiction might assume such a character. The latter case would be verified when the owner of the digital primary goods obtains benefits by renting or transferring digital goods or services in their own jurisdiction.

As regards the distribution of the tax base attributable to market jurisdictions among themselves, it is necessary to select a parameter for this purpose, such as the percentage of the sales amount made in each market jurisdiction.

Once the fractions of the “digital economy tax base” (DETB) corresponding to the digital jurisdiction and the market jurisdiction(s) have been determined, the Digital State and the Market States will each apply the rate on said tax base which has been determined on the basis of the exercise of their sovereignty.

An example:

A company owns primary digital goods consisting of a digital platform that allows to "download" movies (secondary digital goods), which in turn, maintains and updates such platform. It obtains income from transactions made both in the jurisdiction itself (A) and in another jurisdiction (B).

Company´s total income: $ 1,000 (“digital economy tax base)
Sales destination: 60% local market (A), 40% in the other jurisdiction (B)
Internationally agreed % for the digital tax base: 50%
Internationally agreed % for the market tax base: 50%
Income tax rate in jurisdiction A: 25%
Income tax rate in jurisdiction B: 30%

Assessment of the total Tax Base in Jurisdiction A
Taxable amount for being a digital jurisdiction: $ 500 (digital tax base)
Taxable Base Amount for being a market jurisdiction: $ 500 x 0.6 = $ 300
Total Taxable Base in Jurisdiction A: $ 800
Tax in Jurisdiction A: 0.25 x $ 800 = $ 200

Tax Base Calculation in Jurisdiction B
Taxable amount for being a market jurisdiction: $ 500 x 0.4 = $ 200
Tax in Jurisdiction B: 0.30 x $ 200 = $ 60

7.2 INCOME TAX COLLECTION MODALITY FOR “MARKET JURISDICTION”

Considering that the entity owning the primary digital goods collects the income and computes the costs derived from the digital economy, and is located outside the “market jurisdiction”, the State of said market jurisdiction is hampered in its determination of the tax base and in the collection of said taxes.

For this purpose, the digital State could collaborate either by providing information on the amount of taxable profit or, notwithstanding this exchange of information, by collecting the corresponding tax that will be then sent to the State of the “market jurisdiction” (a fee could even be agreed upon to be paid to the digital State for the provision of this service).

It should be noted that among the difficulties that could arise when applying the determinative and collection methodology described, there could be regulatory differences for the tax base determination between the different jurisdictions in question. However, bearing in mind that most tax systems are based on similar criteria, an international consensus could be reached regarding rules on this matter.

An alternative to the collection method described could be that - based on the accounting information of the entity that owns the primary digital goods provided by the digital State - the market State determines its tax base, calculates the tax, and proceeds with the tax withholding at the income tax source. The disadvantage of this procedure would be that the company located in the “digital jurisdiction” may exercise the “grossing up” in its billing for the residents of the “market jurisdiction”, with the disadvantages that will be described below.

7.3 COMMENTS ON COLLECTION THROUGH WITHHOLDINGS IN THE MARKET JURISDICTION

One collection modality that is being adopted by some countries is the collection of a tax at the time of payment for digital services. In other words, when the consumer pays for the purchase or rent of secondary digital goods or digital services, he or she pays an additional amount in the form of tax.

The withholding described above is implemented as a form of levying the lease of primary digital goods or the lease or sale of secondary digital goods or digital services that are being leased or sold from outside the jurisdiction. Example: a tax added to the payment of a subscription to the service of a digital platform offered from another jurisdiction that allows watching films.

In this regard, we have already commented some disadvantages in relation to this tax which, for the sake of brevity, may be referred as ("Digital Economy - Tax on profits in international transactions. Need to await a global coordination"[7])**.**

Despite this reference, the following observations are to be made:

a) For international transactions, if an income tax is collected through withholding systems at source, this may in fact -from an economic point of view, given the oligopolistic characteristics of the market for the sale/provision of digital goods and

[7]“Digital Economy – Tax on profits in international transactions. The need to await a global coordination” 3 December, 2018, Gabriel Sullivan – Centro Interamericano de Administraciones Tributarias. https://www.ciat.org/digital-economy-tax-on-profits-in-international-transactions-the-need-to-await-a-global-coordination/?lang=en

services - result, in whole or in part, in a consumption tax applied on the residents living in the market jurisdiction, thus not levying, in whole or in part, the income on digital goods or services ("grossing up» application). That is to say, the tax economic burden is not on the subject intended by law (the owner of the digital goods or the digital service provider).

b) Likewise, if a tax on the consumption of the services in question already exists in the jurisdiction itself, the implementation of tax withholdings on profits may factually result in two taxes on the same taxable capacity, consumption.

c) As per items a) and b), it appears that the introduction of this type of withholdings or perceptions results in damages to resident consumers and to domestic economy in general.

d) In view of the significance of digital economy, which is having an increasing impact on many more sectors of the economy as time goes by, the criterion related to the economically burdened subject within the framework of the collection of an income tax through collections or withholdings at the source should be especially considered when designing the taxability of such services.

PART VIII

TOWARDS AN INTERNATIONAL COORDINATION. TAX TREATMENT EQUITY AND SIMPLICITY IN DIGITAL ECONOMY.

In the present document, an attempt has been made to develop a practical proposal, both for tax administrations and taxpayers, in order to determine and collect the income tax of the digital economy based on the objectives established by BEPS actions, in particular Action 1, an economic analysis of value generation in the digital economy, and a reference to the doctrinal foundations provided by the Italian School of taxing powers which are aligned with the BEPS Actions criteria.

In this regard, it is expected that the rules that are finally agreed upon internationally will levy income where economic activities take place and value is added, at the same time that they are not made complex for the purposes of their interpretation and application, all of which will contribute to fair taxation, the facilitation of administration by the tax authorities, the existence of reasonable compliance costs for the taxpayers and the encouragement of voluntary compliance by the latter.

In this sense, it is worth mentioning the final 2015 report of the aforementioned BEPS Action 1 regarding the “Treatment of Tax Challenges in Digital Economy”, when stating[8]:

[8] OECD: Organization for Economic Cooperation and Development. “Addressing the Tax Challenges of the Digital Economy”, Action 1: 2015 Final Report, p. 20: “… Tax rules should be clear and simple to understand, so that taxpayers know where they stand. A simple tax system makes it easier for individuals and businesses to understand their rights and obligations. As a result, businesses are more likely to make optimal decisions and respond to intended policy choices. Complexity also favors aggressive tax planning, which may trigger deadweight losses for the economy”
OECD: OECD/G20 Project on Base Erosion and Profit Shifting», How to address fiscal challenges in Digital Economy», Action 1 p. 176: 2014 Objectives: Tax rules should be clear and simple to understand, so that taxpayers know where they stand. A simple tax system makes it easier for individuals and businesses to understand their rights and obligations. As a result, businesses are more likely to make optimal decisions and respond to intended policy choices. Complexity also favors aggressive tax planning, which may trigger deadweight losses for the economy”

"… Tax rules should be clear and simple to understand, so that taxpayers know where they stand. A simple tax system makes it easier for individuals and businesses to understand their rights and obligations. As a result, businesses are more likely to make optimal decisions and respond to intended policy choices. Complexity also favors aggressive tax planning, which may trigger deadweight losses for the economy".

CONCLUSION

Within the framework of BEPS Actions, in particular Action 1, the aim is to ensure that the benefits of the digital economy are levied where economic activities take place and value is added. This criterion finds its doctrinal base in the taxing powers of the Italian School.

Consequently, in order to analyze the digital economy taxation within the framework of BEPS actions, it is first necessary to analyze the way in which value is generated in the aforementioned economy.

For this purpose, we have classified the goods and services of the digital economy into primary and secondary digital goods and digital services.

As regards primary digital goods, their creation is possible thanks to the activity and conditions offered by the digital State, which is why the latter has the taxing powers to levy the income derived from the transfer of ownership or location.

As for secondary digital goods and digital services, they are created, and therefore acquire value, when their supply, which was made possible by the primary digital goods (therefore the digital State), interacts with the demand made possible by the market State. Mindful of this circumstance, the taxing powers to levy the income derived from the sale and/or location of secondary digital goods and services corresponds to both the digital State and the Market State.

When the digital State and the market State do not coincide in their identity, international double taxation takes place. Unlike international double taxation in the traditional economy, which is mainly originated by two States applying different jurisdictional nexuses, residence or source, the international double taxation that occurs in the digital economy derives from the application of the same jurisdictional nexus by both States. That is, both states base their taxing powers on the fact that both enable the value generation of the digital goods or service.

Due to the fact that it would be too complex to determine the extent to which each of the States, digital and market, contributes to value generation, it is understood that the tax base must be distributed on an agreement based on percentages, firstly between the digital State and the Market States, and then among the latter by taking into account, for example, the sales volume in each jurisdiction. Likewise, procedures could be agreed upon to confirm or review, every certain period, the percentages and parameters agreed upon for the tax base distribution.

As regards the tax base valuation, it is suggested that the financial statements of the entity that owns the digital goods are used, which are prepared in accordance with international accounting standards.

As regards tax collection from the Market States, this would be the responsibility of the digital State, which would remit the tax collected to the Market States (this service provided by the Digital State could be compensated by a fee paid by the Market States).

Finally, it is to be expected, regardless of the proposals made in this article, that whatever the rules internationally agreed upon to tax and collect income derived from the digital economy may be, they will bear in mind the place where economic activities are carried out and value is added, and that they are not made complex for the purposes of their interpretation and application, all of which will contribute to fair taxation, to the administration by the tax authorities, the existence of reasonable compliance costs for taxpayers, and voluntary compliance by the latter.

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