Digital Service Taxes under the objective scope of Double Tax Conventions and the Colombian approach

Impostos sobre Serviços Digitais no âmbito objetivo das Convenções de Dupla Tributação e a abordagem colombiana

Impuestos sobre servicios digitales en el ámbito objetivo de los Convenios para la Doble Imposición y el enfoque colombiano

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Abstract

In assessing whether a Double Tax Convention covers a tax[1], the starting point is Article 2, which specifies the objective scope of the treaty. According to this article, the convention applies to "taxes on income and on capital", which means that what matters is not the label or the form of the levy but whether it is imposed on income. Consequently, the question that arises is whether the digital tax service fulfills the criteria to be considered for imposition on income and, consequently, falls under the scope of the article. The authors find that digital tax services are designed and structured to be taxed on income, and therefore, they fall within the objective scope of double tax treaties, regardless of their label or justification used for their implementation. Additionally, the present study will examine the approach adopted by Colombia.

Key words: Digital Service Tax, Double Tax Convention, Income Tax, Digital Economy, Colombia, Tax Law, International Tax Law, Significant Economic Presence.

Resumo

Ao avaliar se uma Convenção para Evitar a Dupla Tributação abrange um tributo, o ponto de partida é o Artigo 2º, que especifica o âmbito objetivo do tratado. De acordo com esse artigo, a convenção se aplica aos "impostos sobre a renda e sobre o capital", o que significa que o que importa não é a denominação nem a forma do gravame, mas se ele incide sobre a renda. Consequentemente, a questão que se coloca é saber se o imposto sobre serviços digitais cumpre os critérios para ser considerado como incidindo sobre a renda e, portanto, se enquadra no âmbito do artigo. Os autores concluem que os impostos sobre serviços digitais são concebidos e estruturados para tributar a renda e, por conseguinte, inserem-se no âmbito objetivo dos tratados para evitar a dupla tributação, independentemente de sua denominação ou da justificativa utilizada para sua implementação. Além disso, o presente estudo examinará a abordagem adotada pela Colômbia.

Palavras-chave: Convenção para Evitar a Dupla Tributação, Imposto sobre a Renda, Economia digital, Colômbia, Direito tributário, Direito tributário internacional, Presença econômica significative.

Resumen

Al evaluar si un Convenio para Evitar la Doble Imposición abarca un determinado tributo, el punto de partida es el artículo 2, que precisa el ámbito objetivo del tratado. Según

1 Based on the OECD and UN model tax conventions.

este artículo, la convención se aplica a los "impuestos sobre la renta y sobre el capital", lo que significa que lo relevante no es la denominación ni la forma del gravamen, sino si recae sobre la renta. En consecuencia, la cuestión que se plantea es si el impuesto a los servicios digitales cumple los criterios para considerarse un gravamen sobre la renta y, por lo tanto, queda comprendido en el ámbito del artículo. Los autores concluyen que los impuestos a los servicios digitales están diseñados y estructurados para gravar la renta y, en consecuencia, se ubican dentro del ámbito objetivo de los convenios para evitar la doble imposición, con independencia de su denominación o de la justificación utilizada para su implementación. Además, el presente estudio examinará el enfoque adoptado por Colombia.

Palabras clave: impuesto a los servicios digitales, Convenio para la Doble Tributación, impuesto sobre la renta, economía digital, Colombia, derecho tributario, derecho tributario internacional, presencia económica significativa.

Introduction

In a world where economies are digitized, tax systems are challenged to keep up with new business models. The increasing importance of intangibles has required reconsideration of rules meant for a world based on physical presence. Under current norms, profits are usually taxed primarily in the jurisdiction where a business has a physical presence or establishment (PE) (Ojeda-Pinto, 2018), which many argue is inadequate in the digital age (Karnosh, 2021).

In this context, Digital Services Tax (DST) comes into play. In very general terms, DSTs are tax gross revenues from targeted digital activities, such as, online advertising revenue in their local market, platform intermediation, and monetizing or selling their user data. Normally, these taxes apply when those revenues are attributable to users located in a jurisdiction. They typically are built on scope thresholds, such as global group revenue and/or in-country revenue, targeting large companies. Moreover, they apply modest rates to the gross digital revenues attributable to the jurisdiction.

Attribution of the taxable base typically uses operational metrics to determine and allocate the relevant portion of revenues to the local jurisdiction, compliance is then imposed on registration and filing process, and in some plans, withholding methods directly with the local counterparties. Rather than treating the on-line usage as passive rent, in the case of DST, the on-line usage is viewed as an active and substantive contributor to income. As such, user location serves as a valid proxy of economic presence, and in the absence of a sufficient physical presence serves as a reasonable normative basis for entitlement to allocation of taxing rights.

This paper develops from that basis and raises the question of whether DSTs could be considered as "taxes on income or on capital" under Article 2 of double tax treaties, and also uses the Colombian approach in this regard[2]. This analysis is conducted on a general basis by treating common logic and standard design features of these taxes rather than focusing on any one specific country. The use of the Colombian approach is illustrative in supporting the conclusions and demonstrating what could be implemented to address this discussion.

I. Objective scope of the Convention

According to Article 2.1[3], the Convention applies to "taxes on income and on capital", and Article 2(2) clarifies that "taxes on income and on capital" encompass all taxes imposed on total income, on total capital, or on elements of income or capital. Each treaty typically lists the specific taxes of each contracting state that are covered, but these lists are not exhaustive. Article 2(4) provides that the treaty shall also apply to any "identical or substantially similar" taxes that are introduced after the treaty is signed, in addition to or in place of the listed taxes, which means that the objective scope of a DTC is dynamic and focuses on the *nature* of the tax, not its name or label.

The wording of Article 2 allows member countries not to have to update the list of taxes covered, but to incorporate those taxes that meet the requirements and facilitate legal traffic of a changing global economy, as "the name of the tax is not determinative, and article 2 of the OECD Model Tax Convention could cover taxes that are badged as excise taxes but which are, in substance, income taxes" (OECD, 2018, p. 2).

The question in this regard is whether the Digital Service Tax (hereinafter "DST") is a tax on income and, therefore, covered. Thus, the characteristics of such a tax must be analysed.

II. Characteristics of an income tax

There is no definitive or universally accepted delineation of a "tax on income,". In fact, defining it in a closed and exhaustive fashion would not be wise, as it would allow States to avoid the application of treaties through formalistic redesign of levies. Nonetheless, some general features and indicators show that a levy is a tax on income in substance. These indicators or characteristics are the following: (A) the tax is not borne by the final consumer of the service, i.e., it relies on the taxpayer that earns and not on who spends (Karnosh, 2021), therefore, its imposition must be focused on the recipient of the income, and it (B) takes into account the economic circumstances of the recipient (OECD, 2018).

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2 This article originates from a research project that was started in the context of one of the author's participation in an international tax law competition. The curiosity evoked by a specific issue considered in that context inspired the current, more general analysis.

3 Whenever this document refers to an "Article" without identifying the governing instrument, it should be understood to refer to the corresponding article of the OECD Model Tax Convention of 2017.

(C) The tax base is generally the net income of the supplier (OECD, 2015), and its collection is based on the income obtained by the taxpayer in a given period. Generally, the tax period is a specific period of 12 months, which normally matches with the calendar year (Burns and Krever, 1998).

A. The tax is levied on the recipient of the income

The charging provision is intended to tax income obtained by the individual or entity who could have benefited from providing the specific good or activity that generates the income (Ismer and Blank, 2015).

Unlike some consumption taxes, which are incurred by the buyer and measured by spending, income tax is incurred by those who earn and measured by what is collected. In the case of a service, the income tax is based on what the service provider has, while the consumption tax is based on what the service recipient spends. This distinction is important. If there is a tax designed such that the legal incidence is on the buyer, it is moving towards being an income tax (Ismer & Jescheck, 2018).

B. The tax seeks to capture the economic benefits of the income recipient

Income taxes normally take into account the principle of ability-to-pay, which means that taxes on income are commonly designed based on how much economic gain a taxpayer has, based on the idea that one's tax burden should be proportionate to one's ability to absorb it (Burns and Krever, 1998). In practice, this is why income taxes usually have progressive rate structures, and why they allow deductions for expenses that reduce one's net income. The notion is to capture the actual increase in the taxpayer's wealth over the tax period and tax that amount. With that in mind, the tax scope is not aimed at taxing the buyer's consumption of goods and services since they are not the taxpayers of the income tax (OECD, 2015).

C. Generally, the tax base of the income tax is the net income

The charging provisions seek to impose taxation on a net amount because this value truly reflects the taxpayer's ability to pay (Burns and Krever, 1998), which embodies, as mentioned before, the progressive approach to taxing income, i.e., a higher income level leads to a higher tax, to apply a significant tax burden only to those who can afford it (Eleniewisky, 2014).

Most comprehensive income taxes allow deductions for business expenses (Evans, 2014). which are the expenses incurred by the person or legal entity to obtain the income plus any capital allowances or amounts allowed by the internal legislation as a deduction (Burns and Krever, 1998).

A notable exception in income tax design is the use of withholding Taxes (hereinafter "WHT"), which is the mechanism that is most widely used in the international community for the collection of income taxes for non-residents due to its convenience in administrative practice. Regarding this point, it is necessary to specify two important aspects: (i) withholding taxes are applied to the gross and not net income of the taxpayer, and on some occasions (ii) the withholding tax becomes the final tax (Burns and Krever, 1998).

As mentioned before, the final withholding tax on gross income is the conventional method to tax non-residents, as "in the case of non-resident taxpayers, returns are not usually required or forthcoming so that the withholding is final in fact" (Vann, 1998, p. 42). Therefore, the tax liability is satisfied through final withholding since, in this manner, the tax is paid, which is preferable from the perspective of administrative simplicity.

Moreover, the income of non-residents is generally taxed on a flat-rate basis, as the progression scale is typical of the taxation of the residence country (Vann, 1998), hence, in international taxation, it is common that the domestic law charges flat-rate final withholding taxes on the gross income obtained as a means to ensure the payment of income taxes.

III. DSTs as income taxes

Matching the nature of the DST and the essential elements of the income tax, the following characteristics are met: (A) The taxpayer under DST is the corporation that provides the digital service (the platform, the search engine company). The recipient of the income is the corporation, not the consumer. Therefore, criterion (A) is satisfied as DSTs do not fall on the final consumer in legal incidence; they belong to the entity that derives the revenue. Even if companies may shift the burden onto the user in practice, the legal incidence is borne by the company, not the user or customer. (B) The taxable event is the receipt of income (the revenue) from users located in the jurisdiction, which results in an increment to the corporation's wealth. It is not a tax on a transaction, but rather a tax on the result of a transaction. The DST in other words seeks to tax the income stream resulting from digital activities taking place in the jurisdiction. In this case, the destination is taxing the income that results in an increase in the taxpayer's net wealth, rather than limiting the tax to the consumption behavior of the user. The objective is to tax a portion of the income that currently is not included in the source taxation in the source market as contemplated. This is consistent with this criterion.

Characteristic (C) is when DST may be different to a classic income tax. Tax bases for DST are gross revenue and not net income. However, as stated above, it works similarly to final withholding taxes for the non-resident income. For DST, the taxpayer is a non-resident digital company with limited PE in the jurisdiction; so, it is comparable to interest or royalty payments to non-residents where the source country typically imposes gross withholding. Thus, a DST is essentially a type of final withholding tax on income for digital services, calculated in a simplified way.

Considering these points, DST fulfils the provision established in Article 2.4 as it is a tax that is substantially similar to the income tax. The main reason to classify it as out of the scope of income taxes is to avoid the application of the Convention and prevent the tax benefits of the treaty by the application of the internal legislation of the country.

However, not everyone agrees with this conclusion. The debate remains open. For instance, The UK HM Revenue and Customs (2018) asserts that the DST does not fit the criteria for listed taxes, nor is it identical or substantially similar to the income tax. The argument against its classification as an income tax is based on factors such as the absence of a specific definition in the OECD Model Convention for income tax or income, and the tax's focus on gross receipts rather than net income, meaning the net increase in a taxpayer's economic wealth over a period, calculated by subtracting relevant costs and expenses from gross receipts. Thus, according to the UK authority, the scope of the convention would not cover the income obtained by digital services, a statement that we do not support as the DST is substantially like the income tax and the argument regarding the imposition of the net income as the taxable income, does not take into account the exemption of such rule when the WHT becomes the final tax, which is imposed on the gross income.

IV. Colombian approach

The Organization for Economic Cooperation and Development published a Base Erosion and Profit Shifting work plan to establish a global agreement on taxing multinational companies that provide digital services; however, it was not successful (Quimbayo, 2021). Consequently, unilateral responses around the world started to appear, such as the case of Colombia, which implemented the concept of significant economic presence (hereinafter "SEP") through the Law 2277 of 2022. This was inspired by global discussions on Pillar One and Article 12B proposals from the UN[4], and it is significant because it incorporates the digital services levy as part of the income tax system, rather than as a separate indirect tax.

The Colombian government has established certain criteria to determine whether a taxable person has SEP in the country, which are that (a) their gross income from transactions with customers in Colombia exceeds 31,300 Tax Value Units (UVT), or (b) if their digital company interacts with 300,000 or more users located in Colombia.

There are two taxation systems available to the taxpayer's choice. They can either opt for a withholding at the source, which acts as a final tax with a 10% rate on the total value of the payment. Or they can choose to register for the income tax form and pay a 3% rate on the gross income derived from the sale of digital goods or services provided to users located in Colombia.

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4 In fact, to define some concepts specific of the digital economy such as customer, user, and digital interface, the Colombian authority refers to Pillar 1 of BEPS, as well as Article 12B proposed by the Committee of Experts of the United Nations regarding its Model Convention to Avoid Double Taxation.

The Colombia case is quite interesting and lightful for the discussion as they introduced a provision that states that this is an income tax, which allows the objective application of the DTC and does not establish clauses aimed at a treaty override or treaty dodging. They do recognize that this tax aims to capture the income obtained by companies that do not have a physical presence, which resolves the absence of a permanent establishment in digital activities.

The criteria set to establish PES follow the OECD Action I- Final Report, whereas "a new nexus based on the concept of significant economic presence" was proposed to tax digital services. This new nexus was divided into three factors, which were used in the Colombian case: (a) the revenue, as the value "generated from digital transactions concluded with in-country customers through an enterprise's digital platform" (2015, p.107), transactions that would cover the exchange of goods and services. Furthermore, in this factor, a level of revenue threshold was proposed to reduce the possibility of manipulation, which would also help the administration to identify the digital sales of the enterprise.

In addition, the (b) digital and (c) user factors aid in clarifying the interaction between the consumer and the digital platform, which is essential in the tax treatment of the DST. The use of both factors can be seen in the legal definitions established in the Decree regarding digital concepts, such as digital interface and user, terms needed to set the criteria needed to determine if the user is in Colombian territory, e.g., the IP address used at the moment of the digital operation, the credit card used in the transaction, the shipping address for the sale of goods situated in Colombia, among others (EY, 2024).

The withholding applied to the gross income of the enterprise, as a final tax on a flat rate base is a measure that matches the essence of the income tax, as it has been stated throughout this article, idea that was also proposed by the OECD:

> This withholding tax could in theory be imposed as a standalone gross-basis final withholding tax on certain payments made to non-resident providers of goods and services ordered online or, alternatively, as a primary collection mechanism and enforcement tool to support the application of the nexus option described above, i.e. net-basis taxation (2015, p. 113).

The Colombian case demonstrates that although the DST is a novel and challenging tax, the international tax regime provides the tools needed to classify it, ergo, to regulate the allocation of the income in the absence of a physical nexus of the taxpayer to the State source, without the need to resort to undesirable international practices or leaving discussion that gives uncertainty to the taxpayers. This may be a proposal that other jurisdictions may pursue if they want to preserve their tax base from digital consumption but also want to maintain their tax treaty obligations. MLI for digital nexus if Pillar One is unsuccessful.

V. Conclusion

The emergence of DSTs, and the interplay with double tax treaties, exemplifies a basic problem in the international tax system which is that 20th Century tax principles and 21st Century digitalized business models do not always align.

From a substantive meaning, DSTs have the characteristics of an income tax. The taxpayer under DST is the corporation that provides the digital service, the destination is taxing the income that increases the taxpayer's net wealth, rather than limiting the tax to the consumption behaviour of the user and the fact that the tax bases for DST are gross revenue does not imply that it cannot consider as an income on tax as it is essentially a type of final withholding tax on income for digital services, calculated in a simplified way.

Article 2 will capture any tax that is in substance on income. Therefore, a DST would fall within the material scope of treaties as taxes on income, or at least be "substantially similar" to them, resulting in treaty obligations applying specifically to them.

However, we recognize that there are still some disagreements in the international community regarding the DST being deemed income tax, covered by Article 2 of tax treaties. However, Colombia has illustrated this potential for domestic tax treatment, without disclaiming the treaty framework, and has presented a position where the DST is characterized as an income tax. This is not only a view that academics have mentioned, but also, in the current situation, it has been given a normative, express provision.

In fact, Colombia's case provides constructive guidance by enacting the new nexus for income tax. From a treaty standpoint, that is more honest behaviour. The Colombian case shows that unilateral measures does not need to lead to treaty dodges; they can also be treaty-conscious innovations.

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