Colombian Tax Bill – Significant Economic Presence

Colombia: Reforma tributaria, presencia económica significativa

Projeto de lei tributária colombiana – presença econômica significativa

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Abstract

Taxing the digital economy is a challenge from a political and economical point of view. Since long time it has been discussed that income taxes should be levied where value is created. The present article aims at explaining why Significant Economic Presence is not factor of value creation. Furthermore. taking into consideration that current nexus and transfer pricing rules are based on physical presence, the article explores the critical points of the implementation of a unilateral income tax on the digital economy in light of international tax treaty law.

Key words: Significant Economic Presence, Transfer Pricing, Digital Economy.

Resumen

Gravar la economía digital es un desafío desde el punto de vista político y económico. Desde hace mucho tiempo se ha debatido que los impuestos sobre la renta deberían recaudarse allí donde se crea valor. El presente artículo pretende explicar por qué la presencia económica significativa no es un factor de creación de valor. Además, teniendo en cuenta que las reglas actuales de nexo y precios de transferencia se basan en la presencia física, el artículo explora los puntos críticos de la implementación de un impuesto unilateral a la renta en la economía digital a la luz del derecho de los tratados tributarios internacionales.

La fiscalización de la economía digital es un reto tanto desde el punto de vista político como económico. Desde hace tiempo se ha discutido que los impuestos sobre la renta deben ser recaudados en donde el valor ha sido creado. El presente artículo intenta explicar por qué la presencia económica significativa no es un factor de creación de valor. Asimismo, teniendo en cuenta que las actuales reglas de nexo y precios de transferencia están basados en presencia física, el artículo explora los puntos críticos de la implementación unilateral de un impuesto de renta sobre la economía digital a la luz del derecho fiscal internacional.

Palabras clave: presencia económica significativa, precios de transferencia, economía digital.

Abstrato

Tributar a economia digital é um desafio do ponto de vista político e económico. Há muito que se discute que o imposto sobre o rendimento deveria ser cobrado onde o valor é criado. O presente artigo pretende explicar porque é que uma Presença Económica Significativa não é factor de criação de valor. Além disso. tendo em consideração que as atuais regras de nexo e preços de transferência se baseiam na presença física, o artigo explora os pontos críticos da implementação de um imposto unilateral sobre o rendimento na economia digital à luz do direito dos tratados fiscais internacionais.

A fiscalização da economia digital é uma resposta tanto ao ponto de vista político como econômico. Desde então, foi discutido que os impostos sobre o aluguel devem ser reavaliados onde o valor foi criado. O presente artigo pretende explicar por que a Presença Econômica Significativa não é um fator de criação de valor. Assim como, tendo em conta que os atuais regulamentos de conexão e preços de transferência são baseados na presença física, o artigo explora os pontos críticos da implementação unilateral de um imposto de renda sobre a economia digital à luz do direito fiscal internacional.

Palavras-chave: presença econômica significativa, preços de transferência, economia digita.

Introduction

The enhancement of telecommunications has enabled an extremely high level of connectivity which allows companies to carry out businesses in innovative ways. Multinational Enterprises (MNE) correctly understood this and developed business models that target final consumers directly through the Internet. By way of example there is Facebook, Google, Netflix and Airbnb which, among others, have been classified by the doctrine as Highly Digitalized Businesses (HDB).

In this regard, a discussion within the area of international taxation arose as to which country has the right to levy corporate income tax, and how nexus and profit allocation rules should work. Current nexus and profit allocation rules are based on physical presence and significant peoples' functions.

Imagine for instance Netflix's operative model. Netflix Inc. is a corporation that provides streaming entertainment services. Organized and existing under the General Corporation Law of the State of Delaware[1], with headquarters in Los Gatos, CA,[2] Netflix Inc. is resident in the United States for tax purposes. Netflix sells memberships to consumers which allows them to access digital content stored in the cloud, all they need is an internet connection. Suppose these consumers are in Colombia. As Netflix provides services in Colombia without physical presence, all the revenue from Colombian sales exits the country towards the US without paying corporate income tax in Colombia. Currently, this situation does not trigger any violation of the Law, but stresses that the current rules of

1 Netflix, Certificate of Incorporation.

2 Corporate Office Headquarters.

international taxation are not equipped for answering the challenges imposed by the digitalization of the economy.

The OECD and G20 have made significant effort to design a cross-border taxation system for the digitalized economy. They have recognized the importance that *users* have for the functioning of digitalized business models and agreed on the need to create a new taxing right at the head of the *market country*.[3] BEPS action on digitalized economy[4] established the concept of *value creation* as the guiding principle for taxing digital economy. This concept appeared because of the wish to tax business models that challenge the deficiencies of the current tax system.[5] To legitimate taxation of digitalized businesses at the market country, nexus and profit allocation rules should link the market country to the place where the MNE carries out core activities for its operational model.

The main characteristics of digitalized business models are: first, being involved in the economic life of a jurisdiction without any or any significant presence, achieving operational local scale without mass.[6] Second, relying and investing on intangible assets, specially IP, which are crucial to their business models.[7] Third, data and user participation.[8] Based on these characteristics, the OECD acknowledged that physical presence does not represent reliable criteria to identify where a digitalized business carries out valuable core activities of their operational model.

A. Current nexus and profit allocation rules under tax treaty rules

International tax treaty law requires two elements to tax non-resident enterprises (NRE): nexus and profit allocation.

1. Nexus

Nexus is the connection between the taxing State and the non-resident taxpayer that deems taxation to be legal.[9] This concept is based on the notion of *jurisdiction* as the power to declare and enforce the law when a particular set of facts are given.[10] However, when these facts are not purely of domestic nature they can trigger jurisdiction in different States,

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3 OECD, *Unified Approach under Pillar One*; The right to levy corporate income tax is currently divided between the *residence* and the *source* country.

4 OECD, Action 1 Interim Report, Chapter 2.

5 Becker & Englisch, p. 2.

6 *Supra. 29*, p. 24.

7 OECD, Action 1 Interim Report, p. 24.

8 *Ibid.*, p. 24.

9 Gadžo, The Principle of 'Nexus' or 'Genuine Link' as a Keystone of International Income Tax Law, p. 6.

10 *Ibid*.

leading to controversial outcomes or, in the case of taxes, to double taxation. The aim of international tax treaty law is to harmonize nexus rules to determine under which circumstances a country is entitled to tax.

Current nexus rules for non-resident taxpayers are based on physical presence.[11] Permanent establishment[12] is the figure by which the administration of the State of source is allowed to tax the profits produced by a resident of the other contracting State. It recognizes that a dependent agent[13] or a fixed place of business through which the business is wholly or partially conducted[14] allows a State to levy corporate income tax. Examples of permanent establishments are a place of management, a branch, an office, a factory, a workshop, or a place of extraction of natural resources.[15] This tool has successfully permitted international taxation for a long time; however, it is short when taxing digital economy as these businesses are carried out without physical presence.

2. Profit allocation

Transfer pricing rules are vital for taxing cross border business models as they ensure the correct allocation of profit. Transfer pricing is the area of tax law and economics concerned with ensuring that prices charged between associated enterprises, or between different parts of a single enterprise, for the transfer of goods, services and intangible property accord with open market prices (unbiased prices).[16] Transfer pricing aims at preventing the manipulation of the tax base which consequently would modify the amount of tax collected.

Current transfer pricing rules are based on the *arm's length principle* (ALP). According to this principle, members of an MNE are considered separate and independent entities rather than inseparable parts of a single unified business.[17] Based on that, it compares the dealing conditions of associated enterprises (comparable controlled transaction) with the dealing conditions of independent enterprises in comparable transactions and comparable circumstances (comparable uncontrolled transaction). When the dealing conditions differ from the comparable uncontrolled transaction, adjustments must be made. This analysis between the controlled and the uncontrolled transactions is called the *comparability*

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11 OECD, Unified Approach under Pillar One, p. 7.

12 OECD, *Model Convention* 2017, Article 5.

13 *Ibid.*, Article 5(5).

14 *Ibid.*, Article 5(1).

15 *Ibid.*, Article 5(2).

16 IBFD Tax Research Platform, *Transfer Pricing*.

17 OECD, Transfer Pricing Guidelines, p. 35.

analysis and it is the heart of the application of the arm's length principle.[18] Note that the adjustments under the arm's length principle are for tax purposes and do not affect the terms of contractual obligations.[19]

The comparability analysis works the same with non-resident taxpayers. The permanent establishment is considered as a separate entity and profits are allocated accordingly to the functions performed, assets used, and risks assumed.[20] However, the problem arises when the non-resident taxpayer conducts a business without physical presence in the market country. As it is the case with digitalized businesses and dependent agents' permanent establishments, when physically there are no functions performed, assets used nor risks assumed, there is no justification for remuneration,[21] and consequently taxation of income is zero.

II. Taxation of significant economic presence in Colombia

Despite the taxation of the digital economy has gained momentum in the international agenda, the development and implementation of new international tax rules will take longer than what economies and governments of market countries are willing to wait. Even more so when it is a developing economy.

On 17 November 2022, the Colombian congress approved a new tax bill, which includes a new income tax on MNEs providing digital services in Colombia, i.e., MNEs with significant economic presence in Colombia. A MNE is deemed to have significant economic presence in Colombia if its gross revenue from sales to customers in Colombia exceeds 31'000 UVT[22] (COP 1'314'772'000 in 2023). A MNE with significant economic presence in Colombia will be subject to 3 % rate income tax levied on the gross revenue from sales to customers in Colombia. The new provision does not apply to MNE tax resident in jurisdictions with whom Colombia has signed a Double Taxation Treaty.

A. Digital Service Tax

In 2018, aiming at taxing the digital economy as source of base erosion and profit shifting, the European Union proposed to implement a unilateral Digital Service Tax levied on income derived from digital activities performed within their jurisdiction. Companies with a total annual worldwide revenue of EUR 750 Mio and EUR 50 Mio revenues in the EU would be subject to a 3 % DST. Despite this initial proposal failed to reach

18 OECD, Transfer Pricing Guidelines, p. 35.

19 *Ibid.*, p. 33.

20 Theophilou, p. 36; OECD, *Model Convention* 2017, Article 7(2).

21 Chand, Achieving Certainty in an Uncertain Profit Allocation Environment, p. 1.

22 Unidad de Valor Tributario (Tax Value Unit).

implementation, the EU argued that it was not an income tax, and therefore was not in scope of double tax treaties.

Contrary to the DST, Colombia admitted that the new SEP tax is by nature an income tax. Whether the governments name it income tax or not highly depends on political and economic reasons. As for technical reasons, we believe that that the new SEP is essentially an income tax. Therefore, Colombia correctly limits the scope of the new provision to jurisdictions with which no DTT has been adopted. As explained in section 2.3 –, current treaty rules on allocation of profit are based on physical presence and significant people's function. According to current treaty rules on allocation of profit, physical presence and peoples' functions are the fundament of creation of value, which deems taxation to be legal. If the new SEP income tax were levied on digitalized business resident in jurisdiction with whom Colombia has a DTT, it would entail a breach of international tax treaty law.

B. Significant economic presence and value creation

Despite current transfer pricing rules are based on physical presence and people's function, the OECD have acknowledged that physical presence is not decisive in identifying where value creation takes place within the operation of digitalized businesses.

The question that arises is as to whether significant economic presence represents value creation? In other words, whether sales to customers in Colombia represent a core activity of the operation of a digitalized business?

The guiding principle of value creation came up in 2015 with the BEPS action plan as a 'negative source rule' to eliminate tax avoidance.[23] As shell companies located in low or no tax jurisdiction (tax heavens) do not perform any substantial activity, value creation has been used as a device to exclude tax heavens from claiming jurisdiction over MNEs' business profits.[24] Two of the fundamental principles on which any legal system is built upon are *equal treatment*[25] and *legal certainty*[26]. Equal treatment entails equal subjection of all to the ordinary law,[27] and legal certainty ensures that the same set of facts lead to the same legal consequence. Therefore, physical, or digital, "*same business functions should lead to the same tax consequences*."[28]

Several definitions of economic *value* are given within the doctrine. Many economists have dedicated extensive work on defining what is value. For Becker and Englisch, "*the 'value' of a good in conventional tax terms is the selling price*" as the maximum

23 Jimenez, p. 621.

24 OECD, Addressing the Tax Challenges of the Digitalisation of the Economy, p. 5-6.

25 Allan, Ch. V, p. 129.

26 Raz, Ch. IV.

27 Law, "The rule of Law".

28 Buriak, p. 10.

willingness to pay for it.[29] For Buriak, value lays on the specific business activities that lead to the generation of income.[30] For Das, value is the competitive advantage of the firm as how efficient and unique it is in the market.[31] However, in existing market economies it is admissible to associate value with production and distribution factors. The report on double taxation presented by experts to the Financial Committee of the League of Nations in 1923[32] already concluded that corporate income should be taxed at the place where the enterprise has its *origin* factors[33]. In general, it is safe to conclude that value respond to the essential business activities that lead to the generation of income.

The aim at taxing the digital economy emerged as a result of the deficiencies of the current tax system to tax digitalized business models with three main characteristics: they are involved in the economic life of a jurisdiction without any, or any significant, presence, achieving operational local scale without mass,[34] they rely and invest on intangible assets, specially IP, which are crucial to their business models[35] and they rely on data and user participation.[36] The question that arises is which of these three characteristics represents essential activities for the NRE in the market country that lead to the generation of income?

In March 2019,[37] the OECD submitted three proposals on how to develop new nexus and profit allocation rules. Each of the proposals covers one of the above-mentioned characteristics: user participation proposal,[38] significant economic presence proposal[39] and marketing intangibles proposal[40].

According to the OECD, the significant economic presence proposal "is motivated by the view that the digitalization of the economy and another technological advance have enabled business enterprises to be heavily involved in the economic life of a jurisdiction without significant physical presence."[41]

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29 Becker & Englisch, p. 163.

30 Buriak, p. 5.

31 Das, The Concept of Value Creation, p. 2.

32 Bruins et al.

33 *Ibid.*, p. 29-32, 39-40.

34 OECD, Action 1 Interim Report, p. 24.

35 *Ibid*.

36 *Ibid*.

37 OECD, Addressing the Tax Challenges of the Digitalisation of the Economy.

38 *Ibid.*, p. 9.

39 *Ibid.*, p. 16.

40 *Ibid.*, p. 11.

41 OECD, Addressing the Tax Challenges of the Digitalisation of the Economy, para. 50.

Significant economic presence would be deemed to exist based on several factors that evidence a sustained interaction with the market country such as: (1) user base and associated data input; (2) the volume of digital content derived from the jurisdiction; (3) billing in local currency; (4) a website in local language; (5) after sales service or repair and maintenance; (6) sustained marketing and promotion activities.[42]

Significant economic presence describes a general effect of digitalization but does not provide a solid argument that shows why value is created. As Professor Chand accurately states, digital economic presence "*does not begin by assessing the non-resident suppliers' efforts to create value in the Market Country but rather starts with the assumption that the presence of a market must be rewarded*".[43] According to the Technical Advisory Group on E-Commerce *"[…] the mere fact that the realization of business transactions requires an interaction between the supply of goods or services by an enterprise and the demand in a market State has not historically been considered by countries to provide a sufficient link for considering that the profits of the enterprise arising from these transactions should, for the purpose of income taxation be sourced in the market State*".[44] The BEPS project has strengthen the application of the 'supply' approach by ensuring that profits should be taxed where value is created and where economic activities take place.[45]

On the other hand, developing intangibles in a market country is an essential activity that leads to the generation of income to the NRE. According to Professor Chand "*Professor Dale Pinto emphasizes in his doctoral thesis that protection of intangible property (IP) is critical for enterprises operating in the digital era*."[46] For instance, in 2019, Netflix spent 2.65 billion USD in marketing activities which represented more than 15% of its total costs.[47] In the same year, Facebook spent 9.87 billion USD in marketing activities which represented more than 21 % of its total costs;[48] developing intangibles is a vital function for the generation of income.

Conclusion

The biggest critic to the new tax is that it creates an economic distortion, by prevailing international tax principles that may lead to double taxation. A new unilateral tax as such

42 OECD, Addressing the Tax Challenges of the Digitalisation of the Economy, para 51.

43 Chand, Allocation of Taxing Rights in the Digitalized Economy, p. 1031.

44 OECD, E-Commerce: Transfer Pricing and Business Profits Taxation, para. 41-42.

45 Chand, Allocation of Taxing Rights in the Digitalized Economy, p. 1025.

46 Chand, Allocation of Taxing Rights in the Digitalized Economy, p. 1027.

47 Netflix Investors, *Financial Statements*; (in thousands) cost of revenue: 12'440'213; marketing: 2'652'462; technology and development: 1'545'149; general and administrative: 914'369.

48 Facebook Investor, *Income Statements*; (in millions) cost of revenue: 12'770; research and development: 13'600; marketing and sales: 9'876; general and administrative: 10'465.

does not allow to determine the taxable base in a unified approach with the resident jurisdiction. Therefore, it will be up to the resident jurisdiction to eliminate double taxation via tax credit. Nonetheless, the implementation of a new tax on digital businesses operating remotely in Colombia is a correct choice to prevent base erosion and profit shifting. Despite the government incorrectly called it Significant Economic Presence, the content of the new tax responds to the need of taxing the digital economy. In particular, the new nexus based on sales is a safe harbor upon which the OECD Pillar 1 approach to taxing the digital economy is be based.

The discussion around value creation should serve as a guiding principle to develop a consistent international tax system. Therefore, when looking at the new SEP tax one should not focus on the formal name, but on the content of the provision. Furthermore, Colombia is not the only country that has implemented such a tax, and now together with other countries such as France, Austria, Italy, Spain, Turkey, etc., Colombia is joining to raise political pressure on the adoption of a global consensus on taxing the digital economy.

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