

# DIFFICULT DIGITS: TAX CHALLENGES IN THE DIGITAL ECONOMY

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From entertainment, media, and retail to communication, education, and even healthcare, the advent of the internet and the proliferation of information technologies has transformed almost every part of our lives. Thanks to digital tech giants such as Google, Amazon, Facebook, and Yandex (to name but a few), everyone today has better access to goods, easier travel, cheaper commutes, quicker bookings, and a myriad of opportunities for long-distance communication.

The digital economy is growing at an unprecedented rate. This is evident from the increase in e-commerce, as well as the growing number of non-cash transactions. In Kazakhstan alone, the number of online market participants has increased from 1.3 million to 2.3 million from 2017 to 2018. It is expected that this figure will reach a staggering 15 million by the year 2025. Meanwhile, the volume of non-cash transactions has doubled over the last two years, increasing from 5.1 trillion Kazakhstani tenge in 2018 to 13.3 trillion tenge in 2019.



The effect of the digital economy on daily life is only “one side of the coin.” The other side its impact on business. It enables all companies – ranging from startups to large multinational enterprises – to reduce costs and expand their offerings over greater distances. This omnipresence is due to the unique business models specific to the digital economy.

Although the digital economy is rapidly evolving into the economy in and of itself, its tax perspective has not been fully calculated. On average, companies engaged in digital businesses pay half the effective tax rate of traditional businesses – 9.5% versus 23.2% respectively. This is compared to an average annual revenue growth of 14% for large digital firms as opposed to 0.2% - 3% percent growth for more traditional companies.

Current tax principles were designed decades ago and were aimed at businesses with a physical presence. Their physical presence normally provided grounds for

governments to exercise their taxing rights. However, with the rise of new business models, digital businesses have access to customers in other countries without a physical presence. Since tax law relies heavily on physical presence, profits derived through digital activities are not subject to taxation in the market/country where the consumers reside.



On a global level, this creates an imbalance. On one hand, large companies make huge profits abroad without paying a proper level of taxation in the consuming countries, and those countries with a relatively low level of digitalization, like Kazakhstan, suffer from tax “leakage.” The following comparison of a traditional business model and a digital business model illustrates this problem.

## ***The Traditional Model***

Normally, if a company has long-term business activities in a foreign country it creates a so-called “permanent establishment.” As a non-resident entity that operates in a foreign jurisdiction on a regular basis, the entity should register its physical presence (i.e. the permanent establishment) in the form of a branch or a subsidiary to account for its income and pay the corresponding taxes. For instance, if a non-resident company engages in road construction in Kazakhstan, it normally has or rents an office, hires personnel, imports equipment, and ensures that all legal requirements, including license and permit requirements, are met.

According to Kazakhstani tax legislation, the company’s presence and activity in Kazakhstan will lead to creation of a “permanent establishment.” The company will hence be required to register its permanent establishment and pay taxes on income generated from construction activities in Kazakhstan.

## ***The Digital Models***

Digital business models, on the other hand, allow for income to be generated in foreign countries without a physical presence, hence with few or no tax liabilities. The following examples include some of the most common business models used to generate income in the digital economy.

- First, there are social networks and search engines. These platforms generate income from the fees that advertisers pay in exchange for unique information on user consumer behavior that allows advertisers to target their ads to specific user categories. Information on users' tastes, preferences, and spending patterns is accumulated based on the user data collected and analyzed by social networks and search engines.
  - Second, there are e-commerce (online sales) platforms used to sell and purchase goods and services (or book a hotel/order a taxi) over computer networks by placing and receiving orders. E-commerce platforms generate income in the form of commissions that suppliers of goods and services pay in exchange for the opportunity to post orders.
  - Last, there are gaming platforms. Currently, many online gaming platforms provide an opportunity for players to purchase certain game-related features. If you are familiar with the online game *World of Tanks*, you know that players spend real money to upgrade their virtual tanks. This trade in intangibles earns money for gaming platform operators.

These examples show just a few of the business models commonly used in the digital economy. Yet none of these models require a physical presence for income to be generated in a foreign country. With a population actively engaged in the digital economy and consuming digital services provided by non-resident companies, Kazakhstan, alongside many other countries, is witnessing a situation where revenue is flowing to foreign jurisdictions without taxation, thus without benefit to the country of origin.



The global community has expressed growing concern about the tax planning opportunities that the digital economy affords. Through various creative approaches, current tax systems may be used to artificially reduce taxable income and even shift profits to low-tax jurisdictions where little or no economic activity by the digital business occurs. In trying to find ways to make digital companies pay their fair share of taxes, foreign governments are asking questions to identify where economic activity in the digital economy is performed, where and how it should be taxed, and who should collect the revenue. All these concerns boil down to the main question: how does a country modify a decades-old tax framework to tax the digital economy?

In seeking to answer this question, governments have joined forces to share ideas for upgrades that would enable the current tax framework to be fit for the digital age. Endeavors to design a new tax system revolve around two allies: the OECD and the European Union.



The OECD aims to find a long-term solution to the problem with a uniform tax system that would fit the whole world. This grand solution, according to plans, will be presented to the public by the end of 2020, although some doubt the feasibility of the timeline. Considering that a viable long-term solution requires the consensus of roughly 130 countries, the timeframe is optimistic. While the OECD is aiming for a long-term consensus-based solution to taxing the digital economy, the European Union (EU) is pouring its efforts into two different streams simultaneously.

The first goal of the EU is to take stopgap measures to prevent at least some of the tax leakage associated with digital activity. To do that, the EU is proposing an interim tax that would apply to the following three types of digital activity: the *online placement of adverts*, the *sale of collected user data*, and *activity related to digital platforms facilitating user interaction*. Companies engaged in these activities will be subject to a 3% tax on income if their total annual revenues generated from digital activities in the EU exceed 50 million euros and total annual worldwide revenues exceed 750 million euros. The second goal of the EU is to design a new tax system for the Union that would line up with the system suggested by the OECD, but would also enable EU member states to establish a single digital market incorporating one taxation system in the long-term.

Given the urgency of the problem of taxation in the digital age, a growing number of countries have taken interim measures (similar to those proposed by the EU-) and introduced their own taxes on digital services without waiting for a consensus-based solution. So far, 19 countries have implemented direct taxation, and 66 countries have implemented indirect taxation on digital services, showing that the world is in the midst of a revolution as different countries develop varied and unique approaches to digital taxation.

France famously pioneered a digital services tax, introducing a direct tax on digital services with retroactive effect from 1 January 2019. Initially, the tax applied at 3% on gross revenues generated by non-resident companies providing a digital interface, targeting advertising and suppliers of user data collected for advertising purposes. The tax applied to companies whose total worldwide revenue and income from taxable services rendered to the French population exceeded 750 million euros and 25 million euros respectively in the preceding tax period (i.e. a year).



In late November 2019, however, French Finance Minister, Bruno Le Maire announced that France had agreed to suspend the digital services tax until December 2020 in exchange for the U.S. agreeing to hold off on retaliatory tariffs on French goods.

Belarus and Russia happen to be among the pioneers of indirect taxation for digital services in the CIS. Belarusian VAT on digital services came into effect on 1 January 2018 and required non-resident companies rendering electronic services to individuals in Belarus to register for VAT purposes and file corresponding tax returns in Belarus. VAT may be collected either by the non-resident or by an intermediary engaged in processing the corresponding payments for the electronic services. With a tax framework similar to the one used in Belarus, the Russian VAT imposed on B2C supplies of electronic services to Russian customers came into effect on 1 January 2017. The Russian government later introduced VAT on B2B supplies effective as of 1 January 2019.

Kazakhstan is also responding to the latest trends in the digital economy. A draft proposal submitted to the Prime Minister's Office in October 2019 intends to introduce amendments to the Kazakhstani Tax Code for digital services performed by non-resident entities in Kazakhstan. The amendments are expected to come into effect on 1 January 2021 and are aimed at imposing VAT liabilities on non-resident companies providing electronic services to individuals residing in Kazakhstan.

Non-residents with activities under the aforementioned conditions will be required to charge and collect VAT at 12% of the earnings of the corresponding digital services. In addition to the individual's residence, other factors such as the use of a Kazakhstani network (IP) address, a telephone number registered in Kazakhstan or an account registered

in a Kazakhstani bank to process payment for the digital services, may also trigger a non-resident's VAT liabilities in Kazakhstan.

Although the stopgap measures taken by countries on an individual level (such as those above) solve some of the problems related to taxing the digital economy, they result in an inconsistent approach to taxation on a global level. This, in turn, may lead to distorted measures of economic activity, unfavorable investment climates, and instances of multiple taxation. The ultimate effect of individual taxation efforts by countries acting on their own could defeat the overarching principles at the core of taxation.

Taxation is supposed to be equitable between types and forms of business activity, to be clear and simple to understand, to be dynamic enough to keep up with latest developments, and to provide the right amount of tax at the right point in time, avoiding both double taxation and non-taxation. In this light, the long-term solutions that the EU and the OECD are working on are paramount to the success of efforts to adjust the current tax system to meet the demands of the digital economy. Although the tax systems designed by the OECD and EU have much in common, there are considerable differences in the means that the two systems utilize to achieve those goals.



The EU model is based on the concept of a "*significant digital presence*." Unlike the traditional tax principle of physical presence, digital presence is assessed on the basis of the amount of revenue, the number of users, or the number of contracts that an entity may generate in each EU member state. Companies that meet the requirements of a "*significant digital presence*" in an EU member state will be subject to corporate tax in that state. In contrast, the OECD tax framework provides three alternative solutions. These three alternatives revolve around the concepts of "*significant economic presence*," *user participation*, and *marketing intangibles*.

The concept of "*significant economic presence*" has been proposed to determine the presence of a non-resident enterprise in a foreign country on the basis of factors that indicate long-term purposeful digital interactions within the "*market country*." This includes revenue generated in

the foreign country and is supposed to be considered in combination with other factors such as the number of users, the amount of associated user data input, the volume of digital content generated in the foreign country, billing activities conducted in the local currency of the foreign country, and after-sales support services or marketing activities in the foreign country (whether online or offline). With such a broad definition, the OECD has yet to decide which of these are most relevant to the concept of “*significant economic presence*” and to establish appropriate thresholds where necessary.

The second proposal on “*user participation*” focuses on the value created by an active user base. Business models, such as social media platforms, search engines, and online marketplaces, collect a plethora of data related to their users, customers, suppliers, and operations. Information on products or services used may provide a valuable input for the business, helping to improve existing products and services as well as aid providing products and services to a new group of customers. The value that digital businesses collect in a foreign country goes broadly unnoticed from a tax perspective. In order to better align value creation with profit allocation mechanisms, this proposal aims to account for the value created by active and engaged users in a foreign country.

The third OECD proposal, based on the concept of “*marketing intangibles*,” relates to a foreign market’s perception of an entity’s trade or brand name or to other marketing intangibles like customer relationships in that

foreign country. Since a non-resident entity can remotely access a jurisdiction and affect the way in which the customers in that market perceive the non-resident’s brand or how those foreign customers interact with each other and the brand’s products, a non-resident may ultimately create favorable conditions for its business in that market. The value created by forming a favorable climate via marketing intangibles is at the core of this proposed tax principle.

### **Conclusion**

In summary, the evolution of the digital economy has resulted in new business models that the current tax system has yet to harness. Much of today’s business is conducted without any need for “*physical presence*”. The result is that many countries (like Kazakhstan) with populations consuming a large range of products offered by the digital economy, are suffering tax leakage. With multinational entities making huge profits without due taxation in their market jurisdictions, fair taxation in the digital economy is a world-wide concern.

Countries are currently in the midst of a paradigm shift when it comes to a “*fit-for-purpose*” taxation system, and – one thing is clear – the digital economy will continue to evolve into an ever-greater phenomenon regardless of whether the EU and OECD can reconcile their views on a viable tax framework. To ensure fair taxation policies that meet the demands of the digital age, countries need to develop a sustainable consensus-based solution that can be applied globally.



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