BACKGROUND PAPER

Taxing Developing Asia's Digital Economy

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DISCLAIMER

TAXING DEVELOPING ASIA'S DIGITAL ECONOMY

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Abstract

The rise of the digital economy has challenged the traditional tax systems for all the major taxes, with particular concerns about tax planning by multinational enterprises. The challenges with the taxation of the digital economy have led to tax reform initiatives that could significantly reform the current tax systems and enhance the taxation of the digital economy. This paper considers these reforms and the response of developing Asia to these reforms, and finds that the response has been mixed, with developed countries more likely to adopt the reforms. Despite these reforms, the revenue impact for developing Asia will likely be small. The paper concludes by setting out tax reform strategies that could be adopted in developing Asia to address the taxation of the digital economy.

I. INTRODUCTION

1. The digital economy has expanded significantly changing the nature of how commerce is conducted, including in developing Asia.[1] All countries in the Asia and Pacific region are impacted by the digital economy, whether through the information and communication technology (ICT) sector, e-commerce, online services, or goods and services provided through online platforms and marketplaces. Asia is the region with the largest internet usage in the world having more than 2.5 billion users,[2] with users tripling in the last 10 years. The ongoing growth in internet usage means that the digital economy in Asia will continue to significantly expand in the future. Asia is also the home to some of the largest global companies operating in the digital economy.

2. The rise of the digital economy has challenged the existing tax structures, especially as they relate to cross-border transactions. The international tax system was built on a foundation of traditional commerce, which assumed businesses operating in a country had a physical (bricks and mortar) presence in the country. That presence is not always necessary with the digital economy, as foreign businesses can provide goods and services without having any physical presence in the country.

3. The mismatch between the tax rules and the operation of the digital economy limits the ability of countries to collect taxes from cross-border digital transactions, and also creates opportunities for tax planning, at the expense of government revenues. Multinational enterprises (MNEs) are especially adroit at exploiting the tax planning opportunities to significantly reduce their tax liabilities. Tax issues can also arise with domestic transactions in the digital economy, especially for online peer-to-peer transactions, because of a lack of clarity on how these transactions should be treated under domestic tax laws.

4. The need to address the pressures of digitalization on existing tax structures, and broader international tax concerns, has led to a number of multilateral and unilateral tax initiatives. The most notable initiative being the Group of Twenty (G20)-Organisation for Economic Co-operation and Development (OECD) project on Base Erosion and Profit Shifting (BEPS) Action Plan, and the subsequent work of the Inclusive Framework—a forum of 141 countries that are collaborating on the implementation of actions arising from the BEPS Action Plan. Finding consensus on the best approach to tax the digital economy has been difficult because of the complexities in addressing the issue. However, agreement has been reached recently with most of the Inclusive Framework countries to proceed with new international tax rules.

[1] The 46 countries in the Asia and Pacific region identified as such by the Asian Development Bank (ADB) are listed in the Appendix.

[2] Statista.

5. The pressure for change and the delay in reaching an international consensus have led to some countries and regions adopting, or at least considering, unilateral initiatives to address the taxation of the digital economy. This includes introducing digital services taxes. A range of alternative taxing mechanisms have also been proposed, some requiring radical reform of the international tax framework.

6. Addressing the taxation of the digital economy in developing Asia can be a contributor to domestic revenue mobilization, which is essential in the region. Developing Asian economies face substantial challenges to lift overall tax revenues, with many having low tax-to-gross domestic product (GDP) ratios. The average tax-to-GDP ratios in developing Asia was 16.4% (2018), with the ratios ranging from about 8% to 27%.[3] About one-third of developing Asia countries have tax-to-GDP ratios below or close to 13%, which is estimated to be the minimum tax-to-GDP ratio necessary to achieve a significant acceleration in growth and development, [4] and significantly below what is necessary to fully fund the spending required to achieve the Sustainable Development Goals (SDGs). [5] These fiscal challenges have been made more difficult because of the fiscal impact of the coronavirus disease (COVID-19) crisis.[6] Addressing the taxation of the digital economy is important in protecting the tax base, and potentially increasing tax revenues.

7. Much of the literature on taxing the digital economy has been part of the broader research on addressing international tax issues. For example, this literature covers potential theoretical solutions to international tax issues (International Monetary Fund [IMF] 2019) for a summary of these solutions) and the revenue cost of tax avoidance because of inadequate international tax rules (OECD 2015; IMF 2014; Crivelli, De Mooij, and Keen 2016; and Cobham and Jansky 2018, which are discussed in section III). As part of the BEPS project, the OECD and the Inclusive Framework have also issued a paper assessing the economic impact of taxing the digital economy (OECD 2020a). Also, there has been much commentary on these issues. The literature on issues specifically relating to taxing the digital economy cover a range of topics, including taxing the peer-to-peer economy (Aslam and Shah 2017), taxing value generated by users under the corporate income tax (CIT) (Aslam and Shah 2020), the trade implications of taxing digital services (Avendano 2021), and administering the value-added tax (VAT) on digital services (Brondolo and Konza 2021). The issue of digitalization and taxation in Asia was

[3] International Centre for Tax and Development Database and OECD Global Revenue Statistics Database.
[4] Gaspar, Jaramillo, and Wingender (2016).
[5] The SDGs are 17 global goals set by the United Nations to be met by 2030. The goals aim to address poverty, protect the environment, and advance peace and prosperity. The role of tax in addressing the SDGs is discussed in the 2018 Platform for Collaboration on Tax report on Taxation and the Sustainable Development Goals.
[6] For example, globally average revenues as a share of GDP have fallen from 27.0% in 2019 to 25.2% in 2020. The fall in emerging and middle-income countries in Asia was from 25.3% to 23.6%. (IMF Fiscal Monitor April 2021).

addressed in a recent IMF paper that reviewed the digital landscape in Asia and the effect of tax reform proposals on taxes across all Asian countries (IMF 2021).

8. This paper focuses on taxing the digital economy in developing Asia. The paper discusses the challenges faced in developing Asia in taxing the digital economy, reviews the international tax initiatives, and proposes potential responses to the challenges. The paper is organized as follows: section II seeks to define the digital economy in developing Asia, section III discusses the challenges in taxing the digital economy, section IV reviews the international tax initiatives to address these challenges, section V discusses how Asian countries have so far responded to taxing the digital economy, section VI outlines potential tax policy and administration responses that developing Asia countries can adopt, and section VII provides a summary conclusion.

II. DEFINING THE DIGITAL ECONOMY IN DEVELOPING ASIA

9. There is no generally accepted definition of the digital economy because digitalization plays a role in almost all areas of the economy.

10. The Asian Development Bank (ADB) has suggested that the digital economy is the "contribution of any economic transaction involving both digital products and digital industries to GDP".[7] Digital products are goods and services with the main function of generating, processing, and/or storing digitalized data. Digital industries are the primary producers of such products. The core digital products are software publishing, web publishing, telecommunication services, and specialized support and services.

11. The IMF distinguishes between the "digital sector" and the "digital economy" for statistical purposes.[8] The digital sector is the core activities of digitalization, that is (i) ICT goods and services; (ii) online platforms (e.g., Google, Facebook, Alibaba); and (iii) platform-related activities (e.g., the sharing economy—peer-to-peer platforms), including ridesharing apps and peer-to-peer accommodation platforms. In comparison, the digital economy is the digitalization of the modern economy, that is, digitalization (e.g., internet usage) that has penetrated almost all sectors of the economy.

12. The Inter-Agency Task Force on International Trade Statistics[9] defines digital trade as "all trade that is 'digitally ordered' and/or 'digitally delivered'." Digitally ordered trade is "the international sale or purchase of a good or service, conducted over computer networks by methods specifically designed for the purpose of receiving or placing orders." Digitally delivered trade is "international transactions that are delivered remotely in an electronic format, using computer networks specifically designed for the purpose."

[7] ADB (2021).
[8] IMF (2018).
[9] OECD, WTO, and IMF (2020).

13. For tax policy purposes, having a specific definition of the digital economy is not essential; what is important is ensuring that digital transactions, including the resulting income and profits, are adequately taxed. This is reflected in the general consensus in international discussions on addressing the taxation of the digital economy, that the digital economy should not be isolated from other activities and be given special treatment. Therefore, the Inclusive Framework's proposed new international tax rules are designed to cover all sectors, not just the digital economy. An exception to having to define digital services may be for digital services taxes where countries may seek to specify the types of digital services that are subject to the tax. The options for taxing the digital economy are discussed further in section IV. For the purposes of this paper, the terms "digital economy", "digital sector", and "digitalization" are used interchangeably.

14. Because of the various definitions and measurement methodologies of the digital economy, it is difficult to arrive at a definitive size of the digital economy in developing Asia. However, there are several indicators to demonstrate the significance of the digital economy in developing Asia. The level of internet usage in developing Asia shows the potential extent of penetration of digitalization in the economy. As mentioned previously, the region has more than 2.5 billion internet users. However, Figure 1 shows that the level of internet usage varies significantly across developing Asia, with more than 80% penetration in East Asia, but much lower penetration (about 40%) in the Pacific islands and South Asia.

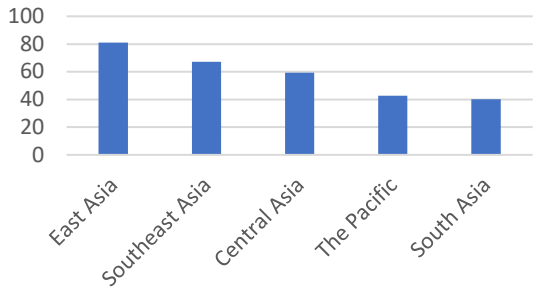
15. The contribution of the digital sector to the broader economy in developing Asia is demonstrated by the ICT sector trade in the countries and the extent of e-commerce. Figure 2 shows that the ICT sector as a share of total trade (both exports and imports) is significant in East Asia and Southeast Asia economies, compared to the other developing Asia regions. The other three regions are essentially importers of ICT goods. The data shows also that there has been significant increase in ICT trade activity between 2019 and 2020, which suggests increased demand because of COVID-19. Figures 3 and 4 show e-commerce sales, both in amount and as a share of GDP, for the 6 largest developing Asia countries in terms of e-commerce sales (these 6 countries are among the top 20 e-commerce countries in the world). The People's Republic of China (PRC) is dominant in terms of total sales, with e-commerce being a significant share of GDP for most of the countries.

16. Developing Asia is also the location of the headquarters of some of the largest tech companies in the world. Figure 5 shows that 6 of the largest e-commerce companies by revenue are headquartered in Asia, with 4 of those being in the top 5, all of which are Chinese companies. The largest being JD.com followed by Alibaba.

17. The size of the digital economy in developing Asia, and the presence of large tech companies in the region, highlights the need to ensure the effective taxation of the digital

economy. Therefore, the tax system needs to be designed to capture effectively tax on the income, profits, and transactions relating to the digital economy.

Figure 1: Developing Asia Internet Penetration, 2021 (%)

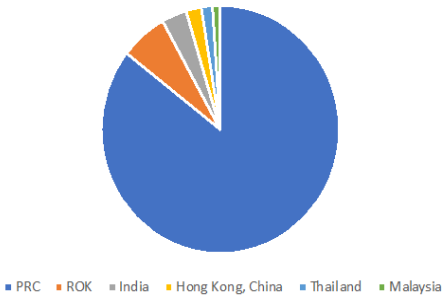


Source: Datareportal.com

Figure 2: ICT Share of Total Trade, 2019-2020 (%)

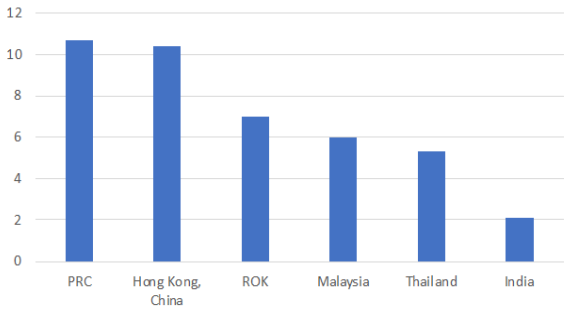
ICT = information and communication technology.
Source: UNCTAD Trade Statistics

Figure 3: B2C E-commerce sales US$ bn, 2019



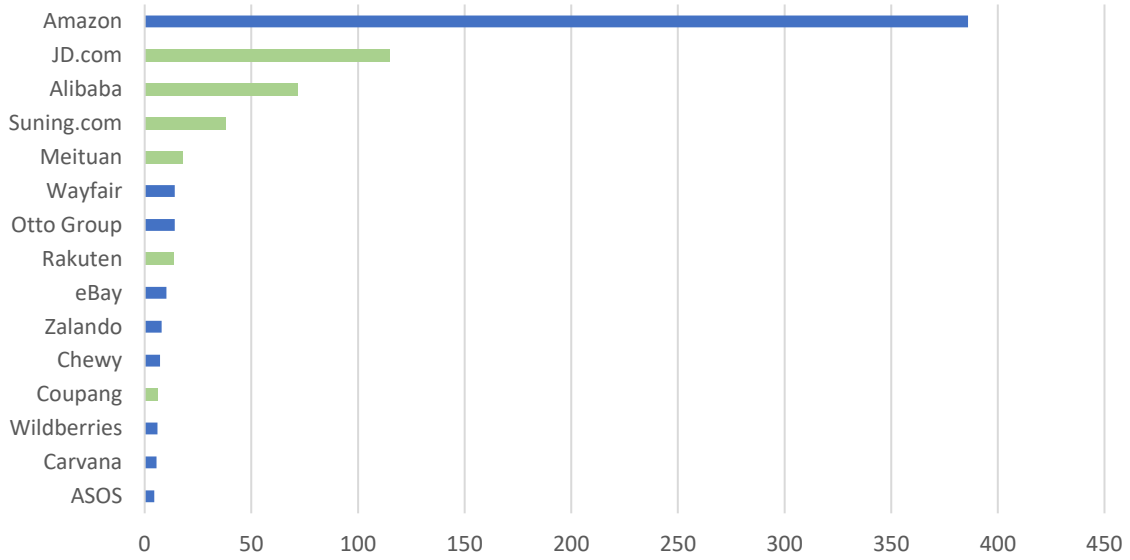
B2C = direct supplies to consumers, US = United States.
Source: UNCTAD (2020)

Figure 4: B2C E-commerce sales % of GDP, 2019



B2C = direct supplies to consumers, GDP = gross domestic product.
Source: UNCTAD (2020)

Figure 5: Largest E-commerce Companies by Revenue 2021 (US$ bn)



Note: Asian countries are in light green bars.
Source: Markinblog.com.

III. THE CHALLENGES IN TAXING THE DIGITAL ECONOMY

18. Many of the challenges in taxing the digital economy relate to cross-border tax issues and weaknesses in the existing international tax framework, but there are also domestic tax issues. Much of the discussion in this section focuses on the challenges relating to international tax rules, given their recent prominence. However, there is also discussion on domestic tax issues relating to the digital economy, such as the taxation of the sharing economy. These are discussed briefly subsection III.B, and also in more detail in section IV on the VAT.

A. Understanding the International Tax Framework

19. The current taxation of cross-border transactions relating to the digital economy relies on the existing international tax framework. This framework involves the interaction of domestic tax laws and tax treaty obligations, with the main concern being the allocation of taxing rights between countries, that is, which country or countries can tax a particular item of income. The framework seeks to avoid double (or no) taxation.

20. Digitalization complicates the usual international tax principle that the country where profits are derived (the “source country”) has the first taxing right on that income. This complication is because of the difficulty in identifying the source country; for example, identifying the source of profits on the sale of software that is provided from a platform in one country but is downloaded by a user in another country. Despite having the first taxing right,

the source country may forgo taxing the income for its own policy purposes (e.g., to attract foreign investment) or under a double tax treaty (DTT) (see discussion para. 24).

21. The country where the taxpayer (e.g., an MNE's parent company) resides (the "residence country") may also tax the income earned (usually referred to as "foreign source income"). Countries have two broad ways of taxing this income: (i) worldwide taxation—the foreign source income is taxed in the residence country, usually with a tax credit (i.e., a foreign tax credit) given for taxes paid in the source country to avoid double taxation; and (ii) territorial taxation (or exemption)—the foreign source income is exempt from tax in the residence country and, therefore, is taxed only in the source country (countries may place conditions for access to the exemption, such as having a required level of ownership, or minimum tax rate in the source country). Most developing countries, including in developing Asia, apply worldwide taxation, but there are exceptions with countries such as Malaysia, Thailand, and Singapore adopting a territorial tax system.

22. The concept of "permanent establishment" is also important in understanding the operation of the existing international tax framework to the digital economy. A permanent establishment arises when a business, that is not legally resident, has an enduring presence in the source country, so that the source country has the taxing rights on the profits of that business. The definition, which is usually included in both domestic law and tax treaties, is important to ensure that the source country can tax foreign MNEs that are conducting business in the country. However, the definition usually requires a physical presence in the country, which is not sufficient to cover many cross-border digital transactions.

23. Withholding taxes are also a key element in the international tax framework. When certain payments are made to foreign entities, the payer is required to withhold tax on the payment, to ensure that the source country receives some tax for income earned in the country. Withholding taxes usually apply to interest, dividend, and royalty payments, and in some cases to fees for technical services (e.g., managerial, technical, or consultancy fees). In some countries, royalties include payments for use of intangible assets, which is a common feature in the digital economy.

24. DTTs, which are agreements between two (or more) countries for the avoidance of double (or no) taxation, are important in the international tax framework. The purpose of DTTs is also to facilitate trade and investment between countries. DTTs can determine whether income is taxed in the source country, including defining a permanent establishment, and the rate of withholding tax on that income. Like the broader international tax framework, DTTs do not address taxation of the digital economy adequately. The definition of permanent establishment in the DTTs usually does not cover digital transactions, and the withholding taxes often do not cover digital related payments.

25. The current international tax framework, and the uncertainty of its application to digitalization, can be exploited by MNEs to reduce their tax liabilities. MNEs can use tax planning strategies to exploit weaknesses, including uncertainty, in the framework. These strategies are not unique to the digital economy and can be used by any MNE, but the uncertainty around the application of the international tax framework to digitalization provides a greater opportunity to use these strategies. Examples of these strategies include abusive transfer pricing—mispricing of related party transactions; exploiting mismatches—taking advantage of the different treatment of the same transaction in different countries; and treaty shopping—exploiting DTTs by routing income through countries with the most advantageous DTT. The objectives of these strategies are usually to shift income to low-tax jurisdictions (or into more lightly taxed forms) and away from higher-tax jurisdictions (or out of more highly taxed forms), and/or to shift tax deductions so they can be claimed in higher-taxed jurisdictions rather than in low-tax jurisdictions. The weaknesses in the framework are because of different tax outcomes in the source and residence country. These outcomes can be because of specific policy choices made by the countries (e.g., tax rates), or to unintended or unforeseen outcomes, which is often the case with digitalization.

B. Challenges in Applying the International Tax Framework to the Digital Economy

26. The OECD has observed three characteristics of digital business models that create opportunities for tax planning:

(i) significant economic activities within a country, and/or stages of production across multiple countries, but with little significant physical presence (referred to as “scale without mass”);

(ii) reliance on intangible assets, including intellectual property; and

(iii) the role of data and user participation, including network effects, to generate value (e.g., a social media site may use data on users to sell targeted advertisements).[10]

27. There are challenges in taxing the digital economy that arise from the observed characteristics:

(i) As mentioned previously, the inadequacy of international tax rules to effectively tax digital transactions. This is because the rules are based on physical presence (i.e., permanent establishment rules), which is lacking in many cross-border digital transactions. This has resulted in concerns that MNEs are using tax planning to avoid taxes on the profits arising from the cross-border digital transactions.

[10] OECD (2018).

(ii) The inadequate international tax rules are often accompanied by a lack of sufficient domestic tax laws to tax MNEs, including digital businesses, that have significant operations in a country. For example, countries may lack adequate domestic laws covering permanent establishments, transfer pricing rules,[11] and withholding taxes on payments to nonresidents.

(iii) The difficulty in collecting VAT and similar taxes on goods and services provided from overseas suppliers. The usual method for taxing supplies of goods and services is through consumption taxes, predominantly via a VAT, also known as a goods and services tax (GST) in many Asian countries. VAT (and customs duties) on imported goods can be collected usually at the border, but that is not possible for imported digital services as they are provided electronically directly to the consumer. Foreign suppliers of those services are often not required to register for VAT and so the tax is not collected on those supplies. Also, goods may not be taxed on import because of VAT exemptions for low-value imported goods.

(iv) The reliance on intangibles, and payments for the use of these intangibles, that are often located in low-tax countries. Intangibles cover a range of assets (e.g., licenses, trademarks, brands, goodwill, and patents), with the use of intangibles (e.g., software and data) being prevalent in the digital economy. It is common for MNEs to locate their intangibles in low-tax jurisdictions and then require affiliates in high-tax jurisdictions to pay for the use of those intangibles. This results in tax deductions in the high-tax country and income in the low-tax country. It can also be difficult to determine arm's length prices for these intangibles, as there may be no comparable prices, which gives MNEs flexibility in pricing and makes it difficult for governments to argue against the prices.

(v) The uncertainty in taxing the peer-to-peer economy on digital platforms (e.g., ridesharing apps such as Uber, Grab, Didi, Gojek, and Ola; and peer-to-peer accommodation platforms such as Airbnb and Tujia). It can be difficult to determine what is the nature of these transactions (e.g., for ridesharing apps, whether the drivers are employees or independent contractors), and therefore how they should be treated under a range of tax laws, including the CIT, personal income tax, payroll taxes, and VAT.

28. The challenges mentioned this section are prevalent in developing Asia. As will be discussed later, countries in developing Asia have adopted a range of tax measures to address these challenges.

[11] As a minimum, transfer pricing rules should require arm's-length pricing between related parties. The OECD provides guidance on transfer pricing rules; for example, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017. The OECD guidance has been updated as part of the BEPS project.

1. Tax Competition

29. Governments may also take advantage of the limitations of the international tax framework and MNEs' desire for lower taxes by offering tax incentives, that is, tax exemptions and other incentives aimed at reducing the taxpayer's tax liabilities. This can result in tax competition between countries. Examples of these tax incentives include CIT holidays, reduced tax rates, or increased tax deductions for certain taxpayers or sectors, and special economic zones with a range of direct and indirect tax concessions. Often, businesses operating in the digital economy are the target of these tax incentives, as countries are eager to attract investment in the sector. These incentives are common in developing Asia, especially for the ICT sector. The Appendix lists the countries in developing Asia with such incentives.

30. The benefit of these incentives is questionable;[12] they have a high fiscal cost, yet are often redundant (i.e., there is no additional investment as it would have been made without the incentive); they often rank low in importance in investment decisions (other factors may be more important, such as rule of law, labor costs, good infrastructure, and macroeconomic stability); and their impact may go beyond the country that is granting the exemption by impacting both investment flows to other countries, and their tax revenues as taxable profits may be diverted to the lower-tax country.

C. Potential Revenue Forgone by Tax Avoidance

31. The size of the overall revenue loss from tax avoidance, including relating to the digital economy, is difficult to determine, but is estimated to be significant. In 2015, the OECD estimated that the annual cost of MNE tax avoidance ranged from US$100 to $240 billion, or about 4%–10% of CIT revenues in 2013 (OECD 2015). The IMF, using different methodologies, has estimated that the (unweighted) average revenue loss across sampled countries was 5% of current CIT revenue (IMF 2014).

32. Evidence suggests that the revenue impact of tax avoidance is likely to be larger for emerging and developing economies, including in developing Asia, than for developed economies. The IMF study mentioned in para.31, estimated that the revenue loss from MNE tax avoidance has a larger impact for non-OECD countries. Crivelli, De Mooij, and Keen (2016) estimate the revenue loss for developing countries from BEPS as being at least US$200 billion. They conclude that tax base spillovers (i.e., changes to the tax base because of real activities or profit shifting) as a result of changes in another country's tax rate are stronger for non-OECD countries than OECD countries. They also tentatively estimate that the long-run revenue loss because of tax avoidance is higher for non-OECD countries at about 1.3% of GDP, compared to

[12] A 2015 report prepared by the IMF, the OECD, and the World Bank for the G20 Development Working Group found that many low-income countries provide tax incentives, but these incentives are often ineffective and inefficient (IMF 2015).

OECD countries at about 0.9% of GDP. This is even more significant, given that developing countries' total taxes as a share of GDP are usually much lower than OECD countries, that is, the revenue loss from tax avoidance is likely to be a much greater portion of total revenues.

33. The revenue loss in Asia from tax avoidance is estimated also to be significant. Cobham and Jansky (2018) estimate that the average net revenue loss from tax avoidance for South Asia is from 1.7% to 1.9% of GDP, and for East Asia and the Pacific from 0.6% to 0.7% of GDP. Some countries, such as Singapore, obtain revenue benefits from profit shifting, likely because of their low tax rate, while other countries in the region, mainly developing countries, are estimated to suffer losses. Several developing Asia countries are estimated to lose revenue of more than 2% of GDP.

34. These revenue estimates do not identify losses by sector. However, it is likely that MNEs in the digital sector benefit significantly from tax planning. For example, United States (US) MNEs in sectors relating to the digital economy have lower effective tax rates than the average for all entities. The average effective tax rate for all US companies is 5.76%. This compares to effective tax rates of 0.58% for software (entertainment) companies, 3.3% for software (internet) companies, 2.77% for software (systems and applications) companies, and 3.71% for computer companies.[13] The effective tax rate for online retailers was 2.93% compared to 12.48% for general retail.

35. MNE tax avoidance does not just result in revenue losses, but also has other economic impacts. These include distorting the location of foreign direct investment (FDI), with evidence that tax impacts on both the flow and stock of FDI;[14] distorting the location of mobile intangible assets, especially as they relate to the digital sector; and MNEs structuring their financing in a country to reduce their tax liabilities, usually with a bias towards debt. The ability of MNEs to exploit these tax avoidance techniques can also provide MNEs an unfair competitive advantage compared to local enterprises that do not have the same access to the cross-border tax planning devices.

IV. TAX INITIATIVES TO ADDRESS THE DIGITAL TAXATION CHALLENGES

36. In responding to taxation and digitalization, there is debate about the extent of changes necessary to address the issue. Some argue for fundamental reform, while others argue that the existing rules are broadly sufficient to address the issue. However, despite some reservations, and as mentioned previously, there is general consensus that the digital economy

[13] Damodaran Online. https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datacurrent.html.

[14] De Mooij and Ederveen (2008), in reviewing economic literature on investment effects, suggest that a 10-percentage point reduction in a country's effective average tax rate increases its stock of FDI, on average and in the long run, by more than 30%.

should not be isolated from other activities and has special treatment, given the rapid change and the wide coverage of these technologies.

37. There are tax initiatives to address the tax challenges with digitalization, covering direct taxes (e.g., income taxes), discrete digital taxes, and VAT. These are discussed in the rest of this section.

A. Direct Tax Initiatives

38. Most of the direct tax initiatives are multilateral, generally proposed by the G20-OECD or European Union, but some countries have acted unilaterally with their own measures.

1. Group of Twenty-Organisation for Economic Co-operation and Development Base Erosion and Profit Shifting Project

39. The most prominent multilateral initiative on taxation and the digital economy is from the G20-OECD BEPS project. The BEPS project commenced in 2013, leading to the finalization of plans for 15 BEPS Actions in 2015. Some countries have begun to reform their domestic laws and tax treaties to implement BEPS-related changes. However, BEPS Action 1, which seeks to address the taxation of the digital economy, is the action that has taken most time to resolve. The OECD and the Inclusive Framework have been considering various proposals to reform the international tax framework to ensure that the rules on determining a business' presence in a country ("nexus rule") reflect developments in the digital economy, and to provide fairer allocation of profits between countries. These rules are not just to raise revenues, but also aim to provide tax certainty for taxpayers and tax administrations.

40. On 8 October 2021, after a period of consultation on draft reforms, the OECD and the Inclusive Framework released a statement[15] that set out a new framework for international tax reform, which consists of a two-pillar reform:[16]

(i) Pillar 1 ensures a fairer distribution of profits and taxing rights between countries that focuses on the largest MNEs, especially those in the digital economy. The basic elements are as follows (Box 1 provides a simplified illustration of the operation of Pillar 1.):

(a) Applies to MNEs with global turnover/revenue greater than €20 billion (US$27.4 billion) and profit (before tax) above 10% (the threshold will be

[15] OECD (2021b).

[16] As of January 2022, 137 of the 141 IF members had agreed to the rules, with Kenya, Nigeria, Pakistan, and Sri Lanka not agreeing at this stage.

reduced to €10 billion [US$13.7 billion], depending on a review commencing in 7 years).

(b) A new nexus rule determines if a country is eligible for a profit allocation; an MNE must derive at least €1 million (US$1.4 million) revenue in the country, or for lower GDP (<€40 billion [US$54.8 billion]) countries at least €250,000 (US$342,500) revenue.

(c) The profit that can be allocated (referred to as "Amount A") is 25% of residual profits, that is, profits in excess of 10% of global turnover/revenue. Profits will be based on financial accounting income with some small adjustments.

(d) The share of Amount A allocated to a country will be calculated based on a "revenue-based allocation key" where the revenue source is the location where the goods or services are used or consumed. (The revenue allocation key and the source rules for specific categories of transactions are yet to be determined.)

(e) Rules will be developed to ensure appropriate and simplified "arm's length" prices for in-country marketing and distribution activities, with a focus on low-capacity countries, to simplify and provide certainty for tax administrations and taxpayers in relation to transfer pricing rules (referred to as "Amount B"). The work on these rules is to be completed by the end of 2022.

(f) The Amount A rules, including measures to prevent double taxation, will be implemented through a Multilateral Convention (MLC)[17] that will be developed and available for signature in 2022, with commencement in 2023.

(g) No new digital services taxes or similar measures will be imposed from 8 October 2021 until the earlier of 31 December 2023 or when the MLC comes into force; the mode for removing existing digital services taxes, including any transitional arrangements, is still under consideration.

(ii) Pillar 2 proposes a global minimum CIT rate that countries can use to protect their tax bases, including protection from tax planning by MNEs operating in the

[17] The Multilateral Convention is a multilateral framework that all countries can join, even if they have no DTTs.

digital economy, and to reduce tax competition. The basic elements are as follows (Box 2 provides a simplified illustration of the operation of Pillar 2.):

(a) Two connected rules (that will need to be included in domestic laws), known as the Global Anti-Base Erosion (GloBE) rules, that ensures tax is paid at the minimum tax rate either in the country where the MNE resides or in the source country where the income is earned:

(1) Income Inclusion Rule (IIR). A country can impose a top-up tax on foreign source income derived by a MNE parent that is resident in its jurisdiction, if the foreign income was taxed in the source country at an effective tax rate lower than the minimum rate.[18]

(2) Under-Taxed Payments Rule (UTPR). A source country can deny a tax deduction, or make a similar adjustment, if a payment to a related party in another country is taxed in that country below the minimum rate and is not subject to tax under an IIR.[19]

(b) The GloBE rules apply to MNEs with global turnover greater than €750 million (US$1 billion), though a country is free to apply a lower threshold when applying the IIR to MNEs headquartered in their country.

(c) The GloBE minimum tax rate is 15%.

(d) The top-up tax will use an effective tax rate test calculated on a country-by-country basis that uses a common definition of covered taxes and tax base.

(e) The rules will have some exclusions, including a de minimis exclusion for those countries where an MNE has revenues of less than €10 million (US$13.7 million) and profits less than €1 million (US$1.4 million), and a "substance carve-out" that allows MNEs to reduce the tax base on which the minimum tax will be applied (the reduction is based on payroll and

[18] It is intended that the IIR be applied on a top-down approach so that taxing priority is given to the country in which the entity closest to the top of the MNE group resides, with special rules for cases where significant ownership of an entity is split with persons outside the MNE.

[19] The UTPR provides for an exclusion for MNEs in the initial phase of their international activity (i.e., a 5-year exclusion from when the MNE comes within the scope of the GloBE rules and where the MNE has a maximum of €50 million (US$68.5 million) intangible assets in no more than five foreign countries).

tangible assets to recognize the existence of real economic activity in the country). [20]

(f) Subject to Tax Rule (STTR) is an additional rule that allows the adjustment of provisions of a DTT with a developing country so that a source country can impose additional tax on payments of interest, royalties, and other defined payments, where the recipient is not taxed or is taxed at a nominal CIT rate[21] below a minimum rate of 9%. The taxing right will be limited to the difference between the minimum rate and the tax rate on the payment. This measure is specifically aimed to protect developing countries.

(g) A country is not required to adopt the GloBE rules, but they are required to accept the application of the rules by other Inclusive Framework members.

(h) Pillar 2, which will require changes to domestic laws, should be brought into law in 2022 to commence in 2023, with the UTPR coming into effect in 2024.

41. Despite the October 2021 agreement, there are still challenges to be overcome before implementation, in particular, obtaining approval for the changes to domestic tax laws to implement the reforms by each country's legislative bodies.

42. The Inclusive Framework proposals are overlaid on the exiting transfer pricing rules, with some adjustments, so many of the complexities with these rules will remain. However, as mentioned in para. 40, Pillar 1 proposes a simplified and streamlined transfer pricing rule for in-country baseline marketing and distribution activities, which is focused on the needs of low-capacity countries.

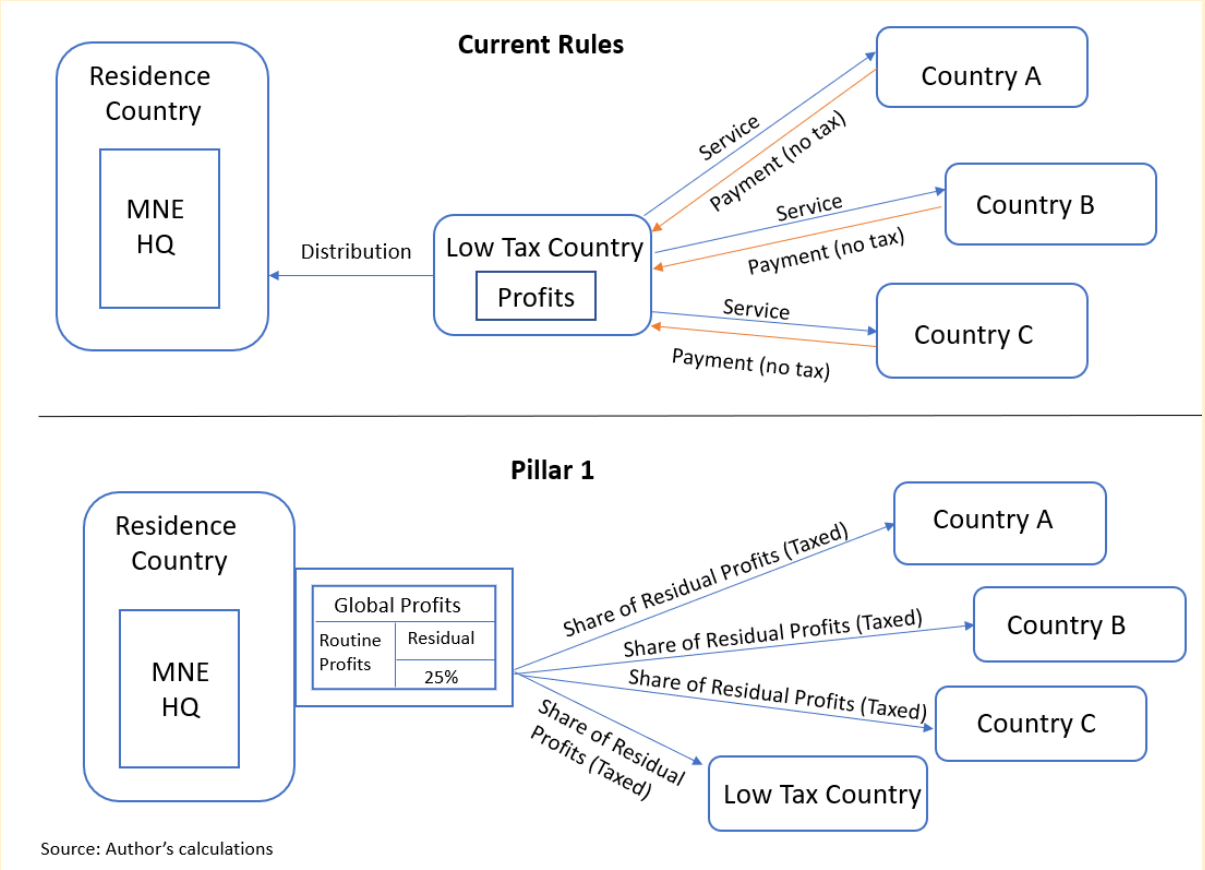
Box 1: Illustration of Pillar 1

The example below is a simplified case, and assumes that the multinational enterprise (MNE) satisfies the requirements for Pillar 1 and the countries are entitled to the allocation of profits. In the example, the MNE is providing digital services to consumers in countries A, B, and C. As there is no physical presence in those countries, it is likely that no income tax is paid in the countries on the income and profits relating to the digital services. It is also assumed that the services and payments are channeled through a low-tax country. Under Pillar 1, the global profits of the MNE will be

[20] The substance carve-out is 5% of the carrying value of tangible assets and payroll (in the transition period of 10 years, the carve-out will apply to 8% of the carrying value of tangible assets and 10% of payroll, with these percentages gradually declining over the 10 years).

[21] The CIT rate used for the STTR is the nominal CIT rate, unlike the GloBE rules which use the effective CIT rate.

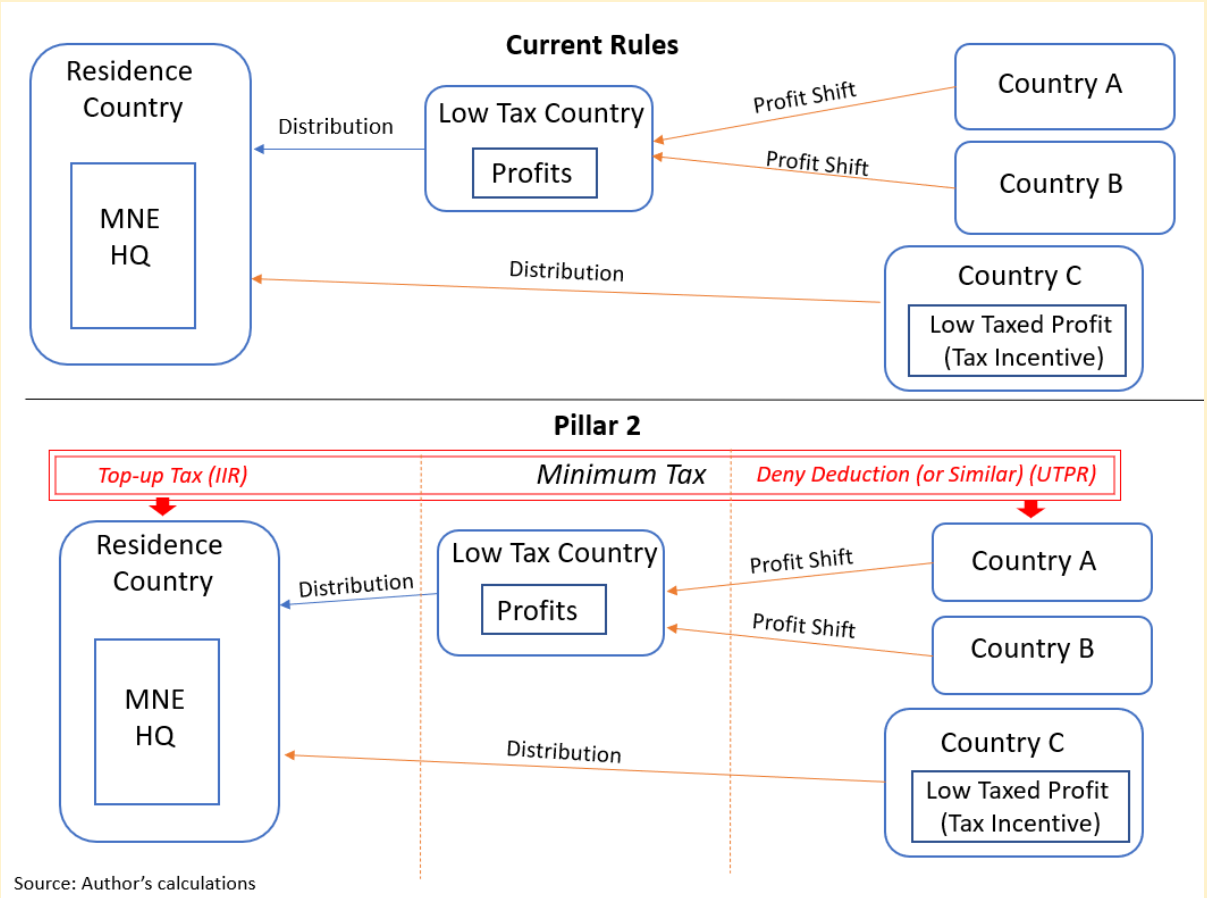
calculated first, and those profits will then be separated into routine profits and residual profits, with 25% of the residual profits available for allocation to each of the countries in accordance with the "revenue-based allocation key". The allocated profits can then be taxed in each of countries A, B, and C, providing them with potential tax revenue.



Source: Author's calculations

Box 2: Illustration of Pillar 2

The example of Pillar 2 is a simplified case, and assumes that the multinational enterprise (MNE) satisfies the requirements for Pillar 2. In the example, the MNE is providing digital services to consumers in countries A and B. The MNE uses tax planning to shift profits from countries A and B to a low-tax country so that limited tax is collected in countries A and B, and the effective tax rate in the low-tax country is below the minimum of 15%. Country C provides tax incentives so that the effective tax rate on profits in that country is below the minimum tax rate of 15%. Under Pillar 2, the residence country of the MNE may collect top-up tax because of the low effective tax rates in the low-tax country and, similarly, low rates on the income subject to the tax incentives in country C. If the resident country does not impose top-up tax, countries A and B could deny a deduction or similar adjustment to ensure that tax is collected at the minimum rate in those countries.



Source: Author's calculations

2. Expanded Definition of Permanent Establishment—United Nations Model Double Tax Treaties Proposal

43. Another initiative is to address the limited definition of permanent establishment (i.e., the reliance on a physical presence), including a proposal by the United Nations Committee of Experts on International Cooperation in Tax Matters. The committee has approved a change to the UN Model Tax Convention specifically focused on digital services. The UN Model Tax Convention is a model DTT between developed countries and developing countries that aims to protect the taxing rights of developing countries.

44. In April 2021 the committee approved a new Article 12B of the model DTT that allows the country where the recipient of the digital services resides to tax those services. "Automated digital services" is defined as "any service provided on the internet or another electronic network, in either case requiring minimal human involvement from the service provider". Specifically, it includes online advertising, supply of user data, online search engines, online intermediation platforms services, social media platforms, digital content services, online gaming, cloud computing services, and standardized online teaching services. A country can tax

the gross income at a low rate agreed between the DTT countries—suggested as a modest withholding tax at a rate of 3%–4%—or the MNE can ask to be subject to CIT on a net basis (the net basis is calculated based on a formula using the MNE's profitability ratios). The changes to the model DTT are not automatic and so must be negotiated between countries as part of their DTT negotiations.

45. Some countries have also taken their own measures to amend the definition of permanent establishment, with most adopting the concept of "significant economic presence" to determine if a permanent establishment exists. Countries, such as Israel, India, and Belgium, have adopted (or proposed) various approaches to defining significant economic presence, including the amount of revenue from digital services, number of users in the country, and level of an internet site's connection with the market.[22] The operation of an amended definition may be impacted by DTTs, as most DTTs include a definition of permanent establishment and the DTT may override domestic law. However, countries can seek to renegotiate DTTs.

3. European Union Proposed Digital Levy

46. In 2018, the European Union (EU) Commission proposed two initiatives to address the taxation of digital services: (i) a long-term solution to allow EU members to tax profits generated from digital services in the country without the need for the business to have a physical presence; and (ii) while the long-term measure is being developed, a short term solution to impose a digital services tax (or digital levy) of 3% on gross revenue from digital services. The proposal was to commence from 2023, but was deferred pending developments with the BEPS Action proposal. The October 2021 announcement on new international tax rules should overcome the EU concerns that led to the two initiatives, but there is still some pressure within the EU for a digital levy to assist in recovering reduced revenues because of the COVID-19 crisis. At this stage, there has not been agreement among the EU member countries for the tax.

4. Unilateral Discrete Digital Taxes

47. A growing number of countries have recently introduced taxes specifically focused on the digital economy. These taxes include digital services taxes; digital access taxes, for example license fees; digital data taxes; and withholding taxes on payments related to the digital economy (e.g., by expanding the definition of royalty for purposes of withholding taxes on payments to nonresidents). These taxes can cover a wide range of digital services, or may be focused on only one or a small number of services (e.g., online advertising, or sale of user data). Some countries have introduced these as an interim measure until the Inclusive Framework or EU multilateral initiatives were settled and implemented. As mentioned previously, a

[22] The concept of economic presence or nexus rather than physical presence is also being used by US states for apportionment of corporate tax and for imposing sales tax, given the rise of cross-state online transactions.

requirement of the Pillar 1 reform is that digital services taxes must eventually be removed. Some countries, such as India, have suggested that there should be a gradual phasing-out of these taxes, given the revenue mobilization needs in many developing countries. There seems to be some recognition of this issue in the transitional proposals for digital services taxes in the OECD/Inclusive Framework announcement on 8 October 2021. The use of discrete digital taxes in developing Asia is discussed in section V.

5. Other Unilateral Measures

48. Several countries have introduced reforms that apply to MNEs more generally, and so also apply to MNEs operating in the digital economy. One measure is a diverted profits tax, introduced in the United Kingdom and Australia, which is a protective measure to impose additional tax to arrangements that divert profits to a low-tax country. From 1 January 2018, the US also introduced three international tax measures to protect their tax base by reducing the incentive for US companies to shift profits offshore by moving intangible assets to a low-tax country (the Global Intangible Low Tax Income);[23] providing an incentive for US companies to keep their intangibles in the US and export the goods and services arising from those intangibles (Foreign Derived Intangible Income); and limiting the benefits of tax deductions for large US MNEs for certain payments to foreign related companies (Base Erosion and Anti-Abuse Tax).

6. Proposals for Alternative Taxing Mechanisms

49. There have been several proposals for more comprehensive and radical changes in the international tax framework. One of the limitations of the Inclusive Framework proposals is that they only apply to very large MNEs. In the case of Pillar 1, it is only about 100 large MNEs. Therefore, many MNEs can potentially still take advantage of tax planning opportunities. The alternative prominent proposals are taxing mechanisms that overhaul the whole basis for allocating profits between jurisdictions, much further than the changes to profit allocation proposed in Pillar 1.

50. The most discussed mechanism is “formula apportionment” where the global profits of MNEs are allocated across countries in which an MNE conducts business by a formula which approximates the activities in each location, such as sales, payroll, or assets, or some combination of these factors.[24] This is similar to Pillar 1, but under formula apportionment all

[23] The interaction between the Global Intangible Low Tax Income regime and the new GloBE rules is being considered.

[24] The US states and Canadian provinces use a form of formula apportionment to determine state and provincial corporate taxes. The EU Commission also proposed a formula apportionment as an element of its common consolidated corporate tax base (CCCTB). The CCCTB was first tabled in 2011, but agreement could not be reached. The CCCTB was relaunched in 2016, but agreement still has not been reached so the mechanism is unlikely to be adopted in the medium term.

profits could be allocated across countries, rather than 25% of residual profits under Pillar 1, and could cover most MNEs.

51. Other alternative taxing mechanisms include[25] destination-based cash flow tax, destination-based allowance for corporate equity, and alternative schemes for sharing residual profits. The latter is similar to Pillar 1, but with alternative mechanisms for calculating routine profits (e.g., a fixed return on tangible assets or using traditional transfer pricing methods) and allocating residual profits. Routine profits are allocated to the place where production takes place, while residual profits are allocated using a formula approach (e.g., destination sales, number of users).[26] The IMF has estimated that introducing a residual profit allocation scheme could double the level of residual profits available for allocation with half of this in 16 Asian countries. Countries with low average GDP per capita would especially benefit (IMF 2021).

B. Value-Added Tax Initiatives

52. The application of the VAT to the digital economy is also an important issue being addressed by governments. VAT is imposed under the destination principle so that VAT is payable in the place of consumption of the good or service. However, as mentioned previously, it is difficult to apply VAT to digital-imported services and it can be difficult also to collect VAT on some goods acquired online from overseas suppliers. The imported services can cover a wide range of supplies, such as internet advertising, data sharing, and services provided by peer-to-peer platforms.

53. There are several reasons it is difficult to collect VAT on these imported goods and services. Foreign suppliers are usually not required to register for VAT and so the supplier is not a taxpayer in the country where the goods and services are consumed. When goods are imported there is an opportunity for the customs administration at the border to collect any VAT due, but services are usually provided direct to the consumer without physically crossing the border, so it is difficult to identify the services that have been consumed in the country. Goods may also not be taxed on import because of VAT exemptions for low-value imported goods, usually to avoid the administrative burden of collecting the VAT on small-value items at the border.

54. Some countries have addressed this issue in two main ways; first, by requiring large online suppliers to register for VAT in the country where the goods and services are consumed. The foreign supplier has to assess, collect, and remit the VAT to the country. Some countries also require that the nonresident supplier appoint a local tax agent or representative to facilitate the collection of the tax. Also, many countries simplify the tax filing and collection for

[25] A more detailed discussion and analysis of these possible taxing mechanisms is in IMF (2019).

[26] A more detailed discussion of the schemes for sharing residual profits is in Beer et al. (2020) and Devereux et al. (2019).

these foreign suppliers. For example, there may be no need to provide invoices, but foreign suppliers cannot claim input tax credits for VAT paid on business inputs. The total supplies for a period usually have to be above a certain threshold, which may be the same as the threshold for domestic businesses or it may be a higher threshold.

55. A second measure is to apply a reverse charge for business-to-business (B2B) supplies. A "reverse charge" is where the business receiving the goods or services imposes VAT on the supply and then immediately claims an input tax credit for that VAT. The adoption of these measures in developing Asia is discussed in section V.

56. One challenge is identifying the country in which the goods are consumed (often referred to as the "place of supply"). The place of supply for B2B services is less of a concern where the reverse charge mechanism applies, as that mechanism confirms the location of the supply. However, for direct supplies to consumers (B2C), it can be difficult for the supplier to determine the location of the consumer. For example, is it where the consumer is located at the time of the supply, or where they usually reside? It is usual for the place of B2C supplies to be the location of the consumer's residence. There are proxies that countries can adopt for determining residence, such as the recipient's billing address or home address, the location of the internet protocol of the device used to acquire the service, and the location of the purchaser's bank or credit card account. Most countries are guided by the OECD guidelines on these issues (OECD: International VAT/GST Guidelines).

57. A further challenge is how to apply VAT to the sharing economy, which provide goods and services via a digital platform. The sharing economy is having a significant impact on sectors such as tourism, transport, professional services, and financial services. These platforms may take two broad forms: (i) an electronic marketplace, where goods or services are ordered and supplied through an electronic intermediary that plays a direct role in the transaction (e.g., Amazon, Alibaba, JD.com, Lazada, and Shopee); and (ii) an electronic platform bringing together buyers and sellers but not directly involved in the supply of the goods or services (e.g., Airbnb, Tujia, Uber, and Grab). VAT can arise for an electronic marketplace on the supplier of the goods, that is, the actual marketplace or the original supplier. In the case of an electronic platform, VAT can arise on the supplier and on any fees paid to the platform.

58. The mechanisms for taxing these marketplaces and platforms are evolving, with various mechanisms being adopted by countries. For example, in the case of electronic platforms, some countries place the burden on the platform to meet any VAT obligations on the transaction. This is seen as a simpler mechanism for compliance and tax administration. Also, tax authorities see opportunities in the marketplaces and platforms for simplifying reporting and filing obligations for suppliers, as well as providing information on the transactions to assist compliance monitoring and collection. The OECD has released guidance on these issues (The Impact of the Growth of the Sharing and Gig Economy on VAT/GST Policy and Administration).

V. HOW HAVE ASIAN COUNTRIES RESPONDED TO THE DIGITAL TAXATION CHALLENGES AND INITIATIVES?

59. There have been a variety of responses in developing Asia to the challenges and initiatives in taxing the digital economy. There are four broad responses to the tax challenges: (i) participation in the Inclusive Framework and G20-OECD proposals (i.e., Pillars 1 and 2); (ii) changes to the definition of permanent establishment in domestic laws to include cases where there is no physical presence in a country but there is a digital presence; (iii) discrete digital taxes; and (iv) applying VAT to digital transactions, especially cross-border transactions. The response of individual countries depends on the type of taxes (i.e., income tax, discrete digital taxes, and VAT) and the country's circumstances (e.g., size and development of the economy and the share of the economy relating to digital transactions). The approach of developing Asia to these responses is discussed below, with a summary table in the Appendix.

A. Income Taxation

60. About half of developing Asia countries (20 of the 46 countries) are members of the Inclusive Framework, which is designing Pillars 1 and 2 (Appendix). The largest participation is from the East Asian, South Asian, and Southeast Asian countries, with 67% of those countries being members. About 38% of Central Asian countries are members, while in the Pacific, only 21% of countries are members. For the latter countries, it is likely that the international initiatives are not a priority, given the size of the digital economy in those countries, and the need to give priority to domestic tax issues, which are the main revenue sources. There is also often a lack of human and financial resources to fully participate in the Inclusive Framework, and a preference to wait and see how the initiatives and their implementation progresses.

61. The limited participation in the Inclusive Framework, and the decision by two Asian countries (Pakistan and Sri Lanka) not to agree to the new international tax rules at this stage, means that only 18 of the 46 (39%) of developing Asia countries have agreed to adopt the new rules. This participation is low compared to other regions. For example, 46% of Sub-Saharan Africa countries and 71% of Latin American and Caribbean countries have agreed to the new rules. Despite the limited participation by developing Asia countries, they may participate in the Inclusive Framework and its initiatives at a later date, or they may adopt some of the rules in their domestic tax laws without participating in the Inclusive Framework.

62. The Pillar 2 reforms are targeted at reducing the impact of tax competition because of low CIT rates and tax incentives, especially to the ICT sector. Nearly all countries in East Asia, South Asia, and Southeast Asia provide ICT income tax incentives (Appendix). About half of Central Asian countries, and only two Pacific island countries offer these incentives. While a large portion of developing Asia countries have not yet agreed to the new international rules,

they may be impacted as countries that have agreed to the rules apply top-up taxes because of the lower taxes from tax incentives in the source country. This is discussed further in section VI.

63. The other income tax reform is expanding the definition of permanent establishment to include cases where there is no physical presence but a digital presence in a country. This reform has only been adopted by two developing Asia countries: Indonesia and India (Appendix). This is not unexpected, as not many countries in the world have made this reform. An alternative reform mentioned above is to adopt the new Article 12B of the UN Model Tax Treaty, which expands the definition of permanent establishment to include a digital presence. Many developing Asian countries adopt elements of the UN Model Tax Treaty, so those countries may seek to include the new Article 12B in future negotiations or renegotiations of DTTs.

64. The income tax initiatives are intended to operate in conjunction with existing transfer pricing rules, but many developing countries find it difficult to apply the rules in practice. Many developing countries, including in developing Asia, have introduced transfer pricing rules, often based on the OECD guidelines,[27] that should allow them to address some abusive transfer pricing, at least the most obvious. However, in many developing countries, the rules are rarely, if ever, applied, and often only in very simple cases. There may be various reasons for this: a lack of understanding on how to apply the rules; difficulty in finding, or knowing how to determine, comparable arm's length prices; and uncertainty or reluctance in dealing with MNEs, who are often supported by very skilled representatives with significant experience in dealing with transfer pricing issues.

B. Discrete Digital Taxes

65. A small number of developing Asia countries have discrete digital taxes, that is, 7 of the 46 countries (15%) (Appendix). There is no standard digital tax regime in the region, with the tax type, tax base, and tax rates varying significantly. However, the taxes can be categorized into two broad types: (i) digital services tax (DST), that is, a direct tax on income from the digital services (the name of the tax may vary in each country); and (ii) withholding taxes, that is, a withholding tax on payments to a foreign supplier of digital services. (This may be achieved by expanding the definition of royalties subject to withholding tax to cover payments for certain digital services.) Table 1 provides a brief summary of the discrete digital taxes in the region. The majority of countries with a discrete digital tax apply a withholding tax on payments to nonresidents for digital services. Table 1 also shows that most of the discrete digital taxes have commenced only recently. The first such tax in the region was the equalization levy, which was introduced in India in 2016 at a rate of 6% on advertising revenues. The levy was expanded in 2020 to cover e-commerce but at a tax rate of 2%. The equalization levy raised ₹1,136 crore

[27] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017.

(US$174 million) in 2019-20 and 1,493 crore (US$229 million) in the first 10 months of 2020–2021,[28] which is less than 0.1% of total tax revenue. The discrete digital tax rates in developing Asia are mostly about 5%–6%, although for withholding taxes these rates can be varied under DTTs.

66. It is not clear what will be the fate of these taxes if the Inclusive Framework proposals are implemented as announced, as a requirement of the proposals is that no new DSTs or similar measures can be imposed from 8 October 2021 until the earlier of 31 December 2023 or when the MLC comes into force. The process for removing existing DSTs, including any transitional arrangements, is still under consideration. This further consideration is likely a result of the resistance by some countries to the requirement to remove DSTs. This may be because of the impact on their revenue, given that the revenue gains from Pillars 1 and 2 may be less than the revenue loss from removing the DST.[29]

67. The reasons for the proposed removal of the DSTs are concerns about double taxation and the potential impact on cross-border trade in digital services. The US is particularly concerned that large US MNEs, mostly tech companies, are the target of these taxes, and so have threatened retaliatory trade measures. The proposed reforms should not impact on withholding taxes, as these are not DSTs, and there is usually provision in domestic laws and DTTs for crediting any withholding taxes paid in a foreign country.

Table 1: Discrete Digital Taxes in Developing Asia

Economy	Tax Type	Tax Rate	Tax Base	Threshold	Date Commenced
India	Equalization Levy	6%	Gross advertising payments	Total payments to nonresident >₹100,000 (US$1,355) per year	June 2016
	Equalization levy	2%	E-commerce online goods and services (directly or via platform)	Digital services revenue in India >₹20 million (US$271,029) per year	April 2020
	Withholding tax	1%	Gross sale of goods and services through digital or electronic facility or platform	For individuals and families—transactions >₹0.5 million (US$6,776)	October 2020

[28] https://economictimes.indiatimes.com/news/economy/finance/govt-collects-rs-1492-crore-equalisation-levy-between-apr-2020-jan-2021/articleshow/80879675.cms.

[29] For example, IMF (2021) estimates that the revenue effect of Pillar 1 is that India will lose revenue of about 0.01% of GDP. The loss of revenue will be greater if India also has to remove its equalization levy.

Economy	Tax Type	Tax Rate	Tax Base	Threshold	Date Commenced
Indonesia	Electronic transaction tax	10%	Applies to cross-border e-commerce sales (directly or via an online marketplace) if no digital permanent establishment because of a DTT	Must exceed: Gross turnover in Indonesia of Rp600 million (US$41,930) a year (50 million a month); or users in Indonesia of 12,000 a year (1,000 a month)	March 2020
Malaysia	Withholding tax	10% (can vary under double tax treaties)	Revenue from digital services (i.e., services delivered or subscribed over internet or another electronic network)		May 2019
Pakistan	Withholding tax	5%	Payments for offshore digital services		July 2018
Taipei,China	Withholding tax	As agreed with tax authority	Payments to foreign providers of online advertising and for e-services		January 2017
Thailand	Withholding tax	5%	E-commerce supply of goods and services in the country		Not yet determined
Viet Nam	Withholding tax	Variable rates	Income derived by nonresidents from digital and e-commerce operations in the country		January 2021

Source: KPMG Taxation of the Digitalized Economy, 22 July 2021.

C. Value-Added Tax

68. VAT on imported goods and services as part of the digital economy is gradually being introduced in developing Asia. Currently, 19 of the 37 countries (51%) with a VAT in the region have rules that apply VAT to the digital economy in some form. In addition, two countries in the region (Fiji and the Philippines) have proposed introducing similar rules. Table 2 sets out briefly the regimes that apply in the region. Many of the countries have only recently adopted these rules (Table 2), which is consistent with the recent global trend to introduce such rules. Only one Pacific Island country has proposed this reform, but this may change as these countries obtain a better understanding of both the measures and the experience of countries that have adopted the reform.

69. At this stage, there are few developing Asia countries that have special VAT rules for goods and services supplied via digital platforms, other than for cross-border transactions. India does have such rules—the supplier of the goods and services and the platform operators are compulsorily required to register for the GST, and the operator is also required to collect tax at a rate of 1% from the supplier. A country can rely on its ordinary VAT rules to tax these transactions, but as mentioned previously, these platforms do provide opportunities to simplify the collection of VAT on the many transactions undertaken via these platforms.

Table 2: VAT on Foreign Suppliers of Digital Goods and Services

Economy	VAT Rate (%)	Tax Base	VAT Registration?	Reverse Charge Rules B2B	VAT Registration Threshold	Date Commenced
Armenia	20	Digital services to microenterprise or turnover taxpayer (i.e., not to individuals or registered VAT businesses)	Yes	No	AMD115 million (US$239,151)	2020
Azerbaijan	18	Banks withhold VAT on online supplies paid by individuals	No	Yes, if nonresident not registered		2021
Bangladesh	15	Digital services	Yes	Yes	Tk30 million (US$349,340)[a]	2019
Bhutan	7	Digital services	Yes	Yes	Nu5 million (US$67,735)	2021
Cambodia	10	E-commerce services, including online goods and services	Yes	Yes	KR250 million (US$61,371)	April 2021
People's Republic of China	9/13	Imported goods by e-commerce	No	Yes, for imported services		2016
Fiji	9	Digital services	Yes	Yes	F$300,000 (US$141,082	Proposed
Georgia	18	B2C telecommunication, broadcasting and electronic services	Yes	Not applicable	None	2021
India	18	Digital services	Yes	Yes	₹2 million (US$27,092)	2016
Indonesia	10	Digital goods and services	Yes	Yes	Sales in excess of Rp600 million (US$41,930) per year or 50 million per month Internet traffic/access in Indonesia 12,000 per year or 1,000 per month	2020
Kazakhstan	12	Digital servicers	Yes	Yes	T30,000 (US$201,060)	2022
Republic of Korea	10	Digital services	Yes	Yes	None	2015
Malaysia[b]	6 RM10 per night	Services tax—digital services Tourism tax—tourism accommodation services provided by digital platforms	Yes Yes	Not applicable Not applicable	RM500,000 (US$119,670) None	2020 2021
Pakistan	2	Online marketplaces withholding	Not applicable	Not applicable		2021

Economy	VAT Rate (%)	Tax Base	VAT Registration?	Reverse Charge Rules B2B	VAT Registration Threshold	Date Commenced
Philippines	12	Digital services	Yes	Yes	₱3 million (US$58,831) (digital service providers must have a resident agent or office)	Proposed
Singapore	7	Digital services	Yes	Yes	S$1 million (US$740,579)	2020
Tajikistan	18	Digital services	Yes	Yes	TJS1 million (US$88,616)	2021
Taipei,China	5	B2C E-services > NTD 480,000 (US$17,344)	Yes	Yes		2019
Thailand	10	Digital services	Yes	Yes	B18 million (US$540,832)	2021
Uzbekistan	15	Digital services	Yes	Yes	SUM1 billion (US$92,110)	2020
Viet Nam	2–5[c]	Financial institutions withholding for e-commerce supplies of goods and services includes a VAT component	Not applicable	Yes		2021

VAT = value-added tax.

[a] The registration threshold for nonresidents who are supplying digital services is higher than the standard VAT registration threshold.

[b] Malaysia's does not have a standard VAT, but it has a Sales and Services Tax.

[c] The withholding rate for Viet Nam is different to the standard VAT rate (i.e., 10%).

Sources: KPMG Indirect Tax Table, International Bureau of Fiscal Documentation, country laws, and tax administrations.

VI. WHAT TAX POLICY RESPONSES SHOULD DEVELOPING ASIA CONSIDER ADOPTING TO ADDRESS THE DIGITAL TAXATION CHALLENGES?

70. The responses to the digital taxation challenges will depend on the particular circumstances of each country. Relevant factors include the size of the country in terms of population and the economy; the level of economic development; the level of technological development, including internet usage; the size of the digital economy, including the digital sector as a share of the total economy; the presence of large digital sector MNEs operating in the economy and if their headquarters are located in the country; the country's fiscal position, including the need for revenue; the existing tax system in the country; and the tax administration capacity in the country.

71. In designing responses to the digital taxation challenges, it is important to consider the reform objectives. A clear objective is to gain more revenue, or at least protect the tax base. However, other objectives should also be considered. The reforms should seek to make the tax

system fairer and provide a level playing field to ensure that the tax system does not give MNEs a competitive advantage over domestic firms. This fairness should lift tax morale (i.e., attitudes to paying tax) in the country. The design of the reforms should also aim to provide tax certainty for taxpayers and the tax administration. Finally, to the extent possible, the reforms should not be overly complex to reduce compliance costs for taxpayers and enable effective administration by the tax authorities.

72. In addressing digital taxation, the non-tax impacts of any reform measures should be considered. For example, the tax measures adopted may have implications for digital services trade. Taxes such as a DST, or requiring foreign suppliers of digital services to register for VAT, may discourage trade in digital services. The WTO and trade agreements may need to address the impact of these reforms.[30] Changed tax rules may also impact on the location of FDI (discussed further in para. 82).

73. The responses discussed in this section are categorized by types of tax—income tax, discrete digital taxes, and VAT—given that the various tax initiatives are also categorized by these broad tax types. As mentioned previously, while some of these reforms are not directly targeted at the digital sector, in particular the income tax measures, they will impact on that sector, as many of the large MNEs are in the digital sector.

A. Income Tax

74. The response to the new international tax rules proposed by the Inclusive Framework, will depend on whether the country participates in the Inclusive Framework and agrees to the rules (i.e., Pillars 1 and 2). This agreement necessitates each country's government and legislature to approve participation in the MLC and to ratify the agreement, and to pass any necessary changes to domestic laws. There is no guarantee that all major countries will be able to achieve such approval.

75. While developing Asia countries that participate in the Inclusive Framework and have agreed to the new rules will be expected to adopt and implement the rules, before doing so they should carefully consider the final details and ensure that major countries, such as the US and the EU countries, have adopted the rules. In the case of Pillar 1, the participating countries should carefully consider the final details of the proposed MLC and the implications for the country. In the case of Pillar 2, participating countries are expected to amend their domestic laws to implement the new rules, although they are not obligated to change the laws, but must accept the application of the rules by other IF countries.

[30] Avendano (2021) has a discussion of these issues.

76. The decision to implement the Pillar 1 profit allocation should include consideration of the revenue impact for the country. The IMF has estimated the revenue effects of the estimated allocation of residual profits under Pillar 1 (Amount A) for the Asia and Pacific region.[31] The analysis, which is for all industries and not just the digital sector, shows that the maximum gains will be small at about 0.04% of GDP, with the countries benefiting most being developed countries (e.g., Australia and Japan), resource-rich countries (e.g., Papua New Guinea and Solomon Islands), and countries with large markets (e.g., the PRC and the Republic of Korea). Most of the other developing Asia countries would have very small gains or losses of no more than 0.01% of GDP. Four economies are expected to have larger losses including Thailand (0.05%); Viet Nam (0.11%);[32] Singapore; and Hong Kong, China (both about 0.15%). The latter is because of their role as investment hubs, as they currently have a larger share of residual profits because of their business-friendly environments and low tax rates. There is almost no impact for the smaller Pacific Island countries, likely because of the limited presence of large MNEs in the countries, and their small share of allocated residual profits.

77. These revenue estimates can guide developing Asia countries that are not members of the Inclusive Framework as to whether they should join the Inclusive Framework and sign the MLC.[33] Most of the developing Asia countries that are not part of the Inclusive Framework appear to gain little benefit from Pillar 1, and so there may be limited incentive to participate. This is particularly the case for smaller countries that have limited tax administration capacity and more pressing domestic tax issues. The investment and marketing/distribution hubs, such as Singapore and Hong Kong, China, may lose revenue from Pillar 1, but those economies have already agreed to Pillar 1.

78. The Pillar 2 minimum CIT tax reforms (i.e., the GloBE rules) could be applied in developing Asia countries in two broad ways: (i) a country, such as the PRC, that has large MNEs headquartered in the country may impose top-up tax if another country where the MNE operates imposes an effective tax rate that is below the minimum tax rate (the IIR rule discussed in section IV); (ii) alternatively, the country in which the MNE is operating may deny a tax deduction or make a similar adjustment if the residence country will not impose the minimum tax on a payment to the residence country (the UTPR rule discussed in section IV).

[31] IMF (2021).

[32] The IMF suggests that the loss in Viet Nam is because of the profit reallocation of Japanese MNEs (IMF 2021).

[33] Countries that join the IF must commit to adopting four BEPS minimum standards. This is in addition to deciding on whether to adopt the new international tax rules. The minimum standards relate to (i) treaty shopping (BEPS Action 6), by including in DTTs a limitation of benefit or more general principle purpose test provisions to restrict access to benefits; (ii) transfer pricing documentation and country by country reporting (BEPS Action 13); (iii) harmful tax practices (BEPS Action 5), including the peer review of tax rulings and preferential tax regimes; and (iv) tax treaty dispute resolution measures (BEPS Action 14).

79. The impact of the first application is that countries that have large MNEs headquartered in the country can potentially collect more taxes from these MNEs for operations in other countries. This may potentially benefit economies, such as the PRC; Taipei,China, and the Republic of Korea, which all have large digital sector MNEs active in other countries. The impact of the second application is that countries with MNEs operating in their jurisdiction can ensure that the MNE is paying some tax in the source country.

80. The determination of whether these rules apply depends partly on whether a country's effective tax rate applied to an MNE is below the minimum tax rate of 15%. The calculation of the effective tax rate will depend on the income, and tax on that income, for an MNE.[34] However, as a guide to the effective tax rates, it is useful to consider standard CIT rates in developing Asia countries. Table 3 shows that, in all but two developing Asia countries, the standard CIT rate is equal to or higher than the minimum tax rate of 15%. Despite these standard CIT rates, a country may have a lower effective tax rate because of a special low CIT rate for certain sectors or taxpayers (e.g., foreign investors) in the country or because of a tax exemption or other incentive. Weidemann and Finke (2015) estimate that, for the Asia and Pacific region, tax incentives for private investments reduce the effective tax rate by 8.6 percentage points on average. They also conclude that incentives for the ICT sector, together with incentives for developing specific geographical areas, result in the lowest effective tax rates.

Table 3: Corporate Income Tax Rates in Developing Asia, 2021[a]

Economy	Rate (%)	Economy	Rate (%)	Economy	Rate (%)	Economy	Rate (%)
Central Asia		**South Asia**		**Southeast Asia**		**The Pacific**	
Armenia	18	Afghanistan	20	Brunei Darussalam	18.5	Cook Islands	20
Azerbaijan	20	Bangladesh	32.5	Cambodia	20	Federated States of Micronesia	NA
Georgia	15	Bhutan	30	Indonesia	22	Fiji	20
Kazakhstan	20	India	30	Lao People's Democratic Republic	20	Kiribati	20–35
Kyrgyz Republic	10	Maldives	15	Malaysia	24	Marshall Islands	NA
Tajikistan	23	Nepal	25	Myanmar	25	Nauru	20
Turkmenistan	20	Pakistan	29	Philippines	30	Niue	30
Uzbekistan	15	Sri Lanka	24	Singapore	17	Palau	NA
East Asia				Thailand	20	Papua New Guinea	30
Hong Kong, China	16.5			Timor-Leste	10	Samoa	27
Mongolia	25			Viet Nam	20	Solomon Islands	30

[34] The effective tax rate is calculated by dividing the tax on income by the income based on financial accounts with some adjustments to align the financial accounts with tax purposes. A more detailed explanation is in OECD (2021c).

Economy	Rate (%)	Economy	Rate (%)	Economy	Rate (%)	Economy	Rate (%)
People's Republic of China	25					Tonga	25
Republic of Korea	25					Tuvalu	30
Taipei,China	20					Vanuatu	NA

NA = not applicable.

[a] These are standard CIT rates. A country may offer different rates for certain sectors or taxpayers.

Sources: KPMG Corporate Tax Rates Table, country ministries of finance, and tax administrations.

81. An impact of the Pillar 2 reforms is that it may negate the benefit of tax incentives offered by a country, especially to foreign investors in the ICT sector. This is because the MNE may be subject to top-up tax in the country where the MNE is headquartered so that any exemption, low tax rate, or other tax reducing incentive provided to the MNE may be offset by top-up tax in the residence country. The amount of the top-up tax may be reduced to the extent the substance carve-out applies (the carve-out is based on payroll and tangible assets, discussed in section IV), in recognition of the existence of real economic activity in the country. The effect of Pillar 2 is that it may reduce tax competition and the "race to the bottom" on CIT rates, with a potential floor of a CIT rate of 15%. However, the effectiveness of Pillar 2 to achieve this will depend on the determination of the effective tax rate, and the impact of the reduction of the tax base because of the substance carve-out.

82. As many developing Asia countries offer tax incentives, especially to the digital sector, each country will need to decide if it retains the tax incentives. In making those decisions, countries should recognize that the benefit of the incentives may be undone by the top-up tax and the residence country will be collecting tax that the source country could have collected. A further consideration, as mentioned in section III, is that the benefits of many of the tax incentives are questionable.[35] There should also be less pressure to provide tax incentives to attract foreign investment, given that all countries are potentially impacted by the minimum tax. A country may still see benefits from the tax incentives for domestic companies operating in the ICT sector. Although, to the extent that those companies expand to operate in other countries, the UTPR rule may be applied to them in the other country. Another impact of the potential negation of benefits of tax incentives and tax competition is that it may result in MNEs placing greater emphasis on non-tax factors in deciding the location of investments (e.g., lower labor costs), which may lead to the redirection of investments to other countries.

83. Expanding the definition of "permanent establishment" in domestic laws to include digital services provided in the country, even if there is no physical presence, is a measure all countries can adopt. This change can be made unilaterally by a country by amending its

[35] Megersa (2019) provides a summary of the literature on the evidence of tax incentives and their consequences in Asia.

domestic tax laws. The changed definition does not need to be limited to large MNEs, so it can cover all foreign entities that provide digital services in the country. However, some limitation on the value of transactions in the country (e.g., a de minimis rule) may be useful for administration purposes. This limitation may also reduce the impact on small businesses that could be deterred from expanding beyond their own jurisdiction if the tax requirements in a potential new market are administratively burdensome. DTTs may override any changes to the definition of permanent establishments. Therefore, countries should ensure that the revised definition is included in any new DTTs and be a part of renegotiations of existing DTTs. The proposed Article 12B of the UN Model Tax Treaty can provide an alternative for covering this issue in a DTT. Obtaining agreement from developed countries for a revised permanent establishment definition or Article 12B may be a challenge, given the often strong negotiating position of developed countries. It also recognized that DTTs can take a long time to negotiate or renegotiate, sometimes several years.

84. Regardless of the adoption of the new initiatives, it is important for developing Asia countries to apply their existing transfer pricing rules, and introduce them if they are not present in domestic laws. It is essential that domestic tax laws include an arm's length rule, and this should be supported by basic transfer pricing rules. These rules can be included in domestic laws and regulations, or guidelines. Guidance in applying transfer pricing rules can be found in OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017 and the UN Practical Manual on Transfer Pricing for Developing Countries (2017). Developing countries may find it useful to introduce some safe harbor rules, which mean that more complex transfer pricing rules do not apply if the transaction is below a certain amount or within a specified percentage. This can provide certainty to taxpayers, reduce compliance costs, and be easier to administer. Some developing Asia countries with a more sophisticated tax administration may consider the transfer pricing approaches taken by the PRC and India that differ from the OECD rules in how they account for location savings.[36] While transfer pricing rules usually apply to cross-border-related party transactions, they should also apply to domestic-related party transactions, especially if there are domestic companies entitled to tax incentives, as abusive transfer pricing can arise with these transaction.

85. The revenue impact of the proposed income tax reforms is difficult to estimate. The OCED has estimated that Pillar 1 will see the reallocation of about US$125 billion profits.[37] As mentioned in para. 76, IMF (2021) has estimated the revenue impact of Pillar 1 for countries in

[36] Location savings are location-specific market features or factors of production (e.g., market size, low labor costs) that provide firms with a financial benefit compared to providing the same good or service in another location. It is argued that the OECD rules do not adequately deal with this situation as suitable comparative prices do not exist. Therefore, India and the PRC have developed their own practical transfer pricing rules to take account of location savings.

[37] OECD (2021b).

the Asia and Pacific region—the revenue implications are small for most countries with the most obvious losers being investment hubs. The OECD has also estimated that the additional global tax revenues from Pillar 2 is about US$150 billion per year. The specific country and regional revenue impacts, including for developing Asia, will depend on the response of MNEs and how governments apply the Pillar 2 rules and/or respond to the implications of the rules (e.g., whether a source country decides to change their tax incentives or CIT rate in response). The expansion of the permanent establishment rules should have a small positive revenue impact, but it will again depend on the response of MNEs to the rules. Much of the revenue gains are likely to arise from digital MNEs, given that, globally, they are some of the largest companies.

B. Discrete Digital Taxes

86. The imposition of DSTs is clearly under threat, at least for countries that are members of the Inclusive Framework and have agreed to the new international tax rules. The countries that already have a DST can continue to apply those taxes until the MLC comes into force, which is not until at least 2023, with the transitional rules still under consideration by the Inclusive Framework. An option that the Inclusive Framework could consider is allowing low-income developing countries to continue to apply DSTs, say at a low rate, given the urgent need for revenue for many of these countries.

87. Countries that have not agreed to the international tax rules proposed by the Inclusive Framework should be able to impose DSTs. However, they will have to remove them if they join the Inclusive Framework or agree to the reforms. It is also unclear how the Inclusive Framework countries may respond to DSTs imposed by countries outside the Inclusive Framework, and whether there may be some retaliatory measures.

88. In determining whether to impose a DST, countries should also consider other arguments for the imposition of DSTs, in addition to the revenue-raising objective. One argument for a DST is that it can be used as a corrective tax (i.e., seeking to address negative externalities). For example, DSTs may be adopted to address the overuse of digital products (e.g., social media) because of concerns about the negative impact on the physical and mental health of users. A DST may also seek to address concerns about manipulation of content, privacy, and ownership of personal information. Another argument for a DST is that it may partly address a country's concerns about the market power of digital MNEs. The ease of entry into a market by digital MNEs can enable them to gain substantial market power, undermining the competitiveness of small and local digital companies, and potentially usurping local media, including controlling content seen by users.[38]

[38] Cui (2019) has a discussion on the justification of a DST beyond revenue raising.

89. Despite the potential removal of DSTs, countries can still use withholding taxes to ensure tax is paid on payments for digital services. The Inclusive Framework proposals do not prevent a country from imposing withholding tax on such payments. This can be achieved by amending domestic tax laws to include a specific withholding tax on certain payments to nonresidents for digital services, or to expand the definitions of one of the existing payments subject to withholding tax, such as royalties, to include payments for digital services. As shown in Table 1, a number of developing Asia countries have adopted this reform. The STTR rules included in Pillar 2 (discussed in section IV) also allows developing countries to impose an effective withholding tax of up to 9% if a DTT imposes a nominal CIT rate below 9% on the income paid to the recipient.

90. The advantage of the withholding tax approach is that the withholding tax is usually creditable in the recipient's country so that double taxation is avoided. This is not the case for DSTs as they are usually not creditable in the recipient's country and so can result in double taxation. The limitation of this withholding tax solution is that DTTs often limit the extent and rate of certain withholding taxes so this needs to be taken into account in assessing whether expanding the withholding taxes to digital services will be beneficial to a country.

91. The revenue impact of imposing discrete digital taxes is small (discussed in section V on the revenue impact of the equalization levy in India). However, the introduction of these taxes can provide much-needed revenue, especially for developing Asia countries with low tax-to-GDP ratios. They have a political dimension also, as it sends a clear signal to the public that taxes are being collected from the large digital MNEs operating in the country.

C. Value-Added Tax

92. Requiring VAT registration for foreign companies that are providing goods and services, including digital services, is the simplest mechanism for ensuring that VAT is paid on these goods and services, especially digital services. As mentioned previously, about one-half of developing Asia countries with a VAT have these rules (Appendix). The remaining countries should consider adopting these rules. The international experience is that many of the large MNE suppliers of digital services are willing to register, with their main concern being that the processes for registration, invoicing, filing, and payment are simplified (e.g., no requirement to provide VAT invoices). The rules could also cover foreign suppliers of low value goods that may currently be exempt from VAT on imports.

93. In requiring a foreign supplier to pay VAT, it is important to have clear "place of supply" rules. The place of supply rules could include requiring B2B supplies to VAT-registered businesses to be subject to a reverse charge, with VAT on B2C supplies (and to businesses not registered for VAT) to be imposed by the foreign supplier and forwarded to the relevant

country tax authority. As mentioned in section IV, the location of the consumer for digital services could be determined by following the OECD guidelines on this issue.

94. Another factor in requiring foreign suppliers to register for VAT is to determine the VAT registration threshold for these suppliers. Most countries apply the same VAT registration threshold to local and foreign suppliers. This is the case in developing Asia countries, except in Bangladesh which has a higher threshold for foreign suppliers. An advantage of having a higher threshold is that it encourages small businesses in a region to expand into other countries without having the tax compliance burden of having to pay VAT in a foreign country. It also reduces the administrative load on the tax authority. The disadvantage is that it may give a competitive advantage to foreign businesses over local small business that have to pay the VAT.

95. The VAT treatment of digital platforms will depend on the type of platform. For electronic marketplaces, the foreign or domestic platform should be registered and required to charge VAT on supplies to domestic consumers. The application of VAT to electronic platforms that bring together buyers and sellers is not as clear. As mentioned previously, applying the standard VAT rules would require the platform to register for VAT and also the seller if their sales exceed the VAT registration threshold.[39] However, a simpler approach may be to require the platform to impose the VAT. This can ensure that VAT is imposed on the transaction and make it easier for the tax authority to administer, as they only have to deal with the platform and not multiple sellers. Other options include requiring the platform to withhold an amount from the payment to the seller in lieu of the VAT, on the basis that the seller may not register for the VAT—this is essentially a compliance measure. As mentioned previously, there is ongoing work on the best international practice for these transactions, so developing Asia countries in the interim could adopt one of the options requiring the platform to collect tax.

96. These VAT measures should increase VAT revenues. The size of the revenue gains for reforms targeted at cross-border transactions will depend on the amount of those transactions, especially in digital services, and the extent to which they are not already being taxed. For example, at present, the cost of a B2B digital service should be reflected in the final price paid by the consumer, and so the correct amount of VAT should be collected from the consumer. However, there are circumstance where VAT will not be collected from the final consumer (e.g., if the B2B digital service relates to an exempt supply or the local business is in the informal economy). Therefore, the reforms can facilitate VAT collection on the B2B digital service that may have previously not been collected. The proposed reforms relating to digital platforms and marketplaces will protect the tax base and, therefore, revenue.

[39] The seller would have to impose VAT on the supply to the platform, and then the platform would impose VAT on the supply to the consumer and obtain a VAT input credit for the tax imposed by the seller.

D. Tax Administration

97. While the focus of this paper is on tax policy reforms in taxing the digital economy, digitalization also provides many opportunities for tax authorities to improve tax compliance. The advances in technology have enabled tax authorities to improve collections, provide better taxpayer service, and simplify compliance for taxpayers through the use of ICT systems, data, and automation.[40] These advances have the potential to assist greatly in domestic revenue mobilization. Access to these technologies is important for developing Asia countries, especially those with limited tax administration capacity.

98. Also, the electronic marketplaces and platforms used in the digital economy provide opportunities for tax administration reform. These platforms can act as custodians of the tax administration by acting as an intermediary between the tax authority and the suppliers. This has the potential to simplify VAT collections and VAT reporting and filing obligations for suppliers, as well as providing information on the transactions to assist compliance monitoring and collection by the tax authorities.[41]

E. Capacity Building

99. The reforms being proposed to tax the digital economy are extensive and complex. Therefore, many countries in developing Asia will require capacity building to assist them to understand, assess, and implement the reforms. It can be difficult for countries, especially those with limited tax administration resources, to fully understand and address these issues. International organizations such as ADB, the IMF, the OECD, and the World Bank can provide assistance, as can bilateral donors.

100. There is also an opportunity for regional forums such as the Asia Pacific Tax Hub, the Pacific Islands Tax Administrators Association, and the Study Group on Asian Tax Administration and Research to provide regional specific capacity building. This could include training, providing guidance materials, and linking countries to regional experts.

VII. CONCLUSION/FIVE TAKEAWAYS

101. **The rise of the digital economy has challenged the traditional tax systems.** The international tax rules have proved inadequate in dealing with cross-border transactions, with MNEs exploiting the weaknesses in the existing international tax framework. There is also uncertainty on how to apply VAT to imported digital services.

[40] A detailed discussion of the potential of the digital transformation for tax administration is in OECD (2020b).
[41] A discussion of the potential of electronic platforms to assist tax administration is in Aslam and Shah (2017).

102. **The challenges with the taxation of the digital economy have led to tax reform initiatives that could significantly reform the current tax systems and enhance the taxation of the digital economy.** The major initiative is the proposed new international tax rules developed by the OECD and Inclusive Framework that are a major reform of the current international tax framework. The proposed rules will reallocate the profits and taxes of MNEs, but are complex. Countries have also adopted unilateral measures, such as requiring foreign suppliers to register for, and impose, VAT on services provided in another country, as well as introducing discrete digital taxes such as a DST.

103. **The response of developing Asia to these reforms has been mixed, with the more developed countries likely to adopt the reforms.** Less than half of developing Asia countries have agreed to the new international tax rules. Around half of the countries with a VAT have introduced rules that require foreign suppliers to impose VAT on cross-border digital services. The number of developing Asia countries that have introduced discrete digital taxes is very small.

104. **The revenue impact of the various reforms for developing Asia will likely be small, although the final impact is still uncertain.** Analysis so far suggests that the Pillar 1 reforms will have a small impact on revenue in developing Asia with some small gains and small losses. The most affected economies are investment hubs, such as Singapore and Hong Kong, China, that will lose revenue because of the reallocation of profits. The impact of Pillar 2 is likely to be small as most countries have CIT rates above the minimum rate of 15%. However, it is possible that the tax benefits of tax incentives that reduce the effective tax rate may be undone by Pillar 2, which may be a concern as many developing Asia countries offer tax incentives, especially to the ICT sector. The revenue from VAT on cross-border digital services and DSTs is also expected to be small, but the tax is potentially significant for the MNEs.

105. **The tax reform strategy for addressing the taxation of the digital economy in developing Asia will depend on the country's circumstances (e.g., economic development, size of the digital economy, need for revenue, and tax administration capacity), so careful analysis should be undertaken before adopting the new global initiatives.** The strategy for the future for developing Asia countries could include the following (some of these reforms may have already been adopted by a country):

(i) For those countries that have agreed to the new international tax rules, before signing the MLC and changing domestic laws they should carefully review the details of the new rules and the proposed MLC, assess the implications for the country, and ensure that major countries have signed and implemented the new rules.

(ii) Developing Asia countries that have not agreed may prefer to wait and see the final rules and MLC before committing, especially if tax administration capacity is low and there are more pressing domestic tax issues.

(iii) All developing Asia countries should review their tax incentives, especially for the ICT sector, to determine if they will be impacted by the new rules.

(iv) Developing Asia countries should also consider expanding the definition of "permanent establishment" to cover digital services provided in the country, even if there is no physical presence—the changes should be to domestic laws and DTTs.

(v) Developing Asia countries should ensure that their domestic tax laws and rules include adequate transfer pricing rules (possibly with presumptive safe harbors) and the country should effectively apply these rules.

(vi) Countries with a DST may retain the DST, while permitted under the Pillar 1 rules and until the transition requirements for removing the DSTs are settled, but all developing Asia countries should consider applying withholding taxes to payments to nonresidents for digital services.

(vii) Those developing Asia countries that do not require foreign suppliers of digital services and goods to register and collect VAT should consider doing so, while ensuring simplified rules for registering, filing, and paying the VAT.

(viii) Developing Asia countries should clarify the rules for collecting VAT on digital marketplaces and platforms, and the tax authorities should utilize the benefits of these platforms to enhance compliance.

(ix) Capacity development providers should consider providing assistance to developing Asia countries so that they can better understand the issues and initiatives in taxing the digital economy.

APPENDIX: SUMMARY OF TAXATION OF THE DIGITAL ECONOMY MEASURES IN DEVELOPING ASIA

	Member of IF	ICT Income Tax Incentives	Digital PE	Discrete Digital Tax (DST/WHT)	Cross-Border VAT on Digital Goods and Services
Central Asia (8)					
Armenia	√	√			√
Azerbaijan		√			√
Georgia	√	√			√
Kazakhstan	√	√			√
Kyrgyz Republic		√			
Tajikistan					√
Turkmenistan					
Uzbekistan					√
East Asia (5)					
Hong Kong, China	√				NA
Mongolia	√	√			
People's Republic of China	√	√			√
Republic of Korea	√	√			√
Taipei,China		√		√	√
South Asia (8)					
Afghanistan					
Bangladesh		√			√
Bhutan		√			√
India	√	√	√	√	√
Maldives	√				
Nepal		√			
Pakistan	√	√		√	√
Sri Lanka	√	√			
Southeast Asia (11)					
Brunei Darussalam	√	√			
Cambodia		√			√
Indonesia	√	√	√	√	√
Lao People's Democratic Republic		√			
Malaysia	√	√		√	√
Myanmar		√			NA
Philippines		√			P
Singapore	√	√			√

Thailand	√	√		√	√
Timor-Leste					NA
Viet Nam	√	√		√	√
The Pacific (14)					
Cook Islands	√				NA
Federated States of Micronesia		√			NA
Fiji		√		2	P
Kiribati					
Marshall Islands					NA
Nauru				2	NA
Niue					
Palau					NA
Papua New Guinea	√				
Samoa	√				
Solomon Islands					NA
Tonga					
Tuvalu					
Vanuatu					
Countries—46	**20**	**27**	**2**	**7**	**19/37 (2P)**

DST = digital services tax, ICT = information and communication technology, IF = Inclusive Framework, NA = not applicable, P = proposed, PE = permanent establishment, VAT = value-added tax, WHT = withholding tax.

Notes:

1. The ICT income tax incentives include those incentives that are specifically directed at the ICT sector. They do not include general tax incentives that cover all sectors, such as for large foreign investment in any industry, even though an ICT investor may access those incentives.
2. Fiji and Nauru have special taxes on telecommunication companies, which are wider than DSTs but are also partially targeted at digital services.

Sources: Country tax administration and Ministry of Finance; International Bureau of Fiscal Documentation; KPMG Taxation of the Digitalized Economy, 22 July 2021; and Organisation for Economic Co-operation and Development.

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