Global digital operators have to pay VAT according to Sri Lankan tax laws

Following is an interview with Department of Inland Revenue former Deputy Commissioner General N.M.M. Mifly

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Q. Digital company taxation local versus foreign has become a subject of concern in the COPF, where it has been pointed out that an unfair playing field is prevalent with the advantage going to foreign digital players operating in Sri Lanka. How do you think this has happened?

A. The digital economy allows room for tax evasion, avoidance, and double non-taxation of both direct and indirect taxes, by using loopholes in the domestic tax statutes. This is done, especially by non-resident digital service providers.

It goes without saying that the non-payment of due taxes by international digital service providers has a direct adverse impact on their local competitors/counterparts. Creating such an uneven playing field has resulted in a loss of confidence in the efficiency of our tax system.

Q. What do you estimate the quantum of loss to the Sri Lankan exchequer to be, as a result of not following a proper method of taxation?

A. *The Organization for Economic Cooperation* and Development (OECD) report dated 2 June 2022, on "VAT on international digital trade" has projected that the growth of the global digital economy would be doubled from 2019 to 2024 respectively from $ 3,351 trillion to $ 6,767 trillion. 60% of this digital economy is from the Asia-Pacific region, including Sri Lanka.

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This rapid leap of the digital economy was predicted on the back of the global COVID-19 pandemic that virtually locked down the entire world, and the digital ecosystem stepping up to meet the challenge. Just as every coin has two sides, the digital economy too has two sides especially when it comes to taxation.

The positive side is the economic boom which contributes to the country's GDP and money circulation due to mass consumption and consumerism. This is mainly due to the easy and quick online purchase of goods and services.

This fact is further confirmed by the increase of tax revenue in 2023 by approximately 60% (Rs. 1,490 billion) over the previous year which was at only Rs. 940 billion. This increase in tax revenue was possible owing to several reasons including consumerism. The digital economy has continued to add value amidst economic hardships and inflation, and will further grow to expand their footprint into the terrestrial economy.

Q. How do other countries and international tax authorities face this challenge of nonpayment of due taxes by foreign digital service providers?

A. There is no internationally accepted mechanism to charge VAT from suppliers of digital services, especially when they are non-resident persons or entities. However, the OECD in its publication, "The International VAT/GST Guidelines Global standard" recommends the 'Destination principle' i.e. the final jurisdiction where the consumption takes place. Following guidelines issued by OECD are noteworthy i.e.

- Guideline 2.2: Equal treatment of economic operators that carry out similar transactions
- Guideline 2.4: Non-discrimination between foreign and domestic businesses
- Guideline 3.1: Taxation by the jurisdiction of consumption.

It is clear that VAT is not charged on the taxable supply of a person based on the physical presence of such a person, but on the place where the consumption, or rather the supply of such services takes place.

Q. What are the different types of taxes applicable to digital service providers?

A. There are two types of taxes involved in the supply of digital services, they are Direct Tax which is *Income Tax, and Indirect Tax or Sales Tax, which is VAT.*

Income tax involves two types of income i.e. active income such as income from businesses and passive income such as income from rent, and interest, etc.

My answer here is limited to business income derived from the supply of digital services especially by international players or rather non-resident companies. Further, the taxation of non-resident person differs as per the Double Tax Avoidance Agreements (DTAA) of a country with another country. Since Sri Lanka has such DTAA with more than 45 countries with which it has substantial business transactions, the answers are given accordingly.

Internationally (excluding USA) accepted method of imposing income tax on a person or a company is on the basis of residency in a particular country or tax jurisdiction. For example, tax is imposed on the active income of a business derived by a person/company in Sri Lanka, on the basis of physical presence of the person or company concerned.

If physical presence cannot be established by a tax jurisdiction from where the business income was derived, the taxing right of the person/company would go to the person or company's resident tax jurisdiction during the said year of assessment.

Establishing physical presence of a person (natural person) or company (legal person) varies from natural person to a legal person. Article 5 of Double Tax Avoidance Agreements (DTAA) explains in detail the physical presence of a person as the Permanent Establishment (PE) which could be categorised as Asset PE, Service PE and Agency PE. The taxing rights of passive income derived by a person in Sri Lanka, generally goes to the source country where the income was generated, irrespective of the residency status of the person concerned.

Last year, the Inclusive framework of the OECD introduced the Pillar One solution for multinational companies engaged in the provision of digital services. According to *Pillar One, multinationals can be made to share a percentage of profit as taxes, with tax jurisdictions where they operate* with no physical presence (PE) established.

It is clear that the imposition of income tax on a person is predicted on the physical presence of such a person. If a person is non-resident and the business was carried out without any physical presence of such person or his agent, then Sri Lanka loses the right to tax such a person and the taxing right goes to the tax jurisdiction where he/she was resident.

Q. Can VAT be charged on global companies operating in Sri Lanka?

A. VAT is charged on goods or services based on the place where they are supplied and consumed and not based on the physical presence of the person supplying them, i.e. if the company directly carries on a taxable supply in Sri Lanka or through another person or through an agent, such person can be legally registered for VAT purposes.

The Inland Revenue Act, No. 24 of 2017 which deals with the imposition of income tax and the VAT Act, No 14 of 2002 which deals with VAT, are in line with internationally accepted mechanisms of taxing income or the taxable supply of a person.

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The relevant Section 2(1) reads as follows. "Subject to the provisions of this Act, a tax, to be known as the Value Added Tax (hereinafter referred to as "the tax") shall be charged – (a) at the time of supply, on every taxable supply of goods or services, made in a taxable period, by a registered person in the course of the carrying on, or carrying out, of a taxable activity by such person in Sri Lanka."

It is to be noted here that the word used by the legislature is "a registered person", that implies any person who directly carries on a taxable supply in Sri Lanka or through another person or through an agent, such person can be legally registered for VAT purposes.

Q. Is it possible to get a non-resident person/company to comply?

A. Yes, our lawmakers had foreseen such a situation when they passed the VAT Act in 2002. There are four different sections in the VAT Act handling the registration of a person for VAT purposes i.e.:

I. **Voluntary Registration of the direct person:** Any person (Resident or Non-Resident) engaged in the business of taxable supply of goods or services in Sri Lanka is required to be registered for VAT with the CGIR in terms of section 10(1) (vii) of the VAT Act.

II. **Forced Registration by the Commissioner General of Inland Revenue (CGIR):** If such person fails to register himself as per requirement of Section 10, the CGIR should register such person under section Page | 5 14(1)(c) of the VAT Act, through forced registration after according him a fair hearing prior to the registration.

III. **Forced Registration by the CGIR of a person connected with the business:** Section 52(1) of the VAT Act provides the CGIR for making an employee or any other officer of that person as the Principal Officer and for making him liable to do all such acts, matters and things which are required to be done in terms of the provisions of the VAT Act.

IV. **Forced Registration by the CGIR of an agent of the person concerned:** If a Principal Officer of the Non-Resident Person, who directly involved in the taxable activity, could not be found or was not available, Section 55 of the VAT Act provides for the alternative solution in the form of appointment of an agent.

V. **The Agent is defined in Section 83 of the VAT Act as:** any person in Sri Lanka through whom such person or partnership is in receipt of any profits or income, arising in or derived from Sri Lanka;

It is the common sense that large scale business of digital services, employing thousands of employees cannot be carried on or carried out without even agent or employee of the person who engaged in the taxable activity.

Q. Isn't it a requirement to establish Agency-Principal or Employer-Employee contracts for registration of a person for VAT purposes on behalf of the nonresident person who supplies digital services?

A. The legal principle of "Substance Vs Form" in the taxation arena and accounting emphasises the importance of looking beyond mere formalities or legal structure of transactions. It underlines the taxing or practical reality of the situation.

The principle acknowledges that the true nature of a transaction may be more important for tax and accounting purposes than its legal form if any.

The VAT Act has anti-avoidance measures in place to disregard transactions that lack economic substance or have been structured for tax benefits. These measures aim to prevent taxpayers from exploiting legal technicalities to reduce their tax burden.

Section 64A of the VAT Act reads as follows: "Where the assessor is of the opinion that any transaction which reduces or would have the effect of reducing the amount of tax payable by any person is artificial or fictitious or that any disposition is not in fact given effect to, he may disregard any such transaction or disposition and the parties to the transaction or disposition shall be assessable accordingly."

Any possible contention of the non-existence of agency-principal agreement, or any other similar argument, shall be untenable in the face of the facts and the substance stated above.

Q. How do you see the non-registration of non-resident digital service providers as opposed to their registered local counterparts in terms of taxation?

A. One of the foremost principles of taxation is fairness and equity, suggesting that the tax burden should be distributed fairly among taxpayers ensuring a level playing field.

Horizontal equity — especially in the case of indirect taxation, asserts that taxpayers in similar economic situations should be treated similarly. In other words, people with similar revenue and circumstances should pay similar amounts of tax. This principle aims to eliminate arbitrary distinctions that may lead to unfair treatment. Any different treatment of similar circumstances of the tax environment leads to the erosion of tax and confidence in the tax system.

This creates an unfair edge in highly competitive commercial marketing. The OECD guidelines, too, emphasise the equal and non-discriminatory treatment of similar business carried out by local and international players in supplying digital services, especially in terms of VAT.

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Q. Some professionals say the VAT Act needs amending as there is no provision in it to tax the supply of digital services by international players, out of the tax jurisdiction. How do you respond?

A. As I clearly pointed out earlier, VAT is charged on the taxable supply made in Sri Lanka by a registered person who carries out a taxable activity. Accordingly, such an organised business activity conducted in Sri Lanka is clearly a taxable supply and cannot be carried on without a principal officer or an agent of the digital service supplier.

The VAT Act describes four types of registration so that none could escape *the VAT net, simply because taxing a similar tax*able supply of a local person while not taxing a similar and identical taxable supply of a non-resident person, is discriminatory and against the fundamental principle of fairness and efficiency in taxation.

I am of the view that the VAT Act does not need to be amended to bring non-resident players into the VAT net. What is needed is the correct understanding and interpretation of the relevant law. As the chairman of COPF, Dr. Harsha de Silva said in a COPF meeting which went viral on social media, foreign and local suppliers of digital services providing the same service need to be taxed equally, otherwise it is not fair to the local industry.

Q. Do other countries in our Asia-Pacific region charge VAT on the supply of digital service carried out by non-resident persons?

A. Yes, several countries in the Asia-Pacific region charge VAT on the supply of digital services such as Australia (10%), Bangladesh (5%-15%), China *6%-13%), India (18%), Japan (10%), Malaysia (6%) and South Korea (10%).

Further, a significant amount of tax revenue could be generated from the application of the VAT law on digital services especially in the backdrop of the unprecedented economic crisis the country is facing.