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Withholding Taxes in the Digital Economy Era

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Taxation of the digital economy has become a war in the post-BEPS world. As with any war, there are more or less clear rivals and there will be of course winners and losers. It goes without saying that there are also "casualties" in this conflict, i.e. those policy options initially included in the drafts published by the OECD in the framework of BEPS Action 1 and the post-BEPS work on the digital economy[1] and later fallen out of favour. There is no doubt that the abandonment of certain proposals (such as a bandwidth or "Bit Tax" in the 2014 Interim Report or "equalization Levies" in the 2015 Final Report) must be welcomed; they were as a matter of fact wrong propositions[2]. In contrast, other policy options were discarded perhaps too early. In my view, this is particularly the case for withholding taxes (WHT), which after appearing in the 2014 Interim and the 2015 Final Reports as a viable option were suddenly labelled as "*uncoordinated and unilateral actions*[3]" in the 2018 Interim Report and finally disappeared as an autonomous alternative in the March 2019 Public Consultation Document.

Many scholars have mercilessly attacked WHTs in general and particularly in the context of the digital economy and probably they have good grounds for it. However, not all WHTs are equal. Only a low tax rate, stand-alone, gross-basis final WHT on services in *business-to-business* transactions[4] would meet the objectives of the proposal and result in several advantages:

1. The proposal operates within the current international tax regime avoiding radical amendments of the "source-residence" paradigm or the transfer-pricing standard, or other alternatives (*e.g. equalization levies*) that purport, both naively and maliciously, to run outside the system. The inertia of a century-old conservative international tax regime should not be seen as a minor enemy by any reform proposal. In contrast, many countries already tax income obtained by non-resident service providers in the absence of a Permanent Establishment and even in the absence of other thresholds. OECD-patterned Double Taxation Conventions (DTCs) may represent a stumbling block. However, there is a growing tendency to include separated provisions allowing source taxation of so-called fees for technical services in treaties concluded between developing countries and, to a lesser extent, between developing and developed countries. Actually, this trend seems to be reinforced by the introduction, in 2017, of a new provision in the UN Model Tax Convention attributing taxing rights to the source state in relation to fees for technical services.
2. By covering all services, the proposal avoids the complexity often linked to scopes listing specific types of transactions and, above all, removes any hint of ring-fencing the digital economy. Tax ring-fencing of the digitalized economy was abhorred in the 2015 Final Report; this repudiation was maintained in the 2018 Interim Report and yet many of the "surviving"

policy options at this point of the process necessarily imply a ring-fencing effect (*i.e.* new nexus based upon significant "digital" presence or the "user participation proposal" under the 2019 Public Consultation). Other options discarded by the OECD, but unilaterally (and massively) used in national practice, might result in double or triple ring-fences. Equalization levies targeted to specific digital services rendered by "digital giants" is a case in point.

3. A stand-alone, gross-basis final WHT on services in B2B contexts would be self-enforcing if the deduction of payments to non-residents for services is made conditional on the effective withholding. This easiness for compliance and enforcement is particularly fitting for a solution intended to meet the needs of the 139 jurisdictions currently integrating the BEPS Inclusive Framework whose Tax Administrations often lack the resources to properly deal with more sophisticated alternatives. Indeed, other proposals such as the Virtual PE have been harshly criticized for generating significant challenges with regard to compliance and enforcement, inasmuch as the State in which the PE is located should become aware that a non-resident taxpayer effectively exceeds the threshold(s) upon which the existence of the PE is based and assess the income generated and attributable to that PE. Recently proposed alternatives, such as revised profit allocation rules outlined in the 2019 Public Consultation, seem to be well aware of these difficulties and therefore point to formulaic solutions. However, as summarized by Barry Larking[5], inaccuracy and unfairness of mechanical solutions and infeasibility of the residual profit split method to allocate market taxing rights are two of the ten most frequently commented issues by stakeholders on the OECD´s digital tax consultation.

Notwithstanding, it also has to be admitted that our WHT proposal is not a panacea. Taxation of gross income regardless expenses incurred is probably the feature at which its opponents focus the most in. There is no doubt that the existence of differing profit margins among industries and business settings imply that taxation on gross basis would lead to unequal results. However, the importance of this problem should perhaps be tempered. In the first place, it has to be borne in mind that, even though providing services in the digitalized economy may require substantial initial investment, rendering subsequent services frequently requires limited marginal costs. Additionally, much of the criticism is based upon the vexing myth that a WHT on services would not be creditable in the residence State. However, it seems clear that in a treaty context – of course, if the treaty provides for source taxation of cross-border services – the tax withheld at source would be credited against taxes due in the residence state. Although this would depend on its domestic regulations, in a non-treaty context, the tax withheld at source would be creditable in the residence state according to its unilateral foreign tax credit method when existent. It is true that a credit in the residence State would be of little help for loss making companies, but if source or residence States are seriously concerned about this issue, they could always relieve these adverse effects by means of targeted measures such as special rules for start-ups, loss-making and low-margin companies and obviously by removing any legal obstacle for the deduction of foreign tax credits.

Overall, the goal of this post was for the reader i) to notice that not all WHT have the same impact or same shortcomings with regard to the taxation of the digitalized economy; ii) to understand that if some runners (Virtual PE/WHT/Equalization Levies) start the marathon at the start and others (Pillars one or two) incorporate at kilometre 30, there is no guarantee whatsoever that the best will win in the end; and iii) to feel tempted to read our fully fledged proposal[6] as to review in-depth arguments and engage in a deeper, more elaborated discussion on a subject matter that should not be ignored only because the OECD decided so.

References

[1] 2014 Interim Report, 2015 Final Report, 2017 Call for Input, 2018 Interim Report, 2019 Policy Note and 2019 Public Consultation.

[2] See our criticism to OECD, EU or pure unilateral "equalization levies" as the worse option contained in 2015 Final Report: Báez Moreno, Andrés; Brauner, Yariv. *Tax Policy for the Digitalized Economy under Bejamin Franklin's Rule for Decision Making.* /In/ Tax and the Digital Economy. Challenges and Proposals for Reform (W. Haslehner, G Kofler, K. Pantazatou, A. Rust eds.) Alphen aan den Rijn: Wolters Kluwers, 2019, pp. 67-100.

[3] Interim Report 2018, p. 134; 139-140.

[4] The advantages of the proposed model against other potential or existing WHT regimes are considered in detail in: Báez Moreno, Andrés; Brauner, Yariv. *Tax Policy…op. cit.* pp. 77-82.

[5] Larking, Barry. *OECD Weighing Extensive Input on Digital Economy.* /In/ Tax Notes International, May 6, 2019.

[6] Initially presented in: Báez Moreno, Andrés; Brauner, Yariv. *Withholding Taxes in the Service of BEPS Action 1: Address the Tax Challenges of the Digital Economy*. /In/ White Papers Series, IBFD, 2015 and later fine tuned in: Báez Moreno, Andrés; Brauner, Yariv. *Tax Policy for the Digitalized Economy…op. cit.* and Báez Moreno, Andrés; Brauner, Yariv. *Taxing the Digital Economy post BEPS…Seriously*. /In/ https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3347503.

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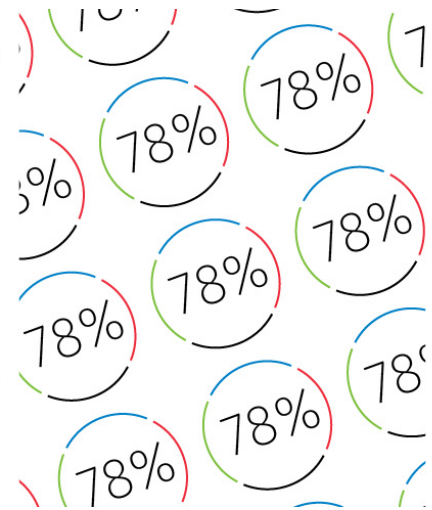

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