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Withholding Taxes in the Service of BEPS Action 1: Address the Tax Challenges of the Digital Economy

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ABSTRACT:

This position paper provides possible solutions to the challenges presented to the international tax regime by the digital economy. It considers the option of installing a broad withholding mechanism based upon the base erosion principle both as a primary response to these challenges or in support of a new nexus-based solution.

Executive Summary

This position paper of the IBFD Academic Task Force (hereinafter IBFD Task Force) relates to the OECD's work on BEPS Action 1 and is devoted to withholding tax aspects. It provides possible solutions to the challenges presented to the international tax regime by the digital economy. This paper considers both the option of installing a withholding tax mechanism as the primary response to these challenges and the option of using withholding taxes in support of a nexus-based solution of the kind explored by a companion position paper authored by P. Hongler and P. Pistone (hereinafter Hongler & Pistone Paper).

The IBFD Task Force views the nexus-based solution as superior to the withholding tax solution proposed herein since it better fits the system in place and therefore it is both more consistent with the OECD's conservative evolutionary approach to the matter (it is likely to be more efficient, i.e. less wasteful) and it would likely be easier to fine-tune in order to reach a stable balance between source and residence taxation.

The two key issues addressed by this position paper, as well as the entire BEPS Project, are (i) under-taxation of so-called stateless income and (ii) an unacceptable division of tax revenues (collected from the digital economy) that leaves source jurisdictions wanting. These are two distinct issues and a solution to one may negatively impact the other. We therefore chose to, first, address the former, emphasizing the negation of base erosion and, second, correct for the latter, providing mechanisms to further correct if necessary.

Consequently, we propose the design of a globally standard 10% final withholding tax on all base-eroding business payments to registered non-residents, with specific, again globally standard, exemptions to payees registered to be taxed under a net taxation scheme. Such net taxation scheme may be a nexus-based solution or an elective scheme to avoid the withholding tax proposed here. This proposal depends on a reliable, globally standard, quick, cheap and automatically shared registration system shared by at least the major economies, such as the BEPS countries.

Other exemptions may also be standardized for payments subject to in-place withholding schemes (e.g. employment), to non-base-eroding payments (e.g. dividends) and to non-digital goods and services (e.g. material, rents and services performed by humans on the ground).

Payments to unregistered payees will be subject to a higher 15% withholding tax. These would include payments to accounts in or owned by low- or no-tax jurisdictions (say, a 15% general corporate tax threshold). This tax may be non-final and partially refundable upon filing.

B2C transactions should initially be exempt as non-base eroding. Yet, if countries are already concerned with the revenue division implications of such a decision, a complimentary final withholding tax of 15% could be collected on all payments cleared by financial institutions, unless the payees register to be taxed under any net taxation scheme. Strict regulation and international cooperation are crucial for this solution to work.

C2C transactions do not necessitate a distinct taxing scheme.

The withholding tax scheme is not perfect; however, in the case that countries cannot reach agreement on a nexus-based scheme it permits a simple, if crude, response to the challenges of the digital economy. As such, however, it requires monitoring and perhaps tweaking over time. Therefore, the scheme should be accompanied by a review mechanism.

The proposed solution does not directly employ a definition of the digital economy, on which it is notoriously difficult to achieve a consensus. Nevertheless, if countries insist on basing a withholding tax on a legal definition, this paper offers to follow a functional definition that, similarly to the whole withholding tax solution, although not perfect, could cover most of the bases at this time. We view this option as the least desirable of the solutions mentioned in this paper.

Lastly, the proposal raises several potential interactions with related BEPS matters. Most directly, the VAT response to the challenges of the digital economy may well correspond to our proposal, especially in the need for a coordinated, standard registration-based response. One should bear in mind, however, the tax mix implications. Furthermore, the multilateral instrument (Action 15) may be used for efficient standardization of the solution. Advances in reporting (e.g. CbC) and automatic information exchange, as well as all monitoring aspects (Actions 11-13) also fit well with the necessary review mechanism. The treatment of capital income is left to other Actions (2-6).

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The IBFD Task Force generally views the latter (nexus-based) solution as superior to a withholding-based solution explored in this paper, as explained here and in the Hongler & Pistone Paper. We nonetheless elaborate on the withholding option to permit a comprehensive discourse of the merits and challenges that the various options present and to allow flexibility in the process of building a political consensus around a collaborative effort to tackle the challenges presented to the international tax regime by the digital economy. As explained below, we think that the latter, alternative solution is superior to no action, since such omission to act would result in uncoordinated responses taken unilaterally by different countries. The experience of BEPS teaches us that this outcome is clearly undesirable.

1. Introduction

1.1. Source taxation

The challenges presented by the digital economy to the international tax regime are not really new. Globalization at the turn of the millennium amended global business in now well-known (and profound) manners that could not be seamlessly tackled by the acceptable norms. Remote, cross-border business has been reformulated repeatedly throughout the 20th century (and on to the 21st). From radio waves to satellite-remitted content, from distant catalogue sales to electronic commerce, the fundamental physical presence requirement for tax jurisdiction has become increasingly anachronistic.

To date, the instinctive response to these challenges had been not to revise the rules to adapt to the new business environment but rather to tweak their application based on the principles of which these rules have been derived. Physical presence evolved as the primary trigger for tax jurisdiction as it, and more specifically its permanent establishment (PE) articulation, represented a *fair and legitimate compromise between source and residence claims* for tax jurisdiction. Put simply, a source country may only tax a foreign person if such person participates to a significant extent in its economy – and only to the extent of such participation – with PE-type physical presence being an acceptable proxy for such sufficient participation. Questions then arose whether catalogues replacing on-the-ground sales persons or (later on) computer servers could trigger PE treatment. Countries have tried to massage the physical presence rules to also include things beyond flesh-and-blood and brick-and-mortar. However, perhaps because of the pace of progress in the development of the digital economy these attempts are now acknowledged as insufficient. Income generated by the digital economy increasingly escapes taxation and to a larger extent escapes taxation at its source.

These two outcomes are distinguishable and hence should be tackled in turn, and perhaps differently. First, the latter is not so obvious a problem. Viewed narrowly from the perspective of the current norms governing the international tax regime, source taxation is not warranted in most cases of the digital economy since its principal participation in the source economy is supplying goods and services to local customers, and such participation is not sufficient to constitute source taxation jurisdiction. Yet, source jurisdictions now claim that the mere volume and importance of the digital economy and the flexibility of its business models increasingly permit operation in a manner that avoids source taxation. This claim may take two slightly different forms: it may be a claim by a developing, including emerging, economy that such development is unfair since it accelerates the wealth transfer from developing to developed countries, and it may also take the form that such development has so fundamentally altered the global economy that it left the current compromise (based on physical presence) inappropriate as it is no longer viewed as a fair and legitimate balance between source and residence taxation. Regardless, it is clear that the BEPS project must consider these claims to *accommodate "more" source taxation* – particularly of income generated by the digital economy - based on both theoretical and political grounds.

Second, it is clear that the digital economy's escaping taxation as *stateless income* or in so-called *double non-taxation* is not acceptable and as such it is the *primary target of the BEPS Project*. Furthermore, taxing this income resolves only part of the problem; one must also determine who should tax, or more accurately who should enjoy, the proceeds of the taxation of the digital economy, causing us to again consider the fairness and legitimacy issue described above.

Lastly, this discussion assumes the existence of clear source and residence jurisdictions based on the old paradigm, yet source, always an elusive legal concept, is particularly hard, perhaps impossible, to determine in the context of the digital economy. As such, however, it could be viewed from an instrumental perspective and be connected to the market concept explained in the Hongler & Pistone Paper. The present paper follows that approach.

The BEPS Project has decided to take a conservative yet evolutionary approach, working toward increasing source taxation, yet keeping the fundamental structure of the international tax regime intact, including the reliance on the residence versus source paradigm, a balancing PE-style threshold for business taxation (at source) and consequently the retention of the source concept. The IBFD Task Force treats these as given, leaving the question of their challenge to another occasion.[1]

1.2. Basic premises

The above analysis means that the physical presence rules require reformulation. The most obvious way of doing that would be to effectively lower the PE threshold with particular attention to digital economy cases. This is also the approach preferred by the IBFD Task Force and this approach is elaborated on in the Hongler & Pistone Paper. The present paper explores an alternative approach or, alternatively, a complementary implementation of the PE approach described above, using a withholding tax mechanism. The paper generally supports the OECD's conservative evolutionary approach so long as it keeps the principle of a fair and legitimate division of taxing jurisdictions intact. Therefore, our solutions do not divert from

1 This is therefore not a normative paper, but rather a paper that strives to contribute to a sound design of a withholding tax mechanism once a political decision to pursue it was made.

the source/residence dichotomy; they assume the retention of corporate income taxation and do not consider general formulary taxation as it is beyond the scope of the BEPS Project.

The withholding tax solution is a second-order alternative to a nexus-based solution (digital PE), yet it is feasible and worthwhile even if it cannot by itself solve all the issues raised by the digital economy. In that respect, we submit to a pragmatic approach that prefers an incomplete solution to no change.

We further make a few technical assumptions: first, based on past experience we assume that the withholding tax should generally not be collected by end consumers; second, it is undesirable and probably not feasible to shift to a source of payment system acceptable in some countries with strict currency controls; third, as elaborated on below, a straightforward definition of payments for digital goods and services should not be expected and therefore alternative schemes should be devised; and fourth, simple recharacterization schemes, such as automatic recharacterization of all digital payments to royalties, should be rejected since they are likely to result in more rather than less inefficient tax planning on the one hand and in undisciplined enforcement by taxing authorities on the other hand.

In our opinion, the primary target for a withholding tax should be base-eroding payments (deductible payments, COGS, etc.). Complementarily, payments to low- or no-tax jurisdictions must be specifically addressed in concert by the productive countries.

The standard withholding tax should not be overly high as to limit cross-border business or create too large an incentive for evasion, yet it cannot be too low and as such converted into an elective "toll charge". The withholding tax should possibly be final, yet an option to register and file for net taxation should always be permitted. It may also be useful to negotiate a *de minimis* rule, possibly conditioned on simple filing. The possibility of failure of the collaborative effort should be taken into account. If so, and as this is a discussion of revenue sharing, one may think about an alternative mechanism based on clearing, either at the source or the residence country level or both. Conversely, a withholding mechanism is probably incompatible with complex, multi-country situations and therefore may only be fathomed in the framework of the current international tax regime.

The interaction between consumption taxes and the withholding tax should be considered as well. This may need to take place in the longer term as such a discussion is not normally an inherent part of the international tax policy discourse. Nevertheless, this discussion may prove to be important if it were found that certain taxes work significantly better than others in the digital economy.

1.3. Why then withholding?

The logic behind a withholding approach would be that a nexus-based approach may fail once its direct reliance on actual physical presence is broken. The difficulties faced by the agency PE and service PE concepts are indicative of the difficulty in establishing the even more innovative digital PE notion. Moreover, expansion of PE taxation to digital transactions may raise the question of the logic and desirability of using different PE thresholds in different industries. This question is particularly acute once the OECD has decided that it would not "ring-fence" the digital economy. Furthermore, even if a nexus-based approach is taken, one must discuss its implementation. The difficulty of simply attributing profits to a non-physical PE and the opposition of the OECD to formulary taxation (which is, again, taken as a given, leaving its assessment to another occasion), may require a remedial tool, such as a withholding tax to adequately implement the nexus-based approach in the digital economy.

This paper therefore proposes the design of a globally standard 10% final withholding tax on all base-eroding payments to non-residents, with specific, again globally standard, exemptions to payees registered to be taxed under a net taxation scheme (under a nexus solution or independently of it). Other exemptions may be standardized, such as for payments in connection with employment. Yet other exemptions - payments for inputs beyond the digital economy – may either be standardized or left to separate negotiations; however, one could easily think of some basic examples: rents, business equipment, interest paid to registered financial institutions, etc.

The 10% level is of course not set in stone, yet there are good reasons not to have the rate too low or too high. Such reasons do not apply to payments to accounts in or owned by low- or no-tax jurisdictions (say, a 15% general corporate tax threshold). Therefore, the paper proposes to employ an increased rate of 15% or more to such payments. This withholding tax may be designed as a non-final tax, leaving the option of registration and filing a return for a refund of the increased portion.

A complimentary final withholding tax of 15% will be collected on all payments cleared by financial institutions, including credit card companies, to non-residents, unless the payees register to be taxed under a net taxation scheme (under a nexus solution or independently).

Last but not least: a review mechanism to study the shift of tax revenues among jurisdictions and the compliance costs and patterns should be established on a bilateral or multilateral basis to examine the effects of the regime and consider the necessity of a clearing mechanism to balance such effects on the revenues collected by the relevant countries.

This proposal is not perfect, but it is based on the assumptions made and the approach taken by the BEPS Project, and assuming that a nexus-based approach is rejected, we believe that it presents a realistic and balanced solution that is capable of being implemented and stable, and hence desirable under the circumstances. It is particularly desirable if one realizes that a failure to deliver a standard solution under BEPS Action 1 is likely to result in a mix of unilateral responses by different countries. We have already seen some countries experimenting with digital PE rules and others are likely to resort to some sort of withholding in an attempt not to be left out of the revenue-making opportunities that the political climate surrounding the BEPS Project may project. Nonetheless, if BEPS teaches us any lesson, it is that uncoordinated policy responses are undesirable.

The rest of this paper is organized as follows: section 2 briefly discusses the theoretical foundation and the source versus residence paradigm. Section 3 focuses on a definition of the digital economy and related transactions that may be subject to the said withholding taxes. This section questions the efficacy of using such a definition and the possibility of avoiding it. In a natural tax law progression, once qualification and source are discussed it is possible to turn to the taxing rules. Section 4 contains the heart of the proposal made by this position paper: the imposition of a withholding tax on digital transactions. This section is divided into separate subsections: for B2B, B2C, and other transactions, based on the conclusion established in this section that these different business models present distinct issues that require distinct solutions. Section 5 deals with the technical aspects of withholding taxes, including particularly the distinction between using the withholding tax as a primary solution or as a collection mechanism in the service of a nexus-based solution as advocated by the Hongler & Pistone Paper. Section 5 discusses the interaction between a withholding mechanism and VAT responses to the digital economy – in itself an issue raised by BEPS Action 1. In particular, this section points to the similarity of challenges that VAT and the corporate tax are facing in light of the digital economy, the compatibility of solutions based on both these taxes and the question of the tax mix, or the necessity of solutions based on both of these taxes rather than, for instance, just one of them. The Appendix puts the analysis and proposals made by this paper into practice by examining them on a set of examples developed for both of the IBFD Task Force's papers. It applies the withholding tax proposals to the same examples to which the Hongler & Pistone Paper applies the nexus-based solution.

2. Theoretical Foundations, Source and Residence

Recent academic work has significantly discouraged deep theoretical research on the fair allocation of taxing rights based upon the traditional dichotomy of source and residence inspiring the current international tax regime. Against this background, a further inquiry into the theoretical foundations for (source) taxation of transactions related to the digital economy may be deemed useless. Translating this general idea to the specific area of the digital economy, in the words of Professor Schön:[2]

> [T]he outcome of the game is truly open and one should not look for the holy grail of a "natural" allocation of taxing rights [related to income generated by the digital economy]. "Perhaps the most fundamental rule of international taxation is" – as Bird and Wilkie have put it – "that there are no rules of international taxation."

This might be the primary reason why, despite significant academic work on international taxation of the digital economy, traditional tax policy principles underlying source taxation have not been systematically confronted with this new reality.[3]

Nevertheless, this does not mean that the pursuit of a general principle upon which basing source taxation of transactions related to the digital economy remains a useless practical exercise. In our view, this effort might have two decisive advantages:[4]

(1) It might well help in the design and justification of the distributive rules (in our case withholding tax dealing with the new international tax rules for digital transactions). As stated previously, what might be taxed – either in an international or a pure domestic context - is a rather artificial and arbitrary decision. But once a taxable event has been selected, further details of the created tax liability can or (must) be construed in line with the initial decision.[5] This reflection might bear interesting fruits in our research as regards several specific issues, particularly in the difficult problem of source taxation of B2C transactions.

(2) If the selected technical grounds are properly designed, it might serve the principle of legal certainty. Instead of further research on fair allocation of taxing rights, emphasis should be placed upon finding a proper technical basis from which certain and enforceable rules might be deducted. In our view, this result may be reached if the selected basis works in a discrete (non-continuous) way. We mean thereby that the concurrence of the basis for taxation might be clearly answered with a yes or a no, triggering source taxation only in the first case. Gradual backgrounds always generate

2 W. Schön, *International Tax Coordination for a Second-Best World (Part I)*, 1 World Tax J. 1, sec. 3.3.1.4. (2009), Journals IBFD.

3 There are of course significant exceptions: D. Pinto, *E-Commerce and Source-Based Income Taxation* ch. 2 (IBFD 2003), Online Books IBFD; but with this rather inexpressive conclusion (sec. 2.3.): "After analysing the basis for each of these principles and how they justify source-based taxation in a traditional context, it has been argued that they remain applicable in an electronic commerce environment, thereby establishing the first argument of the thesis that source-based taxation of electronic commerce transactions is theoretically justifiable. It therefore follows that source-based taxation should continue to apply in an electronic commerce context".

4 Not the very justification of source taxation, in our opinion.

5 As stated by German scholars and significant case law of the German Constitutional Court, while the selection of a taxable event is a rather arbitrary decision, the legislator has the burden of a consequent implementation of its initial taxing decision (*Folgerichtigkeitsgebot*).

complex interpretation issues and, if the rules dealing with the taxable base are not properly designed, generate a significant risk of inconsequent taxation.

It is our view that the background that meets at the same time all the above-mentioned requisites is the erosion of the tax base of source countries. We do not mean thereby the undermining of a previous fair level of source taxation, in the sense normally used by the BEPS Project,[6] but rather the fact that income derived by non-residents might be deductible against the tax base of the source country (base erosion principle).[7] As stated, this background allows consistent construction of detailed rules in reference to the new withholding tax regime (gross or net taxation, taxation of B2C transactions, sourcing rules, etc.) and, if combined with a proper definition of "withholdable digital transaction",[8] increases the legal certainty required to avoid under- or over-withholding. The less accurately this definition is drafted, the more necessary this underlying background will be for a proper and certain interpretation of the scope of the new withholding tax.[9]

The base erosion principle has frequently been criticized as an insufficient link to justify source taxation by itself.[10] As mentioned previously, other, more sophisticated theoretical backgrounds, such as, for example, the benefit theory, have not proven more efficient in the search for a fair allocation of taxing rights to the source state.[11] And what is even worse in our opinion is that the election of the benefit theory, if followed by a new definition of the PE nexus, might lead to an incoherent development of the theoretical starting point. The profit as taxable base bears no relation to the use of public goods by non-resident taxpayers;[12] in a nutshell, the benefit theory and profit taxation, under whatever PE design, embody a *contradictio in terminis*.[13]

In our opinion, and particularly in the context of the BEPS Project, there is no need to further research the justification for source taxation. Source taxation might be justified by itself as a proper means to fight double non-taxation.[14] Instead of looking for evanescent backgrounds, policy options should instead focus on a simple, certain, useful and enforceable technical starting point.

6 As Arnold puts it, "[T]he OECD BEPS action plan does not identify the provision of services as a means of eroding the tax base of countries that requires action" (B.J. Arnold, *The Taxation of Income from Services*, in *Papers on Selected Topics in Protecting the Tax Base of Developing Countries*, Draft Paper No. 2, May 2013; http://www.un.org/esa/ffd/wp-content/uploads/2014/10/20140604_Paper2_Arnold.pdf (accessed 26 Jan. 2015)).

7 B.J. Arnold, *The Taxation of Income from Services under Tax Treaties: Cleaning Up the Mess – Expanded Version*, 65 Bull. Intl. Taxn. 2, sec. 3.1.5. (2011), Journals IBFD.

8 As the one contained in section 2. of this position paper.

9 This necessity becomes dramatic if the withholding tax is only based upon the so-called "base erosion approach" *i.e.* if a payment is withholdable just as a consequence of eroding the tax base of the source country by being either deductible by a source country purchaser or if it forms part of its cost of goods sold (R. Doernberg & L. Hinnekens, *Electronic Commerce and International Taxation* p. 315 (Kluwer Law International 1999); R. Doernberg, *Electronic Commerce and International Tax Sharing*, 16 Tax Notes International, p. 1013 (1998).

10 E.g. *see* Arnold labelling the base erosion principle as a "subsidiary principle" that may justify a lower threshold for source country taxation of income (Arnold, *supra* n.8, at 66).

11 In this respect, *see* the hard-hitting critique of Prof. Schön, *supra* n. 2.

12 R. A. Green, *The Future of Source Based-Taxation of the Income of Multinational Enterprises*, 79 Cornell L. Rev. 18, p. 29 (1993); C.E. McLure, *Source-Based Taxation and Alternatives to the Concept of Permanent Establishment*, in *2000 World Tax Conference Report*, at 6:3, 6:4.

13 The (constitutional) problems of profit – or, more in general, ability to pay – considerations in taxes or fees theoretically based upon the benefit principle have been considered elsewhere: A. Báez, *Las tasas y los criterios de justicia en los ingresos públicos: una depuración adicional del ámbito de aplicación del principio de capacidad contributiva*, 144 Revista Española de Derecho Financiero, pp. 953-969 (2009).

14 For evident reasons, resident taxation is ill equipped to deal with the problem. Whether or not BEPS Action 3 will change this situation is still very much in the open. In any case, the outlook is not particularly encouraging as the problem seems to have its origin elsewhere (*see* Y. Brauner, *BEPS: An Interim Valuation*, 6 World Tax J. 1, para. (4) (2014), Journals IBFD.

Lastly, there is a practical idea that can also serve to justify the base erosion principle as a theoretical justification for source taxation (in the field of the digital economy). The most recent and relevant initiative of the UN Committee of Experts on International Cooperation in Tax Matters consists precisely in a new withholding tax obligation on technical services built upon the base erosion principle.[15] A solution based upon this rationale might therefore avoid a progressive gap between the OECD and the UN Models or, in other words, enhance the possibilities of effective incorporation of developing countries to a new consensus.

3. Definition Issues

The digital economy presents one of (if not *the*) most direct challenge to the international tax regime, pressing on its weakest point – the not-so-seamless interaction of its economic and legal roots. On the one hand, efficiency and neutrality seem to require that income generated by the digital economy be taxed in the same manner as income generated by more traditional means. The OECD decision not to "ring-fence" the digital economy follows this logic, as well as the administrative concern regarding the possibility of enforcement of the boundaries between the digital and non-digital economies. However, administrative concerns, or even certainty about the difficulties of applying the current rules to the digital economy, made this an issue in the first place. The former round of debate focused on e-commerce, ending with a conservative resolution: to better and more flexibly apply the old rules to the new reality. This attempt has garnered unsatisfactory results that led us to the current round of discussions.

Consequently, it is understood that a better-tailored solution is required for the challenges presented by the digital economy, yet one that would not "ring-fence" it. In simple terms, this means that *the same taxing principles and standards should apply to the whole economy*, yet it is possible that special derivative rules will apply separately to the digital economy.

The most obvious next step would be to define the digital economy or income generated by the digital economy (as we focus in this paper on income taxation) so that we can begin to think about the appropriate rules that should apply to it exclusively. Next, this section seeks such a definition, but we do so mindful of the possibility of avoiding the pitfalls of legal definitions through alternative rules. Our preference, as already mentioned, is *not to resort to measures that rely on a legal definition* of the digital economy for both theoretical and practical reasons. This section, however, discusses this inferior option in order to explain our preference to avoid a legal definition and the difficulties that adopting a definition based approach may present.

3.1. Defining the digital economy

The BEPS Action 1 discussion draft does not define the digital economy. Reading most of the work on this topic, one gets the impression that the preferred approach is to use a mechanism of the "smell test" sort to identify digital economy issues. This may be useful, especially in a preliminary investigative stage such as the one in which the BEPS Project is currently engaged; however, it would be problematic if one were to impose a withholding tax on payments related to digital transactions. An important observation in this context is that withholding taxes are potentially useful in very specific circumstances. A key requirement for the success of a withholding tax mechanism is a reasonably clearly defined target or payment.

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15 Note from the Coordinator of the Subcommittee on Tax Treatments of Services: Draft Article and Commentary on Technical Services, E/C.18/2014/CRP.8, p. 6. Arnold, *supra* n. 7, at 3.

A reasonably clearly defined target or payment is required because otherwise withholding agents, upon whom compliance with the rules is critical to their efficacy, are unlikely to act optimally. They may over-withhold simply to relieve themselves of any potential liability. Such behaviour would result in an undue hardship for investors and thereby hinder the digital economy, which is clearly something the OECD is careful not to do. Withholding agents might also under-withhold, succumbing to pressure applied by the taxpayer based on the vagueness of the definition, naturally defeating the purpose of the rule. Therefore, *for a definition to be useful, it needs to be reasonably clear*.

The definition must also be *standard*. The core of the current difficulties faced by the international tax regime, leading to the BEPS Project, was the variety of different, uncoordinated domestic law responses to the same international tax issues. Furthermore, the definition must *correspond to the purpose* of the rule using the definition – the imposition of a withholding tax mechanism. It would therefore be futile, for example, to rely on a generally accurate, dictionary-style definition if it cannot be appropriately used to identify when one should or should not withhold. These three conditions seem obvious, yet a quick review of the literature on the taxation of the digital economy reveals that little attention was paid to them in recent years.

The term "digital economy" is often traced to a 1997 book title,[16] yet *a useful, universal legal definition has yet to be produced* (by that book or elsewhere). In an often cited work, Australia defined the digital economy as "the global network of economic and social activities that are enabled by platforms such as the Internet, mobile and sensor networks."[17] This is an example of a rather useful dictionary definition that cannot be used for our purposes. One could imagine a paraphrase of such definition such as "all payments in connection with economic and social activities that are enabled by platforms such as the Internet, mobile and sensor networks." The problem with this definition is that it is probably both over- and under-inclusive. A lot of payments, perhaps even the majority of business payments, relate in some way or other to digital economy networks and it may be difficult to determine when this relation is sufficient to mandate withholding. Moreover, payments are often made with remote connection to digital products but with immediate connection to non-digital products in circumstances where the payor (and definitely the payee) are unaware of the connection. Such circumstances may indicate an appropriate circumstance for non-withholding yet it would be difficult to draw the line here and to distinguish true and merely declared ignorance in these cases.

The definition may be under-inclusive since it mentions particular platforms that may not be exhaustive even at present and are unlikely to be so in future. The use of non-exclusive language ("such as") provides little remedy because it is too general and likely to end up being too vague and useless again. Other proposals do not fare better.[18]

Unable to satisfactorily define the digital economy, *one may limit the definition to its most important applications*. Indeed, to date, most of the work in this context had been done on electronic commerce. Alas, that work focused on the redefinition of the PE notion to include

16 D. Tapscott, *The Digital Economy: Promise and Peril in the Age of Networked Intelligence* (McGraw-Hill 1997).

17 Australian Government, Department of Broadband, Communications and the Digital Economy, What is the digital economy?; available at: http://www.dbcde.gov.au/digital_economy/what_is_the_digital_economy [Accessed 9 July 2012]. Cited by J. Li, *Protecting the Tax Base in the Digital Economy*, *Papers on Selected Topics in Protecting the Tax Base of Developing Countries*, Draft Paper No. 9, June 2014: http://www.un.org/esa/ffd/tax/2014TBP/Paper9_Li.pdf (accessed 1 Nov. 2014).

18 E.g. *see* the OECD definition from 2012: "The digital economy is comprised of markets based on digital technologies that facilitate the trade of goods and services through e-commerce"; http://www.oecd.org/daf/competition/The-Digital-Economy-2012.pdf, p. 5.

digital presence. Such redefinition is not helpful for the purposes of this paper if we wish to use such definition to impose a withholding tax.

In 2011, the OECD came up with: "An electronic transaction is the sale or purchase of goods or services, conducted over computer networks by methods specifically designed for the purpose of receiving or placing of orders."[19] This definition is too limited since it does not adequately address digital goods and services.

Many experts have written about the difficulty of separating the digital economy from the rest of the economy. Add to that the pace of progress of this economy and it is easy to understand why there is a lack of consensus about its definition. We therefore propose a pragmatic approach. First, we would prefer to avoid the need to use a definition, as explained elsewhere in this paper. Second, if necessary, we would prefer an instrumental definition that would emphasize precision, even at the expense of limiting the scope. Lastly, following an instrumental and pragmatic approach, we would prefer the use of specific platforms, with the understanding that the evolution of the digital economy may quickly make these platforms obsolete. A mechanism to update and improve the definition would have to be put in place to make it workable and address this issue in future.

Paraphrasing on the above examples, this definition might read as follows: "A withholdable digital transaction is the sale or purchase of goods or services of any type, conducted over computer networks or effected over platforms such as the Internet, mobile and sensor networks." The definition is possibly still over-inclusive, yet that could be corrected, if desired, by exempting particular taxpayers or industries that do not present tax avoidance risks.

4. Withholding on Digital Transactions

One cannot simply take a general decision to impose a withholding tax on digital transactions. Even beyond the definitional issues explored above, one should consider both the conceptual and practical aspects of an imposition of the tax. Digital transactions take different forms and follow different business models and, accordingly, may be affected differently by the tax. Most obvious is the difference between B2B and B2C transactions. We know from early experiences with electronic commerce taxation that imposing a withholding obligation on consumers has not been successful. Similarly, in the VAT context, reverse charging obligations have not been particularly effective. Nonetheless, similar obligations work much more effectively in a pure business environment. Since we know that *B2B transactions overwhelmingly dominate the digital economy*, a reasonable and expected conclusion would be to try and *distinguish between the taxing mechanisms applicable to B2B and B2C transactions and focus on the former rather than the latter*. This section therefore begins with a discussion of the merits of such an approach, dealing solely with B2B transactions, followed by a separate discussion devoted to B2C and C2C. Lastly, for completeness, the option (inferior to the above in our opinion) of applying a single withholding tax to all digital transactions is discussed.

4.1. B2B

The business-to-business model dominates the digital economy. It is therefore natural to focus on it when one attempts to tackle the challenges presented by the digital economy. Moreover, it is business taxation and more particularly the corporate tax base that is the main

19 *See* OECD, *Guide to Measuring the Information Society*, p. 72 (2011).

focus of the BEPS Project. It follows that B2B should be its focus in this context. Of course, B2C transactions also generate income potentially subject to corporate taxation; however, beyond its smaller volume, it involves other regulatory control mechanisms, such as the involvement of fairly disinterested financial institutions (mainly banks and credit card companies) or of consumption taxes and tax authorities, and therefore presents a different – we dare say a lesser – problem, even if perhaps more costly per tax dollar collected. The first question would then be whether one could distinguish between B2B and B2C (leaving the other formats aside for now) to make this approach workable. We believe that the answer to that question must be affirmative. The current tax rules require business enterprises to register as such in most countries, obtaining one form of a taxpayer identification number and status or another that identifies them as such. Similarly, consumption taxes, such as VAT, that present similar needs to distinguish businesses from consumers also make such requirements. Indeed, the current rules do not work perfectly in this regard, yet one could be creative with incentives to encourage compliance, particularly in the context of the digital economy tax we propose, as elaborated below. Moreover, registration of digital businesses participating in a country's economy would be practically necessary under both the PE and the withholding tax solutions, and therefore does not present a particular disadvantage to the withholding approach. We conclude that both the different and rather non-substitutable business models and the already existing registration requirements make the *distinction between B2B and B2c non-problematic*.

Our proposal is therefore that every business-deductible payment[20] would be subject to the withholding tax suggested unless a qualified exemption code is presented to the payor by a registered person. Examples for this latter occasion could include:

(a) an employee (obviously registered as such with the payor) receiving wages;

(b) a payment for material identified as non-digital (and therefore exempt as such if the countries wish to continue this practice) by a specific customs code, made to a qualified company, a qualified company may be registered as not having a PE, having a normal PE or as having a digital PE under the nexus-based scheme developed by the Hongler & Pistone Paper; and

(c) a payment for services provided by a business that does not qualify for the service PE or the digital PE status, as the case may be, or for services not attributable to such PEs provided by a registered business.

Note that this withholding tax may operate as a collection mechanism for the nexus-based solution explained by the Hongler & Pistone Paper (and as such it may be final or not with a requirement for a corresponding double tax relief mechanism), as a complementary measure or a backstop to such a solution, or as a stand-alone solution. The latter case means that a digital PE is not implemented, which would then require an *independent registration apparatus*. Such an apparatus should operate along the same lines of the PE threshold developed by the Hongler & Pistone Paper, yet it could also be simpler, even to the extent of requiring all payees to acquire a status with tax authorities in connection with which they receive business payments.

One may view this requirement as onerous, and indeed it should be designed carefully to minimize the burden on business, yet it is essential if a withholding tax approach is to be given any chance of success. We think that there are good reasons to believe that the

20 E.g. the payment of a non-deductible payment of dividends to a shareholder that is obviously registered with the company as such would not be subject to this withholding tax, although one may contemplate folding these payments into this regime as well.

registration apparatus can be designed and implemented with very little real burden on business. First, the standardization of taxpayer identification is necessary to the success of the global information exchange. The work done in this context, particularly by the global forum, should result in some sort of a system that could easily be used for the purpose of identifying businesses potentially subject to the withholding tax proposed by this paper. Such identification would then need to be associated with one of very few statuses for the purposes of the withholding tax, and provided to payors upon payment for compliance purposes. This is not much different from current practices regarding royalties, for example, and what we now call royalty payments are one of the primary targets of the withholding tax proposed herein. Again, this identification apparatus does impose an additional burden on business since such a burden may be designed to be minimal and it is likely to be the least disruptive and most effective if globally standardized. One should therefore reject opposition to the withholding tax approach based on the hardship that the registration requirement imposes on business as such and, to be clear, one should also reject any attempt to argue that the provision of the specific codes regarding status to payors for the purposes of accurately withholding may result in revelation of business secrets or similar arguments such as those made against the CbC reporting.

The withholding solution should not be technically much different if our proposal not to rely on a limited definition of withholdable digital economy payments were rejected. In that case, following our analysis in section 3., the primary burden of the withholding tax solution is effectively transferred from the taxpayers to the withholding agents – i.e. the payors. Such a solution would have an entirely different focus than that of our proposal: it would depend on the qualification of each specific transaction rather than the status of taxpayers. The withholding agents would need to make the judgement call for each payment and determine whether it is or is not subject to withholding. We believe that it is obvious that such a burden is much costlier overall than the burden of registration and provision of status codes by payees to payors, and therefore it is bound to be less efficient. Nevertheless, in the event of any doubts, this may be studied more carefully as it is eventually an empirical question. We think that such a solution is more inefficient because it is less likely to be standardized. It is reasonable to believe that different withholding agents would interpret the definition differently and, even more problematic, different countries' laws would end up interpreting the definition differently, leading to the same type of incoherence that led to the BEPS problem.

The withholding tax proposed above should generally satisfy the intention to tax income that may now entirely escape taxation. It does not necessarily satisfy, however, the intention to realign the revenue division mechanism that is at the heart of our problem. A withholding tax typically means revenue collection by the residence state of the payor (or pseudo residence state – such as in the case of PEs). This is a practical outcome that is favoured by some states (e.g. Brazil). It is presented as source taxation, coupled with a source rule that follows the residence of the payor. Nonetheless, despite the practicality of this rule it is theoretically unjustifiable. Weak as the source concept may be, it clearly cannot support a justification for tax jurisdiction based on such residence of the payor rule. This rule may not be too objectionable in closed economies and countries with very strict exchange controls such as Brazil, yet it is unfathomable in dynamic open economies. The costs of currency controls are likely to exceed the perceived certainty benefits of such systems, if any. Without strict currency controls it would be easy to circumvent these rules and they should therefore be viewed as undesirable for our purposes.

Consequently, we need to establish an alternative rule – essentially a source rule – that would ensure not only the collection of taxes but also their fair and legitimate allocation. One option may be to separate the collection from the allocation of the taxes, i.e. to establish a clearing mechanism, or formula, to allocate collected revenue from the digital withholding tax among the relevant jurisdictions. This solution will require a high level of cooperation among all important jurisdictions, well beyond what we witness today and likely beyond what we might witness in the short to medium term future, regardless of the efforts in the area taken by the BEPS Project. Formulary taxation may achieve an adequate result, yet we have seen that even in the limited circumstances of Europe a more limited proposal such as the CCCTB has not yet gained traction. Also, it seems that the BEPS Project has not acquired the taste for formulary solutions.

An alternative would be to erect a more targeted, instrumental rule that would fulfil the role of the source rule. This is easier where withholding is used in the service of a PE solution. In that case, the digital PE country is allocated the revenue properly attributed or paid to such PE. This revenue may be collected by another country – e.g. when the payor purchases a digital good or service for use in the PE country when it does not have a PE in such country itself – but in such circumstances the collection country would be considered to be assisting the PE country in the collection of revenue (say, under a provision parallel to article 27 of the OECD Model). One could think of a mechanism to compensate the collecting country for its services in such circumstances. If a PE solution is not adopted, there are still two scenarios, under the first of which the withholding tax would refer to a particular registered taxpayer in a country and hence it would not be that different from the scenario described above. A more complex scenario would occur when a payment is made and the withholding tax is collected without a strict registration of business regime (either because countries fail to establish such a regime or because certain payments are made in or with respect to activities in non-cooperative countries). In such a case it is possible to employ an apportionment rule, under which the collected revenue is shared among the countries in which the taxpayer made more than minimal profits. This may seem difficult to implement, yet not prohibitively so. The collecting country collects the revenue and is responsible to obtain information about the taxpayer, either directly (its CbC report comes to mind in this context) or via its country of residence, and then allocate the revenue among countries in which the taxpayer made significant profits (say, above 5% of total profits) on a proportional basis. There should be a default rule under which the funds remain with the collecting country subject to a notification (transparent) mechanism in cases of lack of cooperation or similar circumstances.

Our preferred solution would be to *primarily match payments with their base erosion effect.* Most commonly, that would mean match them to a deduction potentially claimed. In the more straightforward cases, and we believe in the overwhelming majority of cases, this would mean that the payor is likely to claim the deduction in its country of residence or its PE country. In both cases, it would not be complex to employ the matching rule, basically conditioning a deduction upon withholding tax collection. From a technical perspective this rule is likely to require an anti-abuse norm to prevent abusive shifting and address imperfect matching of payments and deductions (including double dips and other tax planning schemes deemed unacceptable). The more serious challenge, however, is not technical, but conceptual, as it provides a dominant destination basis for the tax, determined by the user not the provider, whereas the PE solution, for example, allocates at least some of the income away from the user – in the country of the activity, similar to the current OECD norms. An illustration may explain this difference. Assume a digital service provider located in state A with a customer located in state B. The source of payment to such service provider is difficult to determine under the current regime. This can be a rather low-tech transaction made over the phone, but the customer and the service provider are still located in two different countries when the service is provided. The current OECD policies would generally deem state A the taxing jurisdiction in this case. Our above-described preferred withholding tax solution (i.e. matching payments with base erosion effect) would clearly deem state B the taxing jurisdiction. A PE solution of the kind described in the Hongler & Pistone Paper would give state A the preference, unless the taxpayer has many clients or a large volume or value of activity in state B and then it would prefer state B. This illustration clearly explains why we view the PE solution as superior to the withholding tax solution. It is capable of balancing the claims of states A and B, and hopefully reaching a fair and legitimate division of revenue among them. The same could be achieved by a withholding mechanism, yet with much more complexity, less accurately and with a more significant departure from the current regime. We think that if a withholding solution is chosen nonetheless, a better alternative to the complexity entailed by the above would be to give preference to state B, but to significantly limit such preference. This could be done by further reducing the rate of withholding (e.g. to 7% rather than 10%) or by defining easy-to-follow circumstances under which registered taxpayers could be exempt from the withholding mechanism and given an option (and incentives) to subject themselves to net taxation in their country of registration.

Lastly, there remain pending accounting issues, such as differences in deductibility among countries, yet we chose to leave these outside the scope of this paper since they are unlikely to affect the final choice of taxing method and because we think that coordination of the tax accounting rules, if not their standardization, is an issue whatever method is chosen, including under the current regime.

4.2. B2C

Since we assume that our preferred B2B solution described above cannot simply also be employed in the case of B2C transactions (B2C transactions of the digital economy should be defined by default as opposed to B2B transactions, i.e. payments for goods or services by persons other than registered businesses), the question arises whether the scope of a new withholding tax should also cover this kind of transactions. Whether the definition of covered transactions embraces B2C transactions is of course not the core of this issue.[21] We should rather concentrate our arguments on whether or not these transactions should be covered from a policy perspective and whether the withholding tax solution works for them on a practical level. In case the selected wording covers this kind of transactions, but there are no sound reasons for it, a simple exclusion rule should be added.[22] These transactions may be taxed by other means, directly or indirectly.

According to the theoretical backgrounds described in section 2. of this paper, the answer, at least in terms of consistency, seems evident. If the rationale for source taxation and even one of the definitions previously provided for the new withholding tax are identified with the existence of base eroding payments, in the absence of deduction by the payer against his local tax base no withholding should arise. This is evident in the “base erosion approach” literature.[23]

21 E.g. it is evident that if a definition as the one described in section 2. is selected - “A withholdable digital transaction is the sale or purchase of goods or services of any type, conducted over computer networks or affected over platforms such as the Internet, mobile and sensor networks”- B2C would be covered at least at first glance.

22 The addition of the words “if the payments are made by or in the course of an enterprise” might serve this purpose. This has been the option in the recent UN proposal for the taxation of technical services in order to exclude payments made by individuals for personal consumption (*see* Note from the Coordinator of the Subcommittee on Tax Treatments of Services: Draft Article and Commentary on Technical Services, E/C.18/2014/CRP.8, p. 12).

23 When dealing with the proposal strictly for e-commerce purposes (Doernberg & Hinnekens, *supra* n. 10, at 315; Doernberg, *supra* n. 10, at 1013; Li, *supra* n. 18, at 42. Not so clear, however, in the new proposal of the UN for the taxation of technical services (Note from the Coordinator of the Subcommittee on Tax Treatments of Services: Draft Article and Commentary on Technical Services, E/C.18/2014/CRP.8, p. 12).

Apart from its consistency with the selected starting point, the exclusion of B2C transactions from the scope of the new withholding tax might have additional positive implications. There is an evident simplicity advantage derived from the fact that no withholding tax applies in cases of private consumption. A different solution might lead to tax collection problems. As stated before, compelling consumers to withhold would be logistically difficult and for this reason the BEPS Report on the Digital Economy when describing the withholding tax option states: "To avoid requiring withholding by individual consumers, one potential option to be considered would be to require withholding by the financial institutions involved with those payments."[24] This would require the involvement of financial institutions, credit card companies and online payment systems agents (such as PayPal) in the fulfilment of withholding obligations. The problem will not only be the new burden imposed on these withholding agents, but also the technical feasibility of the proposal that would require verification of several data the access to which will not always be easy even for these qualified intermediaries.[25] Nevertheless, as it has already been stressed, these withholding tax obligations currently exist in certain jurisdictions for financial intermediaries or certified tax collection agents.[26]

On the other hand, several disadvantages of the B2C exclusion can be detected. One of the most visible shortcomings of the exclusion of B2C transactions in a withholding tax option would be the loss of revenue suffered by the market (source countries) in comparison at least with the PE scheme developed by the Hongler & Pistone Paper.[27] Nevertheless, the problem might not be so worrying if we take into account that (i) from a strict quantitative point of view, B2C transactions amount to a small part of the whole digital economy[28] and (ii) the loss of revenue generated by the exclusion of B2C transactions would be compensated, at least in the perception of the market/source countries, by the increased taxation rights in relation to the digital economy compared to the current situation according to the traditional PE regime (including service PEs).[29]

The exclusion of B2C transactions has also been blamed for generating non-neutral outcomes, as far as non-resident tax payers might perform transactions for consumers in the market countries free of tax, obtaining thereby a significant competitive advantage.[30] This problem might have caused recent legislative amendments in the field of consumption taxes as refers to services rendered by non-residents to local private consumers.[31] Even if this issue cannot be ignored, its practical dimension must not be exaggerated. As stated by Doernberg, a withholding based on the principle of base erosion does not raise the overall level of taxation but is merely intended to allocate the tax base among states.[32] The income gained by the non-resident taxpayer from the transactions performed for private consumers will only be exempted in the state of source but subject to tax according to the local rate of the resident state. This might generate a problem only in cases where the taxpayer is a resident in a low-

24 OECD, *Addressing the Tax Challenges of the Digital Economy* p. 146(2014).

25 The OECD has in fact raised that question stating that if financial institutions were required to withhold the tax in lieu of withholding by individual customers, consideration should be given to how to ensure that those financial institutions could reliably determine which transactions were within scope (OECD, id., at 154).

26 W. Hellerstein, *Jurisdiction to Tax in the Digital Economy: Permanent and Other Establishments*, 68 Bull. Intl. Taxn. 6/7 sec. 4. (2014), Journals IBFD.

27 Of course, not if we compare the withholding tax solution with exclusion of B2C transactions with the current allocation of taxing rights to the market/source state under traditional PE standards.

28 According to current available data, more than 90% of e-commerce is B2B (WTO E-commerce Report). Also, according to the OECD Discussion Draft (para. 62) the vast majority of e-commerce consists of B2B transactions. To the present authors' knowledge, there are no market prediction studies in relation to this proportion.

29 Pinto, *supra* n. 3, at 186.

30 Id.

31 In fact this might have been the rationale for the progressive reform of the European VAT system as refers to digital services rendered by non-EU suppliers (2003) and EU suppliers (2015) to EU final consumers. Pinto refers to the same problem in the US sales taxes (Pinto, id.).

32 Doernberg, *supra* n. 10.

or no-tax jurisdiction; but even in this latter case, and unless we are dealing with a pure B2C firm (a company performing only or predominantly B2C transactions),[33] this lack of neutrality would be compensated by the increased tax rate proposed for payments to accounts in or owned by low- or no-tax jurisdictions.

In any case, the hypothetical lack of neutrality generated by the exclusion of B2C transactions would never achieve the current situation according to the traditional PE rules, added to the fact that in the later case this lack of neutrality is also projected on B2B transactions. Perhaps this lack of neutrality would be more accurate if we compare the withholding tax solution with a new PE nexus as proposed in the Hongler & Pistone Paper. So, being as it is true that a new nexus PE approach would not make any difference between B2C and B2B transactions, it is by no means less true that the all-or-nothing rule typical of the PE approach might also generate a significant lack of neutrality. The breach of the continuity requirement (the non-existence of a PE leads from full to none taxation), which is also present in traditional physical and personal PEs, might become even more dramatic in (new nexus) PEs where the lack of one threshold unit (day, dollar, user or consumer) might lead from full taxation of income attributable to the PE to no source taxation at all.[34]

In a nutshell, the loss of revenue for the market state and the non-significant loss of neutrality that the exclusion of B2C transactions might generate do not appear sufficient reasons to complicate the withholding mechanism generating, at the same time, an outcome that is inconsistent with the theoretical background of the proposal, at least not at the early stages of this regime.

In the case that market (source) economies would be concerned about the division of the tax base shortcomings of the non-extension of the withholding tax to B2C transactions, we see no better solution other than to impose the burden on financial institutions to collect the tax. They should then be charged with the same withholding tax obligation of 15% on payments made to non-registered payees. They will exempt payments declared by payors as exempt, such as payments on which payors have already withheld or exempted under the B2B regime. They should also be able to exempt payments from residents of countries in which the payees are registered to be taxed on a net basis. This would require allowing payees to register as B2C providers; registration that would permit them to be taxed on a net basis.[35] With respect to each of these, it would be the responsibility of the financial institutions to collect payment codes for residences of both payor and payee and corresponding registration code for the payee with the payor country of residence. Although this is not impossible, it does put an additional burden on the financial institutions that must be considered. It seems that in this case, countries should cooperatively provide some incentives to compliant financial institutions, make the automatic exchange of registration information as cheap and seamless as possible and tighten regulation of non-compliant financial institutions.

4.3. C2C transactions

This category of transactions is frequently separated from B2B and B2C and has gained significant importance in the digital economy. Nonetheless, we do not believe it merits separate treatment when it comes to the description of a new withholding tax. If we take

33 Finding pure B2C digital firms is not easy, the online gambling sector being the only clear example in this respect. Companies assisting C2C transactions might be also included in this group even if there is no impediment for these taxpayers to also perform B2B transactions.

34 On the continuity approach and avoidance of the all-or-nothing rule, *see* Schön, *supra* n. 2, at 99-101.

35 Note that this is a somewhat different regime than the PE solution explained in the Hongler & Pistone Paper, since it is a self declaration of a PE, i.e., with no necessity of testing the threshold question under article 5, only attribution under article 7, preferably based on the principles of article 7 of the OECD Model (2008).

online classifieds and auction-based sites as examples, we will be able to check the veracity of the former statement.

The Internet provides support for the performance of traditional transactions between customers that are normally dealt with by traditional tax categories. To give an example, a transaction performed via Airbnb, an online accommodation portal, even if clearly related to the digital economy, will result in an ordinary lease agreement. An eBay transaction will result in its turn in an ordinary sale of movable property.

Of course the service rendered by Airbnb or eBay – normally a pure intermediary service – must also be considered, but in this case we will be able to apply the B2B (if the recipient is business) or B2C (if the recipient is a private consumer) schemes as previously described.

5. Design Issues

The digital economy presents not only new business models that challenge the current tax rules conceptually, but also severe practical challenges to the ability of governments to collect revenue. Indeed, in many cases, governments simply have not been collecting revenue from the digital economy[36] and in others the collection came up very short, triggering, inter alia, the BEPS Project. It is therefore important to take extra care with the design of any tax measures applicable to the digital economy.

It would be useful to first summarize the basic proposal: All payments made by businesses to registered payees should be subject to a final 10% withholding tax. Payments may be exempt from the tax upon provision of registration and exemption codes by payees. All payments to unregistered payees should be subject to a non-final 15% withholding tax. Next, the following sections discuss the details of this proposal.

5.1. Rates

Unlike normal tax rates that reflect the political choices of nation states, the rate of a digital economy withholding tax should be internationally standard and set. This is because the purpose of the tax is to set a fair and legitimate standard for division of revenue among residence and source states. This paper mentions throughout several more complex mechanisms, such as clearing and revenue sharing ideas, yet it is important to understand that the choice of a withholding tax to tackle the challenges presented by the digital economy means a preference for a simple and somewhat crude solution, and a belief in low-level international collaboration, in comparison to the digital PE approach, for example. Indeed, it is likely that in the large majority of cases the tax would simply mean that the source state collects and keeps it, no more, no less.

The rate should reflect an appropriate share of the tax base allocated to the source state. It should therefore be sufficiently high, shadowing the corporate tax. Another reason to keep it sufficiently high would be to satisfy its base erosion role. The rate should also be kept sufficiently low, to satisfy the residence countries that control the tax base at present and hence may perceive the withholding tax as a concession they make in favour of source jurisdictions. This argument is quite weak since the residence jurisdictions have not been collecting on this tax base much in the first place. A more significant reason not to set the rate too high would be to reduce the incentives to evade it. Note, however, that this is not an optimization argument, since it is likely that taxpayers will continue to have a strong

36 E.g. *see* the moratorium on taxation of the Internet.

incentive to attempt evasion of the tax at any acceptable level (one could study this point in more depth, but it is beyond the scope of this paper); it is rather an argument based on the aspiration to design the tax according to its purpose and keep it at a level that would be generally perceived as fair and legitimate. Furthermore, the tax should be kept at a level that would not significantly hamper business.

Taking all this into account, the rate should be anywhere between 5% (that may be viewed as insignificant by source jurisdictions as this is a rate often charged by accommodating conduit jurisdictions for treaty shopping accommodation) and 15% (a level close to the actual net corporate tax rate in some jurisdictions). Therefore, 10% came to mind to make calculations simple, but of course this is not a magic number and it could be negotiated up or down without qualitatively changing our proposal.

Lastly, we think that another rate should be used to address payments to non-compliant jurisdictions. It is well known that it is difficult to define tax havens and the like, yet for the purposes of this proposal that inherently embodies a choice for a simple, imperfect solution, it is clear that a simple line should be drawn. The same 15% corporate tax rate comes to mind, but, again, the threshold rate could be a little higher or lower with little effect on this proposal. The elevated withholding tax rate should match the threshold rate, so our proposal is to impose a 15% withholding tax on payments to non-registered payees, including payees resident in jurisdictions with a corporate tax rate below 15%. Note that a PE of a resident of a sub-15% jurisdiction in a non-sub 15% jurisdiction should be eligible to register as such and enjoy the 10% rate. Also note that the 15% corporate tax rate line drawn does not address effective tax rate reductions, again, partly to keep the solution simple and easily workable, and partly because BEPS Action 5 is tasked with dealing with harmful tax competition issues.

5.2. Exemptions

A full prescription of exemptions would be beyond the scope of this paper, yet the basic idea behind the proposed withholding tax would be to capture all payments connected with the digital economy with a strong preference for the capture of base-eroding payments with as little disruption as possible to the current rules of the international tax regime (reflecting the conservative evolutionary approach), yet without tying ourselves to a definition of digital economy payments.

Therefore, low-risk payments to identifiable taxpayers that are already taxed on a net basis should be exempt. The most obvious examples would be wages and deductible payments made to PEs. The latter may be payments made to a digital PE of the kind described in the Hongler & Pistone Paper in the scenario that the proposed withholding tax is proposed as a backup or as a mechanism at the service of such a solution (and not as an alternative to it). Note that these payments do not present a qualification problem since they are rather easily and clearly distinguished from other payments, and they are already subject to unique tax regimes with little concern of abuse through characterization schemes.

Interest and dividend payments (but not royalties) should similarly be exempt. Dividends are not generally base-eroding payments and are controlled by article 10 of tax treaties. As such, they present no unique problem from the perspective of the digital economy other than in the context of hybrid arrangements, yet these present an issue that is not unique to the digital economy and are dealt with in other BEPS Actions and hence are beyond the scope of this paper. Similarly, capital gains from the sale of shares do not concern this paper. Interest payments are base-eroding payments, but, again, their treatment should be left to the working groups on the above-mentioned other BEPS Actions. Furthermore, these payments are defined and although they may be quite easily be recharacterized, they do not pose the same issues presented by the digital economy, and indeed they are addressed elsewhere by the BEPS Project (Actions 2, 3, 4 and 6).

All other business payments, including royalties,[37] will be subject to the withholding tax unless countries believe that they are clearly beyond the scope of the digital economy. For example, payment for the rental of equipment, land or buildings, or for their purchase, payment for material and payments for services entailing individuals present on-site, etc. The construction of a list of standard payments should not be complex. There may be some controversial payments, but yet again, if their treatment would follow the principles set out above, the method should be fairly feasible and non-controversial. These miscellaneous, clearly not digital economy payments may be more susceptible to manipulation than the other exemptions. Taxpayers would have a clear incentive to inflate these payments, perhaps at the expense of other (closer to the digital economy) payments. However, we believe that the scale of abuse is likely to be at levels lower than any definition-based mechanism that would not be based on a widely scoped withholding tax. First, because such payments are already subject to other tax safeguards, such as the transfer pricing rules. Second, the country of the payor would have the strongest incentive to ensure that exempt payments are not inflated. Being the "source" countries, they are also in the best position to monitor the application of the system: the payment is likely made within their jurisdiction, it is their tax base that is eroded and the payor (who is the withholding agent, not the taxpayer) is under their control. The most difficult cases are likely to be base-eroding payments for mixed equipment such as computerized machinery. When it is supplied together with additional digital products, it would be difficult to allocate the appropriate price to each component. Most countries to date may view mixed products as primarily tangible so this may be an avenue to avoid the new withholding tax. Nevertheless, this may be dealt with by either separating the tangible from the intangible component or even simply not exempting payments for machinery that predominantly derives value from software and connectivity.

5.3. Finality

Every withholding tax presents the question of finality, being a practical, inaccurate gross tax mechanism in a system dominated by net taxation. In brief, it is much simpler to use a final tax, yet this means sacrificing accuracy and sometimes neutrality.

If one chose to employ a withholding tax alone, as proposed in this paper, we would support making the tax final. The mere choice of a withholding tax reflects preference for simplicity and certainty, and a final tax would serve this preference better. However, beyond that, accuracy and neutrality are not completely sacrificed, since the tax would be final only from the perspective of the source (or payment) state in the case that the residence state would provide a credit for the tax. The relative low rate of the tax should make such credit mechanism meaningful and meet the purpose of the tax: a fairer division of revenue between the source and the residence states.

Fairness may require that the 15% elevated rate for payments to non-registered payees not be final, especially if a period of transition into the tax should be permitted. We propose that an

37 One could argue that so-called "literary" royalties should remain within the scope of article 12, yet we do not see the theoretical support for the distinction between royalties and business profits, especially in the context of the digital economy. In any event, if countries insist on that, article 12 may simply be left intact or amended to whatever scope countries wish. This action may create an area of uncertainty and open an opportunity for taxpayers to more aggressively include as many payments as possible within the scope of article 12. In the authors' view, this is inappropriate.

option be granted to payees subject to this rate to file a tax return claiming a refund of the excess 5% paid to the country of source. The return should be filed with both jurisdictions consistently. The option to file is particularly recommended in the case that a withholding tax is used in support of a primary PE solution of the type described by the Hongler & Pistone Paper.

The choice of a withholding tax necessarily entails a significant burden on struggling enterprises. These may include start-up companies, companies in transition, loss-making companies and low-margin companies. For these companies, the tax would mean a pure cost (and a cash strap) that further encumbers them and makes it difficult for them to succeed. These companies also differ from each other in their loss of support by the system. We may wish to support start-up companies, but not necessarily help lengthen the winding-down period for failed enterprises. It is difficult, however, to distinguish between these types of companies on a fair basis and past experience demonstrates that such attempts have not necessarily been successful.[38] It is perhaps possible to add special rules for start-up companies that would work better, perhaps via special registration, but we believe that on balance, the option to register and be taxed on a net basis sufficiently balances the impact of this tax. Enterprises choosing not to register may be the ones with insignificant expenses; for them, the low 10% rate should be viewed as adequately balanced. Lastly, if countries are seriously concerned about the impact of this tax, they may further balance its impact in other ways, such as ensuring carry-forward of foreign tax credits, special exemptions or even refund of taxes schemes.

5.4. Transition

This may be an early stage at which to design the transition into the system proposed in this paper, since the proper rules depend on the exact details of the solution and the circumstances of its adoption; however, we chose to briefly mention this matter for completeness' sake. The PE solution should not cause significant concern upon transition since it merely alters the existing definition of a PE and therefore would only require care in the transition years to prevent abuse.

The adoption of a withholding tax solution is somewhat more complex since it introduces a completely new mechanism and a broad withholding obligation. This would require legislation and regulation in all countries, a process that may take time and is open to evasion in the interim. Nevertheless, a major shift of business is unlikely to happen in response to the tax since the focus of compliance and enforcement is on the market and the destination and not the origin, which could not easily be abused. It is unlikely that payors would change residence or equivalent payment locations due to these withholding obligations.

5.5. Incentives

Countries should consider the use of incentives to promote proper withholding. There is ample experience in the employment taxes and VAT areas that could help here. We would suggest just one example in this regard: countries could agree to a very small administrative award to the withholding agents. This award could be facilitated similarly to a tax refund. The critical stage in the imposition of a withholding tax such as that proposed in this paper is its launch and, in order to safeguard sufficient compliance, that would ensure its success

38 The US exceptions from the PFIC regime are an example. *See* IRC §1298(b).

incentives may be proven useful. These incentives may be tested over time and reviewed and amended as needed.

5.6. Standardization

Last, but not least, we emphasize the importance of collaboration among as many productive countries as possible in an effort to standardize the tax regime applicable to the digital economy. If a withholding tax were chosen to feature, such collaboration is a condition to its chances of success.

Defection should not be highly attractive, since such a move would perhaps attract certain additional business and may reduce to some extent the cost of goods and services in the defecting country market, but that would come with a revenue price. The challenge would be to implement a comprehensive and standard registration and coding system for the identification of businesses. This has a cost, both monetary and political. The latter may present the biggest risk for the success of the scheme. Once the standard registration and coding system is in place, it would be in the interest of all productive countries to collaborate. The BEPS Project's launch proves that and the added value in the areas of exchange of information and administrative assistance would only make these incentives more attractive and effective.

5.7. Tax treaty implications

If a withholding tax were to be implemented in lieu of a nexus-based solution of the kind described in the Hongler & Pistone Paper, we propose making the following amendments to the OECD Model:

(1) A new article 7(4) should provide:

"Payments made by an enterprise of a Contracting State or by a permanent establishment situated in a Contracting State may be taxed in that State. The tax so charged shall not exceed:

(a) 10 per cent of the gross amount of the payments if the payee is an enterprise of the other Contracting State or a permanent establishment situated therein duly registered with the first-mentioned Contracting State for the purposes of this paragraph; and
(b) 15 per cent of the gross amount of the dividends in all other cases.

The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this tax, including specified exemptions for non-base eroding and other similar payments."

It would be good if a standard set of exemptions is elaborated in the Commentary.

(2) Correspondingly, the old article 7(4) would become article 7(5).

(3) Article 7(1) would be amended to begin with the phrase: "Subject to the provision of paragraph 4."

(4) We recommend that article 12 be eliminated. There is no need to amend articles 10, 11, and 15, as explained above.

The same scheme could also serve the nexus solution as a collection mechanism. It seems best to leave the model of operation of the withholding tax to the parties or to the Commentary.

In the case that a definition-based solution is chosen, the definition should be added to article 7 and the withholding reference should not be to "payments" but rather to "digital payments" or any other name found fit.

Furthermore, in the case that countries wished to impose a B2C tax, this proposal should be amended according to the mode preferred. The simplest way to do that would be to impose the tax on all payments (not just those made by businesses); however, this is not recommended, as explained above. Alternatively, the tax may be required to be applied in a specific mode to financial institutions. The mechanism should be similar to the above, but a much more elaborate set of definitions and controls would be required. A separate report would be required to address these adequately.

All of the above depends on a standard registration and qualifications scheme that could be developed in the Commentary or externally to the Model; however, in any event, we believe that it should not affect the text of the Model itself for the sake of effectiveness and flexibility. If countries chose to more strictly standardize a withholding tax solution, specific amendments may be made to articles 26 and 27 of the OECD Model, as already explained above.

6. Withholding and Value Added Taxes

Corporate income taxation is not the only concern of BEPS Action 1, at least if we consider its literal formulation. Indeed, the original Action Plan, when describing the specific action, stated: "Issues to be examined include … how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services."[39] Even when the relationship between direct and indirect taxation poses numerous and interesting theoretical and practical problems, focusing strictly on the new withholding tax proposal as an option to face BEPS problems in the context of the digital economy; here, we will deal with only two specific issues.

6.1. Market/source income taxation as consumption tax?

Source taxation of income related to the digital economy in the absence of traditional PE presence – we refer thereby to either a new nexus PE or a withholding tax on digital transactions – has been frequently criticized for generating quasi-consumption taxes.[40]

We think this criticism is highly nominalistic and therefore generates a sterile legal debate. This does not mean that the economic nature of a tax might be totally irrelevant from a legal point of view (e.g. *see* the debate on fiscal federalism in Germany or article 2 of the OECD Model). However, unless this relevance is proven, we believe the question to be rather formal and of limited use. In a nutshell, what is the relevance of source taxation of digital transactions being considered a consumption (instead of an income) tax?

39 The final report has also dedicated significant attention to this issue: OECD, *supra* n. 25, at 133-138, 147-148 and 152.

40 In regards to criticism of the hypothetical (new nexus) PE in relation to the BEPS Action Plan, *see Comments received with respect to the public discussion draft on BEPS Action 1 (Address the Tax Challenges of the Digital Economy)*, pp. 91-96. In relation to withholding on digital transactions it has been raised rather as a rhetoric question; *see* Doernberg, *supra* n. 10, at 1013; Pinto, *supra* n 3, at 183.

But even if it were accepted that this question is of particular significance, the criticism remains misleading. As pointed out by Doernberg, in a direct reference to a withholding tax built upon the base erosion approach, even if a tax on the cost of cross-border purchased inputs may look very much like an excise tax, which may inhibit international trade, it differs in two significant ways: first, the tax would be creditable in the state of residence, so the withholding tax should not increase the overall tax burden. Second, the taxpayer retains the right to file on a net basis in the source state if the withholding tax burden exceeds the tax burden on net income attributable to activities in that state.[41]

In short, a withholding tax proposal as the one contained in this position paper does not significantly alter the current nature of (corporate) income taxation but merely allocates taxing rights in a different manner.

6.2. Interactions between the new withholding tax and VAT problems of the digital economy

The BEPS Report has essentially identified two main challenges for the collection of VAT in the context of the digital economy: the exemptions for imports of low value added goods and remote digital supplies to consumers.[42] The first problem is hardly related to the corporate income tax concerns that have prompted the initiatives exposed in these papers. Nevertheless the issue concerning the remote digital supplies to consumers presents interesting connections to many of the critical points analysed in this position paper.

At face value one might think that these two areas of concern are rather mutually exclusive as far as the proposal contained in this paper clearly pleads for exclusion of B2C transactions of the new withholding tax (*see* section 4.), whereas the main concern in the VAT field is precisely the remote supplies to final consumers. Even if this is true and this position paper does not result in an alignment of income and consumption taxes derived from cross-border supplies of digital services to consumers, a new withholding tax on digital transactions might still render significant fruits as a complementary tool for VAT given that:

(1) The OECD has denounced how domestic suppliers are required to collect and remit VAT on their supplies of services and intangibles to their domestic consumers while the non-resident supplier, depending on the scenario,[43] could structure its affairs so that it collects and remits no or an inappropriately low amount of tax.[44] We do not pretend that this lack of neutrality will be compensated by a withholding tax system that, in its turn, also discriminates B2B and B2C transactions. Nevertheless, and in comparison to the current situation in which in the absence of a traditional PE the digital economy totally escapes source taxation, we would like to point out that a withholding tax as the one proposed in this position paper could mitigate the incentive for domestic suppliers to restructure their affairs so that their supplies of services and intangibles are made from an offshore location, especially if this location is identified with jurisdictions with a low corporate tax rate (*see* the increased 15% withholding tax rate as described in section 5.). Of course this compensation would be rather scarce if the offshore provider performs only or predominantly B2C transactions but, as referred to in section 4., this is rather exceptional.

41 Doernberg, id., at 1013.
42 OECD, *supra* n. 25, at 133-137.
43 It depends on whether VAT rules allocate the taxing rights to the jurisdiction where the supplier is resident to the jurisdiction where the customer is resident.
44 OECD, *supra* n. 25, at 136.

(2) Those jurisdictions (such as EU Member States) that have decided to allocate the jurisdiction to tax (for VAT purposes) to the consumer residence have had to introduce a mechanism that requires the non-resident supplier to register, collect and remit VAT according to the rules of the jurisdiction in which the consumer is resident. As recognized by the OECD, there is no available data to determine reliable conclusions on compliance levels, but the experience in countries that have implemented such an approach suggests that a significant number of suppliers comply by either registering in the VAT jurisdiction and collecting and remitting tax on their remotely delivered services or by choosing to establish a physical presence in the jurisdiction and effectively becoming a "domestic" supplier.[45] As further indicated, high-profile operators, which occupy a considerable part of the market, particularly wish to be seen to be tax-compliant, notably for reputational reasons.[46]

For those jurisdictions that already have experience with these registration duties, the implementation of the registration apparatus defined in sections 4. and 5. might be less onerous. Additionally, there is no reason to exclude a single registration process for both purposes, the new withholding tax and VAT on cross-border B2C supplies[47] – with the required specific nuances for each tax involved.[48]

For those jurisdictions which still do not charge VAT on B2C transactions in cross-border situations or have little or no experience dealing with registration procedures of non-resident suppliers, the registration duties accompanying the new withholding tax may eventually facilitate an easier transit to B2C taxation at destination.

In either of the above two scenarios (experienced and non-experienced countries as to VAT taxation of B2C transactions), the conclusions recently presented by Hellerstein appear to be right:

> The underlying problem that the digital economy raises for income tax regimes is the same problem that it raises for consumption tax regimes once one determines that there is substantive jurisdiction to tax in a country, namely, the practical difficulties of enforcing a tax when the economic actors that one normally looks to for tax enforcement are physically absent.[49]

Lastly, at this stage of the project, both the will and ability to fully tax the digital economy under both income and consumption taxation are preliminary and incomplete. However, if this changes, one should consider the tax mix implications, i.e. whether taxation in general is too burdensome. It seems unimportant in this early stage, yet such thinking may have other, more immediate implications. For example, assuming that the withholding tax regime fails while the VAT regime succeeds, it would be possible to reassess the policy and shift more or all of the burden to consumption taxation (or vice versa, with different complications). The point is that a review and assessment mechanism must be established that points to the relevant tenuous issues, most importantly the B2C aspects of this proposal.

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45 Not all authors seems so optimistic: M. Lamensch, *Are "reverse charging" and the "one-stop-scheme" efficient ways to collect VAT on digital supplies?*, 1 World Journal of VAT/GST Law 1, p. 7 (2012).

46 OECD, *supra* n. 25, at 136.

47 The similarity of both registration processes has already been emphasized by certain authors, e.g. Hellerstein, *supra* n. 27, at 350.

48 One-stop-shop procedures seem more difficult given that out of highly integrated areas, the European Union is the only regional organization to offer this simplified procedure.

49 Hellerstein, *supra* n. 27, at 351.

Appendix: Case Studies

For the purposes of this paper, we chose to refer to the same case studies presented by the Hongler & Pistone Paper. These case studies illustrate best the differences between the proposals, i.e. the simplicity and crudeness of the withholding tax solution versus the more accurate, yet complex (although also more consistent with the current rules) nexus-based solution. Note also that both solutions require significant collaboration among the productive jurisdictions.

(A) Cloud computing

(1) Example: Company A

Company A provides cloud services to customers in multiple countries. It is resident of country A and therefore has a country A tax identification number. It also obtained a market registration number in country X, where it sells some of its services. Customer X is a corporation resident in country X. X purchases services from A. The price paid is generally deductible as a business expense in country X.

Pursuant to the proposed withholding tax, X should withhold 10% of the payment it makes to A. X should remit the payment to country X, together with the payee's (company A) country of residence tax identification number and its country X's market registration number. Country X then automatically shares this information with country A. The deduction in country X and the credit, if any, in country A are conditioned upon the provision of the payment and the three items of information. Failure of A to register with country X would result in a 15% withholding tax obligation.

Using a definition-based withholding tax rather than our proposed scheme should not change much this scenario, since it is clear that cloud services fall in any definition that would be used. Note, however, that some bilateral tax treaties include service PE provisions. We think that priority should be given to the digital solution over a service PE, yet the reverse is workable as well, although we also believe it is more prone to abuse.

Lastly, the 10% withholding tax could be used in complement to a digital PE solution. In that case, A should register with country X. There are three possible scenarios. First, A is certain to have a PE in country X. In this scenario, the rule may or may not require withholding; however, the key issue would be to declare being a taxpayer under the PE rules for the year in country X. In a second scenario, A may declare with country X that it clearly does not expect to have a PE in country X (based on the solution explained in the Hongler & Pistone Paper). In this scenario, country X may grant A an exemption and may audit A accordingly. The exemption is then submitted to X, which can then refrain from withholding. A third scenario is that A is uncertain whether it will or will not have a PE in country X. In that case, it is required to submit registration information to its customers and X must withhold and remit the information to the country X authorities. At the end of the year, A should file with country X declaring either a PE and a regular tax return or no PE, requesting a refund. One can immediately observe that this scheme would require the constitution of effective registration and quick filing (and refund) schemes to gain support.

(2) Example: Company B

Company B is an entertainment service provider. It is resident in country B. It is primarily a B2C company and therefore most of its customers do not expect to deduct the payments they make to B in exchange for the services (either the ad hoc or the subscription payments). If B provides services to businesses, then such businesses are in the same circumstances as company X in the Company A example above.

Non-businesses, primarily individual taxpayers, are not subject to withholding obligations under our proposal. In the case that B2C would be subject to this regime, however, it would be required to use a qualified financial intermediary that would withhold 15% of each payment. This alternative proposal, mentioned in section 4.2. of this paper, would permit the financial intermediary not to withhold if B registered with country X to be taxed on a net basis.

In the case where the withholding tax is used to complement a PE solution of the kind explained by the Hongler & Pistone Paper, the consequences are the same as above.

(3) Example: Company C

For our purposes, company C is a mix of company A and company B. Since the withholding obligation is imposed on the payors separately, this case is not different than that mentioned the above. There may be a question about retail chains where multiple withholding taxes may apply. For example, company C sells a licence to company B above that sells the licence to company X, the customer in country X. Under our proposal, company B would withhold 10% on the payment it makes to company C. In the case that B2C is not taxed, the payment of X to B would not be subject to withholding tax. B is taxed by country B on its profit (if it withholds appropriately on the payment to C). Country B also collects the withholding tax on the payment made by B to C. Country C taxes the profit of C minus a credit for the withholding tax collected by B, if any. Alternatively, country X may wish to tax B2C and collect via the credit company withholding tax via the credit company on the payment made by X to B or, alternatively, tax B on its (net) profit made in country X. In this case, country X collects either the withholding tax or the net tax on the profit made by B in connection with the sale to X. Country B collects the residual tax on such profit and the result for country C is unchanged. One can readily observe that under the latter scenario the revenue has shifted from the country of the retailer to the country of the customer. This outcome is closer to that under a PE solution of the kind explained in the Hongler & Pistone Paper; however, it has its costs in terms of complexity and burden on the market and on financial institutions as described above.

(B) E-commerce or online retailer

Online retail such as this is not principally different from the scenario described above in the company B case. However, the case here may present sales through tax havens or low-tax jurisdictions. Such structures triggered the BEPS Project and hence should be directly addressed. If the circumstances do not change, then the final business customers, such as X, would be required to withhold 15% on the payment, since the vendor would not be a registered taxpayer in a more than 15% corporate income tax jurisdiction. The vendor may wish to register for net taxation in country X, assuming such registration is acceptable in country X, and if it does so, may be exempt from the withholding tax (so it could declare an exemption code with X, the payor). Alternatively, country X may permit the vendor to file a tax return with country X and consequently file a request for a refund of 5% (the sum beyond the 10% regular withholding tax rate) of the tax withheld.

Individual residents of country X purchasing similar digital goods and services would not be expected to deduct their payments for such goods and services and therefore are not required to withhold under our primary proposal. However, under the alternative proposal, the payment would have to be facilitated by a regulated financial institution and that financial institution would be required to withhold 15% tax from the payment and remit it to the country X authorities.

(C) Internet advertising

(1) Example: Company D

The revenue of company D mainly derives from advertising on the search engine website it operates and other network websites However, company D (besides the advertising business)also has other revenues such as from selling mobile phones. Company D sells its services in nearly all countries worldwide and has over one billion users worldwide. Consider now the revenue obtained by company D from its clients in state X. Advertising services in this context will be predominantly B2B transactions and therefore the price paid is generally deductible as a business expense in country X.

According to these facts, the solution would be identical to that provided for company A above as relates to internet advertising services.

(2) Example: Company E

Company E operates an online platform that allows users to implement a personalized website and to easily connect with other users. Its income stems primarily from advertising services on such platform. Company E also generates income from games played on its platform on personal computers.

As regards to advertising services, the solution would be identical to that provided for company D above and more in general for companies providing digital services exclusively or almost exclusively in B2B scenarios.

As regards income from games played on its platform on personal computers (normally pure B2C transactions), the solution would be identical to that provided for company B above.

(3) Example: Company F

Company F traditionally publishes a daily newspaper in the United States and worldwide but it also operates a news website. Print advertising amounts to approximately 75% of total advertising revenues of company F. Therefore, quite a significant part of the advertising income of company F stems from its digital appearance. Besides, company F also operates a digital subscription system with approximately 700,000 subscribers per annum.

As regards advertising services, the solution would be identical to that provided for company D above and more in general for companies providing digital services exclusively or almost exclusively in B2B scenarios.

As regards income generated by online subscriptions, company F would be a mix of B2B and B2C and therefore the solution offered for company C above will be applicable. Note that the withholding solution automatically sorts B2B from B2C since it applies to the payor not the taxpayer.

(4) Example: http://www.ifa2014mumbai.com/

The IFA India Branch organized the annual IFA Congress in 2014. Besides subscription fees paid the by the participants, income was also generated by way of providing online advertising services on the above-mentioned website.

As regards advertising services, the solution would be identical to that provided for company D above and more in general for companies providing digital services exclusively or almost exclusively in B2B scenarios.

As regards income generated by subscription fees paid by participants, assuming normally a B2B pattern, the solution would be that provided for company A above. Nevertheless, in case our proposal not to rely on a traditional legal definition of digital transactions is refused, such subscriptions fees might face difficult qualification under definitions like that contained in section 3. of this position paper. Additionally, this is one of those cases in which a negotiated *de minimis* rule would make sense to the extent that the ordinary registration process might prove too burdensome.

This case perhaps also raises the issue of non-for-profit taxpayers. If in the above case India chose not to tax the IFA India Branch, it could provide it with an exempt registration status. The branch could then declare that status and/or a *de minimis* scenario status in the various countries in which payments are made. This option complicates our proposal, but it presents no conceptual difficulty, simply a trade-off between different policies. For the sake of coherence we would prefer not to exempt such base-eroding payments.

(D) Internet app store

(1) Example: Company G

Company G produces and sells computers, mobile devices and various electronic applications. Furthermore, company G operates an online app store. The annual sales of company G amounted to USD 150 billion and partly (i.e. approximately 10%) consisted of net sales of online applications or music downloads.

As regards income generated by online subscriptions, company G would be a mix of B2B and B2C and therefore the solution offered for company C above will be applicable.

One complication that such examples may present is that the customer often purchases the apps from a store and not from the vendors. If the vendors pay fees to the store then the solution is straightforward. It is more complex when the store deducts its fees from the collections, i.e. on a contingent basis. The base erosion approach may assist us here if the vendor would be denied a deduction unless it withholds on the deemed payment it makes to the store for its services. The basis for withholding should be equal to the deduction requested. Note that the revenue here goes essentially to the residence country of the vendor.

Another option is to use the alternative B2C scheme, requiring financial intermediaries to withhold on the payments by the customers. This would shift revenue to the market jurisdictions. A withholding requirement on the above-described deemed payment could also be made.

(E) Further case studies

(1) Example: Company H

Company H divides its income into various segments:

- *Search engine and other advertising generating websites:* Company H operates various websites and earns income from selling advertisement opportunities on these websites. A considerable amount of revenue is attributable to an agreement with another huge provider of online advertising services.
- *Online dating platform:* Company H also operates various online dating platforms. Singles pay an annual subscription fee per year in order to have access to these websites.
- *Media:* Company H also operates various media platforms that allow users to publish their self-made videos on these websites.

Regarding the advertising services, the solution would be identical to that provided for company D above and more in general for companies providing digital services exclusively or almost exclusively in B2B scenarios.

Regarding the online dating platforms, transactions on these are pure B2C transactions, so the solution would be identical to that provided for company B above.

Assuming that the third type of platform operated by company H is free of charge, no further problems arise. If the customers are required to pay a fee, the solution would be the same as that provided for the online dating platforms.

(2) Example: Company I

Company I is an on-demand taxi service operating through mobile devices. Using the software of company I allows finding the nearest driver to a certain location. Company I provides a no-cash-payment solution. This means that the services are charged through credit card operations. Company I has more than 400,000 active users and it had more than 1.2 million annual requests. The average gross revenue per ride amounted to USD 22 in the past year.

This is a typical C2C structure and we refer here to our statements in section 4. as regards the fact that it cannot be considered an additional category separated from B2B and B2C transactions. Company I renders pure intermediary services, to which we would apply the B2B scheme (if the recipient is a business) or the B2C scheme (if the recipient is a private consumer) as previously described.

(3) Example: Company J

Company J connects people offering accommodation to tourists or business travellers. It operates its service in more than 30,000 cities and 190 countries. It is a marketplace for people that want to rent out parts of or their entire dwelling.

Company J charges a 3% service fee from host payouts every time a reservation is made. Such deduction should cover the cost of processing guest payments. Furthermore, company J adds a 6%-12% service fee to guest payments every time a reservation is booked.

Here, we face again a typical C2C structure for which, as stated previously, B2B or B2C solutions should be offered. As both hosts and guests might be businesses or consumers (with a clear predominance of the latter), the solutions offered for company C above might be applicable (alternative solutions for companies A or B).

(4) Example: Company K

Company K operates an online music streaming platform through which artists can offer their songs to users worldwide. Users either pay a monthly fee or they only have access to the free services of company K, which are regularly interrupted by adverts. Company K distributes approximately 70% of revenue to the holders of publishing rights, respectively, music labels. The exact amount of remuneration also relates to the particularities of certain jurisdictions.

Company K is primarily a B2C company and therefore the solution offered for company B above would be applicable. In the event that businesses (entertainment industry) could also have access to the services of company K by paying additional fees, the scheme described for company A above would be applicable.

Note that the payments to music labels would also be subject to the withholding tax, as B2B transactions, unless countries chose to retain the current regime for taxing royalties, a decision that we do not recommend.

(5) Example: The R&P case

Research and Publishing (R&P) is a not-for-profit foundation based in Luxembourg, with subsidiary offices in Singapore, New York (USA), and Mumbai (India). R&P began operations as a centre for specialized legal information and documentation, its greatest asset being its documentation centre which amalgamates in one place historical legal documents, publications and archives from all over the world. Having started as a research centre for access and consultation of physical documents also responsible for the publication of many books, articles and journals of a legal nature, the scope and nature of its services have expanded to include many activities that are currently deemed to be included within the field of digital economy.

R&P currently offers a number of international legal services to customers located worldwide that are only viable due to the current technological development and are thus susceptible to the taxing challenges posed by the digital economy.

Even if the use of R&P services by final consumers cannot be discarded, this company operates predominantly in a B2B scenario and therefore the solutions offered for company A above would be applicable. We do not think any of the products offered by R&P (access to databases, online teaching and legal research) are outside the scope of the proposed withholding tax either under a non-definitional approach based upon the base erosion principle or according to a definition as the one contained in section 3. of this position paper. Note, however, that in countries where a service PE solution exists or a regular PE is triggered and duly registered, it is possible that payments for services on the ground be exempt from the withholding tax.

(6) Example: Company L

Company L is a bank and financial service provider. It offers an online application for mobile devices that allows the following actions:

- access trading accounts directly;
- place entry and market orders:
- manage open orders and positions across all instruments groups; and
- view account balance, equity and margin details.

Depending on the traded products, the commission might deviate. For instance, if you purchase NASDAQ shares, the commission will be 0.10% (minimum USD 15). Company L might also offer other online services such as e-banking.

As regards both pure financial services and e-banking services, company L would be a mix of B2B and B2C and therefore the solution offered for company C above will be applicable.