

The Need for Plan B

The danger in writing an editorial about recent events and current trends is that the situation may change suddenly, and the editorial becomes irrelevant soon after (or even before) it is published. However, in the case of this editorial, the author thinks that that is unlikely. This editorial argues that Amount A of Pillar I is not going to enter into force in the near future, and that there is an urgent need for a Plan B: that is, an alternative form of taxation of the digitalized economy,¹ ideally (and idealistically) based on a common pattern for domestic taxation. To be more precise: this editorial assumes that the Multilateral Convention ('MLC') which is being currently drafted to implement Amount A will not achieve a critical mass of ratifications to come into force in the near future (if at all). To avoid the danger of a multiplicity of different, perhaps overlapping, perhaps conflicting, digital services taxes ('DSTs'), this editorial argues for a Plan B under which a common form of DST is developed (or, at least, common principles for domestic DSTs are developed), certainly well before the end of this year.²

Most people have recognized for some time that the MLC to implement Amount A was unlikely to achieve critical mass. Current rumours are that the draft of the MLC is several hundred pages long, and that it has an entry-into-force clause which requires ratification by countries where 60% of in-scope companies are based before it

comes into force. Given the predominance of in-scope companies in the United States, that is effectively a condition that the MLC will not come into force unless ratified by the US. Rather tellingly, on 5th June the co-chair of the Inclusive Framework is reported as having said that the MLC needs to be broken down into palatable pieces and should be explained to tax authorities so that they understand what it is that they are signing.³ If the draft MLC is as long as rumours have it, then this process – which is entirely reasonable (states should understand what it is that they are signing) – will take many months. However, even explaining the MLC to a large number of states will not surmount the requirement of ratification by a critical mass. Even assuming that the MLC is open for signature in July or August or September this year, there is no realistic prospect that ratifications will reach critical mass in the foreseeable future (if at all).⁴

In this context it should be recalled that the 8 October 2021 'Statement on a Two Pillar Solution'⁵ states: 'No newly enacted Digital Services Taxes or other relevant similar measures will be imposed on any company from 8 October 2021 and until the earlier of 31 December 2023 or the coming into force of the MLC'. It seems almost certain that the earlier of those dates will be 31 December 2023. At that point in time, the moratorium on new DSTs falls away.

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¹ The author has lost track whether the term should be the digitalized economy, the digitized economy, or the digital economy. This editorial typically uses 'digitalized economy' and 'digital services'.

² The need for a Plan B has been apparent for many months. In fact, it is arguable that as soon as it was clear that the implementation of Amount A would require a MLC, and that the likelihood of the United States ratifying such a convention was minimal, work should have begun on a Plan B at that stage. Given the lack of transparency, it is possible that work on a Plan B has been taking place in secrecy, but that seems extremely unlikely. The OECD and the Inclusive Framework seem to have proceeded on the assumption that any work on a Plan B would be an effective admission that Amount A was not going to be achieved. However, taking an ostrich-like approach doesn't make it any more likely that Amount A will achieve critical mass.

There are some excellent proposals for improved DSTs, and the author does not intend to ignore those, but cannot survey them in a short editorial. However, one that is particularly deserving of attention is the African Tax Administration Forum (ATAF)'s *Suggested Approach to Drafting Digital Services Tax Legislation* (see ATAF Admin (ataftax.org) (accessed 12 Jun. 2023)).

³ See *OECD Body Co-chair Falls for Modular Pillar I Tax Accord Process*, Tax Notes International (6 Jun. 2023).

⁴ There is an interesting question as to whether countries that have no realistic intention to ratify a convention, or fundamentally hope that a convention will never enter into force, should even sign the convention. Article 18 of the Vienna Convention on the Law of Treaties imposes certain obligations on a state that has signed but not yet ratified a convention, including the obligation to refrain from acts which would defeat the object and purpose of the treaty prior to its entry into force. In principle at least, a state might sign a convention with the intention of ratifying it if, and only if, it becomes likely that it will achieve a critical mass and enter into force. Adopting Plan B and enacting a DST in the meantime does not defeat the object and purpose of the MLC, but it is hardly consistent with that object and purpose. There is a danger that international tax law will be brought into disrepute if a large number of states sign the MLC with no intention of ratifying it, or even hoping that it will never enter into force, and with the intention of enacting a DST in the meantime.

⁵ OECD/G20 Base Erosion and Profit Shifting Project, Statement on a Two Pillar Solution to Address the Tax Challenges Arising from the Digitalization of the Economy, OECD 8 Oct. 2021. (*Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (8 Oct. 2021), oecd.org (accessed 12 Jun. 2023)).

In a letter sent on 30th May to the director and deputy directors of the OECD Centre for Tax Policy and Administration, the US Council for International Business called for an extension of the DST standstill agreement as it has provided ‘temporary stability to the global tax system’.⁶ In the view of the author of this editorial, that would be the worst thing to do. If there were a realistic prospect that the MLC would achieve critical mass within a matter of months, that might make sense, but that is quite unrealistic. An extension of the standstill deadline would continue the current uncertainty and would simply put off the dreaded day when one has to recognize that Amount A is a dead parrot. Meanwhile, many states that wish to tax digitalized businesses, and have been forbearing from doing so (and losing substantial revenue as a result), would continue to lose that valuable revenue. The solution is not an extension of the DST standstill deadline, but the acceleration of work on Plan B.

So, what would Plan B consist of? It seems pretty clear that it will involve some form of DST, whether it is called that, or an equalization tax, or an electronic transaction tax or something else. A significant number of countries have enacted some form of DST, though they are mostly in suspense at present because of the October 2021 standstill deadline.⁷

The author of this editorial does not have anything like a fully worked out blueprint for a Plan B DST. That is well beyond the author’s capability. However, the author would like, in the remainder of this editorial, to suggest some principles that might be adopted. His underlying thesis is that a common form of DST, based upon common principles reflected in the national law of different countries, is more desirable than for each country to develop independently its own approach to taxing the digitalized economy. A common approach would go some way to ensuring that businesses that operate in the digitalized economy would face, in effect, only one form of tax, based upon common principles, rather than a multitude of different national taxes. At present, a multinational corporation faces and manages to cope with different corporate income taxes imposed by different countries, but at least they are based on some common underlying principles. The attraction of a Plan B is that it should establish some common principles and, ideally, a common pattern for DSTs to be adopted by a goodly number of countries that wish to have such taxes.

This is not to suggest for one moment that Plan B would endeavour to pressurize countries into adopting a

single common tax. There must be the possibility for each country to determine for itself the scope of its DST and the applicable tax rate(s). However, the author thinks that there is still much advantage to be gained from endeavouring to develop a pattern for a DST based upon some common principles.

I PRINCIPLES FOR A COMMON DST UNDER PLAN B

The first principle that one might recommend for a common form of DST is that it should be non-discriminatory. One of the criticisms of existing DSTs from the multinational companies within their scope is that they are discriminatory against large, overseas multinationals who are subject to the tax, as against local competitors that are not subject to the tax. A non-discriminatory DST would draw much of the sting of this criticism. In any event, some countries have non-discrimination as a principle for taxation in their constitution, and discriminatory taxation may conflict with international obligations. One principle for a common DST should be that it is non-discriminatory.

The application of this in practice means that the tax should apply both to domestic companies making supplies of digital services and to non-resident companies as well. Assuming that there is a *de minimis* threshold for the tax (e.g., the tax only applies to businesses that supply digitalized services with a turnover in excess of, say, EUR 250m per year and in-country revenue from these services of, say, EUR 25m per annum) this should not be set so high that it applies in practice only to large, foreign multinationals.

Similarly, in terms of the scope of the tax, this should be designed so that the tax in practice does not fall only on non-resident companies and not on domestic companies. There is much to be said for a broad-scope DST which applies to a wider range of automated digital services: that avoids boundary problems as to whether a particular service falls within the scope of the tax or not, and it also allows greater amounts of revenue to be collected at a lower rate.⁸ Obviously, it should be a matter for each government to decide the scope of the DST it wishes to impose, and some countries may not wish to impose a DST on certain digital services (for example, online gaming maybe taxed in an alternative fashion). However, as a principle, a common DST should not be imposed in a way that is in practice discriminatory.

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⁶ See *U.S. Trade Group Calls for Extending OECD Digital Tax Moratorium*, Tax Notes International (5 Jun. 2023).

⁷ For an excellent survey of direct and indirect taxes on the digitalized economy, see KPMG, *Taxation of the Digitalised Economy: Developments Summary* (22 Dec. 2022).

⁸ Article 12B(6) of the UN Model Double Taxation Convention defines ‘automated digital services’ as including: online advertising services; supply of user data; online search engines; online intermediation platform services; social media platforms; digital content services; online gaming; cloud computing services; and standardized online teaching services. Some of these categories are more likely to overlap and cause boundary issues than others.

A second principle for a common DST is that it should, so far as possible, be operated by withholding of tax or collection of tax from the person paying for the digital services. If a common DST is going to be attractive for developing countries in particular, collection of the tax through withholding rather than by assessment of the taxpayer (who may be non-resident, but not necessarily) is an important design feature.

To go into this point in a little greater detail, where the automated digital service is provided to another business (and, for example, the cost of the service is likely to be a deductible business expense), then requiring that business to withhold the DST and account for it to the revenue authorities should be feasible. If the *de minimis* threshold for liability to the DST is not set too high, then the supplier of the services should be able to notify the business to whom the services are supplied that tax has to be withheld. Invoices could be issued which show that the payer for the services should withhold tax on the payment.

Where the digital service is supplied to a large number of non-business customers, however, it is not going to be feasible to require those customers to withhold tax and pay it to the relevant authority. Instead, the digital service supplier is going to have to calculate the DST on the supply (whether the supply is grossed up to include the DST, or whether it is treated as a DST-inclusive supply) and will have to account for the DST itself to the tax authority in the state of location of the customer. In practice, of course, it is likely that some digital service providers will be supplying both business customers and non-business customers and will have to register with the tax authorities in the state of location of the customer and account (probably monthly or quarterly) for the DST to the revenue authority.⁹

As a third principle, ideally the common DST should be designed in such a way that it is consistent with existing principles for taxing business profits, so far as that is feasible. This is something of a tall order: the DST is intended in principle to be a tax on the profits of companies supplying digital services. However, the basic nature of the tax – particularly the imposition of a gross withholding tax/tax on the price of services supplied to customers (as explained above) can be a long way from taxing net profit. One of the criticisms of DSTs is that, while purporting to tax the profits of the digital service provider, the tax is payable even if the provider is making

no profit or has a very low profit margin. Thus, a 3% DST does not sound like a great deal, but if the supplier has a low profit margin, then it may be equivalent to a tax on the net profit of 30% or 40% or 50%. If the DST is to be a tax on the net profit of the digital service provider, and to be applied in a similar fashion to normal corporate income tax, then this requires some rather special design features for the common DST.

What it suggests is the possibility of a two-stage tax. At the first stage the tax is applied as a flat-rate tax on gross revenue, whether by withholding by the business person to whom the service is supplied or by a mark-up on the supply of the service to other customers (as explained above). As a second stage, the digital service supplier makes a return to the state (or states) imposing the tax, showing its net profit from the supplies of digital services to each state, and applying the normal corporate income tax rate. Assuming the first-stage, gross revenue charge is imposed at a sufficiently high level, companies will have an incentive to compute the net profit and will usually be in a repayment scenario, claiming a repayment of the tax previously withheld or paid over to the revenue authority(ies).

There is something of a partial precedent for this type of two-stage taxation in Article 12B of the UN Model. That provides for a gross withholding tax on revenue or, at the taxpayer's election, under Article 12B(3) a tax on its 'qualified profits' from automated digital services. The UN Model version provides this alternative treatment at the request of the beneficial owner of the income from automated digital services. The suggestion here is that the pattern for a common DST might provide in all cases for this two-stage taxation (though the company making the supplies is only likely to bother with the second stage if it results in a repayment of the tax collected at the first stage).¹⁰

This concept of a two-stage process of taxing digital services may combine a system of withholding at source on payments (or payment of a gross tax on turnover where suppliers are to non-business customers) with a net tax imposed as a second stage that is consistent with normal principles for taxing corporate profits. However, this approach does raise further issues of consistency with international tax principles, particularly double taxation conventions.

A fourth principle for a common DST is, then, that, ideally, it should be possible to implement it without

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⁹ Without going into further detail, it is assumed that the IP address of the customer device would be treated as the place of location of the customer. The possibility that the customer to whom the service is targeted (e.g., online advertising services) may be in a third state is discussed further below. The Indian Equalization Tax contains alternative tests for determining the persons to whom the tax applies. In terms of a common DST, what is important is that there is no danger that the same supply could be regarded as subject to DST in two (or more) countries. For example, if a customer receives a supply on a device with an IP address registered in one state, but while actually present in another state. As the withholding tax is a first stage of collection, it may be that the place of registration of the IP address is used as the sole indicator of location of the customer.

¹⁰ There are other precedents for a flat-rate withholding tax as a first stage of taxation, and a second stage based upon a return showing net profits. For example, in some countries artists and sportspersons (usually if non-resident) are subject to an initial withholding of tax on gross revenue from a performance or contest: subsequently, the taxpayer may submit a new-basis return once expenses for the event are known. The taxpayer will usually do that if this results in a repayment of part of the tax withheld at the first stage.

having to renegotiate the double taxation conventions of the country imposing the tax. This is, in a sense, the difficulty with the UN Article 12B proposal: the article was designed to be inserted into double taxation conventions when concluded or by renegotiation. Even if a methodology is developed through the UN for a fast-track instrument to amend double taxation conventions, it is by no means the case that many developed countries would be willing to insert Article 12B into their treaties. Ideally, therefore, a common DST should not require treaty amendment.

This is where the two-stage taxation approach potentially may be helpful.

So far as the first stage tax is concerned, this is a tax on gross revenue or turnover and not a tax on profits. No expenses would be deductible, and the scope and rate of tax would be clearly different from a normal tax on income or profits. Subject to the precise design, it should be possible to say that this is not a tax on income falling within the scope of existing double taxation conventions. Of course, existing double taxation conventions do apply to some gross withholding taxes on categories of income, such as withholding taxes on royalties. However, the first stage tax may be designed in such a way to make it clear that it is a tax on gross revenue or turnover, rather than a tax on income or profits.

The same is not possible, however, with regard to the second stage tax which is clearly designed to be a tax on net profits. That runs directly into two of the most obvious problems in taxing the profits of digital businesses where there are double taxation conventions at play.

First, it is unlikely that the company supplying the services has a permanent establishment as defined in domestic law or in the double taxation conventions of the country that is seeking to impose the second stage DST. Secondly, even if one could get around this by defining some form of significant presence as a permanent establishment (which, in any event, would probably require the amendment of most double taxation conventions), the problem would then still arise in determining the amount of profit to be attributed to the permanent establishment. Even if the pre-2010 version of the OECD Model, Article 7, were applied, it is hard to see how one would determine the profits of the distinct and separate enterprise. Any attempt to apply the Authorized OECD Approach under the post-2010 version of Article 7 would fall down on the identification of the functions, assets and risks to be attributed to the deemed permanent establishment.

However, this may be where the two-stage process of taxation offers a solution. First, it would be a matter of choice for the multinational enterprise supplying the digital services whether or not it proceeded to the second stage,

computed its net profits, and then made a claim for repayment. There seems no reason why a claim for repayment – an amount of tax having already been collected at the first stage – should not be made conditional on the taxpayer waiving any rights it has under the relevant double taxation convention. That is, in order to have its basis for taxation shifted from gross revenue to net profits, and (usually) to obtain a repayment, the company would make its claim based purely on domestic law and without the application of double taxation conventions. This may depend on the country concerned, but for some countries¹¹ a taxpayer can rely entirely on domestic law and not claim the benefit of a double taxation convention. The second-stage of the taxation process, which converts the liability from the first-stage tax on gross revenue to the second-stage tax on net profits is essentially a process of making a tax repayment claim based entirely on domestic law.

The same approach applies, in a sense, to the determination of the profit attributable to a country under Article 7. The amount of net profit to be calculated as part of the repayment claim depends entirely on domestic law and not on the provisions of a tax treaty. In practice, the domestic law imposing the second stage DST might go further and the domestic law could contain a methodology for determining the net profit to be shown in the repayment claim. Again, Article 12B of the UN Model provides an interesting pattern here as the draftsman of that article clearly foresaw the problem of determining the net profit. Thus, Article 12B(3) provides for the 'qualified profits' to be a fixed percentage of the amount resulting from applying the profitability ratio of the digital services business segment to the gross annual revenue derived from the state in which the customers are located. It would seem sensible that the second stage DST (i.e., the tax on net income) should also adopt a common and formulaic approach to the determination of the net profit based upon the application of the profitability ratio of the business segment. Again, the provisions of a double taxation convention are irrelevant since the conversion from the first-stage tax on revenue to the second-stage tax on net income depends entirely on a domestic-law-based claim.

As explained, the concept of the two stage DST sidesteps the application of the existing double taxation conventions. If a taxpayer were to argue that the second stage DST (i.e., the tax on net income) conflicted with the double taxation convention, then domestic law might provide that the overall result would be that the second stage fell away and the gross revenue tax imposed at the first stage remained applicable. The taxpayer would have absolutely no incentive to argue incompatibility with the tax treaty if the result would be that the taxpayer would be worse off if successful.

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¹¹ The UK and India, for example.

One issue that would be of concern, particularly for businesses based in the United States, would be whether this second stage DST, which endeavours to tax net income, would be creditable in the US. Perhaps all one can say about that is that, if this was an approach that was commonly adopted, it would be in the interests of US business to lobby for regulations to provide that this tax should be creditable. After all, the tax is endeavouring to tax net income, but does so by sidestepping the tax treaty (the taxpayer would have to make a claim for repayment based on domestic law and not on the tax treaty) and based on a formulary approach to determining the net profit using a profitability ratio.¹²

One last point might be made about the possibility of a two stage DST as outlined here. The first stage, gross revenue tax is, of course, collected either by the state where the person who pays for the service is located or where the digital service provider is located. In many cases that may be where the customer is located: the recipient of the service may itself be the customer. However, because the tax is collected where the payment for the service originates, that is not necessarily the state where the customer is located.¹³ However, a two-stage DST could bring in the taxing right of the state of the customer at the second stage. That is, it could operate on the basis that, when the supplier of digital services makes a claim at the second stage to be taxed on its net income, and makes a repayment claim from the state which has collected the tax, the details of the claim could identify the location of the customers and there could be a transfer of tax to the state where those customers are located.¹⁴

Perhaps this might be illustrated by an example. Let us suppose that an Australian company engages a Singaporean company to provide online advertising services. Let us also suppose that the Singapore company adds the gross revenue

DST when it makes a charge to the Australian company and remits that tax to the Singapore revenue authorities. If all the customers to whom the advertising service is directed are in Singapore, then Singapore has correctly collected this tax. Suppose, however, that half of the customers to whom the online advertising services are directed are in Malaysia. This will be known by the time that the digital service provider makes its second stage claim to be taxed on a net income basis and to have a repayment of part of the tax. As part of its tax return at the second stage, it would show that 50% of the customers were in Malaysia. On that basis, the Singapore revenue would repay the excess tax that has been collected, paying half of the remaining tax to the Malaysian revenue authorities. This achieves, therefore, what Amount A is supposed to achieve: taxation in the market jurisdiction where the users are located.¹⁵

2 CONCLUDING COMMENTS

This editorial has been something of a thought experiment, toying with possible principles for a common form of DST. The pattern outlined here may be feasible or it may not be. That is really beyond the point. The point of this editorial is, as explained at the outset, that work is needed urgently on a Plan B. Amount A has had its chance and if there is not a critical mass in support by the end of this year then it is wrong to allow the uncertainty and the non-taxation of the digitalized businesses to continue. Hopefully, this editorial will spark off some thinking and work towards a common form of DST, or at least some principles that could be common to DSTs adopted by different states.

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¹² The tax would not be a voluntary tax as such since the taxpayer would have been subject to the (compulsory) first-stage gross revenue tax. The taxpayer would be making a choice to turn that first-stage tax on gross revenue into a second-stage tax on net profit and would do so if this resulted in a repayment of tax. Nor would the taxpayer have failed to mitigate their tax liability by failing to make a claim under the tax treaty: a claim under the tax treaty would simply have the effect that the (probably higher) gross revenue tax would continue to apply.

¹³ This is a consequence of the use of a withholding tax approach which is noted in the Commentary to Art. 12B of the UN Model: *see* para. 75 of the Commentary to Art. 12B of the UN Model.

¹⁴ In this context, one of the useful developments through the work on Amount A has been the development of internationally recognized sourcing rules for income, which identify the customer for the supply of various services. Those rules – which seem to be the first ever attempt to identify internationally recognized sourcing rules – could well be employed in this context.

¹⁵ The question might realistically be asked what incentive does Singapore have to agree to transfer part of the tax it has already collected to another revenue authority. The answer may well be given by asking what incentive did any government have to agree to Amount A of Pillar I which involved giving up tax jurisdiction by recognizing a new nexus of the state where the user was situated. Also, the answer may be that, if this reflects a common form of DST, Singapore simply recognizes that it is not entitled to retain tax which properly belongs to another jurisdiction (because the users are situated there). Singapore, of course, continues to be able to tax the profits of the Singaporean company that provided the online advertising services: it simply shares the net income, second stage DST on the basis that the tax is payable to the state where the users are located.