UN tax committee adopts Article 12B for model treaty rules on digital services

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In brief

The United Nations, through its Committee of Experts on International Cooperation in Tax Matters, has approved recommended language for bilateral treaty rules to address taxing rights around income arising from Automated Digital Services (ADS). The new Article 12B and associated Commentary will form part of the 2021 version of the UN Model Tax Convention (MTC). It would have an impact only when two contracting states negotiate (or renegotiate and amend) a tax treaty between them. Therefore, it may have less widespread effect than any consensus to which countries agree in discussions being led by the OECD in conjunction with the G20 and the 139 Inclusive Framework member countries.

In detail

Background

The increasing digitalisation of businesses has given rise to debate about the effectiveness of existing international tax rules that primarily allocate tax rights based on the physical presence of a business in the market jurisdiction (source jurisdiction). The OECD has been working to achieve consensus in G20 member states and the 139 countries that comprise the Inclusive Framework on redesigning the existing tax system to meet the challenges of the digitalising economy (Pillar One and Pillar Two proposals). In the meantime, some countries have adopted unilateral measures including gross digital services taxes (DSTs). The UN's tax committee - comprising 25 experts from a range of countries but operating in their personal capacities - has recommended an alternative set of rules, about which countries could bilaterally agree for ADS. This adoption by the committee reflects the primary use of the UN's MTC by developing countries as a benchmark for negotiating tax treaties. The rest of this Alert addresses those recommended rules.

Taxing rights over automated digital services

Apart from the state of residence of the beneficial owner of the ADS income (Residence State), the Source State from which payments arise would also be granted the right to tax those activities. Unlike the proposals that the OECD is considering, art. 12B does not allow any de minimis thresholds, so any business, regardless of size, could be in scope (although the Commentary states that thresholds could be adopted).

Meaning of ADS

ADS are services provided on the Internet or other electronic network requiring minimal human involvement. The test of minimum human element should be applied for the supplier and not the recipient of the service, and it does not include the involvement of the human element over creating, supporting, or maintaining the system needed for providing services.

The definition referred to in the Commentary by way of examples is instructive but not necessarily exclusive. This ADS definition includes: (i) online advertising services; (ii) supply of user data; (iii) online search engines; (iv) online intermediation platform services; (v) social media platforms; (vi) digital content services; (vii) online gaming; (viii) cloud computing services; and (ix) standardised online teaching services.

Services would not fall within the ADS definition if they were in the nature of: (i) customised professional services; (ii) customised online teaching services; (iii) services providing access to the Internet or to another electronic network; (iv) online sale of goods and services other than ADS; and (v) revenue from the sale of a physical good, irrespective of network connectivity.

Income from ADS within scope

ADS source income (ADSI) within scope of the rules would include payments made by a permanent establishment (PE) or resident of the Source State (unless it is borne by a PE in the Residence State).

However, there would be excluded payments that are regarded as:

- royalties (subject to withholding tax (WHT) under Art. 12 MTC) or fees for technical services (subject to WHT under Art. 12A MTC)
- amounts in excess of the arm's length principle (ALP), the application of Art 12B being limited to that ALP amount (although the excess may be taxed under other provisions).

Gross basis

Tax in the Source State would be limited to a certain percentage of the gross amount of the income to be bilaterally agreed in the treaty between the countries, unless the beneficial owner opts for the net basis to apply instead.

The Commentary suggests a 'modest' tax rate of 3% or 4%. Countries may bilaterally include thresholds for the application of Art. 12B to reduce the taxpayer population that would be subject to possible excessive taxation because of applying gross basis taxation to ADS.

Net basis

The beneficial owner can request the Source State to tax it on a net basis, i.e., tax an amount of deemed 'qualified profits' applying the usual corporate income tax rate in the Source State.

The qualified profit would be 30% of the amount resulting from applying to the ADSI the higher profitability ratio of the ADS business segment or, if it does not maintain segment level accounts, the overall profit ratio:

- for the beneficial owner
- for the group (to prevent manipulation of profit within the group, although it is suggested that countries could instead apply an anti-abuse rule).

> ***Example***
> The beneficial owner receives gross payments from the Source State of 100 and has a profit of 25% on all its ADS activities; but worldwide, the group has a 40% profit margin.
>
> The qualified profits would be 30% * 40% * 100 = 12
>
> If the treaty negotiated percentage is 4% and the domestic CIT rate is 29% the beneficial owner might opt for the net basis, since 4% of 100 gross basis is more than 29% of 12 on the net basis.

Some committee experts expressed the view that the recommended figures are too onerous. The Commentary allows for the 30% to be negotiated down. It is also suggested that countries could provide a 'carve out' for routine functions.

If segment level profit or the overall profit ratio are not available to the Source State, then the taxation will be on gross basis.

The takeaway

The application of Art. 12B to provide for either a gross or net basis of taxing income from ADS in the Source State is dependent on take-up in bilateral tax treaties. A large minority of the UN's Tax Committee experts were not in full agreement with the details and the Commentary recognises that a number of countries may not include Art.12B. The Commentary also allows for countries to diverge from elements of the rules even if they do include a version of Art. 12B. There will be considerable interest from some developing countries in pursuing the elements reflected in Art. 12B, particularly if they may be dissatisfied with a potential global consensus and prefer a bilateral mechanism rather than resorting to unilateral measures.

Let's talk

For a deeper discussion of how this issue might affect you, please get in touch with your usual PwC contact or one of the following:

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