

# United Nations

## Taxation of Digitalized Economy – Proposed UN Solution

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A popular joke<sup>[1]</sup> goes like this:<sup>[2]</sup>

When NASA first started sending up astronauts, they quickly discovered that ball-point pens would not work in zero gravity. To combat this problem, NASA scientists spent a decade and \$12 billion developing a pen that writes in zero gravity, upside down, on almost any surface including glass and at temperatures ranging from below freezing to over 300 °C.

The Russians used a pencil.

What can be compared from the above is the approach taken by OECD and UN to address the issue of taxation of digitalized economy. While OECD's approach is most methodical and is full of complexities, the UN approach is far simpler, easy to understand, transparent as outcome is easy to predict and probably serves the purpose.

The first draft of new Article 12B – Income from Automated Digital Services was recently released by the UN Tax Committee. This article contains an analysis of the proposed article 12B.

### 1. Background and the Mandate

The 20th Session of the United Nation's Committee of Experts on International Cooperation in Tax Matters (UN Tax Committee) was conducted online in June 2020.

As per the summary of the session captured in outward-facing message issued by Secretariat to the public on 26 June:

The Committee discussed possible drafting work that could be done in the framework of the UN Model Double Tax Convention to address issues raised by the digitalized economy, with the importance also raised in discussion of ensuring a clear framework, purpose and objective for such work. Without prejudice to the inclusion or otherwise of any provision in the Model, a drafting group of those who had spoken in favour of such work was tasked to provide a first draft proposal by the end of July, seeking to take on board not only the calls in favour of such a provision, but also relevant discussions about clarifying objectives and recognizing practical complexities. This will then be considered by the wider Membership of the Committee.

The above paragraphs from the Cover Note suggest that at the 20th Session a decision was taken to draft a new provision. The *Drafting Group of developing country Members of UN Tax Committee* (Drafting Group) took up the work of drafting a new article and its commentaries to address tax challenges of digitalized economies for insertion in the UN Model Tax Convention.<sup>[3]</sup> The Drafting Group consist of 13 committee members. The draft prepared by this Drafting group would be further considered by the wider Committee. The UN Tax Committee consist of 25 members.

It appears that the issue was discussed in the UN Tax Committee meetings in last couple of years, but it is for the first time that the developing country members of the UN Tax Committee got a mandate to create a draft article and commentaries thereon. What is important to note is that the Drafting Group submitted its complete proposal in less than one month's time, whereas even after a few years the world is yet to see a complete proposal of the OECD/IF on this issue.

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\* Author is Mumbai based Chartered Accountant. Views expressed in this article are the personal view of the author and do not represent views of any organization.

1. See <https://www.neowin.net/forum/topic/142019-nasas-space-pen/> (accessed 19 Aug. 2020).  
2. Author has highest level of respect for work done by all the scientists. This joke is used in lighter vein only to do some comparison of approaches.  
3. *UN Model Double Taxation Convention between Developed and Developing Countries* (1 Jan. 2017), Treaties & Models IBFD.

## 2. Proposed Article 12B

The text of proposed article 12B is reproduced hereunder:

### **New Article 12B – Income from Automated Digital Services**

1. Income from automated digital services arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, income from automated digital services arising in a Contracting State may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the income is a resident of the other Contracting State, the tax so charged shall not exceed \_\_\_\_ percent (the percentage is to be established through bilateral negotiations) of the gross amount of the income.

3. Notwithstanding the provisions of paragraph 2, the beneficial owner of the income from automated digital services referred to in that paragraph may require the Contracting State where the income from automated digital services arises, to subject its qualified profits from automated digital services for the fiscal year concerned to taxation at the tax rate provided for in the domestic laws of that State. For the purpose of this paragraph, the qualified profits shall be 30 percent of the amount resulting from applying the beneficial owner's profitability ratio or the profitability ratio of its automated digital business segment, if available, to the gross annual revenue from automated digital services derived from the Contracting State where such income arises. Where the beneficial owner belongs to a multinational group, the profitability ratio to be applied shall be that of the group or, if available, of the business segment of the group relating to income covered by this Article.

4. The term "income from automated digital services" as used in this Article means any payment in consideration for any service provided on the internet or an electronic network requiring minimal human involvement from the service provider. The term "income from automated digital services" does not, however, include payments qualifying as 'fees for technical services' under Article 12A.

5. The provisions of paragraphs 1, 2 and 3 shall not apply if the beneficial owner of the income from the rendering of automated digital services, being a resident of a Contracting State, carries on business in the other Contracting State in which the income from automated digital services arises through a permanent establishment situated in that other State, or performs in the other Contracting State independent personal services from a fixed base situated in that other State, and the income from automated digital services are effectively connected with:

- (a) such permanent establishment or fixed base, or
- (b) business activities referred to in (c) of paragraph 1 of Article 7.

In such cases the provisions of Article 7 or Article 14, as the case may be, shall apply.

6. For the purposes of this Article, subject to paragraph 7, income from automated digital services shall be deemed to arise in a Contracting State if the payer is a resident of that State or if the person paying the income, whether that person is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the obligation to make the payment was incurred, and such payments are borne by the permanent establishment or fixed base.

7. For the purposes of this Article, income from automated digital services shall be deemed not to arise in a Contracting State if the payer is a resident of that State and carries on business in the other Contracting State through a permanent establishment situated in that other State or performs independent personal services through a fixed base situated in that other State and such expenses are borne by that permanent establishment or fixed base.

8. Where, by reason of a special relationship between the payer and the beneficial owner of the income from automated digital services or between both of them and some other person, the amount of the income, having regard to the services for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the income shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

The Drafting Group has also written a commentary on this new article.

### 3. Broad Overview of Article 12B – Key features

The structure of proposed article 12B of the UN Model is broadly comparable to article 10 (dividend), article 11 (interest) and article 12A (fees for technical services), which give taxing right to the source country. The source country is given the taxing right on the basis that the income arises in that country. There is no need to have a permanent establishment for such taxing right. If the person earning income has a permanent establishment in the source country and income is effectively connected to such permanent establishment, the income is taxed in terms of article 7.<sup>[4]</sup>

The taxing right is given to the source country for income from automated digital services arising in the source country. As is the case with other articles, the contracting states are expected to bilaterally negotiate the highest rate of tax which can be charged by the source country on income from automated digital services. Article 12B also gives an option of taxation on net basis. This option is to be exercised by the person earning income.

### 4. Key Concepts

#### 4.1. Automated digital services

The term “income from automated digital services” is defined to mean any payment in consideration for any service provided on the Internet or an electronic network requiring minimal human involvement from the service provider. The key features of this definition are:

- The services must be provided over the Internet or an electronic network.
- Human intervention in rendition of such services should be minimal.

##### 4.1.1. General principles

The draft commentary on the proposed article 12B gives general principles for determining whether income is covered within the scope of article 12B:

- A service is regarded as automated when the user is able to make use of the service because of equipment and systems being in place, which allow the user to obtain the service automatically, as opposed to requiring a bespoke interaction with the supplier to provide the service.
- Human intervention from the user’s side is to be ignored.
- The focus is on the provision of service and therefore does not include human interventions in creating or supporting or maintaining the system needed for provision of service.
- The threshold of minimal human intervention would not be crossed where the provision of service to new users involves very limited human response to individual user requests.
- An important indicator of the concept of “automated” is whether there is the ability to scale up and provide the same type of service to new users with minimal human involvement.
- On the other hand, a non-automated digital business would see a proportionate increase in per unit costs in connection with providing the services to new customers.
- No distinction is made between different Internet, or electronic network transmission methods, to regard a service as automated digital service.

These general principles give good guidance for determining what constitutes “income from automated digital services”. In addition to these general principles, the commentary also give guidance on what specifically does and does not qualify as automated digital services.

##### 4.1.2. Services qualifying as automated digital services

On the basis of the general principles, the following services are considered to be automated digital services:

Online advertising services	Online advertising services are understood as online services aimed at placing advertisement on a digital interface, including services for the purchase, storage and distribution of advertising messages, and for advertising monitoring and performance measurement.
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4. If such condition is satisfied in the context of fixed base, provisions of article 14 of the UN Model will be attracted.

Online intermediation platform services	Online intermediation platform services and social media services involve a digital interface available to users for the purpose of enabling interaction between users, including for the sale, hire, advertisement, display or other offer by users of particular goods, services, user-generated content or other property to other users.
Social media services	
Digital content services	Digital content services implies the automated provision of data in digital form, such as computer programs, applications, music, videos, texts, games and software, other than the data represented by a digital interface.
Cloud computing services	Cloud computing services are those providing standardized on demand network access to information technology resources.
Sale or other alienation of user data	Sale or other alienation of data means the provision of data to a third-party customer, where the data is generated by users of a digital interface, and is collected, compiled, aggregated or otherwise processed into data through an automated algorithm. For the purposes of this paragraph, "data generated by users" refers to all directly or indirectly identifiable personal data.
Standardized online teaching services.	Standardized online teaching services are those involving the provision of an online education programme provided to an unlimited number of users, which does not require: (i) the live presence of an instructor; or (ii) significant customization on behalf of an instructor to a particular user or limited group of users, whether with respect to the curriculum, teaching materials, or feedback provided.

### 4.1.3. Services not qualifying as automated digital services

On the basis of the general principles, the following services are not considered to be automated digital services:

Customized services provided by professionals	The expression "customized services provided by a professional" includes services whether individually or as a firm, such as those provided by a lawyer, accountant, bookkeeper, architect, engineer, medical professional or financial or other specialized expert consultant.
Customized online teaching services	Customized online teaching services mean live or recorded teaching services delivered online, where the teacher customizes the service (such as by providing individualized, non-automated feedback and support) to the needs of a student or a limited group of students and the Internet or electronic network is used as a tool simply for communication between the teacher the student.
Services providing access to the Internet or to an electronic network	It may be clarified that services providing access to the Internet or to an electronic network are out of the scope of article 12B; the provision of access (i.e. connection, subscription, installation) to the Internet or to an electronic network irrespective of the delivery method, namely over wire, lines, cable, fibre optics, satellite transmission or other means, typically requires a degree of local infrastructure and is subject to local telecommunication regulations.
Online sale of goods and services other than automated digital services	"Online sale of goods and services other than automated digital services" is intended to refer to the sale of a good or service completed through a digital interface where: (i) the digital interface is operated by the provider of the good or service; (ii) the main substance of the transaction is the provision of the good or service; and (iii) the good or service does not otherwise qualify as an automated digital service.
Broadcasted services including simultaneous Internet transmission	Broadcasted services including simultaneous Internet transmission are understood as services that are simultaneously provided via broadcast to the general public over communication networks other than the Internet or electronic networks.
Composite digital services embedded within a physical good irrespective of network connectivity ("Internet of things")	The expression "composite digital services embedded within a physical good ("internet of things")" applies irrespective of the network connectivity of that physical good, provided that there is no separately identifiable automated digital service revenue stream attached to that physical good.

### 4.1.4. Overlaps

Payments qualifying as "fees for technical services", are specifically excluded from the scope of article 12B. This means that one will have to first examine applicability of article 12A and only if that article is not applicable, the provisions of article 12B can be applied.

Article 12B does not categorically address the potential overlap between "income from automated services" and "royalties"; however, the commentary recognizes the issue and gives the following guidance:

The distinction between payments for consideration of services and royalties is clear in principle. Under Article 12, paragraph 3, royalties are payments for the use, or the right to use, certain types of property or information concerning industrial, commercial or scientific experience (so-called know-how). In contrast, the performance of services does not involve any transfer of the use of, or the right to use, property. However, in practice it is often difficult to distinguish between royalties and fees for services, including automated digital services, especially with respect to so-called mixed contracts. Guidance with respect to the distinction between fees for services and royalties is provided in paragraph 12 of the Commentary on Article 12 of the United Nations Model Convention, which reproduces paragraphs 11.2–11.6 of the Commentary on Article 12 of the OECD Model Convention.

## 4.2. Qualified profits

The option to get taxed on net basis is a unique feature of article 12B. Thus the service provider has the following options:

- offer the income from automated digital services to tax at a rate bilaterally agreed by the parties; or
- offer the income from automated digital services at the tax rates provided in the domestic law of the source country. This rate is to be applied on qualified profits.
- It appears that the option is to be exercised on a yearly basis i.e. for the fiscal year.

While the proposed commentary indicates that the first option (i.e. taxation in terms of article 12B(2)) is a gross basis withholding, that may not necessarily be true. Article 12B(2) only gives the maximum rate of tax which can be applied on the income by the source country. Whether this is to be applied on gross basis or net basis depends on the domestic law of source country.

Thus theoretically net basis of taxation can be possible under both the options, however practically the first option will most likely be adopted as a withholding on gross basis.

Article 12B(3) contemplates the following qualified profits:

	1	2	3	4
	Where the service provider does not belong to a multinational group		Where the service provider belongs to a multinational group	
X	Gross annual revenue from automated digital services derived from source country Multiplied by Profitability ratio of			
Y	the service provider entity	Automated digital services business segment of the service provider entity, if available	the multinational group	Automated digital services business segment of the multinational group
Resultant amount (Z)	$X*Y = Z$	$X*Y = Z$	$X*Y = Z$	$X*Y = Z$
Qualified profits	30% of Z	30% of Z	30% of Z	30% of Z

The tax rates provided in the domestic law of the source country are to be applied on the qualified profits.

## 4.3. Profitability ratio

As per the commentary, the profitability ratio of the beneficial owner or the multinational group to which the beneficial owner belongs, is understood to be the total annual profits divided by the total annual revenue, as revealed by the consolidated financial statements of the beneficial owner or of the group it belongs to, or of the automated digital services business segment, as the case may be.

## 5. Conclusion

Article 12B proposed by the drafting group of the UN Tax Committee is welcome and desirable. This is still a first draft and certainly there would be further improvements to this. It addresses only automated digital services but not the consumer facing business. Unlike OECD, there is no economic impact analysis behind article 12B.

The best part of the UN approach is that it is easy to understand as well as implement. Against this, OECD's Pillar 1 is extremely complex and may not be giving certainty as regards the extent to which the source countries/developing countries would get their fair share of tax revenue. Even after five long years, the final technical solution is yet to arrive and then comes the political consensus. The Pillar 1 Blue Print suggests that several issues are yet open. Against this, the UN Drafting Group has offered a very simple solution in a very short period of time.

The author hopes that the solution offered by the UN is seriously considered by various stakeholders as an option. Ultimately, a simple, transparent and easy to implement solution is desirable.