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The Tax Sovereignty Principle and Its Peaceful Coexistence with Article 12B of the UN Model Tax Convention

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One important 'right' of the sovereign State - tax sovereignty - carries meaningful content. States' anxiety over tax sovereignty is legitimate. The ability to control tax policy enables a State to meet its functional duties (revenue raising and fiscal policy design) and support its two important democratic norms - democratic accountability and democratic legitimacy. Obviously States do not exercise unimpeded control over tax policy choices - they are influenced and constrained by the political economy within their own domestic system (e.g., pressure from taxpayers) and by the need to account for the implications of their tax rules globally (e.g., whether a State's new tax be deemed a creditable and justified tax by other countries).[1] Despite the constraints, tax sovereignty is one of the fundamental components of the sovereign State. Tax sovereignty may be characterised as a State's autonomous power to positively levy taxes, and as such one can see why States are keen to retain it. At the same time, tax sovereignty is about the State's power to *not* tax, and in particular the State's power to relieve global capital of the burden of taxation in order to induce it to efficiently reallocate itself geographically. Hence, while exercising their right over tax sovereignty, States need to maintain a careful balance in levying taxes so as to satisfy the aspirations of all stakeholders, including itself.

Raison d'etre of introduction of Article 12B

With the advent of modern means of telecommunications and the spread of digitalisation, enterprises have the ability to effectively engage in substantial business activities in the market country without a fixed place of business there, or to conclude contracts remotely through technological means with no involvement of individual employees or dependent agents. Since existing permanent establishment (PE) provisions in the United Nations Model Tax Convention (UN MTC) do not cover in their ambit any income arising in market jurisdictions from automated digital services (ADS), the United Nations (UN) Committee of Experts on International Co-operation in Tax Matters (UN Tax Committee) took this subject as a matter of priority to be dealt with and decided to focus on a tax treaty provision under the UN MTC that would enable jurisdictions to ap-

Abstract

Article 12B of the United Nations (UN) Model Tax Convention (MTC) provides developing countries with a practical and easy way to administer policy solutions for taxing the digital economy, in particular income from Automated Digital Services. It merges seamlessly with the existing provisions of the UN MTC and it is completely aligned and coexistent with the Tax Sovereignty Principle.

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L'article 12B du Modèle de Convention fiscale (MTC) des Nations Unies (ONU) offre aux pays en développement un moyen pratique et facile d'administrer des solutions politiques pour taxer l'économie numérique, en particulier les revenus des services numériques automatisés. Il s'intègre parfaitement aux dispositions existantes du MTC des Nations Unies et est complètement aligné et coexistant avec le principe de souveraineté fiscale.

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El artículo 12B del Modelo de Convenio Tributario (MTC) de las Naciones Unidas (ONU) ofrece a los países en desarrollo una forma práctica y sencilla de administrar soluciones políticas para gravar la economía digital, en particular los ingresos procedentes de los Servicios Digitales Automatizados. Se integra perfectamente con las disposiciones existentes del MTC de la ONU y está completamente alineado y coexiste con el principio de soberanía fiscal.

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ply their domestic legislation levying taxes on income derived from digital business models.

Important features of Article 12B

Recognizing that the role of tax sovereignty for a democratic sovereign State is important for formulating any policy at the multilateral level, this important requirement has been duly taken into cognizance in the proposal of the UN Tax Committee while working on taxation of the digitalised economy and is duly reflected in the provisions of Article 12B[2] in the UN MTC.

In addition, the most distinguishing feature of Article 12B is that it effortlessly fits into the UN MTC as an entirely new provision. It neither takes away any taxing right enshrined in existing provisions of the MTC nor does it fetter the tax sovereignty of States in terms of applying curbs on their domestic laws.

Simplicity and administrability is the essence of Article 12B. The UN Tax Committee's approach has been to find a solution, which is relatively simple to comply with by business as well as tax administrations and at the same time, results in a definite and legitimate share of tax for market jurisdictions.

Article 12B specifically addresses Automated Digital Services

Article 12B is deemed to automatically apply once the automated digital service (ADS) (having minimal human intervention and administered through electronic network, internet) has been provided and has no thresholds in terms of its application. This ability to derive income from a country with little or no physical presence there is considered by the UN Tax Committee to justify source taxation of income from ADS. The term 'automated digital services' includes especially:

- 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.

Under Article 12B, a State is entitled to tax payments for ADS if the income is paid by a resident of that State or by a non-resident with a PE or fixed base in that State and the payments are borne by the PE or fixed base. Article 12B allows a State to tax income from certain digital services paid to a resident of the other State on a gross basis at a bilaterally negotiated rate with an option to the taxpayer to pay tax on a net profit basis for the whole year. The provisions have been carefully designed keeping in mind that many developing countries have limited administrative capacity and need a simple, reliable and efficient method to enforce tax imposed on income from ADS derived by non-residents. A withholding tax imposed on the gross amount of payments made by residents of a country, or non-residents with a PE or fixed base in the country, is well established as an effective method of collecting tax imposed on non-residents. Such a method of taxation may also simplify compliance for enterprises providing such services in another State, since they would not be required to compute their net profits or file tax returns, unless they opt for net income basis taxation. The possibility that payments in consideration for ADS may be subject to double or excessive taxation is also reduced or eliminated under Article 23 (Methods for the Elimination of Double Taxation) of the UN MTC.

Article 12B does not overlap FTS provisions in tax treaties

In a different context, a tax expert[3] has posited that developing countries should be careful that the concept of value creation may not be used to contest the existing taxing rights relating to Fees for Technical Services (FTS), which they have so painstakingly negotiated in tax treaties. In keeping with this line of thinking to accord due importance and protection to FTS provisions that exist in tax treaties based on the UN MTC, the ADS covered under Article 12B does not overlap or intersect the FTS provisions enshrined in Article 12A of the UN MTC. In addition, it is provided that Article 12B shall not apply if the payments underlying the income from ADS qualify as 'royalties' or 'FTS' under Article 12 or Article 12A of the UN MTC as the case may be.

Article 12B does not apply curbs on domestic laws

Article 12B has no impact on unilateral tax provisions imposed by countries like equalisation levy which shall continue to be retained. Both Article 12B and equalisation levy can be applied simultaneously. Going forward, if States incorporate such unilateral tax provisions into the tax treaties, only in that case will Article 12B subsume such unilateral tax provisions, thereby implying that States retain their sovereign right whether to enlarge or not to enlarge the scope of Article 12B and simultaneously, whether to subsume or not to subsume the unilateral tax provisions within Article 12B.

UN backed Dispute Resolution Mechanism retains Sovereignty of States

The UN's International Financial Accountability, Transparency and Integrity for Achieving the 2030 Agenda (FACTI) Panel released its report in February 2021[4] containing 14 main recommendations. In regard to a proposal on the introduction of mandatory binding arbitration to addressing taxation of the digitalised economy (which has not found favour with the UN Tax Committee and thus, does not figure in Article 12B or any other provision under the UN MTC), the report observes that in that scenario, companies embroiled in related international tax disputes would have their cases adjudicated, not by countries and their courts, but by international arbitration panels whose decisions would be binding. Such a move will exacerbate tensions between countries' sovereignty to enforce tax rules and taxpayers' desire for certainty. Moving to mandatory arbitration could have dramatic, and unexpected, negative implications for raising revenue. Lessons should also be learned from the negative experiences countries have had with investor-state dispute settlement under international investment agreements. Countries have grappled with challenges relating to sovereignty; the potential violation of national constitutions; cost of arbitration and lack of resources; the possibility of unfair outcomes and biased arbitrators; lack of transparency; and lack of experience with investment dispute settlement. Under Recommendation 4C, the panel has inter alia observed at page 25 of its report that a tax dispute resolution mechanism under the auspices of the UN would provide an unbiased forum for Member States to resolve tax disputes. This fair international mechanism for dispute resolution should maintain a focus on the policy objective of raising resources for sustainable development investment. Through training programmes, this mechanism could also help create better channels for dispute settlement, such as mediation and conciliation, at the national level. It would retain some respect for both sovereignty and tax certainty for taxpayers.

Conclusion

Simplicity and administrability is the essence of Article 12B. Article 12B neither takes away any taxing right enshrined in the existing provisions of the UN MTC nor does it fetter the tax sovereignty of States in terms of applying curbs on their domestic laws. Article 12B merges seamlessly with the existing provisions of the UN MTC and keeping in mind the motto of the UN which is 'peaceful coexistence', Article 12B is completely aligned and coexistent with the Tax Sovereignty Principle.

Endnotes:

[1] Refer to paper by Diane M. Ring, Boston College Law School titled "Democracy, Sovereignty and Tax Competition: The Role of Tax Sovereignty in Shaping Tax Cooperation"

<https://lawdigitalcommons.bc.edu/cgi/viewcontent.cgi?referer=&httpsredir=1&article=1240&context=lsfp> accessed on 06 May, 2021.

[2] See https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2021-04/CITCM%2022%20CRP.1_Digitalization%206%20April%202021.pdf.

[3] Refer to article dated 2 March 2020 by Mr. Rasmi Ranjan Das titled "The Concept of Value Creation: Is It Relevant for the Allocation of Taxing Rights?"

<https://research.ibfd.org/ - /doc?url=/collections/bit/html/bit_2020_03_o2_2.html%23bit_2020_03_o2_2_s_5.> accessed on 06 May, 2021.

[4] Refer to report of the FACTI Panel, February, 2021 <https://uploads-ssl.webflow.com/5e0bd9edab846816e263d633/602e91032a209d0601ed4a2c_FACTI_Panel_Report.pdf>.

Annex

ARTICLE 12B – INCOME FROM AUTOMATED DIGITAL SERVICES

1. Income from automated digital services arising in a Contracting State, underlying payments for which are made to a resident of the other Contracting State, may be taxed in that other State.

2. However, subject to the provisions of Article 8 and notwithstanding the provisions of Article 14, 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 payments underlying the income from automated digital services.

3. The provisions of paragraph 2 shall not apply if the beneficial owner of the income from automated digital services, being a resident of a Contracting State, requests the other Contracting State where such income 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. If the beneficial owner so requests, subject to the provisions of Article 8 and notwithstanding the provisions of Article 14, the taxation by that Contracting State shall be carried out accordingly. For the purposes of this paragraph, the qualified profits shall be thirty percent of the amount resulting from applying the profitability ratio of that beneficial owner's automated digital services business segment to the gross annual revenue from automated digital services derived from the Contracting State where such income arises. Where segmental accounts are not maintained by the beneficial owner, the overall profitability ratio of the beneficial owner will be applied to determine qualified profits. However, where the beneficial owner belongs to a multinational enterprise group, the profitability ratio to be applied shall be that of the business segment of the group relating to the income covered by this Article, or of the group as a whole in case segmental accounts are not maintained by the group, provided such profitability ratio of the multinational enterprise group is higher than the aforesaid profitability ratio of the beneficial owner. Where the segmental profitability ratio or, as the case may be, the overall profitability ratio of the multinational enterprise group to which the beneficial owner belongs is not available to the Contracting State in which the income from automated digital services arises, provisions of this paragraph shall not apply; in such a case, the provisions of paragraph 2 shall apply.

4. For the purposes of paragraph 3, "multinational enter-

prise group" means any "group" that includes two or more enterprises, the tax residence for which is in different jurisdictions. Further, for the purposes of paragraph 3, the term "group" means a collection of enterprises related through ownership or control such that it is either required to prepare Consolidated Financial Statements for financial reporting purposes under applicable accounting principles or would be so required if equity interests in any of the enterprises were traded on a public stock exchange.

5. The term "automated digital services" as used in this Article means any service provided on the Internet or another electronic network, in either case requiring minimal human involvement from the service provider.

6. The term "automated digital services" includes especially:

- 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.

7. The provisions of this Article shall not apply if the payments underlying the income from automated digital services qualify as "royalties" or "fees for technical services" under Article 12 or Article 12A as the case may be.

8. The provisions of paragraphs 1, 2 and 3 shall not apply if the beneficial owner of the income from 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 is effectively connected with:

(a) such permanent establishment or fixed base, or

(b) business activities referred to in clause (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.

9. For the purposes of this Article and subject to paragraph 10, income from automated digital services shall be deemed to arise in a Contracting State if the underlying payments for the income from automated digital services are made by a resident of that State or if the person making the underlying payments for the automated digital services, 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 payments was incurred, and such payments are borne by the permanent establishment or fixed base.

10. For the purposes of this Article, income from automated digital services shall be deemed not to arise in a Contracting State if the underlying payments for the income from automated digital services are made by a resident of that State which 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 underlying payments towards automated digital services are borne by that permanent establishment or fixed base.

11. 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 payments underlying such 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 payments underlying such income from automated digital services shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

This brief is part of the South Centre's policy brief series focusing on tax policies and the experiences in international tax cooperation of developing countries.

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