SOUTH CENTRE

TAX COOPERATION POLICY BRIEF

www.southcentre.int

No. 16 ● July 2021

Article 12B - A tax treaty solution by the UN Tax Committee for taxing digital incomes

By Rajat Bansal *

Introduction

The third International Conference on Financing for Development held in Addis Ababa in July 2015, which was attended by the Heads of State, Ministers for Finance, Foreign Affairs and other high-ranking Government officials from 174 countries resulted in the adoption of the Addis Ababa Action Agenda,[1] which was subsequently endorsed by the United Nations General Assembly in its resolution 69/313 of 27 July 2015.[2] While noting that the financing needed to achieve the United Nations' 2030 Agenda for Sustainable Development is extremely large, of the order of trillions of dollars annually[3], the Addis Ababa Action Agenda provided that for all countries, the mobilisation and effective use of domestic resources, collected largely through taxes,[4] is central to the pursuit of sustainable development.

Treaty barrier for taxation of income of digitalised businesses

As is said in the tax arena, taxes are paid - nations are made. Taxes on the income of corporations and individuals constitute a large chunk of total taxes raised by the countries all over the world. Additional domestic resource mobilisation by countries requires the augmentation of income and corporate taxes by broadening the tax base and strengthening the tax administration amongst other measures. A significant portion of incomes arising in the developing countries belongs to the multinational corporations and foreign companies as a result of business activities carried on by them in these countries. Taxation of such income is as per the domestic tax law of countries, which generally requires meeting of a nexus threshold such as 'business connection' in the Indian tax law, as similarly occurs in other countries. Taxation of income from intangibles such as royalties and fees is generally governed by separate rules not requiring nexus by way of a business connection. Instead, payment from the concerned country is sufficient to fasten the tax liability.

In the case of foreign enterprises and non-residents, taxation as per domestic tax law is subject to the double taxa-

Abstract

Taxation of income of multinational enterprises engaged in digitalised businesses by source or market jurisdictions is currently the most important challenge before the international tax community. The current membership of the United Nations Tax Committee in April 2021 finalised a tax treaty solution to address this challenge. This brief explains the rationale for coming up with a particular solution of inserting a new Article in the United Nations Model Tax Convention, its merits and how it can be beneficial for all countries, especially the developing ones.

***

L'imposition sur les revenus des entreprises multinationales dans des activités numériques par les juridictions de la source ou de marché est actuellement le défi le plus important pour la communauté fiscale internationale. La composition actuelle du Comité fiscal des Nations Unies a finalisé, en avril 2021, un accord de convention fiscale pour relever ce défi. Ce rapport explique la raison d'être d'une solution particulière consistant à insérer un nouvel article dans le Modèle de convention des Nations Unies, ses mérites et comment il peut être bénéfique pour tous les pays, en particulier les pays en développement.

***

La tributación sobre los ingresos de las empresas multinacionales dedicadas a actividades digitales por las jurisdicciones de origen y las de mercado es actualmente el desafío más importante para la comunidad tributaria internacional. El actual conjunto de miembros del Comité en cuestiones de tributación de las Naciones Unidas finalizó, en abril de 2021, una medida de tratados tributarios para abordar este desafío. Este informe explica la justificación para la solución particular de agregar un nuevo artículo a la Convención Modelo de las Naciones Unidas, sus méritos y cómo esto puede ser beneficioso para todos los países, especialmente los en desarrollo.

* The author Rajat Bansal is at present a member of the United Nations (UN) Tax Committee of Experts. He was the Co-coordinator of the Drafting Group of the UN Committee members from developing countries, who steered Article 12B. The views expressed are personal.

tion avoidance agreements or bilateral tax treaties. These bilateral agreements or treaties are entered into by countries for allocating taxing rights amongst themselves and also for eliminating double taxation besides other purposes such as exchange of information for tax purposes and dispute resolution for treaty matters through a special process called mutual agreement procedure.

The tax treaties generally require a stricter threshold as compared to the domestic tax law for permitting taxation of business income of the foreign entity by the source or market country. This threshold under tax treaties, known as Permanent Establishment (PE), requires the existence in the source country of a fixed place or an agent dependent on the foreign entity, through which business is carried on by the foreign entity in the source country. This age-old PE rule on threshold was good for taxing business income from various activities of multinational enterprises engaging in cross-border activities till the advent of new business models galvanised by the advent of digital and communication technologies, which do not require physical presence or agent's presence for doing business in a foreign territory at a very large scale. Many streams of income from these new business models do not get classified as royalty or fees for technical services either under the domestic tax laws or under the tax treaties. Therefore, because of the existing tax treaties, countries cannot exercise taxing rights over the income from business activities carried out by multinational enterprises or foreign companies by engaging exclusively over the Internet or other digital networks in their territories. It does not help if the domestic tax law is modified unilaterally, since tax treaties override the domestic law to the extent it is more beneficial for the taxpayer. Changes in tax treaty provisions are hence essential for taxation of the income from digital business models by the market or source countries.

Role of Model Tax Conventions

However, changing the tax treaty is quite a different proposition from changing the domestic tax law. Change in tax treaty needs fresh negotiations with the treaty partner country to reach a new agreement. Most of the times, countries negotiate the tax treaties based on internationally recognised model tax conventions. The two well-known model tax conventions for bilateral tax treaties are the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention on Income and Capital and the United Nations (UN) Model Tax Convention between Developed and Developing Countries. The main difference between the two Models is in the allocation of taxing rights between the treaty partner countries. The UN Model Tax Convention which is for negotiation of a tax treaty between developing and developed countries grants more taxing rights to the source countries, as compared to the OECD Model Tax Convention. Both the Model Tax Conventions have the same threshold of PE i.e. physical presence or presence of a dependent agent in the source or market country for permitting the taxation of the business income of a foreign entity. Most tax treaties of the world - numbering around three thousand - have provisions taken from one of the two Model Tax Conventions. Provisions different from the two Model Tax Conventions are not so common. Due to this, change in the system of taxation of income from digital businesses under bilateral tax treaties of the world essentially requires change in the PE rule in the Model Tax Conventions first.

Role of national measures for digital taxation

Post Group of Twenty (G-20)/ OECD Base Erosion and Profit Shifting Project deliverables in 2015, the growing impatience with the situation of no clear-cut solution to tax digital business incomes saw various countries all over the world resort to what are known as unilateral measures.[5] These unilateral measures are about digital service taxes or equalisation levies which have been designed to avoid conflict with the tax treaty provisions. Criticism of unilateral measures has been severe, that they circumvent tax treaty rules and cause double taxation. However, unilateral measures were a manifestation of a very long wait by market jurisdictions for international tax rules to change and their growing impatience. Further, unilateral measures have acted as a catalyst to accelerate the process of finding a solution to the issue of allocation of taxing rights for digital economies.

Work taken up in the UN Tax Committee

Work on tax challenges posed by digitalised economies has been undertaken in the United Nations by the present membership of the Committee of Experts on International Cooperation in Tax Matters (UN Tax Committee), which is a committee of twenty five experts drawn from different countries, developing as well as developed.[6] Each membership of the Committee works on various issues of contemporaneous importance in the area of international tax policy for a fixed term of four years. The most important function performed by the UN Tax Committee is to update the UN Model Tax Convention. The UN Model Tax Convention is a creation of the committee of experts acting in their personal capacity. But it commands respect and wide acceptability in the tax treaty negotiations around the world.

The present membership of the Committee worked on addressing tax challenges of digitalised economies since inception of its term, i.e. 2017, independently of the work in other international forums. In its final session held in April 2021, it approved inclusion of a new tax treaty provision Article 12B[7] in the United Nations Model Tax Convention to allow taxation of income from automated digital services by the source or market countries without any requirement of PE, i.e. physical presence or agent's presence. The inclusion of Article 12B has been driven by a group of members[8] of the UN Tax Committee solely from developing countries, who believed that the developing countries needed a simpler solution with a share in entire profits derived from the market economies and not just a share in the non routine profits.

The scope of the new provision on automated digital services covers 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 amongst other digital services that may fall within the general definition in the provision. The incidence of taxation is on the basis of location of the payer for the automated digital services.[9] The new provision has two options for taxation, first by way of withholding tax at the time of each payment and second by way of net annual income of the foreign entity computed on the basis of revenue derived locally from the market jurisdiction and the global profitability of the multinational enterprise (MNE) group. Taxpayer can choose whichever option suits it more.

How the UN Tax Committee solution is different

The tax treaty solution by the UN Committee would be relevant where the countries first have the provision to tax income from digital economies in their domestic law. This is in line with the hitherto followed practice of leaving it to sovereign countries to tax or not to tax a particular stream or class of income.[10] In other words, there is no suggestion to tax income from the digital economy if a country does not wish to do so.

The UN solution is also a continuation of the system that is prevalent till now globally of taxing income of multinational enterprises by source countries in a decentralised manner under their respective domestic laws, with which tax treaties interact to allocate taxing rights as well as alleviate double taxation through grant of tax credit by the treaty partner country. There is no change from the existing system for elimination of double taxation and dispute resolution followed presently in respect of taxation of income of foreign enterprise derived through a permanent establishment.

Thus, under the UN approach, there is no fundamental departure from the current system of taxing business income of multinational enterprise groups and stability as well as continuity is maintained. It would be much easier for developing countries to adapt to a system similar to the one they are used to rather than an entirely new system of multilateral or centralised taxation. Further, the UN solution does not interlink or mix different kind of taxation issues as a precondition for moving forward.

Conclusion: Looking forward – A UN Multilateral Instrument

Insertion in the UN Model Tax Convention would grant required legitimacy to the new provision for adoption by countries in their existing or new tax treaties. One swift way to include the new provision in the bilateral tax treaties could be via a UN multilateral instrument[11] which would allow bilateral match making between various countries which join it. The High Level Panel on International Financial Accountability, Transparency and Integrity for Achieving the 2030 Agenda (FACTI Panel) has also suggested a similar approach in its recommendation for a "UN Tax Convention."[12] Inclusion of the new provision in the bilateral tax treaties of the world can, on one hand result in fair allocation of taxing rights between market and residence countries in respect of automated digital services and on the other perhaps put an end to the unilateral measures being taken by the countries.

Endnotes:

[1] Available from https://sustainabledevelopment.un.org/content/documents/2051AAAA_Outcome.pdf.

[2] Available from https://www.un.org/en/development/desa/population/migration/generalassembly/docs/globalcompact/A_RES_69_313.pdf.

[3] See https://developmentfinance.un.org/sites/developmentfinance.un.org/files/FSDR_2021.pdf.

[4] Para. 22 of Addis Ababa Action Agenda.

[5] See https://www.southcentre.int/research-paper-111-may-2020/.

[6] See https://www.un.org/development/desa/financing/what-we-do/ECOSOC/tax-committee/tax-committee-home.

[7] 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.

[8] See https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2020-10/CITCM%2021%20CRP.41_Digitalization%2010102020%20Final.pdf.

[9] See https://www.alainet.org/en/articulo/208698.

[10] See https://www.southcentre.int/tax-cooperation-policy-brief-14-june-2021/.

[11] See https://www.southcentre.int/tax-cooperation-policy-brief-15-june-2021/.

[12] Recommendation #2. See: https://uploads-ssl.webflow.com/5e0bd9edab846816e263d633/602e91032a209d0601ed4a2c_FACTI_Panel_Report.pdf

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.

Efforts to reform international cooperation in tax matters are exhibiting a distinct acceleration. The direction of change must recognize and incorporate innovations in developing country policies and approaches, otherwise the outcomes will obstruct practical paths to development.

The policy brief series is intended as a tool to assist in further dialogue on needed reforms.

***** The views contained in the policy briefs are personal to the authors and do not represent the institutional views of the South Centre or its Member States.**

Previous South Centre Tax Cooperation Policy Briefs

No. 1, May 2018—Ecuador and Its Fight Against Tax Havens by Lorena Freire G.

No. 2, May 2018— Transfer Pricing: Concepts and Practices of the 'Sixth Method' in Transfer Pricing by Veronica Grondona

No. 3, August 2018— Interaction of Transfer Pricing & Profit Attribution: Conceptual and Policy Issues for Developing Countries by Dr. Vinay Kumar Singh

No. 4, September 2018—Exchange of Information: Indian Experience, Developing Country Implications by Jahanzeb Akhtar

No. 5, December 2018—The Definition and Treatment of Tax Havens in Brazilian Tax Law between 1995 and 2015 by Alexandre Akio Lage Martins

No. 6, January 2019— Illicit Financial Flows: Conceptual and Practical Issues by Hon. Irene Ovonji-Odida and Algresia Akwi-Ogojo

No. 7, February 2019— Developing Countries and the Contemporary International Tax System: BEPS and other issues by Marcos Aurélio Pereira Valadão

No. 8, July 2019— Improving Transfer Pricing Audit Challenges in Africa through Modern Legislation and Regulations by Thulani Shongwe

No. 9, September 2019— Gender, Tax Reform and Taxation Cooperation Issues: Navigating Equity and Efficiency under Policy Constraints by Mariama Williams

No. 10, November 2019— Addressing Developing Countries' Tax Challenges of the Digitalization of the Economy by Monica Victor

No. 11, February 2020—The Role of South-South Cooperation in Combatting Illicit Financial Flows by Manuel F Montes

No. 12, September 2020—Base Erosion and Profit Shifting in the Extractive Industries by Danish and Daniel Uribe

No. 13, February 2021—Making the UN Tax Committee more effective for developing countries by Abdul Muheet Chowdhary

No. 14, June 2021—The Tax Sovereignty Principle and Its Peaceful Coexistence with Article 12B of the UN Model Tax Convention by Kuldeep Sharma, ADIT (CIOT, UK)

No. 15, June 2021—Conceptualizing a UN Multilateral Instrument by Radhakishan Rawal

SOUTH CENTRE

The South Centre is the intergovernmental organization of developing countries that helps developing countries to combine their efforts and expertise to promote their common interests in the international arena. The South Centre was established by an Intergovernmental Agreement which came into force on 31 July 1995. Its headquarters is in Geneva, Switzerland.

Readers may reproduce the contents of this policy brief for their own use, but are requested to grant due acknowledgement to the South Centre. The views contained in this brief are attributable to the author/s and do not represent the institutional views of the South Centre or its Member States. Any mistake or omission in this study is the sole responsibility of the author/s. For comments on this publication, please contact:

The South Centre
International Environment House 2
Chemin de Balexert 7-9
PO Box 228, 1211 Geneva 19
Switzerland
Telephone: (4122) 791 8050
E-mail: south@southcentre.int
https://www.southcentre.int

Follow the South Centre's Twitter: South_Centre