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Tax Issues related to the Digitalization of the Economy

Tax Issues related to the Digitalization of the Economy: Report

Summary

This paper was prepared by the Subcommittee on Tax Challenges Related to the Digitalization of the Economy for discussion by the Committee at its 18th Session. It proposes a general workplan for the subcommittee work, proposes some guiding principles, and seeks Committee view on four questions that have arisen in the subcommittee work and where views of the committee will help focus the work going forward.

The Subcommittee is mandated by the Committee as follows:

“The Subcommittee is mandated to draw upon its own experience as a body widely representative of affected stakeholders and engage with other relevant bodies, and interested parties with a view to:

- Analyzing technical, economic and other relevant issues;
- Describing difficulties and opportunities especially of interest to the various affected agencies of developing countries;
- Monitoring international developments;
- Describing possible ways forward; and
- Suggesting measures and drafting provisions related to the digitalization of the economy, regarding:
 - Income taxes;
 - Double tax treaties, and
 - VAT as well as other indirect taxes.”

I. INTRODUCTION

1. The Committee of Experts on International Cooperation in Tax Matters as constituted in 2017 formed a Subcommittee on Tax Challenges Related to the Digitalization of the Economy (the “UN Subcommittee”) to address the tax challenges of the digitalization of the economy. The Subcommittee is mandated to draw upon its own experience as a body widely representative of affected stakeholders and engage with other relevant bodies and interested parties with a view to analyzing technical, economic and other relevant issues; describing difficulties and opportunities especially of interest to the various affected agencies of developing countries; monitoring international developments; describing possible ways forward and suggesting measures and drafting provisions related to the digitalization of the economy, with regard to income taxes, double tax treaties and VAT as well as other indirect taxes.
2. The Committee and the Subcommittee discussed these matters in the 15th and 16th Sessions of the Committee and in the Subcommittee Meetings held on the sidelines of the 16th and 17th Sessions. After the 17th Session of the Committee, the Subcommittee had a meeting from 16-18 January 2019 in Paris, France, kindly organized by the Nigerian Embassy, to consider how to take forward its mandate, with a particular view to what should be presented for consideration, discussion and decision, by the UN Committee of Experts for International Cooperation in Tax Matters at its 18th Session from 23rd to 26th April 2019.

II. SUBCOMMITTEE MEETING IN PARIS DURING 16TH-18TH JANUARY 2019: WORK PROGRAMME DRAWN

3. During the Paris Subcommittee meeting, following a presentation of work done by the Task Force on the Digital Economy (TFDE) / Inclusive Framework on BEPS (IF) so far on “Addressing the Tax Challenges of the Digitalization of the Economy”, the Subcommittee members exchanged views and questions with the TFDE/IF Secretariat to better understand the status of that work and forward plans. Thereafter, the Subcommittee discussed the matter amongst its members and came up with a Work Plan. The Subcommittee identified the tax challenges of the digitalization of the economy as fundamentally relating to inability of the jurisdiction (for current purposes referred to as the “source jurisdiction”) under the physical presence criteria of tax treaties, to tax business profits of certain *new* business models not requiring a *physical* presence in the market to derive such profits. Traditional business models, it considered, require such a presence to derive such profits, and that presence allows the source jurisdiction to tax them under existing international rules. The Subcommittee noted that an additional but related challenge exists for some smaller economies, which is the lack of domestic legislation that effectively addresses the new business models, so that taxes can be levied and collected on the profits derived from such models. It was also noted that there are VAT issues that need to be addressed.
4. Pursuant to the above, it was decided that the Subcommittee would present to the Committee a Paper for consideration at its 18th Session, describing possible approaches for addressing these challenges, with special reference to the situation of developing countries. A subgroup was constituted to develop an initial draft of the Paper for

consideration by the Subcommittee. In preparing the Paper, the following guiding principles were to be followed:

- Avoiding both double taxation and non-taxation;
- Preferring taxation of income on a net basis where practicable; and
- Seeking simplicity and administrability.

5. An important decision was for the Subcommittee to adopt an approach *independent of similar work being pursued in other fora*, while giving due consideration to developments which will inform its work. The Subcommittee also was of the view that at this stage of its work, it had sufficient information available to it to proceed with the above-mentioned work, and did not need to circulate a questionnaire. It will give further consideration as to how to most effectively engage with stakeholders, as the need arises. To achieve its mandate, the Subcommittee decided that it should propose guidance on:

- (1) Tax treaty issues;
- (2) Domestic law issues; and
- (3) VAT issues;

with subgroups being formed as appropriate to address aspects of this work.

6. This Paper has been drafted by a small group of the Subcommittee members, hereinafter referred to as Drafting Group. The original intent was to discuss the questions raised in the Paper via email within the Subcommittee. Time proved too short to fully complete this process and to obtain input from a sufficient number of Subcommittee Members. The Co-coordinators of the Subcommittee, being of the opinion that it would be in accordance with the Work Program agreed by the Subcommittee in Paris and with a view to the agreement in the Committee on the time limits for the distribution of Paper to the Committee, present the Paper to the Committee for consideration and discussion at its 18th Session in New York in April 2019. Accordingly, this Paper is presented to the Committee with issues/questions for discussion in boxes below.

III. TAX TREATY ISSUES

A. Challenge to existing nexus rules under tax treaties due to digitalization of the economy

7. Digitalization of the economy, which is increasingly becoming all-pervasive, has focused attention on whether the existing international rules under tax treaties that allocate taxing rights among countries need to be updated. The spread of digitalization has not changed the fundamental nature of the core activities that businesses carry out as part of a business model to generate profits. To generate income, businesses still need to source and acquire inputs, create or add value, and sell to customers. To support sales activities, the businesses are still required to carry out market research, advertising and customer support. Digital technology has had a significant impact on how these activities can be carried out at a very large scale, with high speed and without necessarily having a physical presence in the market country, thereby avoiding payment

of any tax in that jurisdiction. This leads to the key question as to whether the present definition of Permanent Establishment (PE) under tax treaties based on physical presence is appropriate. Broadly, most tax treaties are based either on the UN Model Tax Convention or the OECD Model Tax Convention. The two models are similar in structure but differ in several aspects, with the UN Model providing a wider scope of a taxable nexus for business profits, through a PE. The definition of PE is essentially based on a fixed place of business, and also may include (depending on which Model is followed) service or construction activities carried on for a specific duration, the existence of a dependent agent and the collection of insurance premiums. The concept of PE effectively acts as a threshold which measures the level of economic presence of the non-resident in a jurisdiction. Once this threshold is met, for the purpose of the allocation of taxing rights, in a legal fiction the PE is attributed the profits it might be expected to make if it were a distinct and separate enterprise. However, with the advent of modern means of telecommunication and the spread of digitalization, 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, raises questions about the continuing suitability of existing PE or nexus rules.

B. Work done in other fora so far

8. The tax challenges arising from the digitalization of the economy were identified as one of the main areas of focus of the G-20/OECD Base Erosion and Profit Shifting (BEPS) Action Plan, leading to the 2015 BEPS Action 1 Report on *Addressing the Tax Challenges of the Digital Economy* (the Action 1 Report). The Action 1 Report recognized that digitalization and some of the business models that it facilitates present important challenges for international taxation. The Report also acknowledged that it would be difficult, if not impossible, to “ring-fence” the digital economy from the rest of the economy for tax purposes because of the increasingly pervasive nature of digitalization. The Report observed that, beyond BEPS, digitalization raised a series of broader direct tax challenges, chiefly relating to the question of how taxing rights on income generated from cross-border activities in the digital age should be allocated among countries. While identifying a number of proposals to address these concerns, none were ultimately recommended.
9. After the OECD/G20 BEPS package, the TFDE continued to work under the aegis of the IF and came out with an interim report, *Tax Challenges Arising from Digitalisation – Interim Report 2018* (the Interim Report). As regards the broader tax challenges relating to the allocation of taxing rights, the Interim Report first provided an in-depth analysis of new and changing business models in the context of digitalization. This enabled the identification of three characteristics i.e., cross jurisdictional scale without mass, reliance on intangible assets including IP and data and user participation/synergies with IP, that are frequently observed in certain highly digitalized business models, and the discussion of their implications for the existing profit allocation and nexus rules. It was noted, however, that countries had different views on the scale and nature of these challenges. The Interim Report described

countries as falling into three groups, which ranged from countries that considered that there was a need to change the existing profit allocation and nexus rules to varying degrees (i.e., first and second groups) to countries that considered that no action was needed beyond addressing BEPS issues (i.e., third group).

10. Since the delivery of the Interim Report, the IF and the TFDE continued their work including on addressing broader tax challenges. In this regard, the IF/TFDE has been mainly considering two proposals focusing on the allocation of taxing rights (the “broader tax challenges”) that would modify the rules on profit allocation and nexus based on the concept of user contribution or marketing intangibles. Recently, there has been another proposal before the IF/TFDE based on the concept of Significant Economic Presence (SEP), presented by a group of developing countries. All three proposals would require changes to nexus and profit allocation rules. On nexus, all three proposals argue for a re-thinking of the traditional nexus concept and, in different ways and different extents, go beyond the limitations on taxing rights determined by reference to a physical presence.
11. The user participation and marketing intangibles proposals both are based on the principle that business profits should be taxed in the countries in which value is created and argue that the profit allocation and nexus rules should be amended to better reflect that principle. The user participation proposal would likely apply only to certain business models highly reliant on user participation (e.g., social media platforms, search engines, and online marketplaces), while the marketing intangibles proposal would apply to businesses that have significant marketing intangibles. The common point both proposals are seeking to address is that a business with a physical situs outside of a market jurisdiction can nonetheless be said to have an active presence or participation in that jurisdiction and *generate value* in that jurisdiction through its user or customer-related activities, even if they are conducted remotely. Under the existing methods, unless an enterprise is physically present in a user or customer’s jurisdiction, including through a dependent agent, it generally will not be subject to tax there. Under the user participation and marketing intangibles proposals, even where the physical situs of a business is substantially outside of a market jurisdiction, it is possible for that business to have an active presence or participation in that jurisdiction and generate value through customer/user facing activities that can be said to take place in that jurisdiction. The user participation approach is intended to be relatively narrow in scope and apply to taxpayers in certain businesses, including online advertising and certain multisided platforms – those for whom user participation is seen as representing a significant contribution to value creation – and only applies to the income attributable to such user participation. The marketing intangibles approach is likely to cover those same companies even if mechanically this approach would focus more broadly on marketing intangibles found in a range of businesses (particularly consumer products businesses), of which the contributions of an engaged user base would be but one example.
12. The third proposal brings in the concept of Significant Economic Presence as the nexus rule to address tax challenges relating to digitalization. The option of “significant economic presence” was one of the three options that were discussed in Chapter VII of

the Final Report on Action 1 of BEPS, for addressing the tax challenges of the digital economy. Under this proposal, a taxable presence in a country would be created when a non-resident enterprise has a significant economic presence on the basis of factors that are evidence of purposeful and sustained interaction with the economy of that country via technology and other automated means. For establishing the nexus in terms of significant economic presence, some factors, which were also referred to in the Action 1 Final Report, are suggested to be taken into account. These are: revenue generated on a sustained basis from a jurisdiction, the user base and the associated data input, the volume of digital content collected through a digital platform from users and customers habitually resident in that country and other factors such as billing and collection in the local currency, a website in the local language, delivery of goods to customers being the responsibility of the enterprise or the enterprise providing other support services, such as after-sales service or repairs and maintenance or sustained marketing and sales promotion activities, either online or otherwise, to attract customers to the digital enterprise. The developing countries which made this proposal are of the view that all of the above factors, including possible new factors that are evidence of sustained and purposeful participation of a digitalized enterprise in the economic life of a country, need to be discussed and deliberated in detail so as to develop a concrete design of the new rule based on “significant economic presence”.

13. On profit allocation, the user participation proposal envisages that the profit allocated to a user jurisdiction, in respect of the activities/participation of users, would be calculated through a non-routine or residual profit split approach. Under this approach, the profit attributed to the routine activities of a multinational group would continue to be determined in accordance with current rules. A proportion of the non-routine profit of the business would, however, be allocated from the entities that are currently realizing that profit to the jurisdictions in which users are located. The proposal acknowledges the potential challenges in calculating non-routine profit across a multinational group, and the additional difficulties that there would be in trying to calculate non-routine profit at the level of an individual business line. It is also acknowledged that this would be a mechanical approach and would rely on formulas that could only approximate the value of users, and the users of each country, to a business.
14. Under the marketing intangibles proposal, current profit allocation and nexus rules would be modified to require that the non-routine or residual income of the MNE group attributable to marketing intangibles and their attendant risks would be allocated to the market jurisdiction. All other income, such as income attributable to technology-related intangibles generated by research and development and income attributable to routine functions, including routine marketing and distribution functions, would continue to be allocated among members of the group based on existing transfer pricing principles. Alternatively, the allocation could be done under a revised residual profit split analysis that uses more mechanical approximations. As with any residual profit split, this would require a number of steps including: the determination of relevant profit, the determination of routine functions and their compensation, the deduction of routine profit from total profit and finally the division of the remaining or “residual” profit. In

this respect, there are different ways in which routine profit could be determined for the purposes of computing the amount of non-routine income to be subject to the profit split, ranging from a full transfer pricing facts and circumstances analysis to a more mechanical approach (e.g., a mark-up on costs or on tangible assets). Second, and once the amount of routine profit is determined and subtracted from total profit, there are different ways of determining the portion of non-routine or residual profit attributable to marketing intangibles, ranging from, e.g., cost-based methods (e.g., costs incurred to develop marketing intangibles versus costs incurred for R&D and trade intangibles) to more formulaic approaches (e.g., using fixed contribution percentages, which may differ by business model). Once the amount of income attributable to marketing intangibles is determined, it would be allocated to each market jurisdiction based on an agreed metric, such as sales or revenues. In this context, revenue of MNE's active in the advertising industry, as many digital businesses are, would be sourced not by reference to the residence of the payer but by reference to the customers that are targeted by the advertisement – e.g., in the online platform context, generally the users of the platform.

15. On profit attribution, the SEP proposal recognizes both production and sales as essential for generation of profits, and that neither can be ignored for the purpose of determining the profits that would be taxable in a jurisdiction. The jurisdictions that contribute towards demand by facilitating the economy, or by maintenance of markets, and the ability of its residents to pay that enable sales, as well as the jurisdiction that contributes to the production or supply of goods, contribute towards the business profits of an enterprise. In some cases, the market jurisdiction also contributes infrastructure networks that are used by the enterprise to perform its services or to deliver its products. This gives rise to a valid justification of taxation by them of the profits to which their economies have contributed. Value and profits for the enterprise can be generated by a new category of third parties (“users”) whose activities create value and profits for the enterprises without being directly remunerated financially, and who may not be very different from other individuals such as employees, contractual workers or vendors. Accordingly, the activities carried out by “user” need to be treated at par with the activities carried out by such other individuals. The “users” contribute in the form of: generation of content, network effects, creation of content and depth of engagement. As the attribution of profits must be aligned with value creation, the activities and existence of users in a particular jurisdiction should be taken into account as a factor for profit attribution to an enterprise with a significant economic presence in that jurisdiction. Under one possible approach, once the threshold level of sustained interaction with the local economy has been established (which as noted could include measures of user engagement), the value generated via user interaction could be taxed by means of establishing a clear proxy such as revenue generated from transactions undertaken with those users. In the case of developing countries, using such a proxy could simplify the determination of attributable profits and collection of tax, as countries could levy their income tax by means of withholding on transactions undertaken with users located therein. Market jurisdictions under this proposal should provide for a credit for withholding paid during loss periods to be carried forward indefinitely. The SEP proposal envisages another possible way of attributing profits based on the user factor as fractional apportionment. It notes that Article 7 of the UN

Model and the pre-2010 OECD Model Tax Convention both provide for attribution of profit to a permanent establishment based either on the direct accounting method or on the apportionment method, where books of account are not maintained for the PE. For fractional apportionment purposes, one would need to determine: (a) the definition of the tax base to be divided; (b) the determination of the factors based on which that tax base is to be divided; and (c) the weight of these factors. According to the proponents of the SEP approach, the tax base can be determined by applying the global profit rate to the revenues (sales) generated in a particular jurisdiction. For apportionment of business profits of an enterprise which has a physical presence PE, the three factors, that is, sales (demand side factor), asset and employees (supply side factors) would be taken into account. In the context of the digital economy, users play a significant role in generation of business profits. Therefore, the factors based on which the tax base is to be divided could also include users. As users can supplement the role of assets and employees in contributing to the profits of the enterprise, user contribution could be included as a factor in addition to the other three factors - i.e., sales (demand side factor), employees and assets (supply side factors). For apportionment of business profits, where users have no role to play, sales, employees and assets are generally given equal weighting. The users generally substitute for assets and employees of the enterprise, therefore, when giving weight to the user as a fourth factor, consideration must be given to the intensity of their participation.

C. Interim unilateral measures by countries to tax profits of digitalized businesses

16. The BEPS Action 1 Report 2015 developed options to address the broader direct tax challenges of the digital economy. While finally evaluating these challenges, the Report did not recommend any options though it was stated that countries could introduce any of the options in their domestic laws as additional safeguards against BEPS, provided they respect existing treaty obligations, or in their bilateral tax treaties (para 357 on page 137 of the Final Action 1 BEPS Report - Chapter 9) and noted as follows:

“Countries could, however, introduce any of the options in their domestic laws as additional safeguards against BEPS, provided they respect existing treaty obligations, or in their bilateral tax treaties. The adoption of the options as domestic law measures could be considered, for example, if a country concludes that BEPS issues exacerbated by the digital economy are not fully addressed, or to account for the time lag between agreement on the measures to tackle BEPS at the international level and their actual implementation and application. The options may provide broad safeguards against BEPS and ensure that a domestic taxing right is available for remote transactions involving digital goods and services, which is currently not the case under most countries’ domestic laws. Countries could take this approach with the intent to address their concerns about BEPS issues in the short term and gain practical experience with the application of the options over time, fostering co-ordinated domestic law approaches and informing possible future discussions. In addition, countries could bilaterally agree to include any of the options in their tax treaties.”

With no consensus on taxation of the digital economy, some countries have resorted to unilateral measures. Such measures are broadly of four kinds:

- (i) alternative applications of the permanent establishment threshold (such as “significant presence” tests or “virtual” permanent establishments);
- (ii) withholding taxes (in particular for industries such as advertising, broader definitions of royalties);
- (iii) “equalization” levies on internet advertising and digital services taxes; and
- (iv) specific regimes to deal with large MNEs such as the UK and Australian Diverted Profit Taxes and the recent US Base Erosion Anti-Abuse Tax.

D. Value creation as a basis for taxing rights for developing countries

17. The first two proposals under consideration by the IF (user participation and marketing intangibles) assume that the principle of “value creation” (generally, but not always, interpreted as a focus on the supply side only) should remain the appropriate guide for determining where profit should be allocated within the context of direct taxation, but suggest that modern business models require a reconsideration of where and how value creation occurs. The whole concept of “value creation” may mean different things to different people and needs to be looked at from the lens of developing countries. The market price, as well the volume of sales, both result from the interaction of demand and supply within a market, and are contributed to by factors on both the demand side and the supply side. The supply side factors are related to production and marketing, whereas the primary demand side factor that influences the price of a good or service and the profitability of the enterprise supplying them, is the paying capacity of consumers. The paying capacity of consumers is a function of the state of that economy, including: availability of public goods, law and order, market facilitation, infrastructure as well as redistribution of resources (income support and subsidies) to the consumers directly or indirectly, using public resources. By stabilizing, promoting, preserving and augmenting the paying capacity of the consumers, the State and the public resources belonging to that economy play a vital role in contributing to the profits generated by enterprises having a significant economic presence in that jurisdiction, and the resultant value of the enterprise. The profits arise only when an economic good produced by supplier is paid for by a consumer during the sale transaction. The performance of a sale thus has two limbs – the buyer and the seller and their interaction both lead to the creation of value and profits.

18. The counter-argument is that, while in terms of economic theory both demand and supply are needed to create market value, this does not necessarily mean that rights to impose a given tax should be allocated between countries based on both factors. The demand/consumption side has always been a necessary component of market value – digitalization has not changed this. It has been the policy choice, however, to allocate corporate taxing rights between countries based on a supply-side analysis of where the various functions of a firm that contribute to its profitability are undertaken. It has similarly been the policy choice to use other taxes – notably VAT, sales tax and various

excises – to tax consumption. There are sound economic reasons for using different taxes to address different elements of the economy. Some countries may be wary about further increasing taxes on consumption. Further, incorporation of an explicit demand element into corporate income tax implies that market countries would gain the right to tax a portion of the profit associated with bare exports to that country of a range of products from oil, minerals and agricultural products to textiles and machinery. While this may benefit countries with large domestic markets such as large emerging market economies, it would tend to involve loss of a portion of an important corporate tax base for many smaller developing countries which have limited domestic markets and for which exports of natural resources and agricultural or manufactured products are an important source of earnings.

Question A to the Committee on Paragraphs 17 & 18 and the principles governing the allocation of taxing rights

Within the Drafting Group, a question arose about the principles that should govern the attribution of taxing rights.

One view is that, if after deliberation, the Committee concludes that the market is to be rewarded, it might open the discussion regarding the allocation of taxing rights for other (i.e. traditional) business models. That should also raise the question of whether this paradigm shift is broadly in the interest of developing countries. According to this view, many smaller developing countries (with small domestic markets) reliant on export earnings could be detrimentally affected by a shift toward incorporation of demand/destination elements. For example, analysis in a draft IMF report on “Corporate Taxation in the Global Economy” with respect to various weighting factors under formulary apportionment shows that while large emerging market economies (e.g., the BRICs) would tend to benefit from the weighting of sales/market, this would not be the case for many lower income developing countries, which tend to benefit more when allocation is based on where MNEs engage staff (employment).

The counter-view is that rewarding the market does not mean that allocation of taxing rights is solely on the basis of market or sales but a combination of factors including sales, users, digital presence etc are to be seen. Thus, the change being discussed is about tax challenges posed by digitalization of economies only and any solution, if reached, should be confined to digital businesses only.

According to this counter-view, the discussion in paragraph 17 is about the validity of the “value creation” principle as a basis of taxing rights, especially from the developing countries’ or market economies’ point of view, since it seems to ignore demand side factors and focuses on supply side aspects only. Further, according to this view, it is not being argued in paragraph 17 that the value creation is only due to the demand side factors without the role of supply side factors Whereas paragraph 18 seems to advocate that value creation is only a supply side phenomenon and any mention of demand side factors would make the taxation a “destination-based tax”. In this regard, the SEP proposal, while recognizes the role of the demand side factors, takes under consideration multiple factors as a basis for nexus and not sales alone. A nexus based on multiple factors would not affect small economies engaged in export of raw material. According to this view, there is no suggestion to create nexus on the basis of sales alone, neither is the proposal to change nexus rules for non-digitalized businesses. In that sense, whenever any proposal for a new nexus rule will be decided, it can be kept confined to digital businesses only. A difficulty, noted by another member, is the fact that “digital businesses” have not clearly been defined under the SEP proposal.

The Committee is invited to discuss and express views on the principles that should govern the attribution of taxing rights in the Committee meeting. Is value creation the valid criterion? Should the demand side notion be taken into account?

19. Further, discussion on value creation could involve consideration of “location savings”, a concept of value creation that is accepted by many developing countries, including emerging countries. It includes factors such as the lower costs of labour and real estate in most developing countries, which are seen as contributing an often unrecognized value to the multinational that arguably should be accounted for in transfer pricing analysis. Many proponents of the “value creation” approach based on corporate activities would argue, however, that because such savings are not *created* by the multinational, but merely *captured*, they should not be considered in the taxation calculus.

20. The fact that several factors may be relevant to value creation inevitably means that “each nation has an incentive to establish and encourage ‘value creation’ meanings that will favor that nation.” One risk of the current emphasis on “value creation” as the foundation stone is that if there is no consensus on what it means, then any consensus based on the term will be seen through different lenses, with the consequent possibilities of an uncertain investment environment and double taxation or even double non-taxation. This suggests that if the term is used, it is important to be specific about which meaning is intended. Also, some would argue that the emphasis on “value creation” as the basis for taxing digitalized economy does not match with the widely followed policy and practice of many developed and developing countries for taxing passive income (i.e., dividends, interest, royalties, etc.) in the source country. On the other hand, there is an argument that this allocation is entirely consistent with a supply-side notion of value creation in that in the case of passive income, the earnings may reasonably be said to arise in the place where the underlying asset or property right is deployed by the owner, which is most easily determined by looking at the residence of the payor of the fee (i.e., the royalty, interest or dividend).

Question B to the Committee:

Within the Drafting Group, a question arose of whether it is accurate to state that taxation at source of passive income is consistent with the supply-side notion of value creation.

One view is that the allocation of taxing rights to a jurisdiction can be supported by taking into account the supply-side notion of value creation because the earnings may reasonably be said to arise in the place where the underlying asset or property right is deployed by the owner - which is most easily determined by looking at the residence of the payer of the income.

Another view is that under tax treaties of developing countries, under the UN Model and as per the position of several OECD countries on the “Royalties” Article of tax treaties, taxing rights for passive income are simply allocated to the source country or “demand side”.

The Committee is invited to discuss the issue of whether it is accurate to say that taxation at source of passive income is consistent with the supply-side notion of value creation.

IV. POSSIBLE FRAMEWORK FOR CHANGES TO THE UN MODEL CONVENTION TO ADDRESS TAX CHALLENGES OF DIGITALIZATION FROM DEVELOPING COUNTRIES' POINT OF VIEW

21. Under the current tax treaty models including the UN Model, many highly digitalized businesses conducted by MNEs do not pay income taxes or corporate taxes in market countries, including developing countries, despite deriving significant revenues from remote operations carried on there. Taking cognizance of this, relevant work was conducted under the BEPS Project, and has intensified with the more recent discussions under the Inclusive Framework and its Task Force on the Digital Economy. Still, countries have varying positions and no consensus has been reached so far in these fora on the so-called *broader tax challenges* of digitalization. Another matter of concern is countries proceeding with interim measures unilaterally.
22. From a developing countries' point of view, the solution to the issue on taxing profits of digitalized businesses derived from the market economy may be to take into account that the value of digital goods or services out of which the profits are generated is contributed to by several factors that could be deemed to create nexus in the country hosting these markets, which country, for certain digital business models, would thereby have a right to tax them. At the same time, the solution should be simple to administer by tax administrations and easy to comply with by taxpayers. If the approach adopted is complex, it may lead to disputes and potential double taxation. Developing countries often neither have the capacity to administer complex solutions nor are they equipped to handle costly international dispute settlement processes.
23. The UN Committee has an important role to play here by developing, after the examination of options, a provision in the UN Model on a new nexus rule and a related profit allocation methodology to address the peculiarities of digital business models, and which takes into account the perspective of developing countries in particular. This work should take into account the work done in other fora, particularly the Inclusive Framework, including whether such approaches as are developed there are suitable for developing countries or could be modified. The work done in other fora for a relatively long time has shown that the design of a nexus rule and a mechanism to allocate profits that are easily administrable, given the complexity of the matter, may involve trade-offs in terms of accuracy as to measuring, allocating various shares of income, and delineating the scope of the rules, i.e. identifying the business to which they would apply. There should be an openness to consider compromise solutions, which would satisfy the legitimate aspirations of market countries, including those that are developing countries, and yet are not unfair to the jurisdictions in which the MNEs are resident. In this regard, the following points may be relevant for consideration of the Committee:
 - (i) Based on the interaction of supply and demand, rather than the mere "supply side" approach that is often meant when reference is made to "value creation", changes to the UN Model would be suitable as an option for developing countries. The Committee may consider whether to modify the permanent establishment

definition (Article 5) to include remote activities that involve intensive engagement by MNEs with market economies (e.g., by mobilization of contributions from users) that do not involve local human intervention by personnel or dependent agents, or by adopting supplementary nexus rules for purposes of taxing profits arising from the provision of digital services or the supply of goods through digital means. Another approach could be to consider rules similar to those concerning taxation of passive income to allow source taxation of digital services (e.g., a new Article 12 B). Consideration would include whether such taxation could be undertaken on a net basis.

Question C to the Committee on subparagraph (i) of paragraph 23:

Changes to the UN Model based on the interaction of supply and demand.

Within the Drafting Group, the question came up of whether it is appropriate to indicate that changes to the UN Model Tax Convention should be based on the interaction of supply and demand, rather than merely the “supply side” approach.

According to one view, modifying current corporate tax allocation principles to include demand side elements would not be favourable to many smaller, export-reliant developing countries.

The counter-view is that it is necessary to refer to demand side factors in this subparagraph. Further, since the work is targeted towards addressing allocation of taxing rights for digital businesses only, any possible solution would clearly be delineated and targeted towards digital businesses with specified features only. This solution, if found, cannot automatically apply to export of raw material type businesses which do not have those specified features of digital businesses. The concern expressed in this regard is hence not valid, to proponents of this counter-view.

The Committee is invited to comment on the issues raised in subparagraph (i) of paragraph 23.

- (ii) Various approaches could be considered for allocating profits. The members of the Inclusive Framework have agreed to examine approaches based on the determination of non-routine profits and routine profits, and the allocation of a portion of the latter to market jurisdictions based on certain activities considered to be closely related to the market, e.g., user interaction and/or exploitation of marketing intangibles. While simplicity and ease of administration have been identified as objectives, it remains to be seen if these concepts can be developed into approaches that are administrable by countries with limited administrative capacity. The openness to consider formulaic approaches is a major development and encouraging. Given its novelty, the broad international community might be

more prepared to experiment with formulaic approaches to allocation in a constrained area, at least initially. These approaches, however, seem to require a considerable level of information exchange. To the extent that all countries will be trying to compute the same amounts (to determine the “pie” to be allocated), smaller countries may be able to rely to some extent on the efforts of others. These and many other issues, however, remain to be worked out. In the context of the proposal on Significant Economic Presence, the Inclusive Framework is also planning to examine an alternative approach based on a broad formulary apportionment, that could also be considered. “Modified deemed profit” methods are also contemplated in the BEPS Action 1 Report of 2015 in the context of the Significant Economic Presence concept (paragraphs 289 to 291) and could similarly be explored. These presumptive tax schemes envisage taxation on a net basis though they compromise accuracy in favor of simplicity. It needs to be noted in the same context that even the conventional approach based on transfer pricing is not completely accurate in that a range of prices can often be justified in any given situation. Achieving certainty and administrability may well require sacrificing accuracy to some extent, especially in the context of digitalized business taxation, where complete accuracy seems to be an unattainable target.

Question D to the Committee on subparagraph (ii) of paragraph 23:

1) Complexity of the approaches examined by the Inclusive Framework.

Within the Drafting Group, the question came up whether the approaches examined by the Inclusive Framework, based on routine vs. non-routine profits, are unreasonably complex.

One view is that it is premature to conclude that those approaches are unreasonably complex (given work is ongoing and one of the objectives is to explore simplicity) Further, the alternative approach, i.e. Formulary Apportionment, is simple in theory but can be significantly complex in practice. It would require all the countries hosting the operations of a given MNE to agree on the definition of a common tax base, the allocation factors and their weights, and to jointly audit and jointly agree on the taxable profit of the entire MNE group and the allocation to each country. This would require exchange of information, coordinated tax administration and multi-party dispute resolution on an unprecedented scale.

Another view is that the description of the method for calculating routine and non-routine profits in the Marketing Intangibles approach itself shows how complex it is. In essence, the approach requires first the determination of marketing intangibles, then their contribution to profits, which would need to be determined using two sets of assumptions and then take their difference, i.e. the “marketing intangible adjustment”. The calculation of contribution through two sets of assumptions would require, on one hand, allocating marketing intangibles as per current Transfer Pricing Guidelines and on the other hand, by allocating them to the market jurisdiction. In this methodology, at first the modification of the current profit allocation and nexus rules would be

required, but in the end existing Transfer Pricing Guidelines would be used.

An alternative way of allocating non-routine or residual income under the Marketing Intangibles approach is to allocate income using a revised residual profit split method, which would require a number of steps including: (i) the determination of relevant profit, (ii) the determination of routine functions and their relevant functions and their compensation, and (iii) the deduction of routine profit from total profit and finally the division of remaining or “residual” profit. Different ways are suggested for computing routine profits for the purposes of determining non-routine profits, ranging from a full transfer pricing approach to applying a profit split.

Developing countries do not have the capacity to administer such complex techniques.

Regarding Formulary Apportionment, paragraph 4 of Article 9 of the UN Model Tax Convention provides for profit attribution on an apportionment basis. The same provision was found in the OECD Model Tax Convention until 2010. Issues related to exchange of information, coordinated tax administration and multi-party dispute resolution do not appear to have been faced by countries having such provisions on any large scale.

The Committee is invited to comment on whether the approaches examined by the Inclusive Framework, based on routine vs. non-routine profits are unreasonably complex.

- (iii) Withholding taxes can be explored as a mechanism to improve compliance and to support the application of new allocation of profit rules. Consideration would include whether such taxation could be undertaken on a net basis. This approach, while providing for specific levels of taxation in the market jurisdiction, may also contribute to tax certainty, reducing disputes amongst tax administrations and taxpayers.

V. CHANGES REQUIRED TO THE DOMESTIC LAW

24. Whether to tax cross border profits of digitalized businesses under domestic law is an exclusive and sovereign decision of a country. If new taxing rights are allocated to countries under tax treaties as a result of the work described above, it would also be necessary to implement provisions under domestic law to tax such profits. The UN Committee can develop design considerations for domestic taxation measures to address the challenges of the digitalized economy. This work would involve similar considerations as for the tax treaty solutions and would follow that work.

VI. GUIDANCE ON ISSUES RELATED TO VAT AND OTHER INDIRECT TAXES

25. The OECD has already released post-BEPS guidance in this area, in the form of Mechanisms for the Effective Collection of VAT/GST Where the Supplier is not Located in the Jurisdiction of Taxation.¹ This guidance has been widely adopted and there is useful experience available based on the countries that have already acted in this area. Many countries have reported generally good cooperation from large digital MNEs and several have reported collecting more revenue than had been originally anticipated. UN guidance could take this into account. The well-followed path in this area can potentially make it a type of “low-hanging fruit” which developing countries might consider for “harvest”. Consideration of gaps that could be filled for the benefit of developing countries or special considerations and alternative approaches specific to their concerns would need to be carefully addressed.

¹ <https://www.oecd.org/tax/tax-policy/mechanisms-for-the-effective-collection-of-VAT-GST.pdf>