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Tax consequences of the digitalized economy – issues of relevance for developing countries

Co-Coordinators' Report

Summary

This note reflects the progress made in the Subcommittee on Tax Issues related to the Digitalization of the Economy.

It presents a draft for a proposed introduction of a new Article 12B ("Income from Automated Digital Services") into the UN Model with Commentary, prepared by a Drafting Group consisting of 14 members of the Committee seeking consideration of an additional provision in the UN Model Tax Convention to deal with certain aspects of taxation in an increasingly digitalized economy.

It also contains a short summary by the Co-Coordinators of the written and oral comments submitted by other members in preparation for, during and after a virtual meeting of the Subcommittee held on 25, 26 and 27 September. The Drafting Group has taken these comments into consideration as far as they thought they contributed to the improvement of the proposed article.

At its 21st meeting, the Committee is invited to have a discussion on the amended Draft for Article 12B included in Annex 1 to this note and on the submitted comments summarized in this note and to take such decisions as it sees fit on how best to take the matter forward including on the proposed text.

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Introduction and earlier sessions

Since the formation of the Subcommittee on Tax Issues related to the Digitalization of the Economy ("the Subcommittee") during the current membership of the Committee of Experts on International Cooperation in Tax Matters ("the Committee") the Co-Coordinators have submitted the following reports:

E/C.18/2018/CRP.12 was submitted in preparation of the 17th session held in October 2018 in Geneva and discusses the basic approach for the Subcommittee and suggests a way forward.

E/C.18/2019/CRP.12 was submitted in preparation of the 18th session held in New York in April 2019 and reflected the results of a Subcommittee held in Paris in January 2019 and kindly hosted by the Nigerian embassy. The note contains a Paper drafted by a drafting group formed during the meeting in Paris. It contains the guiding principles for the work of the Subcommittee agreed during that meeting:

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

It also notes the challenges to existing nexus rules under tax treaties due to digitalization of the economy and discusses whether value creation is the appropriate basis for attributing taxing rights for the interest of developing countries.

E/C.18/2019/CRP.16 was submitted in preparation for the 19th session held in Geneva in October 2019. It reflects the results of the discussions during the 18th Session held in April in New York, where it was agreed that a paper would be drafted for presentation at the 19th session of the Committee:

(a) Including an explanation and evaluation of proposals internally developed or developed in other forums;
(i) Describing the advantages and disadvantages of the abovementioned proposals;
(ii) Giving special attention to:
a. The interests of developing countries;
b. Administrability, fairness and certainty;
(iii) Taking into account different economies and market forces;
(iv) Without losing sight of the principles agreed at the meeting of the Subcommittee held in January 2019, as indicated in paper E/C.18/2019/CRP.12;

(b) Considering, where relevant, expert commentaries on issues relating to the digitalized economy;

(c) Aiming at finalized proposals within the term of the current membership of the Committee.

The proposed parts to be included in the paper were as follows:

1. Introduction, general background, reasons for the work and guiding principles;
2. Relevance and analysis (advantages and disadvantages) of work in other forums:
    (a) Inclusive Framework on Base Erosion and Profit Shifting;
    (b) International Monetary Fund;
    (c) European Union;
    (d) African Tax Administration Forum;
    (e) Others;
3. Possible alternative or modified approaches for allocation of taxing rights and nexus rules, including withholding taxes;
4. Conclusions.

E/C.18/2019/CRP.16 contained an introductory Chapter in which, based on the discussions during the 18th session and on the ongoing international debate, fundamental questions were raised that could form the basis for decisions on the further work to be done.

It also contained a Chapter describing recent developments in other international bodies. For an agreed Chapter on possible alternative or modified approaches for allocation of taxing rights and nexus rules, including withholding taxes, no contributions were received.

E/C.18/2019/CRP.16 was discussed in the Subcommittee meeting held in the context of the 19th session but was not finalized and, while forwarded to the full Committee, was never formally discussed in the full Committee.

A large part of the time devoted to this issue during the Committee's 19th session was dedicated to the (then) recently published Inclusive Framework's "Unified Approach". It was decided during the meeting that comments on the Unified Approach would be submitted in the name of the Committee.

Developments during and after the 20th session and action needed

2. E/C.18/2020/CRP.25 was submitted in preparation of the 20th session held virtually in May 2020. It included an overview of the work so far done and it had attached the submitted comments to the Inclusive Framework on the Unified Approach that was agreed after an intensive exchange of view between the members of the Committee. It also attached a note written by Mr. Rajat Bansal of the Committee describing a new proposal to attribute additional taxing rights to supplement resources of developing countries. Mr. José Troya of the Committee also re-presented some unpublished comments made to the Committee at the 18th Session which related to alternative approaches to taxing the digitalized economy for developing countries. Note that all comments by Members should be treated as made in their personal capacity, in which they act.

3. During the 20th meeting it was decided that a Drafting Group would be formed, consisting of 13 (later 14) members of the Committee seeking consideration of an additional provision in the UN Model Tax Convention to deal with certain aspects of taxation in an increasingly digitalized economy. That Drafting Group, coordinated by Committee members Mr. Carlos Protto and Mr. Rajat Bansal presented a proposal for a new Article 12B ("Income from Automated Digital Services") to be included in the UN Model. It was circulated to all members and was published on the UN Website together with an explanation of the status of the Draft.

4. A number of Committee members submitted comments to the draft and the Drafting Group replied to these comments. The draft and the comments were discussed during a virtual meeting of the Subcommittee held on the 25, 26 and 27 August 2020. Unfortunately, not all parts of the proposed Article, the proposed Commentary and the submitted comments could be discussed.

5. It was decided that it would be useful that the Drafting Group continue its work and prepare an amended draft taking into account the comments submitted by members and observers as far as the drafting group considered them an improvement of their draft;

6. It was also agreed that the Co-Coordinators, in this Report to the Committee, will annex the draft (recognizing that while there was considerable support for the proposal it was not yet an agreed document and is without prejudice to the position of any of the members of the Subcommittee).

7. Finally, it was agreed that the Co-Coordinators in this Report will also note the main comments of Subcommittee Members.

8. Annex 1 contains the proposed text of a new Article 12B to be introduced in the UN Model Double Taxation Convention between Developed and Developing Countries with Commentary, as most recently proposed by the Drafting Group.

9. The next part of this Report summarizes the comments to the original Draft submitted by members of the Committee.

10. At its 21st Session, the Committee is ***invited to have a discussion on the amended Draft included in Annex 1 to this note and on the submitted comments summarized in this note and its attachments and to take such decisions as it sees fit on how best to take the matter forward including on the proposed text.***

11. Additionally, the Co-Coordinators take the opportunity to report that a very successful (virtual) UN workshop on practical and policy aspects of taxation in a digitalized economy was organized on 9-11 and 15-17 September. Around 200 participants, mainly from developing countries, attended the sessions. Experts from academia, business sector, NGO's, international

organizations and governments, including several members from the Committee, presented and discussed different issues. The program included sessions on general aspects and on multinational, unilateral and bilateral issues regarding the taxation of digitalized economy, multilateral approaches to address profit-shifting and administrative and capacity development aspects. The Workshop will be further discussed as part of agenda item 3(g) on Capacity Building.

Summary of Comments on the Draft

12. The comments that some members of the Committee made to the Draft can be divided in two categories.

1. Comments questioning the policy considerations on which this proposal is based and its effectiveness;
2. Comments questioning the way the proposal is drafted and how it would operate in practice;

13. Please note that the following list of comments received represents a summary by the Co-Coordinators seeking to reflect views put in short form. In order to maintain balance, gist of response of Drafting Group to these comments is also mentioned alongside the comment received. It does not purport to exhaustively address issues raised or the response of Drafting Group and Members are directed to the submissions received (including as discussed and responded to in the Annexes to this paper) and to the further discussions on these and other comments at the 21st Session, The responses to comments from the Drafting Group are, like the draft Commentary at Annex 1, an important part of the balance of this paper and are found at Annexes 2, 3 and 4 of this paper.

On the policy behind the proposal and on its effectiveness

- The UN Tax Committee should discuss, explain and recognize a clearly formulated principle on which to base attribution of taxing rights. The policy choice to tax income from (only) ADS in the State where the payment arises should fit in that principle and the current commentary should better tailor the rationale, which has been copied from the rationale for the article on the fees for technical services. The Drafting Group (DG) has responded that after the August Subcommittee meeting, the Commentary has been completely overhauled and drafted afresh to address this concern.
- In the absence of an agreed principle it is unclear what the rationale behind the proposal is and which problem it is intended to solve. The Drafting Group wondered why this question has not been raised in the Inclusive Framework where another solution is under development to address the same tax concerns.
- Members in favor of the provision argue that the mere extension of taxing rights for source countries justifies the proposal in addition to it addressing a BEPS issue and significant engagement in the market jurisdiction with no physical presence.

- Other Members questioned the characterization of issue of taxation of digital services as a BEPS issue (covering individuals is not consistent with this rationale) and noted that the proposed sourcing rule is inconsistent with the stated rationales). Due regard to this concern being raised at the time of August Subcommittee meeting, the DG has deleted all reference to BEPS concerns in the revised Commentary since the main objective of introduction of Article 12B is allocation of taxing rights to market jurisdictions also over this income.
- Some comments suggested it is not correct that non-resident service providers have an unjustified advantage over domestic service providers. DG has addressed this concern by deleting the reference in the Commentary.
- A monetary threshold could be considered to avoid disproportionate administrative burdens. The DG is not in favor of this and has drafted reasons for its approach in the Commentary.
- Developing countries generally do not have many treaties in force. For them solely developing a treaty provision would not help as it does not create taxing rights for a government. On the other hand, the DG is of the view that the objective of the proposal is to address concerns raised due to the existing tax treaty rules requiring physical presence. Where there is no treaty, taxation as per domestic law, if any, will prevail.
- Moreover, it is not clear how many countries do have domestic provisions in place that would tax income from ADS and are now restricted by existing treaty provisions. The DG is of the view that States are sovereign in deciding their own tax system.
- These countries would be better helped with advice concerning how to introduce and administer such rules and by sharing experiences from members whose countries do have these domestic measures in place including ensuring that such provisions are consistent with other international obligations such as trade obligations. As per the DG, priority has to be given to develop a provision to be included in the same instrument creating the problem, as previously identified. Guidance on domestic legislation could be provided later, if any country needs such advice.
- It is unlikely that many countries (especially those in which major digital companies are resident) will accept this provision in their treaties as the issue at stake is a multilateral issue and requires a global solution. With reference to the approach used by the Inclusive Framework it is noted that it is far from evident that for the profits that will now be taxable in the market state a corresponding adjustment (or tax credit) should be given in the other contracting state and not in another (or several other) state(s). Concerns were therefore raised that the bilateral provision will lead to over-taxation of digital companies and/or unrelieved double taxation. As per the DG, a multilateral approach also raises concerns, complexity for instance being one and less than fair share of allocation of revenue being other besides complex multilateral dispute settlement mechanism as well as complex process for elimination of double taxation. As per the DG, a bilateral solution will work in the same way as it has worked for existing physical presence rules.

On the operation of the provision

- It is questionable whether several terms in the provision are defined well enough to be implemented and administrable (i.e.: Automated Digital Service, minimal human involvement, multinational group, profitability ratio, business segment). The DG has, in the revised Commentary, expanded considerably on these aspects though.
- It was noted that the concept of ADS was taken from the IF work and it should also be clarified whether and which documents released by the Inclusive Framework would be relevant for the interpretation of these terms. As per the DG, the Article 12B and its Commentary has been drafted in a manner that is self-contained and there is no need to refer to any of the IF documents.
- The option of taxation on a net base is commended, however some comments questioned the basis for the choice for the 30% proportion of MNE profitability in paragraph 3 and suggested that 30% is too high. The DG has after the August Subcommittee meeting explained this issue in the Commentary.
- More clarity is also needed on how this option would operate in practice. Though it has already provided guidance in revised Commentary, the DG is open to any suggestion on this aspect.
- The provision aims to tax payments made by the recipient of the service. In many of the targeted business lines the services will be rendered for free (to individuals) and the income of the service provider will come from advertisement and payments by others (other businesses) to whom the (automated digital) service arguably is not delivered. The DG in its response has explained that advertising itself is an automated digital service.
- The definition of ADS in the Article would suggest (contrary to what is included in para 31 of commentary) that human intervention in creating, supporting and maintaining the system should be taken into account. It is unclear why that should not be the case. As per the DG, the question is unclear and, in any case, the position is not different in IF.
- If the ADS provider would have a PE to which the payments are attributable, and taking into account that the service requires little human involvement, the profits attributable to that PE (since Article 7 will not be amended) will be minimal. It is not clear why a non-resident without a PE should pay taxes on a gross basis (or on a net basis taking into consider profits of the MNE) and non-residents with a PE would only pay taxes on a small net base. The arguments in favor of attributing additional taxing rights to the market state appear to be equally strong in situations where there is a PE. DG has responded to this comment in Annexure.

14. The rest of this paper is comprised of the aforementioned Annexes.

Annex 1:

The proposed draft for a new Article 12B and its Commentary

The following is the clean version of the revised draft Article 12B and its Commentary.

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, subject to the provisions of Articles 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 income from automated digital services.

3. Notwithstanding the provisions of paragraph 2, the beneficial owner of the income from automated digital services may request the 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, the taxation by that Contracting State shall be carried out accordingly. For the purpose of this paragraph, the qualified profits shall be 30 percent of the amount resulting from applying the profitability ratio of that beneficial owner's automated digital business segment to the gross annual revenue from automated digital services derived from the Contracting State where such income arises. Where segment-wise 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 income covered by this Article, or of the group as a whole in case segment-wise accounts are not maintained by the group, provided such profitability ratio of the multinational group are higher than the aforesaid profitability ratio of the beneficial owner.

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 "royalties" or 'fees for technical services' under Article 12 or Article 12A as the case may be.

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.

Commentary on new Article 12 B

INCOME FROM AUTOMATED DIGITAL SERVICES

A. General considerations

1. Digital technology has a very significant impact on how cross border business activities can be carried out at a very large scale, with high speed and without necessarily having a physical presence in the market jurisdiction. Question has arisen whether the existing rules under tax treaties allocating taxing rights amongst countries based on permanent establishment criteria are any longer appropriate in respect of the new business models based on digital technologies. The concept of permanent establishment effectively acts as a threshold and only where this threshold is met, any taxation in the market jurisdiction is possible under the existing tax treaty rules. The concept of permanent establishment in Article 5 is essentially based on a fixed place of business, and also includes service or construction activities carried on for a specific duration, the existence of a dependent agent and the collection of insurance premiums. However, with the advent of modern means of telecommunications and the spread of digitalization, 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.

2. Tax consequences of digitalized economies, especially from the point of view of developing countries were therefore recognized as a matter of importance by the United Nations Committee of Experts on International Cooperation in Tax matters, which engaged itself in this work during its 15th session. The Committee of Experts identified income from automated digital services as a matter of priority to be dealt with and decided to focus on tax treaty provision under the United Nations Model Convention that would enable jurisdictions to apply their domestic legislation levying taxes on income derived from digital business models. Committee's approach has been to find a solution, which is relatively simple to comply with by the businesses as well as tax administrations and at the same time, results in a definite share for market jurisdictions. As a result of these considerations, Article 12B has been added to the United Nations Model Convention in 20XX expanding the taxing rights for States from which payments for automated digital services are made.

3. Article 12B allows a Contracting State to tax income from certain digital services paid to a resident of the other Contracting State on a gross basis at the rate negotiated bilaterally and specified in paragraph 2 of the Article with an option to the taxpayer to pay tax on a net annual profit basis under paragraph 3 of the Article. Under Article 12B, a Contracting State is entitled to tax payments for automated digital services if the income is paid by a resident of that State or by a non-resident with a permanent establishment or fixed base in that State and the payments are borne by the permanent establishment or fixed base. Income from automated digital services are defined to mean payments for services provided on the internet or an electronic network requiring minimal human involvement from the service provider. Until the addition of Article 12B, income from automated digital services, derived by an enterprise of a Contracting State was taxable exclusively by the State in which the enterprise was resident unless the enterprise carried on business through a permanent establishment in the other State (the source State) or provided professional or independent personal services through a fixed base in the source State

4. The taxation of income from automated digital services on a gross basis under Article 12B may result in excessive or double taxation. Although, the rate is to be bilaterally negotiated, the possibility of excessive or double taxation can be taken into account by having a modest rate (i.e.: 3% or 4%) of tax on income from automated digital services under paragraph 2 of Article 12B. Moreover, paragraph 3 allows the non-resident provider to require taxation on a net basis by following the global profitability ratio of the beneficial owner or the multinational group to which it belongs to. The possibility that payments in consideration of automated digital services may be subject to excessive or double taxation is also reduced or eliminated under Article 23 (Methods for the Elimination of Double Taxation).

5. Article 12B allows payments in consideration for automated digital services to be taxed by a Contracting State on a gross basis. Many developing countries have limited administrative capacity and need a simple, reliable and efficient method to enforce tax imposed on income from services 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 permanent establishment 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 services in another State since they would not be required to compute their net profits or file tax returns, unless they themselves opt for net income basis taxation.

6. Article 12B does not require any threshold, such as a permanent establishment, fixed base, or minimum period of presence in a Contracting State as a condition for the taxation of income from

automated digital services. In this regard, modern methods for the delivery of services allow non-residents to perform substantial services for customers in the other country with little or no presence in that country. This ability to derive income from a country is considered by a majority of the members of the Committee to justify source taxation of income from automated digital services, also in scenarios where there is little or no physical presence in the source jurisdiction.

7. Where income from automated digital services are dealt with in both Article 12B and Article 7, paragraph 6 of Article 7 provides that the provisions of Article 12B prevail. However, this priority for Article 12B does not apply if the beneficial owner of the income from automated digital services carries on business through a permanent establishment in the Contracting State in which the income arise, and those services are effectively connected with the permanent establishment or business activities referred to in (c) of paragraph 1 of Article 7. In this situation, paragraph 5 of Article 12B provides that the provisions of Article 7 apply instead of Article 12B.

8. In order to reduce uncertainty and inconsistencies, paragraph 4 explicitly clarifies that Article 12B does not apply to income from automated digital services where such income is also regarded as "royalty" or as "fee for technical services" falling under Article 12 or 12A, as the case may be.

9. Due to the nature of the automated digital services, it is unlikely that income from automated digital services are dealt with in both Article 12B and Article 14. However, if the beneficial owner of the income performs independent personal services in the Contracting State in which the income from automated digital services arise through a fixed base situated in that State and the automated digital services are effectively connected with the fixed base, Article 12B, paragraph 5 provides that the provisions of Article 14 would apply instead of Article 12B. However, and to avoid uncertainty, reference is made in paragraph 2 clarifying that it applies notwithstanding the provisions of Article 14.

B. Commentary on the paragraphs of Article 12B

Paragraph 1

10. This paragraph establishes that income from automated digital services arising in one Contracting State and paid to a resident of the other Contracting State may be taxed in the other Contracting State. It does not, however, provide that such income is taxable exclusively by the State of residence.

11. The expression "income from automated digital services" is defined in paragraph 4 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 term "payment" has a broad meaning consistent with the meaning of the related term "paid" in Articles 10 and 11. As indicated in paragraph 3 of the Commentary on Article 10 (quoting paragraph 7 of the Commentary on Article 10 of the OECD Model Convention) and paragraph 6 of the Commentary on Article 11 (quoting paragraph 5 of the Commentary on Article 11 of the OECD Model Convention), the concept of payment means the fulfilment of the obligation to put funds at the disposal of the service provider in the manner required by contract or custom.

12. Article 12B deals only with income from automated digital services arising in a Contracting State and paid to a resident of the other Contracting State. It does not, therefore, apply to income from services arising in a third State. Paragraph 6 and paragraph 7 specify when income from

automated digital services are deemed to arise in a Contracting State and deemed not to arise in a Contracting State, respectively. However, unlike Article 10, which does not apply to dividends paid by a company resident in a third State, Article 12B applies to income from automated digital services paid by a resident of a Contracting State or a third State that are borne by a permanent establishment or fixed base that the resident has in the other Contracting State.

Paragraph 2

13. This paragraph lays down the principle that the Contracting State in which income from automated digital services arise may tax those payments in accordance with the provisions of its domestic law. However, if the beneficial owner of the income is a resident of the other Contracting State, the amount of tax imposed by the State in which the income from automated digital services arises may not exceed a maximum of percent of the gross amount of the payments, as may be negotiated.

14. When considered in conjunction with Article 23 (Methods for the Elimination of Double Taxation), paragraph 2 establishes the primary right of the country in which income from automated digital services arises to tax those payments in accordance with its domestic law (subject to the limitation on the maximum rate of tax if the beneficial owner of the income is a resident of the other Contracting State). Accordingly, the country in which the recipient of the income is resident is obligated to prevent double taxation of those payments. Under Article 23 A or 23 B, the residence country is required to provide relief from double taxation through the exemption from tax of the income from automated digital services or the granting of a credit against tax payable to the residence country on the income from automated digital services for any tax imposed on such income by the other Contracting State in accordance with Article 12B. In this regard, where a country applies the exemption method under Article 23 A, it is entitled to apply the credit method under Article 23 A, paragraph (2) with respect to items of income taxable under Article 10, 11, 12, 12 A or 12B. A resident of State R, deriving income from State S, may have a loss in State R, or in State S or in a third State. For purposes of the tax credit, in general, a loss in a given State will be set off against other income from the same State. When the total income is derived from abroad, and no income but a loss not exceeding the income from abroad arises in State R, then the total tax charged in State R will be appropriate to the income from State S, and the maximum deduction which State R is to allow will consequently be the tax charged in State R. Other solutions are possible. As indicated in paragraph 66 of the OECD Commentary on Article 23 B quoted in paragraph 16.7 of the Commentary on Article 23, some States are very liberal in applying the credit method. Some States are also considering or have already adopted the possibility of carrying over unused tax credits. Contracting States are, of course, free in bilateral negotiations to amend the Article to deal with any of the aforementioned problems. Consequently, whether the tax paid in the source State according to Article 12B is relieved in the State of residence in the same year or in subsequent years would depend on domestic laws and practice of each State.

15. The maximum rate of tax on income from automated digital services is to be established through the bilateral negotiations of the Contracting States. Although, the rate is to be bilaterally negotiated, it is recommended to have a modest rate, i.e.: 3% or 4%.

16. A precise level of withholding tax on payments in consideration of automated digital services, should take into account several factors, including the following:

- the possibility that a high rate of withholding tax imposed by a country might cause non-resident service providers to pass on the cost of the tax to customers in the country, which would mean that the country would increase its revenue at the expense of its own residents rather than the non-resident service providers;

- the possibility that a tax rate higher than the foreign tax credit limit in the residence country might deter investment;
- the possibility that some non-resident service providers may incur high costs in providing automated digital services, so that a high rate of withholding tax on the gross payment may result in an excessive effective tax rate on the net income derived from the services;
- the fact that a reduction of the withholding rate has revenue and foreign exchange consequences for the country imposing withholding tax, and
- the relative flows of payments in consideration for automated digital services (e.g., from developing to developed countries).

17. The requirement of beneficial owner is included in paragraph 2 to clarify the meaning of the words “paid to a resident” as they are used in paragraph 1 of the Article. It clarifies that a Contracting State is not obliged to give up taxing rights over income from automated digital services merely because such income was paid directly to a resident of another State with which the first State had concluded a convention.

18. Since the term “beneficial owner” is included in paragraph 2 to address potential difficulties arising from the use of the words “paid to a resident” in paragraph 1, it is intended to be interpreted in this context and not to refer to any technical meaning that it could have had under the domestic law of a specific country. The term “beneficial owner” is therefore not used in a narrow technical sense (such as the meaning that it has under the trust law of many common law countries[1]), rather, it should be understood in its context, in particular in relation to the words “paid to a resident”, and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.

19. Relief or exemption in respect of an item of income is granted by a State to a resident of the other Contracting State to avoid in whole or in part the double taxation that would otherwise arise from the concurrent taxation of that income by the State of residence. Where an item of income is paid to a resident of a Contracting State acting in the capacity of agent or nominee it would be inconsistent with the object and purpose of the Convention for a State to grant relief or exemption merely on account of the status of the direct recipient of the income as a resident of the other Contracting State. The direct recipient of the income qualifies as a resident but no potential double taxation arises as a consequence of that status, since the recipient is not treated as the owner of the income for tax purposes in the State of residence.

20. It would be equally inconsistent with the object and purpose of the Convention for a State to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons, the report from the OECD’s Committee

[1] For example, where the trustees of a discretionary trust do not distribute income from automated digital services earned during a given period, these trustees, acting in their capacity as such (or the trust, if recognized as a separate taxpayer) could constitute the beneficial owners of such income for the purposes of Article 12B even if they are not the beneficial owners under the relevant trust law.

on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Conduit Companies"[2] concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has as a practical matter very narrow powers which render it in relation to the income concerned a mere fiduciary or administrator acting on account of the interested parties.

21. In these various examples (agent, nominee, conduit company acting as a fiduciary or administrator), the direct recipient of the payments in consideration of automated digital services is not the "beneficial owner" because that recipient's right to use and enjoy the income is constrained by a contractual or legal obligation to pass on the income received to another person. Such an obligation will normally derive from relevant legal documents but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the right to use and enjoy the income unconstrained by a contractual or legal obligation to pass on the income received to another person. This type of obligation would not include contractual or legal obligations that are not dependent on the receipt of the payments by the direct recipient such as an obligation that is not dependent on the receipt of the income and which the direct recipient has as a debtor or as a party to financial transactions. Where the recipient of payments in consideration of automated digital services does have the right to use and enjoy the income unconstrained by a contractual or legal obligation to pass on the income received to another person, the recipient is the "beneficial owner" of such income.

22. The fact that the recipient of payments in consideration for automated digital services is considered to be the beneficial owner of such income does not mean, however, that the limitation of tax provided for by paragraph 2 must automatically be granted. This limitation of tax should not be granted in cases of abuse of this provision. As explained in the section on "Improper use of the Convention" in the Commentary on Article 1, there are many ways of addressing conduit company structures and, more generally, treaty shopping situations. These include specific anti-abuse provisions in domestic law and treaties, general anti-abuse rules in domestic law and tax treaties, judicial doctrines, such as substance-over-form or economic substance approaches, and the interpretation of tax treaty provisions. Whilst the concept of "beneficial owner" deals with some forms of tax avoidance (i.e. those involving the interposition of a recipient who is obliged to pass on payments in consideration of automated digital services to someone else), it does not deal with other cases of treaty shopping and must not, therefore, be considered as restricting in any way the application of other approaches to addressing such cases.

23. The above explanations concerning the meaning of "beneficial owner" make it clear that the meaning given to this term in the context of the Article must be distinguished from the different meaning that has been given to that term in the context of other instruments[3] that concern the

[2] Reproduced at page R(6)-1 of Volume II of the full-length version of the OECD Model Tax Convention.

[3] See, for example, Financial Action Task Force, International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation—The FATF Recommendations (OECD-FATF, Paris, 2012), which sets forth in detail the international anti-money laundering standard and which includes the following definition of beneficial owner (at page 109): "the natural person(s) who ultimately owns or controls a customer and/or the person on whose behalf a transaction is being conducted. It also incorporates those persons who exercise ultimate effective control over a legal person or arrangement." Similarly, the 2001 report of the OECD Steering Group on Corporate Governance, "Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes" (OECD, Paris, 2001), defines beneficial ownership as follows (at page 14): In this Report, "beneficial ownership" refers to ultimate beneficial ownership or interest by a natural person. In some situations, uncovering the beneficial owner may involve piercing through various intermediary entities and/or individuals until the true owner who is a natural person is found. With respect to corporations, ownership is held by shareholders or members. In partnerships, interests are held by general and limited partners. In trusts and foundations, beneficial ownership refers to beneficiaries, which may also include the settlor or founder.

determination of the persons (typically the individuals) that exercise ultimate control over entities or assets. That different meaning of “beneficial owner” cannot be applied in the context of the Convention. Indeed, that meaning, which refers to natural persons (i.e., individuals), cannot be reconciled with the express wording of Article 10, subparagraph 2(a), which refers to the situation where a company is the beneficial owner of a dividend. In the context of Articles 10, 11, 12, 12A and 12B, the term “beneficial owner” is intended to address difficulties arising from the use of the words “paid to” in relation to dividends, interest, royalties, fees for technical services and income from automated digital services rather than difficulties related to the ownership of the underlying property or rights in respect of which the amounts are paid. For that reason, it would be inappropriate, in the context of these articles, to consider a meaning developed in order to refer to the individuals who exercise “ultimate effective control over a legal person or arrangement”.[4]

24. Subject to other conditions imposed by the Article, the limitation of tax in a State remains applicable when an intermediary, such as an agent or nominee located in the other Contracting State or in a third State, is interposed between the beneficiary and the payer but the beneficial owner is a resident of the other Contracting State. The text of the United Nations Model Convention was amended in 2001 and 2017 (following amendments to the OECD Model Convention in 1995 and 2014) to clarify this point.

25. To avoid uncertainty, paragraph 2 explicitly states that it applies subject to the provisions of Article 8 and notwithstanding the provisions of Article 14. Under Article 8, profits from the operation of ships or aircraft in international traffic derived by an enterprise of a Contracting State is taxable only in that State. Under Article 14, income from the performance of professional or other independent personal services by a person who is a resident of a Contracting State is taxable by the other Contracting State only if the services are performed through a fixed base in the other Contracting State that is regularly available to the person or if the person stays in that State for 183 days or more in any twelve-month period commencing or ending in the relevant fiscal period. However, due to the nature of the automated digital services, it is unlikely that income from automated digital services are dealt with in Article 8 or in Article 14. To provide clarity, paragraphs 39 and 41 include, respectively, categories of services that are considered to be automated digital services, and categories of services that are not.

Paragraph 3

26. Paragraph 3 gives the beneficial owner of the income from automated digital services the option to be taxed on a net basis annual taxation, as against the withholding mechanism provided for in paragraph 2. According to this paragraph, the beneficial owner of the income may request the Contracting State where the income arises to be subject to taxation on its qualified profits, as defined in the paragraph. This option would provide relief in those cases where the taxpayer may have a lower tax liability than the liability determined as per withholding tax mechanism as also in cases where it has a global business loss or a loss in the relevant business segment during the taxable year.

27. Paragraph 3 defines the qualified profits to be 30 percent of the amount arrived at by applying the profitability of the beneficial owner’s automated digital services segment to the gross annual revenue derived from such services in the Contracting State where such income arises. Where segment-wise accounts are not maintained by the beneficial owner, overall profitability ratio of the beneficial owner will be applied to determine qualified profits. However, if the beneficial

[4] See the Financial Action Task Force’s definition quoted in the previous note.

owner belongs to a multinational group, the profitability ratio to be applied shall be of the group's automated digital services segment or of such group if segment-wise accounts are not maintained by the group, provided the profitability ratio of the multinational group is higher than the profitability ratio of the beneficial owner at entity level. This is with a view to neutralize the possible reduction of the profitability due to tax-driven related party transactions in the multinational group.

28. The profitability ratio of the beneficial owner or the multinational group to which the beneficial owner belongs, is understood to be the annual profits divided by the annual revenue, as revealed by the consolidated financial statements of the automated digital services business segment of the beneficial owner or of the group it belongs to, or of the beneficial owner or the group as a whole, as the case may be. Unless bilaterally agreed otherwise between the Contracting States, the profit to be used for calculating profitability would be profit before tax as per accounts of beneficial owner, or the consolidated accounts of the MNE group[5], as the case may be, with adjustments such as exclusion of income tax expenses, exclusion of dividend income, and gains or losses in connection with shares, adding back expenses not deductible for corporate income tax purpose due to public policy reasons, etc.

29. In order to avoid disputes and to provide certainty, not many adjustments are envisaged to be made to the profit as per accounts while determining the profits to calculate the profitability for purpose of this paragraph. The profitability of the multinational enterprise to be used for the purpose of paragraph 3 would be for the same fiscal year. The information concerning the profitability figure of multinational group may be furnished by the taxpayer along-with supporting evidence. The tax administration of the Contracting State where the income from automated digital services arise, may in appropriate cases make cross verification of correctness of declaration by the taxpayer through exchange of information mechanism under the tax treaty, if required. According to the international standards on transfer pricing[6], a multinational enterprise group is a group of associated enterprises with business establishments in two or more countries. Multinational groups of companies generally operate worldwide through locally incorporated subsidiaries or permanent establishments.

30. Qualified profits have been taken to be 30% of the amount arrived at by applying profitability to the local revenue in recognition of the fact that entire profits arising from the market jurisdiction cannot be attributed to it. The figure of thirty percent is based on allocation by assigning equal weightage to assets, employees and revenue.

31. Qualified profits shall be taxable at the tax rate provided in domestic law of the Contracting State. The domestic law may also be having procedure for registration of such service providers as well as necessary forms to be filed for facilitating taxation of income from automated digital services on net income basis. Similarly, taxes withheld at source, if any as per paragraph 2, would be taken into account against the tax liability determined on net basis.

32. One member of the Committee considered that the profitability ratio could be reduced in situations where profits from some business segments are compensated by losses from other business segments. For this reason this member considers that paragraph 3 should be modified in order to introduce a mechanism where the beneficial owner's qualified profits is the higher

[5] The relevant financial accounting standard for the MNE Group would be the financial accounting standard used by the ultimate parent entity in the preparation of its consolidated financial statements.
[6] i.e.: Practical Manual on Transfer Pricing for Developing Countries, United Nations, New York, 2017 and OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD, Paris 2017 .

among: (i) the group's overall profitability ratio (ii) the beneficial owner's overall profitability ratio, and (iii) the beneficial owner's profitability ratio of the automated digital services business segment.

Paragraph 4

33. Paragraph 4 defines "income from automated digital services" for purposes of Article 12B as payments in consideration for any service provided on the internet or an electronic network requiring minimal human involvement from the service provider.

34. A service is regarded as automated when the user is able to make use of 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. In determining whether a service requires minimal human involvement, the test only looks to the supplier of service, without regard to any human involvement on the side of the user for example where the user may input certain parameters into an automated system to obtain a customized result. Furthermore, the definition focuses on provision of service and therefore does not include human involvement in creating or supporting or maintaining the system needed for provision of service, maintaining and updating the system environment, dealing with system errors, or making other generic, non-specific adjustments unrelated to individual user requests. 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 / input at the service delivery point or where in individual cases involving particular, more complex problems, the programmes running the system direct the customer to a staff member.

35. An important indicator of concept of automated is whether there is ability to scale up and provide same type of service to new users with minimal human involvement. This feature aims to identify automated digital services businesses that benefit from significant economies of scale, rather than to suggest that there is no human involvement required in the business. For many automated digital services businesses, developing the system that delivers the offered service may require a large degree of upfront human involvement and capital inputs such as creating algorithms to deliver the automated service including such features as tailoring the offering to user's preferences. It distinguishes automated digital services businesses by looking to whether the marginal cost in terms of additional human involvement of providing the same services to additional users is nil or almost nil. In other words, once the service offering of an automated digital business is developed (such as music catalogue or social media platform), then the business can provide that service to one user, or to many more, on an automated basis with the same basic business processes. On 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.

36. The aspect of providing service over the internet or an electronic network distinguishes it from other service provision methods, such as the on-site physical performance of a service. No distinction is made between different internet, or electronic network transmission methods, to regard a service as automated digital service. It is also not affected by whether or not the service provider owns, leases or otherwise controls the transmission equipment.

37. The definition of "income from automated digital services" in paragraph 4 is exhaustive; other payments for services are not included in the definition and are not dealt with in Article 12B. See the examples in paragraphs 38 and 40 below. If there are multiple supplies that are identifiable and substantive in their own right, then each individual supply is to be tested against the

definition.

38. On the general principles above, the following services are considered to be automated digital services:

- Online advertising services;
- Sale or other alienation of user data;
- Online search engines;
- Online intermediation platform services;
- Social media platforms;
- Digital content services;
- Online gaming;
- Cloud computing services;
- Standardized online teaching services.

The categories are not mutually exclusive, for example, a digital content service could be funded in whole or in part by online advertising.

39. The above-listed services are described as follows:

(i) 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. It includes related systems for attracting potential viewers of the advertisements and collecting content contributions from them and data regarding them, including via the provision of services such as access to the digital interface. Online advertising services include direct advertising services, such as where social media platforms, online search engines, online intermediation platforms and digital content providers directly sell advertising inventory for display on the digital interfaces they operate. It also extends to the automated systems and processes for the purchase and sale of advertising inventory (such as demand-side platforms, supply-side platforms, ad exchanges, ad verification services, etc.). Given the broad definition of "digital interface" it also includes online advertising displayed on an Internet-connected good ("Internet of things") provided that there is such an identifiable advertising revenue stream.

(ii) 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, such as a user's habits, spending, location, environment, usage of services, hobbies, or personal interests, including anonymized and aggregated data (including geo location information and user traffic levels). The source of data may be collected as raw data by the enterprise itself (e.g. the manufacturer/seller of a home heating system collecting data about energy use, or a social media company collecting data about its users) or it may be acquired from another business. The source of the data would not be relevant provided that it is generated by a user through a digital interface.

(iii) Online search engines imply making a digital interface available to users for the purpose of allowing them to search across the Internet for webpages or information hosted on digital interfaces. Many online search engines are monetized through online advertising services and/or services transmitting data about users. To the extent these services are funded via

online advertising or the sale of data, such revenue would be treated under those respective categories (including for revenue sourcing purposes).This category extends to instances where an online search engine charges users for access, for example under a subscription model, or where online search engine technologies are provided for incorporation into a third-party host website (e.g. a “search box”).This category does not include services such as online databases or ‘internal’ website search functions that are not monetized, where the search results are limited to data hosted on that same digital interface (or related digital interfaces). However, if an online database or an ‘internal’ website search function service involves monetization of services or meets the general definition of automated digital service, it will be covered under Article 12B.

(iv) Online intermediation platform services involve a digital interface available to users for the purpose of enabling interaction among themselves, 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. It does not include the online sale of goods and services of the platform’s own inventory. This category applies where the service enables the interaction between third party users, irrespective of the nature of the interaction, the characteristics of the users involved, whether an underlying transaction is itself automated digital service, or the extent of the service provider’s activities in facilitating the interaction. This category extends to instances where the online intermediation platform charges users for its online intermediation services, for example through commission, listing or subscription fees. To the extent the intermediation service is funded via online advertising or the sale of data, such revenue would be treated under those respective categories.

(v) Social media platforms involve making a platform available on a digital interface to facilitate the interaction between users or between users and user-generated content. This category includes a range of activities that rely on an active and engaged user base to create value, such as social and professional networking websites, micro-blogging platforms, video or image sharing platforms, online dating websites, platforms dedicated to sharing user reviews, as well as online call and messaging platforms, some of which could overlap with online intermediation platforms. This category extends to instances where the social media platform charges users for access, for example under a subscription model. To the extent these services are funded via online advertising, the sale of data, or subscription models (which follows the business model for digital content services), such revenue would be treated under those respective categories above. This category does not extend to instances where user interaction is merely incidental to the core purpose of the digital interface, for example where a company sells its own inventory online and the website allows users to post comments or reviews or where a website allows a user to engage in an online chat with a sales representative.

(vi) Digital content services implies the automated provision of content in digital form, such as computer programs, applications, music, videos, books, other texts, games , online newspaper, online libraries, online databases and software, other than the data represented by a digital interface, whether by way of online streaming, accessing or downloading digital content, whether for access one time, for a limited period or in perpetuity. This category captures the different forms which digital content can take when acquired by a user but it does not include simply making a digital interface available to users. The purpose from a user’s perspective in a digital service transaction is the acquisition of the digital content. By way of background, the streaming and downloading consists of the same process of transmitting data, either as a continuous flow (in effect like a temporary download) or as a file saved to the

user's device available for later use. A number of streaming services allow both temporary streaming and downloading, but from the perspective of the automated digital service provider, the process is essentially the same. Despite being defined as royalties according to paragraph 3 of Article 12, the sale of software also meets the general definition of automated digital service where the provision of that software is automated requiring minimal human involvement to make it available to users and the software is delivered over the Internet. As such, software that is accessed or downloaded over the Internet would therefore qualify as automated digital service under the "digital content services" category, or it may also qualify under the "cloud computing" category ("Software-as-a-service"). Therefore, since the last sentence in paragraph 4 clarifies the interaction with other articles in cases where elements of income could be regarded as being covered in Articles 12 or 12A, Article 12B does not apply to the sale of software even if it is provided via streaming or downloading as a digital content.

(vii) Online gaming means making a digital interface available for the purposes of allowing users to interact with one another in the same game environment. This category applies to all multiplayer gaming enabled by the Internet, such as massively multiplayer online games, or other games that enable multiplayer functionalities, and regardless of the device or platform the game is accessed through. The provision of in-game purchases, or any other online purchases within the game is also under this category. This category does not include single-player games (which if streamed, accessed or downloaded over the Internet would be under the category of digital content services) or the purchase of a game sold on tangible media (as above for software, and which would fall under Article 12).

(viii) Cloud computing services are those providing standardized on-demand network access to information technology resources, including infrastructure as a service, platforms as a service, or software as a service (such as computing services, storage services, database services, migration services, networking and content delivery services, webhosting, and end-user applications and software).The network access to on-demand standardized IT resources includes all types of standardized cloud computing services, including computing services, storage services, database services, migration services, networking and content delivery services, webhosting, and end-user applications and software. Cloud computing services are typically provided in a standardized and highly automated way. Standardized cloud computing services may be 'assembled' or configured together for a particular customer (whether by the service provider or by the customer on a self-serve basis). Some cloud computing services, however, involve a high degree of human involvement to customize the service to the needs of a particular client. Such services are not automated digital services and therefore outside the purview of Article 12B.This way, a bespoke cloud solution involving a high degree of human involvement on behalf of the provider's staff (e.g. engineers or consultants) to create a new computing solution (as opposed to configuring existing solutions) is not considered to be included. To the extent that the human involvement relates only to the configuration of standardized cloud computing products, the integration of standardized cloud computing products into a customer's existing IT architecture, or ancillary customer support, the human involvement will be considered ancillary to the cloud computing service, which would be covered by this category.

(ix) Finally, 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: (a) the live presence of an instructor; or (b) 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. This category includes pre-packaged, non-

customized education products such as a pre-recorded series of lectures, and the content of which is not customized to each individual user (e.g. massive open online courses). Although these services may allow users to discuss the course content with each other on discussion forums within the platform, there is no or only limited interaction with instructors. Another key feature of standardized teaching services is that course work completed by the user is generally not marked by the instructors, but either marked automatically, or by other users. This category does not cover online education products that are customized to a student, or to a limited group of students, which may incorporate certain ancillary elements that are automated (e.g. a prerecorded lecture offered as part of a customized education package; automatically graded assignments accompanying a live-streamed lecture). Such services do not also meet the general definitions of automated digital services, and as such are not included in paragraph 39 under the category of customized online teaching services.

40. On the general principles in paragraphs 32 to 35 above, the expression "income from automated digital services" does not include:

i. Customized professional services;
ii. Customized online teaching services;
iii. Services providing access to the Internet or to an electronic network;
iv. Online sale of goods and services other than automated digital services;
v. Revenue from the sale of a physical good, irrespective of network connectivity ("internet of things").

41. The above-listed services are described as follows:

(i) The expression "Customized professional services" includes services whether provided individually or as a firm, such as legal, accounting, architecture, engineering, medical professional or financial or other specialized expert consultant. Customized professional services are not within the general definition of automated digital services. Although such services may be delivered online (e.g. legal advice sent by email, an architect sending drawings in PDF format; or an accountant sending calculations in a spreadsheet), they require customization to each client, through the tailored exercise of professional judgment and bespoke interactions. These services are not automated and require more than minimal human involvement on behalf of the professional individual or firm. They would also not be scalable without additional human involvement.

(ii) 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. This category confirms that customized teaching services delivered online are not within the general definition of automated digital services where the Internet or electronic network is used as a tool simply for communication between the teacher and student. This includes online education packages that are significantly customized to a student, or to a limited group of students, even where certain ancillary elements of the product are automated (e.g. a prerecorded lecture offered as part of a customized education package; automatically graded assignments accompanying a live-streamed, customized lecture). However, standardized online teaching service with ancillary interaction with an instructor is described in paragraph 38 as an automated digital service.

(iii) The expression "Services providing access to the Internet or electronic network" applies to the provision of access (i.e. connection, subscription, installation) to the Internet or electronic network, irrespective of the delivery method. This category covers the provision of access (i.e. connection, subscription, installation) to the Internet or electronic network irrespective of the delivery method, namely over wire, lines, cable, fibre optics, satellite transmission or other means, although there may be change in situation as technology advances. Internet Service Packages in which the Internet access component is an ancillary and subordinate part (i.e. a package that goes beyond mere Internet access comprising various elements(e.g. content pages containing news, weather, travel information; games fora; web-hosting; access to chat-lines etc.)) are not covered by this category. In such cases, the rules applicable to dual category automated digital services and bundled packages would apply.

(iv) Online sales of goods and services other than automated digital services involve the sale of a good or service completed through a digital interface where: the digital interface is operated by the provider of the good or service; the main substance of the transaction is the provision of the good or service; and the good or service does not otherwise qualify as an automated digital service. This category applies to sellers that use a digital platform to sell their own non-digital goods and services to customers. While the sale can be transacted over the Internet, these businesses are sellers of non-digital goods and non-digital services, rather than offering a digital service per se. This is the case of online selling of tickets for international transport, to which paragraph 2 of Article 12B clarifies that such profits are covered by Article 8. Applying the general definition of automated digital service, the provision of the intended good / service is not of a type that is automated but requires additional human interventions to make that service available to additional users.

(v) Irrespective of the network connectivity of a physical good, , revenue from the sale of that physical good is not considered to be covered by Article 12B provided there is no separately identifiable automated digital service revenue stream attached to that physical good (either at the time of purchase or a later date). Increasingly, physical goods may be connected to the Internet, or bundled with an online service. Beyond the sale of the physical good, such goods can be additionally monetized with a customer beyond the purchase of the physical good through different revenue streams (whether at the outset at the time of purchase or at a later date), and those revenue streams are captured by existing categories of automated digital services included in paragraph 37. Common examples include:(a) the monetization of data collected from the connected object is an automated digital service; (b) online advertising revenue relating to advertisements displayed on the connected object; and (c) the user of the connected object may pay for different types of automated digital services relating to, and / or to be accessed through, the connected object. To the extent that these revenue streams are separately identifiable from the sale price of the physical good, that automated digital service revenue stream would be captured by Article 12B. Further consideration is required to address cases where a separate revenue stream can be inferred even if not explicitly identified as such. There are certain types of machinery and industrial products that may contain a digital component. For example, monitoring the performance of an engine and providing remote technical support. This will typically require significant human involvement to provide the core function, which is using that information to conduct maintenance and repairs on the machinery. This is related to the operation of the machinery, rather than the service provider separately monetizing that data in an automated way with a third party. This means that the Internet-enabled functionality of the machinery would not meet the general definition of automated digital service or any item included in paragraph 37.There are certain products, known as the Internet of things, that provide a network of everyday devices, appliances, and

other objects equipped with computer chips and sensors that can collect and transmit data through the Internet, which enables additional features of the product to be used. It may be that many consumer goods now contain some software and may in the future be Internet-enabled, and bringing all such items into the scope of automated digital services would be over-broad having regard to the general definition of paragraph 4, given that the sale of a physical good is not automated digital service because it is not a service, nor is it provided over the Internet or through an electronic network. Treating a portion of Internet of things goods as within the scope of Article 12B may be difficult in practice– as it would require trying to separate the value of the digital component of the service. Based on the guidance above, the scope of Article 12B would include the revenue from the Internet of things to the extent separately identifiable as another automated digital service on the list included in paragraph 37.

42. There may be a situation where particular kind of automated digital services may wholly or partly fall under scope of royalty or of technical services covered by Article 12 or by Article 12A, as the case may be. Provisions of Articles 12 or 12A would apply where such automated digital services are wholly overlapping with the scope of those articles. This is clarified through second sentence of paragraph 4. Where, however, part of services amongst bundle of automated digital services are falling within scope of royalties or of technical services, taxation of such part only would be governed by Article 12 or 12A, as the case may be, and for the remaining, Article 12B would apply.

43. There may be activities which are not clearly severable. Where substantial part of the overall activity fulfills the criteria under paragraph 4 of Article 12B and the remaining elements derive significant benefits from their connection to the elements having characteristics under paragraph 4, then the overall service may be regarded as covered under Article 12B. By contrast, where the elements fulfilling criteria or matching characteristics under paragraph 4 of Article 12B are merely ancillary or a technical support feature for the rest of the service (example an automated chat function to screen a user's request as an entry point to the service), and rest of the service requires human involvement, the overall service may not be considered as covered under Article 12B.

44. It should be noted that, while Article 12A excludes payments by individuals for services for personal use from the definition of "fees for technical services", paragraph 4 of Article 12B does not make a similar exclusion. In consequence, Article 12B also applies to automated digital services provided to individuals for their personal use. Even though such payments would not normally be deductible by those individuals for tax purposes, it cannot be disregarded that many multinational enterprises that rely on digital business models derive a very significant portion of income from the provision of automated digital services generally to individual consumers. Since, the imposition of withholding tax obligations on such payments by individuals under domestic law may be difficult to enforce and might cause compliance problems for individuals consuming automated digital services supplied remotely by non-residents, other mechanisms for collection may be required. Such mechanisms are already in place in some countries.

45. In this sense, domestic legislation in some jurisdictions levying taxes on automated digital services requires non-resident providers to present a tax return where the tax obligation has been self-assessed and subject to examination by the tax administration. Other jurisdictions, instead, have the obligation to determine and pay the tax due by the non-resident provider, to the financial intermediary that individual consumers access to make the payments for the automated digital services involved.

46. It may sometimes be required to distinguish between payments in consideration for automated digital services and payments or fees towards technical services in order to determine whether Article 12B or Article 12A is applicable. In other situations, such differentiation may need to be done between payments towards automated digital services and payments that constitute royalties so as to determine whether Article 12B or Article 12 is applicable For this purpose, the principles in respective Articles, i.e. paragraph 4 of Article 12B, paragraph 3 of Article 12A and paragraph 2 of Article 12 together with the Commentary on the Articles need to be carefully applied to decide the characterization of the payment. Thereafter, as explained in paragraph 41 above, the particular Article will take precedence over the other. With respect to so-called mixed contracts, the appropriate course would be to break it down, on the basis of information contained in the contract or by means of a reasonable apportionment, the whole amount of stipulated consideration according to various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper to it.

Paragraph 5

47. This paragraph provides that paragraphs 1, 2 and 3 do not apply to income from automated digital services if the person who provides the services has a permanent establishment or fixed base in the State in which the income arises and the income is effectively connected with that permanent establishment or fixed base. In this regard, paragraph 5 is similar to Article 10, paragraph 4, Article 11, paragraph 4, Article 12, paragraph 4, and Article 12A, paragraph 4. Thus, if a resident of one Contracting State provides automated digital services through a permanent establishment or fixed base located in the other Contracting State, the payment received for those services will be taxable by the State in which the permanent establishment or fixed base is located in accordance with Article 7 or Article 14, rather than in accordance with Article 12B.

48. Since Article 7 of the United Nations Model Convention adopts a limited force-of-attraction rule, which expands the range of income that may be taxed as business profits, paragraph 5 also makes paragraphs 1, 2 and 3 inapplicable if the income from automated digital services are effectively connected with business activities in the State in which the income arise that are of the same or similar kind as those effected through the permanent establishment.

49. The paragraph does not define the meaning of the expression "effectively connected." As a result, whether income from automated digital services are effectively connected with a permanent establishment, fixed base or business activities similar to those carried on through a permanent establishment must be determined on the basis of all the relevant facts and circumstances of each case. In general, income from automated digital services would be considered to be effectively connected with a permanent establishment or fixed base if the automated digital services are closely related to or connected with the permanent establishment or fixed base or if the business activities are similar to those carried out through the permanent establishment. This will be the case where the remuneration paid to the person providing the services is borne by the permanent establishment or fixed base in the State in which the income arises.

50. Where paragraph 5 applies, payments for consideration of automated digital services are taxable by the State in which the income arise as part of the profits attributable to the permanent establishment in accordance with Article 7 or the income attributable to the fixed base in accordance with Article 14. Thus, paragraph 5 relieves the State in which the income from automated digital services arise from the limitations on its taxing rights imposed by Article 12B.

Where Article 7 applies as a result of the application of paragraph 5, most countries consider that the State in which the permanent establishment is located is allowed to tax only the net profits from the automated digital services attributable to the permanent establishment. Article 7 does not preclude taxation of business profits attributable to a permanent establishment on a gross basis, but a Contracting State must not discriminate against residents of the other State in violation of paragraph 3 of Article 24 (Non-discrimination). Similarly, where Article 14 applies, most countries consider that the State in which the fixed base is located is allowed to tax only the net income derived from the automated digital services.

Paragraphs 6 and 7

51. Paragraph 6 lays down the principle that the State in which income form automated digital services arise for purposes of Article 12B is the State of which the payer of the income is a resident or the State in which the payer has a permanent establishment or fixed base if the payments for the automated digital services are borne by the permanent establishment or fixed base. It is not necessary for the services to be provided in the Contracting State in which the payer is resident or has a permanent establishment or fixed base. Whether a person is a resident of a Contracting State for purposes of Article 12B is determined in accordance with the provisions of Article 4 of the Convention.

52. Where there is an obvious economic link between automated digital services being provided and the permanent establishment or fixed base of the payer to which the services are provided, the income from automated digital services are considered to arise in the State in which the permanent establishment or fixed base is situated. This result applies irrespective of the residence of the owner of the permanent establishment or fixed base, even where the owner resides in a third State.

53. Where there is no economic link between the automated digital services and the permanent establishment or fixed base, the payments for automated digital services are considered to arise in the Contracting State in which the payer is resident. If the payer of fees for automated digital services is not a resident of a Contracting State, Article 12B does not apply to the income from automated digital services unless the payer has a permanent establishment or fixed base in the Contracting State and there is a clear economic link between the automated digital services and the permanent establishment or fixed base. Otherwise there would be, in effect, a force-of-attraction principle for payments in consideration for automated digital services, which would be inconsistent with other provisions of the United Nations Model Convention.

54. Paragraph 6 is subject to paragraph 7, which provides an exception to the source rule in paragraph 6. Paragraph 7 deems payments in consideration for automated digital services made by a resident of a Contracting State not to arise in that State where that resident (the payer) carries on business through a permanent establishment in the other Contracting State or performs independent personal services through a fixed base in the other Contracting State and the payments for automated digital services are borne by that permanent establishment or fixed base. As a result, in these circumstances, the Contracting State in which the payer is resident is not allowed to tax the payments for automated digital services under paragraph 2 or 3.

55. The phrase “borne by” must be interpreted in the light of the underlying purpose of paragraphs 6 and 7, which is to provide source rules for income from automated digital services. A Contracting State is entitled to tax income from automated digital services under paragraph 2 or 3 only if the income arises in that State. The basic source rule in paragraph 6 is that income from

automated digital services arise in a Contracting State if the payer is a resident of that State or the payer has a permanent establishment or fixed base in a Contracting State and the payments in consideration for automated digital services are borne by that permanent establishment or fixed base. However, the basic rule is limited by the deeming rule in paragraph 7 where the payer is a resident of a Contracting State but the payments in consideration for automated digital services are borne by a permanent establishment or fixed base that the payer has in the other Contracting State.

56. Where payments in consideration for automated digital services are incurred for the purpose of a business carried on through a permanent establishment or for the purpose of independent personal services performed through a fixed base, those payments will usually qualify for deduction in computing the profits attributable to the permanent establishment under Article 7 or the income attributable to the fixed base under Article 14. The deductibility of the automated digital service payments provides an objective standard for determining that the payments have a close economic connection to the State in which the permanent establishment or fixed base is situated.

57. The fact that the payer has, or has not, actually claimed a deduction for the payments for automated digital services in computing the profits of the permanent establishment or the income of the fixed base is not necessarily conclusive, since the proper test is whether any deduction available for those payments should be taken into account in determining the profits attributable to the permanent establishment or the income attributable to the fixed base. For example, that test would be met even if no amount were actually deducted as a result of the permanent establishment or fixed base being exempt from tax or as a result of the payer simply deciding not to claim a deduction to which it was entitled. The test would also be met where the payments for automated digital services are not deductible for some reason other than the fact that such expenses should not be allocated to the permanent establishment or fixed base.

Paragraph 8

58. The purpose of paragraph 8 is to restrict the operation of the provisions concerning the taxation of income from automated digital services in cases where, by reason of a special relationship between the payer and the beneficial owner of the income or between both of them and some other person, the amount of the payment exceeds the amount that would have been agreed upon by the payer and the beneficial owner if they had stipulated at arm’s length. Paragraph 8 provides that in such a case the provisions of the Article apply only to the last-mentioned amount and the excess part of the payments for automated digital services would remain taxable according to the laws of the two Contracting States, due regard being had to the other provisions of the Convention.

59. It is clear from the text that in order for this paragraph to apply the payments in consideration for automated digital services held to be excessive must be due to a special relationship between the payer and the beneficial owner of the income or between both of them and some other person. There may be cited as examples of such a special relationship cases where remunerations for automated digital services are paid to an individual or legal person who directly or indirectly controls the payer, or who is directly or indirectly controlled by the individual or is subordinate to a group having common interest with the individual. These examples, moreover, are similar or analogous to the cases contemplated by Article 9.

60. On the other hand, the concept of special relationship also covers relationship by blood or

marriage and, in general, any community of interests as distinct from the legal relationships giving rise to the payment in consideration for the automated digital services.

61. With regard to the taxation treatment to be applied to the excess part of the payments for technical services, the exact nature of such excess will need to be ascertained according to the circumstances of each case, in order to determine the category of income into which it should be classified for the purposes of applying the provisions of the tax laws of the States concerned and the provisions of the Convention. Unlike Article 11, paragraph 6, which, because of the limiting phrase "having regard to the debt-claim for which it is paid," permits only the adjustment of the rate at which interest is charged, paragraph 8 permits the reclassification of the remuneration for automated digital services in such a way as to give them a different character. This paragraph can affect not only the recipient of the payments, but also the payer of excessive remuneration for automated digital services; if the law of the State where the payer is resident or has a permanent establishment or a fixed base permits, the excess amount can be disallowed as a deduction, due regard being had to other applicable provisions of the Convention. If two Contracting States have difficulty in determining the other provisions of the Convention applicable, as cases require, to the excess part of the remuneration for automated digital services, there would be nothing to prevent them from introducing additional clarifications in the last sentence of paragraph 8, as long as they do not alter its general purport.

62. Where the principles and rules of their respective laws oblige the two Contracting States to apply different Articles of the Convention for the purpose of taxing the excess part of payments in consideration for automated digital services, it will be necessary to resort to the mutual agreement procedure provided by the Convention in order to resolve the difficulty.

Annex 2:

Response by the Drafting Group to the comments received before the August 2020 Subcommittee meeting

The Drafting Group, thanking the members who have sent written comments, have provided the respective responses. Below is the analysis of each of those comments.

[Note that the reference to "Sl" in the Drafting Group Comments is to the numbered comments by individuals. Where there are sub-questions they are denoted as "sl"]

A.- GENERAL COMMENTS

1. Following the line of my comments on the parallel proposal to include payments for software in the definition of royalties I am increasingly concerned with the argument that taxing rights on payments can be based on the fact that services or goods delivered by the payee create "an increasing level of engagement in the economic life of States where they are used" or, as is stated in §1 of the proposed Commentary a "substantial involvement in another State's economy" or the "maintenance of a significant economic presence". Nobody really knows what that means and with the globalization of the economy can serve as argument for taxation of any profit in any state. If this is the justification for taxation the UN Tax Committee adheres to as a principle, it should be made clear what those terms exactly mean, the principle should be properly described in the introductory part of the Model and we should think through what that means for services generally and why it would not apply to the sale of goods generally. The current UN Model attributing taxing rights to the payer state on royalties, including the use of industrial equipment to that definition, already suffers from that unprincipled approach. This problem was increased with the introduction of article 12A into the Model. At this stage we should thoroughly reflect on the question whether and why we want to follow that path.

Response at the time of Subcommittee meeting: As also noted in comment, these justifications are there in 12A Commentary already. Doubting these statements at this stage, when they already stand adopted in the UN Model for another Article relating to taxation of services introduced as recently as 2017, would cast doubt on the UN Model up-dation process. As to the question whether and why we want to follow that path, the answer is obvious, i.e. allocation of taxing rights to source State as well. Further, why do we need to do this now while has not been done for Articles 12 and 12A. Moreover, even the other forum has proposed source State taxation.

Further Response: The Commentary on 12B in "General considerations' i.e. Part A has been considerably modified and it is not following Article 12A Commentary in that sense.

2. It is unclear exactly what issue this proposal seeks to address. It would be helpful to more clearly set out the problem and how it is proposed to be addressed. I recognize that there may not be agreement on this but, clearly articulating the problem and the rationale would strengthen the proposal. The rationale set out in the proposal is largely a cut and paste of the rationale in the UN Model Commentary related to Article 12A (Fees for Technical Services).

It is not clear that all of the Article 12A Commentary is relevant and, to the extent it may be, it requires customization to the situation of payments for automated digital services, including examples to better articulate a coherent rationale. The rationale for the change seems to be justified on the basis that (i) an enterprise can be "substantially involved in another State's economy without a PE or fixed base" and "with advancements in means of communication and information technology, an enterprise…can provide substantial services to customers in the other Contracting State and therefore maintain a significant economic presence in that State" and (ii) payments for automated digital services represent a BEPS concern. I recognize that both rationales come from the Commentary to Article 12A. However, it is not clear to me what is meant by (i) – it is too vague to be a relevant grounding for a taxing right and why it should lead to a source state taxing rights in respect of payments for automated digital services. On (ii), I question the characterization of a payment for automated digital services as primarily a BEPS issue. This issue seems to be more about a desire to reallocate taxing rights to the source country rather than a concern that the relevant profits are subject to low or no tax. Source countries have been clear that their concerns about allocation of taxing rights with respect to automated digital services are independent of whether or not the income is taxed in the country of residence. If the BEPS assertion is made, more detailed analysis is required in this respect.

<u>Response at the time of Subcommittee meeting:</u> What the proposal seeks to address, the problem and the rationale is well known to everyone. There has been enough debate. The same is covered in General Considerations i.e. paras 1 to 5 [former paragraphs 1, 4 and 5 no longer appear in the revised version] of proposed Commentary. The same can be expanded or elaborated further and fine-tuned to justification for addressing tax challenges of digitalized economies. We see no harm in using rationale for 12A, which is already adopted in UN Model and which covers a segment of services without physical presence. In fact if there is substantive argument, the question should rather be why not. Already, Article 12A Commentary has been modified or adapted suitably. This can be further refined by Drafting Group. As regards comment on (i) i.e. reference to significant economic presence, the same is a concept in BEPS Action 1 report which was used in 12A Commentary. We find nothing vague here. We agree that rationale for introducing 12B has more to do with allocation of taxing rights to source countries rather than base erosion. As noted in Executive Summary of BEPS Action 1 Report, digital economies do exacerbate BEPS issues. Hence a reference in para 8 of draft Commentary in Article 12B is justified.

<u>Further Response:</u> The Commentary on 12B in "General considerations' i.e. Part A has been considerably modified and it is not following Article 12A Commentary in that sense. Moreover, it is clearly articulated that it is an allocation of taxing rights issue. Hence reference to it being a BEPS issue has been altogether removed.

3. I appreciate the simplicity and the clear structure of the proposed approach. However, the simpler a legal concept is the more questions may arise in practice. I believe further work is needed to clarify the concept in its whole and to improve the definitions in the text and in the commentary. For example, the requirement of "minimal human involvement" is not yet clearly defined. Other notions are used in the commentary without real further explanation (see no.34 and 35 of the Commentary). This may lead to considerable problems in applying the provision and would lead to numerous MAP-cases, which in the absence of mandatory arbitration might provoke a real impediment to making automated digital services available.

<u>Response at the time of Subcommittee meeting:</u> We feel that the concept of 'minimal human element' is quite clear. The Commentary on paras 34 and 35 [38 and 40 of the revised version] can be expanded further if need be. It is not felt that the proposal would give rise to disproportionately higher MAP cases. Since situation is not different from existing treaty Articles, there does not appear to be need for a special consideration of mandatory arbitration.

<u>Further Response:</u> 'Minimum human involvement' has been elaborated further in the Commentary on paragraph 4. Commentary on paragraph 4 has been expanded very much now.

4. The draft provision and its accompanying commentary are largely modelled after the existing Article 12A (FTS) in the UN MTC. I have some doubts as to whether Article 12A of the UN MTC is a good model to adopt for Automated Digital Services (ADS) purposes. First, the sourcing rule used in Article 12A (based on where the payor is) may not be directly applicable for ADS purposes. This is due to the multi-sided nature of digital business models. For example, countries where users are located would not be allocated the taxing rights. While we have yet to define the problem that we are trying to solve with this provision, this outcome does not seem to be close to what some have intended based on the past discussions that we have had. Second, it is an established principle that taxation should be based on where value is created (connection between the location of income-producing activities and the ability of the country to tax those activities). As such, I would be very concerned if this draft provision leads us towards a destination-based tax.

<u>Response at the time of Subcommittee meeting:</u> The proposal is based on sourcing rule of 'payment' rather than user location', the latter being an administratively difficult proposition. Consciously, the proposal has been pegged to payments. As far as 'value creation' as a concept for taxing rights is concerned, we find the whole concept of value creation to be too subjective and vague. Also, UN Model does not rely on value creation as a key factor to allocate taxing rights between States.

<u>Further Response:</u> No change in position on sourcing rule. However, the Commentary on 12B in "General considerations' i.e. Part A has been considerably modified and it is not following Article 12A Commentary in that sense.

5. Although admittedly the review and update of the UN Model is a key part of our mandate it should be noted that treaty provisions do not *create* taxing rights. If the Committee is of the opinion that this provision reflects a proper approach to the attribution of taxing rights, the treaty provision should be the final stage of our work. The mandate of the Subcommittee on tax issues related to the digitalization of the economy expressly suggests to develop measures and possible provisions with regard to income taxes and double tax treaties. We should realize that the proposal is supposed to be in the interest of developing countries. Most of them do not have an extended treaty network and these countries are better helped with suggestions for their domestic legislation and with shared experiences from other countries than with treaty provision that might never be included in their treaties.

<u>Response at the time of Subcommittee meeting:</u> Whether to tax or not a particular stream of income under its domestic law is something to be decided by each country or jurisdiction. It is their sovereign right. This is the policy followed by both UN and OECD so far, while developing respective Models. For instance, UN Model provides for source taxation of

income from immovable property, dividends, interest, royalties, capital gains, income from employment, some type of pensions, without any further guidance to source States on how to exercise that taxing right in through their domestic legislation.The challenges exacerbated by the digitalized economy is related to the allocation of taxing rights according to tax treaties, which rely on physical presence. In the absence of tax treaties, all jurisdictions are free to decide on their tax system. Thus, focusing on a tax treaty provision is the first task to be accomplished. In any case, this proposal does not preclude further developments guiding jurisdictions on how to better design their domestic tax laws. But progress on first i.e. tax treaty provision should not be made subject to guidance on domestic law taxing provisions, which can be done later, if required. The last observation on absence of wide tax treaty network is applicable to everything done by UN Model updating work by the Committee. By this logic, we should stop working on UN Model and should start providing guidance on how to design domestic tax law first. Other aspect is that, in the absence of tax treaties, those countries face no challenge since they are free to tax income from digital services without any barrier.

<u>Further Response</u>: Already responded to. Nothing further to add.

6. One area of concern related to this proposal is how it can "solve" the "digital" problem if countries hosting digital MNEs are unlikely to agree to such a provision. To try to obtain buy-in from a wide spectrum of countries (both developed and developing) it is necessary to consider comments from Committee Members with diverse views, and also to more broadly consult with delegates from countries not represented on the current membership of the UN Tax Expert Committee. Further, to move towards an international consensus, it is important to consult with business and other interested stakeholders to test the feasibility of the proposal and identify the administrative challenges. It is also important to note that proposing a treaty provision only addresses the situation when tax treaties are in place, and many developing countries do not have wide tax treaty networks meaning that it will not help many of the least developed countries.

<u>Response at the time of Subcommittee meeting:</u> The UN Model does not solve problems itself. It is a guidance for countries (specially for developing countries) that want to negotiate taxing rights that sometimes they already have and may give up while negotiating a real DTA. The provision is proposed to be inserted in UN Model *precisely* to provide guidance to both developing and developed countries to introduce such a provision in their bilateral tax treaties. Such provision will also address the unilateral measures introduced by several countries increasingly including developed countries, resulting in double taxation. In fact, non-insertion of such provision at earliest is proliferating such unilateral measures, which no one can stop otherwise, taxation being a sovereign right of countries, without any guidance provided to States on how to protect such right in their tax treaties. International consensus is not the purpose of the United Nations Model Double Taxation Convention between Developed and Developing Countries. Our mandate is to keep it under review and update it as necessary, giving special attention to developing countries and countries with economies in transition in dealing with such an issue. As regards taking into account everyone's views the same has already been done for three and half years in the Committee and it is very clear that consensus or convergence of views on this would never be achieved. In due course of time, once the proposal is before the Committee to be adopted, all necessary consultations would take place. Further, due to the proposal being in public domain already, comments if any from all stakeholders can come in a natural manner. Last

statement has already been addressed being there in the comment above at serial number 4.

<u>Further Response:</u> **Already responded to. Nothing further to add.**

7. The proposed treaty provision only applies to non-residents. It seeks to apply a withholding tax on the gross amount of payments for automated \ services or alternatively net taxation on "qualified profits". It is unclear from a policy perspective why a non-resident providing automated digital services should pay a gross tax, or a net tax on its multi-national entity level profits, while the same non-resident could establish a PE or a local subsidiary in the source jurisdiction and pay tax on only a small portion of the profits attributable to the PE or local subsidiary. I welcome the inclusion of an option for the non-resident to be taxed on a net basis. I think this is a key element of the proposal that could help alleviate some of the risks and challenges associated with taxation on a gross basis – i.e., double taxation or excessive taxation. That being said, I think the proposal as currently drafted requires significantly more work to make it administrable and provide clarity and certainty in respect of how it will operate in practice (see additional comments below under paragraph 3).

<u>Response at the time of Subcommittee meeting:</u> **Tax treaties deal with taxation of non-residents almost always. There is no exception here. As regards why should a non- resident pay tax on gross or net basis as envisaged instead of establishing a PE etc., this depends on business model chosen by non- resident. There can be no objection or concern if a non-resident prefers to set up a PE or fixed place to render ADS. It is entirely taxpayer's choice depending on overall pros and cons, taxation being just one dimension. How the net basis taxation will operate in practice is primarily a subject matter of respective domestic laws. In both UN and OECD Models as well as Commentary, this approach has been followed always. Both Models, even for Article 7 do not provide guidance on how the tax base (net profits) has to be determine, but only making a reference to what would have been the income for an independent party engaged in similar business activities under the same conditions. In any case, para 28 of proposed commentary [paragraph 31 of the revised version] already contains guidance on this which can be further augmented by Drafting Group if need be.**

<u>Further Response:</u> **Changes have been made in paragraph 3 and the Commentary thereto to provide clarity and certainty.**

8. The proposed Article is largely drafted based on the structure of Articles 10, 11, and 12. It is not clear that this structure always works or provides for the most appropriate rule. See comments below related to paragraphs 1 and 2 of the Article where I suggest a formulation closer to Article 12A and comments on paragraph 6 of the Article related to the proposed sourcing rule. Further, as noted above, the proposed commentary is largely a cut and paste from the Commentary to Article 12A and more work needs to be done to adapt the commentary to the current situation.

<u>Response at the time of Subcommittee meeting:</u> **The suggestion to change from income from automated digital to "payments for ADS' can be examined and considered. As regards, sourcing rule, please see comments on Sl No. 3 above. Lastly, we agree to refine the Commentary.**

<u>Further Response:</u> **Matter has been examined and the formulation of Income from**

automated digital services is found to be most suitable. Some change has been made in para 2 language. Commentary has been considerably overhauled and refined.

9. The definition of automated digital services and the related commentary seems to rely heavily on the work done by the Inclusive Framework. It would be appropriate to acknowledge the work of the Inclusive Framework (see below under paragraph 4).

<u>Response at the time of Subcommittee meeting:</u> **Reliance on IF work for this purpose has been done in order to reduce uncertainty and to avoid spill overs related to different scoping (e.g. not providing guidance on what can be conceived as a digital service). As regards acknowledging IF work, while it is true that the definition of ADS is same as IF work, it needs to be noted that it still a work in progress for IF. In any case, this does not seem to change anything. Lastly, the intention of the proposal is not to describe what other fora is developing. In any case, such acknowledgement could be inserted rather in a report instead of Commentary to 12B.**

<u>Further Response:</u> **Already responded to. Nothing further to add.**

10. It should also be noted that such a change to the Model would require a number of consequential amendments to other parts of UN Model and Commentary. Consideration should also be given to how such a provision would interact with the proposal to add software to the definition of royalties and how it would interact with the unified approach being developed by the Inclusive Framework.

<u>Response at the time of Subcommittee meeting:</u> **On first part, we agree and it can be achieved in a similar fashion as was done for 12A in previous Committee. This issue is already identified by the drafting group. On interaction with software, first the person making the comment needs to specify whether the software proposal is acceptable to her. Otherwise, it is irrelevant. Secondly, ADS does not cover customized software or the software bought other than through internet or electronic means. In the event of change in definition of royalties in Article 12 as proposed, it will be specified in para 4 of Article 12B that the term income from ADS does not cover payments towards software qualifying as 'royalties'.**

<u>Further Response:</u> **Change has been made in paragraph 4 of Article 12B to clearly state interaction with Article 12.**

11. In addition, in absence of a monetary threshold, the tax for automated digital services could create disproportionate administrative burdens for both taxpayers and tax administrations. Small and middle-sized companies with little international business might face an administrative disadvantage compared to multinational enterprises.

<u>Response at the time of Subcommittee meeting:</u> **The monetary threshold will be a matter of domestic law. It is expected that the countries would have a local monetary threshold for local revenue before imposing taxation on ADS under the domestic law. Therefore there is no reason for disadvantage to small and medium enterprises. Other items of income are covered in the Model (interest, royalties, fees for technical services) allocating taxing rights to source States without any monetary threshold. Disadvantages for small and middle-sized companies were not addressed in those other provisions in the Model.**

Further Response: Already responded to. Nothing further to add.

12. We also should consider that the tax will most likely be passed on to the consumer. This argument especially holds true, if source-state taxation on a gross basis takes place. In times of the Covid-19-crisis we should be careful to avoid measures that might reduce economic stimulus for the economy. A tax negatively impacting consumers and mid-sized companies might therefore not be the best choice for taxing the digital economy. The proposed taxation on a gross basis is destined for excessive taxation.

Response at the time of Subcommittee meeting: There is no reason to assume that the tax will be passed on to the consumer in all situations. In any case, such situation for ADS taxation is no different from similar scheme of taxation for royalties and FTS. Further, guidance has already been provided in the Commentary to keep such taxation at a modest reasonable rate. In addition, the removal of source taxation under Articles 10, 11, 12 or 12A has not been suggested because of Covid-19. The question whether the gross basis taxation would give raise to excessive taxation, depends on the maximum level of withholding tax that might be agreed during bilateral negotiations. On the other hands, MNEs that rely in digital business models have been proved to be as profitable as MNES to which Articles 10, 11, 12 or 12A apply -or even more profitable though-, so the tax charged in market jurisdictions would not put at risk their profitability.

Further Response: Already responded to. Nothing further to add.

13. Although the draft also provides the option for taxation on a net basis, the Commentary itself shows that matters may not be so easy as they appear: no. 29 of the Commentary [31 of the revised version] already contains a dissenting view. Although it is correctly stipulated there that the draft so far does not respect losses, the alternative method provided in no. 29 [31 of the revised version] possibly is not easy to handle, because three different profitability ratios have to be determined and compared with each other.

Response at the time of Subcommittee meeting: It is incorrect to say that the draft does not respect losses. Para 3 indeed takes care of losses and this is clarified in para 26 [26 of the revised version] of the Commentary. The alternative mechanism provided in paragraph is to address a minority vies. If this minority views is kept, advantages and disadvantages of such mechanism could be developed to provide more guidance.

Further Response: See the change in paragraph 3 of Article and related Commentary.

14. While Article 12 A explicitly excluded payments for services for personal use (reasoning see paragraph 72 of the Commentary to Article 12 A), income generated by automated digital services provided to individuals is included in the scope of Article 12 B. Might this be a logical breach, which is not thoroughly explained in the draft of the Commentary to Article 12 B? Moreover, I have doubts whether the differentiation between both Articles will always be clear, e.g. teaching: teaching by an educational institution would be excluded from Article 12 A, but if it is realized automatically in a standardised form it would be included in Article 12 B?

Response at the time of Subcommittee meeting: The first aspect, i.e. coverage of services for personal use has been dealt with in para 41 [44 of the revised version] of draft Commentary

at length. Businesses in scope are similar to those covered by the developments at the IF, where Amount A under the Unified Approach also tax income derived from automated digital services rendered to individuals. Reasons for differentiation vis a vis Article 12A are also explained there. The illustration provided on 12A versus 12B itself provides an answer when it would be a 12A case and when it would be 12B case. It is acknowledged that some cases may require analysis of facts and circumstances to decide where would they fall but it is felt neither too common nor unsurmountable.

<u>Further Response:</u> The new version of paragraphs 39 and 41 of the draft Commentary elaborates on more precise definitions of services within and without the scope of Article 12B, in particular as regards teaching services

15. In contrast to the Commentary to Article 12 A the draft of the Commentary to Article 12 B so far does not contain reasons against the inclusion of the potential Article 12 B. I assume that this would be added if the work was taken further?

<u>Response at the time of Subcommittee meeting:</u> This is up to members who are against the proposal to elaborate on those reasons. A minority view can always be added in line with long standing tradition respecting minority views.

<u>Further Response:</u> Already responded to. Nothing further to add.

B.- OTHER COMMENTS / COMMENTS ON ARTICLE PARAGRAPHS AND COMMENTARY RECEIVED

<u>Paragraph 1:</u>

16._ On **§** 1:
- Parallel with art 12A is clear.
- Why used “income” (neither of arts 10,11,12,12A uses “income”)
- Why not “profit” (as in art 7) in lieu of “income”. See also comments on §2.

<u>Response at the time of Subcommittee meeting:</u> There is no specific label for this type of income (contrary to interest, royalties and fees). Income is generically used regardless of whether it is gross or net, in opposition to the term “profit” that is used to address net income. According to Merriam-Webster Dictionary, the term “income” means “gain usually in money that comes in from labor, business or property”, while the term “profit” means “the gain after all the expenses are subtracted from the total amount received”. As used in the Model (for example, see Article 1 and Article 6), “income” has a broader meaning, which is deliberately differentiated from “net income” (or profits).
Ha111ving said above, this point is for consideration of Drafting Group and would be seen.

<u>Further Response:</u> After examination, the present terminology is found to be best under the circumstances and in context of ADS. One change has been made in para 2 of Article though.

16. Rather than the formulation of “income from automated digital services” it is suggested to more closely align with the formulation used in Article 12A to read “payments for automated digital services”.

Response at the time of Subcommittee meeting: **Point covered in Sl No.16 above.**

Further response: **Already responded to. Nothing further to add.**

Paragraph 2:

18. On **§** 2:
    - What is the reason not to copy "notwithstanding the provisions of Article [7 and] 14 and subject to the provisions of Article 8 [12A], 16 and 17" as included in Article 12A?
    - Is there such a thing as "gross amount of the income". Isn't income = receipts minus costs? And isn't that 'profit'?

Response at the time of Subcommittee meeting: **There is no need to make clarification in respect of Article 7 since according to Article 7.6, Article 7 will never prevail over Article 12B. In case of overlaps, if the income is attributable to a fixed base, according to paragraph 5 of Article 12B, Article 14 will apply. Paragraph 10 of the commentary of Article 12B addresses this issue. After deliberations, it can be re-examined whether to insert Article 14 reference in paragraph 2 of Article 12B if so decided. For clarity sake, reference to Article 8 can be inserted. Paragraph 4 already excludes from the scope of Article 12B income covered by Article 12A. There is no room for Articles 16 or 17 to be susceptible of application with regard to automated digital services.**

Further response: **Paragraph 2 has been modified to clarify the interaction between Articles 8 and 14. Paragraphs 9, 25 and 41 of the Commentary now elaborate on this issue.**

17. Consideration should be given to explicitly setting out in paragraph 2 the intended interaction with Articles 8 and 14 as is done in paragraph 2 of Article 12A.

Response at the time of Subcommittee meeting: **All points covered in Sl No. 18 above.**

Further response: **Paragraph 2 has been modified to clarify the interaction between Articles 8 and 14. Paragraphs 9, 25 and 41 of the Commentary now elaborate on this issue.**

18. The provisions aims to tax the payments by the recipient of the service. In many of the targeted business lines the services will be rendered for free (to individuals) and the income of the service provider comes from advertisement and payments by others (other business) to whom the (automated digital) service arguably is not delivered.

Response at the time of Subcommittee meeting: **The proposal is based on sourcing rule of 'payment' rather than user location', the latter being an administratively difficult proposition. Consciously, the proposal has been pegged to payments.**

Further response: **Already responded to. Nothing further to add.**

19. The proposed taxation on a growth basis is destined for excessive taxation.

Response at the time of Subcommittee meeting: **It would depend on the maximum level of withholding tax agreed during bilateral negotiations. On the other hands, MNEs that rely in digital business models have been proved to be as profitable as MNES to which Articles**

10, 11, 12 or 12A apply -or even more profitable though-, so the tax charged in market jurisdictions would not put at risk their profitability.

Further response: Paragraphs 4 and 15 now address this issue.

Paragraph 3

22. On § 3:
    1. [Beneficial owner of the] "Profits" (as in art 7) seems more appropriate than "income".
    2. Is "gross [annual] revenue" in this context the same as "gross amount of the income" referred to in §2?
    3. What is the basis for the choice of the 30% rate?
    4. Given the "or" in the 2nd sentence, who makes the choice?
    5. The terms "profitability ratio", "multinational group" and "business segment" are only defined, or described, in the commentary. Why not in the article?

Response at the time of Subcommittee meeting: 1&2, In our view, 'beneficial owner of income' in first sentence sounds better. In §2, reference is to each payment whereas in § 3, reference is to total payments or revenue derived in the year. Anyways, the terms 'income', 'profits' and 'revenue' wherever used can be revisited and suitably aligned or modified.
3. Basis of 30% is because full profits are not to be taxed in market jurisdiction. As far as 30% ratio is concerned, the same is a reasonable estimate in this regard based on profit attribution done in various countries by tax authorities in PE cases without accounts.
4. The choice is of MNE as per availability.
5. To make it easier to read.

Further response: 1&2. Same as Sl 16.
3. Basis of 30% has been explained in para 30 of Commentary now.
3. Paragraph 3 has changed now to remove confusion.

23. I welcome the suggestion for the alternative of a net basis of taxation for the taxpayer. I have the following suggestions:
    - First, the drafting of the main article could be better refined to give more clarity that a net basis of taxation can be an alternative for the taxpayer.
    - Second, please clarify how the 30% proportion was derived.

Response at the time of Subcommittee meeting: All points covered in Sl No. 22 above.

Further response: Paragraph 30 of the Commentary now provides an explanation for the basis of 30%. Paragraph 3 of Article 12B has been changed now to clarify the optative nature of paragraph 3.

24. The draft article offers affected taxpayers the option to instead be taxed on their "qualified profits" from automated digital services under the rules and at the rate adopted by the source country. For purposes of this net income option, qualified profits are defined as 30 percent of the amount calculated by multiplying the beneficial owner's global profit margin as reported in its consolidated financial statements by its total automated digital services revenue in the contracting source country.

I welcome the option for the non-resident to choose to be taxed on a net basis which recognizes a general principle agreed at our subcommittee meeting in January 2018. However, more details are needed for the approach to work in practice. Unless a very low rate (1-2%) is chosen for the withholding tax it is likely that most taxpayers would choose net taxation.

The option to be taxed on a net basis is the key element of the proposal, but is too vague to be implementable or administrable. It is equivalent to an income tax which says that a company should pay tax on its "profit", but does not define profit. This ignores the complex rules that are required in order to establish clearly what is taxable income on a net basis – e.g. allowable deductions, timing of recognizing revenue and expenses, etc. It is not feasible to leave it up to each country to decide its own rules. Other issues that need to be addressed include:

- On what basis was a 30% rate established? This deserves more discussion and analysis. This is also an item that could be left to bilateral negotiations similar to the withholding rate itself.
- Need a clear definition of MNE.
- How will the market jurisdiction audit the group-wide financial statements to properly apply this provision? In many cases, the residence country may not be the ultimate parent of the group and thus may well not have access to group-wide financial information.
- How are segments to be chosen? Does "if available" imply that this is at the discretion of the company? If so, how do authorities prevent choice of segments for tax reduction purposes? It seems doubtful that this provision is clear enough to be administrable.

<u>Response at the time of Subcommittee meeting:</u> As regards the observation that most taxpayers would choose net basis taxation, choice would be between ease of compliance and tax burden.

The observation that profit is not defined in Article 12B.2, UN Model Article 7 practice is same. The profit computation is to be done as per domestic law. Here, even that is not the case since profits are pre-decided i.e. global profitability applied on local revenue and 30% thereof.

Regarding how 30% was determined, see Sl No. 21 above.

Definition of MNE is as per OECD TP Guidelines and clear enough in our view. Specific suggestions can be further considered.

How market jurisdiction will satisfy itself on group profitability is matter of domestic law. It could be self- declaration by MNE Group supported by documentation and if required, verified through exchange of information mechanism.

For the last point, see sl no. 4 of Sl No. 22. We appreciate that there is scope of further clarity here.

<u>Further response:</u> Indicative rate now mentioned in Commentary paras 4 &15.

For 30% rationale, para 30 of Commentary gives it.

Commentary on para 3 has been expanded to deal with some of the concerns.

On the last point, drafting of para 3 of Article now provides a clear sequence of application.

Paragraph 4

25. The definition needs to be fleshed out more clearly to provide for clarity, certainty and to avoid disputes.

<u>Response at the time of Subcommittee meeting:</u> **In our view, definition is quite elaborate and clear. It can be further worked upon.**

<u>Further response:</u> **Commentary has been elaborated and expanded. More guidance can now be found in paragraphs 39 and 41 of the Commentary.**

26. Two comments:

(i) Do we need to define "income from…"? or only define "automated digital services"?

(ii) Hard to judge how reliable the definition itself is. Is "on the internet" or "an electronic network" and "minimal human involvement" clear enough?

<u>Response at the time of Subcommittee meeting:</u> **(i) This point can be examined further, being a drafting issue only.**

(ii) We feel the definition is quite robust. A very similar approach is being undertaken by the IF on Amount A.

<u>Further response:</u> **(i) After examination, the present terminology is found to be best under the circumstances and in context of ADS. One change has been made in para 2 of Article though.**
(ii) Commentary on para 4 has been considerably expanded.

27. I believe further work is needed to clarify the concept in its whole and to improve the definitions in the text and in the commentary. For example, the requirement of minimal human involvement" is not yet clearly defined. Other notions are used in the commentary without real further explanation (see no.34 and 35 of the Commentary).

<u>Response at the time of Subcommittee meeting:</u> **We took the definition developed under the Unified Approach. If needed, we can in-depth the concepts also in the same sense as the IF might do.**

<u>Further response:</u> **Commentary on para 4 has been considerably expanded. More guidance can now be find in paragraphs 39 and 41 of the Commentary.**

Paragraph 5

28. Two comments:

(i) If the ADS does not (by definition) need human involvement how can the income be "effectively connected" with a PE.

(ii) And if it is, what profit do we think will be attribute to that service in the PE? That might be very low and the best way to avoid a WHT. Or is it the same (qualified) profit as defined in § 3?

<u>Response at the time of Subcommittee meeting:</u> **(i) The UN Model does not follow the AOA, so profit attribution under Article 7 is not restricted to the principle of significant people**

function.
(ii) Even though the comment follows the logic according to MNEs derive in-scope income in the absence of physical presence, there could be cases where there is such presence. Moreover, the IF also relies on that taxable presence as a plus factor for consumer facing businesses covered by Amount A

Further response: Already responded to. Nothing further to add.

Paragraph 6

29. The sourcing rule in paragraph 6 allocates taxing rights according to the location of the payer for the services (generally consistent with the sourcing rule in Articles 10, 11, 12 and 12A of the UN Model). This differs from that which has been discussed by the Inclusive Framework under Pillar 1, which is based on the location of the users. For example, for an online advertising service like Google, when a French company pays for Google ads targeted to users in India, this rule would allocate the taxing rights to France. Pillar 1 would allocate the taxing rights to India.
A discussion of this sourcing rule, and how it accords with the policy rationale for the proposal, would be helpful.

Response at the time of Subcommittee meeting: This aspect has been covered in General Comments.

Further response: Already responded to. Nothing further to add.

30. Why should the article apply if the payer, being resident of one CS, has a PE in a 3rd State with which the payment is borne by that PE?

Response at the time of Subcommittee meeting: Payments borne by PEs in third States, are covered by paragraph 6, and is the typical sourcing rule we also find in Articles 11, 12 and 12A.
Paragraph 7 states that Article 12B does not apply if the income is attributable to a PE in the State of residence of the beneficial owner of the income.

Further response: Already responded to. Nothing further to add.

General considerations on the Commentary

31. As mentioned above, the Commentary is largely a cut and paste from the Commentary for Article 12A (but ordered differently) but in many cases the commentary is not sufficiently tailored to the situation of payments for automated digital services. For example:
    - Paragraph 1 – The relevance to automated digital services is not clear – should more specifically relate to automated digital services.
    - Paragraph 1 - A change in the allocation of taxing rights between countries is not a safeguard against BEPS. Need to further explain whether this is a BEPS issue and how – should give examples as was done in the Commentary on fees for technical services.
    - Paragraph 2 – The relevance to automated digital services is not clear - "as a

result of these considerations" – need to set out considerations; what is the "larger project on services"?

- Para 4 – the statement "countries have different interpretations of those rules, which can make their application difficult for all parties" – may be true for Article 12A (see detailed commentary explaining this), but it is not clear that it is true for payments for automated digital services. The issue is more that certain countries are unhappy with the current allocation of taxing rights and argue for a change in the allocation; this is not a question of interpretation challenges.
- Paragraph 5 – "they might have been subject only to low taxes (or no tax at all) on the income earned in their country of residence." It is inaccurate to suggest that the push for greater source taxing rights is driven by concerns about an inadequate level of taxation in the residence country.
- Para 6 – use of "modest rate" is not helpful – suggest using language from Article 12A Commentary (see para 15 of Article 12A commentary).
- Para 7 – compliance burden – unless the withholding rate is very low, non-resident enterprises are likely to ask for net taxation, then simplicity of gross taxation does not exist.
- Para 8 – need further discussion/explanation about whether and why payment from a resident in a particular jurisdiction implies that any substantial services are performed in that jurisdiction.

  Given the divergence of view among Members, there are likely to be minority views, which will be included at a later date depending on the direction of the work.

<u>**Response at the time of Subcommittee meeting:**</u> **Para 1 - It is not said that proposal is a safeguard against BEPS issues. Admittedly it is a measure towards allocation of taxing rights. Reference in para 1 to BEPS is also in a different context.**

Para 2 - Reference to automated digital services may come from holistic reading of Commentary.

Para 2 - "Larger project on services" is the one started in 2012 and ended up with Article 12A in 2017. This has already been stated in Art 12A Commentary

Para 4 - This can be examined.

Para 5 - Inadequate level of taxation in country of residence point can be seen for required change.

Para 6 - language of last sentence of para 15 of Art 12A Commentary has not been used after due consideration. In our view, language used in para 6 is ok.

Para 7 - As regards the observation that taxpayers would choose net basis taxation, choice would be between ease of compliance and tax burden.

Para 8 - The same question seems not to be asked at the IF. We are much past this stage.

Regarding Minority Views, the same can always be recorded as per UN Tax Committee's processes.

<u>**Further response:**</u> **Commentary under 'General Considerations' has been completely**

revamped.

Reference to BEPS issues removed and it is made clear that this is an allocation of taxing rights issue.

Commentary referring to "as a result of these considerations' and "larger project on services" completely modified.

Commentary containing the statement "countries have different interpretations of those rules, which can make their application difficult for all parties" completely modified.

Paragraph 5 – "they might have been subject only to low taxes (or no tax at all) on the income earned in their country of residence."-Modified

Suggestion for low withholding tax rate made explicitly in paras 4 & 15 of the Commentary.

Paragraph 1 of the Commentary

32. Refer to my general comments. Quotation from BEPS Action 1 is selective. Why not mentioned the conclusion about impossibility to ring fence the digital economy. Paragraph also incorrectly refers to BEPS aspects. Taxation issues related to the digitalization of the economy are not related to BEPS concerns.

<u>Response at the time of Subcommittee meeting:</u> It is selective on purpose because the Committee only takes into account other fora but it has its own proposal.

On BEPS aspects, many MNES have also structured their business models to shift profits to low tax jurisdictions. Further, as noted in Executive Summary of BEPS Action 1 Report, digital economies do exacerbate BEPS issues. Hence a reference in para 8 of draft Commentary in Article 12B is justified.

<u>Further response:</u> No change on first. On second, reference to BEPS being rationale has been changed.

Paragraph 2 of the Commentary

33. I am unaware of Committee's "larger project on the taxation of income from services". Where and when was that agreed?

<u>Response at the time of Subcommittee meeting:</u> The one started in 2012 and ended up with Article 12A in 2017. This has already been stated in Art 12A Commentary.

On BEPS aspects, many MNES have also structured their business models to shift profits to low tax jurisdictions. Further, as noted in Executive Summary of BEPS Action 1 Report, digital economies do exacerbate BEPS issues. Hence a reference in para 8 of draft Commentary in Article 12B is justified.

<u>Further response:</u> Accepted. The paragraph has been redrafted.

Paragraph 3 of the Commentary

34. This (or another) paragraph should contain some explanation on the process, on whether the Committee prefers a multinational solution but that the OECD/IF could not deliver that solution. Moreover there must be a reference to (the relevance of) what has been written in the context of IF on ADS. In that context there should at least be spent some words on the choice not to include Consumer Facing Business.

<u>Response at the time of Subcommittee meeting:</u> **Initiatives have always been welcomed by the Committee…but except for two Members (Rajat and Jose), no other member suggested any alternative proposal.**

The UN Committee is neither required nor obliged to explain in its Model or Commentary why a particular approach is different from other Fora's approaches. If needed, the place to do that might be Subcommittee report, but not the UN Model. Article 12B only deals with a model bilateral provision for interested countries.

<u>**Further response: No further comments.**</u>

35. I would like to better understand the economic basis for deeming that the income has arisen in the payer state.

<u>Response at the time of Subcommittee meeting:</u> **The same question seems not to be asked at the IF. We are much past this stage.**

<u>Further response:</u> **The policy rationale for the allocation of taxing rights to the State where payments arise can be found in paragraph 1 of the Commentary. Most digital services are remunerated whether by the user or by businesses wanting the digital provider to show the user an advertisement. In both cases, the person paying is receiving a digital service. Clarification in this sense can be found in paragraph 39 of the Commentary.**

Paragraph 4 of the Commentary

36. I disagree with last sentence. It is true that countries have different preferences, but the there is no discussion on the interpretation of the rules.

<u>Response at the time of Subcommittee meeting:</u> **This can be examined.**

<u>Further response:</u> **The paragraph has been redrafted.**

Paragraph 5 of the Commentary

37. Paragraph incorrectly refers to tax advantage for non-residents and falsely assumes they are not subject to any domestic tax. Dissatisfaction with the tax rate in other states is a pillar 2 concern and is not related to preference for source taxation.

<u>Response at the time of Subcommittee meeting:</u> **Tax treaties prevent taxation of business profits in the absence of physical presence. Local providers of similar services are taxed (tax treaties do not prevent States to tax their own residents).**

Dissatisfaction with tax rate in other state point can be seen for required change.

<u>Further response:</u> **The paragraph has been redrafted.**

38. I propose to delete paragraph 5.
For services in general that are provided from outside of a contracting stage, there is little basis to conclude that non-resident service providers have an unjustified advantage over

domestic service providers. Domestic service providers should rightly pay corporate tax in the place of establishment since it is in that State and benefits from the local infrastructure. This is not the case for non-resident service providers. This is further amplified in the case of automated digital services as such services are provided over the internet with little intervention from the service provider itself.

<u>Response at the time of Subcommittee meeting:</u> Not accepted. Tax treaties prevent taxation of business profits in the absence of physical presence. Local providers of similar services are taxed (tax treaties do not prevent States to tax their own residents).

<u>Further response:</u> Already responded to. Nothing further to add.

Paragraph 6 of the Commentary

39. Reference to article 23 reminds us of necessity to reflect on necessary amendments to other articles (23, 24, other?).

<u>Response at the time of Subcommittee meeting:</u> This is already in noted. The cover note that introduces the proposal already highlight the need to make corresponding modifications to other articles.

<u>Further response:</u> Already responded to. Nothing further to add.

40. Please refer to my earlier comment. If there is no sound economic basis for giving the taxation rights to the payer state, we are also grappling with the problem of an unjustified allocation of taxing rights.

<u>Response at the time of Subcommittee meeting:</u> The same question seems not to be asked at the IF. We are much past this stage.
<u>Further response:</u> Already responded to. Nothing further to add.

Paragraph 7 of the Commentary

41. Please refer to my earlier comment. If there is no sound economic basis for giving the taxation rights to the payer state, we are also grappling with the problem of an unjustified allocation of taxing rights.

<u>Response at the time of Subcommittee meeting:</u> The same question seems not to be asked at the IF. We are much past this stage.

<u>Further response:</u> Already responded to. Nothing further to add.

Paragraph 8 of the Commentary

42. Not clear why the ability to derive income without physical presence justifies source taxation. Reference to profit shifting and base erosion are false. There is no (artificial) profit shifting and the justification seems to be independent from the question whether there is base erosion.

<u>Response at the time of Subcommittee meeting:</u> **The same question seems not to be asked at the IF. We are much past this stage.**

<u>Further response:</u> **Already responded to. Nothing further to add.**

43. In the case of payments for automated digital services, it would be more appropriate to introduce a threshold so as not to increase compliance burden on smaller enterprises and individuals. It would also not be cost-effective to tax them.

<u>Response at the time of Subcommittee meeting:</u> **The monetary threshold will be a matter of domestic law. It is expected that the countries would have a local monetary threshold for local revenue before imposing taxation on ADS under the domestic law. Therefore there is no reason for disadvantage to small and medium enterprises.**

<u>Further response:</u> **Already responded to. Nothing further to add.**

44. <u>Two comments:</u>

    (i) This paragraph assumes, among other things, that there will be base-erosion and profit shifting aspects when residents make payment to non-resident service providers for automated digital services. I would like to better understand the basis for these assumptions. If not, I suggest to delete this paragraph.

    (ii) I note that this is the same as the commentary to Article 12A. I suggest to validate this point with the Committee.

<u>Response at the time of Subcommittee meeting:</u> **(i) On BEPS aspects, many MNES have also structured their business models to shift profits to low tax jurisdictions. Further, as noted in Executive Summary of BEPS Action 1 Report, digital economies do exacerbate BEPS issues. Hence a reference in para 8 of draft Commentary in Article 12B is justified.**

(ii) Yes, this is subject to decision in Committee. It is only a draft.

<u>Further response:</u> **Reference to BEPS concerns is in general removed/diluted. Rationale is allocation of taxing rights.**

Paragraph 10 of the Commentary

45. It seems that Article 12B would apply across the board to all relevant payments for automated digital services, even if these were paid to individuals.

    If so, there are justifications to exclude individuals from the scope of Article 12B as payments to or from individuals would likely pose less of a BEPS risk, and individuals who are automated digital services providers are unlikely to pose the same competitive threat to source states' domestic automated digital service providers (as mentioned in paragraph 5 of this draft Commentary for which I have other comments).

    It would be important to insert new paragraphs in this draft Commentary to reflect the views of members who disagree with the insertion of this Article, similar to what has been done for Article 12A.

<u>Response at the time of Subcommittee meeting:</u> **Coverage of services for personal use has**

been dealt with in para 41 [now paragraph 44] of draft Commentary at length. Minority views can be included in accordance with UN Practices and Procedures.

<u>Further response:</u> Reference to BEPS concerns is in general removed/diluted

Paragraph 13 of the Commentary

46. Like § 41 on art 12A the reference to interest seems to disregard art 11(5).

<u>Response at the time of Subcommittee meeting:</u> Appears to be a valid point. Correction may be needed in para 41 of Art12A Commentary [now paragraph 44] as well as here.

<u>Further response:</u> Current paragraph 12 has been amended.

Paragraph 16 of the Commentary

47. In paragraph 16 of the proposed Commentary the reference should be to "automated digital services", not fees for technical services.

<u>Response at the time of Subcommittee meeting:</u> Noted. Change will be done.

<u>Further response:</u> Current paragraph 16 has been amended.

Paragraph 17 of the Commentary

48. Why have 4th and 5th bullet of § 45 on article 12A not been copied? Why have §§ 46-51 on article 12A not been copied?

<u>Response at the time of Subcommittee meeting:</u> Fourth bullet of para 45 of Art 12A Commentary is not taken as 12B WHT may be lower than 12 or 12A. Fifth bullet can be included.

If the reference to Article 14 is introduced in paragraph 2 of Article 12B, paragraphs similar to 46-51 of commentaries on Article 12A can also be introduced.

<u>Further response:</u> The bullet has been added to now paragraph 16.

Paragraph 26 of the Commentary

49. It is unclear on which provision it is based that a taxpayer with global losses will not have positive qualified profits.

<u>Response at the time of Subcommittee meeting:</u> The reference to global losses in paragraph 26 are those related to the business segments in scope of Article 12B. It does not refer to global losses in cases where there are many business segments, not necessarily all within the scope of Article 12B.

<u>Further response:</u> No further comments.

Paragraph 27 of the Commentary

50. Is revenue = income?. Over which period are "Total annual profits" measured? Last sentence seems to be (partly?) deleted.

<u>Response at the time of Subcommittee meeting:</u> As stated above also, the terms íncome', 'profits' and 'revenue' wherever used can be revisited and suitably aligned or modified.

<u>Further response:</u> After examination, the present terminology is found to be best under the circumstances and in context of ADS. One change has been made in para 2 of Article though.

51. I would like to seek the following clarification:

    a) Do taxpayers have a choice in applying paragraph 2 (gross basis) or paragraph 3 (net basis) under Article 12B? Or would the tax administration always apply paragraph 2, while the taxpayers could seek to invoke paragraph 3 and request offsets/refunds from what has been paid under paragraph 2?

    b) Are we still applying the same sourcing rule as per paragraph 2 of Article 12B i.e. based on where the payer is located? What if the MNE reports such gross annual revenue using a different methodology e.g. location of the user (VPN? Physical location?)

<u>Response at the time of Subcommittee meeting:</u> a) Yes, taxpayers have an absolute choice.

b) The sourcing rule for 12B is payer based.

<u>Further response:</u> a) Now clarified by modifying para 3 of Article and the Commentary.

b) No change

Paragraph 28 of the Commentary

52. Paragraph refers to domestic law in source (market) state. Last sentence refers to resident state and assumes too easily that source tax will be taken into account. Seems appropriate to dedicate a separate paragraph to the resident state and whether application of 12B (3) leads to application of art 23A (while WHT at source would generally lead to application of art 23B).

<u>Response at the time of Subcommittee meeting:</u> The intention of para has not been understood. The credit of taxes withheld referred to in last sentence is not in respect of residence State but in source or market jurisdiction where tax is so withheld under para 2. The situation is where in a tax payer's case, tax has been deducted at source or withheld under para 2 from some payments and that taxpayer opts for net basis taxation under para 3. In such a situation, credit for taxes withheld will be available is what is being conveyed. There is no involvement of Article 23 here.

As far as application of Article 23 vis a vis residence State is concerned, paragraphs 6 and 15 of the proposed commentaries already refer to the application of Article 23 to eliminate double taxation. If needed, more guidance could also be provided

<u>Further response:</u> No further comments.

53. In paragraph 28 of the proposed Commentary it should be stated that the domestic rate should be the same rate charged to domestic companies to ensure that a discriminatory rate is not set for such non-residents.

Regarding paragraph 29 of the proposed Commentary, it seems premature to be including a minority view (which would follow any process agreed by the Committee) on the definition of qualified profits. I struggle to understand the fairness of, or the basis for, the minority view – i.e., choosing the highest of 3 amounts as the "qualified profit". I would like to better understand the reasoning behind this view and how it would work in practice.

Response at the time of Subcommittee meeting: Para 28: This will be governed by Article 24 and there is no need to state that here.

Para 29: This was view of one Member of Drafting Group and has been included to reflect that. The alternative mechanism provided in paragraph is to address a minority vies. If this minority views is kept, advantages and disadvantages of such mechanism could be developed to provide more guidance.

Further response: Para 28 [now renumbered as paragraph 31] No change. Para 29: [now paragraph 32] Position is altered due to change in para 3 of Article.

54. There are enforcement issues when it comes to providing this particular option. This is recognized in paragraph 28 of this draft Commentary. It is not clear who the taxpayer in the source country would be and who has the filing obligation.

Response at the time of Subcommittee meeting: The taxpayer in source country is the non-resident service provider and he only has the filing obligation.

Further response: Already responded to. Nothing further to add.

Paragraph 29 of the Commentary

55. Issue to be dealt with under Practices and Procedures. If we are going to reflect the opinions of individual members in the whole commentary, it is going to be a mess.

Response at the time of Subcommittee meeting: Reflection of Minority views is as per UN Practices and Procedures.
Further response: No further comments.

56. […] the alternative method provided in no. 29 possibly is not easy to handle, because three different profitability ratios have to be determined and compared with each other.

Response at the time of Subcommittee meeting: See response on Sl No. 53 above.

Further response: Position is altered due to change in para 3 of Article.

57. I have the following questions:

    a) How would the effect of carried forward losses be taken into account?

    b) What would the rationale for not recognizing the offsetting effect of losses?

    If the beneficial owner were in a loss position, would there be any further tax imposed?

Response at the time of Subcommittee meeting: Carried forward losses are not to be reckoned. It can be taken as a balance that on one hand global loss for the year is recognized under para 3 despite a view that the local PE may still be profitable, carried forward losses

are not to be reckoned to keep implementation simple and fair.

<u>Further response:</u> Already responded to. Nothing further to add.

Paragraph 30 of the Commentary

58. Refers to "requiring minimal human involvement from the service provider". What if the service requires human involvement from another entity (related or third party)?

<u>Response at the time of Subcommittee meeting:</u> This situation needs to be examined. Is it a case of abuse especially for a related party situation? Please provide illustration with some facts.

<u>Further response:</u> In our view, it will qualify as ADS.

Paragraph 31 of the Commentary

59. Unclear why human intervention in creating, supporting and maintaining the system is not taken into account to determine whether human involvement is required? What is the justification and why is it not included in the definition?

    The sentence "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" seems to be applicable to many businesses, e.g. supermarkets, book sellers. The sentence "On 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" seems incorrect. Generally, the per unit cost would be stable if not decreasing for all business with an increase of customers. That is the whole idea of economies of scale and by no means specific for ADS.

<u>Response at the time of Subcommittee meeting:</u> The reference is to human intervention in market jurisdiction where services are rendered. Maybe "per unit" could be deleted and "proportionate" could be sufficient. We will see.
A similar approach is taken by the IF under Amount A

<u>Further response:</u> The Commentary has been expanded to provide much more clarity.

Paragraphs 34 -35 of the Commentary

60. Other notions are used in the commentary without real further explanation

<u>Response at the time of Subcommittee meeting:</u> Point covered in Sl No.27 above

<u>Further response:</u> The Commentary has been expanded to provide much more clarity. More guidance can now be find in paragraphs 39 and 41 of the Commentary.

Paragraphs 38 of the Commentary

61. Unclear why this could not fall under art 12B as § 31 has stated that creating, supporting and maintaining the system is not taken into account to determine whether human involvement is required?

<u>Response at the time of Subcommittee meeting:</u> Similar approach undertaken by IF under Amount A.

<u>Further response:</u> Former paragraph 38 has now been included in section (iii) of paragraph 41 and has been expanded to provide much more clarity.

Paragraphs 1-39 of the Commentary

62. As mentioned above, paragraphs 1-39 of the proposed Commentary should acknowledge the work of the Inclusive Framework.

<u>Response at the time of Subcommittee meeting:</u> Response on this in General Comments.

<u>Further response:</u> Already responded to. Nothing further to add.

Paragraph 40 of the Commentary

62. I have the following questions:

    What if the taxpayer is unable to segregate the Art 12A services from the Art 12B services in the bundle? Would Art 12A or Art 12B apply?

    If a taxpayer was able to segregate the Art 12A services from the Art 12B services, and if the taxpayer wishes to opt for net basis of taxation for Art 12B services, would the taxpayer be allowed to do the same for the services under Art 12A?

<u>Response at the time of Subcommittee meeting:</u> There can be a way to segregate pooled services or bundled services first and then apply 12A or 12B respectively.

Net basis is only for 12B portion.

<u>Further response:</u> Newly added para 43 in Commentary addresses this.

Paragraphs 41-42 of the Commentary

63. Refer to my comments on paragraphs 2 and 4 of Article 12B. The individuals to whom the services (for their personal use) are delivered, generally don't pay for those services. Profits for service providers comes from advertising by other parties.

<u>Response at the time of Subcommittee meeting:</u> Response has already been given above. The intention is to cover payments made by the person requiring the advertisement. Who and where the viewer is turns to be irrelevant for Article 12B.

<u>Further response:</u> No further comments.

64. As written in my general comments, this is an extremely important paragraph for administrations. Should be expanded and elaborated and include practical experience from Committee members and their States.

<u>Response at the time of Subcommittee meeting:</u> Contributions to expand this paragraph are welcomed.

<u>Further response:</u> No further comments.

65. While Article 12 A explicitly excluded payments for services for personal use (reasoning see paragraph 72 of the Commentary to Article 12 A), income generated by automated digital services provided to individuals is included in the scope of Article 12 B. Might this be a logical breach, which is not thoroughly explained in the draft of the Commentary to Article 12 B? Moreover, I have doubts whether the differentiation between both Articles will always be clear, e.g. teaching: teaching by an educational institution would be excluded from Article 12 A, but if it is realized automatically in a standardized form it would be included in Article 12 B?

<u>Response at the time of Subcommittee meeting:</u> Even though coverage of services for personal use has been dealt with in para 41 [now paragraph 44] of draft Commentary at length, response on this in General Comments be seen.

Regarding teaching activities, in the draft commentary (paragraphs 34, 35, 36 and 37) [now paragraphs 38, 39, 40 and 41] a distinction is made on the situations where teaching activities are in and out of scope.

<u>Further response:</u> The new version of paragraphs 39 and 41 of the draft Commentary elaborates on more precise definitions of services within and without the scope of Article 12B, in particular as regards teaching services.

66. In respect of paragraphs 41-42 of the proposed commentary there should be further explanation regarding how collection will work when the payment is made by an individual. In addition, the compliance burden on the non-resident and the tax administration should be considered if a tax return is required to be filed in the source country.

    In respect of paragraph 45 of the proposed commentary, it is not clear that the same challenge in distinguishing automated digital services from royalties exists as it does with fees for technical services (especially for many categories of automated digital services). It is suggested that examples be provided of particular cases where it may be difficult to make such distinctions.

<u>Response at the time of Subcommittee meeting:</u> Para 41-42: This is a matter of domestic law.

Former Para 45 [this paragraph has now been replaced by new paragraph 46]: If any examples are suggested, please provide so that the same can be considered.

<u>Further response:</u> Further addition made in Commentary.

Paragraph 45 of the Commentary

67. I suggest adding examples to illustrate how Article 12B would work, akin to the Commentary to Article 12A.

<u>Response at the time of Subcommittee meeting:</u> This can be considered.

<u>Further response:</u> Former paragraph 45 has been replaced by new paragraph 46 to provide better guidance. However, contributions in the form of examples are welcomed.

Paragraph 48 of the Commentary

68. Last sentence refers to the situation where the payer has a PE in the source state. Provision in art 12B(5) refers to situation where payee has a PE.

<u>Response at the time of Subcommittee meeting:</u> Agree. We need to revise the last sentence. Similar analysis requires the final sentence of paragraph 106 of Commentary on Article 12A.

<u>Further response:</u> Last sentence is 'This will be the case where the remuneration paid to the person providing the services is borne by the permanent establishment or fixed base in the State in which the income arises.'' Thus, it does not refer to anyone's PE. Obviously, it is the payer's PE. If still a doubt, it can be discussed.

Paragraph 49 of the Commentary

69. Relation between art 12B(5) and art 24 needs further reflection.

<u>Response at the time of Subcommittee meeting:</u> Request to elaborate on what is sought. A note be provided.

<u>Further response:</u> Not pursued by querist.

Paragraph 50 of the Commentary

70. If the services are not provided IN the country where there is a PE, why should the payment be borne by that PE??

<u>Response at the time of Subcommittee meeting:</u> The sentence in the paragraph takes into account the fact that most digital services are provided remotely, and no actual service is performed IN the State of source, but is performed abroad to the PE, which bears it as a deductible expenditure.

<u>Further response:</u> No further comments.

71. Examples should be provided (as was done in the Commentary on fees for technical services).

<u>Response at the time of Subcommittee meeting:</u> This can be considered.

<u>Further response:</u> Not considered necessary due to addition of new paragraph 46 and deletion of former para 45.

Paragraph 52 of the Commentary

72. The meaning of the last sentence is unclear to me.

<u>Response at the time of Subcommittee meeting:</u> For Article 12B(6) to apply, it is required that the payer is a resident in the State of source or the service is born by a PE situated in the State of source. To be borne by the PE, it is required that the service received is in connection with the activities performed through such PE. If there is no such connection, it cannot be argued that the service is borne by the PE and, therefore, the income does not arise in the State where the PE is situated.

The final sentence states that in a situation where the service is not connected with the

activities performed through the PE, it will be an undesirable effect that the income derived from the performance of the digital service to be consider to arise in the State where the PE is situated, and that is the reason why it is assumed that the income does not arise in that State.

Further response: **No further comments.**

Paragraph 53 of the Commentary

73. The paragraph leaves unanswered the question why this exception would not apply to payments borne by a PE in a third state.

Response at the time of Subcommittee meeting: **The underlying intention of paragraph 7 is to clarify that income does not arise in the State where the payer is a resident if it is born by a PE in another State.**

If necessary, it could be included that the answer to the "why?" question is because it arises in the State where such PE is situated. And that other State is the relevant one to allocate taxing rights on that income, under the tax treaty between that State and the one where resides the beneficial owner of the income.

Further response: **See correction in para 54 (earlier 53) of Commentary. '…….third state' was an error which has been corrected.**

Annex 3:

Response by the Drafting Group to the comments received before the August 2020 Subcommittee meeting

The analysis by the Drafting Group of each written comment received after the August Subcommittee meeting can be found below.

1. Comments - email dated 1st September

On the Commentary

1) As the definition of ADS relies heavily on the work done in IF on ADS I would strongly suggest that in some point in the Commentary it be reflected and the Commentary give guidance as to how relevant (existing or future respectively) papers regarding ADS from IF are for the interpretation of the Article.

Response: This can be stated in Drafting Group's forwarding Note.

On the Article:

2) - Para 1: No additional comments

3) - Para 2, 4 and 6: As I commented earlier, my interpretation would be that the ADS (especially because of the factor "Minimal human involvement") is delivered to the individual user of websites, while the payment in many ADS businesses would come from enterprises to whom arguably the ADS service is not delivered. If we would want to include these payments from the advertisers in the ADS income, I believe we would need an additional linking provision.

Response: In those business models where enterprises make payments, they receive an advertising digital service, so there is no need for further elaboration to cover such payments.

4) - Para 3: as observed during the SubCo meeting it should be made clearer that the choice to apply either the entity's or the group's profitability ratio is up to the taxpayer.

Response: This has been clarified fully now with amendment in paragraph 3 of Article 12B

5) - Para 3: It is not clear over which period the profitability ratio is measured, only the current taxable period or also previous years.

6) - Para 3: I would recommend including definitions (e.g. on "profitability ratio", "multinational group", "business segment") in an additional paragraph of the Article, rather than in the Commentary

Response: Necessary clarity has been provided in Commentary on para 3 to the extent possible.

7) - Para 4: The definition in the Article would suggest (contrary to what is included in para 31 of commentary) that human intervention in creating, supporting and maintaining the system *<u>should</u>* be taken into account. If that is not intended, I would suggest making that part of the definition in para 4

<u>Response:</u> Commentary on para 4 of Article has been considerably augmented.

8) - Para 5: This paragraph is in my opinion the weakest link in the Article. If the ADS provider would have a PE to which the payments are attributable, and the service requires little human involvement, it appears to me that the profits attributable to that PE (since article 7 will not be amended) will be minimal. It also raises the (more policy related) question why additional (to current standards) profits *<u>should be</u>* attributed to the market state when there *<u>is</u>* a PE and *<u>should not be</u>* attributed when there *<u>is</u>* a PE. The arguments in favor of attributing additional taxing rights to the market state appear to be equally strong in situations where there is a PE.

<u>Response:</u> the UN Model does not follow the AOA, so according to Article 7, profits attributable to PEs do not depend on significant people function. Article 12B is necessary in scenarios where the service is not provided through a local PE. If according to assets, functions and risks, the income is attributable to the PE, so Article 7 applies, and market jurisdictions have no problems. Currently, those services are provided in the absence of any presence in the market jurisdictions.

9) - Para 7: The paragraph leaves unanswered the question what would happen if the payer of the ADS-fee would carry on a business through a PE in a third state and the expenses are borne by that PE

<u>Response:</u> Article 12B of that DTA does not apply. But Article 12B of the DTA between the State of residence of the service provider and the State where the PE is located is applicable, allocating taxing rights to the latter.

2. <u>Comments - email dated 10 September 2020</u>

<u>General comments</u>

10) There is a global understanding that the rules of international taxation need to be reviewed and adapted to the changes brought about by the digitalization of the economy. 1 welcome the opportunity to comment on the draft proposed by the UN DET Subcommittee Drafting Group in light of the interesting discussions we had on the occasion of the August 2020 session of the Subcommittee. The Subcommittee should keep in mind that any possible provision reallocating taxing rights to market jurisdictions will likely be most effective and helpful to developing countries if as a minimum the following criteria can be met:

- The provision should be based on sound principle. At this point, the rationale for the proposal, which in essence is a copy and paste of the rationale for technical fees in Article 12A of the UN Model Double Taxation Convention, should more clearly be articulated and tailored to digital services. 1 share the concerns already expressed by some other colleagues of the SubCommittee that the argument for reallocating taxing rights based on “a substantial involvement in another State’s economy” is very vague (and could serve as an argument to tax almost any profit in any state).

<u>Response:</u> Commentary in Part A General Considerations has been completely revamped.

11) The operation of the rule should align with its rationale. The current proposal implies that the provision of the substantial services to clients or customers should be the source of the right to tax. However, the draft of Article 12B determines the source of the services based on the State of residence of the payer, which will often not be the State where the services are performed.

<u>Response:</u> A distinction has to be made between the digital services rendered by the MNE to business willing to have advertisements being viewed by user, from the digital service provided by the same MNE to the users (search engines, social media). The only stream Article 12B seeks to tax is the first one, which is the one from which MNEs derive income. Both streams are linked, and one will not exist without the other, and that is the reason why Article 12B allow a net determination of the tax base, to allow expenses to perform the overall activity being deducted in calculating the tax obligation

12) The provision should be balanced. In the context of gross basis taxation of digital services, which typically incur substantial development and infrastructure expenses for service providers, a low nominal withholding tax rate should be encouraged. A withholding tax of 3 per cent on gross revenues may often exceed the total net profit of at least some of the taxed activities. It is appropriate in principle to include an option for non-residents to be taxed on a net basis (see paragraph 3). It is however not understandable on what basis a 30 per cent profit allocation rate should be applied in the absence of any clear factual foundation. Overall, the net taxation rule requires further analysis and work.

<u>Response:</u> Regarding the need to have a low withholding tax rate, Commentaries in paras 4 & 15 now suggest a low rate range. Para 30 of Commentary addresses justification for 30%.

13) The provision should be easily administrable. It will be therefore important to take the time to consult with business and other interested stakeholders to test the feasibility of the proposal. Further explanation as to how collection will work when the payment is made by an individual is also important and needed.

<u>Response:</u> The withholding mechanism included in paragraph 2 is an easily administrable provision, like those established in Articles 10, 11, 12 and 12A.

14) The solution should not result in an increased risk of double taxation or over-taxation. There is a potential for double or over-taxation in particular when the payer is not a resident of the State where the services are being performed. The interaction of an eventual Article 12B with Article 12A and a possible new version of Article 12 (including the use of software) needs to be analyzed and dealt with in more detail. As currently drafted, the proposed text of a new Article 12B would in my view fall short of fulfilling a number of the relevant criteria

<u>Response:</u> Paragraph 4 of Article 12B has been modified by providing clarity vis a vis operation of Article 12 in order to address this issue. Commentary para 8 & 42 also clarify this aspect amply.

<u>Technical comments</u>

15) Par. 1 and par. 2. The Commentary should relate more specifically to automated digital services, and not simply be a copy and paste of the rationale of Article 12A. If the policy rationale is basically the same as for Article 12A, the fact that payments by individuals are excluded from Article 12 A and are covered by Article 12 B needs to be explained. It is not clear if and why this is a BEPS issue and how this would tie in with the fact that non-deductible payments to individuals are covered by the provision. This needs to be further explained.

<u>Response:</u> Commentary in Part A General Considerations has been completely revamped. BEPS reference has been altogether removed from the Commentary and it is clarified that allocation of taxing rights is the justification.

16) In the interest of administrative ease and to avoid disputes, terms like "minimal human involvement" as well as "Multinational group" or "profitability ratio" should be more clearly defined.

<u>Response:</u> This has been done to the extent feasible by expanding the Commentary.

17) Par. 3 The concerns of USCIB re. the option for net taxation needs to be seriously taken into consideration. The calculation is crucial to finding a fair solution. Among many other points it seems inappropriate to allocate routine returns to a market jurisdiction when the related activities and assets are located elsewhere. From a point of view of administrative ease, the possibility for the taxpayer to elect in advance an *ex post* annual payment would be welcome, in order to avoid the risk of contingent withholding taxes, in particular for companies which might be incurring start-up losses or operating on small margins. A materiality threshold could also be considered.

<u>Response:</u> WE believe that entire profits of MNE are result of its global activities and it is not possible to differentiate between routine and non-routine profits for allocating the same to market jurisdictions.

18) Par.4 The draft refers to the OECD definition of automated digital services including the positive and negative lists, Additional work is needed to bring about more clarity to the many gray areas of that list.

<u>Response:</u> Commentary has been expanded to provide more clarity.

19) As noted above, the application of the rule to services supplied to individuals is not explained from a policy point of view. Furthermore, the possible mechanism to collect withholding tax in such cases is unclear and needs to be outlined in detail

<u>Response:</u> It has been explained in para 44 of Commentary.The UN Model Tax Convention does not provide further guidance on domestic law issues. It allocates taxing rights, and it is up to sovereign States to develop mechanisms to enforce such taxation.

20) Par. 5 If the main issue is one of allocation of taxing rights, as pointed out in the discussion during the August 2020 session of the Subcommittee, it seems inaccurate to generally imply that the existence of a source tax in the market jurisdiction is justified by an inadequate level of taxation in the residence country.

Response: Agreed. And hence, Commentaries appropriately modified.

21) Par. 6The sourcing rule needs to be coherent with the rationale of the rule. As drafted, in an example where a company resident in State A would pay for Google ads targeted at users in State B, it seems that the taxing rights would be allocated to State A (?).

Response: As indicated above, we make a distinction between two digital services: the search engine on the one hand, rendered to consumers, and the online advertisement, on the other hand, rendered to business. It is the last one that Article 12B taxes because is the only one that gives rise to a payment.

22) Par. Simplicity will only be achieved if the rate of withholding tax is reasonably low, or else most taxpayers may need to opt for net taxation, which would result in a costly and administratively burdensome process for both tax administrations and taxpayers in a wide range of countries. In consequence, a potential feature of a withholding tax, i.e. simplicity, would be completely lost in the process.

Response: Guidance has been provided on this in paras 4 & 15 of Commentary.

23) Finally, it seems that the proposal could lead to a result where a non-resident without a PE would pay taxes on a gross basis (or on a net basis taking into consideration the profitability of the entire MNE or of segments of it), and a non-resident with a PE would pay less tax on an established net base under otherwise identical material circumstances. This would not be a satisfactory outcome.

Response: We don't agree on that statement. According to the proposal, a non-resident without a PE would pay taxes on 30% of its profits derived in the source State, while a non-resident with a PE would pay on 100% of its profits derived in the source State.

3. Comments by email dated 11th September

24) Although I understand the urge to take into account ADS provided to individuals for their personal use, paragraph 72 of the Commentary to Article 12 A and paragraph 41 of the draft commentary to Article 12 B contradict each other:
"Article 12 A - Such payments would not normally be deductible by those individuals for tax purposes, and therefore the payments would not cause any erosion of the tax base of the State in which the fees for technical services arise (paragraph 72 of the commentary).

Article 12 B= Even though such payments would not normally be deductible by those individuals for tax purposes, it cannot be disregarded that many multinational enterprises that rely on digital business models derive a very significant portion of income from the provision of automated digital services generally to individual consumers (paragraph 41 of the commentary)."

The content of paragraph 41 of the commentary to Article 12 B is very similar to the justification for the introduction of Article 12A in paragraph 2 of that commentary. Thus, explanation needs to be found why the model provides contrary solutions for comparable situations in order to make/keep the commentary stringent.

Response: **BEPS reference has been altogether removed from the Commentary and it is clarified that allocation of taxing rights is the justification**

Unlike FTS, ADS is used extensively by individuals. When justification for new taxing right is allocation of taxing rights and not BEPS, covering ADS to individuals is very much justified. Some jurisdictions have never liked the exclusion of services rendered to individuals in Article 12A. However, to avoid inconsistencies, Article 12A might now be changed to make it consistent with Article 12B.

25) The same problem arises with the imposition of withholding tax. In the case of Article 12 A the imposition of withholding tax on the payment by individuals is described as difficult to enforce and with potential to cause serious compliance problems. Whereas in the case of Article 12 B only (non-serious) compliance problems are described, which might require other mechanisms for collection (which in the case of Article 12 A does not seem to be an alternative).

Response: **Please see previous response.**

26) With regard to the alternative of passing on the tax collection to the finance intermediary that individuals access to make the payment for the ADS (paragraph 42) I wonder whether this means that banks/credit card issuers or platforms such as "PayPal" should function as those intermediaries? And if so, is this really a feasible option?

Response: **As indicated in paragraph 44, some legislations require those intermediaries to charge credit card holders with the tax and they are responsible for paying the tax to the tax administration, In this case, the tax burden is passed on to the consumer. In other cases, legislations may require credit card holders to withhold the tax, in which case the tax burden is supported by non-resident digital service providers, to the extent the demand elasticity does not allow them to increase the prices and transfer the tax burden to the consumers.**

27) With regard to paragraph 55 (which copies paragraph 113 of the commentary to Article 12 A) I wonder why the last sentence has been left out ("The deductibility…provides an objective standard…").

Response: **The last sentence has been added.**

28) Whereas in paragraph 115 and following examples for the application of paragraphs 5 and 6 of Article 12 A are provided, this is not the case for paragraphs 6 and 7 of Article 12 B. Are there any reasons for that?

Response: **Now this particular Commentary has been completely revamped. There is no need for these references.**

4. Comments - email dated 12th September

29) Interaction between paragraph 2 and paragraph 3

Applying a withholding tax on the gross basis to services would run the risk of double taxation, since income from services are different from dividends, interest and royalties in that it usually

bears a relatively higher level of costs when being derived.
Response: Digital services, while involving limited human intervention, do not bear a high level of costs when delivered in great scale.

30) Article 12(B) has made a good attempt to reduce double taxation by allowing the taxpayer to request for a net basis taxation. I understand from the discussions in the August Subcommittee meeting that as long as the taxpayer makes such a request, it will sure be able to get the approval from the tax administration. I wonder whether it would be possible to have that explicitly stated in paragraph 3.

Response: This has been done.

31) I am also concerned that in cases where a withholding tax has been first applied and the taxpayer has later been allowed to elect for net basis taxation, the lengthy refund mechanism in many countries may mean that it will take a long time or even prove practically impossible for the taxpayer to get a refund of the overpaid withholding tax. I wonder whether some guidance on the refund procedure could be provided for in the commentary if not in the provision itself.

Response: Refund of taxation not in accordance with the DTA is a domestic law issue….the same for any other of income withheld in excess

32) The calculation of "qualified profits" in Paragraph 3 Paragraph 3 requires the MNE's group profitability ratio to be used when the taxpayer itself claims a loss. I understand that this requirement is intended to address the situation where a profitable taxpayer may use intra-group transactions to lower its profitability ratio for the purpose of avoiding or reducing its tax liability related to Article 12(B). However, I am concerned that it could result in situations where a taxpayer that is truly in a loss situation will need to pay tax on deemed net income in the source jurisdiction. Therefore, I would like to suggest using the taxpayer's (or the ADS segment of the taxpayer, if available) profitability ratio as the default option, and the MNE group's profitability ratio in cases where tax avoidance has been identified.

Response: Intra group transactions aiming at lowering the profitability ratio of a specific entity is not easy to detect, so as to state that tax avoidance has been identified. It would be very burdensome for Tax Administrations to proof. In any case, para 3 of Article 12B has now been modified.

33) I have always believed that when the taxpayer has no presence and thus no functions performed in a source jurisdiction, it shall be subject to no taxation in the source jurisdiction on its routine profits which are based on functions. Therefore, I am concerned that without any carve out for routine profits from the profitability ratio, the source jurisdiction would have applied taxation on routine profits which have already been taxed by jurisdictions where routine functions have been performed. This would give rise to double taxation and the residence jurisdiction may find it unfair, or would be unable (e.g. when there are routine functions performed in a third jurisdiction), to give a relief. So, I would like to suggest a carve out for routine profits from the profitability ratio.

Response: WE believe that entire profits of MNE are result of its global activities and it is not possible to differentiate between routine and non-routine profits for allocating the same to market jurisdictions. Having said that, recommendation for specific modest rate has been made in paras 4 & 15 of Commentary.

34) **Unilateral measures** think it would be desirable to make it clear in the provision that Contracting States will refrain from introducing unilateral measures or withdraw the earlier introduced unilateral measures at the same time of implementing 12(B), and that these unilateral measures are not limited to the taxes covered by the tax treaty but would include other taxes such as the Digital Service Tax (DST).

Response: Domestic unilateral measures that go beyond the provisions of Article 12B will be considered as taxation contrary to the convention, so, Article 25 applies, similarly to taxation of any other income which is contrary to other provisions of the DTA.

5. Comments received - email dated 15th September

General comments

35) Thanks to the drafting group for producing this draft, which is a very helpful starting point. I must reiterate that issues related to taxing income from the digitalization of the economy are very complex irrespective of the method chosen. Therefore, I remain skeptical about our ability within the remaining short time of our membership to come up with a well-defined article and commentary that would be useful and not give rise to double taxation and a lot of unresolved disputes. I also question the priority to finalize this work within this short timeframe since at this point in time many developing countries neither have domestic legislation in place, nor an extensive treaty network.

Response: By the time the League of Nations released the 1928 Model, Article 5 was already there allocation taxing rights on business profits, without a well-defined article and commentary and it didn't addressed double taxation cases that led to unresolved disputes, but nevertheless, the principle was already there and it was perfected afterwards. Why are we more server with income from digitalized services than with other types of income? Many developing countries don't even have domestic legislation to tax capital gains derived from indirect transfer of immovable property or capital gains on shares and the Model also has paragraphs 4 and 5 in Article 13.

36) I will focus on giving technical comments, since I understood from our discussion that such comments would be more useful than comments on different policies. It would however been easier to draft these treaty provisions if the rationale for the provisions were clearer. For example, if BEPS is a main reason for having these provisions, there would then be no reasons to include individuals.

Response: Commentary in Part A General Considerations has been completely revamped. BEPS reference has been altogether removed from the Commentary and it is clarified that allocation of taxing rights is the justification.

Comments on the provisions and the commentary

37) ***Paragraph 2:*** This paragraph is giving taxing right to the State from where income from automated digital services (ADS) is arising. To understand where the income is arising you must rely on the definition of ADS in paragraph 4 and the deemed revenue sourcing rule in paragraph 6 to be able to conclude that income from ADS is arising in the State where the payer of the payment is a resident. It would have been helpful to know the rationales behind the decision on linking the source of this revenue to the *payment* of the services. The rationales behind linking interest, royalties or even technical fees to the payment of those revenues do not seem to be equally applicable to payments for ADS. It is also clear that there are different opinions on where income from ADS arises. The Inclusive Framework has in its work on taxation of the digitalization of the economy chosen other revenue sourcing rules more connected to the location of the user. These different policy choices may potentially also lead to unrelieved double taxation. Thus, the reasons behind this provision should be clarified. In many (most?) cases where individuals use ADS, the services are for free (Facebook, Google, etc.) and consequently since there is no payment for the use of the services there will be no tax in the State where the user is. The revenue stream stemming from this kind of services is instead linked to advertisements connected to the services. It is very unclear if such income ever could be taxed under this provision. And would it in such a case be taxed in the State where the payer of the advertisement is a resident? Is that a fair result? It also seems quite easy circumvent the rules by structuring the transaction in a way that the payment is coming from (or even going to) a low-tax jurisdiction. There seems to be many reasons for not applying these rules to individuals. Furthermore, it is unclear why the term "income" is used instead of "payment" if these different terms would always mean the same in this article. It would be much clearer to use payment in paragraph 2 since those two words in general are not synonyms.

Response: We applied the same rationale than the one in Articles 11, 12 and 12A. If it is different here, why not there? In a bilateral tax treaty relationship, double taxation is fully eliminated. Moreover, according to a relevant tax treaty, the State where the user is a resident will not be granted any taxing right, so there is no room for multiple taxation According to Article 12B, those streams will be taxed in the jurisdiction where the payer for the advertisement is a resident (which, by the way is the jurisdiction where a deduction is claimed). We do not object to business being structured in a way that payments come from a low tax jurisdiction. In such a case, no deduction shall be claimed in the jurisdictions interested in introducing Article 12B. The term income from automated digital services is defined in paragraph 4 as "any payment in consideration for any service....". Article 11 covers interests paid, Article 12 covers royalties paid, Article 12A covers Fees for technical services paid....and Article 12B tries to cover income from digital services paid, since there is no specific name for this type of income. In Spanish, at least, the term "fees" doesn't work. This has been examined and no better alternative was found.

38) ***Paragraph 3:*** I appreciate the inclusion of an option to use a kind of net-based taxation. However, this provision requires a lot of further work and analysis to make it a realistic

option. To apply the profitability ratio of a multinational group in a bilateral relationship does seem to be challenging and risk giving very unfair results. If for example the profitability of a company in a multinational group regarding its digital services to a person in country A is very high, but the profitability of the whole group is quite low, then the lower profitability ratio would be applied in relation to country A irrespective of the fact that the market in country A might be much more profitable than other markets. Adding a multilateral aspect to an article that is being applied in a bilateral relationship also seems to add a lot of complexity. It is very difficult to clarify how to calculate the profitability ratio of the group and to define on what income the profitability ratio should be applied. What accounting standards would be used to calculate total annual profits and the total annual revenues? Groups having only small or medium-sized companies do not even have financial statements on a consolidated basis. Further, what are the reasons for choosing the parameters used to calculate the ratio? Such a provision based on group wide calculations would be quite complex and hard to administer and would probably lead to many disputes. I therefore suggest deleting the last sentence. If the sentence is kept it must be explored what is meant by a multinational group. That is a very vague term and the explanations in the commentary is not clear enough. It does not seem appropriate to refer to terms used in transfer pricing while applying the arm´s length standard, since those rules have a very different purpose. It should also be clarified how to identify different business segment. Furthermore, there is no explanation on the rationales behind choosing **30 %** of qualified profits. 30 % seems to be too high to make this provision a realistic option to taxation on gross profits.

<u>Response:</u> But then there is the aspect of intra group transactions used specifically to reduce entity's profitability. Guidance has been provided in the Commentary on how to obtain profitability of the Group. Already a definition of multinational group is there. If any alternative which is better is there, please suggest that. Rationale for30% has been provided in para 30 of the Commentary.

39) ***Paragraph 4:***This provision and its commentary must be further analyzed and elaborated. What is meant by "any payment in consideration for"? Does it matter who the payer is? What if the person who is the user of the services pays by using another person's credit card and those persons are resident in different jurisdictions? What is meant by "any service provided on the internet or an electronic network"? In the draft provisions of the commentary there are examples on the types of services that would be included (para 34) and excluded (para 36). These examples seem to be very similar to the positive and negative lists of the OECD/IF work on Pillar One. However, it is not clear why the examples in paragraphs 34 and 36 to some extent are deviating from the lists in Pillar One. It should also be analyzed if the result of using these OECD/IF definitions is reasonable, taking into consideration that in Pillar One the payment is not the normal indicator of where the source of the income is. It should be better explained what is included in the quite vague and broad expression "social media services". Further, it should be clarified if "on-line gaming" is included or not. It would also be very helpful with some examples regarding the expression "Composite digital services embedded within a physical good irrespective of network connectivity ("internet of things")". What is meant by "requiring minimal human involvement from the service provider". There must be examples to illustrate what is covered by this expression. What is minimal and what is not minimal?

Response: These questions are also relevant in the context of Articles 11 and 12, but did not give rise to any specific guidance in the UN Model. Commentary on para 4 of Art 12B has been considerably expanded to provide much more clarity.

40) ***Paragraphs 5-7:*** Further analysis is needed on the rationales behind these paragraphs and the consequences of applying them. There needs to me more technical work on the provisions and the administrative burden of applying the provisions should be considered.

Response: In our views, we don't see why this Membership of the Committee has to be much more severe with Article 12B than former Memberships have been with on other provisions of the UN Model.

41) ***Thresholds:*** It is reasonable to have a threshold, for example a revenue threshold, considering the administrative burden for both taxpayers and tax administrations of applying this article. There might be situations where the tax collected is much less than the costs to administer the tax. For tax certainty reasons, it would be better to have a threshold in the treaty itself, rather than relying on provisions in internal laws in different jurisdiction.

Response: If other articles in the UN Model don't have thresholds (e.g.: Articles 11, 12 and 12A), we don't see why Article 12B should need them to allocate taxing rights to source States.

42) There are many similarities between ADS and software. It should be analyzed in which aspects this proposed article is overlapping with the proposal to include software in the definition of royalties and the consequences thereof. If there is an overlap it must be clarified which provision prevails. But clarification is also needed to identify where the boundaries between the provisions are. For example, if on-line gaming would be regarded as an automated digital service, but also be viewed as a software and article 12 B would prevail, then the income would be taxed under that article with for example an option to use net taxation. But if on-line gaming is only considered to be a software and not an ADS, then the income would be taxed under article 12 with potentially very different results. Therefore, this work should be coordinated with the work regarding software.

Response: Clarity has been provided on operation of Art 12B vis a vis Art 12.

Annex 4:

Response by the Drafting Group to the comments received from US Council for International Business (USCIB)

<u>USCIB Comments by email of 18 September</u>

USCIB members are very concerned about the possibility of multiple inconsistent approaches to the issue of the taxation of the digitalizing economy. USCIB has objected to the proliferation of digital services taxes (DSTs) globally. Multiple inconsistent approaches to the same tax issue will result in double (or multiple) taxation which will discourage foreign investment especially in smaller jurisdictions where the return on investment will be less and therefore the impact of additional costs and taxes will be greater. We, therefore, urge caution in proceeding with a new approach to taxing the digitalizing economy while a multilateral approach is under discussion at the OECD through the ongoing work of the Inclusive Framework.

Response: We feel that the multilateral approach is complex and difficult to implement for and does not result in fair or reasonable share for developing countries. USCIB should rather request other Forum to give up its approach which is being criticized all around for its complexity.

Policy concerns

1. <u>Rationale for the proposal</u>

USCIB is concerned that the stated policy rationale of the proposal does not appear to be aligned with its structure. Paragraph 1 of the proposed commentary provides:

[A]n enterprise of one Contracting State can provide substantial services to customers in the other Contracting State and therefore maintain a significant economic presence in that State without having any fixed place of business in that State and without being present in that State for any substantial period.

This implies that the provision of the substantial services to customers should be the source of the right to tax. Draft Article 12B, however, determines the source of the services based on the residence of the payor.[7] Thus, for example, the source of the payment for digital advertising services would be the residence of the payor regardless of where the service was performed or where the market for the advertising was located.

The OECD is taking a different approach to sourcing Amount A under Pillar 1. The OECD looks to the location of the consumer of the service (in the case of advertising, the person to whom the

[7] The source rule is more complex than this but for this purpose, we focus on the main part of the rule.

advertising is directed). These differing rules reflect different goals and could ultimately result in double taxation as different countries source the same income to different locations.

Alternatively, the rationale for this tax could be that it prevents base erosion, in which case it should not apply to non-deductible payments (those made by individuals for personal services). Further, not every deductible payment made to a nonresident of the payor jurisdiction is base eroding. If a deductible payment is made for services that enhance a company's ability to sell its goods and services, then as long as the payment is arm's length (which it should be when services are provided between unrelated parties), that payment is not base eroding. In fact, such payments are "base enhancing" because the company should be more profitable as a result of the payments for services. For example, the company may be able to sell its goods and services to a wider audience or use external computing services that it could not afford, or would exceed the expected additional revenue, if it had to develop IT resources in-house.

A fundamental disconnect on source rules between the UN and OECD proposals will result in the same income being potentially subject to tax in different jurisdictions, with no means of eliminating double taxation because there is no agreement on which jurisdiction has the primary right to tax. The UN approach should be consistent with the work of the OECD Inclusive Framework wherever possible, especially on sourcing rules, as any disconnect is likely to result in multi-layer taxation, excessive compliance costs on businesses, and significant intercountry disputes. This highlights the need for these challenging international tax issues to be addressed on a multilateral basis, instead of through bilateral treaties, where many unintended consequences will result.

Response:

(a) The Commentary quoted by USCIB has been considerably modified now.

(b) It is not understood why UN approach should be consistent with OECD and why not the other way around.

(c) On merits, the justification for 12B approach is explained henceforth. A distinction has to be made between the digital services rendered by the MNE to business willing to have advertisements being viewed by user, from the digital service provided by the same MNE to the users (search engines, social media). The only stream Article 12B seeks to tax is the first one, which is the one from which MNEs derive income. Both streams are linked, and one will not exist without the other, and that is the reason why Article 12B allow a net determination of the tax base, to allow expenses to perform the overall activity being deducted in calculating the tax obligation

2. <u>Gross basis taxes</u>

Gross basis taxes have an adverse impact on lower profit margin/loss businesses. A gross basis withholding tax is the primary mechanism for imposition of this tax. While the draft provides an election to apply an approximation of net basis taxation, it is not clear how that operates. USCIB believes that the draft indicates that there would be withholding in all cases and that the person subject to the tax would bear a difficult burden of proof with respect to a net basis taxation filing to request a refund.

Given that withholding tax would apply to businesses with very different profit margins, it will in practice, be impossible to set the rate in a way that can translate a tax on revenues as being equivalent to a tax on profits. Multinational enterprises ("MNEs"), especially small and mid-size enterprises ("SMEs") that are either loss making or generating relatively low margins, likely could not support a gross basis withholding tax, even at a very low rate that potentially approximates the amount that would be collected if applied to profits. Due to cash flow constraints, it is likely that application of a withholding tax could push an otherwise profitable transaction into an economically unviable one that could require SMEs to severely curtail their global business activity. For example, a withholding tax of three percent on gross revenues may exceed the entire net profit from some of the taxed activities – even for the larger enterprises. This is the case for some of our members that receive commissions for acting as an intermediary or incur a loss on in-scope revenue activities. If the company cannot afford to bear the cost upfront and cannot pass along the cost to customers, then the only other option would be to cease doing the business that is incurring the withholding tax. Obtaining refunds of overpaid tax, especially requiring a successfully substantiated net basis filing, can be a long-term, difficult exercise, so companies may be reluctant to rely on obtaining a refund in the case of a low-margin business. In many countries, obtaining a refund can be a multiyear process requiring significant amounts of documentation and detailed information. This arduous process is likely to lead many businesses to instead choose to reduce or cease their investment in countries adopting these rules.

Because there are no thresholds, the gross basis withholding tax would apply to the first dollar of income. For companies that might be incurring start-up losses or operating on small margins this would discourage entry into new markets and therefore might discourage competition with existing service providers. The option to elect a proxy for net basis taxation might not be feasible for small service providers because the costs associated with determining and substantiating net taxation for small amounts of revenue might be too high.

Response: The withholding tax mechanism is with a view to have an administratively simple mechanism. USCIB's point about variation in profit margins is equally applicable to Articles 10, 11, 12 & 12A, which are there in both UN and OECD Models for ages. The problem is mitigated by recommendation on a modest withholding rate and now even recommending a value on one hand and the net basis taxation option on one hand.

3. <u>Amount of profit allocated to "source" jurisdiction is inappropriate</u>

The draft proposal would allocate 30% of the profits to the market or "source" jurisdiction, on the basis of a profitability ratio. While the technical issues with this proposal are discussed below, USCIB has two policy concerns with this proposal. First, the 30% allocation is too high. Second, routine profits would be attributed to the "source" jurisdiction, inconsistent with the work of the Inclusive Framework on Amount A for automated digital services.

As discussed above, the stated purpose for this proposal is to allow taxing rights to the "source" jurisdiction when there is no fixed place of business or other physical presence for any substantial period of time. Thus, activities generating the reallocated profits must be taking place elsewhere. Even "digital services" have a footprint in the real world. They require software and algorithms that are written, maintained, and operated by engineers outside the "source" jurisdiction. MNEs incur high costs in the form of owning and operating server farms and network infrastructure. Allocating routine returns to the "source" jurisdiction when these activities and assets that contribute to the generation of such profits are elsewhere inappropriately shifts taxing jurisdiction and ignores the high costs of such investments made outside the source jurisdiction. Profit reallocations to "source" jurisdictions on top of existing transfer pricing also create circumstances where results may be inconsistent with the arm's length standard under the OECD guidelines. Furthermore, fractional profit split or formulary apportionment moves further away from the arm's length standard and decreases the ability to amend existing transfer pricing legislation to get relief in the "surrender" country.

When there are few activities in the "source" jurisdiction, there is simply no justification for allocating 30% of the deemed profit to that jurisdiction. In such a case, a 30% allocation of the profit to the market seems to be a tax on market access since it bears no relation to activities or investments by the taxpayer in the "source" jurisdiction. This allocation also ignores the fact that deductible services will generate income in the country of the service recipient. That is, the service recipient is only purchasing services with the expectation of furthering its business activities and the income from those incremental business activities will be taxable in the country of residence. So, the 30% number suggested by the draft proposal would be on top of income earned by the service recipient as a result of the services that were provided. This is clearly an over allocation to the "source" jurisdiction.

Response: USCIB assumption is that no weightage is to be assigned to sales activity i.e. demand side and profits are result of only supply side factors. We don't agree to this. WE believe that demand side has a very important role to play in the profit generation. The League of Nations example on Californian oranges be referred to in this regard, i.e. if there were no sales or demand for oranges in market jurisdiction, no profits would have materialized despite all the cultivation etc. We strongly believe that the cross-border profits are result of global activities of enterprise and it is not correct to talk about routine and non-routine profits in an artificial manner. Further, we feel that 30% is a reasonable estimate and justification for the same has now been provided in paragraph 30 of the Commentary.

4. Impact on nexus for other purposes

USCIB members are also concerned that allowing taxation in circumstances where there is little to connect the service provider to the "source" jurisdiction may lead to other assertions of jurisdiction. For example, countries may seek to impose other legal obligations on businesses subject to these rules, such as the creation of nexus for VAT purposes or product liability with respect to goods sold through an intermediary service. If the UN Tax Committee adopts provisions along these lines, then they should explicitly prohibit extensions of jurisdiction to any other tax or non-tax regulatory requirements outside of the narrow focus of the rules under Article 12B. Furthermore, the UN should make clear to countries that any reallocated profits do not create any deemed payment transaction to which VAT, withholding taxes, or other taxes apply.

Response: This appears hypothetical or far-fetched to us.

Technical concerns

5. One overarching issue is the application of multiple bilateral negotiated agreements to tax a single global business. In particular because the profitability ratio is a group- wide ratio, if different countries reach different agreements as to the definition of the profitability ratio or the definition of the group, which is near certain given the bilateral nature of the agreement, then double taxation is likely. This problem is made worse because the profit allocation is so high.

Response: There is no such problem for a single enterprise. Where the enterprise facing source or market jurisdiction is part of an MNE, profitability ratio to be used is as per consolidated accounts. Further clarity has been provided on scope of expected adjustments to the book profits in the Commentary on paragraph 3 of Article in paragraphs 28 & 29. The definition of Group is not such a big issue in our view. Nevertheless, it can be refined further if any good suggestions are there.

6. <u>Paragraph 3</u>

- It is not clear whether the election can be made in advance of withholding, so that the taxpayer will only pay net taxes or whether there would be withholding in all cases followed by a request for a refund. One way to address this would be to permit taxpayers to elect the net basis approach in advance.
- Thirty percent of qualified profits would be allocated to the "source" state. Qualified profits are determined using a profitability ratio. The commentary indicates that the profitability ratio is total annual profits divided by total annual revenue. It is not clear what level of profits (profits before taxes as the OECD is proposing as part of Pillar 1 or some other measure) would be used or whether adjustments would be required or permitted.
- Since there is no threshold for application of these rules, some smaller groups that are subject to the rules might not have consolidated financials. What would be the starting point in these cases? The application of a withholding tax mechanism (which taxes discrete transactions as they occur) on the basis of historical financial information is also problematic.
- Even though this proposal is supposed to avoid the need to make adjustments in other jurisdictions, because this is a group wide profitability ratio, it may be that income is allocated to the "source" state from third countries and there is no mechanism for relieving double taxation. That is, if the service provider that transacts with the service recipient/payor is a routine service provider, then it may not earn enough income to support the 30% allocation to the service recipient/payor. The allocated income would then need to come from another jurisdiction and there is no mechanism for making that adjustment and no mechanism for relieving double taxation.
- The profitability ratio is supposed to be determined on a segmented basis if those numbers are available. There is no indication of what that means. The financial information used to implement any changes should be financial data that is readily accessible for both taxpayer and tax authority rather than something that needs to be prepared specifically to implement these rules.

- There is no definition of multinational group although the commentary indicates that this is supposed to be consistent with the standard for applying transfer pricing rules to related party transactions. This may be too broad a definition for purposes of determining profitability levels on a group basis.

Response:

- **Drafting of Paragraph 3 has been modified to allow electing of net basis taxation and it to prevail on taxpayer so electing.**
- **Which profits are to be used has been clarified in Commentary along-with scope of expected adjustments in paragraph 28 & 29 of Commentary on paragraph 3 of Article 12B.**
- **We expect hardly any such cases. In any case, if the multinational group does not have consolidated accounts, profitability of enterprise should apply.**
- **The cascading effect of double tax relief under Article 23 has worked for several years till now. Situation is no different for 12B.**
- **Segmented results are very well known to be maintained by enterprises all over the world as well as MNEs. In any case, segmental results are to be used in Art 12B approach, on availability basis and there is no stipulation to compel enterprises to maintain them for this purpose exclusively.**
- **MNE definition: The definition is not such a big issue in our view. Nevertheless, it can be refined further if any good suggestions are there.**

7. <u>Paragraph 4</u>

- The draft proposes to adopt the OECD definition of automated digital services including the positive and negative lists; however, there is no early resolution contemplated for gray areas. Any definitions should be as comprehensive as possible to ensure a level playing field between competitors. For example, if cloud is considered to be ADS then this should apply to all cloud providers, not just a subset of providers.
- Also, the definition applies to services supplied to individuals. In such cases withholding is extremely unlikely to occur. (See para 41) Applying this tax to payments by individuals for personal services also undercuts what we understand to be a possible policy rationale for Article 12B because payments by individuals are unlikely to be deductible and therefore do not "erode the tax base."
- Paragraph 42 of the proposed Commentary raises the possibility of financial intermediary involvement in tax collection, although the mechanism is unclear. In the VAT context, business has raised the difficulties of financial intermediaries being involved in tax collection because they are unlikely to know what the individual is purchasing (e.g., how will they know whether the transaction involves a good or service and if a service what kind of service) and therefore are not able to appropriately determine particular transactions that are subject to tax.

- Paragraph 44 of the proposed Commentary acknowledges the lack of a definition of the term "services" and suggests that "the term "services" should be understood to have a broad meaning in accordance with ordinary usage to generally include activities

carried on by one person for the benefit of another person in consideration for a fee." This definition is potentially flawed in that many ADS are not provided for a fee.

Response:

- **Guidance on what would constitute ADS has been considerably augmented in present version of Article 12B Commentary.**
- **Rationale for 12B is not base erosion but it is allocation of taxing rights. This has been made clear in the Commentary now. Guidance on how withholding is feasible in cases of individuals is contained in paragraph 44 of the Commentary.**
- **The paragraph referred to on lack of definition of 'services' etc. has been omitted.**

8. <u>Paragraph 5</u>

This paragraph provides a priority rule that prioritizes taxation of business profits under Article 7 (or Article 14) over Article 12B. On its face this does not raise technical issues but paragraph 47 of the proposed Commentary contains a force of attraction rule that may be difficult to apply.

Response: We don't think so. Since FOA is part of UN Model, its inclusion here was necessary.

9. <u>Paragraph 6</u>

- This paragraph provides the source rule, which diverges from the proposed OECD rule. The rule provides: "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 … in connection which the obligation to make the payment was incurred, and such payments are borne by the permanent establishment…" The proposed OECD rule, on the other hand, is trying to locate the marketplace and source the payment based on the location of the marketplace and the residence of the payor is explicitly not used to determine source. The conflict that this creates might be most obvious in the case of advertising. If a company resident in State A pays for digital advertising that is displayed to and consumed by someone in State B, then this rule would source the payment to State A, while the OECD would treat the revenue from the advertising as sourced to State B. This inconsistency could result in significant double taxation.

- USCIB is concerned that this source rule is tied to the decision to withhold on the payment. If the source were determined differently, then withholding would be extremely difficult if not impossible because the location of the consumer of the advertising may not be known when the payment is made.

Response: Same as (c) of Point 2 above.

10. Paragraph 7

This paragraph provides an exception to the above source rule based on the residence of the payor if the payor has a PE in the other Contracting State and the expenses are borne by that PE. This rule is too narrow. If the payment is borne by a PE in any other jurisdiction, then there would seem to be no rationale for the country of the residence of the payor to have the primary right to tax. The country of residence would not necessarily be the marketplace and there would be no base erosion since the payment is borne by a PE located elsewhere. Applying this narrow rule is likely to increase double taxation since other jurisdictions have a better claim to taxing this income.

Response: There seems to be a misunderstanding here. The rule here is that the ADS income is not considered to be arising in State of residence of payer if it is borne by payer's PE in other State.