UN's Proposed Article 12B – Light at the End of the Tunnel

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Digital economy offers great potential and facilitates an environment for conducting business without the need of a physical presence in a country. While digitization has made rapid strides in every sector, business has identified innovative solutions effectively mining the digital explosion. Even the by-standers who were not convinced on the digital alternative are now forced to embrace the digital way on account of Covid 19. A shift based on interest and opportunity has now become a shift for survival.

The current rules of taxation are woefully inadequate to tax income that could arise to an entity without a taxable presence in a jurisdiction. The issue is further compounded by the fact that the discussions and debate on arriving at agreed parameters for taxing digital economy move at a pace which is much slower than the pace at which technology is growing.

Polarisation

Taxing the digital economy is clearly not easy and the views in circulation have clearly indicated that there are two extreme positions. On the one side, there is OECD which has played a very major role under the Pillar One exercise and the discussions have been going on for a long time without a consensus based solution. Considering the urgency, the Unified Approach was introduced for discussion. The Unified Approach has its share of criticism. It is unlikely to find favour amongst market jurisdictions for the following reasons:

(i) While there is recognition of taxing rights through a nexus, mere taxing right would not serve any purpose if the amount of profits available for taxation is negligible.

(ii) Profits are profits but the Unified Approach makes a distinction between routine and non-routine profits.

(iii) Allocation of residual profits between profits attributable to market jurisdiction and profits attributable to other factors such as trade intangibles is a complex exercise.

(iv) Identification of baseline marketing and distribution function for digital businesses would be a huge challenge.

(v) The formulary approach is quite complex and it may not be easy to develop formulae for allocation of profits across different business models.

If there are issues with reference to Pillar One as proposed, the Equalisation Levy 2.0 introduced by India through a Finance Act, 2020 is also an extreme step and is on the other side of the spectrum. India's new levy is overarching and has failed to understand the distinction between supply of digital goods and digital services as against supply of goods or services which may use the digital or electronic facility. The new Equalisation Levy (EL) under Section 165A of Finance Act, 2020 has the following challenges:

(i) Legislative competence would be an issue given the fact that the subject matter of the levy is already subject to GST under powers conferred by Article 246A read with Article 269A and Article 279A.

(ii) Online Information Database Access and Retrieval Services (OIDAR) when provided a non-resident to a business entity attracts IGST under reverse charge mechanism and OIDAR services when provided to individuals and other non-businesses attracts GST in the hands of the non-resident on forward charge basis at 18%.

(iii) Overlapping of taxes is permissible through judicial pronouncements if there are different aspects of the same transaction. When the 'supply' aspect is already subject to GST, the same supply aspect cannot again be subject to EL.

(iv) The levy is on a non-resident e-commerce operator. Can it be said that there is sufficient nexus to

India for justifying the extra-territorial operation in terms of Article 245(2) in the light of various judicial pronouncements.

(v) The definitions are very wide and while the objective was to plug the possible loss of revenue from digital businesses located outside India, the provisions may end up taxing traditional supplies merely because a digital or electronic facility was deployed.

(v i) The levy under specified circumstances referred to in Section 165A(3) is quite vague and would pose serious challenges for compliance.

(v i i) There is no appellate remedy if a person is aggrieved by an intimation issued under Section 168 and appellate remedy is provided only for penalty.

(viii) There is a timing difference whereby the exemption under Section 10(50) of the Income Tax Act, is applicable only after 01.04.2021 whereas the EL is applicable from 01.04.2020.

While both the OECD's approach on non-routine profits and India's approach on an all-encompassing levy have polarised the positions, there is a new entrant which clearly appears to be light in an otherwise dark tunnel.

The United Nations Model Double Taxation Convention

The United Nations Model Double Taxation Convention between Developed and Developing Countries was a document that was drafted under the auspices of the Economic and Social Council of the United Nations, through Resolution 2004/69. The Council through this Resolution also mandated the Committee of Experts on International Cooperation in Tax Matters ("the Committee") keep under review and update as necessary, the Model Tax Convention.

The aim of the Model Tax Convention is to serve as a template for interested nations, to use in the drafting of their 'Double Taxation Avoidance Agreements' (DTAA) and thereby allocate taxing rights over income between those countries.

There are over three thousand tax treaties in force between nations, and the UN Model serves as the foundation to about a third of these documents and has provided developing nations a comprehensive guide to the protection of their taxing rights.

India has assigned importance to the UN Model and many elements can be seen in the tax treaties signed by India. Examples include the concept of service PE, taxation of royalties, etc.

New Article 12B

Tax treatment of payments for digital services has been identified through a new Article 12B. The key features of the draft provision are given below:

(i) 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.

(ii) However, income from Automated Digital Services (ADS) 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 .....% (percentage to be established through bilateral negotiations) of the gross amount of income.

(iii) Notwithstanding para 2, the beneficial owner may require the source State to subject its qualified profits from ADS to taxation at the tax rates provided in the domestic law. Qualified profits is identified as 30% of the amount resulting from the beneficial owner's profitability ratio or profitability ratio of its ADS business segment if available to the gross annual revenue from ADS derived from the contracting State where such income arises.

(iv) ADS is defined as any payment in consideration for any service provided on the internet or an electronic network requiring minimal human involvement from the service provider. Income from ADS would not include payments qualifying as fees for technical services.

(v) The provisions are not applicable if the beneficial owner of the income from the rendering of ADS being a resident of the contracting State carries on business in the other contracting State through a permanent establishment in the other State or performs in the other State independent personal services, fixed base situated in that other State and the income is effectively connected to (i) such PE or fixed base; or (ii)

business activities referred to in Article 7(1)(c).

Commentary to Article 12B

The Commentary recognizes that on account of rapid changes in modern economies it is possible for an enterprise resident in one State to be substantially involved in another State's economy without a permanent establishment or fixed base in that State and without any substantial physical presence in that State.

The OECD BEPS Action Plan 1 illustrates the difficulties faced by tax policy makers and tax administrations in dealing with new digital business model made available through the digital economy. The OECD Final Report 'Addressing the Tax Challenges of the Digital Economy', 2015 did not recommend for the time being, a withholding tax on digital transactions (which include digital cross border services); nor did it recommend a new nexus for taxation in the form of Significant Economic Presence Test (SEP). However, it was recognized that the countries were free to include such provisions in their tax treaties among other additional safeguards against BEPS.

Key observations from the commentary

(i) Article 12B allows the 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.

(ii) Inability of countries to tax income from ADS provided by non-resident providers under the UN Model Convention before addition of Article 12B may have given non-resident service providers a tax advantage.

(iii) Taxation of income from ADS on a gross basis under Article 12B may result in excessive or double taxation. However, the possibility is reduced or eliminated under Article 23 dealing with methods of elimination of double taxation. Further, the possibility of excessive or double taxation can be taken into account by having a modest rate of tax on income from ADS under para 2 of Article 12B. Further, para 3 allows a non-resident provider to require taxation on a net basis by following the global profitability ratio.

(iv) 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 on the gross amount of payments is a well-established and effective method of collecting tax.

(v) Article 12B does not require any threshold such as a permanent establishment, fixed place and minimum period of presence as a condition.

(vi) 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.

(ix) 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.

(x) The definition focusses on provision of service and therefore does not include human interventions in creating or supporting the system needed for provision of service.

(xi) 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 and electronic network transmission methods to regard a service as ADS.

(xii) The definition of income from ADS in para 4 is exhaustive. The following services are considered to be Automated Digital Services:

- Online advertising services;
- Online intermediation platform services;
- Social media services;
- Digital content services;
- Cloud computing services;
- Sale or other alienation of user data;

- Standardised online teaching services.

(xiii) Each of the aforesaid items are explained in para 35 of the Commentary.

(xiv) ADS does not include

- Customized services provided by professionals.
- Customized online teaching services.
- Services providing access to the internet or to an electronic network.
- Online sale of goods and services other than automated digital services.
- Broadcasted services including simultaneous internet transmission.
- Composite digital services embedded within a physical good irrespective of network connectivity (internet of things).

(xv) Para 39 is significant and provides that online sale of goods and services other than ADS is intended to refer to the sale of good or service completed through a digital interface where: (i) the digital interface is operated by the provider of the good or service; (ii) the main substance of the transaction is the provision of the good or service; and (iii) the good or service does not otherwise qualify as an automated digital service.

There shall be Light

This new draft is the outcome of the 20th session of UN Committee of Experts on International Cooperation in Tax Matters virtual meeting.

The primary objective of this draft provision 'Article 12B' is to appropriately allocate taxing rights and establish a viable method for the imposition of the tax. This draft Article prescribes that the income arising from automated digital services be taxed on a gross basis. To be instituted as a withholding tax which the country of source of such income may impose, with the rate at which the tax will be imposed, left to be deliberated and arrived at by the Contracting States.

The Draft Article 12B strikes a middle path. It addresses the issue of taxing rights and ensures that the source State gets a right to tax Automated Digital Services. Further, it makes the process simpler through a withholding mechanism. It is also beneficial to the owner residing in the other State on account of the elimination of double taxation through treaty. It differs from the Unified Approach on account of its simplicity and certainty of revenue and differs from the EL on account of an identified scope of applicability.

An interesting dimension of the new Article 12B is that it completely dispenses with the traditional requirement of a permanent establishment or a fixed place of business in a country by a foreign enterprise. Further, it does not look at significant economic presence and does not contemplate threshold limits or transaction limits.

Developing countries as well as countries which are keen to tax the digital businesses are likely to accept the new Article 12B with possible variations. Variations are likely since the scope of ADS could be considered as limited by some countries. However compared to the extreme positions of complex formulas resulting in negligible revenue and catch all phrases capturing even non-digital businesses, the new Article 12B of UN Model is a breath of fresh air and indicates possible light at the end of tunnel.