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Automated digital services-The UN Proposal at glance

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A couple of days ago, in the last weekly session of the Indiana-Leeds Summer Tax Workshop, I attended the presentation of a fascinating paper by Steven A. Dean *(A Constitutional Moment in Cross-Border Taxation)*(1) where the author analyzes the political and economic predominant influence of central economies in the design and shape of post-WWI in international tax law. In his own words, the author mentioned that (the) *article offers a glimpse of what might have been—and perhaps still could be—by imagining a world in which marginalized countries willing to gamble on a new approach to taxing cross-border transactions gain a voice in setting the global tax policy agenda.*

In his magnificent work, Professor Dean recognizes that Core *"concepts articulated after World War I and enshrined in bilateral treaties after World War II favor influential states by protecting powerful economic actors"* and that *"… this basic law of cross-border taxation can change—even though no formal mechanism exists to achieve it—but states eager for reform lack access to the levers of power"*.

This *status quo* has created a formidable barrier to change beyond the interest of the most powerful nations, even more severe nowadays after OECD took the flags of the peripheral countries, including BRICS, now grouped and coopted in the inclusive framework of BEPS, in which I consider it is the most surprising and gigantic political success of OECD in the international tax arena of this decade.

According to Professor Dean, *Expanding the cast of cross-border tax constitutional characters beyond Europe, the United States and the OECD would increase the potential for fundamental change. States on the periphery, marginalized and poorly served … (today) would be more likely to embrace a departure from a status quo designed without their interests in mind … A more diverse group of decision makers, bringing different experiences and perspectives to bear on challenges faced by the classification and assignment algorithm since the Kennedy era might have more success in finding a lasting solution. Unfortunately, the emergence of a constitutional actor from beyond North America and Europe—able to serve the distinct concerns of relatively small and poor states—seems little closer than a century ago.*

I am not so skeptical as Professor Dean is concerning the emergence of new policy actors in the international tax arena, and perhaps the new proposal coming from the UN Committee of Experts on International Cooperation in Tax Matters (the UN Tax Committee) on the taxation of automated digital economy, which is at the core of this contribution, represents a fresh start, a revamping of a

different interest group with a voice on the matter different from that of the, for some agonizing, OECD 2.0 project.

In an article published in these same pages last June,(2) I alerted the fact that: *The OECD's BEPS 2.0 project is currently navigating turbulent waters partly because of the unexpected Covid19 crisis and its impact on state budgets and the need for additional revenues, and partly because of internal tensions and conflicts within OECD dominant group of industrialized countries, the 140-member-state inclusive framework, and the business community. Disagreements include (but are not limited to) the ring-fencing of the digital economy taxation (an idea that China and The US strongly oppose), and the allocation of taxing powers to market jurisdictions under Pillar I of the OECD Unified Approach.*

I also criticized OECD's current approach concerning Pillar I on the following bases: *... the national administrations of emerging economies perceive that, in allocating direct taxing rights over the new economy, OECD is excessively pegged to a theoretical economic approach and lacks the political flexibility needed to arrive at a satisfactory outcome that genuinely contemplates the national interest of market states; or, even worse, that in the re-slicing of the greater pie coming from the direct taxation of income derived from the digital businesses, the central economies influence the OECD to follow a path that would change nothing (or almost nothing) in terms of allocation of taxing powers to markets, while adding simultaneously extreme complexity to the administration of the system, far beyond the capacity of emerging countries' tax administrations*.(3)

Coming to the alternate approaches unilaterally developed by States to the taxation of the digital economy, I surfed there over the various recent experiments, including the equalization tax, the digital PE, and digital service taxes –DST–,(4) to finally land in the LATAM experience of withholding taxes based on financial source;(5) I recalled then that *some Latin American countries have resorted to ... source rules that confer income tax jurisdiction to the country where the service recipient, customer or client is situated, regardless of the place where the service or good provider performs its activities, i.e., even in the case in which the foreign provider's sole nexus to the taxing jurisdiction is precisely the residence of the service recipient, customer or client paying for the digital service*.(6)

On the issue of whether the sole residence in the market jurisdiction of the service recipient, customer, or payer might be deemed as a sufficient nexus for the income of the foreign digital service provider to fall within the taxing powers of that jurisdiction, I pointed out that conventional international tax law has already receipted the payer residence as a legitimate connection,(7) while domestic LATAM legislation in countries like Argentina, Brazil, Mexico, and Peru has long contemplated cases in which the tax is applied where the payer is located.

In line with the above, on August 6, 2020, the UN Tax Committee released a proposed optional UN model tax treaty article (the Proposal) that, radically departing from OECD's unified approach to Pillar One, would grant taxing rights to the treaty country where customers of a treaty-partner automated digital services provider are located.(8)

The Proposal would add new Article 12B to the UN Model Double Taxation Convention between Developed and Developing Countries (UNMC), requiring foreign providers of automated digital services to pay income tax at source by means of either (i) a withholding on gross income (whose rate is to be agreed upon by the parties to the treaty), or (ii) on net income pursuant to an

apportionment formula. Under the Proposal, the foreign automated digital services provider is allowed to choose whether to assess the tax on a gross basis or on net income.

The proposed Article 12B, paragraphs 2 and 3 contemplates gross and net basis source taxation as follows:

2. *... 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 ... of the gross amount of the income.*

3. *... the beneficial owner of the income from automated digital services ... may require the Contracting State where the income ... arises, to subject its qualified profits ... for the fiscal year concerned to taxation at the tax rate provided for in the domestic laws of that State. For the purpose of this paragraph, the qualified profits shall be 30 percent of the amount resulting from applying the beneficial owner's profitability ratio or the profitability ratio of its automated digital business segment, if available, to the gross annual revenue from automated digital services derived from the Contracting State where such income arises...*

In accordance to point 6 of the Commentary to the Proposal, the taxation of income from automated digital services on a gross basis under Article 12B may result in excessive or double taxation, but that possibility is reduced or eliminated under Article 23 (Methods for the Elimination of Double Taxation). Moreover, chances of excessive or double taxation may be ameliorated either by setting forth a modest withholding rate on gross income, or by the automated digital service provider requiring taxation on a net basis by following the global profitability ratio provided for in Paragraph 3.

Also, as explained in point 8 of the Commentary, Article 12B does not require any threshold –such as a permanent establishment, fixed base, minimum period of presence, or minimum turnover in a Contracting State– as a condition for the taxation of income from automated digital services at source to be triggered.

The withholding rate at source is left to the treaty partners' agreement but the Commentary alerts in point 17 that the determination of precise level of withholding tax should take into account several factors, including the following: (i) the possibility that a high rate of withholding tax might cause nonresident service providers to pass on the cost of the tax to customers in the country; (ii) the possibility that a tax rate higher than the foreign tax credit limit in the residence country might deter trades in the source country; (iii) 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; and (iv) the relative flows of payments in consideration for automated digital services (e.g., from developing to developed countries).

Proposed Article 12B, paragraph 4 define income from automated digital services in the following terms:

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 'fees for technical services' under Article 12A.

In accordance to point 31 of the Commentary, a service is regarded as automated when the user is able to make use of the 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. The definition focuses on the provision of the service and, thus, does not include human interventions in creating or supporting or maintaining the system needed for the provision of the service. An important indicator of the "automated" concept is whether there is ability to scale up and provide the same type of service to new users with minimal human involvement. 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.

Based on the above, point 34 clarifies that the following services are considered to be automated digital services: (i) online advertising services; (ii) online intermediation platform services; (iii) social media services; (iv) digital content services; (v) cloud computing services; (vi) sale or other alienation of user data; (vi) standardized online teaching services.

On the contrary, according to point 36 of the Commentary, income from automated digital services does not include: (i) customized services provided by professionals; (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) broadcasted services including simultaneous internet transmission; and (vi) composite digital services embedded within a physical good irrespective of network connectivity ("internet of things").

Point 41 of the Commentary points out that article 12B encompasses B2B and B2C automated digital services as well. However, recognizing that concerning B2C services, the imposition of withholding tax obligations on such payments would be difficult to enforce and might cause compliance problems for individuals consuming automated digital services supplied remotely by non-residents, the Commentary observes that other mechanisms for collection may be required (e.g., self-assessed payment by the nonresident provider).

Paragraph 5 of proposed Art. 12B sets forth that:

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.

In other words, in the context of this paragraph, the State in which the income from automated digital services arise is released from the limitations on its taxing rights imposed by Article 12B, and article 7 or article 14 controls.

Paragraph 6 of proposed Article 12B lays down the principle that the State in which the income form automated digital services arises 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 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. Paragraph 7, in turn, is a consequence of the same principle:

6. … *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. … *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.*

Considering the need to conceive an income tax system that grants peripheral countries a fair share in the global revenues coming from income generated by the new economy, the Proposal appears to be a good start for a feasible, workable, simpler solution which, though sacrificing a strict theoretical adherence to value creation concepts sought by OECD, would allow a satisfying outcome to so far marginalized states, without subjecting private stakeholders to excessive or double taxation.

Of course the proposal will face strong opposition from The US and China since it targets specifically –ring-fences– digital businesses. In any case, it is good news that countries marginalized from the decision making process at OECD, because of the predominant influence of industrialized countries, find a place to voice their interest in a revitalized UN tax Committee, and the latter has come out with a prudent alternate proposal.

(1) See, Dean, *A Constitutional Moment in Cross-Border Taxation,* unpublished.

(2) Kluwer International Tax Blog, June 2, 2020, *Market access based income tax on cross-border digital trades: A second best for the LATAM Region?*

(3) Id. note 2.

(4) For countries' reasons to resort to non-income levies rather than to the income tax system, see Teijeiro*, A call for a Sustainable Response to the taxation of Digital Economy within the International Income Tax System*, Kluwer International Tax Blog, October 5, 2017.

(5) For the traditional distinction between economic and financial source see Pires, *International Double Taxation of Income,* Kluwer. 1989; Teijeiro, Opening of the Pandora Box in the International Tax Field (three-part article), Tax Practice International Tax Review, Bloomberg-

BNA, vol. 42, 2015 (particularly parts I and II).

(6) Id. note 2. These are the cases under the domestic tax laws in force in Peru (pre-BEPS legislation) and Uruguay (post-BEPS legislation). A similar proposal was discussed in Argentina in 2017, exclusively for B2B cross-border digital services, but the proposed provision was eliminated from the bill drafted by the Executive Branch right before the bill of what was later the 2017 tax reform (Law 27,430) were sent to Congress for consideration. On the Uruguayan system see Riccardi Sacchi, *while in the quest for the Holy Grail… Uruguay is already taxing income from Uber and Netflix,* Globetaxgov, March 8, 2019.

https://globtaxgov.weblog.leidenuniv.nl/2019/03/08/while-in-the-quest-for-the-holy-grail-uruguay-is-already-taxing-income-from-uber-and-netflix/

(7) The UN Model allocates taxing rights for technical services to the jurisdiction of the payer in article 12A, paragraph 5, UNM (2017).

(8) See proposed text

https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2020-08/TAX%20TREATY%20PROVISION%20ON%20PAYMENTS%20FOR%20DIGITAL%20SERVICES.pdf

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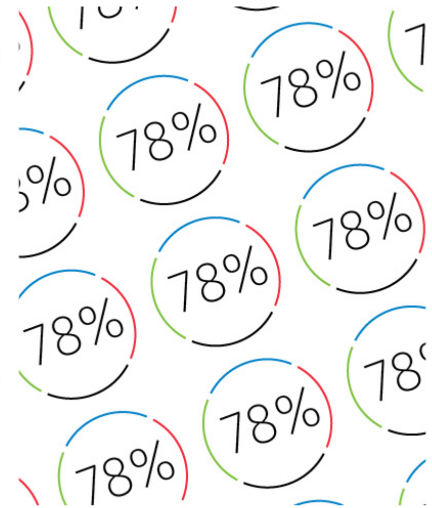

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