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Taxation of Digitalized Economy

Analysing the United Nations Article 12B Solution

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Executive Summary

The United Nation Committee of Experts on International Cooperation in tax matters at the United Nations has approved to add Article 12B in the UN model tax convention in order to include the taxation of *"automated digital services"* (ADS). The new Article 12B and associated Commentary forms part of the 2021 version of the UN Model Tax Convention. It would have an impact only when two contracting states negotiate (or renegotiate and amend) a bilateral tax treaty between them. Pursuant to insertion in the bilateral tax treaties, apart from the residence state of the beneficial owner of the ADS income (Residence State), the Source State from which payments arise would also be granted the right to tax those activities. Article 12B does not allow any de minimis thresholds, so any business, regardless of size, could be in scope (although the Commentary states that thresholds could be adopted bilaterally).

At the outset, one must appreciate the efforts of the UN expert committee for coming up with a rather simple solution to such a complex issue. Even though this solution seems to be a straightforward approach to transform tax rules in an increasingly digitized economy, several policy and technical issues need evaluation. Additionally, one has to be prepared for multiple roadblocks during the course of its implementation.

First, Article 12B attempts to provide a bilateral tax solution to address challenges of a digitalized economy when the issue at hand clearly demands a multilateral solution. Relevant to note, OECD supported by around 139 jurisdictions (*including India which is a part of the OECD Steering Group working with the Inclusive Framework members to advance technical discussions*) is working to reach a multilateral consensus to address tax challenges of digitalization. Unlike the OECD Inclusive Framework where governments are negotiating for a consensus-based solution, the UN Tax Committee comprises 25 tax experts acting in their personal capacities and do not necessarily represent their governments' views.

Second, in the quest to simplify the process, the proposal covers automated digital services and ring fences specific digital business models. Such a narrow scope of application leaves open several other business models that could be taxed. This may then result in giving governments an opportunity to unilaterally impose tax measures for business models outside the scope of ADS. The very ethos of a global digitalized economy is based on the principle that all businesses can, with or without the benefit of local physical operations, participate in an active and sustained manner in the economic life of any market jurisdiction. Hence, designing a global tax reform based on sector-specific definitions and including only specific business models will prove too limited conceptually to result in a system fit for the long term. A system that is neutral in its foundational rules will be best able to accommodate the unforeseeable evolution of business models.

Third, the proposal essentially provides taxation on a gross basis, to be collected through imposition of withholding taxes on outbound payments (unless the beneficial owner opts for the net basis to apply instead). Gross based taxation is generally considered as a viable option for passive incomes such as dividend income or interest income etc. which is a single source of income. A gross-based tax does not account for significant expenditure incurred by automated digital service providers and may impose a significant tax burden on Multinational Enterprises (MNEs) which is disproportionate to the profits they derive from markets. This may potentially deter MNEs from operating in such markets. Another concern is that gross based taxation might also trigger the companies to pass on the tax to the end users which would then be counter-productive for the contracting states.

Fourth, the proposal also offers a net based taxation. For an MNE operating in several countries, computing “qualified profits” in accordance with laws of each country raises administrative difficulties and significant compliance costs, that may leave MNEs with no choice but to forcefully opt for gross based taxation which suffers from technical challenges. Additionally, profit attribution of 30 % departs from the current profit allocation under Transfer Pricing Rules. Dissimilar from the OECD draft, which is the Pillar One Blueprint, the UN Expert Committee’s draft is not evidently backed by detailed research. Attributing 30% of qualified profits without considering the facts and circumstances of each case i.e. the presence of functions, assets and risk in every jurisdiction could lead to excessive taxation for certain MNEs.

Fifth, net based taxation options will not be available to the entities where the segmental or overall profitability ratio of the MNE group is not available with the contracting state. In cases where country-by-country reports are not available (which is generally the case with smaller MNEs), the MNEs who do not have a group turnover exceeding Eur 750 million will have to forcefully opt for a gross based taxation method.

On the **implementation front**, *firstly*, the enforceability of this proposal is going to be an uphill task for the countries choosing to opt for this mode. In order to enforce this, it would require amendments in thousands of tax treaties currently operating around the world. Though it gives an option to the countries to bilaterally negotiate the terms of agreement, it would require significant efforts to negotiate with each of the countries. It is unlikely that countries (particularly countries of residence of digital service providers) will accept this provision in their treaties as the issue at stake is a multilateral issue and requires a global solution.

Secondly, a bilateral tax treaty negotiation would create inconsistency in the tax rates and approaches towards taxing the entities and will not benefit the MNEs who will have to structure their business in accordance with country wise tax treaties rather than a uniform set of rates applicable. Further, with emerging business models, the scope of taxation will only increase and it would again require negotiation to amend the tax treaties. On the other hand, a multilateral approach will help in maintaining uniformity and consistency which would help the businesses as well as the governments. Also, bilateral negotiations taking place specifically between developed and developing countries might also witness disparity in terms of power of negotiation while deciding upon a rate of tax.

There is a greater need for all the countries to be on the same page on this issue be it developing or developed. Given the current economic situation globally, businesses need certainty. A multilateral international consensus-based framework would be the most prudent way forward to address tax challenges of digitalization.

I. Background

The emergence of new technologies and its application in a variety of systems has led to challenges with respect to regulation for many Governments, including India. Taxation issues due to digitalization of the economy has been a significant bugbear amongst these challenges. With uncertainty rising and several issues arising, the international community has recognized the need to address the tax challenges presented by digitalization of the economy at a multilateral level.

The OECD has been working to achieve consensus in G20 member states and the 139 countries that comprise the Inclusive Framework on redesigning the existing tax system to meet the challenges of the digitalizing economy (Pillar One and Pillar Two proposals). It is expected to deliver an agreement by mid 2021 and finalize the Pillar One and Pillar Two Proposals during the course of the year.

In the meanwhile, the UN committee of experts on International Cooperation in tax matters has recommended the addition of Article 12B to the UN Model Taxation Convention to address tax challenges of the digitalized economy. Article 12B was approved by the committee in April 2021. Article 12B seeks to tax income arising from automated digital services. The committee's efforts in presenting rather a simple solution to address tax challenges of digitalized economy is commendable. A large minority of the UN's Tax Committee experts however were not in full agreement and have raised their concerns which have been noted in the commentary[1].

Article 12B prescribes two processes in which tax could be collected by the contracting states through bilateral negotiations. Either the two governments agree to a certain percentage of gross based withholding tax (3% - 4% recommended) under their bilateral tax treaty for which rates should be negotiated bilaterally or the MNE may request the source country to tax its profit on a net basis. The article provides the list of automated digital services that will come under the ambit of this article (online advertising services, supply of user data, online intermediation platform services, social media platforms, digital content services, cloud computing services, and standardized online teaching services.)

This study seeks to analyze Article 12B on **technical and implementational grounds** and evaluate whether it could be considered as a practical solution to address tax challenges of digitalization.

1 Para 16, Commentary on UN Tax Proposal, https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2021-04/CITCM%2022%20CRP.1_Digitalization%206%20April%202021.pdf

II. Analysis of UN Tax Solution

The newly inserted Article 12B of the UN Model Tax Convention aims to provide a solution to address tax challenges of an increasingly digitized economy. As with other initiatives of the UN in the past, some aspects of Article 12B are inspired by the proposals which are still under discussion at the OECD forum. These include the definition of ADS, which is inspired by ADS as covered in the OECD's Pillar 1 proposal, though the OECD Inclusive Framework (IF) goes further to suggest Consumer Facing Businesses (CFB) which is not covered under Article 12B. Further in the final version of Article 12B and the commentary thereto which has been accepted as part of the UN Model Convention (during the 22nd UN Sub-Committee session held during 19-28th April, 2021), is starkly different from the penultimate version introduced by the Co-Coordinator's Report in October, 2020. The following aspects have been weaved in as "large minority views", and included as alternate texts as suggested in the commentary:

1. Inclusion of Minimum Global Threshold: a threshold based on the worldwide revenue of the taxpayer during the fiscal year for the purpose of protecting small-size taxpayers.
2. Inclusion of De-minimis Threshold of underlying payments for ADS from the source company: a threshold based on the revenue from ADS derived from the source State for the purpose of protecting taxpayers that have just entered a particular market, since they would more often be operating at a loss during the start-up stage
3. Possibility of exclusion of B2C transactions on account of difficulty in administering withholding taxes: this has been suggested on the understanding that the imposition of withholding tax obligations on such payments by individuals under domestic law would be difficult to enforce and might cause serious compliance problems for individuals utilizing automated digital services supplied remotely by non-residents.
4. Possibility of limiting the coverage to only non-routine profits: this option is suggested on the understanding that if the taxpayer has no presence and thus not performing any functions in the source state, it should not be subject to taxation in the source state on its routine profits which are based on such functions.

Further the proposal under Article 12B continues to be different from OECD proposal in the following important aspects:

1. The nexus rule: while Article 12B gives taxing rights to the country from where payments are emanating, the OECD Pillar 1 prescribes separate nexus rules depending upon the nature of the underlying income e.g. weightage is given to the underlying users in case of online advertising services, or to location of data in case of data transfer services.
2. Option of taxation on gross withholding tax, which is in stark contrast with the complex formulas prescribed under Pillar 1 to determine the tax base.
3. The formulary apportionment rule i.e. the net taxation rule under Article 12B which presumes a certain percentage as deemed profit.
4. The consideration of routine profit within the ambit of the Net taxation rule [though the commentary also allows for the alternate of taxation of non-routine profits]
5. The absence of a simplified registration mechanism as under OECD [where it would be enough for companies to register only with the country where the Ultimate Parent Entity resides]. In fact, the commentary in Article 12B specifically prescribes that States are free to apply its own laws as the procedural questions are not dealt with in the Ar-

ticle.
6. The absence of any mechanism for dispute prevention as has been specifically prescribed under OECD.
7. Scope: Article 12B has a narrow scope and applies only to automated digitals services whereas OECD is applicable to Consumer facing businesses as well.

Considering the construct of the UN proposal under Article 12B as it stands today, the following may be some points of considerations:

A. Basis of determining Nexus

The UN as a body is representative of 197 nations. However, the Co-coordinator committee, which has recommended the insertion of Article 12B consists of only 25 members – who are also only individual experts, not specifically representing their respective states but advising in an individual capacity. It thus cannot be said that the UN Article is a proposal which reflects a collective and united understanding and acceptance of how taxing rules should apply to address tax challenges of digitalization.

It is in this context that the contours of the UN proposal should be appreciated. The taxing rights granted under the UN proposal are in terms of where the payments are made. This is quite different from the complex ascertainment prescribed under the OECD Pillar 1 which gives a varied basis depending upon the nature of the transaction – for instance Pillar 1, for online advertisement, also factors in where the users are located and for provision of data, it factors in where the data is located. As opposed to this the UN proposal, in its 'simplistic' approach, only considers the function of source of payment.

Such a 'simplistic' approach may actually be detrimental in the interest of developing countries in cases where they may not house the paying entity but may house factors which actually add value to the transaction e.g. the users, data etc. For example, in case of online advertising services, the service provider and the payer may both be located in developed countries, while the target audience may actually be located in developing countries. In view of the contours of Article 12B, only the jurisdiction of the payer which may be in a developed nation will get the taxing rights, whereas in this example the developing country would not get any share in the tax pie.

B. Gross-based taxation

Article 12B provides an option for taxing the income arising from ADS on a gross basis i.e. an imposition of a withholding tax by the source country on gross income of the ADS provider as per their 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. The rate of such tax will be arrived at through bilateral negotiations between the contracting states.

Fundamentally, a gross based taxation is usually suggested in the context of incomes which do not involve a significant amount of investment and expenses to render the underlying services on an ongoing basis. This pattern emerges if one studies the existing incomes which are subjected to gross-based taxation i.e. dividend income (Article 10 of the UN model), interest income (Article 11), royalty (Article 12) or even Fees for Technical Services (Article 12A), which are typically passive incomes. The present proposal to tax income from ADS is an aberration in this trend because, one can argue, ADS businesses do involve ongoing and significant expenditure to sustain the business e.g. in relation to upgrading software, hardware, research and development, setting up infrastructure, other expenses related to development and maintenance of assets, generation of the revenue system (like payroll, marketing and distribution expenses); insurance, etc. The second dis-similarity between the existing incomes subject to gross based taxation and ADS is that while the existing incomes may be seen as singular source of incomes, ADS, covering a gamut of digital services, can be understood as a business segment in itself and therefore a proposal of gross based taxation for a business segment as a whole is highly peculiar.

Certain fallacies on gross based taxation is infact also recorded in the commentary itself, including:

1. The possibility that a high rate of 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;
2. A tax rate higher than the foreign tax credit limit in the residence country might deter provision of cross border services;
3. Some non-resident service providers may incur high costs in providing ADS, so that a high rate of taxation on the gross payment may result in an excessive effective tax rate on the net income derived from the services;
4. The fact that a reduction of the tax rate has revenue and foreign exchange consequences for the country imposing tax at source; and
5. The relative flows of payments in consideration for ADS (e.g., from developing to developed countries).

Therefore, in fairness, the commentary does provide the alternate view-point as regards gross based income for the negotiating countries to consider while adopting it in the text of their bilateral treaties.

Out of the fallacies noted, the significant one is the probability of the ADS entity passing on the tax cost to the payer in the source country. This then nullifies the philosophy of the source country benefitting from the distribution of taxing rights. One view here is also that the chances of such shifting of burden of taxes is higher in case of large MNEs who have a larger footing in the market for their products thus having more negotiating powers when compared to their customers. Therefore, providing an option of payment of tax on gross basis to such MNEs may actually be counter-productive, given their tendency to pass on the cost to the customer.

Further, in case the source country also has VAT being levied on such payments, such grossing up may also distort the tax base for the levy of such VAT.

Another big challenge is the administration of such a proposal. The UN proposal in fact specifically steps away from dealing with the issue of administration while commenting that "*the Article itself lays down nothing about the mode of taxation in the State in which the income from automated digital services arises. Therefore, it leaves that State free to apply its own laws and, in particular, to levy the tax either by deduction at source or individual assessment. As with other provisions of the United Nations Model Convention, procedural questions are not dealt with in this Article. Each State is able to apply the procedure provided in domestic law*".

The proposal in the main text envisages coverage of both B2B as well as B2C transactions [though the commentary as a minority view also suggests text if countries prefer to exclude B2C transactions]. The basis of inclusion of B2C transactions within the ambit of Article 12B was the recognition of the fact that substantial revenue in the ADS domain emerged from B2C transactions and therefore leaving it out of the tax pie would lead to significant revenue losses. However, while a gross based taxation through the mechanism of withholding taxes can be administered relatively easily, the same is not true for B2C transactions. It was thus critical to also devise a clear strategy for B2C transactions in the Article itself so that there is no disparity in how the proposal is implemented between jurisdictions and the taxed entities were not therefore overburdened on account of compliance requirements. Unfortunately, the UN Model Convention as a medium has its inherent challenges, since such administrative stipulations are not prescribed in any of the Articles and is a challenge not unique to Article 12B itself. As opposed to this, the OECD Pillar 1 approach is not encumbered with such an inherent challenge and has prescribed the useful guidance of allowing taxed entities to register one time in the jurisdiction of the Ultimate Parent Entity where from such country would onwards co-ordinate with the source country.

As an alternative to the gross based taxation, Article 12B also provides for a net-based taxation in the form of the formulary apportionment prescribed under Article 12B(3). However, as per the finalized version, which is now incorporated in the UN Model Convention, the net-based taxation as an option would not be available to countries where the segmental profitability ratio or, as the case may be, the overall profitability ratio of the MNE group to which the beneficial owner belongs is not available to the Contracting State in which the income from automated digital services arises. It is further elaborated in the commentary that application of Article 12B(3) is contingent on the availability of such information in relation to profitability ratio of the MNE group. In certain situations, this information may be available through country-by-country reports exchanged and exchange of information mechanisms may be utilized to obtain this information in certain situations. The country-by-country exchange of information itself is applicable only to groups which have a turnover at the group level exceeding Euro 750 million. Thus, by default, the smaller MNEs who do not have a group turnover exceeding Euro 750 million will be forced to be subjected to the gross based taxation and its inherent challenges as explained above.

C. Net Based Taxation

While the gross based taxation regime suggested in clause 2 of Article 12B can be said to provide simplicity in tax determination, clause 3 thereof does provide an avenue to ADS providers to discharge the applicable tax in the source jurisdiction, at the applicable tax rate, based on its qualified profits. Accordingly, the beneficial owner of the income may request the source jurisdiction to be subject to taxation on its qualified profits, with an intent to provide relief in those cases where the taxpayer may have a lower tax liability than the liability determined as per withholding tax mechanism. This would also hold in cases where it has a global business loss or a loss in the relevant business segment during the taxable year.

Qualified profits are to be considered as 30 % of the amount resulting from the profitability ratio of either(whichever is higher), (a) the beneficial owner's automated digital business segment (overall profitability ratio of the beneficial owner-if segmental accounts not maintained), or (b) business segment of the MNE group (of the group as a whole in case segmental accounts are not maintained) to the gross annual revenue from automated digital services derived from the source jurisdiction. However, in cases where profitability ratio of the multinational enterprise group to which the beneficial owner belongs is not available to the source jurisdiction, ADS providers will be mandated to adopt the gross based taxation (and not permitted to opt for the alternate method provided under clause 3).

The profitability ratio used for determination of the qualified profits is 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. Further, and unless bilaterally agreed otherwise, profit to be used for calculating profitability would be the profit before tax, between the Contracting States.

An illustration of the above laid down methods has been provided below:

1. ABC Inc. exclusively undertakes an ADS business in three different countries (without any operations in the country of its residence) and the revenue / expense from such is as

Country	Gross Revenue	Expense	Profits	Profitability ratio
Country A	1000	400	600	0.6
Country B	800	600	200	0.25
Country C	3000	400	2600	0.87
Consolidated	4800	1400	3400	0.71

below:
In light of the above, in terms of the prescribed net taxation method, the following will be the applicable tax payable in each country where ABC

Country	Gross Revenue (A)	Global Profitability ratio (B)	Amount offered to tax [30%*(A*B)]	Amount offered to tax as a % of profits generated
Country A	1000	0.71	212	35.4%
Country B	800	0.71	170	85%
Country C	3000	0.71	637	25%
Residence Country	4800	0.71	2386	--

Inc. has operations, and its residence country. The above illustrations lay bare the key issue which may arise for countries accepting the option of net taxation, based on the global profitability ratio. For example, while in Country C, ABC Inc. was able to factually achieve a local profitability ratio of around 85%, but only 25% of the profits generated will be taxed therein. Similarly, while the local profitability ratio of ABC Inc. in country B was merely 25%, almost 85% of the total local profits generated therein will be brought to tax. Such disparity in the manner of taxation, though merely simulated here, may prove to be a hindrance to implementation of the option.

The Net Based Taxation is prescribed as an alternative to the gross based taxation route. However, unlike the widely accepted transfer pricing methodology, which is accepted under other Articles in the Convention i.e. under Article 9, the Net Based taxation prescribed in the UN Model is based on a formulary apportionment. Such adoption of a formulary apportionment is very rare and there is no philosophical justification of why the established transfer pricing methodology was given up and the formulary apportionment was adopted for ADS businesses.

Further, Article 12B(3) while prescribing the formulary apportionment, deems 30% to be the qualified profits resulting from applying the profitability ratio of that beneficial owner's ADS business segment to the gross annual revenue from ADS derived from the Contracting State where such income arises . The only explanation which is given as regards justification of 30% is that in arriving at a figure of 30%, the respective roles of assets, employees and revenue in generation of profits were assigned equal weight. However, unlike the OECD Pillar 1 proposal which is based on detailed statistics as also made publicly available in the OECD Impact Assessment Report, the UN Proposal fails to give enough justification to adoption of 30%. For the possibility of a wider acceptance of Article 12B, it thus was crucial that enough justification be narrated in the Commentary about such rate. Commendably, and considering the comments received from various members on the above issue, an alternate text of para 3 has also been proposed, in terms of which the percentage of qualified profits which can be allocated to the source jurisdiction has been left open to bilateral negotiations.

Also, it may also be said that under the proposal, a disproportionate weightage is given to factors of "assets, employees and revenue", while disregarding the fact that the entity may not have any revenue, assets and functions in the source country.

Further and more important, guidance is missing as regards actual components in the computation of profits/profit ratio. The only guidance that is available, though seemingly inadequate is tin para 47 which states that - the profitability ratio of the beneficial owner or the multinational enterprise 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 ADS 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 the profit before tax as per accounts of the beneficial owner, or as per the consolidated accounts of the MNE as the case may be, with adjustments such as for example 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. In the absence of a dispute prevention mechanism (such as under OECD), this may lead to further litigation and disparate treatments of tax paying ADS entities across jurisdictions.

Separately, there is also a possibility of double taxation/ over-taxation. This is for the reason that for the purposes of Article 12B(3) the qualified profits shall be 30% of the amount resulting from applying the profitability ratio of that beneficial owner's ADS business segment to the gross annual revenue from ADS derived from the Contracting State where such income arises. However, 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 which is higher and thus results in the possibility of group profits being taken as the tax base for computation. While Article 23 of the UN Model Convention allows for tax credits and tax exemptions to prevent any instance of double taxation, this mechanism may fail in a situation where an entity is required to pay tax not on its profits, but the profits of a group company.

Another unaddressed issue is that the proposal does not allow for carry forward of losses, which thus creates a discrimination between how such businesses are taxed as compared to traditional businesses.

The other major criticism with the present draft of para 3 was the non-carving out of routing profits. As an illustration, take the case of an ADS provider derives certain ADS related income from the source state and at the same time also has a PE in the source for undertaking routine functions supporting the ADS activities undertaken by the taxpayer. In such a case the PE would have already been taxed in the source state on its routine profits, and hence not carved out such income already taxed in the source state which would lead to the source state taxing the same routine profits twice. To overcome this scenario, an alternate draft of para 3 has been set out which permits carving out of the routine profits of the ADS services provider from its qualified profits.

While Article 12B attempts to provide a simpler option for countries and ADS providers alike to tax the income generated in source jurisdiction, the success of the same will lie entirely on the uniform adoption of Article 12B bilaterally by all countries. While the OECD is also developing its own mechanism for taxation of ADS, in the situation certain countries opt for the UN Model, while others opt for the OECD model, there is bound to be a situation of double taxation. An example of such situation is explained below:

1. ABC Inc., and an online advertisement service provider is a resident of Country A.
2. XYZ Inc., as resident of Country B contracts with, and pays consideration to, ABC Inc. for providing online advertisement services targeted at consumers located in Country C
3. While Country A and Country B have bilaterally negotiated and amended its Tax Treaty based on Article 12B, Country C has not been agreeable to adopting the UN draft and rather have adopted the OECD model qua Country A.
4. While the revenue sourcing rules under the UN model is based on the "payment" for ADS service providers (i.e. the tax will accrue to the jurisdiction where the payer resides), whereas the OECD model has distinct sourcing rules, based on the type of service. For online advertisement services, the revenue will accrue based on the geolocation of the person accessing such advertisement.
5. Hence, in the above example, while the monies paid by ABC Inc. to XYZ Inc. will be taxable in Country B in case of the UN model, the same income will also become taxable in Country C – on account of the OECD model.

While the above illustration is a simplistic take on the possible issues with non-uniform adoption of the UN draft, it still lays bare the need for having a model which is widely and uniformly adopted by all countries.

Further, the text of Article 12B and the commentary thereto nowhere addresses the issue pertaining to the administrative difficulties and compliances which an MNE will have to encounter in relation to determining the profits (for application of net basis taxation) as per the laws and procedures followed in the Market Jurisdiction. Since the procedural aspect is left upon the individual nations to decide, there is bound to be differences in administrative requirements in different jurisdictions, which is likely to add higher compliance costs and burden on the MNEs.

D. Ringfencing only specified services

Given globalization and the digitalization of the economy, all businesses can, with or without the benefit of local physical operations, participate in an active and sustained manner in the economic life of a market jurisdiction, through engagement extending beyond the mere conclusion of sales, in order to increase the value of their products, their sales and thus their profits. Existing international tax rules generally attach a taxing right to profits deriving from a physical presence in a jurisdiction.

Designing global tax reform based on sector-specific definitions might prove to be limited conceptually to result in a system fit for purpose for the indefinite future. Tax reforms should be focused on designing a structure that will stand the test of time through strong grounding in the international tax principles of neutrality, certainty, flexibility, and simplicity. Global tax reform meant to accommodate the possibilities of the global digitized economy as a whole should be based on economic factors that could apply to unforeseen new business models and changes in the global flows of goods and services. A system that is neutral in its foundational rules will be best able to accommodate the unforeseeable evolution of business models.

Article 12B only covers within its ambit "automated digital services", which is defined to include any service provided on the Internet or another electronic network, in either case requiring minimal human involvement from the service provider. It specifically includes online advertising services; supply of user data; online search engines; online intermediation platform services; social media platforms; digital content services;

online gaming; cloud computing services; and standardized online teaching services. It specifically excludes payments underlying the income from ADS that qualify as "royalties" or "fees for technical services" under Article 12 or Article 12A as the case may be.

It requires appreciation that Article 12B while purportedly seeking to address the issue of "taxation of digitalized economy", limits its scope only as regards ADS services while leaving outside the scope other businesses which may also demonstrate lack of territorial nexus, but deserving to be taxed in the source country. The OECD Pillar 1, for this reason does not limit the conversation to only ADS (which is similar in scope under both OECD model and the UN proposal) but also extends it to Consumer Facing Businesses (CFS) and takes the effort to painstakingly describe what entities may qualify as CFS and thus be liable to tax. Thus, Article 12B is limited in its scope to this extent and may not cover other businesses (outside of ADS) which could participate in the source country even without a physical presence.

For that matter, it is more restricted in its scope even when compared to unilateral measures taken by countries such as India, under its Equalization Levy. Though this proposal seems to be simple on paper, it gets complicated in application.[2] It seems to be less neutral, ineffective and non-flexible owing to its narrow scope.[3]

Further, there might also be inherent limitations in the definition of ADS itself (which, importantly, is yet to be universally accepted even during the OECD discussions). As we see from the recent jurisprudence as regards transfer of right to use software in India where the same is understood to fall outside the domain of "royalty", whereas ADS would only cover supply of non-customized/ shrink-wrap software if given on an online medium. Thus ADS, given its limited scope, has also the effect of discriminating between two transactions on the basis of its mode of transmission i.e. online vs. physical.

E. Enforceability of Article 12B

Bilateral agreements find their roots in the domestic tax systems which permits the countries to enter into tax treaties with other countries.[4] Since, as of now, there is no contemplation of a multilateral instrument to implement the UN proposal, a proposal such as this would require specific amendment in each individual tax treaties with the contracting countries preceded by negotiation and deliberation on the tax rate and other provisions of the Article which will take tremendous amount of effort to accomplish.

Including 12B provision in the treaties would mean re-opening of bilateral negotiations between the countries which would ultimately lead to a time consuming process and does not seem to be feasible from a practical standpoint. It will lead to variable tax rates across jurisdictions, thereby contributing to compliance issues for multinational entities. For all intent and purposes it is likely to work in contrast to the goal of achieving ease in taxation of digital services as lack of uniformity regarding the rate and base of taxation are to be amplified when dealing with the nature of the ADS. The approach taken by the committee currently requires critical elements (for instance - tax rate, attribution percentage and scope of qualified profit) of Article 12B to be agreed through bilateral negotiations creating non-uniformity around the globe.

It is also worth mentioning that Article 12B does not expressly prohibit imposition of any unilateral measure. The lack of such prohibition, if unaddressed, could create complexities and uncertainty in cases where both Article 12B and unilateral digital taxes like equalization levy

2 Vikram Chand and Camille Vilaseca, The UN Proposal on Automated Digital Services: Is It in the Interest of Developing Countries? Kluwer International Tax Blog, March 5, 2021, Retrieved from: http://kluwertaxblog.com/2021/03/05/the-un-proposal-on-automated-digital-services-is-it-in-the-interest-of-developing-countries/

3 Id.

4 For instance, in India, see: Section 90, Income Tax Act, 1961 co-exists. For instance, Article 12B is focused on specific automated digital services. There is a possibility that countries may also impose unilateral levies to cover services other than ADS (as specified under Article 12B), thereby leading to additional complexity. Like, scope of India's equalization levy is wider than scope of Article 12B with several overlaps which may create uncertainty on account of tax disputes due to categorization issues.

In matters of dispute resolution, the UN proposal relies on the Mutual Agreement Procedure (MAP) that forms a part of the UN Model Tax Treaty. Though the MAP system has been used by multinational companies for decades, there are certain limitations in the mechanism that is embedded in the model tax treaty. The UN has itself listed the MAP procedure under its Model Treaty as one of the costs commonly associated with tax treaties owing to how it poses challenges to the tax administrations' capacity to negotiate and administer tax treaties.[5] The drawbacks of the system were felt by nations as international tax disputes are increasing at a steady rate owing to a proliferation of cross border transactions thereby presenting a need to enhance these existing mechanisms. An example of such an effort was at the heart of Action 14 (Making Dispute Resolution More Effective) discussions of the OECD, that looked to enhance the existing mechanism through introduction of a 'minimum standard' to be followed by all nations. This seeks to promote good faith in implementation of treaty obligations under MAP, additional administrative processes that promote prevention of disputes along with allowing taxpayers to access the MAP process as per eligibility.[6] Further, the BEPS framework has also suggested a collaborative process, wherein members had agreed to a peer review process to evaluate these changes and to report these developments to the BEPS.[7] Though all these mechanisms sought to enhance bilateral methods, as more multilateral issues arise these solutions continue to fall short and promote further uncertainty in the system, clearly pointing towards a more multilateral mechanism. For example, the OECD Pillar One blueprints are indicative of steps being taken in the multilateral direction, by promoting certainty through new and innovative dispute resolution mechanisms

F. Multilateral vs Bilateral Arrangements: Why a multilateral approach will help solve the road-blocks in the arena of digital taxation?

Over the years countries have adopted different kinds of solutions to reduce or eliminate the issue of double taxation in cross border transactions. They range from unilateral to bilateral to multilateral. Around the time of the Second World War, the OECD picked up the onus of drafting model tax treaties (bilateral in nature)[8], they were then adopted by numerous nations leading to the world we know it as. However, the predominance or preference for bilateral treaties in the arena of tax has not ruled out the need or efficiency of multilateral agreements as businesses and the world evolve. With the advent of new business models, the gaps in existing bilateral arrangements are only widening and pre-existing differences are being exacerbated.

Pursuant to the inadequacy of the existing international tax rules which rely heavily on physical

5 UN Model Double Taxation Convention between Developed and Developing Countries 2017

6 BEPS Action 14 - Mutual Agreement Procedure

7 Alessandro Valente and Federico Vincenti, The importance of mutual agreement procedures in international tax disputes, InternationalTaxationalReview.com, March 2021

8 OECD, Draft Double Taxation Convention on Income and Capital (1963); OECD, Model Double Taxation Convention on Income and on Capital (1977) presence, countries have begun adopting unilateral tax measures such as eg: India's equalisation levy[9], EU Digital services Act[10], and other non-cooperative measures. Proliferation of unilateral tax measures have introduced uncertainty in taxation and may even prove to be a barrier for investment. These measures are also likely to pave the way for an increase in bilateral trade disputes and even extend to additional tariffs being employed on other goods and services as a consequence.

Since businesses across sectors are becoming increasingly digitized, the key question of how businesses should be taxed and how that tax be allocated among countries is one question for governments to answer together. Any fundamental changes to global international tax rules should be consensus-based to reduce tax disputes and conflicts.

Owing to the practical challenges and implementation of bilateral tax treaty negotiations (as discussed above), a multilateral solution could aid in avoiding long winding and cumbersome bilateral negotiations, thereby addressing the urgency of the present situation.

The commentary to the UN proposal also sheds light on the difficulty faced to arrive at consensus regarding key issues such as the recommended rate for taxation on a gross basis[11] and the base of taxation for net approach.[12] This reiterates how important aspects such as the base for taxation and percentage are likely to act as a hurdle during negotiation, as either contracting party will be approaching negotiations with their interests in mind. Owing to the variety of factors that affect the negotiation of such treaties, often developing nations may possess diminished bargaining power. Such a dilemma may contribute to the lack of uniformity in global taxation systems pertaining to digital services. Additionally, proposing a treaty provision approach only addresses situations wherein tax treaties are already in place. It fails to acknowledge the many developing nations that do not have wide tax treaty networks in place, thereby not providing much relief to such nations.

Most importantly, a multilateral consensus-based approach provides for consistency and uniformity in the international taxation rules and is essential to overcome tax challenges of digitalization. So long as multilateral solutions provide for sufficient safeguards to protect bilateral relations, sovereignty of nations and are targeted at specific issues they will prove to be more beneficial in the long run.

Multilateral solutions like WIPO, UNCLOS etc. have been considered a valuable tool in tackling global issues and challenges, and they have played a vital role in shaping global public order as it is today. The recent G20 conference in Rome also focused on the need for 'restored multilateralism' and saw nations stress on the importance of multilateral cooperation in a variety of sectors. Matters pertaining to international taxation were also considered at this year's conference, with members agreeing to host a "High Level Tax Symposium" in July 2021 to "*reform the current system to respond to the new challenges posed by globalization and the digitalization of the economy.*"[13] This is indicative of Governments' commitment to resolve the issues by working on a collaborative solution through consensus-based methods. Such a solution also proves to be more feasible considering it will contribute to uniformity of systems and agreement on common principles of taxation.

9 Sumit Jha, Profits from digital business: India against OECD formula for taxation, Financial Express, November 2019

10 Jefferson Vander Wolk, Is the EU Moving the Goalposts on Digital Services Taxes?, Bloombergtax.com, March 2021

11 Para 13, Commentary on UN Tax Proposal, https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2021-04/CITCM%2022%20CRP.1_Digitalization%206%20April%202021.pdf

12 Paragraph 13 & 41, Commentary on UN Tax Proposal, https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2021-04/CITCM%2022%20CRP.1_Digitalization%206%20April%202021.pdf

13 First G20 Finance Ministers and Central Bank Governors Meeting 26 February 2021, https://www.mef.gov.it/en/inevidenza/First-G20-Finance-Ministers-and-Central-Bank-Governors-Meeting-26-February-2021-00001/

III. Conclusion

After discussing the technical and policy aspects along with the implementational issues, it could be safely said that though Article 12B appears to be a simple and easily understandable solution, it triggers several challenges on the implementational and technical grounds.

The UN committee of experts has put in significant efforts to come up with this proposal and has provided alternatives for some of the concerns raised by the large minority members. Considering the views of large minority members, the Commentary recognizes that "*countries sharing the concerns can choose not to include Art. 12B*" which could further dilute the viability of such proposals.

Apart from the fact that it requires to be bilaterally negotiated and needs amendment in tax treaties, the suggested approach and method of taxation *inter-alia* may create challenges on account of administrability, dispute resolution, double or multiple taxation, and significant increase in compliance cost for the MNEs. Considering the fact that Article 12B ringfences specific business models, it does not cover the wider set of business models which benefit on account of increasing digitalization. Any global tax reform meant to accommodate the possibilities of the global digitized economy as a whole should be based on economic factors that could apply to unforeseen new business models and changes in the global supply chain of goods and services.

Offering a bilateral solution to a multilateral issue does not seem to benefit both countries as well as entities. Bilateral agreements would create non-uniform taxation practices resulting in additional compliance burdens for the subject entities. Further, negotiation between two countries could result in imbalances, where developing nations might be at a disadvantage.

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