OCTOBER 2020

TECHNICAL REVIEW OF THE DRAFT ARTICLE 12B UNITED NATIONS MODEL TAX CONVENTION

AFRICAN TAX ADMINISTRATION FORUM
FORUM SUR L'ADMINISTRATION FISCALE AFRICAINE

1. Introduction

In June 2020, the UN Committee of Experts on International Cooperation on Tax Matters ("UN Committee") released a proposal by one of its drafting groups for an additional provision (Article 12B) in the UN Model Tax Convention and accompanying Commentary to deal with certain aspects of the taxation of a digitalised economy. **This technical review is designed to assist ATAF members in their analysis of the draft Article 12B.**

Many ATAF members have reported difficulties in taxing highly digitalised businesses. Their economies are rapidly becoming more and more digitalised and that digitalisation often enables multinational enterprises (MNEs) to carry out business in African countries with no or very limited physical presence in those countries. This makes it difficult for African countries to establish taxing rights over the profits the MNE is making from those business activities.

This is due to the current international tax rules only allocating taxing rights to a country where a non-resident enterprise creates sufficient physical presence in that country i.e. creating a "nexus" in that country.

Business models that enable an MNE to carry out business in an African country with no or very limited physical presence in that country therefore represent a significant tax risk. The examples cited by commentators of such business models are usually those such as social media platforms, search engines and online marketplaces.

Whilst efforts continue to be made by the OECD Inclusive Framework to develop a consensus-based solution to address tax challenges arising from digitalisation, there is a significant risk for African countries in simply waiting to see whether the OECD Inclusive Framework can achieve an international solution.

This delay could cost African countries millions of dollars of tax and to help members who might wish to act now to address this potential risk, ATAF has developed a Suggested Approach to Drafting Digital Sales Taxation. The Suggested Approach will be available to members at the end of September 2020 when it is published on the ATAF website.

This technical analysis considers how the draft Article 12B might interact with the ATAF Suggested Approach.

2. Overview of the draft Article 12B provision

Broadly, the draft Article 12B provision would allow the source jurisdiction to tax income from the provision of automated digital services paid to a non-resident. The tax would be levied by the source jurisdiction on the gross revenue at a percentage which would need to be established during bilateral treaty negotiations between the source and residence jurisdictions. The Commentary to the draft provision envisages that the taxation would apply by way of a gross withholding tax.

Payments would be sourced to the state where the payer was resident, or to the state of any permanent establishment (PE) where that PE bears the payment. However the provision also permits the supplier of the service to elect to be taxed on net instead of gross basis where the qualified profit shall be 30% of the net profits. The provision is disapplied if the taxpayer has a PE in the source jurisdiction to which the income belongs; or if the income falls within Article 12A of the UN Model because it is a payment made in respect of fees for technical services.

It is important that members note Article 12B if approved by the UN Tax Committee would be a provision in the UN Model Tax Convention and if members wanted to adopt such a provision in their tax treaties this would require bilateral negotiations with relevant treaty partners to add the Article to the existing treaty or to any new treaties.

It is also important to note that a treaty cannot create a taxing right for a jurisdiction. That taxing right must be created through enactment of domestic legislation in the country. If ATAF members wish to create such a taxing right they will need to consider whether they wish to introduce a unilateral measure such as a Digital Services Tax in which case they may wish to use the ATAF Suggested Approach as a tool to assist in drafting such legislation.

If the Inclusive Framework does reach a global consensus based solution Inclusive Framework members may be required to cease applying unilateral measures such as DSTs to MNEs to which the Pillar One Amount A rules apply.

3. Scope of the draft Article 12B and the ATAF Suggested Approach

The Article 12B provision sources the income to the location of the payer. For example if an advertiser pays an advertising fee to a social media platform the country from which that advertising fee is paid would have taxing rights on that payment under Article 12B. The provision is therefore much narrower in scope as it would only allow the payer jurisdiction to tax the specific payment, in this case the advertising fees. Thus, where there are no payments made but the jurisdiction has a significant number of users who may be targeted by the advertising companies, taxing right are not allocated to such a country.

One of the main concerns of digitalisation of economy is to develop new profit allocation rules that would allocate taxing rights where value is created in the digital era. User participation and the network effects created by users are important value streams which need to be remunerated. The proposed Article 12B does not seem to capture this value stream.

The ATAF Suggested Approach enables a country to tax both the income of a non-resident derived directly or indirectly for digital services where the payer of that income is resident in the country and also revenue which may be attributed to a country as a result of user participation (e.g. viewing of online adverts). The Suggest Approach makes it clear that the digital services revenue is not only revenue received or arising directly or indirectly from that country but also other revenue that may be received or arose in another jurisdiction.

The Suggested Approach provides a very broad definition of the term “user” to ensure that the DST is broad in scope. This is necessary in order to ensure that businesses that generate revenue from the provision of digital services that are provided on a standardised basis to a large population of customers or users across multiple jurisdictions, typically using little or no local infrastructure are in scope of the DST.

ATAF members report that only a few payments are currently being made from their countries for digital services and therefore the revenue collection from such payments will be low. It is therefore vital that the country’s taxation rights include revenue that is directly and indirectly attributable to the country from user participation.

4. Taxation on a gross basis

Both the draft Article 12B and the ATAF Suggested Approach tax on a gross basis. As recognised in the Explanatory Notes to the ATAF Suggested Approach taxing on a gross basis carries the risk of over-taxation which may discourage investment into the country. For this reason, the ATAF Suggested Approach recommends that if a country introduces a DST it should be set at a low rate such as between 1% to 3% to reduce the risk of over-taxation.

The draft Article 12B states that a taxpayer can elect to pay tax at the country's domestic rate on its qualified profits, which is defined as 30% of its deemed profit, rather than being taxed on a gross basis. The deemed profit is defined as the local revenue multiplied by the business's profitability ratio. If the taxpayer has other business lines in addition to its ADS business, then the profitability ratio will be that of the ADS segment of its business. Where the business is part of a multinational enterprise (MNE) the profitability ratio will be that of the MNE or the ADS segment of the MNE's business.

The Commentary suggests that the MNE would apply the profitability percentage of its automated digital services segment, if available. This seems to indicate that an MNE will only be required to segment when the information needed for such segmentation is already available. If an MNE is required to segment, rules will be required on a number of issues such as the criteria for what qualifies as a valid ADS segment, whether MNEs are permitted to use disclosed segments that contain some degree of automated digital services revenue or if re-segmentation is required and how indirect costs should be allocated between segments.

The Commentary notes that the profitability calculations should be made based on the consolidated accounting statements of the ultimate parent entity. There are currently no rules set out on which accounting standards can be used and whether adjustments are required to address differences in accounting standards.

Profitability is to be calculated as total annual profits divided by the annual revenue from the consolidated financial statements. It appears that the Article applies to MNEs irrespective of the profitability level of the MNE. Rules are still to be developed on the calculation of losses and whether and for how long such losses can be carried forward.

The issue of relief from double taxation and whether for example it is the residence jurisdiction that must relieve any double taxation is not currently addressed in the Commentary.
Administering the net basis will require countries to access and verify information from other countries on issues such as the segmented profitability ratios which means countries will need an Exchange of Information (EOI) mechanism with such countries.

5. The application of the arm's length principle

The ATAF Suggested Approach taxes on a gross basis and does not require countries to apply the arm's length principle to compute the DST. In the case of the draft Article 12B the primary rule applies taxation on gross basis but where a taxpayer elects to use net basis, a formulaic approach is proposed. However, where the digital services income "belongs to" a PE, it appears Article 12B does not apply and the taxation of the income will need to be computed in accordance with the arm's length principle. This may present challenges for countries with limited transfer pricing capacity as the application of the arm's length principle in the context of highly digitalised business often presents extremely complex transfer pricing issues due to the prevalence of often unique and valuable intangibles which are difficult to value and can lead to lengthy disputes between tax administrations and taxpayers.