TAX CONSEQUENCES OF THE DIGITALISED ECONOMY

INPUT TO THE UNITED NATIONS COMMITTEE OF EXPERTS ON INTERNATIONAL COOPERATION IN TAX MATTERS

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This is an independent submission to the UN Committee of Experts on International Cooperation in Tax Matters (UNTC or Committee). The views expressed are solely those of the authors and do not necessarily reflect the views of any technical groups or institutions they might be affiliated with.

This submission explores how Article 12A, on fees for technical services, introduced in the 2017 version of the UN Model, could be employed as an interim measure to uniformize the application of unilateral digital services taxes (DSTs), and avoid double taxation while a coordinated agreement is not reached on the taxation of digital services.

Worthy of note is the fact that this note refers to an *interim* solution while a multilateral or coordinated approach is not reached. In line with the BEPS Monitoring Group's submission, we share the opinion that a long-term solution for the digital economy debate should be along the lines of establishing a significant digital presence, and amending article 5 to include a new digital services permanent establishment (PE) provision.

This note arose out of the need to establish an interim solution for the multiple DST proposals surfacing across the globe, and to reduce the legal uncertainty associated with the proliferation of unilateral uncoordinated approaches. As further denoted in this submission, this can be achieved by establishing a common tax rate and tax base denominator upon which all individual DSTs can base themselves on and avoid double taxation.

This submission will support that these objectives can be easily achieved through minor amendments to article 12A of the UN Model, or through the introduction of a specific ArticleX (or article 12B) covering digital services taxes.

Prior to exploring the policy considerations surrounding Article 12A, it is worth categorizing what activities could be subject to tax under an interim proposal to tax the most relevant activities taking place in highly digitalized markets.

1. The Digital Economy in scope: Which activities are we intending to tax?

Policymakers and academia have extensively debated what types of services should be included within the scope of a proposed tax on the digital economy. Whereas opinions diverge depending on whether one intends to capture the value generated by the digital services providers or by the users of the digital interface, one outcome that seems to be clear from the analysis of existing and proposed digital services taxes is that they all have as a common denominator the aim to tax profits from online advertisement, with some also focusing on e-commerce and other digital activities. However, online advertisement seems to be the core business model targeted in the debate among national policymakers.

This view is supported not only by the unilateral Digital Services Taxes (DSTs) currently being proposed across the globe (see in the respect Section 3 below), but also by the "Franco-German joint declaration

on the taxation of digital companies and minimum taxation"[1] (Joint Declaration). The Joint Declaration was issued by France and Germany, soon after the EU Council decided not to adopt the Directive Proposal on DSTs[2] and the Directive Proposal for the adoption of a concept of significant digital presence within the EU common market[3]. According to the Joint Declaration, the Franco-German view is that the draft directive for a digital services tax could be amended to be exclusively levied on a tax base referring to online advertisement. The taxation of other digital activities seem to be less of a priority.

The focus on online advertisement makes sense from a political perspective. The GAFA – *Google, Amazon, Facebook and Apple* – are often referred to as 'the Big Four' as a reference to their disruptive effect on the economy and culture. Two of the four GAFA tech companies make all of their profits from online advertisement (*i.e. Google* and *Facebook*). *Amazon* is well-known from operating an online market platform for the sale of goods, but the share of *Amazon*'s profits generated from its online advertisement activities has been growing significantly.

In other words, if the original purpose of digital economy debate was to come to a more fair allocation of tax revenues from the taxation of the big tech companies, it would be appropriate to focus – at least as an *interim* measure – on the online advertisement business.

2. **Online Advertisement**

This brief discusses online advertising by using the business model of *Google* (*Alphabet Inc.*), the market leader, as a template. The organogram used in this section is based on the business model described by google in the French *Google Ireland Ltd.* (1505178/1-1) case disputed in France. The case is currently without object because while pending before the Supreme Administrative Court on appeal by the tax authorities, *Google* agreed to settle the case in 2018. The facts of the case remain highly relevant to understand the business model of the online advertisement business.

At the core of Google's advertisement business is the company's proprietary advertising service, known as *Google Ads* (until 2018 known as *AdWords*). *Google Ads* advertisement integration touches almost all of *Google*'s web properties: any online ads that web users see on their screen when logged into *Gmail, YouTube, Google Maps* and other *Google* sites are instantly generated through the Google Ads platform. Besides display advertising on *Google*' proprietary display network, the *Google Ads* network also generates advertisements that pop up on third-party websites. The publishers of these websites serve as "affiliate marketers": they receive a commission from Google to have the latter show the appropriate advertisement on their website.

For an advertiser to gain the top spot in Google advertisements on keyword search-based advertising, he or she has to outbid other advertisers gunning for the same keyword searches. Higher bids move up the list, while lower bids may not even be displayed. The bidding takes place under the *Google Ads* real-time bidding protocol, which is a programmatic instantaneous auction selling *Google*'s ad inventory (i.e. its own proprietary websites and third-party websites) to the highest bidder for a certain keyword. Advertisers

[1] https://www.consilium.europa.eu/media/37276/fr-de-joint-declaration-on-the-taxation-of-digital-companies-final.pdf.

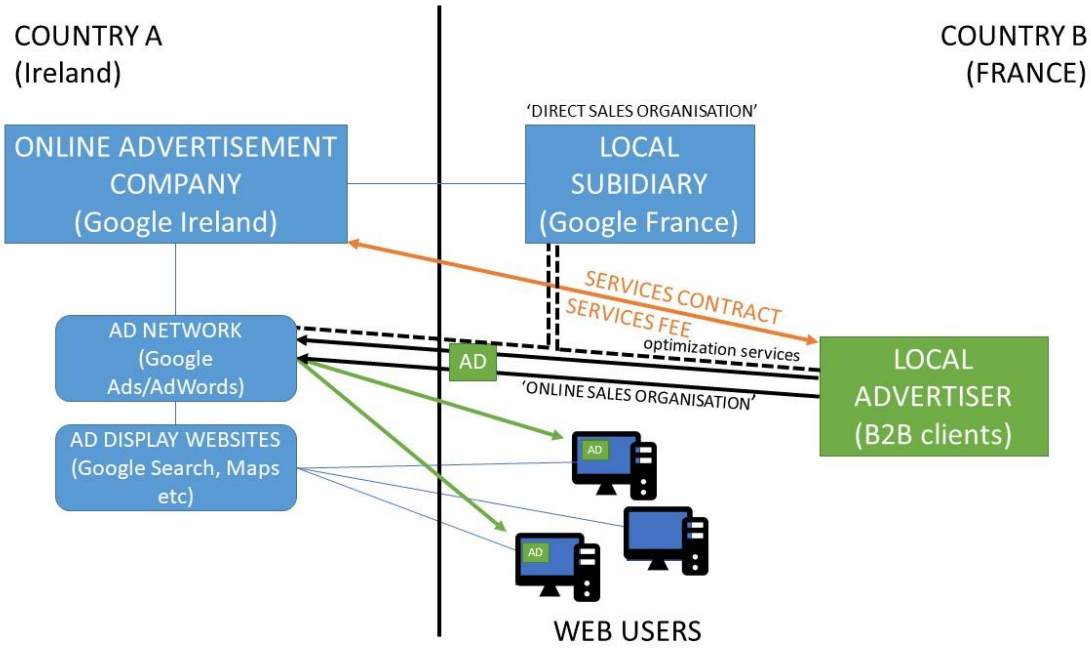
[2] European Commission, "Proposal for a COUNCIL DIRECTIVE on the common system of a digital services tax on revenues resulting from the provision of certain digital services" 2018/0073 (CNS), 21.3.2018

[3] European Commission, "Proposal for a COUNCIL DIRECTIVE laying down rules relating to the corporate taxation of a significant digital presence" 2018/0072 (CNS), 21.3.2018.

pay only when a web user actually clicks on their ad ("cost-per-click") or they pay by the number of times the ad is viewably shown ("cost-per-thousand viewable impressions" (CPM)).

For a company to undertake a successful and efficient online advertisement campaign, the key is to make ads appear on the screens of the right people at the right time. *Google*'s *Google Ads* platform offers multiple parameters to target ads on the *Google Search* or the Google Display Network. Audience targeting focuses on qualities of the audience, like demographic qualities or user interests, search and purchase histories. Content targeting focuses on the quality of the ad itself. Ads can, for instance, be linked to certain content topics or content keywords.

Given the complexity of advertisement campaign optimization via the *Google Ads* programme and the size of the budgets required to generate efficient online exposure, *Google* offers its advertisement service in two modes. In the facts of the French *Google* case, the two modes of *Google*'s operation is described as the 'direct sales organization' (DSO), which is geared towards large budget advertisers and which involves active involvement of *Google* staff to consult the advertiser on how to optimize their advertisement campaigns. The staff employed by a *Google* subsidiary located in the vicinity of the advertiser. The second mode is the online sales organization (OSO), which is geared toward small budget advertisement and which typically functions online, from a distance, and with little involvement of Google staff. The only service offered is the technical service of operating the *Google Ads* programme and showing online ads based on the input given by the advertiser.



Within Europe, the right to operate *Google Ads* was until recently held by *Google Ireland*. Advertisement customers signed contracts with *Google Ireland* and paid all of their fees for *Google*'s services to *Google Ireland.* To operate its 'direct sales organization' mode, *Google* has set up local subsidiaries which employ staff to assist clients in optimizing their *Google Ads* campaigns. The terms of the services provided by the local subsidiaries to *Google Ireland* on the basis of "marketing and services agreement" (MSA). The MSA

provides for a remuneration of these services at a 8% cost-plus basis, which appears to be industry standard.

The *Google France* case focused on the activities performed by the French *Google* staff under the direct sales organization. The tax authorities did not challenge the transfer pricing arrangement. Instead, they contended that the staff of *Google France* formed an agency permanent establishment (PE) of *Google Ireland* to the extent that they signed contracts with advertisers in the name and on behalf of *Google Ireland*. A part of *Google Ireland* profits thus had to be attributed to the agency PE in France. Both the administrative court of first instance and the administrative court of appeal rightly rejected the tax authorities' claim. It is highly unlikely that even under an extended concept of agency PE under the OECD Model (2017) or article 12 the MLI (which has not been opted-out of by Ireland), the courts would confirm the existence of an agency PE.[4]

The crux of the matter lays elsewhere. First of all, there is the question of the remuneration of the local 'consultancy services' provided by the local *Google* subsidiary employees. In light of the value chain of the online advertisement industry, it is believed that the 8% cost-plus remuneration is too low.[5] Secondly, there is a lack of a taxing right in the countries where the advertisers are located. Resolving these two issues are the core objectives of the OECD Pillar 1 proposals.

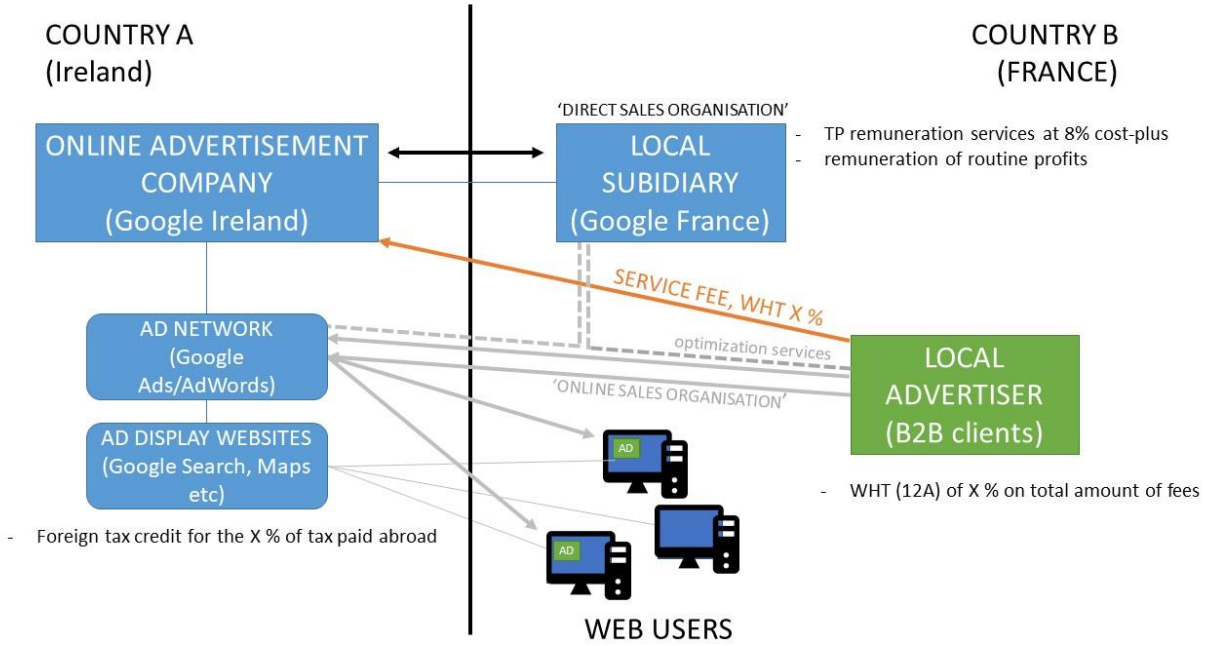
Employing the Article 12A dynamics to the existing proposal for a unified approach put forward by the OECD, one would have it that the routine profits would remain with the residence State. The proceeds of the withholding tax under Article 12A would stand for a non-residual amount, that is, the profits generated for the services occurring in the market economy. Finally, under a treaty context, assuming countries insert the Article 12A type provision into their bilateral tax treaties, amount C would stand for the credit (or exemption) granted in the residence state for the tax that was already levied in the market economy, thus reducing the scope for disputes under Article 23 (MAP).

For the purpose of the *interim* measure we propose, it is however important to focus on the following conclusions drawn from the above description of *Google*'s online advertisement model, which we believe reflects the operations of all players in the online advertisement market.

First of all, the online advertisement business is a B2B business. *Google* might have millions of individuals using their products, but these individuals are not customers. The customers are enterprises. These enterprises pay for online advertisement services and their expenses are set off against taxable profits in their state residence.

[4] For more on the *Google France* case, *see*: B. Michel, The French Crusade to Tax the Online Advertisement Business: Reflections on the French Google Case and the Newly Introduced Digital Services Tax, 59 Eur. Taxn. 11 (2019), Journal Articles & Papers IBFD.

[5] For a description of the value chain of online advertisement, *see* B. Michel, The French Crusade to Tax the Online Advertisement Business: Reflections on the French Google Case and the Newly Introduced Digital Services Tax, 59 Eur. Taxn. 11 (2019), Journal Articles & Papers IBFD.



Secondly, *Google* offers an advertisement placement service – which differs from the selling of a product, like advertisement space in a local newspaper. The service goes beyond the mere 'selling of access to a database'. The service has a technical component, which is *Google*'s operation of its *Google Ads* programme, which effectively makes advertisements pop up on the right user displays. Part of the services under the 'direct sales organization' mode have the quality of consultancy services: *Google* employees' advice on how to maximize the use of the *Google* technology.

Thirdly, in *Google'*s business model, it is assumed that big advertisers operate in the proximity of their prospective clients, which are the local *Google* product users. *Google France* deals with *Google's* biggest advertisement clients in France, because the local French employees have the most knowledge about the local French market. If a multinational would aim to advertise in Germany, it is highly probable that German clients would be tasked to sign a contract with *Google Germany* for the purpose of advertising in Germany. In other words, the location of the hirer of online advertisement services is a suitable proxy for the location of the users that are targeted by the advertisement.

3. Unilateral Digital Services Taxes

In the last three years, individual countries have started to adopt digital services taxes (DSTs) as an *interim* measure or as a provisional measure serving as a 'big stick' policy.

As further demonstrated in the table below, the proposed tax base (services covered) and tax rates employed by the countries currently employing or proposing a unilateral DSTs differ substantially. This contributes to an environment of legal uncertainty to the extent it increases the potential for double taxation.

	Tax rate	Scope	Threshold Global	Threshold Domestic	Status
Austria	5%	Online advertising	€750 million	€25 million	In force since January 2020
France	3%	Digital interface; online advertising; sale of user data	€750 million	€25 million	In force since January 2019 but suspended until December 2020
Hungary	7.5%	Online advertising	HUF 100 mil (€300,000)	N/A	In force, but zero rated until 2022
India	6% 2%	▪ Online advertising; e-commerce	Annual payments over Rs 2 cr (€250,000)	N/A	In force since 2016, amended in 2020
Italy	3%	Online advertising; digital interface; user data	€750 million	€25 million	In force since January 2020
Malaysia	6%	Online advertising; e-commerce	N/A	RM 500,000 (€106,000)	In force since 1 January 2020
Spain	3%	Online advertising; sale of user data	€750 million	€3 million	In force but first payment not due until end of 2020.
Turkey	7.5%	Online advertising; e-commerce	€750 million	TRY 20 million (€3.1 million)	In force since March 2020
United Kingdom	2%	Search engines; social media	£500 million (€554 mil)	£25 million (€28 million)	In force since April 2020

		platforms; online marketplaces			

A closer look at the table seems to denote that the unifying tax base amongst all countries is online advertising services. Countries will give online advertising more or less prominence, depending on the legal framework from which they derive, with some even using the "online advertising" activity as a criteria to define the larger category of digital services activity, as further demonstrated by the United Kingdom's legislation summarized in the table below.

France	**United Kingdom**
➢ The provision of a digital interface enabling users to enter into contacts and to interact with others ("intermediary services"). ➢ The provision of services to advertisers that aim at placing targeted advertising messages on a digital interface based on data collected about users and generated upon the consultation of such interface. <u>Included:</u> The purchase and storage of advertising messages, advertising monitoring, and performance, measurement, as well as the management and transmission of user data <u>Excluded:</u> the supply of digital content, communication services, and qualifying payment services	➢ *Digital services activity" means providing—* - *(a) a social media service*, - i.e. an online service that promotes interaction between users or makes content generated by users available to other users - *(b) an internet search engine, or* - no definition, but does not include a facility on a website that merely enables a person to search material - *(c) an online marketplace.* - i.e. the main purpose to facilitate the sale by users of particular things for sale - *The provision of a "digital service activity" includes carrying on an associated online advertising service* ➢ <u>Excluded:</u> online financial market places

Shifting attention to the application of DSTs by two non-OECD Member countries, we see the employment of the tax towards an even larger array of services fitting into the online advertisement and e-commerce categories.

Turkey	**India**
➢ Digital advertising services—including advertising control and performance measurement services, data transmission and management related to users, and	➢ Equalization levy of 6% on non-resident providers since 2016: ➢ "specified service" means online advertisement, any provision for digital advertising space or any other facility or

technical services for the presentation of advertising ➢ Sales of any audible, visual or digital content—including computer programs, applications, music, video, games etc., via a digital platform as well as services provided for listening, watching, playing or recording or using such content by use of electronic devices ➢ Services for the provision and operation of a digital platform by which users may interact with each other—including services to sell or facilitate the sale of a good or service among these users ➢ Intermediary services provided by a digital platform to "the digital service providers"	service for the purpose of online advertisement and includes any other service as may be notified by the Central Government in this behalf; ➢ Equalization levy of 2% since 1 April 2020 on a non-resident who: ➢ owns, operates or manages a digital or electronic facility or platform makes an online sale of goods owned by it, or provides services, or facilitates online sale of goods or provision of services to local users. ➢ Does not apply if provider has local PE, or is subject to 6% levy

Based on the evidence presented above, it is our understanding that the UN Model's provision on fees for technical services can be employed to serve as catalysator to harmonize DSTs. The adoption of a withholding tax on fees for technical services has been referred to by the OECD as a valid unilateral measure against base erosion in the face of the digitalisation of the economy.[6]

The need to include a provision in the Models and in the tax treaties is first and foremost based on the assumption that DSTs generally violate tax treaties modelled to the OECD Model, and more specifically article 7. That's because the French DST tax levied on fees paid by French advertisers to *Google Ireland* for its offshore provision of advertisement services through its 'online sales organization', violates article 7 of the OECD Model/UN Model, to the extent that *Google Ireland* does not dispose of a PE in France to which the profits from the services can be attributed.

The DST would be compatible with the Treaty, if it contained a provision modelled to 12A of the UN Model (2017) (or 12A in a modulated version to apply to online advertisement services fees). Note that only online advertisement services are suitable to fall within the scope of 12A. Other digital economy activities included in the various national DSTs, like online market platforms, e-commerce activities, provision of social media platforms or search engines, would be unfit to be characterized as 'technical services' under 12A, because they don't fall within the definition of 'technical services' or because they are provided on a B2C context , and paid for by an individual for services for personal use, thus excluding them from 12A. (*see* 12A(3)(c). As said, online advertisement services are never hired for personal use of an individual. Article 12A could therefore pose as a harmonizing agent to standardize the assessment of DSTs.

4. Applying Article 12A of the UN Model to online advertisement services

[6] OECD/G20 Base Erosion and Profit Shifting Project, *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS* (Paris: OECD Publishing, 2018), available at: *http://dx.doi.org/10.1787/9789264293083-en* [Accessed 27 September 2018], para.355.

Article 12A of the UN Model allows a Contracting State to tax fees for specified technical services paid to a resident of the other Contracting State on a gross basis at a rate negotiated by the Contracting States.[7] Article 12A(3) provides that fees for technical services are defined to mean payments for services "of a managerial, technical or consultancy nature".[8] The UN Commentaries on Article 12A denote that, given the ordinary meaning of the terms managerial, technical and consultancy, the fundamental concept underlying the definition is that the services must involve the application by the service provider of "specialized knowledge, skill and expertise" for the benefit of a client,[9] other than a transfer of information covered by the royalties Article or a professional service referred to in Article 14(2).

According to the Commentaries, the "ordinary meaning of the term 'technical' involves the application of specialized knowledge, skill or expertise with respect to a particular art, science, profession or occupation. Furthermore, the usual meaning of the term "'consultancy' involves the provision of advice or services of a specialized nature".[10]

Likewise, "the ordinary meaning of the term 'management' involves the application of knowledge, skill or expertise in the control or administration of the conduct of a commercial enterprise or organization".[11]

The definition of "fees for technical services" provided in Article 12A(3) is believed to be exhaustive, and does not allow reference to the domestic law of a Contracting State, among other things, in order to reduce uncertainty in the interpretation of the Article.

As a result, online advertisement services would fall within the current definition of fees for technical services in article 12A. As demonstrated in the google example, online advertisement services are 'technical services' that require specialized knowledge, skill or expertise. For certain aspects of this service, it is simply impossible to substitute the market leaders in the industry for other providers, as none would have the knowledge and expertise. The fact that the provision of these services is to a large extent automated does not detract from the fact that it involves specialized knowledge and expertise. To the extent that these services entail employees of the online service provider to tailor and optimize the automated service, the provision of online advertisement services consists of both a 'technical services' component and a 'consultancy services' component.

To implement this understanding of online advertisement services as being covered under the current wording of article 12A, it would suffice for the Commentaries on 12A to be extended , adding a number of explanatory paragraphs to solidify the interpretation.

Should the opposing view prevail that online advertisement services cannot be deemed covered under 12A without changing the wording of the article, it should be noted that the Commentaries on Article 12A currently propose both a narrower and a broader application of this Article. The broad application of the article involves extending the material scope of Article 12A to all fees for services (technical and other services) provided in a Contracting State, and outside that state to a person closely related to the payer

[7] For more information on this topic, see: T. Falcão, "The U.N. Model's New Fees for Technical Services Provision" (23 July 2018) 91(4) *Tax Notes International* 367; and . T. Falcão and B. Michel, "Scope and Interpretation of Article 12A: Assessing the Impact of the new fees for Technical Services Article" *British Tax Review*, [2018] BTR, No.4, 336-354, October 2018.
[8] UN Model, above fn.1, Art.12A para.3.
[9] UN Model, above fn.1, Commentary on Article 12A, para.65.
[10] UN Model, above fn.1, Commentary on Article 12A, para.66.
[11] UN Model, above fn.1, Commentary on Article 12A, para.63.

of the fees.[12] This approach is recommended for those countries concerned with the definition of fees for technical services. By removing the word "technical", source taxing rights would apply to all fees derived by a source state, for services.[13] Under this option, the conceptual approach embodied by the different elements of the definition in Article 12A(2) is of little relevance. This approach has, to some extent, been adopted by Ghana in a number of its recent treaties.[14]

The Protocol of 21 July 2017 to the Argentina–Brazil Tax Treaty (1980), which entered into force on 29 July 2018 also contains an entry referring to technological services. The Protocol provides that technical services also include "services…resulting from automated structures with clear technological content".[15] Arguably, this covers most digital services. In any case, under the wide approach, online advertisement services would in any case be covered under 12A, along with other digital services to the extent that they are not provided to individuals.

Based on the above, it is clear that digital services such as those employed in an online advertising context could fall withing the scope 12A, either as (i) pure technical services, (ii) technical and consultancy services, when human interaction is involved, or (iii) as general services in the wide sense of an expanded definition. It seems thus to be advisable to amend either (i) the language of article 12A to make direct reference to digital services' or (ii) leave the main text of Article 12A as it is, and amend the commentaries to explore how the article might be employed towards digital services. These options will be further explored under the policy considerations below.

It should be noted that article 12A does not necessarily need to set a threshold regarding domestic and global turnover, or to set a fixed withholding tax rate. These are considerations to be addressed by the individual jurisdictions. Article 12A should allocate the taxing rights on fees for online advertisement services. States can unilaterally or bilaterally decide how to further restrict the exercise of this right.

5. **Compatibility between an interim Article on digital services and a digital services PE**

The Article on fees for technical services has the effect of allowing a source state to tax such fees, even when the service provider does not have a substantial presence in the country by surpassing the PE or the fixed base threshold of Articles 5 (including the "service PE" of Article 5(3)(b)), 7 or 14. This is the main distinguishing feature when comparing Article 12A to Article 5(3)(b), Article 7 and Article 14, because, even if the fees for technical services are also for consultancy or independent personal services, Article 12A will confer on the source state the right to apply a tax until the minimum threshold to define presence in the source state under Articles 5(3)(b), 14 or 7 is met. If said threshold is met, article 12A(4) provides that article 7 or 14 applies instead of 12A.

[12] Except for the services excluded in Article 12A para.3(a)–(c).
[13] See UN Model, above fn.1, Commentary on Article 12A, para.26 for the language of the alternative Article provision.
[14] See, for instance, Singapore-Ghana Treaty (2017, not yet in force), above fn.24, Art.13 on "service fees", and Convention Between The Swiss Confederation And The Republic Of Ghana For The Avoidance Of Double Taxation With Respect To Taxes On Income, On Capital And On Capital Gains, signed on 23 July 2008 (Ghana–Switzerland Treaty (2008)) Art.12 "services fees and royalties". In both treaties, the term "technical" is omitted in the relevant Article yet the services caught by the Article are still defined as "services of a 'managerial, technical or consultancy nature'".
[15] See, Argentina–Brazil (1980), Protocol (2017), above fn.63, para.7(b).

Since the taxation of fees for certain technical services is a tax withheld on a gross basis, from a policy perspective, the introduction of Article 12A in a bilateral treaty context provides an incentive for the enterprise engaged in recurrent business in a source state to incorporate or to take on a PE status in order to qualify for net income taxation with respect to the technical services provided in or to that state.

Consequently, the application of Article 12A or an Article 12A type article, would be compatible with further work employed around the concept of a significant digital presence in the source state, or of a digital PE.

6. Policy options to consider in taking this proposal forward

Were there to be agreement amongst the members of the Subcommittee on tax consequences of the Digitalized Economy to include digital services taxes within the array of technical services covered under Article 12A, the following policy options ought to be considered regarding scope, and method of implementation

Scope

Identify what services or activities ought to be included within the concept of digital services. For simplifications purposes, and considering the approaches employed to date, it would be recommended to restrict to online advertising services

Method of Implementation

The method of implementation will differ depending on whether the members chose to (i) amend article 12A (and article 2) to explicitly include matching DSTs within its scope; or (ii) create a new article to deal with DSTs specifically.

(i) Amending Article 12A

Although there are arguments to support that DSTs are already currently included within the scope of technical services, it would be advisable to make amendments to the article to explicitly reference that.

(i) Amendments could occur in one of three ways:

1. Amending the main text of Article 12A and the commentaries to deal with the specificities of the rule; or
2. Amend only the text of the commentaries to explain how digital services as understood under the UN Model are qualified as technical services; or
3. Suggest an alternative clause in the commentaries (much to the example of the general services clause) that would specifically mention and qualify digital services.

(ii) Formulate a new article to specifically deal with DSTs

Although a new article might provide a clearer policy approach to the handling of unilateral DSTs, it might not be feasible, given the impending end of the mandate of the current members of the UN Tax Committee, to have the text of a new article and accompanying commentaries approved by April 2021. The delay in getting such a text through will result in further proliferation of unilateral approaches, and increase the potential for double taxation.

Relief from Double Taxation

(i) Option for amendment of Article 12A

Article 12A works like the other specific articles (10, 11 and 12) in the UN Model. Therefore, a credit/exemption is due at the residence State. Article 23 A and 23B of the UN Model explicitly mention Article 12A, therefore no further amendments would need to be employed in the Model.

(ii) Option for a new ArticleX

Amendments to Article 23 would be required in order to avoid double taxation