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Taxation issues related to the digitalized and globalized economy

Co-Coordinators' Report

Summary

This paper is *for information and discussion* and addresses the work of the Subcommittee on Taxation Issues Related to the Digitalized and Globalized Economy in relation to the workstreams agreed at the Twenty-fourth Session of the Committee being:

- ***Workstream* A** - considering options for a more multilateralized form of implementing Article 12B of the UN Model Tax Convention (Automated Digital Services) and perhaps also a limited number of other optional provisions (such as Article 12A of the UN Model, or a Subject to Tax Rule) as may be potentially relevant to taxing the digitalized and globalized economy; and
- ***Workstream B*** – considering the function and relevance or otherwise of physical presence tests (such as under "permanent establishment" rules) in the context of an increasingly digitalized and globalized economy.

Both workstreams will develop options for consideration by the Committee designed to provide guidance that will particularly, but not exclusively, assist developing countries in this area. The focus has been particularly in scoping and commencing substantive work on Workstream A at this stage.

The Subcommittee ***seeks the Committee's comments and guidance on the issues raised in this note, including the annexed input notes****:*

a. *from Mr. Philip Baker on a possible UN multilateralised instrument relevant to Workstream A (Annex A);*
b. *from Mr. Aart Roelofsen on physical presence, relevant to Workstream B (Annex B); and*
c. *from Ms. Liselott Kana (based on discussions with Mr. Brian Arnold, on A General Outline of a Review of the Taxation of Cross-Border Transactions involving Digital Goods and Services*

Background and Subcommittee Mandate

1. At the Twenty-third Session of the Committee in October 2021, the secretariat provided a paper on taxation in a digitalized and globalized economy (E/C.18/2021/CRP.28). That paper provided an outline of the work of the previous Subcommittee on Tax Challenges Related to the Digitalization of the Economy, including with regard to Article 12B on automated digital services and its Commentary, which now form part of the 2021 United Nations Model Tax Convention.

2. As noted in the Report of the Twenty-third Session, after some discussion the Committee established a Subcommittee on Taxation Issues Related to the Digitalized and Globalized Economy, with Mathew Gbonjubola and Liselott Kana as Co-Coordinators. The mandate is as follows:

The Subcommittee is mandated:

- To identify priority taxation issues related to the digitalized and globalized economy where the Committee may most usefully assist developing countries in differing situations, in particular;
- To initially report to the Committee on such issues no later than its Twenty-fourth Session, in 2022, with recommendations for consideration and a proposed general programme of work.

The Subcommittee may consult broadly, taking into account relevant work by other bodies.

First Meeting of the Subcommittee

3. Fifteen Members of the UN Tax Committee are participating in the Subcommittee, and the **first meeting of the Subcommittee** so constituted was conducted virtually on 10-11 March 2022 to consider its composition and workplan. Not every Subcommittee participant agreed with every aspect of the approaches agreed in this and other meetings of the Subcommittee, and recognizing diverse views will be an important part of the Subcommittee work going forward.

Composition of the Subcommittee

4. As noted above, fifteen Committee Members participate in the Subcommittee. In view of the size of that participation and the diversity of backgrounds and perspectives involved, the Subcommittee decided that the regular participation of the Subcommittee should remain as it is currently, comprised of Committee Members only. The specialist expertise that exists among other participants in the UN Tax Committee work, including observers from countries, business and their advisers, academics and civil society, and the value of their perspectives, was readily acknowledged, however, and it was also agreed that a focused outreach to such experts would be an important part of the Subcommittee work.

5. There are many possible ways in which this balance can be best achieved, including ad hoc participation of non-Committee Member experts in Subcommittee meetings, calls for written inputs and specific dialogue meetings with experts. In further refining its "outreach" strategy, which may vary across subject matters and at various stages of its work, the Subcommittee would welcome the views of Committee Members and Observers at the Twenty-fifth Session on modes of engagement.

6. The Subcommittee **met virtually for a second time on 22 June 2022** to address issues and possibilities for a fast-track instrument (FTI) under Workstream A, and how to approach the issues of Workstream B (physical presence). At a **third meeting on 30-31 August 2022**, the Subcommittee considered these issues further, taking into account issues and options raised by Subcommittee experts and in Secretariat and Co-Coordinator Liselott Kana's initial discussions with some outside experts, Mr. Brian Arnold and Mr. Philip Baker. The focus for the FTI was seen as providing an option for countries that, for whatever reason, might not take up other multilateralized options. It was agreed that this did not entail a comment on such other options as might be available at any particular point in time. It was also recognized that while consideration would be given to which UN Model Tax Convention provisions might be prime candidates for adoption in a FTI, the inclusion in the Model, often with perceived pros and cons addressed in the Commentary, meant that those substantive issues should not be re-opened as part of the FTI workstream. On the other hand, compatibility issues raised by different formulations of treaty provisions, and how they could be addressed with the least complexity, would need to be considered.

7. The Secretariat has indicated to the Subcommittee that the work of the Committee, as an expert group, would be to propose an FTI mechanism, with, it would be expected, a proposed draft text and commentary. It would be for country representatives in another UN forum to formally adopt a text for the ultimate FTI as an international law instrument, and the Secretariat would act as depositary. In the Secretariat's view, there are suitable analogies in other UN instruments for such an approach and a successful outcome, even if it was a new experience for the Committee.

8. The physical presence workstream was discussed, with the benefit of the input notes at Annexes B and C of this paper and it was evident that there were significant differences about the potential justifications for keeping or reducing/ discarding physical presence threshold tests for taxation by the state where the service is supplied. While there was a call to agree an underlying principle at the start of this workstream, the difficulty in identifying such a principle was recognized. The Subcommittee considered that while further consideration would be given to those issues, the more immediate focus should be on commencing the FTI workstream in earnest.

9. The Subcommittee **met for a third time, again virtually, on 28 September 2022**. At that meeting the Subcommittee had the benefit of an input paper by Mr. Philip Baker, an earlier version of the note at Annex A to this Report. The object of the paper and the intent of the discussion on it, which Mr. Baker and Mr. Brian Arnold were invited to participate in, was to commence the discussion on key issues without limiting discussion on relevant points or pre-empting Subcommittee considerations or conclusions. It is in the same spirit, and with the same caveats, that the Subcommittee decided to attach an updated version of Mr. Baker's paper to this report. ***Neither it, nor the other Annexed notes, should be read as in any way limiting Subcommittee consideration or representing Subcommittee conclusions.***

Issues for consideration.

10. Recognizing the Subcommittee Mandate, the Committee-agreed workstream and the discussions so far, issues where Committee comment would be particularly relevant on issues such as the following:

- What type of instrument should be proposed – including what sort of flexibility should be retained to add new provisions over time?
- How to bear in mind the need for an FTI likely to find sufficient favor in practice (in terms of state adherence to the final instrument), while recognizing that success for an FTI would not require all, or even a majority of, UN Member states to adhere to the instrument, and that the Subcommittee and Committee should not reopen issues previously addressed in the Model, such as perceived pros and cons of some provisions;
- The possible value, or otherwise, of a covering agreement plus protocols model for an FTI to countries in formulating bilateral protocols before the FTI comes into effect or in dealing with existing treaty partners not party to it;
- How to best achieve a balance of optionality, workable provisions to address compatibility issues and the need to limit complexity and reduce the need for bilateral discussions;
- Likely provisions that could be the initial focus for inclusion in the FTI. Possibilities mentioned in the Co-Coordinators' report to the last Session include Article 12B on Automated Digital Services, Article 12A on Fees for Technical Services; and the proposed UN Model Subject to Tax Rule.
- Other possible provisions mentioned in Subcommittee discussions have included:
    - Paragraphs 6 and 7 of Article 13 (Capital gains) added to the 2021 UN Model relating to taxation of gains on the direct transfer of some types of property that are inextricably linked to their territory as well as gains on so-called "offshore indirect transfers";
    - The removal of the words "(for the same or a connected project)" in subparagraph

(3)(b) of Article 5 (Permanent establishment) as in the 2017 version of the UN Model; and

- The UN Model optional arbitration provisions –as an option for like-minded states to adopt, whether or not in the context of other agreed mutual changes.

Relationship to the Sustainable Development Goals

11. As noted in the Report of the Committee's Twenty-third Session, held in October 2021, the Committee agreed:

(a) To continue to discuss taxation and the Sustainable Development Goals regularly during sessions, as a permanent agenda item;

(b) To request the secretariat to provide regular updates on taxation and the Sustainable Development Goals, at each session:

(i) To preserve the focus of the Committee's work in the area;

(ii) To identify any gaps in guidance;

(iii) To establish priorities for technical work to be carried out by the secretariat; and

(c) To have subcommittees reflect on the link between their work and the Goals.

12. In addressing paragraph (c) of that conclusion, the Subcommittee recognizes that by promoting fair and effective tax systems, which support both revenue and trade and investment for development, through guidance products and through advising UN DESA on capacity building activities, the Committee's work contributes to achieving the interlinked SDGs as a totality.

13. More specifically in relation to the work of the Subcommittee, an effective guidance effort in this area will promote the balance of revenue needs and the development focused investment climate which many countries seek, by promoting whole-of-government, informed and practical real-world approaches to the issues involved. This builds greater certainty for all stakeholders in tax systems.

14. While contributing to achieving all the interlinked SDGs, this work will particularly contribute to SDG 16 (Peace, Justice and Strong Institutions) in terms of helping develop effective, accountable and transparent institutions at all levels and SDG 17 (Global Partnerships for the Goals), in terms of strengthening domestic resource mobilization, including through international support to developing countries, to improve domestic capacity for tax and other revenue collection.

Next Steps.

15. The Subcommittee intends to continue work on Workstreams A and B after this Twenty-fifth Session of the Committee. It intends to focus particularly (but not exclusively) at this stage on Workstream A, and will report back on the progress at the Twenty-sixth Session.

16. The Subcommittee seeks *the Committee's comments and guidance on the issues raised in this Report, including the Annexed notes*.

ANNEX A: Some initial thoughts on a UN MLI

Input Note by Philip Baker KC

Introduction

1. This input statement contains some initial thoughts on a Fast Track Instrument ("FTI") to implement changes to bilateral double taxation conventions ("DTCs") through a UN Multilateral Instrument (a "UN MLI"). The purpose of this statement is to promote discussion and not to present in any sense a concluded position.

2. A Multilateral Instrument (an "MLI") is, for the purposes of this note, a treaty-level instrument which overlays existing bilateral tax treaties to modify or amend them in a process that speeds up the normal process of often-lengthy, bilateral negotiations to update such provisions. It differs from a comprehensive convention to create a new multilateral treaty (called here a "multilateral convention") in that it only modifies existing tax treaty networks. This creates a limitation on what an MLI can achieve, but the different ambition may make it more readily achievable than a comprehensive multilateral tax convention. (An MLI differs from the UN and OECD Model Tax Conventions in that it is a multilateral, treaty-level instrument, rather than just proposed provisions and commentary that can be drawn upon in bilateral treaty negotiations.)

3. The purpose of a UN MLI would be primarily to implement changes in bilateral DTCs[1] to reflect changes to the UN Model, in a streamlined fashion – i.e. through an FTI. The recent changes to the UN Model that might be considered for this approach include: the insertion of Article 12A; the insertion of Article 12B; the modification of the capital gains provision to cover offshore indirect transfers (Article 13, paras. (6) and (7)). In the future the procedure established by the UN MLI might be used to modify existing DTCs to include, for example, a subject to tax rule ("STTR") or an optional arbitration provision.

4. This note does not discuss which of these recent changes to the UN Model should be given priority (and obviously does not discuss the merits or points specific to any of these proposals). The purpose of this note is to consider an approach through a UN MLI to streamline the process of amendment of the relevant bilateral treaties for those states that agree to make the specific change.

5. Ideally, the process that is established should be capable of repeated uses, so that it can also be employed in the future to insert new provisions or modify existing provisions to reflect future changes to the UN Model. The process should be as simple as possible (consistent with the subject matter of the specific change); it should fit well with the ratification processes adopted by different countries; it should fit well with different legal systems and different official languages. It should take account, in particular, of the interests of developing countries.

Previous examples of MLIs, and lessons that may be drawn

6. There are two examples of an MLI and a multilateral convention which may provide some useful lessons in drafting a UN MLI.

[1] And possibly a small number of regional, multilateral DTCs – e.g. those involving Caricom countries. These regional DTCs are not discussed separately here. They may require a specific provision dealing with them as a modification made by an MLI may come into effect with regard to some parties to the regional, multilateral instrument, but not others.

7. The first example is the Convention on Mutual Administrative Assistance in Tax Matters, (the "CMAA") which was originally drafted by the OECD and the Council of Europe working together and was opened for signature in 1988. That is a stand-alone multilateral convention, dealing only with issues of mutual administrative assistance, and is not tied to any pre-existing DTCs. It does, to an extent, provide a model for a single-issue, multilateral convention which sits outside the normal network of bilateral DTCs. Given that the primary purpose of a UN MLI would be to streamline the amendment/modification of large numbers of existing bilateral DTCs, the CMAA does not provide a great deal of guidance relative to the form of FTI discussed in this note. Nevertheless, a short annex to this paper discusses the possibilities of a stand-alone multilateral convention for certain purposes.

8. The second, recent example is much closer to the purpose of an FTI, and that is the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the "BEPS MLI") which was produced by the OECD BEPS Inclusive Framework in 2016. The purpose of the BEPS MLI was, of course, primarily to modify a large number of existing bilateral DTCs to reflect the outcomes of the BEPS Project; it also contains detailed provisions for mandatory binding arbitration which a smaller group of like-minded countries have adopted. The first of these purposes was more extensive than the current proposal for a UN MLI, insofar as the aim was to implement a number of outcomes from the BEPS Project at the same time. There are several potential lessons to be learned from the BEPS MLI.

Potential lessons from the BEPS MLI

9. One should not lose sight of the fact that one of the most positive outcomes of the BEPS MLI was that it preserved the fundamentally bilateral nature of DTCs, allowing pairs of countries[2] to decide exactly which of the modifications (other than the minimum standards) they wanted to adopt, and allowing a degree of flexibility with respect to the measures adopted and the reservations made. It also leaves room for pairs of countries subsequently to replace or change their existing DTCs further, and possibly to move on from the changes made by the MLI. It focused the implementation on a number of modifications that had already been extensively discussed in the context of the BEPS Project.

10. The BEPS MLI achieved this whilst starting from essentially a unilateral act by each country that was prepared to sign up. Each country identified unilaterally those DTCs to which it was willing to have the MLI apply (its "Covered Tax Agreements"), and outlined the country's position on each of the BEPS outcomes reflected in the MLI. It was then possible to match up the Covered Tax Agreements and the positions of the countries to see where an agreement to modify a DTC might be reached on a bilateral basis.

11. The process that was used to ensure that a number of countries signed the BEPS MLI can provide some important lessons. The BEPS MLI was, of course, based on the BEPS outcomes, so that there was already agreement between some countries on those outcomes (or at least a willingness on the part of some countries to consider making those changes to the treaty relationship). Countries were then asked to notify their initial positions, in terms of the identification of Covered Tax Agreements, and the country positions on particular BEPS-related modifications. The process (sometimes referred to as "speed dating") then allowed pairs of countries very quickly to see whether they were agreed to make a particular modification of a particular DTC. Countries then finalised their positions when they ratified the BEPS MLI. Finally, synthesised texts were developed on a bilateral basis to reflect the DTC as modified. Thus, within the context of a multilateral process, various bilateral steps (the speed dating, and the production of synthesised texts) produced the changes that were agreed upon.

[2] The term "country" is used here for simplification. The BEPS MLI applies to tax jurisdictions that have entered into DTCs but are not independent countries, and any UN MLI would similarly apply to such jurisdictions.

12. The "modification" concept itself was used extensively as part of the BEPS MLI. Rather than seeking to amend the existing DTC (by identifying particular wording, deleting that wording, and substituting replacement wording) the approach of the BEPS MLI was to leave the text of the original DTC in place, but to modify the DTC by the relevant provision of the MLI. Thus, the original DTC might say one thing, but the provision of the MLI would operate in place of or in the absence of the provision in the DTC.

13. It might be noted that this concept of "modification" is most appropriate where existing DTCs are likely to contain existing provisions on a particular topic, and it is desired to modify those provisions. An example under consideration by the UN might be the capital gains article, which might be modified to deal with offshore indirect transfers. On the other hand, where the purpose is to insert a provision that is simply not there in a large number of treaties, a more straightforward method of amendment by insertion may operate rather than the process of modification.

14. The main, substantive provisions of the BEPS MLI (Articles 3 to 17 of the BEPS MLI) utilised a standardized format, which might possibly be followed in a UN MLI. Thus, each substantive article begins with a paragraph setting out the new wording which is to apply to the DTC; this is followed by any optional variations of the text; then a compatibility clause (which typically says that the new wording shall apply "in place of or in the absence of provisions" of the Covered Tax Agreement that deal with that particular topic); then the article identifies the specific reservations that may be permitted (including sometimes a reservation not to apply that article at all); finally the article ends with provisions relating to notification of positions to the depository. This format for MLI articles may not be necessary in all cases, but its use in the BEPS MLI has created familiarity with the concepts of modification, optional variants, compatibility clauses, limited reservations, and notifications to the depository.

15. In terms of other positive lessons from the BEPS MLI, certain other concepts were developed or used (and so became more familiar). This includes concepts such as: "Covered Tax Agreement"; the use of "Contracting Jurisdiction" rather than "Contracting State" to cover non-state parties; the role of a "Conference of the Parties"; and the role of the depository. Some of these concepts were novel (at least in the tax context) and provide at least useful starting points for discussion on the nature and operation of a UN MLI.

16. The process of drafting the BEPS MLI also provides useful lessons. It was drafted in a relatively short time scale, thanks in part to the work of the secretariat. Countries contributed to this process; for example, by identifying potential compatibility issues and specific reservations that might be needed to take account of existing DTC provisions. Several members of the UN Committee of Experts have useful experience of this drafting process.

17. Finally, one might identify the holding of a large signing ceremony as a positive lesson from the BEPS MLI. Not only did it fix a date and provide an impetus for countries to sign the BEPS MLI, but it also marked a concluding date, to an extent, for the BEPS 1.0 Project.

18. At the same time, the BEPS MLI has some key differences from a potential UN MLI that will need to be taken into account. The BEPS MLI is relatively complex, in part because it sought to implement a number of outcomes of the BEPS Project in a single instrument. Greater simplicity may come if each proposed change is reflected in a separate document concluded in the context of a broader (and ongoing) process of updating the text of DTCs. The BEPS MLI is more complex, and it is harder to work through the various options and reservations to determine what modifications are possible between any two countries. This may have deterred some countries from doing other than accepting the minimum standards that are implemented through the MLI.

19. More generally, and perhaps as a way to ensure that as many countries remained on board as possible, the BEPS MLI allowed countries to do no more than accept the minimum standards (and to reserve on or opt out of other provisions, such as on mandatory binding arbitration). While over time countries may change their reservations, that process may require additional legislative proceedings. In the long-term many of the BEPS changes will only have been implemented by a limited number of countries.

20. Partly because of the complexity involved in seeking to implement a number of outcomes in a single instrument, it is difficult to see the format of the BEPS MLI being regularly used as a model for subsequent changes to the bilateral treaty network as a result of subsequent work in the OECD. While there are current discussions of a multilateral convention in connection with Pillar 1 (and possibly Pillar 2), the BEPS MLI does not appear to be regarded as a suitable model for successive agreements to modify the treaty network.

21. One aspect of the drafting of the BEPS MLI from which lessons may be learnt is the transparency of the process. Drafts of the MLI were not exposed for public comment (even though the outcomes that were being implemented were already in the public domain; which distinguishes the BEPS MLI (and any UN MLI for that matter) from other treaties where there is a greater argument for confidentiality surrounding the negotiations). Seeking public comments or inputs into the development of such instruments promotes acceptability and may identify potential difficulties in making the changes workable. If a draft of the BEPS MLI had been exposed for public comment, perhaps a simpler instrument would have resulted. The UN is generally noted for transparency and inclusiveness, and this may be a positive factor in the drafting of a UN MLI.

22. For some countries, the nature of the BEPS MLI meant that it did not fit well with the ratification process under that country's constitution. There were reports of some delegations having difficulty in explaining to their own legislature how ratification and implementation would take place. This may be a point, however, where countries have had to deal with ratification and implementation of the BEPS MLI, and have now resolved these issues.

23. While the concept of modification rather than amendment of existing bilateral DTCs had positive aspects, it does risk creating a more complex position for future application and interpretation of DTCs. For example, a court faced with interpreting a DTC that has been modified by the MLI must look at: the original wording of the DTC, the wording of the MLI, the Explanatory Statement to the MLI, the Commentary that applied to the original wording of the DTC, the Commentary to the wording that is used in the MLI (that Commentary generally being found in the 2017 version of the OECD Model), and any opinions issued by the Conference of the Parties. Additionally, reference may even be made to some of the BEPS Project reports. Synthesised versions of the DTC may or may not assist in the interpretation process: we are yet to see this. There is room for simplification in this context.

24. Finally, it appears that some countries have had to deal with language issues arising from the fact that the BEPS MLI was adopted only in English and French, both texts being equally authentic, whereas the language applied in the particular DTC may not be either of those languages. More generally, greater attention might be given in the context of a UN MLI as to how the DTC as modified by the MLI would work in practice in different countries, with different constitutional systems, different official languages, and different approaches to treaty interpretation. This is important in the UN context where developing countries may have fewer resources to devote to treaty amendment and implementation issues, and where the official language is not English or French.

Concluding comment on lessons from the BEPS MLI

25. It is appropriate to note that the BEPS MLI was intended to achieve some purposes that would be different from a UN MLI. Nevertheless, there are some important lessons that can be drawn from the BEPS MLI. It should also be recalled that the OECD is a different organisation from the UN: the OECD is a consensus organisation, generally seeking support from all participants involved. The UN in general operates frequently through building coalitions, and it may be that a measure can be taken forward which has sufficiently support amongst countries, even if there is no consensus.

26. The initial purpose of a UN MLI is likely to be simpler than the BEPS MLI, with the insertion of Articles 12A and/or 12B into some treaties, and possibly the modification of the capital gains article to take account of offshore indirect transfers as initial purposes.

27. Ideally, a UN MLI will form the basis for an iterative process of amendment and modification of bilateral DTCs in a way that is user-friendly and simpler for countries to implement.

An outline proposal for a UN MLI

28. Drawing on some of the lessons from the BEPS MLI, it is suggested that a UN MLI might be developed along the following lines.

29. First, it might consist of a main text of the UN MLI, plus one or more Protocols.

30. The main text of UN MLI would contain provisions setting out how the MLI (and its Protocol(s)) would operate to amend or modify existing treaties, together with the standard provisions typically found in an international treaty: preamble and scope, interpretation provisions, provisions for signature and ratification, reservations, notifications, role of the depository, subsequent modifications, Conference of the Parties, entry into force, entry into effect, authentic language texts etc. The main text of the MLI would not itself modify or amend specific treaties, or even contain any of the proposed modifications or amendments, but rather provide a framework and process within which the substantive changes would be implemented. The main text of the MLI would be procedural and structural, rather than substantive.

31. The Protocol(s) would then contain the substantive amendment/modification of the existing DTCs.

32. Thus, for example, the First Protocol might cover the insertion of Article 12A. Parties to the UN MLI who wished to adopt Article 12A would sign up to the main text of the MLI and to this Protocol, and would then go through the process of identifying treaty partners with whom they could agree to insert this Article (the process is discussed further below).

33. A Second Protocol might involve the insertion of Article 12B.

34. A Third Protocol might contain the modifications to the capital gains article to give effect to offshore indirect disposals.

35. In the future, further Protocols might deal with the modifications necessary to introduce a Subject to Tax Rule or an appropriate arbitration procedure, for example.

36. The idea behind this structure is that it provides a process and a framework within which each substantive change can be contained in a separate Protocol that deals only with that change. Changes that are made in the future to the UN Model could be reflected in new Protocols, and countries could decide for themselves whether as a matter of policy they wished to adopt that change with regard to some or all of their treaties or not.

37. Thus, if a country supported the inclusion of Article 12A in principle, it would sign the main text of the MLI plus the First Protocol. A country that supported the inclusion of Article 12B in principle would sign the MLI plus the Second Protocol. A country that did not wish to support the introduction of Articles 12A or 12B, but did wish to deal with offshore indirect disposals could sign the main text of the MLI plus the Third Protocol. So long as a country adopted the provisions of any one or more of the Protocols, the country would sign and ratify the main text of the MLI plus the chosen Protocol(s).

38. There is some similarity in this to the adoption of multiple protocols to an existing multilateral convention, such as the European Convention on Human Rights, where each of the (now 16) protocols either amends the original treaty or – and this is where the parallel is quite similar – adds additional rights/provisions. Each country then decides whether it wishes to sign up to that protocol.

39. The underlying idea is, therefore, that the UN MLI is not a one-off event, but rather that it forms the basic structure and framework for the ongoing, streamlined amendments to the existing network of DTCs. This structure and process can be used to implement changes that have already been made to the UN Model (such as Articles 12A and 12B) and future changes to the UN Model that are adopted.

40. So far as each Protocol is concerned, it would contain the new wording to be inserted into or applied to the Covered Tax Agreement, together with any optional variants that countries could adopt. The Protocol would also contain provisions on compatibility with existing wording as well as provisions for reservations and for notifications to the depository. So, each Protocol would have similarities with the structure of the substantive articles in the BEPS MLI.

41. The degree of simplicity or complexity of each Protocol may vary with the subject matter of that Protocol. Where the new provision may give rise to compatibility issues with existing DTC provisions, the Protocol may need to identify different alternative compatibility provisions. The aim, however, would be to try to ensure as simple and clear a provision as possible. Ideally, it would be sufficient to know that two countries had adopted, say, "the First Protocol, implementing Article 12A" to know the broad impact of the change that the countries have agreed. Where the wording of the UN Model leaves it for contracting states to negotiate the level of the source tax charge, the Protocol would also leave that open to be settled bilaterally through the Memorandum of Agreement process discussed below.

42. Each Protocol might also be accompanied by a commentary on the substantive provision dealt with by that Protocol – e.g. a commentary to Article 12A (see further below).

43. It will no doubt help the Committee to envisage and discuss this concept if a draft (or at least an outline) of the UN MLI and (say) one Protocol is prepared: the Committee could then see what this would look like.

44. This input statement does not discuss further the process of drafting of the UN MLI or the Protocols. There are precedents from other areas of the work of the UN where expert groups or commissions have proposed material for the inclusion in a multilateral convention. These proposals are then taken up within the UN system and presented to a conference of states to finalise and sign the convention. The example of the BEPS MLI shows that it is possible for an intergovernmental organisation to prepare a draft treaty which is then taken ahead by a conference of states.

Procedure between States: the Use of a Memorandum of Agreement

45. So far as the procedure to be adopted under the umbrella of the UN MLI is concerned, once the text of a Protocol is drafted, a procedure similar to that of the BEPS MLI could be followed. Countries could be invited to list their Covered Tax Agreements to which they would be willing to have the amendment/modification apply. Arrangements would then be made (equivalent to "speed dating") by which pairs of countries could agree they will make the amendment/modification to their bilateral DTC if they both consider that it should be a Covered Tax Agreement. Rather than a physical "speed dating" event, it should be possible for this to be carried out through a series of online meetings or exchanges of correspondence to take place within a fixed period of time, facilitated if necessary by the Secretariat.

46. One change from the BEPS MLI to consider would be a simplified procedure under which, if two countries had agreed to make the amendment/modification to their bilateral DTC, they would conclude and deposit a Memorandum of Agreement with the depository, containing standardised information necessary for the UN MLI to operate to amend/modify the treaty. This Memorandum of Agreement might, for example, also involve attaching a language version of the wording of the amendment/modification in a language other than the languages of the MLI, if the official language of one or both of the countries was not one of the languages of the MLI. Where the relevant Protocol leaves the level of source country tax open for negotiation, the Memorandum of Agreement would record the agreement of the two countries as to that level. Similarly, where the Protocol contained optional wording or provision for reservations, the Memorandum of Agreement would record the positions agreed between the two countries. The Memorandum of Agreement has some similarity with the country positions under the BEPS MLI that are notified to the depository, and would work on a bilateral basis together with the relevant Protocol.

47. This process envisages, therefore, three legally binding instruments. First, the UN MLI itself which provides the framework and process for the changes to be made. Second, the Protocols, each containing the substantive provisions for one of the amendments/ modifications to DTCs. Third, the Memorandum of Agreement between pairs of countries which brings into force the changes in the specified Protocol between those countries in accordance with the terms agreed in that Memorandum. While these are three separate instruments, they each fulfil a specific function: the framework and procedure; the substantive changes in general; the specific application of those changes to the countries concerned. There is no reason why these three instruments might not be concluded at the same time, possibly in the context of a conference of states called to adopt and implement the UN MLI. Thus, a number of states might at the same session all sign the UN MLI, one or more Protocols, and conclude a series of Memoranda of Agreement between them. The three instruments have some analogy to the situation where states conclude a DTC and at the same time append a protocol and also enter into an exchange of notes between them in relation to the treaty. All three are legally binding instruments and together constitute the treaty between them.

48. In principle, the contents of the UN MLI and the Protocols might be combined in a single instrument. However, the separation into the main text of the UN MLI and Protocols (as discussed above) is intended to allow the process of adopting changes to operate on an iterative basis for the future. Once future changes to the UN Model are adopted, they can be reflected in a new Protocol within the framework of the UN MLI. It would not be necessary to conclude a complete new MLI to implement those changes.

49. Whether the UN MLI and the amendments/modifications are in a single instrument or two instruments, there needs to be an element of bilateral agreement, particularly (but not exclusively) where the relevant change leaves the level of source country tax open for agreement. This is reflected in the Memoranda of Agreement.

50. It is assumed, incidentally, that the MLI itself (and of the Protocols) would be adopted in all the official languages of the UN.

51. One further proposed feature of the UN MLI is that each Protocol might have its own commentary to the amendment or modification. Thus, the Protocol would be "self-contained" with the wording of the amendment/modification and also the commentary in the same place. Some consideration will be necessary as to how the commentary might be subsequently updated and as to the approach to be adopted to the temporal application of those changes.

52. In terms of the policy decisions to be taken by each state's administration, there are effectively three decisions (which might be taken at the same time). First, whether the state supports the framework approach adopted by the UN MLI; second, whether the state is willing in principle to apply the specific amendment/modification in one or more of the Protocols to one or more of its existing DTCs; third, which countries the state might be willing to agree to apply that amendment/modification on a bilateral basis, and the terms under which it would be willing to do so.

53. Where legislative approval is necessary it should be possible for a country to apply that approval procedure on a combined basis to the main text of the UN MLI, together with any Protocols that it has accepted, and together with a batch of Memoranda of Agreement relating to those DTCs that are amended/modified by the MLI plus the Protocol. This would allow the legislature to debate and adopt the series of changes affecting a number of its DTCs at a single hearing. If the state then subsequently signs a further series of Memoranda of Agreement, the legislative procedure might in principle be streamlined somewhat. Since the legislature will have already debated the adoption of the UN MLI framework and the relevant Protocol, the debate would focus only on the application of that Protocol to the specific countries with which memoranda had been concluded. Similarly, if the country subsequently signs a new Protocol and concludes a number of Memoranda of Agreement, the legislative debate would focus only on the change made by that Protocol, and its application to those specific countries. This might be contrasted with the procedural normally adopted in some countries where each and every amending protocol concluded by the country has to be taken individually through the legislative procedure.

54. To give a practical example of how this approach might apply: assume that the First Protocol inserts Article 12A. There are presently 109 countries that have included a provision dealing with fees for technical services in at least one of their DTCs (there are around 220 DTCs in total that have an FTS provision). On the basis that these countries are clearly not implacably opposed to an FTS provision, most (if not all) of these countries could be expected to sign up to the main text of the UN MLI plus the First Protocol, thus showing their willingness in principle to insert an Article 12A in appropriate treaties if so agreed with the other treaty partner. Assume then that a substantial number of these 109 countries signed the UN MLI plus the First Protocol. It would then be a fairly straightforward process to identify all possible Covered Tax Agreements – i.e. the treaties between these countries that have signed and that do not presently have an FTS Article. The next step would be some speed-dating to identify which of these possible CTAs were ones where both parties agreed to insert Article 12A (and to conclude issues such as optional variant wording, rate of tax etc.). Finally, Memoranda of Agreement would be signed between each pair of countries and deposited with the depository. The result would be the streamlined insertion of Article 12A in a large number of treaties.

55. At this stage, these are simply some suggestions for a process of developing a UN MLI. It is very much open for discussion. It would be helpful to have input from members of the UN Committee of Experts on any foreseeable problems that this process might give rise to, or any improvements that might be made to simplify and streamline the procedure.

Pros and Cons of a UN MLI: does an UN MLI streamline the process sufficiently?

56. It is undeniably the case that changes to bilateral DTCs (to reflect changes to the UN Model, for example) can be made through the traditional approach of concluding amending protocols, or even by inclusion in a new comprehensive DTC between the two states. That process is time-consuming and ties up resources of each state. It may take years for a desirable change to be reflected in all the DTCs concluded by a country. In the case of developing countries, there may be limited resources available for that process. The negotiation of amending protocols also has a tendency to trigger discussion of wider amendments to the DTC. One state may ask for further concessions in order to agree to the specific change requested by the other. (A developing country that seeks to insert Article 12A via a traditional protocol may be faced by a request to agree to other concessions to reach agreement). The BEPS outcomes could have been implemented by traditional amending protocols; the BEPS MLI is an example of a process designed to streamline the implementation of agreed outcomes.

57. What then are the pros and cons of a UN MLI, and are they sufficient to merit introducing the process?

58. The principal advantage is to streamline the process of change, as discussed below. However, there are also some secondary advantages. Perhaps some examples of these secondary advantages might be briefly mentioned. The framework established by the UN MLI can create institutions such as a Conference of the Parties to keep the UN MLI and its Protocols under review and resolve issues arising; this would not occur with a bilateral amending protocol. Each Protocol might have a commentary attached and the status of that commentary might be clarified to provide greater certainty; again, that would not usually happen with a bilateral amending protocol. The status of synthesized texts might be clarified in the UN MLI. There are aspects of certainty that can be achieved with an MLI which might be left open in the context of a bilateral amending protocol.

59. The primary advantage of streamlining may be achieved by a UN MLI in two respects: with regard to the process of negotiating the changes, and with regard to the domestic procedure for approving and implementing the changes.

60. So far as the process of negotiation is concerned, one should not underestimate the impact of the creation of a process through the UN that is designed to streamline the amendment/modification of DTC provisions and to facilitate that process. The mere fact that there is a framework and a conference of states called together by the UN to conclude the UN MLI and the relevant Protocols will encourage states to take a position and potentially decide to participate in that process. Individual states do not need to approach their treaty partners to initiate a change; in a sense, the UN is sending out the invitations.

61. Within the context of the changes made by each Protocol, discussions then become single-issue discussions. There is no scope for opening up wider issues or demanding concessions in return for the change.

62. Within the context of each Protocol the wording for the amendment/modification would be supplied by the UN (in all official languages) together with the wording of optional provisions and the permissible reservations. The Protocol would also contain wording to deal with the most commonly anticipated compatibility issues. The commentary to that Protocol might provide guidance on factors to be taken into account in agreeing levels of source country taxation or in agreeing on any optional aspects of the change. All this may be especially important for developing countries with limited personnel resources to negotiate the wording for amending protocols.

63. A standard form of Memorandum of Agreement might be developed for each Protocol by which pairs of states might need only to agree to fill in various blanks during their negotiations and then sign the Memorandum. It may be a little idealistic, but where a future Protocol makes a limited and straightforward change which, say, inserts new wording and has few options and few compatibility issues, it may be as simple as the two countries completing a Memorandum where they fill in the level of source country tax, identify the date from which the change takes effect in each country, and then sign the Memorandum. However, even where the change is more complex, the fact that the discussions take place in the context of the wording of a Protocol (which identifies precisely those issues on which agreement is needed) should, in principle, streamline the process and shorten dramatically the time to agree the change.

64. Turning to domestic procedure, the point has already been made above that the UN MLI process, leading to the conclusion of similar changes in a number of treaties, should allow a single legislative procedure rather than multiple procedures for each amending protocol. That may free up the time of the legislators and of officials. Again, one should not underestimate the impact on domestic procedures of the fact that the change being approved reflects a discussion within the context of the UN which commenced with the work of the Committee of Experts.

65. Whether the introduction of a UN MLI will achieve this streamlining cannot be predicted with any certainty. In principle, it could and should. However, one will not know the answer unless the procedure is attempted. There is the precedent of the BEPS MLI to show that in principle it is possible to amend or modify multiple DTCs. The process discussed here draws on lessons from the BEPS MLI process to achieve somewhat different objectives, including – in particular – an ongoing process which allows future changes to the UN Model also to be implemented through the UN MLI process.

Philip Baker

September 2022

Appendix to the Annex: the advantages and disadvantages of a stand-alone convention

1. While the proposal that is being discussed in this note is for a UN MLI that introduces a process for amending/modifying a series of bilateral DTCs, it is also worth mentioning briefly the possibility of adopting a stand-alone, multilateral convention that deals exclusively with a particular subject matter and which operates outside of the realm of the network of bilateral DTCs.

2. One example of this is the CMAA which deals exclusively with administrative assistance on tax matters. Another example (although not a very successful one) is the multilateral convention for the avoidance of double taxation of copyright royalties which was promoted by the World Intellectual Property Organisation. That is an example of a stand-alone, multilateral convention that deals exclusively with a particular type of income.

3. It might be possible, for example, to have a stand-alone convention that deals exclusively with, for example, automated digital services. With regard to payments falling within the scope of that convention, the convention would override any provisions in existing bilateral DTCs. All issues relating to cross border payments for automated digital services would be covered exclusively by that multilateral convention.

4. Another example might be a stand-alone convention dealing with anti-avoidance, and which sets out – by reference, for example, to a principal purpose test or to a limitation on benefits provision – the circumstances where benefits under existing bilateral DTCs should be denied.

5. The advantages of a stand-alone multilateral convention dealing with a particular topic is that it can separate that topic out from general matters dealt with by the network of bilateral DTCs, and the issue can be covered and applied to countries even where there is no bilateral DTC in existence. Thus, for example, the CMAA makes provision for administrative assistance between countries that have signed up to that Convention, even if there is no bilateral DTC between the countries concerned. Similarly, a multilateral convention dealing with automated digital services could provide for a tax at source on payments for those services even as between countries where there is no bilateral DTC in existence.

6. The disadvantages of a stand-alone, multilateral convention exactly follow from the fact that it is not tied into the network of DTCs. Thus, for example, it cannot rely upon existing definitions, non-discrimination rules, dispute resolution provisions, anti-avoidance provisions and provisions for cooperation that are found in the network of bilateral DTCs. Each stand-alone, multilateral convention would need to provide for these matters which are otherwise dealt with through the network of bilateral DTCs.

7. While the current proposal looks at an MLI that operates within the existing network of bilateral DTCs and amends/modifies those DTCs, it should not be overlooked that there is an alternative form of multilateral convention that may be appropriate for the implementation of other matters that are within the scope of the agenda of the UN Committee.

ANNEX B: Note on Physical Presence

Input Note by Aart Roelofsen

Starting up the discussion in Subcommittee on Digitalization and Globalization of the Economy and in UN Tax Committee

1. During the first session of the current membership of the UN Tax Committee, a Subcommittee on Taxation Issues Related to the Digitalized and Globalized was established.

2. The mandate is as follows:

The Subcommittee is mandated:

• To identify priority taxation issues related to the digitalized and globalized economy where the Committee may most usefully assist developing countries in differing situations, in particular

• To initially report to the Committee on such issues no later than its Twenty-fourth Session, in 2022, with recommendations for consideration and a proposed general programme of work

The Subcommittee may consult broadly, taking into account relevant work by other bodies.

3. During the first meeting(s) of that Subcommittee two workstreams were agreed. The first one relates to the possible development of a Multilateral Instrument.

4. Under the second workstream the Subcommittee would consider the function and relevance or otherwise of physical presence tests (such as under "permanent establishment" rules) in the context of an increasingly digitalized and globalized economy.

5. E/C.18/2022/CRP.6 reflects the first discussion on this item as follows:

Workstream B –

14. The Subcommittee considers that an open consideration of physical presence-based tests to trigger taxing rights in source countries and its continued relevance or otherwise in an increasingly digitalized and globalized economy would be a valuable contribution well adapted to the Committee's diverse character and broad network of observers.

15. While the Subcommittee does not consider that this work should hold up Workstream A above (with the work being done in parallel) it does feel that a first level consideration of the purpose of the permanent establishment rule's focus on physical presence, its operation in the digitalized and globalized world and the relevance or otherwise of options for moving away from it in certain circumstances, as has already happened in Articles 12A and 12B, might be important for the work of the Committee (and perhaps others) in this area. This will also help longer-term consideration of the issues at stake and the best options to address them

16. If at any stage, the subcommittee feels that it needs to propose changes to the Model Convention, it will liaise with the Subcommittee on the UN Model Tax Convention between Developed and Developing Countries, in view of the relevant expertise in that group. The strong cross-participation between the two Subcommittees should assist in this liaison and any necessary work together.

17. As well as the two workstreams, the Subcommittee Members look forward to the opportunity to provide comments that will assist UN DESA in its capacity building in this area, which we

understand will be designed to help developing countries analyze available options in this area and their practical pros and cons and reach their own considered views on the best options for them and how to take forward those options in practice.

6. This note is meant as a starting point for the considerations with a view to the broader and longer-term importance of this discussion as referred to in paragraph 15 above. The note is structured around four questions summarized as “Why”, “What”, “Who” and “How”.

Why?

7. The first question we have to answer is why we are having this discussion. Why do we challenge the relevance of physical presence to trigger taxing rights? In itself, the fact that digitalized business models do no longer require a significant physical presence in the state where it’s consumer are located does not seem to justify that challenge. There could be a justification if physical presence was always meant as a proxy for something, such as economic engagement in a state to a level more than just a toe in the water, and if that something can now be established by virtual presence. The fact that states where these digital businesses are less, active, may be a concern to them, but if the physical presence test is still considered justified, the consequences are equally justified.

8. Another argument often heard is that disparities in treatment favouring digital over bricks and mortar presences is something that may need consideration, especially as it may impact more on local businesses and jobs. In that consideration the question whether it is only an apparent favorable treatment in only the host state or really an overall favorable treatment considering tax world wide should be taken into account.

9. We should therefore determine whether we are facing an issue of principles (taxing rights are based on the wrong criteria) or a practical problem (some states are losing the ability to exercise taxing rights and we want to counter that effect).

10. If we see a principled issue, and if we consider that physical presence is not relevant (anymore), we should, firstly, determine and justify better criteria and, secondly, apply them to ***all*** situations. That means that we should also analyze the consequences of a possible new principle or approach to situations where taxpayers do have a significant physical presence in a state.

11.` Equally if we consider physical presence relevant as a threshold, we have to justify why that is relevant in an increasingly digitalized world.

12. If, on the other hand, we are merely trying to solve a practical (budgetary) problem, we might have to take a closer look at which countries are affected. Is it really only or mainly developing countries who are only losing the ability to tax? What is the effect on services provided between developing countries? Which business sectors raise concerns?

What?

13. Based on the answers to the “why”-question we should decide on which items of income we want to redefine taxing rights. Are we only concerned with business income. And if so, are we only aiming at residual profits (and do we want to continue to apply the arm’s length principle) or do we want to redraft rules for the full business profit. Apart from the evident consequences for PE issues, what would be the consequence for profits from international transport? And do we also want to discuss taxation of employment income, sportspersons and artists, pensions? Or do we adopt a staged approach?

14. At least with regard to business income we should be aware that the re-attribution of taxing rights will be a multinational issue in which more than one state will lose taxing rights for the benefit of the state that complies best to the new criteria.

15. Additionally, we should consider how taxes that many states currently exercise on certain payment leaving their country (most importantly on royalties and technical services, but possibly also dividends and interest) fit into the new approach.

16. We might also want to discuss problems that might rise from the transition from one system to the

other.

17. Finally we should take a broader view and take into account possible consequences on investment decisions by business and how that would affect our conclusions, probably recognizing that businesses making profits should expect to pay taxes on them somewhere. Here also a balance between financial interest and administrability should receive attention.

Who?

18, The question who we want to tax under the new attribution rules will mainly follow from the answers to why we want to redefine that attribution and on which items. One key question will be to which business sectors we want to apply the new rules. Are we only aiming at so called digital businesses and can we properly define and ringfence them? If under “why” we take a principled position, what is the justification for exemption of commodities, extractives, financial services or other sectors? In this section we could also review the reasons for construction, aviation etc. under the PE rules

How?

19, Finally, once agreed on who we want to tax and on which items of income, we must make suggestions on how to tax those items. That would include both an advice on domestic provisions and on treaty provisions and ways to amend them.

ANNEX C: A General Outline of a Review of the Taxation of Cross-Border Transactions involving Digital Goods and Services

Input Note by Liselott Kana, based on a discussion with Brian Arnold

1. **Introduction**
   - The purpose of this review
   - The content of the review
2. **Background**
   - Fundamental structure of the existing international tax system
   - Recent developments in international tax
     - OECD work: BEPS Project and Pillars One and Two
     - United Nations work: Article 12A and 12B
   - The digitalization of the economy and the challenges for the international tax system
3. **Review of the Taxation of Income from Cross-Border Digital Transactions**
   - Domestic law
     - Unilateral tax base protection measures
       - 2017 US tax reform: GILTI and BEAT rules
       - Digital services taxes
       - Expanded definitions of permanent establishment
       - Gross-based withholding taxes on payments for certain digital goods and services
       - Anti-avoidance rules: UK diverted profits tax; Australian multinational anti-avoidance law
     - Implications
       - Increased risks of double taxation
       - Prohibition against digital services taxes (and similar measures) in Pillar One
   - Tax treaties
     - Review of the provisions of the OECD and United Nations Model Conventions with respect to the taxation of cross-border digital goods and services (identification of inconsistencies in the treatment of different types of income digital goods and services e.g. different thresholds for source country taxation of business profits, employment income, capital gains, etc.; remote services and physical presence thresholds)
     - OECD Model Convention
       - Alternative services PE rule
     - Special provisions of the United Nations Model Convention
       - Article 5(3)

        - Article 14
        - Article 12A
        - Article 12B
        - Other provisions
- Multilateral Actions
    - Proposed Pillar One
    - Proposed Pillar Two
    - Other

4. Deficiencies in the Current International Tax System with respect to the Taxation of Cross-Border Transactions Involving Digital Goods and Services

- Inconsistencies in the threshold requirements for source country taxation
- Nexus rules
- Transfer pricing rules
- Treaty restrictions on source country taxation through withholding taxes
- Non-discrimination rules
- Requirement for reciprocity

5. Possible Solutions

- Brief discussion of the pros and cons of possible solutions through changes to domestic law, tax treaties, and multilateral agreements

6. Conclusion