



January 8, 2021

Subcommittee on Tax Challenges Related to the Digitalization of the Economy

Via email c/o: lennard@un.org

Dear Co-Coordination of the Subcommittee,

Thank you for the opportunity to provide our selected observations on the proposed introduction of new Article 12B (Income from Automated Digital Services or ADS) into the UN Model Tax Convention and Commentary to deal with key deficiencies with respect to existing corporate income tax arrangements that have been exacerbated by an increasingly digitalized economy.¹

Background

The proposal would allow gross basis taxation (for instance, through withholding) on cross-border payments with respect to ADS (for instance, advertising, intermediation, social media, digital content provision, cloud computing, sale of data of users of a digital interface etc.), similar to various unilateral withholding taxes on digital services being proposed or adopted by countries, as well as optional net basis taxation.

Our selected observations

In summary, we make the following observations with respect to the proposal:

- We welcome the resolution of the UN Tax Committee to include a new Article 12B in the UN Model, with a focus on the interests of developing countries. We consider that the proposed approach better preserves the taxing rights of developing countries and does so in a simpler way than the existing OECD/G20 Inclusive Framework (IF) proposals, by permitting withholding on gross payments with respect to ADS while also containing an optional mechanism for net basis taxation in order to better manage the downside risks and distortions of gross basis taxation in a digital context.
- The proposal could also lead to a broader reduction in the overall downside risks and distortions threatening the current international tax system in circumstances where treaty partners bring within the scope of their tax treaties those unilateral measures directed at ADS such as digital services taxes (DSTs), which can currently be designed to otherwise fall outside the scope of tax treaties.

¹ The observations expressed in this document are those of the contributors and should not be attributed to the IMF, its Executive Board, or its management.

- Additionally, it seems appropriate that the proposal is to be implemented through the same legal instrument (tax treaties) that created the deficiencies with respect to the existing corporate income tax arrangements (for instance, the current and significant limitations surrounding the existing PE concept and arm's length principle both arise from norms enshrined in tax treaties). In this sense, we also recognize that the treaty proposal is at least bilateral (as distinct from unilateral) but could also be scaled to become multilateral (discussed below). We continue to be of the view that workable multilateral solutions remain critical to achieving an acceptable and sustainable international corporate tax system in order to avoid the continued proliferation of uncoordinated unilateral measures.
- We did wonder why the proposed bilateral approach did not focus on the immediate source of the current deficiencies in existing corporate income tax arrangements (namely, Article 5, and consequently Article 7). However, we suspect that this implementation option was likely explored, but that it was ultimately decided that the legal spillovers were too great when compared to adopting a standalone Article 12B. For instance, the existence of a PE is also relevant for the purposes of applying Articles 10 to 13, 15, 21, 22, 24 and 29 such that modifying Article 5 and consequently Article 7 would therefore require more complex modifications to the UN Model, and create possible confusion with respect to the interpretation of existing treaties.
- While the combination of gross and net basis taxation embodied in proposed new Article 12B does better preserve the taxing rights of developing countries in a simpler way, we still have some concerns. Our key concerns are as follows:
 - The proposal adopts a ring-fenced approach given its scope is confined to ADS. We generally prefer more principled and broader based reforms (for instance, more comprehensive residual profit schemes and a stronger element of destination-basing through a proportionately greater allocation of taxing rights to market jurisdictions).²
 - The proposal will need to be implemented through well-designed domestic tax rules in order to ensure the gross basis taxation and optional net basis taxation mechanisms are administrable and enforceable. It will also likely need to be backstopped by robust access to information arrangements and anti-avoidance measures to safeguard collection under the preserved taxing rights (for instance, robust arrangements so that market jurisdictions have access to information to be able to determine group profitability for the purposes of applying net basis taxation, and measures to combat the contrived use of an offshore related entity to make the payments to the non-resident supplier to defeat gross basis taxation etc.). This is an area increasingly being covered in Fund TA to safeguard (through domestic law measures) gross (and net basis) basis taxation, given that similar issues arise whenever tax authorities seek to levy cross-border net basis tax assessments, and also with respect to the cross-border payment of interest and royalties, which are commonly subjected to gross basis taxation. We see this as an area where greater institutional coordination may be possible given our focus on the design, implementation and administration of domestic tax measures.

² International Monetary Fund (IMF). 2019. *Corporate Taxation in the Global Economy*. IMF Board Paper (Washington, IMF).

- The proposal will also likely need to be coupled with a well-designed implementation strategy to increase the prospect of proposed new Article 12B being taken up more widely. For instance, its real-world success will depend on the negotiated take-up by bilateral treaty partners in new tax treaties, as well the ability to facilitate modifications to existing ones, in which case some sort of enhanced multilateral mechanism could be considered. We think that the incentive for both residence and source countries to revisit outdated tax treaty norms could converge in circumstances where unilateral DSTs otherwise proliferate in source countries, and residence countries seek to bring those measures within the scope of tax treaties in order to give their firms the option of net basis taxation. An existing treaty framework also offers greater certainty and protection, for instance through relief against double taxation and more certain dispute resolution mechanisms.

Concluding remarks

Our analytical work (which remains ongoing) suggests that revenue from existing unilateral instruments such as DSTs is relatively low. Further, the positive revenue impact could become even smaller in circumstances where the ongoing digital tax debate distracts developing countries (and those supporting them) from core and more transformative domestic revenue mobilization efforts such as improvements to their indirect taxes (for instance, VAT/GST). However, we still think, on balance, that the need to restore faith in the fairness and sustainability of the international corporate income tax system does justify exploring a proposal of this kind, particularly in light of its attempt to better preserve the taxing rights of developing countries in a simpler way. We are also of the view that the optional net basis approach may well increase the proposal's appeal, particularly if the optional net basis mechanism serves to facilitate greater convergence between residence and source countries to revisit outdated tax treaty norms in a bilateral (possibly, even, multilateral) way in the face of otherwise distortionary unilateral domestic tax measures.

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