

15 Key Changes in the Original Vs. Revised draft of new Article 12B

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Revised Draft on new Article 12B on Automated Digital Services taxation [ADS], released by UN Committee of Experts on International Co-operation in Tax Matters (UN Committee), specifically excludes payments qualifying as “royalties” under Article 12 from the definition of ADS, apart from FTS under Article 12A which was excluded under original draft; Also, recommends a modest rate of 3% or 4% for taxation, although the same is to be bilaterally negotiated between contracting states; As regards computation of qualified profits [calculated by applying overall /segment profitability ratio to the gross annual revenue derived from Source country], clarifies that the “Unless bilaterally agreed otherwise between the Contracting States”, the profit to be used for calculating profitability ratio would be PBT as per accounts of beneficial owner, or the consolidated accounts of the MNE group with minimum tax-to-book adjustments [which are largely similar to adjustments proposed under OECD’s Pillar 1 Approach under the Building Block pertaining to 'Tax Base Determination'].

Pursuant to [Taxsutra World News Flash](#) sent yesterday, detailed analysis highlighting key changes is now available.

Scope of Automated Digital Services (ADS):

1. Specifically excludes payments qualifying as “royalties” under Article 12 from the definition of ADS. [In the original draft, only “FTS” under Article 12A was excluded]
2. Next, in the exhaustive list of services considered as ADS, online search engines have been included. Detailed explanation on the meaning of each type of ADS service is also included in the commentary.
3. Further, modifies the negative list for the expression “income from automated digital services”:
 - o Customised services provided by professionals;
 - o Customised online teaching services;
 - o Services providing access to the Internet or to an electronic network;
 - o Online sale of goods and services other than automated digital services;
 - o **Broadcasted services including simultaneous internet transmission; [this is excluded in the revised draft]**
 - o Composite digital services embedded within a physical good irrespective of network connectivity (“internet of things”)
4. Noting that there may be activities which are not clearly severable as falling within the scope of Article 12,12A or 12B [i.e bundle of services], clarifies that:
 - o Where substantial part of the overall activity fulfils the criteria under paragraph 4 of Article 12B and the remaining elements derive significant benefits from their connection to the elements having characteristics under this Article, then the overall service may be regarded as covered under Article 12B.
 - o where the elements fulfilling criteria or matching characteristics under paragraph 4 of Article 12B are merely ancillary or a technical support feature for the rest of the service (example an automated chat function to screen a user’s request as an entry point to the service), and rest of the service requires human involvement, the overall service may not be considered as covered under Article 12B.
 - o Where, however, part of services amongst bundles of automated digital services are falling within scope of royalties or of technical services, taxation of such part only would be governed by Article 12 or 12A, as the case may be, and for the remaining, Article 12B would apply.

Rate of tax

5. Although the tax rate is to be bilaterally negotiated, it is **recommended to have a modest rate, i.e. 3% or 4%.**

6. In addition to the factors listed out in the commentary that the contracting states may consider while negotiating a precise level of withholding tax on payments in consideration of automated digital services,

recommends another factor – Impact on revenue and foreign exchange consequences for the country imposing withholding tax

Calculation of ‘Qualified Profits’

7. The revised draft modifies Para 3 of Article 12B to clarify on the computation of qualified profits. Explains that “Where segment-wise accounts are not maintained by the beneficial owner, the overall profitability ratio of the beneficial owner will be applied to determine qualified profits.”

8. Further, where the beneficial owner belongs to a multinational enterprise group, the profitability ratio to be applied shall be that of the business segment of the group relating to income covered by this Article, or of the group as a whole in case segment-wise accounts are not maintained by the group, **provided such profitability ratio of the multinational group are higher than the aforesaid profitability ratio of the beneficial owner.**

9. Explains that this proviso is added with a view to neutralize the possible reduction of the profitability due to tax-driven related party transactions in the multinational group.

10. With respect to calculation of profitability ratio, the commentary further clarifies that “Unless bilaterally agreed otherwise between the Contracting States”, the profit to be used for calculating profitability ratio would be **profit before tax as per accounts of beneficial owner, or the consolidated accounts of the MNE group with tax-to-book adjustments [which are similar to adjustments proposed under OECD’s Pillar 1 Approach] as under:**

- exclusion of income tax expenses,
- exclusion of dividend income, and gains or losses in connection with shares,
- adding back expenses not deductible for corporate income tax purpose due to public policy reasons, etc.

11. The information concerning the profitability figure of multinational group may be furnished by the taxpayer along-with supporting evidence. The tax administration of the Contracting State where the income from automated digital services arise, may in appropriate cases make cross verification of correctness of declaration by the taxpayer through exchange of information mechanism under the tax treaty, if required.

12. The commentary also explains the basis for choosing ‘30%’ rate, stating that the figure of 30% is based on allocation by assigning equal weightage to assets, employees and revenue.

Interplay between Article 8 [International Shipping and Air Transport] and Article 14 [Independent Personal Services] with Article 12B

13. Para 2 of the revised draft has been modified to clarify the interaction between Articles 8 and 14. It is now clarified that the provisions of Article 12B are subject to those of Article 8 and are notwithstanding the provisions of Article 14 [Independent Personal Services].

14. Para 9 of the commentary explains that although it is unlikely that income from automated digital services are dealt with in both Article 12B and Article 14. However, where payments in consideration for automated digital services are incurred for the purpose of a business carried on through a permanent establishment or for the purpose of independent personal services performed through a fixed base, Article 12B, paragraph 5 provides that the provisions of Article 14 would apply instead of Article 12B. To avoid uncertainty, reference is made in paragraph 2 clarifying that it applies notwithstanding the provisions of Article 14.

15. Where payments in consideration for automated digital services are incurred for the purpose of a business carried on through a permanent establishment or for the purpose of independent personal services performed through a fixed base, those payments will usually qualify for deduction in computing the profits attributable to the permanent establishment under Article 7 or, the income attributable to the fixed base under Article 14. The deductibility of the automated digital service payments provides an objective standard for determining that the payments have a close economic connection to the State in which the permanent establishment or fixed base is situated.

Other Changes/Clarifications:

16. The commentary also provides guidance on determination of ‘minimal human intervention’ for concluding whether a service is covered within the meaning of ADS. Para 34 of the revised commentary explains that the test only looks to the supplier of service, without regard to any human involvement on the side of the user. For example, where the user may input certain parameters into an automated system to

obtain a customized result.

17. The commentary clarifies that the definition focuses on provision of service and therefore does not include human involvement in creating or supporting or maintaining the system needed for provision of service, maintaining and updating the system environment, dealing with system errors, or making other generic, non-specific adjustments unrelated to individual user requests.

18. With respect to classification of a service as ADS, the commentary explains that *“An important indicator of concept of automated is whether there is ability to scale up and provide same type of service to new users with minimal human involvement.”*, Explains that once the service offering of an automated digital business is developed (such as music catalogue or social media platform), then the business can provide that service to one user, or to many more, on an automated basis with the same basic business processes. On other hand, a non-automated digital business would see a proportionate increase in per unit costs in connection with providing the services to new customers.