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# Revised Draft of Article 12B – Income from Automated Digital Services

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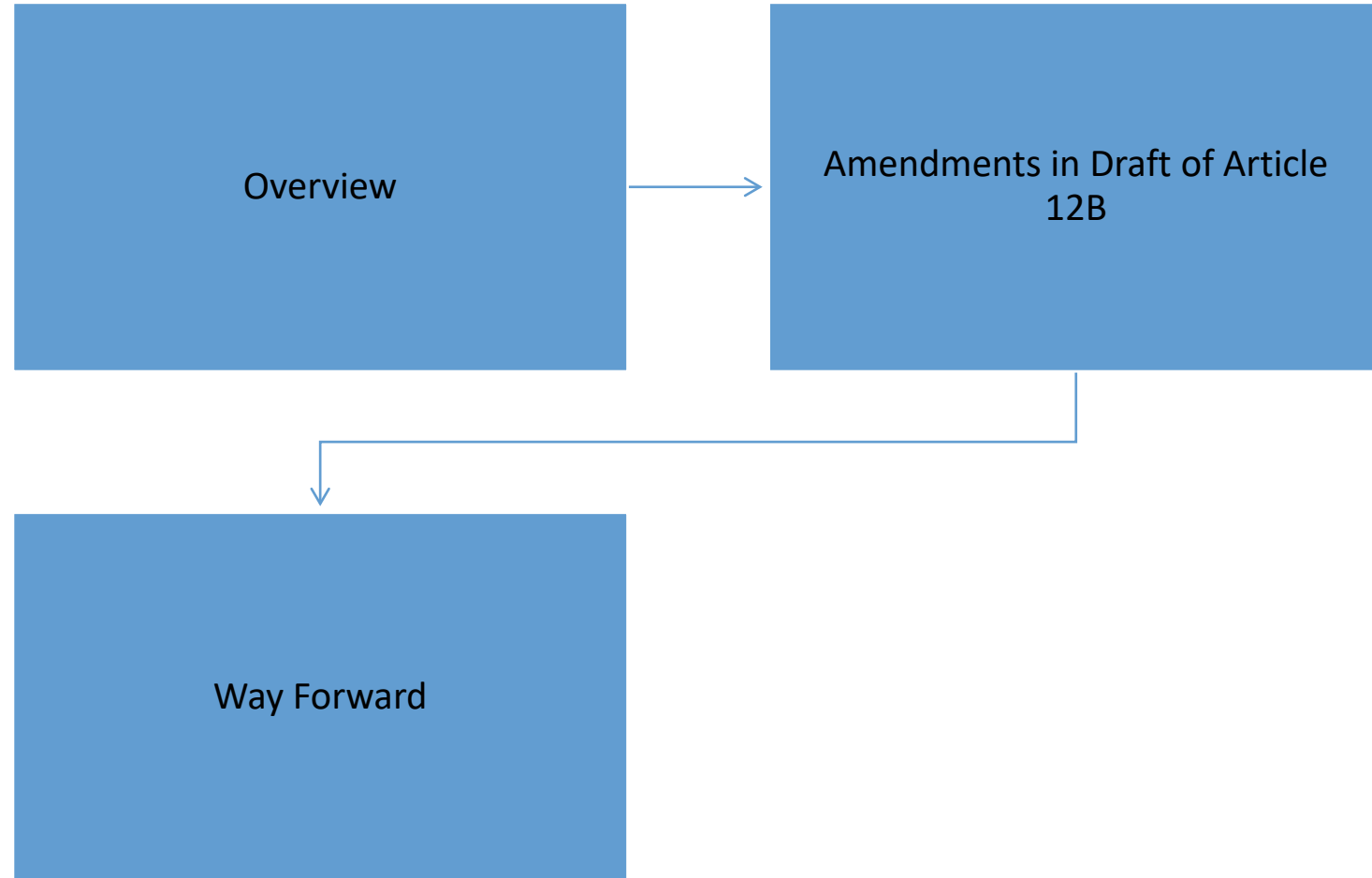
# Research Credits

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# Legends used in the Presentation

ADS	Automated Digital Services
CFS	Consolidated Financial Statements
CIT	Corporate Income Tax
FTS	Fees for Technical Services
NR	Non-Resident
PBT	Profit before Tax
PE	Permanent Establishment
RPT	Related Party Transactions

# Presentation Schema



# Overview

# Overview

- Addressing **tax challenges of digitalization** has become the key priority of International Organisations and domestic economies in order to **combat the base erosion of new business models** resulting from the evolution of ICT

- On this front, the UN committee decided to add a new model treaty provision in its Model Tax Convention, expanding the **taxing rights for States from which payments for automated digital services are made**

- Following the first draft of Article 12B being circulated in August 2020, the revised draft was published in October 2020 after consideration of comments from members of the Drafting Committee and Subcommittee Members

- In today's session we would be discussing on the amendments made in the first draft of proposed Article 12B

# Amendments in the Proposed Article 12B

# Taxation on Gross Basis – Article 12B.2

## As per First Draft

*“However, income from automated digital services arising in a Contracting State may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the income is a resident of the other Contracting State, the tax so charged shall not exceed \_\_\_\_ percent (the percentage is to be established through bilateral negotiations) of the gross amount of the income”*

## As per Revised Draft

*“However, **subject to the provisions of Articles 8 and notwithstanding the provisions of Article 14,** income from automated digital services arising in a Contracting State may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the income is a resident of the other Contracting State, the tax so charged shall not exceed \_\_\_\_ percent (the percentage is to be established through bilateral negotiations) of the gross amount of the income from automated digital services”*



# Implication of the Revision

To avoid uncertainty, paragraph 2 explicitly states that it applies subject to the provisions of Article 8 and notwithstanding the provisions of Article 14.

**Under Article 8, profits from the operation of ships or aircraft in international traffic derived by an enterprise of a Contracting State is taxable only in that State.**

- Example: Profits from online selling of tickets for international transport is subject to Article 8 and not Article 12B because, though the sale is transacted over the Internet, it is sale of non-digital goods or services which is excluded from the definition of income from ADS

**Under Article 14, income from the performance of professional or other independent personal services by a person who is a resident of a Contracting State is taxable by the other Contracting State only if the services are performed through a fixed base in the other Contracting State that is regularly available to the person or if the person stays in that State for 183 days or more in any twelve-month period commencing or ending in the relevant fiscal period.**

However, due to the nature of the automated digital services, it is unlikely that income from automated digital services are dealt with in Article 8 or in Article 14.

# Additions in Commentary to Article 12B.2

## Maximum rate of Withholding Tax

**If the “beneficial owner” of the income is a resident of the other Contracting State, the amount of tax imposed by the State of Source may not exceed a maximum of percent of the gross amount of the payments, as may be negotiated**

The first draft of Article 12B **did not recommend any WHT rate** for the Source State to tax ADS attributable to its territory

However, in the Revised Draft, the Committee has stated that, although the rate is to be bilaterally negotiated, the WHT rate can be **3% or 4%**

# Taxation on Net Basis – Article 12B.3

As per First Draft

*“Notwithstanding the provisions of paragraph 2, the beneficial owner of the income from automated digital services referred to in that paragraph may require the Contracting State where the income from automated digital services arises, to subject its qualified profits from automated digital services for the fiscal year concerned to taxation at the tax rate provided for in the domestic laws of that State. For the purpose of this paragraph, the qualified profits shall be 30 percent of the amount resulting from applying the beneficial owner’s profitability ratio or the profitability ratio of its automated digital business segment, if available, to the gross annual revenue from automated digital services derived from the Contracting State where such income arises. Where the beneficial owner belongs to a multinational group, the profitability ratio to be applied shall be that of the group or, if available, of the business segment of the group relating to income covered by this Article”*

# Taxation on Net Basis – Article 12B.3

As per Revised Draft

*“Notwithstanding the provisions of paragraph 2, the beneficial owner of the income from automated digital services may request the Contracting State where such income arises, to subject its qualified profits from automated digital services for the fiscal year concerned to taxation at the tax rate provided for in the domestic laws of that State. If the beneficial owner so requests, the taxation by that Contracting State shall be carried out accordingly. For the purpose of this paragraph, the qualified profits shall be 30 percent of the amount resulting from applying the profitability ratio of that beneficial owner’s automated digital business segment to the gross annual revenue from automated digital services derived from the Contracting State where such income arises. 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. However, 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.**”*

# Implication of the Revision

- The option of opting for taxation of ADS income on net basis by the Source State was included in the first draft of Article 12B.3

- It was suggested that the taxable value to impose tax at 30% would be the amount resulting from applying the beneficial owner's overall profitability ratio or profitability ratio of ADS segment (if segment accounts are available)

- Likewise, if the beneficial owner was a member of a multinational group, the profitability ratio to be applied shall be that of the group or, if available, of the business segment of the group relating to income from ADS.

- However, the **revised draft has made an addition to the clause** stating that if the **profitability ratio of the multinational group is applied, the same should be higher than the profitability ratio of the beneficial owner at entity level**

- This is with a view to **neutralise the possible reduction of the profitability due to tax-driven related party transactions in the multinational group** (*effects of income shifting by business groups through RPT*)

# Additions in Commentary to Article 12B.3

Profit base for calculating profitability ratio, unless bilaterally agreed otherwise

$$\text{Profitability ratio} = \text{Annual profits} / \text{Annual revenue}$$

If that of beneficial owner

Annual profits would be PBT as per accounts of beneficial owner

If that of MNE group

Annual profits would be PBT as per consolidated accounts

Adjustments to be made to PBT

- Exclude IT expenses
- Exclude dividend income
- Adjustments relating to gain or loss in connection with shares
- Add back expenses not deductible for CIT purpose due to public policy reasons, etc. (Eg: *disallowed expenses arising out of illegal or illegitimate business activity*)

Qualified profits for taxation on net basis = 30% of the amount arrived at by applying profitability ratio to gross annual revenue [i.e.  $30\% * (\text{Adjusted PBT} / \text{Annual revenue})\%$  of Income from ADS in Source State]

# Illustration

## Facts of the Case

- ABC Group in Country A has group companies worldwide which operate in different business segments.
- Co.B in Country B provides digital content services to market in Country C
- Country C exercises its right of source based taxation to tax income from ADS of Co.B
- Co.B opts for net basis taxation subjecting its qualified profits to 20% CIT rate of Country C
- Since Co.B forms part a MNE group, for the purposes of calculating the profitability ratio, the profitability ratio of ABC Group is to be considered as per Article 12B.3
- It is assumed that segment accounts are not maintained and therefore, the overall profitability of ABC Group is considered
- Overall revenue of ABC Group is \$500 and of Co.B is \$300. Assume, its income from sale of digital content services to market economy C is \$150
- Now say, Parent company A in ABC Group has lent \$200 to Co.B during the relevant fiscal year and the effect of tax consolidation under Country A law is that all transactions and payments between group are disregarded for tax purposes
- Co.B in Country B can claim deduction of interest expense of \$40 ( $\$200 * 20\%$ )
- The effect on PBT of ABC group and Co.B (beneficial owner of ADS income) is discussed in further slides

# Contd...

Country A	
ABC Group	
<u>Income:</u>	
Operating revenue	500
Interest from Co. B (It is Nil due to tax consolidation regime)	Nil
<u>Deductible expenses:</u>	
Depreciation	-70
Other allowable business expenses	-90
PBT (Taxable income)	340
<b>Profitability ratio (PBT/OR)</b>	<b>68%</b>



Country B	
Co.B	
<u>Income:</u>	
Operating revenue	300
<u>Deductible expenses:</u>	
Interest paid to Co.A	-40
Depreciation	-10
Other allowable business expenses	-25
PBT (Taxable income)	225
<b>Profitability ratio (PBT/OR)</b>	<b>75%</b>

It is clear from the above, that disregarding transactions between related parties (Co.A and Co.B) in Country A has effect on PBT of ABC Group. In the absence of the said intra-group transaction, PBT of ABC Group would have been 380 (Current PBT:340 + Interest income from Co.B: 40) and accordingly profitability ratio would be 76%  $[(380/500)*100]$



# Implication on Qualified Profits of Co.B

- ✓ For the purposes of taxation of income from ADS in Source State (Country C) according to Article 12B.3, profitability ratio of the MNE group is applied to such ADS income if the beneficial owner (Co.B) part of an MNE group
- ✓ 30% of the amount arrived as above will be taxed according to domestic laws of Country C (20% CIT Rate)

## As per First Draft

Profitability ratio would be 68% (that of ABC Group)

Income from sale of digital content services in Country C by Co.B	150
Profitability ratio	68%
Qualified Profits attributable to Country C	30.6 [(150*68%)*30%]
<b>Tax on above in Country C (30.6 * 20%)</b>	<b>6.12</b>

## As per Revised Draft

Profitability ratio would be 75% (that of Co.B) because Article 12B.3 explicitly states that the profitability ratio of MNE group can be applied only if the same is higher than that of the beneficial owner at entity level. Therefore, here in our case profitability ratio of ABC group is less due to RPT and that of Co.B is higher. Hence, ratio of Co.B has to be considered for the purpose of computing qualified profits

Income from sale of digital content services in Country C by Co.B	150
Profitability ratio	75%
Qualified Profits attributable to Country C	33.75 [(150*75%)*30%]
<b>Tax on above in Country C (33.75 * 20%)</b>	<b>6.75</b>

# Meaning of Income from Automated Digital Services

## – Article 12B.4

### As per First Draft

*“The term “income from automated digital services” as used in this Article means any payment in consideration for any service provided on the internet or an electronic network requiring minimal human involvement from the service provider. The term “income from automated digital services” does not, however, include payments qualifying as ‘fees for technical services’ under Article 12A”*

### As per Revised Draft

*“The term “income from automated digital services” as used in this Article means any payment in consideration for any service provided on the internet or an electronic network requiring minimal human involvement from the service provider. The term “income from automated digital services” does not, however, include payments qualifying as “**royalties**” or ‘fees for technical services’ under Article 12 or Article 12A as the case may be.”*

# Implication of the Revision

The First draft explicitly excluded payments which qualified as FTS under Article 12A from the definition of term “automated digital services”

The Revised draft now **explicitly excludes from the definition of “ automated digital services” payments which qualify as “Royalties” under Article 12**

There may be a situation where particular kind of automated digital services may wholly or partly fall under scope of royalty or of technical services covered by Article 12 or by Article 12A, as the case may be.

**Provisions of Articles 12 or 12A would apply where such automated digital services are wholly overlapping with the scope of those articles.**

Where, however, **part of services amongst bundle 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**

# Additions in Commentary to Article 12B.4

Inclusion in the term “Automated digital services”

Online search engines

Online search engines imply **making a digital interface available to users** for the purpose of allowing them to search across the Internet for webpages or information hosted on digital interfaces.

Many online search engines are **monetized through online advertising services and/or services transmitting data about users.**

To the extent these services are funded via online advertising or the sale of data, such revenue would be treated under those respective categories (including for revenue sourcing purposes).

This category extends to instances where an **online search engine charges users for access**, for example under a subscription model, or where online search engine technologies are provided for incorporation into a third-party host website (e.g. a “search box”).

This category **does not include services such as online databases or ‘internal’ website search functions that are not monetized**, where the search results are limited to data hosted on that same digital interface (or related digital interfaces).

- However, if an online database or an ‘internal’ website search function service involves monetization of services or meets the general definition of automated digital service, it will be covered under Article 12B

# Additions in Commentary to Article 12B.4

Inclusion in the term “Automated digital services”

Online gaming

Online gaming means making a **digital interface available for the purposes of allowing users to interact with one another in the same game environment.**

This category applies to all **multiplayer gaming enabled by the Internet**, such as massively multiplayer online games, or other games that enable multiplayer functionalities, and regardless of the device or platform the game is accessed through.

The provision of in-game purchases, or any other online purchases within the game is also under this category.

This category **does not include single player games (which if streamed, accessed or downloaded over the Internet would be under the category of digital content services) or the purchase of a game sold on tangible media (as above for software, and which would fall under Article 12)**

# Deletions in Commentary to Article 12B.4

Exclusion from the term “Automated digital services”

As per First Draft

The Commentary explicitly excluded such broadcasting services from the term “automated digital services”

Broadcasted services  
including simultaneous  
internet transmission

As per Revised Draft

The Commentary’s exclusion list does not contain such broadcasting services

Though “Broadcasted services including simultaneous internet transmission” has been excluded from the exclusion list of ADS, the **same has not been expressly specified to be classified as ADS for the purposes of Article 12B.**

Hence, there is ambiguity on the coverage of services that are simultaneously provided via broadcast to the general public over communication networks other than the Internet or electronic networks under Article 12B

# Clarification with regard to Inseparable Activities

## Paragraph 43 of Commentary to Article 12B.4

There may be activities which are not clearly severable

Where **substantial part of the overall activity fulfills the criteria under Article 12B.4** and the remaining elements derive significant benefits from their connection to the elements having characteristics under paragraph 4, then the overall service may be regarded as covered under Article 12B.

- Example: Customised online teaching services are excluded from definition of ADS. However, standardised online teaching service with ancillary interaction with an instructor would be classified as automated digital services under Article 12B since substantial part of the activity requires minimum human involvement

By contrast, where the **elements fulfilling criteria or matching characteristics under Article 12B.4 are merely ancillary or a technical support feature for the rest of the service, and rest of the service requires human involvement, the overall service may not be considered as covered under Article 12B.**

- Example: An automated chat function to screen a user's request as an entry point to the service

# Clarification with regard to Mixed Contracts

## Paragraph 46 of Commentary to Article 12B.4

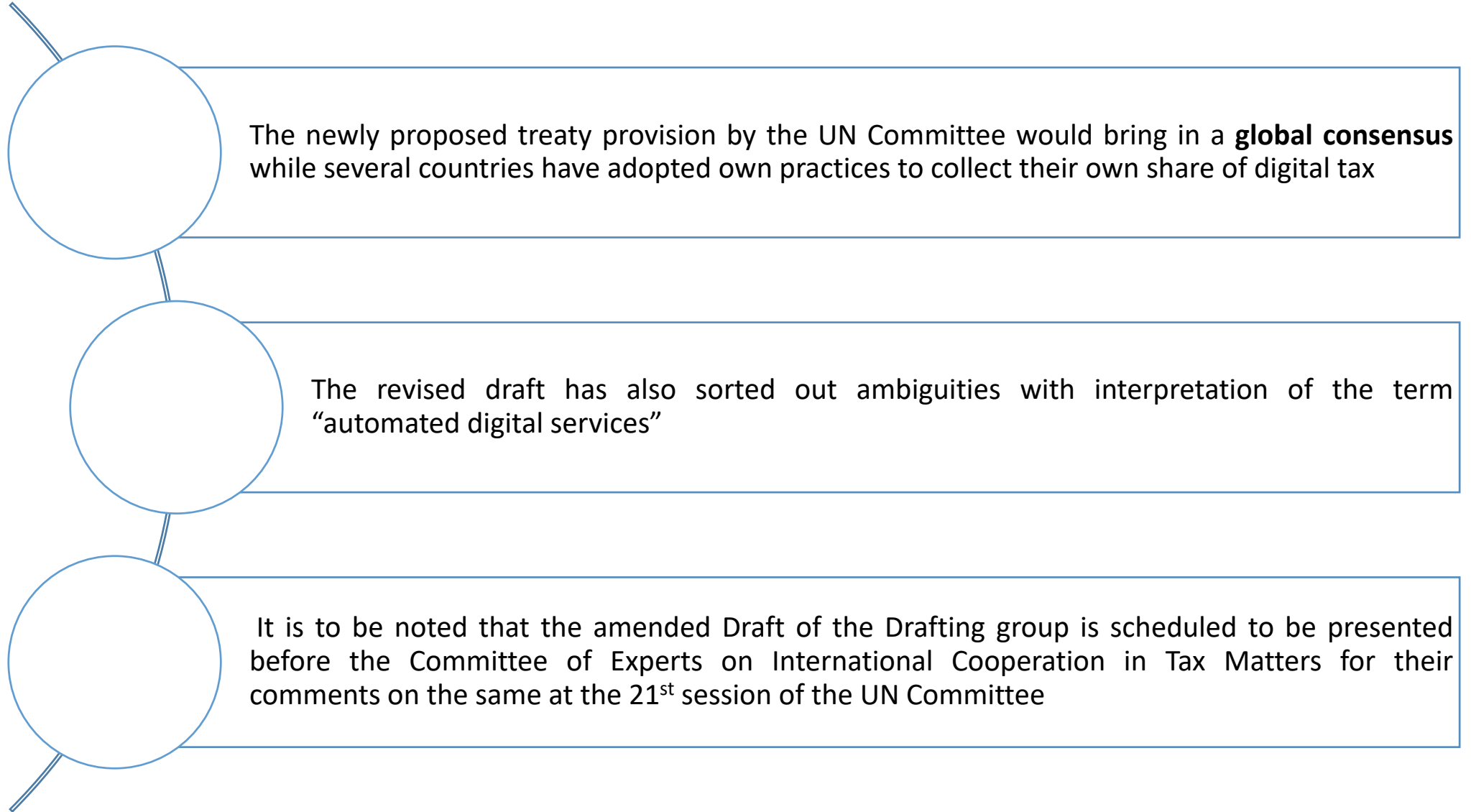
Where there arises **difficulty to distinguish between payments in consideration for ADS and payments for FTS or royalties** so as to determine whether Article 12 or 12A or 12B is applicable, the Committee states that the principles in each of those Articles has to be applied carefully to **decide the characterization of payment**

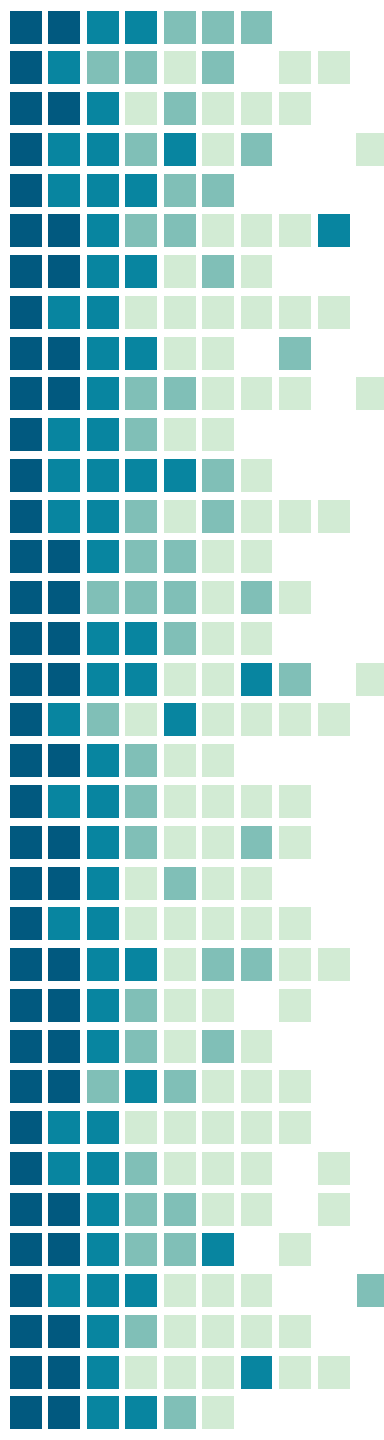
Thereafter, the **particular Article will take precedence over the other** as implied by the express statement in clause 4 of Article 12B

With respect to so-called **mixed contracts**, the appropriate course would be to **break it down, on the basis of information contained in the contract or by means of a reasonable apportionment**, the whole amount of stipulated consideration according to various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper to it.



# Way Forward





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