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Item 4
Framework Convention, Protocol I on taxation of income derived from the provision of cross-border services in an increasingly digitalized and globalized economy and Protocol II

Note by the Secretariat

Potential subjects of the second early protocol[1]

At its Organizational Session, the Intergovernmental Negotiating Committee on the United Nations Framework Convention on International Tax Cooperation (INC-Tax) will decide on the subject of the second early protocol,[2] to be drawn from the list of specific priority areas set out in the terms of reference (ToR) adopted by the General Assembly in December 2024.[3] The options for the subject of the second early protocol are:

(a) Taxation of the digitalized economy;

(b) Measures against tax-related illicit financial flows;

(c) Prevention and resolution of tax disputes;

(d) Addressing tax evasion and avoidance by high-net worth individuals and ensuring their effective taxation in relevant Member States.

Conceptually, a "framework convention" can establish a legal basis for ongoing cooperation toward defined objectives and sets out principles and commitments consistent with the objectives as well as institutional arrangements. In general terms, under the "framework convention-protocol approach" the framework convention and the protocols are interrelated, such that the protocols may set forth more specific commitments, substantive measures and/or additional institutional arrangements. The

[1] Unofficial document prepared by the United Nations Department of Economic and Social Affairs Financing for Sustainable Development Office.

[2] The first early protocol will be on the "taxation of income derived from the provision of cross-border services in an increasingly digitalized and globalized economy." The INC-Tax will have to further clarify, over the course of its work, how to interpret the subject of this first protocol, which might focus on traditional services provided through digital means of communication and/or genuine digital services. Depending on the interpretation of this subject, the INC-Tax might also need to delineate the subject from the "taxation of the digitalized economy."

[3] See A/RES/79/235, and A/AC.298/2.

INC-Tax will negotiate, over the course of its work, the coverage and level of detail of the provisions contained in the framework convention and the early protocols in accordance with the ToR, and different approaches are possible in designing an appropriate treaty regime.

Accordingly, the potential subjects for the second early protocol as set out in the ToR can be considered to have been framed as rubrics potentially capturing a wide array of possible measures that could be taken in respect of each item. The subjects and possible measures in respect of each may have different levels of urgency for Member States, complexity, and anticipated impact on economies and tax revenue, as well as other theoretic and practical considerations.

Against this backdrop, the mandate of the INC-Tax is to decide, at its Organizational Session, on the "subject" of the second early protocol. The choice of a "subject" will express political priorities in respect of a specific issue area of international tax cooperation that Member States wish to address through additional measures in the context of the UN Framework Convention on International Tax Cooperation by means of a separate protocol.

This paper sets out some considerations on the subjects and outlines examples of some issues that could be addressed in a protocol; it does not address all issues pertaining to the choice of the subject.

Taxation of the digitalized economy

Over the last two decades, technological innovation and accompanying changes in consumer preferences have significantly altered how business is conducted and gave rise to new digital business models. This process has gradually transformed traditional segments of the economy, such as agriculture, medicine, and the provision of goods and services. In addition, new digital business models have emerged which are built on digital products and services, data, and the evolution of artificial intelligence promises a wave of further innovation. The digitalized economy has also spurred financial innovation and created new digital asset classes and investment models. Characteristically, the digitalized economy is less inhibited by geographic boundaries, connecting people and intertwining economies in novel ways.

In the digitalized economy, multinational enterprises (MNEs) can conduct cross-border business activities at large scale utilizing intangible assets and other mobile factors, requiring minimal or no physical presence in the market/user jurisdiction. This poses challenges to the effectiveness and equity of the international tax system as tax rules generally require a physical nexus and are largely based on traditional concepts of economic substance, factors of production and their allocation for tax purposes. Due to these factors, the international tax system, while remarkably stable for almost 100 years,[4] began to facilitate tax competition, tax avoidance and evasion.

There is a wide recognition of these issues and their impact on tax revenue and tax competition, and different approaches to addressing some of the challenges have been proposed. Unilateral measures include digital services taxes, equalization levies, withholding taxes, new permanent establishment concepts, such as significant economic presence, as well as indirect taxes, such as value-added taxes (VAT) or goods and services taxes (GST). Bilateral proposals include revisions to model tax treaties to coordinate measures internationally, such as Art. 12A, Art. 12B and the new Art. XX of the UN Model Tax Convention. Lastly, multilateral proposals include a crypto-asset reporting framework (CARF) and Amount A of Pillar One, and model rules for a global minimum effective tax have been developed through the G20/OECD

[4] The origin of the international tax treaty system based on a classification-and-assignment approach and a theory of economic allegiance of items of income can be traced to the 1923 Report by the League of Nations, see Economic and Financial Commission, Report on Double Taxation, submitted by Profs. Bruins, Einaudi, Seligman, and Stamp.

Inclusive Framework on a common-approach basis. Nonetheless, Member States have different views as to the appropriateness and effectiveness of these proposals and particularly the inclusiveness of the processes of their development.

Given the breadth of the tax challenges involved in effectively taxing the digitalized economy, there is a wide range of potential issues to choose from for a protocol. Needless to say, the INC-Tax is at full liberty to develop any new measure as it sees fit. Measures could address, for example, issues in relation to the international tax rules and/or strengthening their administration, and may address structural deficiencies in respect of the nexus threshold or profit allocation rules and their standardized application, or target specific types of transactions, such as digital assets, the use of user data and information or digital services generally. Measures could also pertain to exchange of information or institutionalize capacity building and technology transfer programs.

Measures against tax-related illicit financial flows

Tax-related illicit financial flows present unique challenges for governments and tax authorities as they drain countries of tax revenue, discourage public and private investment and prevent structural transformation of economies and efficiency of policies. Tax-related illicit financial flows encompass a broad range of cross-border tax practices by corporations and individuals aimed at concealing revenues, reducing their tax burden, evading controls, regulations and other laws. They may also cover various forms of harmful or aggressive tax avoidance.

The practices of tax-related illicit financial flows available to corporations and individuals as well as the potential remedies to such practices differ greatly. In the last two decades significant work has been put into tax transparency, with the belief that more transparency about transactions and assets can help remedy the secrecy that remains at the heart of many illicit financial flows. Many tax avoidance and evasion techniques relied on misvalued transactions. This includes both mispriced goods in trade transactions between ostensibly unrelated parties, as well as mispriced transfers within MNEs. There are also challenges with hidden assets which are not reported to residence country authorities. Assets may be hidden through layers of cross-border transaction using trusts and corporate shells to disguise the ultimate beneficial owner of the asset.

There already exists a number of instruments addressing some aspects of tax-related illicit financial flows. These include the automatic exchange of information on financial accounts, country-by-country reporting of MNEs, and maintenance of centralized registries of beneficial ownership information for financial accounts, corporate entities and trusts. Countries have also experimented with measures to put some of these types of information in the public domain, with a wide variety of national practices related to publication and transparency of tax information. At tax treaty level, measures have been developed targeted at some weaknesses and loopholes in bilateral tax treaties, such as the OECD/G20 BEPS Action items and the amendments introduced to the UN Model Tax Convention including on offshore indirect transfers the concept of beneficial owners, as well as the new subject-to-tax-rule adopted by the UN Tax Committee. Again, Member States have different views as to the appropriateness and effectiveness and particularly the inclusiveness of these instruments and measures.

The measures under a protocol on tax-related illicit financial flows would depend on the delineation of the specific issues to be addressed. Options include, for example, coordinated measures to close persisting weakness in international tax rules that facilitate harmful or aggressive tax avoidance, rules to prevent tax treaty abuse, increasing the scope of exchange of information rules to cover additional assets or transactions (e.g. customs information exchange, crypto-assets, real estate),

additional mechanisms to cooperate in relevant audit procedures, establishing more inclusive information exchange arrangements, making beneficial ownership registries and country-by-country reports publicly available, expanding the coverage of beneficial ownership registries, tackling transfer mis-pricing problems, establishing regulatory and supervisory standards for professionals involved in enabling tax-related IFFs, and data gathering and analysis in a centralized center for monitoring taxation in general and the taxation of MNEs specifically. The INC-Tax may, of course, develop new targeted measures not mentioned in this note.

Prevention and resolution of tax disputes

As business models and value chains have become increasingly globalized and dispersed and international tax rules increasingly complicated, cross-border tax disputes become increasingly frequent and difficult to resolve. The effective and efficient prevention and resolution of cross-border tax disputes has thus emerged as a pressing issue for governments and taxpayers alike, promising to reduce cost and increasing legal certainty for cross-border business activity and investments. Such tax disputes can arise from the interpretation or application of the international tax provisions of domestic law or tax treaties. In addition, the UN Framework Convention and the early protocols, like every tax agreement, may themselves become subject to tax disputes.

There are several limitations in bilateral treaty dispute prevention and resolution mechanisms, some of which are addressed in the Handbook on Dispute Avoidance and Resolution developed by the UN Committee of Experts on Cooperation in International Tax Matters.[5] The tax treaty rules are complemented by a patchwork of additional administrative and legal tools outside of the tax treaty network, including the use of mandatory binding arbitration under international investment agreements to address tax-related disputes. Again, member States have different views as to the inclusiveness, effectiveness, and fairness of these approaches. Hence, a more multilateral approach to these issues could help stabilize and bring greater certainty and fairness to the international tax environment. Generally, avoiding tax disputes from arising may alleviate the pressure on dispute settlement mechanisms.

Under a protocol on the prevention and resolution of tax disputes, existing tools could be strengthened, and new tools could be tested. Potential measures on avoiding disputes may encompass, for example, strengthening coordinated advance agreements and administrative assurance as well as increasing the efficacy of cross-border cooperation in respect of joint tax audits. As to cross-border tax disputes, the legal basis both within and outside the current tax treaty network may be strengthened. This may include mutual agreement procedures, confidentiality and secure document exchange, arbitration, and non-binding dispute resolution. However, any measure will have to balance Member States' interest in effective and efficient resolution of tax disputes with the imperatives of and concerns for national sovereignty. Furthermore, the INC-Tax may decide that the institutional provisions of the Framework Convention should encompass mechanisms for the prevention and/or resolution of disputes arising from the implementation of the framework convention. The Framework Convention may also cover aspects of prevention and/or resolution of cross-border tax disputes. Developing a protocol on the prevention and/or resolution of tax disputes may thus need design decision by the INC-Tax on the approach taken as well as careful coordination with provision in the main convention.

Addressing tax evasion and avoidance by high-net worth individuals and ensuring their effective taxation in relevant Member States

[5] See United Nations, *Handbook on the Avoidance and Resolution of Tax Disputes*, 2021, ISBN: 9789212591896.

Wealth and income inequalities globally and within countries have increased significantly while effective tax rates for many high-net worth individuals (HNWI) often have decreased over the last decades. The reasons for these phenomena are complex and include, among other factors, an unequal sharing in the benefits of globalization, structural differences in the rates of return on capital and labor, difficulties in tracing and measuring wealth globally, tax competition among nations for domiciling HNWI, as well as most recently also exacerbating wealth inequalities due to, inter alia, central banks' financial assets purchase and asset price stabilization programs in response to global financial shocks, such as the Global Financial Crisis and the COVID-19 pandemic.

Tax avoidance and tax evasion by HNWI has become more widespread but has not yet received the same level of attention as has corporate tax avoidance, tax evasion and profit shifting. However, many of the same issues discussed under the potential tax-related illicit financial flows (IFFs) protocol are also relevant to the taxation of HNWIs, particularly as research has found that HNWIs have a higher propensity to fail to declare income or assets and have more capacity to pay for complex structuring of transactions and ownership of assets to avoid or evade taxation. The UN Committee of Experts on Cooperation in International Tax Matters has evaluated different proposals to strengthen the fair and effective taxation of wealth and income of HNWIs.

The second protocol under the UN Framework Convention could address tax evasion and avoidance by HNWI and ensuring their effective taxation in relevant Member States. This subject provides space for Member States to craft an instrument tailored to providing a basis for closer cooperation in ensuring the effective taxation of HNWI in relevant Member States. Possible sub-topics under this protocol could include, for example, information sharing on asset ownership and financial accounts through automatic exchange, beneficial ownership transparency instruments and registries, anti-avoidance provisions related to renunciation of citizenship or change of residency, and limits on or transparency provisions for citizenship/residency by investment schemes, or even a minimum taxation agreement for HNWIs that ensures their effective taxation in relevant Member States. The INC-Tax may, of course, develop other new measures not mentioned in this note.