27 June 2025

Intergovernmental Negotiating Committee on the UN Framework Convention on International Tax Cooperation
Workstream II
Co-Leads' Draft Issues Note

I. Introduction

1. Workstream II of INC/Tax is charged with developing the first early protocol, on the "taxation of income derived from the provision of cross-border services in an increasingly digitalized and globalized economy".[1] The draft text of the protocol will be submitted, along with the draft text of the UN Framework Convention on International Tax Cooperation and the draft text of the second protocol on the "prevention and resolution of tax disputes"[2] to the UN General Assembly for its consideration in the first quarter of its 82nd session in the second half of 2027.

II. Possible Scope of Work

2. At its organizational session, INC/Tax considered a note by the Secretariat, A/AC.298/CRP.4, on the four possible subjects for the second early protocol. In a footnote, this note stated:

> 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."

This description is to be understood as an orientation, and not as a limitation of the possible scope of the protocol.

3. The first task with respect to Workstream II is to agree on the scope of the protocol. The work plan for Workstream II anticipates that the INC Plenary will have an initial discussion of the scope and approach of Protocol 1 at its August 2025 Sessions, provide guidance to the workstream at its November 2025 Session, and begin discussing drafting options in late 2025.

4. Workstream II has had [ ] weekly meetings, starting on 13 May 2025. At those meetings, participants first discussed the issues that they encounter in trying to tax non-residents on income from services provided to residents of their countries. At subsequent meetings, participants discussed common structures involving cross-border services with a view to developing principles of taxation that might be reflected in Protocol 1.

[1] See A/AC.298/2.
[2] See A/AC.298/CRP.5.

III. Issues Discussed in the Workstream

5. This section first summarizes the issues discussed in the workstream and the various views that were expressed in order to provide background for the August 2025 Sessions of the INC Plenary. It begins in subsection (a) by describing current rules for the taxation of cross-border services income, both under countries' domestic laws and as modified by tax treaties and explaining why some countries are calling for changes to those rules, with the primary focus on source State taxation.[3] Subsection (b) then describes the workstream's discussions regarding possible new rules for the taxation of income from cross-border services. Subsection (c) mentions some preliminary questions regarding the scope of the protocol. Subsection (d) provides a short summary of the current state of discussions in the workstream.

a. Current rules for taxation of income from cross-border services and reasons for change

6. There are significant differences between the ways that income from cross-border services is taxed under the domestic laws of Member States. These differences affect not only the substantive rules but, as demonstrated during discussions in the workstream, views regarding the relative administrability and fairness of different rules.

7. In many countries, primarily but not limited to developing countries, gross-basis withholding taxes are imposed on all or most payments made from the country to a non-resident. This general rule goes beyond withholding on passive income, such as dividends and interest, that is common even in countries described in paragraph 8. As applied to services, however, application of the general rule means that income from services is taxed no matter where the services are performed. Countries with this system find it easy to administer as they do not have to determine whether the service provider is within their country or, generally, where the services were performed (except in cases where the non-resident's activities within the jurisdiction rise to the level of a permanent establishment or similar threshold under the country's domestic law). Some countries noted that the problem of detecting economic activities within their borders is not limited to multinational enterprises but arises with respect to small enterprises as well. Others explained that taxing the gross amount of the payment means that they do not have to deal with the allocation of income or expenses. In addition, when a payment for services gives rise to a business deduction, tax authorities find it relatively easy to then determine whether the payer has withheld the payment giving rise to the deduction. In at least some countries, non-residents are allowed to file a tax return to pay tax on a net basis; whether taxpayers choose to do so or not may depend on the compliance costs connected with filing such a return compared to the possible reduction of tax.

[3] Most Member States will tax their residents on their worldwide income on a net basis, relieving double taxation either through the exemption method (in which certain income earned abroad is not included in the tax base in the residence State), the credit method (in which the tax that would have been imposed in the residence State is reduced by the amount of taxes paid to the other State), or a mix of both. If the exemption method applies with respect to certain income, the residence State will simply not tax that income and so will have no residual taxing rights. If the credit method applies, the residence State will in principle have residual taxing rights but, whether it actually will collect any tax will depend on a complex interaction between taxation in the source State and limitations in the residence State (including the application of any relevant expense allocation rules).

8. Other countries, including most developed countries, tax income from services primarily based on where the services are performed. Therefore, if a non-resident is physically present in the country while performing the services, the income generally will be subject to tax. Such taxation is usually on a net basis, with deductions allowed for relevant expenses (even if such expenses were paid by another part of the entity (such as the head office) but incurred for purposes of the activities in the other Contracting State). Conversely, under this approach, when services are performed remotely, the resulting income will not be taxed in the country from which payment is made. During the workstream discussions, some countries with this system noted that they believe that taxation based on physical presence on a net basis is more economically correct, efficient, and fairer. Moreover, the resident State is in the best position to determine the net profits. On the other hand, some countries that generally are described in this paragraph noted that they are exploring or have adopted broader nexus rules to take account of new ways of doing business.

9. Because of these basic differences in Member States' domestic laws, tax treaty limitations on taxation of income from cross-border services affect countries described in paragraph 7 more than those described in paragraph 8. Tax treaties (which are usually bilateral) use a system of "classification and assignment" to allocate taxing rights between the two parties (known as "Contracting States"). Under this system, different distributive rules that may restrict or eliminate taxing rights of both source and residence countries apply to different types of income. The OECD Model Tax Convention on Income and on Capital (the "OECD Model") provides that income from many services, including management, technical and consultancy services, is treated as business profits.[4] Because such income is treated as business profits, under Article 7 of the OECD Model it generally can be taxed only in the country of residence of the recipient of the income, unless that taxpayer has a "permanent establishment" in the other Contracting State. A permanent establishment is generally a fixed place through which the taxpayer's business activities are carried out, although a person providing goods or services may also have a permanent establishment by reason of the activities of certain employees or other dependent agents in the other Contracting State. Special rules apply with respect to certain types of services, including international transport (exclusive residence State taxation even if there is a permanent establishment in the other country), entertainment and sports (taxation where the services are performed without a threshold), and serving as a director of a company (taxation where the company is a resident, no matter where the services are performed). These rules tend to align fairly closely with the domestic laws of countries described in paragraph 8.

10. At the first meeting of the Ad Hoc Group of Experts that was charged with developing the UN Model Tax Convention in 1968, a delegate from a developing country argued that income from services should not be treated as business profits in order to allow countries to impose gross-basis withholding taxes. Ultimately, the 1980 UN Model did not adopt this approach; instead, it provided a separate threshold for services that does not require a fixed base but does require physical presence for at least 183 days in the relevant year. Over the years, the UN Model gradually has been changed to allow Contracting States to impose gross-basis taxes on a wide variety of services. In fact, with the adoption of Articles 12AA (all services except certain specialized services), 8

[4] "Business profits" also, of course, includes income from the sale of goods.

(Alternative A) (international transport) and 12C (insurance) in 2025 and 12B (income from automated digital services) in 2021, it is fair to say that the general rule in the 2025 UN Model is that the state from which payment is made is permitted to impose gross-basis taxes on payments for services, with net-basis taxation as an exception that applies when services are physically provided in the source country, usually in connection with the creation of a permanent establishment.[5] This system is more consistent with the domestic laws of countries described in paragraph 7.

11. Although developing countries tend to have smaller treaty networks than developed countries, many of the treaties that they do have are older and/or based on older versions of the UN Model. As a result, they are prevented from imposing their preferred gross-basis withholding taxes on payments to non-residents. Many described these limitations in tax treaties as the most significant barriers they face in trying to tax cross-border services. They also noted that it is difficult for them to modify or terminate treaties once they are in force.

12. Developed countries often argue that the key to improving domestic resource mobilization in developing countries is capacity building and technical assistance so that they can apply transfer pricing rules to deny a deduction to the local payer to the extent that the relevant payment is not viewed as consistent with an arm's length arrangement. However, participants from developing countries noted difficulties with this approach. They often find that there is a lack of comparable transactions between unrelated parties. Participants also mentioned the expense or unavailability of commercial databases, or that the information in such databases is not appropriate for the circumstances of developing countries. Applying these rules results in significant economic burdens in terms of technology and human resources with no guarantee of success in increasing revenue. Some have questioned why they should incur those costs to apply transfer pricing rules that, in their view, put too much weight on activities that take place in the State of residence of the taxpayer or in third states and not enough weight on the contribution of the market where the services are consumed; they believe that there may be simpler and fairer rules that could be considered.

13. There was a general acknowledgement within the workstream that the rules that limit source State taxation to cases in which services are provided in that State do not fully reflect current ways of doing business. Such rules were originally developed in the 1930s or 1940s, when it was difficult to provide services without having a physical presence in the country where the consumer of the services was located, but this is no longer the case. For many who participated in the workstream, the examples discussed demonstrated that it is now possible to provide many services remotely, suggesting that physical presence may now not always be a sufficient or appropriate test for determining taxing rights. Some participants noted that this may be the case even in industries that involve a very close physical connection to the host State, such as the extractives industry and agriculture as technical service fees and management fees may lower the host State's tax base.

b. Developing new approaches to taxing income from services

14. The discussion of common fact patterns also elicited participants' views regarding justifications for possible new nexus rules for services. Participants emphasized that the primary goal of

---

[5] Article 17 (Artistes and Sportspersons) allows taxation of a non-resident who performs certain activities in a Contracting State even if the non-resident does not have a permanent establishment.

any new rules should be to support domestic resource mobilization by providing for a fair allocation of taxing rights. Other goals are to eliminate barriers to cross-border trade and investment, economic efficiency and ensuring tax neutrality, and simplicity and administrability. It was also agreed that any new nexus rules must be "future-proof" by satisfying these criteria even as business models change in ways that are impossible to now foretell.

15. As noted in paragraph 7, a number of Member States tie deductibility of payments to withholding tax because a deduction to the payer with respect to the payment for services represents a cost to the jurisdiction that, in their view, should be offset by taxation of the recipient. A different argument in favor of a new nexus is based on the fact that the non-resident benefits from access to the market. Supporting this view is the contribution of users to the generation of income with respect to many services; the presence of users within their jurisdictions shows that real economic activities are taking place there.

16. For other participants, physical presence in a country continues to provide a strong justification for taxation by that country as it indicates that business activities are taking place there. They take the view that income from services is most appropriately treated as business profits taxed on a net basis. They cautioned that gross taxes on cross-border transactions may create economic distortions and, in the case of services, a barrier to the provision of such services that may inhibit such activity, particularly on services with a low profit margin. They also see no reason for different treatment as between the provision of services and sales of goods. However, as noted above, they did not foreclose the possibility of including additional rules to address situations involving remote services and services provided digitally, although some questioned why mere access to a market in itself indicates value creation.

17. Several participants suggested that it may be appropriate to apply different rules with respect to different types of services such as, for example, intra-company payments. Others noted, however, that it is often difficult to distinguish between services performed through a physical presence, those performed remotely and those performed digitally. If that is the case, rules that produce different results depending on how the services are performed would violate the principle of neutrality, particularly given the ease with which many services can be performed from any location. Such rules would also potentially discriminate against local brick-and-mortar businesses with local ownership, which pay taxes locally and would find it hard to compete against remote businesses that might not pay the same level of taxes. Some participants argued that it can be difficult to determine the "correct" amount of source State taxation because different companies have different profit margins, affecting whether the residence State can actually exercise any residual taxing rights.

18. Participants also discussed the idea of "value creation" more generally and considered whether it is a useful tool for establishing nexus. Several argued that the interplay of supply and demand drives value creation – the development of a product is meaningless if there is no demand for that product. Thus, the market jurisdiction contributes to value and should receive a portion of the tax revenue generated, no matter where the services are physically performed. Another participant pointed out that this argument supports shared taxing rights, not exclusive source-State taxing rights. In later discussions, some participants argued that "value creation" has no independent

economic meaning, but was a concept developed during the OECD/G20 BEPS project to reflect both nexus and income allocation; as such, they argued that it may not be helpful in establishing new nexus rules. However, others suggested that "value creation" could be considered as a basis for creating a new nexus for taxation, and should not be limited to the interaction between demand and supply, but should also include other valuable contributions made by users in a jurisdiction (such as user data and user participation).

19. Several participants mentioned the adoption in their countries of a new nexus, the "significant economic presence" test. This test, which applies to both goods and services, allows taxation when a non-resident enterprise's activities in the jurisdiction produce more than a specified threshold of revenue, it conducts certain marketing activities there or there are other indicia of deliberate targeting of the jurisdiction's market. The monetary thresholds can be tailored to the size of the relevant economy. The workstream did not discuss the approach in great detail but is likely to come back to it after the August 2025 Sessions.

c. Scope of the protocol

20. Because the focus of discussions in the workstream was on the provisions of bilateral tax treaties that currently restrict or eliminate source State taxation, that led the discussions also to focus on the types of taxes currently covered by such treaties – that is, in general, income taxes. However, it was also noted that there are significant ambiguities regarding the classification of various types of relevant taxes. There was, for example, previously a proposal from the Commission of the European Union, that was never adopted by the Member States, that would have viewed digital services taxes ("DSTs") as indirect taxes. Other potentially relevant terms, such as "excise taxes", do not have direct translations into certain languages. Accordingly, the workstream tentatively concluded that it will need to define coverage of the protocol by reference to the nature of the tax, not what it is called. Discussions on this issue will continue.

21. The examples discussed by the workstream included a variety of services and situations, including intragroup payments for technical and managerial services, payments to unrelated parties for remote services and automated digital services. Although the workstream discussed the possibility of having different rules for different types of services, it did not otherwise address the question of the scope of the protocol. Discussions on this issue will take place between the August 2025 Sessions and the November 2025 Session.

D. Summary

22. Overall, the workstream was moving towards consideration of shared taxing rights with respect to income from the provision of services, which may recognize taxing rights for source countries subject to limits so that the residence State retains taxing rights. As it continues its discussions regarding possible new rules, the workstream will further explore whether it is appropriate to apply different rules with respect to different types of services or as between services and sales of goods. Discussions also will continue with respect to the manner of taxation, as some participants prefer gross-basis withholding taxes (with some suggesting considering different rates depending on the service provided) and others prefer net-basis taxation.

IV. Issues for the Committee

23. The Committee is asked to consider:

(a) whether Section III(a) comprehensively describes current rules for the taxation of services and the reasons behind the call for change, or whether there are additional considerations that should be taken into account in the workstream's discussions;

(b) what considerations are most important in developing possible new rules for the taxation of services; and

(c) how the workstream can best define the scope of the protocol in terms of the taxes and services that it will cover.