Intergovernmental Negotiating Committee on the United Nations Framework Convention on International Tax Cooperation

10 July 2025

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SUBMISSION WITH RESPECT TO THE DRAFT ISSUES NOTE ON WORKSTREAM II: TAXATION OF SERVICES

ABSTRACT

This submission makes some suggestions to help focus Workstream II and Protocol 1 on the most important issues. It suggests that the only viable nexus rules for income from services are physical presence and the place of use or consumption; value creation and significant economic presence are too vague to be useful. It also suggests that nexus rules based on either physical presence or on the place of use or consumption are equally valid from a tax policy perspective. The choice between those nexus rules for any particular treaty article is a political decision. As a result, countries should avoid rigid adherence to one rule as opposed to the other and be prepared to compromise in order to reach agreement.

The submission also agrees with the Issues Note that shared taxation is the only viable approach for Protocol 1, which means that the key issue for the negotiations will be determining the appropriate limit on the tax imposed by the country (usually the source country) that has the first right to tax.

Finally, the submission strongly suggests that income from employment services should be included in the scope of Workstream II's work.

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The Co-Leads' Draft Issues Note of 27 June 2025, paragraph 13, states:" 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." I agree with this statement and would suggest that it is supported by the provisions of the United Nations Model Tax Convention, especially the replacement in the 2025 Update of former Article 12A (Fees for technical services) and Article 14 (Independent personal Services) by new Article 12AA and the addition of new Article 12C (Insurance Premiums).

This acknowledgement opens up for discussion the difficult issue of what nexus rule or rules should be used to allocate taxing rights on income from cross-border services. Different rules may well be appropriate for different types of services. In my view, the only two reasonable and practical nexus rules for the taxation of services are those based on the place of physical presence of the service provider performing the services and the place of the use or consumption of the services by the recipient of the services. Both these rules provide objective tests that can be applied in particular circumstances to determine whether the income from services has the required nexus with a particular jurisdiction. In contrast, in my view, the concepts of value creation and significant economic presence, which are also mentioned in the Issues Note, lack objective tests and are too vague to be useful.

In my view, it is important for both developing and developed countries to recognize that the choice between a physical presence nexus rule and a place of use or consumption nexus rule is essentially a political decision. There are no convincing tax policy reasons to prefer one rule over the other; neither is superior or more appropriate. Developed countries prefer a nexus rule based on physical presence because it results in the allocation of more income from services to them to tax and developing countries prefer a nexus rule based on the place where the services are used or consumed because it allocates more income from services to them to tax. Rigid adherence to one rule or the other will be unproductive and may jeopardize efforts to reach an agreement. Compromise is essential.

A fair allocation of the tax revenues from cross-border services through the provisions of tax treaties requires consideration of all the provisions of tax treaties dealing with income from services and must be based on all those provisions, rather than on an article-by-article basis. There are no accepted norms for the allocation of tax revenues among countries based on fairness and, unfortunately, the familiar domestic tax concepts of ability to pay (horizontal equity) and progressive taxation (vertical equity) are not readily transferable to internation equity. This difficulty should be recognized in negotiating the terms of the Protocol so that the negotiations can focus on the practical goal of achieving a realistic measure of rough justice.

The Issues Note concludes by suggesting that Workstream II is "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." (paragraph 22) I agree that shared taxation is the only viable approach. Exclusive taxation of income from services either by the source country or the residence country is unacceptable in terms of the goal of fair allocation of tax revenues (except perhaps for certain specific types of services such as government services). The key issue with respect to the shared taxation approach is determining the appropriate limit on the tax imposed by the country with the first right to tax (which will usually be the source country). Under the OECD Model, fixed limits are used for this purpose, whereas the United Nations Model leaves the limit to be established by the treaty partners.

My final comment is that one significant aspect of the taxation of income from cross-border services is completely missing from the Issues Note, namely, the taxation of income from employment services. In my view, income from employment should be part of the discussions for Protocol 1. Under the current provisions of the OECD and UN Model Treaties, income from employment and income from independent services are treated significantly differently, which creates opportunities for arbitrage between the two categories of services. Although the work on services carried out by the Committee of Experts for the 2025 Update of the UN Model excluded income from employment at an early stage of its work, the reason was not that the Committee thought income from employment was unimportant or completely separate from other services, but rather a lack of time and resources.