The BEPS Monitoring Group

MONITORING MEASURES TO END BASE EROSION AND PROFIT SHIFTING BY TRANSNATIONAL CORPORATIONS

For the kind attention of:

Mr. Ramy Youseff, Chair of the Intergovernmental Negotiating Committee to draft a United Nations Framework Convention on International Tax Cooperation and two early protocols (INC) and Ms. Liselott Kana, Co-Lead of Workstream II.

Cc: Permanent Representatives and Observers to the UN in New York

11 July 2025

Subject: BEPS Monitoring Group submission regarding the Draft Issue Note of Workstream II (WS II – the protocol addressing the taxation of cross border services) of the Intergovernmental Negotiating Committee on the UN Framework Convention on International Tax Cooperation (UN FCITC).

Please find underneath the submission made by the BEPS Monitoring Group (BMG). The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including: the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. This submission has not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here-in, but they support the work of the BMG and endorse its general perspectives. It has been drafted by Bob Michel, Mercy Mbithi, Sol Picciotto and Verónica Grondona.

Abstract

The taxation of cross-border services highlights critical gaps in current international tax rules. Services, increasingly central to economic growth, often involve minimal physical presence in market jurisdictions, undermining source-based taxation and favoring non-resident providers. This imbalance discourages local service sector development while enabling multinational enterprises (MNEs) to exploit "double non-taxation" through low-tax affiliates. A new paradigm is needed—one that fairly allocates taxing rights based on real economic activity rather than outdated physical presence tests.

Two key approaches should be considered: (1) Taxation at source through withholding taxes (WTs) on gross payments, already in place in most countries though with limited enforceability due to the growing amount of tax treaties in place; and (2) Net-basis taxation under a unitary approach, apportioning profits via formulary methods (e.g., considering sales, employment and assets). While WTs offer simplicity, they are still the object of gaps, if implemented without significant economic presence (SEP) definitions. Conversely, net-basis taxation, though complex, ensures equitable profit distribution by linking tax rights to significant economic presence and value creation, particularly in digital markets.

The proposed protocol must reconcile these approaches, prioritizing:

- Fair allocation via unitary taxation and formulary apportionment.
- Simplified source taxation for all services, irrespective of classification.
- Recognition of user-generated value in digital economies, especially for developing countries.

Issues at stake in WS II Issue Note

A. Why is this protocol important?

Services have grown in importance for economic development, yet the taxation of cross-border services exposes the shortcomings of existing rules more starkly than perhaps any other issue. Services inherently involve close interactions between clients and customers—a dynamic further intensified in today's era of new ways of doing business that has seen the monetisation of user-generated content and pervasive data collection. Yet, due to globalization and digitalization, these services can now be delivered seamlessly, often with no or minimal physical presence in the country where the customers are located.

This strikes at the heart of current international tax rules, based on allocating tax rights between residence and source. These rules favor non-resident service providers, creating a disincentive for investment in and growth of local service providers. At the same time, multinationals enterprises (MNEs) can form affiliates resident in convenient jurisdictions where their income is low-taxed, creating the problem of 'double non-taxation'.

A new paradigm is needed, based on a fair and equitable allocation of tax rights where real activities take place. Yet the 'place of performance' test, widely used for services, has been made ineffective by the ease of remote delivery. Indeed, many services are now delivered automatically from the 'cloud'.

B. Critical considerations:

Two potential approaches could be considered in designing a protocol.

1. To strengthen source taxation through withholding taxes (WTs) on payments. Developing countries, in particular, have relied on these due to their administrative simplicity and enforceability. On the other hand, they apply on a gross basis, unrelated to profitability.

This approach has long been advocated by developing countries, and the provision for WTs on services has been gradually strengthened in the UN model convention. This has culminated in the formulation of article 12AA for a WT on all services. However, OECD members oppose and reject this approach.

With the rise of fully digitalised services, some OECD members as well as some developing countries have recently adopted digital services taxes, which are mechanically similar to WTs, on specific digitalised services (e.g. advertising, intermediation platforms, gambling, streaming). These have been formulated as transaction taxes, so arguably outside the scope of tax treaties. By the same token, they have been viewed as barriers to trade in services, being understood in some cases as unfair trading practices by the US, and threatened with trade sanctions. DSTs apply to only a small -though growing- proportion of digitally deliverable services (under 20% by value). While some have argued for a standardisation of DSTs, in our view this would not provide the basis for a consensual or sustainable solution. Its narrow scope would not respond to the scale of the problems posed by taxation of cross-border services, especially for developing countries. At the same time, the selective nature of DSTs could exacerbate trade conflicts.

2. The alternative is net basis taxation, based on a sharing of income from cross-border services. This would be a radical shift, but would ensure a reform of international tax rules fit for this new era.

The ability to generate substantial income from cross-border activities with little physical presence calls for a new approach to the central principles of international tax: (i) the tax nexus, and (ii) the definition and allocation of net income. This was the conclusion of the reports under Action 1 of the OECD/G20 project on base erosion and profit shifting (BEPS). In 2019 the G24 developing countries proposed that the solution should be (i) a new test of 'significant economic presence', coupled with (ii) rules for apportionment of the total profit based on factors reflecting both supply (production) and demand (consumption).

This approach was partially accepted in the proposals under Pillar One, which adopted the principle of taxation of MNEs as unitary enterprises, with formulary allocation of their global income, based on sales. Furthermore, the multilateral convention for Amount A formulated detailed rules which included (i) adjustments to MNEs' global consolidated financial accounts for tax purposes, (ii) a tax nexus based on sales volume, (iii) sourcing rules for sales (importantly including services), and (iv) definitions and quantification methods for relevant apportionment factors (physical assets, employee remuneration and sales).

In this way, work on the Services protocol could build on what has already been achieved in the Inclusive Framework, particularly in the MLC for Amount A. It would also ensure a fair allocation of taxing rights between countries, a key aim of the FCITC.

C. Specific issues addressed in the public consultation

(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.

Section III (a) broadly describes the taxation of income from cross border services and the reasons for change. Our contribution to the same includes the following:

- The situation with withholding taxes on income could be perhaps expanded to include all observable cases. It could probably be the case that withholding taxes are applied to payments made to beneficiaries abroad (non-residents) when there is no 'territoriality', no presence. In several countries (e.g. Argentina, Vietnam), such withholding tax is applied on the basis of a deemed income of national source. Further, the protocol should consider developing country administrative capacities and their preference for withholding tax regimes.

- In respect of the reasons for change, even when there are different considerations in different countries, the interrelation between general deductibility rules, the arm's length principle and withholding taxes could be perhaps clarified further.

  The arm's length principle in relation to intra-group services dictates that we must establish whether the services were actually rendered; hence the benefit test, and once this test is reasonably satisfied, only then do countries apply their minds to whether the 'cost' was charged at arm's length. Therefore, the choice to 'allow or deny' an expense can therefore be at the first step (whether the services were actually rendered) or (whether the charge was at arm's length or not) all this incorporating the exclusions to the same. The clarification could therefore highlight the challenges faced when determining the benefit test (especially documentary evidence and how the service naturally is provided) and challenges in finding suitable comparables once the benefit test has been met. This will showcase the difference between choice to deny deductibility under transfer pricing rules from the general deductibility rules under corporate income tax (CIT).

  The arm's length principle, general deductibility rules and withholding taxes on income act as defensive mechanisms, as anti-avoidance mechanisms, interlinked. But the rules defining them are different. Tax treaties limit the application of withholding taxes, although sometimes also affect the application of general deductibility rules (i.e. if there are different deductibility rules in national legislation in respect of national/ international payments or payments to related parties and non-related parties, the discrimination rule in tax treaties could result in an obstacle to apply such distinct rules). Tax treaties, in article 9 also result in the necessary application of the arm's length principle.

- Another issue that should be addressed in this section refers to the application of the credit or exemption rule. A source jurisdiction may apply a broad definition of the taxable income, but the residence country may deny a credit for such taxes. Even when the design of such specific aspects of the income tax law is a national prerogative, it has however impacted international tax conflicts in the past years. The US in particular has revised its foreign tax credit rules to refuse a credit if a source tax on income from services is based solely on the location of the recipient of the services. A great part of the international conflict could be sorted out if countries (e.g. the US) changed their own national rules in order to allow for an exemption or credit in the case in which the income has been taxed at source through a withholding tax. This is one of the underlying reason for tax treaties being pushed into in developed-developing country relations; a pressure which end up being accepted even when it comes at the price of sacrificing source state taxing rights on services. This sacrifice, on the part of source countries should be reviewed in view of the necessity of domestic source mobilization in developing countries.

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

The protocol should establish clear rules to coordinate the taxation of cross-border services, ensuring consistent treatment across comparable service categories. To achieve this, the protocol must deliver:

- A fair reallocation of taxing rights between jurisdictions, grounded in the principles of unitary taxation and formulary apportionment—ensuring that all profits of multinational enterprises are appropriately allocated across the countries where economic activity occurs.
- A simplification of the right to tax at source payments for all services, regardless of whether they may be classified as technical or professional, or delivered by an independent person or an enterprise.
- Recognition of value creation by market economies in matters user data and user participation due to digitalised economies recognising materiality from a developing country perspective.

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

Section III (c) of the Issue Note describes, in paragraph 20 the discussion held in WS I in respect of the scope of this protocol regarding taxes covered. As it is concluded in such paragraph, what is to be considered is the nature of the tax and not it's denomination which can generate confusion.

It is true that naturally, income taxes should be part of the scope. As described in the Issue Note, while the OECD Model Tax Convention *"…provides that income from many services, including management, technical and consultancy services, is treated as business profits"*, the UN 2025 Model allows for the source country to tax payments of a set of services including technical ones, transport, digital services, insurance, etc. The list is representative, though at least 2 issues could be considered in this respect: a) there are still limitations in respect of technical services for taxation at source that could at least merit a discussion (i.e. whether the definition of technical services should consider the transfer of intellectual property or not) and, b) that there are no practical negotiations in which this new model has been incorporated into bilateral tax treaties (either because of the novelty of the model, or because of the limited interest of developed countries in accepting the adoption of the new UN model with an allocation of taxing rights that favours source countries – in a net balance more developing countries than developed ones-).

DSTs on gross revenues from the sale of defined digital services which are typically applicable to both residents and non-resident companies with global turnover above a certain threshold (set according to materiality realities in developing countries) (i.e. in practice targeting large foreign MNEs) could be assimilated to withholding of income taxes.

In terms of services, this protocol should include, but not be limited to, taxation of Automated Digital Services (ADS) and all other services.

Lastly, the new rules should apply its mind to the reasons that have brought forth recent changes in the taxation of services both in the UN MTC and the OECD Pillar 1 – Amount A, and aim to cure the loopholes envisioned by these changes, completing nexus rules that accord market jurisdictions with the value they create considering user data and user participation. (e.g. viewing of online advertisements and monetisation of user data by tech MNEs).