Intergovernmental Negotiating Committee on the UN Framework Convention on International Tax Cooperation Workstream II

SUBMISSIONS FROM THE COMMITTEE ON FISCAL STUDIES, UNIVERSITY OF NAIROBI

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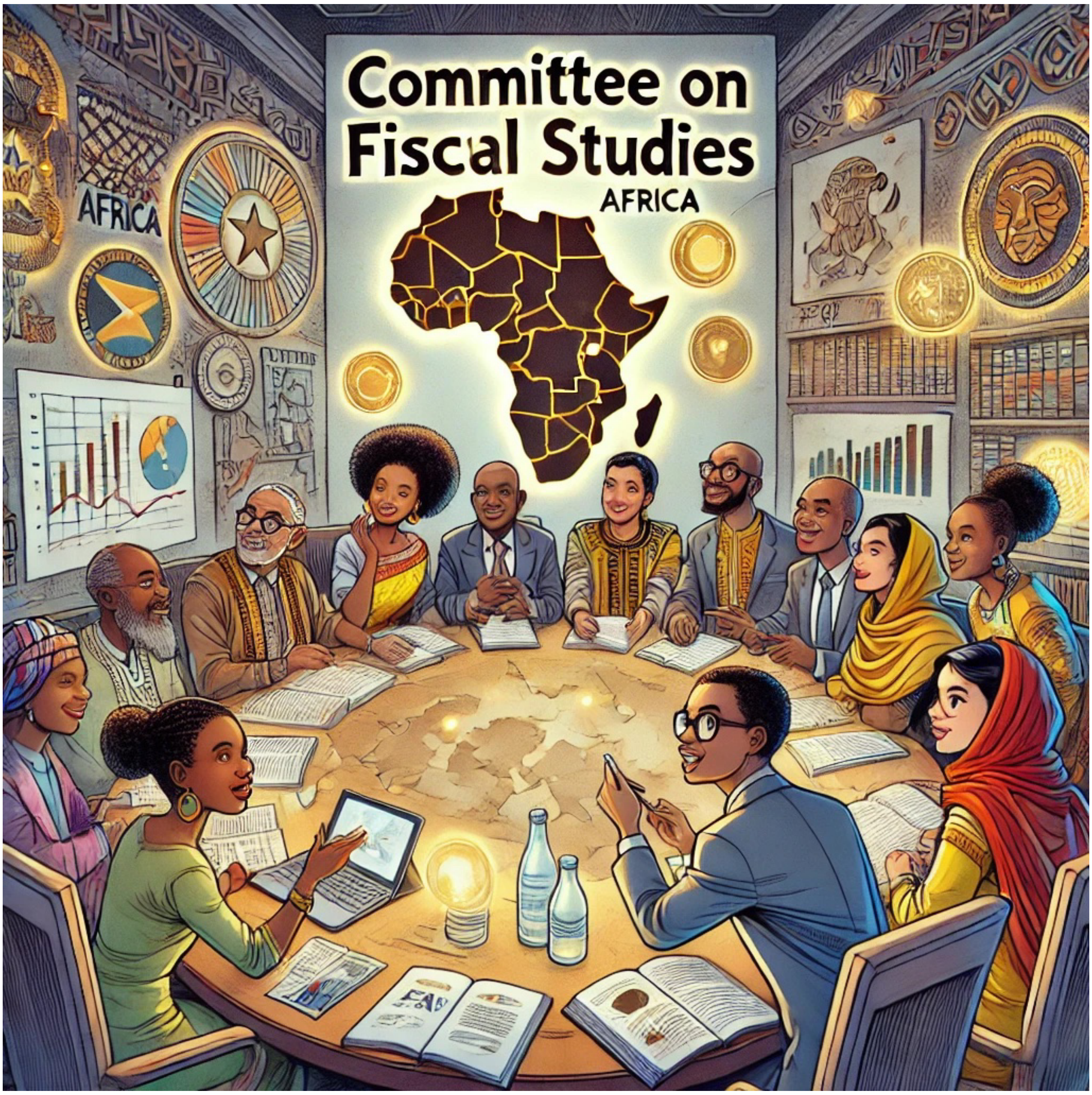

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Workstream II: Protocol on Taxation of Cross-Border Services

Submitted by: Committee on Fiscal Studies, University of Nairobi,
Email: latif@uonbi.ac.ke

ABSTRACT

This submission addresses the three specific questions posed by the Committee regarding the cross-border services taxation. On question (a), whilst Section III(a) of the Workstream II Draft Issues Note (hereinafter 'note') adequately describes current rules, it requires expansion to address treaty shopping mechanisms, conduit structures, and the systematic revenue losses developing countries experience through most-favoured-nation clauses and investment hub arrangements. On question (b), the most critical considerations for new rules must prioritise equitable allocation of taxing rights through source country withholding tax rights, significant economic presence thresholds for AI and generative technologies as emerging service categories, and movement beyond transfer pricing towards formulary apportionment mechanisms. Administrative feasibility for developing countries should guide design choices, favouring gross-basis taxation over complex net-basis calculations. On question (c), the protocol scope should be defined functionally rather than through legal classifications, covering all income-type taxes regardless of nomenclature whilst establishing comprehensive service categories including professional, digital, financial, and intra-group services. Technology-neutral definitions with adjustable thresholds will ensure future proofing whilst preventing artificial avoidance through service categorisation manipulation.

RESPONSE TO QUESTION (A): COMPREHENSIVENESS OF CURRENT RULES DESCRIPTION

Adequacy of Section III(a)

Section III(a) of the note provides a sound foundation for understanding current taxation approaches, correctly identifying the fundamental divergence between developing countries' gross-basis withholding systems and developed countries' net-basis physical presence requirements.

However, several critical dimensions require elaboration to provide the Committee with complete context for Protocol 1 development. These are on:

Treaty Shopping and Investment Hub Exploitation

The current analysis in the note insufficiently addresses how sophisticated tax planning systematically undermines developing countries' domestic tax rules. Multinational enterprises routinely establish service companies in jurisdictions with extensive treaty networks offering reduced withholding rates. Countries such as the Netherlands, Luxembourg, and Singapore have become 'investment hubs' precisely because their treaty networks enable routing of service payments to avoid higher taxes in direct source-residence transactions.

This treaty shopping creates cascading revenue losses for developing countries. When a multinational routes management services through a Dutch holding company rather than providing them directly from the United States, the source country loses the difference between its domestic withholding rate and the reduced treaty rate. These arrangements are entirely legal under current rules yet systematically drain developing country revenues.

Most-Favoured-Nation Proliferation Effects

The note mentions MFN clauses but understates their systemic impact. When developing countries negotiate reduced withholding rates with one treaty partner, existing MFN provisions often require automatic extension of these benefits to multiple other treaties. This creates a 'race to the bottom' where concessions made in one bilateral context automatically erode taxing rights across entire treaty networks.

For example, when Nigeria agreed to eliminate withholding taxes on technical services in its treaty with the United Kingdom, MFN clauses in other treaties required extending this benefit to multiple additional countries, multiplying the revenue impact far beyond the original bilateral negotiation.

Digital Service Tax Responses and Unilateral Measures

The current description inadequately addresses how developing countries have responded to traditional rule inadequacies through unilateral digital service taxes and equalisation levies. Countries including Kenya, Nigeria, and several others have implemented digital service taxes precisely because existing international rules fail to capture substantial digital economic activity within their borders.

These unilateral measures reflect not policy preference, but necessity driven by systematic revenue losses under current international frameworks. The proliferation of such measures demonstrates the urgency of multilateral solutions that provide adequate source country taxing rights.

Transfer Pricing Enforcement Realities

Whilst paragraph 12 of the note mentions developing country difficulties with transfer pricing, the analysis requires expansion regarding why these challenges are structural rather than merely technical. Commercial databases typically lack relevant comparables for developing country markets, whilst the functional analysis required under current guidance systematically undervalues market-specific contributions such as consumer demand, regulatory frameworks, and local infrastructure.

The arm's length principle's emphasis on comparable transactions fundamentally disadvantages developing countries, which often represent unique markets without genuine comparables in other jurisdictions. This creates a technical framework that appears neutral but consistently produces outcomes favouring residence countries with sophisticated transfer pricing documentation.

Revenue Impact Quantification

The workstream would benefit from more systematic analysis of revenue losses attributable to current rule inadequacies. Studies[1] consistently demonstrate that developing countries forfeit substantial corporate tax revenue through treaties limiting source taxation. These revenue impacts must be understood within broader fiscal contexts where developing countries face infrastructure financing needs whilst confronting reduced aid flows and limited borrowing capacity. Source country taxation of cross-border services represents a critical component of domestic resource mobilisation strategies essential for sustainable development financing.

[1] Latif, L and Heitland, M (2023) Paying Attention to The Fiscal Nuances at Play in Negotiating DTAs: Comparative Case Study of the DTAs Between East African States and UAE/Qatar https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4319153

RESPONSE TO QUESTION (B): MOST IMPORTANT CONSIDERATIONS FOR NEW RULES

Primary Consideration: Equitable Allocation of Taxing Rights

The paramount consideration must be correcting systematic inequities in current taxing rights allocation. The existing framework's emphasis on physical presence fails to reflect modern economic realities where substantial value creation occurs through market access, user engagement, and demand-side contributions without traditional permanent establishments.

Source countries contribute to value creation through multiple mechanisms: providing markets with purchasing power, maintaining legal and regulatory frameworks enabling business operations, supplying infrastructure supporting service delivery, and in digital contexts, providing users whose data and engagement generate monetisable value. These contributions justify source country taxation rights regardless of where services are physically performed.

Critical Design Principles[2]

Source Country Withholding Tax Rights

New rules must establish comprehensive source country rights to impose withholding taxes on cross-border service payments. This approach offers immediate revenue collection, administrative simplicity, and prevention of profit shifting through artificial pricing arrangements. The framework should include:

> **Universal Coverage**: Withholding rights extending to all service categories including technical services, consultancy, management fees, digital services, and royalties for intangible assets.
>
> **Differential Rates**: Recognition that service categories have varying profit margins justifies differential withholding rates. High-margin services such as management consulting and technical advisory warrant higher rates than low-margin operational services.
>
> **Minimum Rate Floors**: To prevent treaty shopping, the protocol must establish minimum withholding rates below which contracting states cannot reduce rates even through bilateral treaties.

Significant Economic Presence for AI and Generative Technologies as Emerging Service Categories

The rapid deployment of AI and generative technologies presents novel taxation challenges that the Committee must anticipate. When AI systems are trained on data, cultural content, or linguistic materials sourced from developing countries but monetised globally through subscription services or enterprise licensing, source countries currently receive no fiscal benefit despite providing essential inputs for value creation. This represents a form of digital resource extraction analogous to traditional colonial patterns. Countries like Portugal's development of

[2] Latif, L (2025) Briefing Paper: Towards A Protocol on Taxing Cross Border Services https://papers.ssrn.com/sol3/papers.cfm?abstract_id=5111067

"Amalia"[3] and South Korea's AI Basic Act[4] demonstrate emerging approaches to asserting sovereignty over national data resources used in AI training.

The Committee should explicitly recognise AI training levies as legitimate source country taxation mechanisms, enabling jurisdictions to tax companies that utilise locally-sourced data for commercial AI development.

Additionally, the Committee must address cross-border AI services including automated decision systems in financial services, algorithmic trading, and remote AI consulting, which often escape traditional permanent establishment concepts whilst generating substantial value in source markets. The framework should establish clear nexus rules for AI-driven services based on data sources, user interactions, and economic impact rather than physical presence, ensuring that the digital transformation does not further erode developing countries' tax bases.

Movement Beyond Transfer Pricing

Current transfer pricing rules prove systematically inadequate for service transactions involving intangible assets, proprietary methodologies, or embedded intellectual property. The absence of genuine comparable transactions between unrelated parties renders arm's length analysis arbitrary and resource-intensive.

New rules should explicitly permit formulary apportionment for service income, particularly in digital and intangible-intensive sectors. Formulary approaches based on sales, users, or market presence provide more objective allocation mechanisms whilst reducing administrative burdens for both taxpayers and tax authorities.

Administrative Feasibility Imperative

Rule design must prioritise administrative feasibility for developing countries with limited tax administration resources. This principle favours:

> **Gross-Basis Taxation**: Withholding taxes on gross payments prove more administrable than complex net-basis calculations requiring detailed expense analysis and transfer pricing documentation.
>
> **Objective Thresholds**: Clear revenue or user-based thresholds for establishing taxable presence avoid subjective determinations requiring sophisticated analysis.
>
> **Simplified Compliance**: Standardised reporting requirements and documentation reduce compliance costs for both taxpayers and tax administrations.

Future-Proofing Requirements

New rules must adapt to technological change without requiring constant renegotiation. Technology-neutral language focusing on economic substance rather than specific technologies or platforms ensures continued relevance as business models evolve.

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[3] Amalia: The First Portugues Language LLM https://www.it.pt/News/NewsPost/5065
[4] https://www.trade.gov/market-intelligence/south-korea-artificial-intelligence-ai-basic-act

The framework should establish principles-based approaches with flexibility for implementation details, enabling adaptation to emerging service delivery methods whilst maintaining core allocation principles.

Double Taxation Mitigation

Whilst source country rights require strengthening, new rules must include robust mechanisms preventing excessive double taxation. Residence countries should provide tax credits for source country withholding taxes, with coordination procedures ensuring appropriate relief levels.

Clear relief mechanisms encourage business compliance whilst preserving source country revenue collection. The framework should establish presumptions favouring source country taxation whilst ensuring residence countries retain appropriate residual taxing rights.

RESPONSE TO QUESTION (C): DEFINING PROTOCOL SCOPE

1. Tax Coverage Framework

1.1. Functional Rather Than Nominal Definitions

The Committee should define coverage by reference to tax nature rather than nomenclature, preventing manipulation through classification as direct versus indirect taxes. Coverage should encompass:

All Income-Type Taxes: Including corporate income taxes, withholding taxes, and digital service taxes regardless of legal classification or administrative designation.

Revenue-Based Taxes: Recognising that some jurisdictions prefer turnover-based taxation for administrative simplicity, particularly for smaller service providers.

Emerging Tax Types: Broad definitional language capturing future tax measures designed to address cross-border service income.

1.2. Preventing Classification Manipulation

Previous attempts to limit international tax coordination through classification disputes, such as the European Commission's unsuccessful effort to classify digital service taxes as indirect taxes, demonstrate the necessity of substance-based definitions. The Committee should establish presumptions that taxes imposed on income derived from cross-border service provision fall within scope regardless of legal classification.

2. Service Categories Framework

2.1. Comprehensive Coverage with Practical Distinctions

Whilst the Committee should apply broadly to cross-border services, practical considerations justify specific provisions for distinct service categories:

Professional and Technical Services: Management consulting, technical advisory, legal services, accounting, and similar professional services require standard treatment with full withholding tax rights and SEP application.

Digital Services: Platform services, digital content delivery, software-as-a-service, and automated digital services require specific rules addressing user value creation, data monetisation, and algorithmic value generation.

Financial Services: Cross-border banking, insurance, and investment services may require coordination with existing regulatory frameworks whilst ensuring adequate source country taxation.

Intra-Group Services: Management fees, technical services, and cost-sharing arrangements between related entities require enhanced scrutiny given frequent use in profit-shifting strategies.

Royalties and Licensing: Intellectual property licensing, technology transfer, and similar arrangements involving intangible assets warrant specific provisions addressing artificial IP migration and royalty manipulation.

2.2. Technology-Neutral Definitions

Service definitions should focus on economic substance rather than delivery mechanisms. Rules distinguishing between digital, remote, and physical service provision create artificial boundaries that taxpayers can exploit through restructuring whilst violating neutrality principles.

Instead, definitions should capture economic functions: value creation processes, market engagement mechanisms, and revenue generation activities. This approach ensures continued relevance as technology evolves whilst preventing avoidance through artificial categorisation.

3. Threshold and Scope Limitations

3.1. Proportional Thresholds

Administrative efficiency requires thresholds excluding minimal activities whilst capturing substantial service provision. The framework should incorporate:

Adjustable Revenue Thresholds: SEP rules with revenue thresholds scaled to different market sizes, preventing artificial fragmentation whilst excluding genuinely minimal activities.

Transaction-Based Limits: De minimis rules for individual payments reducing administrative burdens for small transactions whilst preserving withholding rights for substantial payments.

Cumulative Activity Tests: Aggregation rules preventing avoidance through contract splitting whilst recognising legitimate business fragmentation.

3.2. Small Business Accommodations

Simplified rules or exemptions for small service providers reduce compliance costs without undermining revenue collection from significant economic activities. Thresholds should be set sufficiently high to exclude individual contractors and small businesses whilst capturing substantial commercial service provision.

4. Implementation Flexibility

4.1. Graduated Implementation

The Committee should permit graduated implementation enabling countries to adopt provisions according to administrative capacity and development priorities. Core provisions such as withholding tax rights should apply universally, whilst more complex provisions such as formulary apportionment could be optional or subject to delayed implementation.

4.2. Bilateral Flexibility Within Multilateral Framework

Whilst establishing minimum standards for source country taxation, the Committee should permit bilateral agreements providing enhanced cooperation or higher withholding rates where countries agree. This flexibility accommodates varying bilateral relationships whilst preventing erosion below minimum standards.

4.3. Regular Review and Update Mechanisms

Business Model Evolution

The Committee should establish procedures for updating scope definitions as business models evolve, avoiding wholesale treaty renegotiation requirements. Regular review conferences or technical working groups could recommend updates to service definitions or threshold levels.

Technology Adaptation

Rapid technological change requires mechanisms for adapting rules to emerging service delivery methods. Technology-neutral principles combined with regular review procedures ensure continued effectiveness without constant renegotiation.

Conclusion

We thank the Committee in giving our submission due consideration.