Comments on
Scope and Approaches for a Protocol on Services
(Workstream II)

Submitted to the

Intergovernmental Negotiating Committee
UN Framework Convention on International Tax Cooperation

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ABSTRACT

Cross-border delivery of services has grown since they began to be digitally deliverable in the 1970s, accelerating with the internet. This makes it difficult to determine the place of performance, the usual criterion for taxing income from services, between the residence of the provider and the location of the customer. A gross revenue approach, applying a withholding tax (WT) to payments, is easy to administer. Developing countries especially favour WTs, given that they are mostly net importers of services. The rapid growth of digitalised services led some OECD countries and others to adopt digital services taxes (DSTs), that are essentially WTs, but these are regarded by the US as discriminatory trade barriers, exacerbating tensions. Furthermore, DSTs apply to only a small proportion of digitally deliverable services. The UN Tax Committee's model treaty article 12AA is an option, if applied at a low rate; but would not resolve the residence-source tension. The G24 favours the net income approach, as articulated in past submission to the BEPS initiative.

The G-24 reiterates its commitment to an inclusive, sustainable, and equitable international tax system, in which all countries, regardless of their level of development, can protect their tax base and participate on equal terms. We will continue to participate actively in these discussions, which represent a fundamental opportunity to promote a fiscal framework that effectively contributes to sustainable development and strengthens countries' domestic capacity to mobilize resources, without compromising their fiscal sovereignty.

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Background: Globalisation, Digitalisation and the Need for a New Paradigm

Taxation of activities where they take place (at source) is a fundamental right accepted by all states. The potential for double taxation is due to the additional claim by some capital-exporting states, the home countries of multinational enterprises (MNEs), to tax their residents on income earned abroad. These countries have pressed for relief from such double taxation, through tax treaties restricting source taxation. Capital-importing states, especially, have limited their taxing rights to attract foreign investment. In practice, potential double taxation is effectively and routinely mitigated through unilateral measures. The primary role of tax treaties is to establish a framework for intergovernmental coordination; however, the current allocation of taxing rights under prevailing models tends to be regressive, benefiting residence countries. Globalisation and digitalisation have challenged traditional notions of both residence and source, particularly as the economic significance of services has increased and their cross-border provision has become more common. This ongoing internationalisation, initially driven by advancements in information and communication technology (ICT) during the 1970s and further accelerated by the expansion of the internet in the 1990s, continues to reshape the global tax landscape.

Graph 1 (see Annex) illustrates that the increase in digitally deliverable services predominantly explains the rise in payments to non-residents for service imports. Nevertheless, a widening disparity has emerged between developed and developing countries. Even upper-middle-income nations have experienced a net deficit, as indicated by Graph 2, leading to tax revenue losses. While imports of high-quality services can enhance productivity, granting tax exemptions to non-residents places local service providers at a disadvantage and restricts sector growth. Therefore, an equitable solution is required to ensure a level playing field for all stakeholders.

Income from services is typically taxed according to the location where the services are performed. The rise in cross-border services has made determining this location more complex, as service providers and customers are in different countries. Digitalisation has enabled remote provision of services, including areas like medical care, while also facilitating continuous customer engagement and data collection for sales purposes. Consequently, there are grounds for taxation both at the supplier's location and the customer's location.

Exempting non-residents from tax on income generated from services with minimal or no physical presence may discourage inward investment, and challenges arguments made by supporters of tax treaties. Additionally, this can allow income to be attributed to entities in low-tax jurisdictions, potentially avoiding both source and residence taxation. This phenomenon, known as 'double non-taxation,' prompted the *OECD/G20 Base Erosion and Profit Shifting (BEPS)* initiative, which aims to allocate taxing rights based on where activities occur and value is created. Action 1 of BEPS addressed issues within the digital economy, but subsequent reports indicated that digitalisation impacts the broader economy and all service sectors. While the BEPS project did not fully resolve these concerns, it led to a variety of measures and proposals that are currently under evaluation.

Measures Introduced or Proposed

There are two broad approaches, taxes on gross revenues and on net income (see Annex Table).

Gross-Basis Approach

Taxes imposed on revenue, turnover, or payments are generally straightforward to administer. Such taxes enable protection of the source tax base, particularly when applied to payments for business services that are deductible from the customer's business income. These taxes may be levied on any payments made by residents, regardless of the location where the service is performed. They can be specifically directed at certain types of transactions and may generate revenue for countries. Hence, various taxes or levies have been implemented, with impact on telecommunications and digital transactions. Several countries in Africa have introduced levies on digital financial transactions and social media usage. Transaction taxes are typically not included under the scope of tax treaties, which cover only taxes on income and capital. However, when they apply to international transactions, they may be considered trade restrictions. In 1998, the WTO initiated a comprehensive work programme to address all trade-related issues associated with electronic commerce, including fiscal considerations, and this work is ongoing.

Digital Services Taxes (DSTs)

After progress stalled under BEPS Action 1, a larger number of countries introduced digital services taxes (DSTs), with approximately 30 enacting such measures; however, a few—including Canada and India—have since rescinded them. The US Trade Representative determined that many of these DSTs constituted discriminatory trade barriers and responded by initiating trade sanctions. These sanctions were suspended during the BEPS negotiations on Amount A, but more recently, the United States has called for the withdrawal of DSTs as part of broader ongoing trade disputes.

DSTs generally apply to certain types of digitally delivered services, such as intermediation, advertising, gambling, and streaming, though even the most comprehensive DSTs cover only a limited fraction of all digitally deliverable services (see Annex). Some OECD member countries, experiencing imbalances within this segment have introduced DSTs targeted at a small group of highly digitalised multinational enterprises, resulting in conflict. There is broad recognition that a more comprehensive and effective global solution is required.

All Services

Developing countries have aimed to tax income earned by non-residents from services provided within their territories, whereas OECD countries have favoured taxation by the provider's country of residence. This difference has made consensus on tax treaties challenging. The UN model convention includes a provision for a 'Services PE' (5.3.b), along with a methodology for sharing net income through fractional apportionment (7.4). However, these provisions have generally not been used, primarily due to the absence of an established apportionment methodology and difficulties in identifying service delivery via personnel (Issues Paper para. 7).

Instead, developing countries have commonly implemented withholding taxes (WTs) on payments for services. Some early treaties permitted such WTs on professional and technical services and limited the applicable rate, but as OECD countries' service exports increased, they became less willing to include these provisions. The OECD now requires developing countries seeking membership (e.g., Colombia, Brazil) to enter into treaties without such clauses. Alongside the BEPS project, developing countries advocated for the inclusion of WTs in the UN model—initially on technical services (12A) and later on automated digital services (12B). These provisions are now merged in Article 12AA, which has yet to be widely adopted in treaties.

Article 12AA could serve as the basis for a Protocol. Since it applies to gross revenue, it is not linked to profitability. Some OECD countries may accept this form of taxation if the rate remains low (possibly 2-5%), similar to Digital Services Taxes. However, this does not resolve the underlying issues between residence and source-based taxation. While potentially a short-term compromise, it may not provide a sustainable long-term solution.

Several developing countries have also enacted domestic laws taxing income from services based on a *Significant Economic Presence (SEP)*, determined by specified activities and a quantitative threshold (Issues Note para. 19). The tax rate is calculated by applying the standard corporate income tax rate to a percentage of the gross (treated as net) income. This approach effectively applies a WT on gross income at a low rate (such as 6% in Nigeria).

Net Income Approach

Fractional Apportionment

An alternative method for determining the net income of a Significant Economic Presence (SEP) was introduced by India in 2019 intended to ensure compatibility with tax treaties that incorporate article 7.4. This approach involves applying the multinational enterprise's (MNE's) global profit rate to a proportion of local sales revenue, as determined by a three-factor formula. The United Nations Model Tax Convention's article 12B, addressing automated digital services, adopted a similar methodology by specifying the applicable fraction as 30% of gross revenues. Notably, this method can be implemented unilaterally and is consistent with treaties based on the UN model.

Formulary Apportionment

A more comprehensive proposal was recommended by the G24 in 2019 and subsequently incorporated into the design of the draft Multilateral Convention (MLC) for Amount A under Pillar 1. However, the scope of the MLC is currently limited, applying only to approximately 100 of the largest and most profitable multinational enterprises (MNEs), and covers just 25% of their 'residual' profits, limiting the potential revenue that could accrue to countries. This limitation renders Amount A a complex mechanism and retains the existing, often intricate and inefficient, transfer pricing rules for other applications.

Despite these constraints, the MLC's detailed methodology—combined with the global minimum tax provisions in Pillar 2—establishes technical standards for formulary apportionment. These standards include: (i) adjustments to MNEs' global consolidated financial statements for taxation purposes; (ii) a tax nexus determined by sales volume; (iii) sourcing rules for sales, including those related to services; and (iv) clear definitions and quantification methods for the relevant apportionment factors, such as physical assets, employee remuneration, and sales.

RECOMMENDATIONS

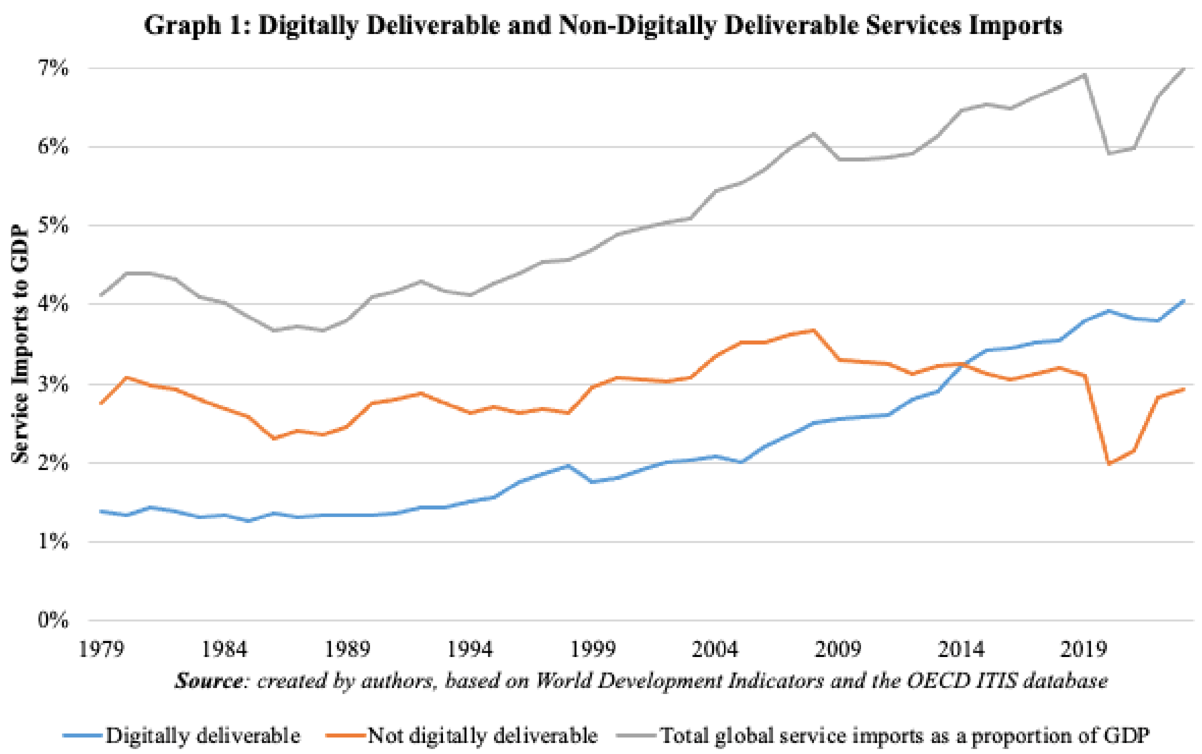
G-24 considers it important that the *Protocol on Services* adequately reflects the diversity of the fiscal realities of States, recognizing the legitimacy of domestic approaches aimed at protecting countries' tax bases. In this regard, we reiterate the importance of explicitly including in the Protocol the concept of *Significant Economic Presence*, as adopted through domestic legislation, which has already been implemented in some countries. This would allow for the taxation of income generated by non-resident companies when there is substantial economic engagement in the local market, even in the absence of physical presence.

In our view, the most promising approach for a sustainable solution would be net income taxation. This could be implemented through a *fractional apportionment* as proposed under India's SEP and designed in Article 12B of the UN MTC; or a *formulary apportionment* as designed under Amount A of the Pillar One. Work on the Services protocol could build on the achievements of the Inclusive Framework, particularly in the MLC for Amount A. It would ensure a fair allocation of taxing rights between countries, a key aim of the *Framework Convention on International Tax Cooperation*. The use of location-specific allocation factors (physical assets, employees, sales) would facilitate administration and hinder avoidance, while ensuring that tax is paid where activities take place and value is created. It would replace the system of adjusting 'transfer prices' which is complex and ineffective, especially for developing countries. Value creation ultimately derives from the knowledge and skill of employees (reflected in both their numbers and remuneration), and investments in fixed capital, while profitability depends on sales to customers. The approaches endorsed (fractional and formulary apportionment) offer a feasible pathway to address the structural imbalance in taxing income from cross-border services and should be central to the design of the protocol.

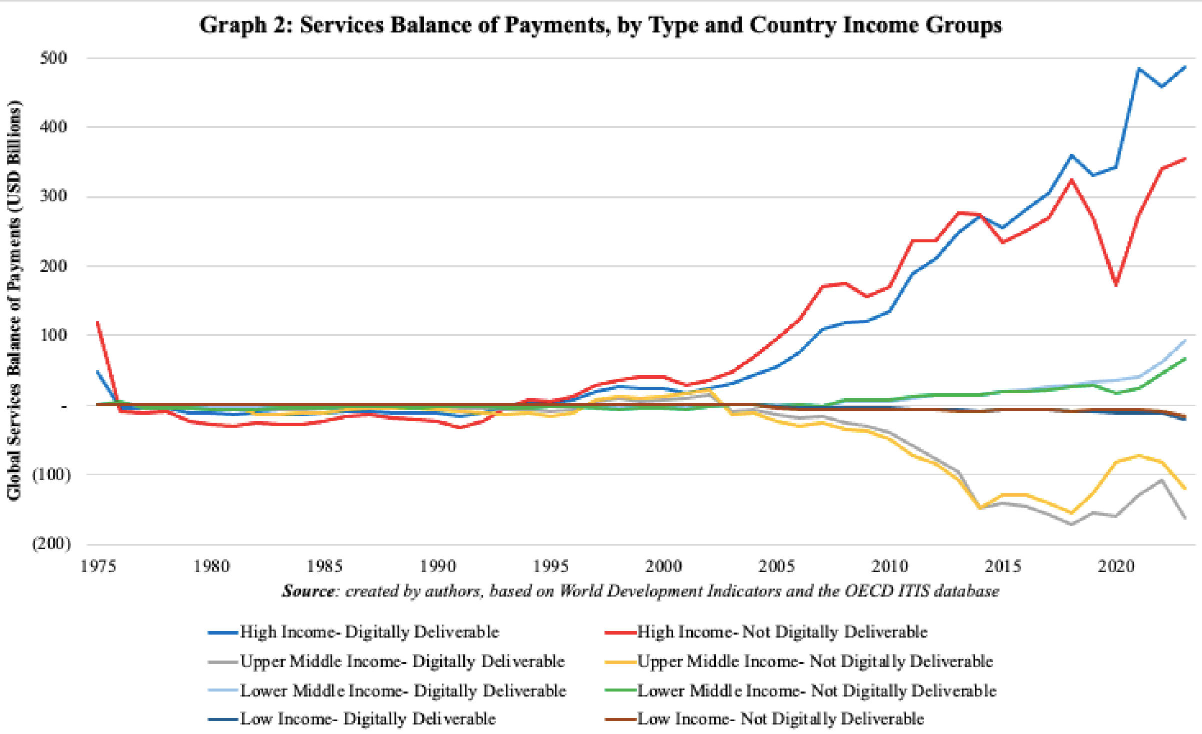
The G-24 underscores that solutions to be adopted must be administrable, proportionate to the capacities of countries, and sufficiently flexible to adapt to different levels of development. Therefore, we support the idea that new rules should be implemented progressively. Likewise, mechanisms for technical cooperation and knowledge transfer should be foreseen to enable developing countries to effectively implement these rules.

Finally, given rapid structural transformation in the context of digitalization and artificial intelligence, it is essential that future rules are not limited to a narrow vision of digital cross-border services. They should, in addition, address in a holistic manner the dynamic nature of ongoing structural transformation in the provision of services. This will help ensure a fair, inclusive, and sustainable international tax system, in line with the principles of equity and sustainable development that guide our international tax policy.

ANNEX – CHARTS, TABLE AND FIGURES



Source: *created by authors, based on World Development Indicators and the OECD ITIS database*



Source: *created by authors, based on World Development Indicators and the OECD ITIS database*

Table: Typology of Measures

Tax Base	Scope/Coverage	Form	Examples
Gross revenue	Digitalised services, e.g. advertising, intermediation platforms, gambling, streaming	DSTs	In force in around 27 countries
	All services producing local revenues	Withholding tax	UN model article 12AA
		SEP + deemed income	Nigeria, Kenya (2025)
Net income	Local services revenues	Fractional apportionment (MNE's global profit rate x fraction of local sales revenues)	UN model art. 12B.3 India consultation 2019
	25% of MNE's global 'residual' income	Apportionment by share of global sales revenue	Draft Amount A MLC
	MNE's global income	Apportionment by factors reflecting supply and demand	G24 proposal 2019

Graph 3: Estimates of Imports In-scope of DSTs and All Digitally Deliverable Services

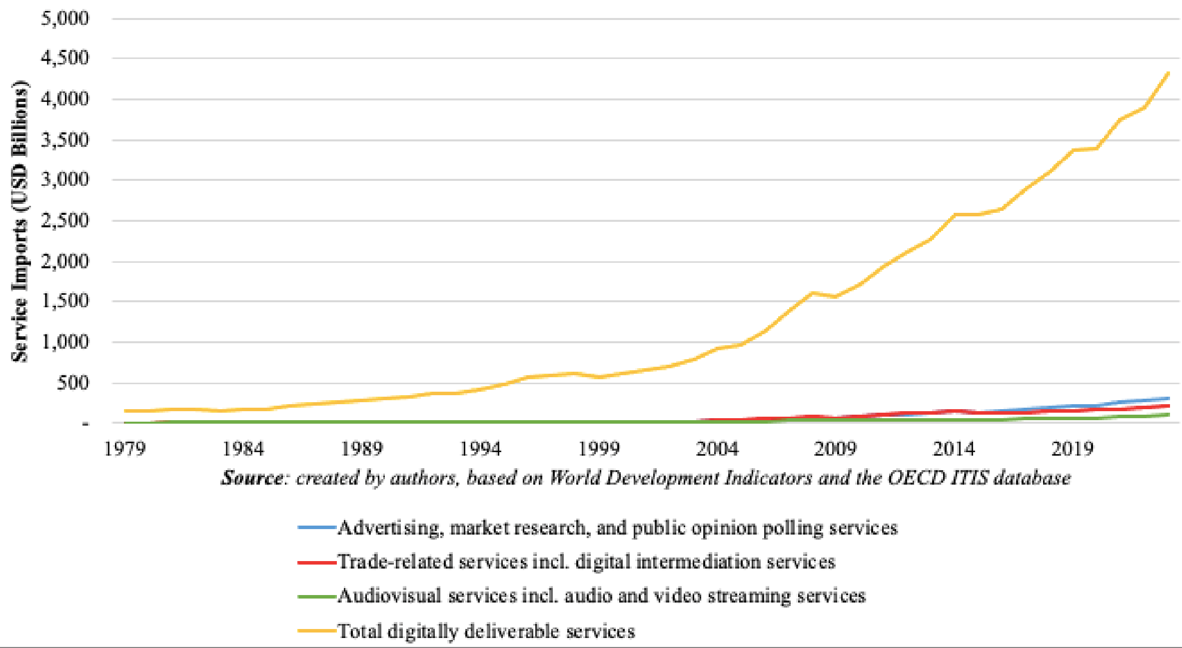
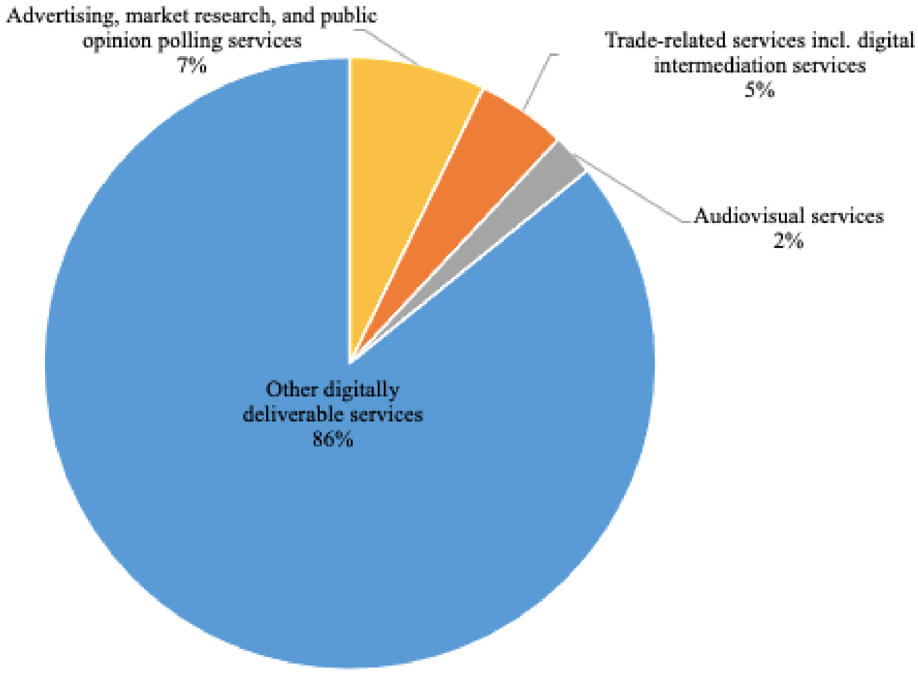


Chart 1: 2023 Imports In-scope of DSTs as a proportion of Digitally Deliverable Services



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