Comments on the Intergovernmental Negotiating Committee on the UN Framework Convention on International Tax Cooperation

Workstream II

Co-Leads' Draft Issues Note

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11 July 2025

Written Comment on the Issues Note: Protocol on the Taxation of Income from Cross-Border Services

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Executive Summary

This comment responds to the Issues Note for Workstream II (the "issues note") concerning the first protocol under the UN Framework Convention on International Tax Cooperation. The note rightly recognizes that income derived from services, particularly in cross-border and digital contexts, is inadequately addressed in the current tax architecture. We agree with the conclusion that physical presence is not a necessary condition for sustained interaction with a jurisdiction and support the move toward rethinking the allocation of taxing rights and nexus. The comment suggests that the protocol considers adopting a new nexus based on sales revenue or other indicators of sustained economic interaction. It should also accept that for administrative simplicity, gross-based taxation may remain necessary in some cases and suggests mitigation of its distortions through tiered rates and deemed profit margins.

The comment supports a shift to shared taxing rights and proposes rules anchored on enduring tax principles: the ability to pay, value creation, simplicity, neutrality and fairness. Although the concept of "value creation" remains somewhat ambiguous from the OECD/G20 BEPS Project, the comment supports a broader interpretation that encompasses both supply-side production and market-side consumption which allows for shared taxing rights.

This comment also argues against a one-size-fits-all approach, recommending instead a coordinated system of acceptable options. These could include both treaty-based and domestic solutions, respecting the tax sovereignty of each Member State, if they converge to support fair and reasonable outcomes.

Furthermore, the comment supports the protocol covering taxes based on their nature, not nomenclature. A rules-based system—anchored in shared taxing rights, pragmatic thresholds, and dispute prevention mechanisms—will reduce uncertainty and support revenue mobilization, particularly for developing countries who are disproportionately net capital importers of services.

What considerations are most important in developing possible new rules for the taxation of services?

1. **Reconsidering the Basis for Taxing Cross-Border Services**

The Terms of Reference of the UN Framework Convention acknowledge a clear purpose: to establish legal grounds for inclusive and effective international tax cooperation. This is especially important for services, where digitalization has exposed the inadequacies of a local physical presence as a condition for source taxation. It is widely agreed that a service provider can engage in regular, economically significant activity in a jurisdiction without ever being physically present. It is also widely acknowledged that it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy.

Therefore, the claim in paragraph 16 of the issues note— by some members —that most service income should be taxed on a net-basis as business profits rests on an assumption that warrants further scrutiny and careful consideration. This approach may give rise to economic distortions and undermine tax neutrality.

The argument that services and goods should be treated identically is overly restrictive and does not reflect established practice. Notably, even the OECD Model Tax Convention applies special rules to certain services based on their specific nature. Accordingly, we welcome the possibility of having additional rules to address situations involving remote services and services provided digitally.

Furthermore, the success of developing sustainable rules depends on the consistent application of core principles. In other areas of taxation, such as VAT on cross-border services, the distinction between goods and services—and even between different types of services—has been adapted to reflect modern economic realities. A similar approach was endorsed under the OE/G20 Pillar 1 rules, where revenue sourcing rules were specifically aligned with the nature of the services provided.

2. Rethinking Value Creation and Fair Tax Allocation

To answer the questions posed under paragraphs 16 and 18 of the issues note on whether mere access to a market indicates value creation and its continued relevance in taxation, our comments are that:

It is essential that any new rules are grounded in established principles of taxation, including the ability to pay, fairness, neutrality, the elimination of double taxation, and the prevention of tax evasion or avoidance that results in under- or non-taxation. Currently, the allocation of taxing rights and attribution of profits is based on the concepts of residence and the jurisdiction where value is created. The OECD's BEPS Project advanced "value creation" as a central idea reforming the allocation of taxing rights. However, the term remains undefined and inconsistently applied, leading to ambiguity and divergent interpretations across legal, economic, and political contexts.

The concept of value creation remains relevant and should inform the development of a new nexus for taxation. Its scope should not be confined to the interaction between supply and demand. Instead, it should be interpreted in a manner that responds to modern economic structures, including digitalized service models. There is a growing view that there has been a misuse of the concept in the OECD BEPS Project. A more accurate interpretation, rooted in the 1923 League of Nations Report, ties value creation to the point of sale—linking it to the point of sale and that that value is created through the economic activities associated with production and sales rather than through the act of consumption itself. On this basis, this view concludes that both production and market countries should be viewed as source jurisdictions for tax purposes.

Additionally, from the League of Nations Report, the ability-to-pay principle, which largely supplanted the benefit principle prevails as the bedrock on which modern taxation is built. It holds that taxes should be levied based on a taxpayer's economic capacity. It further reflects the understanding that taxpayers benefit from the public goods and services provided by the state—such as infrastructure, security, economic stability, an enabling environment for consumption of wealth and its acquisition etc., which would include the access to a market. Governments provide a broad range of services to both residents and non-residents. Thus, the principle is often invoked by source jurisdictions to justify the taxation of non-residents who carry out income-generating activities, in whole or in part, within their territory. Accordingly, tax obligations should be distributed among jurisdictions in proportion to the taxpayer's economic interests in each. That is, market jurisdictions contribute to value by enabling access, infrastructure, and regulation.

This broader view underpins the fairness of granting taxing rights to market jurisdictions even in the absence of a physical presence. A re-examination of value creation from this angle is necessary if the protocol is to serve all Member States. In this way, shared taxing rights for services income become justifiable.

3. Revising the Concept of Nexus

The protocol should build on the precedents established under other platforms that acknowledge sales revenue as a sufficient basis for creating an acceptable taxing nexus, regardless of physical presence.

We propose a new nexus rule for taxing services income, grounded in revenue thresholds or revenue combined with other indicators of sustained activity. This would be applicable to both digital and traditional services that are delivered remotely.

4. Limitations of the PE and the Arm's Length Principle

The issues note highlights the capacity constraints that impact the effective application of the transfer pricing standards, particularly in developing countries. While applying the arm's length principle (ALP) under the Authorized OECD Approach can be economically burdensome, it still offers the most accurate approximation of open market conditions for transactions between associated enterprises and remains relevant for certain types of services. However, this approach is not suited for taxing remote or digitally supplied services. Under the current standard, profits are attributed based on where significant people functions, risks are assumed, and assets are located (local physical presence). For many digital businesses, this means little, or no, profit can be attributed and taxed in the market country. Yet the market remains essential to these businesses. The PE rules and the ALP have demonstrated inadequacies in the digital economy. The OECD Model Tax Convention has yet to be adapted to address this reality, whereas the UN approach has primarily focused on source-based gross taxation.[1]

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[1] Recent provisions on cross-border services—Articles 12A, 12B, 12C, and 12AA—adopted by the UN Committee of Experts on International Cooperation in Tax Matters have predominantly taken a gross taxation approach. Notably, Article 12B on automated digital services includes an option for taxpayers to

While the ALP remains suitable for certain business models, the protocol must provide an alternative route for remote service providers. This could involve:

- in accordance with paragraph 16 of the issues note, having additional rules to address situations involving remote services and digitally provided services
- an alternative profit attribution method beyond the Authorized OECD Approach.

5. Source-Based Taxation: Finding the Right Balance

Adam Smith, in 'The Wealth of Nations', argued that taxation must be equally and equitably distributed in relation to the ability of the taxpayers. This canon of taxation is based on the principle of social justice and ability to pay. However, taxing income on a gross basis is often the only practical option for countries with limited administrative capacity. However, it risks overtaxing low-margin businesses and unfairly taxing those with genuine losses. To address this, the protocol could:

- Aim to reduce the economic distortions associated with the application of gross basis taxation in the source state by ensuring that the difference in revenue outcomes between gross basis and net basis taxation is minimized;
- Reasonably limit source state taxation so that the residence State retains taxing rights by establishing appropriate tax rates;
- Consider tiered withholding rates based on the type of service and average industry profit margins;
- Supplement any rules developed with enhanced dispute prevention mechanisms and including the adoption of safe habours.

Additional considerations that should be taken into account in the workstream's discussions:

Respecting Tax Sovereignty While Encouraging Coherence

It is unrealistic to expect one uniform rule. Countries differ widely in capacity, policy priorities, and tax structure. The protocol should:

- create a tax framework that allows countries to adopt different domestic rules for taxing remote and digitally supplied services; and
- ensure that the interaction of these rules can be seamlessly coordinated to produce acceptable outcomes encouraging cross-border trade and eliminating double taxation.

The aim should be coherence, not uniformity. The protocol can provide a standard reference text—with preamble language, optional model articles, and guidelines for relief mechanisms. Consequently, the Workstream's preliminary conclusion in

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elect taxation on a net profit basis. However, the complexity of the elective (formulaic) net basis taxation system of the article has been the subject of great criticism.

paragraph 20 of the issues note—to define protocol coverage based on the nature of the tax instead of its label—is supported.

Conclusion

The protocol presents a timely opportunity to improve global tax cooperation in a way that acknowledges the modern economy. It should therefore be based on sound principles and allow for multiple implementation paths to produce equity. Most importantly, it should recognize that developing countries need both flexibility and an appropriate allocation of taxing rights. If done well, this protocol can succeed where past efforts have failed—by choosing practicality over perfection, and coordination over uniformity.