For the kind attention of:

Mr. Ramy Youssef, 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.

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Subject: ICRICT submission regarding the Draft Issue Note of Workstream II (Taxation of income derived from the provision of cross-border services in an increasingly digitalized and globalized economy) of the Intergovernmental Negotiating Committee on the UN Framework Convention on International Tax Cooperation.

The Independent Commission for the Reform of the International Corporate Taxation (ICRICT) appreciates the opportunity to provide input to the United Nations negotiating committee of the Framework Convention on International Tax Cooperation.

Abstract

This submission to Workstream II of the Intergovernmental Negotiating Committee on the UN Framework Convention on International Tax Cooperation addresses the urgent need to reform the taxation of cross-border services.

Current tax rules - especially the outdated reliance on physical presence and arm's length pricing - undermine the ability of developing countries to raise revenue, while disproportionately benefiting multinational enterprises (MNEs) headquartered in high-income countries.

The protocol should introduce a new framework based on unitary taxation and formulary or fractional apportionment, aligning taxing rights with real economic activity. By abandoning the separate entity principle and recognizing MNEs as integrated global enterprises, the protocol can ensure a fair allocation of taxing rights and that profits are allocated using objective factors such as employment, sales, and assets.

The Commission also recommends establishing a new nexus rule based on Significant Economic Presence (SEP), allowing countries to tax non-resident firms engaged in sustained economic interaction, including through digital platforms.

The protocol should also coordinate interim measures to ensure source-based taxation of service payments, such as through Digital Services Taxes (DSTs) and withholding taxes.

Comments on the Draft Issue Note of Workstream II

The taxation of services

The proposed protocol on taxing cross-border digital services under the UN FCITC presents a crucial opportunity to address the fundamental flaws in current international tax rules. Services - particularly in our digital age - demonstrate the system's failures most starkly.

While services inherently involve close customer relationships and increasingly rely on user data, current rules allow many of them to be delivered globally with minimal physical presence. This creates significant disadvantages for developing countries, as existing tax frameworks favor non-resident service providers and discourage local industry growth.

Trade in services has grown rapidly as a share of global GDP, especially between 1995 and 2007. The main benefit has gone to high-income countries, which have continued to dominate exports and have enjoyed a growing surplus, while other countries have experienced deficits. Recent data shows that treaty restrictions on the taxation of imports of services generally have asymmetric impacts on both services trade and tax revenues of developed and developing countries (Amaro et al. 2024).

Since the 1990s, with globalization and digitalization, two critical flaws in international tax rules have been exposed: (1) the outdated physical presence requirement for taxation and (2) problematic profit attribution methods.

These developments have intensified the longstanding tension between residence and source based taxation. The OECD model's strict physical presence requirement (unchanged since 1963) creates perverse outcomes:

- It incentivizes cross-border delivery without local establishment,
- It facilitates tax avoidance through conduit entities in low-tax jurisdictions,
- It grants multinationals (MNEs) artificial competitive advantages over domestic providers,
- It depresses local service sector employment, notwithstanding claimed productivity benefits.

The current status of the international tax system has particularly harmed developing economies, as services trade deficits have widened and withholding tax protections have been eroded, causing disproportionate revenue losses. (Amaro et al. 2024) . The system's structural biases continue to privilege global north service providers at the expense of local industries worldwide.

The loss of tax revenues for developing countries is particularly significant for business services, fees which are deductible from the business income of the customers. This directly reduces the source tax base if the income accrues to non-resident service providers.

Developing possible new rules for the taxation of services.

As a Commission, we believe that true reform of the international tax system would begin with confronting the reality that modern-day MNEs are a unified and highly integrated group of entities that are under single control and have a single set of owners. That means jettisoning separate entity taxation of MNEs and the use of transfer pricing rules to determine profit allocation in favour of taxing them as unitary firms.

The arm's length principle's fundamental flaw is its reliance on a fiction: that related entities operate as independent parties. This creates subjective, contested profit allocations that courts struggle to adjudicate, leaving tax administrations powerless against systematic base erosion and profit shifting.

A unitary approach should apportion the MNE's global income to the different jurisdictions based on objectively verifiable factors rather than resort to the fiction of arm's-length transactions or that one could possibly calculate what arm's-length prices might look like. These factors, such as employment, sales, resources used, fixed assets, etc., should be chosen to reflect the MNE's real economic activity in each jurisdiction.

We believe that this protocol can pave the way for the introduction of unitary taxation.

The protocol should set rules for coordinating the taxation of income from cross-border services ensuring coherence in treatment between comparable services. Therefore, the protocol should result in fair reallocation of taxing rights between countries, underpinned by the principle of unitary taxation and formulary apportionment or fractional apportionment of all profits of all multinationals across different jurisdictions.

This will also require the abandonment of the outdated permanent establishment principle and the development of a nexus rule based on the principle of Significant Economic Presence (SEP), whereby a taxable presence will be created in the country when a non-resident enterprise has a SEP, defined as purposeful and sustained interaction with the economy of that country, including sales of goods and services by any means, including digital.

Although the remit of the protocol is to deal with taxation of cross-border services, this approach could provide the basis for a more comprehensive reform of taxation of MNEs. Two methodologies are already available for implementing this approach:

1) One, which has been termed Fractional Apportionment, is to start with the MNE's revenues in the country concerned and apply its global operating profit margin to produce an estimate of net profit to be apportioned. This is the method provided in the UN model convention's Article 12B as an option for source country taxation of income from automated digital services. It was also put forward for public consultation in India in 2019, and proposed by the G24 in the OECD/G20 BEPS project negotiations. This would be relatively easy to implement, and could even be done unilaterally by any state, without the need for coordination or cooperation.
2) The other option, Formulary Apportionment, could be built on the work already done in developing the multilateral convention for Amount A under Pillar One of the OECD "Two Pillar Solution"

agreement. Although it has not been finalised, the draft convention, together with the Model Rules for the global minimum tax under Pillar Two, already include the basic standards needed to apply unitary taxation of MNEs with Formulary Apportionment. These include:

- a new taxable nexus based on a quantitative threshold of sales,
- principles and rules for specifying the source of sales revenue,
- a definition of MNEs global consolidated accounts for tax purposes,
- criteria defining the key factors commonly used for apportionment of profits (assets, employees, and sales).

These standards would provide a good basis for the negotiation of the proposed protocol. Most of the detailed technical work has been done, although the standards could be simplified to make them easier to administer.

The key issues for negotiation would be the factors in the apportionment formula and their weighting, as well as variations for key sectors.

The protocol could address the key weaknesses of Amount A, so to design a comprehensive solution applicable to all MNEs.

Other alternatives to be considered

Whilst we consider that a comprehensive and sustainable reform could be achieved only by a shift to unitary taxation and formulary/fractional apportionment, the protocol could also simplify 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, and including the taxation of Automated Digital Services (ADS).

The new Article 12AA of the UN model treaty, which provides for the application of withholding taxes on technical services and automated digital services, could be the basis for the protocol.

The protocol could also provide a way to standardize and harmonize the existing unilateral measures such as the Digital Services Taxes (DSTs), which can reduce political tension among countries, reduce compliance costs and uncertainties for business, and provide for the elimination of double taxation.

The protocol could help standardise applicable rates and tax returns, and provide for mutual assistance in the enforcement and recovery of taxes to enhance administration efficiency (particularly benefiting low-income countries with limited capacity to enforce tax obligations on MNEs headquartered in other jurisdictions).

Capacity building

We agree with the considerations included in the Co-Leads' Draft Issues Note with respect to the harmful focus on capacity building.

Capacity building is often offered as a panacea to the underlying problems of the current design of the international tax system.

We agree with the view expressed that for many developing countries this places a significant economic burden in terms of technology and human resources with no guarantee of success in increasing revenue, and we also believe that the focus should be to design simpler and fairer rules, which would largely reduce the need for capacity building programmes.

Full and effective participation of observers

Paragraph 21 of the Framework Convention ToR states that "*civil society and other relevant stakeholders are encouraged to contribute to the work of the intergovernmental negotiating committee in accordance with established practices*."

We are very committed and keen to respond to this invitation. However, our contribution can only be meaningful if it is well-informed and timely. With this in mind, we find it deeply concerning that observers have not been invited to participate in the online meetings of the Workstreams. The fact that we have been unable to even observe the numerous meetings that Member States have now had leaves us with a very limited understanding of the specific discussions, and significantly reduces our ability to feed into and respond to the debate.

We would like to stress the importance of allowing for full and effective participation of civil society and trade unions in all meetings of the committee, including the online sessions of the Workstreams.