United Kingdom response to the call for input on Workstream II (Cross-border services) for the First and Second Sessions of the Intergovernmental Negotiating Committee on the United Nations Framework Convention on International Tax Cooperation

21 July 2025

ABSTRACT

We propose that in progressing the work on the first Protocol the Committee clarifies the objectives and issues that it is seeking to address. This should take account of the wider economic impacts, and be informed by economic analysis and input from business. This should include consideration of longer term effects as economies and business practices evolve.

Our view is that physical presence tests should remain a significant factor in allocation of taxing rights in most circumstances, although there may be a case for considering a greater market allocation of taxing rights for certain large and profitable MNEs.

We also highlight the inherent difficulties and economic distortions that can arise from the gross taxation of income from services where there are associated business costs, rather than taxation on the net profits.

DETAILED COMMENTS

Thank you for the Issues Note of 27th June 2025 inviting written comments for the Intergovernmental Negotiating Committee on the work of Workstream II for the first early Protocol.

We have some general comments on the direction of travel and scope of the work and some more specific comments on some of the issues described in the Note.

General comments on the approach to the work

The starting point for Workstream II is the wording in the Terms of Reference and Resolutions which provides only a very high level indication of what the Protocol should cover saying that it should "*address taxation of income derived from the provision of cross-border services in an increasingly digitalized and globalized economy*". The aim of the Workstream is to turn that high level statement into an agreed policy outcome.

The Issues Note focusses largely on the issue of how countries currently tax income services under its domestic law and what limitations there may be on doing so, primarily under existing double taxation agreements. While clearly this will be one aspect to be considered we do not think the Note makes the case as to how and why this focus on source state taxation meets the mandate set by the Terms of Reference and Resolution.

In particular, in taking this work forward we propose:

- that the Committee considers, and sets out clearly, what overall objectives the protocol is aiming to achieve, the specific issues related to the taxation of cross-border services that it will be seeking to address and why, and the considerations that should be taken into account in doing so, based on clear and justifiable principles;
- that these should include taking account of the wider economic impacts on provision of cross-border services both in facilitating or discouraging such activity;

- that economic and legal analysis is undertaken to assess such impacts and the implications of the various policy proposals considered by the Committee,
- that this analysis includes inviting input from businesses and their representatives and taking account of this input in the consideration of policy;
- that the Committee also considers how in the longer term economies and business practices can change rapidly and differently in different countries, so the approach will need to be flexible to adapt to such differences and changes, and a one-size-fits all approach may not always be appropriate to address bilateral provision of cross-border services;
- that the Committee limits the scope of Protocol so that it does not cover the very complex issues arising from the provision of digital services, especially because this appears to be intended as the subject of a later Protocol to the Framework Convention to be considered from 2027.

Specific comments on some of the technical points

Much of the discussion in the Workstream meetings was on what should be the appropriate nexus that would justify a source state's right to tax services income arising there and we have some comments on this aspect.

Physical presence tests

While we think there is a case for considering greater market allocation of taxing rights over the profit of the largest and most profitable MNEs - particularly those providing digital services - our view is that physical presence continues to provide a justifiable basis for establishing nexus for taxation in most situations and should remain a significant factor in allocating taxing rights, as it is for goods. The reason for this is that it generally indicates the strongest connection with the state of physical presence through, for instance, the service provider making use of the state infrastructure, services etc. in a way that will not be the case where the services are provided remotely from outside the state.

Taxation on gross basis

There are well-known issues with an approach to allocation of taxing rights based on the source state applying tax to gross amounts of income without taking account of the deductible costs related to earning that income, particularly where the residence state taxes the net income. The Issues Note refers to some of these issues in paragraph 16. We agree with those participants that take the view that gross taxes on fees for services may create economic distortions and raise barriers to the provision of services including increasing the costs for service users, particularly for low margin services.

It can also result in what we would regard as an unbalanced allocation of taxing rights in favour of the source state, particularly when combined with the absence of a physical presence test where the fees are treated as arising there simply be virtue of it being the state of residence of the payer.

The example below illustrates these points.

Taxation on basis of residence of payer

It has been suggested in the Workstream technical discussions that the residence of the payer could be used to determine source.

In addition to the concerns above about gross taxation of services income, we think that raises difficult questions about the location of source for provision of services, both to businesses and to individual customers that would need careful thought and there are situations where it does not provide a sensible or administrable basis e.g. individual resident of State A consuming services while travelling in State B. More thought would need to be given to appropriate principles/approaches for sourcing the different services that are envisaged would fall within the scope of the proposed protocol.

Deduction of payments as basis for nexus

It was argued by some participants in the Workstream II meetings that where fees for services provided cross-border are a tax-deductible expense for the payer then this is 'base erosion' that is in itself sufficient to justify taxing rights over the payment in the state where the payment arises.

Firstly, we do not think that the reference to 'base erosion' is helpful in this context as it implies that such payments are made as part of an arrangement entered into by the service user (the payer) for the purpose of avoiding tax. Where a business has contracted with a non-resident service provider to provide it with services, with no suggestion of a tax avoidance motive in doing so (which will typically be the case where it involves an unconnected provider), we do not think that it is apt to refer to this as base erosion. Where there is an arrangement involving deductions to artificially depress the taxable income then there are other approaches to tackle this such as transfer pricing and other anti-abuse rules.

Secondly, we do not see how in principle the deductibility of a payment for a service from a non-resident service provider for wholly commercial reasons provides a justifiable nexus for taxation of the service fee simply because the business has decided not to use a local provider. Where a business buys goods from a non-resident supplier the cost of these would also be deductible but it is not suggested that this should itself give the state of payer taxing rights over the profits of the supplier and we do not see why this should be any different where the payments are for services.

Example

Architect in State R provides professional services remotely to client in State S from its office in State R charging fees of 1000 and incurring costs of 500. State S imposes tax of 100 on the architect through a withholding tax of 10% on the gross amount of the fees on the basis that the fees arise in State S because that is where the client paying the fees is resident. State R imposes tax of 125 on the architect by applying its normal business tax rate of 25% on the net profits of 500 but it is also obliged to provide credit relief for the tax of 100 paid in State S is the net amount charged is 25.

The outcome is that State S collects tax of 100 from this provision of services and State R is left with only 25 i.e. 80% of the taxing rights on the income from the services are located to State S and only 20% to State R.

We do not see how in principle this is a justifiable outcome in these circumstances since the connection with State R is clearly much stronger than that with State S. The architect's business is supported directly and indirectly through the state infrastructure and provisions of State R in very many ways, for instance though education and healthcare services, public transport etc. paid for by taxes raised in state R.

In contrast, the architect does not make use of State S's state provision as the services are provided remotely and the only connection with State S is that the client paying the fees is resident there. It is the case that the client will be making use of the provisions of State S but in our view this is too remote and transitory in relation to the business of the architect to justify the significant allocation of taxing rights to State S.

So while we think there is a case for considering greater market allocation of taxing rights over the profit of the largest and most profitable MNEs - particularly those providing digital services – that would not seem to be relevant in examples like the one above.

As a variation of this example, suppose the costs were instead 950. The profit in that case of 50 would be exceeded by the tax suffered in State S of 100, resulting in an overall loss from this services business, raising a barrier to the provision of such services.