KEY ISSUES IN UNFCITC PROTOCOL I

TAXATION OF CROSS BORDER SERVICES IN A DIGITALISED ECONOMY

14 AUGUST 2025

Lyla Latif (PhD)

BRIEFING NO.6/2025 (AUGUST)

1. Overview

From 11-13 August 2025, the Intergovernmental Negotiating Committee's (INC) Work Stream II addressed Protocol 1 on cross-border services taxation within the UN Framework Convention on International Tax Cooperation (UNFCITC). During these deliberations, several critical design questions emerged that will determine the protocol's ultimate effectiveness. Initial discussions focused on the importance of identifying covered taxes and defining the protocol's scope. Debate arose over whether indirect taxation should be included alongside direct taxes, and whether Digital Services Taxes (DSTs) fall within the protocol's remit. Members also sought clarity on whether the protocol would apply to gross-basis taxation, net-basis taxation, or both, as this fundamental distinction affects the entire framework's operation. Subsequently, the question of optionality became contentious, with debates over whether the protocol should be mandatory for all Framework Convention parties or allow countries to opt out entirely. Member states have also resisted including specific withholding tax rates within the protocol, arguing that rate specification should be left to bilateral negotiations or domestic discretion. Additionally, questions arose regarding dispute resolution procedures for conflicts arising under Protocol 1. Four distinct options were presented:

i. resolving disputes exclusively under Protocol 2,
ii. using the Framework Convention's general state-to-state dispute resolution mechanism,
iii. establishing MAP-like procedures specific to Protocol 1, or
iv. relying on normal domestic litigation approaches.

This briefing will first examine the scope and coverage issues, then analyse the fundamental design questions affecting the protocol's structure and effectiveness, particularly optionality and rate specification before turning to the dispute resolution options and their implications for the protocol's enforceability and coherence within the broader UNFCITC framework.

2. Scope and Coverage: Defining the Protocol's Boundaries

It was an expectation that the session debating Protocol I would clearly define which taxes fall within its scope and the basis upon which they apply. These definitional choices carry profound implications for the protocol's practical operation and relationship with existing tax frameworks. However, member states began the session debating over direct and indirect taxation. This debate over including indirect taxes within the protocol reveals fundamental misunderstandings about tax architecture and administrative feasibility. Indirect taxes, such as VAT, GST, and sales taxes operate on entirely different principles from direct taxation and should be excluded from the cross-border services protocol for several compelling reasons. Indirect taxes are consumption-based levies collected at the point of sale or consumption, not profit-based taxes that require complex attribution mechanisms. They already possess established international frameworks through destination-based taxation principles that function effectively for cross-border services. Most importantly, indirect taxes involve fundamentally different administrative systems, collection mechanisms, and policy objectives that would create unnecessary complexity if merged with direct tax coordination. Including indirect taxes would also blur the protocol's focus and create jurisdictional confusion. VAT and GST systems already address cross-border services through established place-of-supply rules and registration thresholds. Attempting to coordinate these systems within a direct tax protocol would create competing frameworks and administrative burdens without corresponding benefits.

Taxing the digital economy was also brought up during the direct and indirect tax debate and the immediate reaction was on Digital Services Taxes – whether this functioned as direct or indirect taxation. DSTs present a different analytical challenge. Despite their novel designation, DSTs function as direct taxes on business income derived from digital services provision. They tax the profits or revenues of specific business activities rather than consumption, making them conceptually aligned with corporate income taxation rather than indirect taxes. The characterisation of DSTs as direct taxes becomes clear when examining their structure: they target business enterprises based on revenue thresholds, apply to profits derived from digital services provision, and operate through mechanisms similar to corporate taxation rather than consumption taxes. Countries implementing DSTs explicitly designed them to capture taxation rights over digital business profits that escape traditional permanent establishment rules. Most critically, DSTs address precisely the cross-border services taxation challenges that motivate the protocol's development. They represent unilateral attempts to tax cross-border digital services in the absence of multilateral coordination. Including DSTs within the protocol would provide coordinated alternatives to these unilateral measures whilst maintaining the focus on direct taxation of business income.

The discussion then moved on to consider whether the Protocol would apply to gross basis taxation (where tax is calculated on the total payment amount) or net basis taxation (where tax is calculated on profits after deducting allowable expenses). This distinction between gross-basis and net-basis taxation represents perhaps the most fundamental design choice facing the protocol. This choice determines whether the protocol operates primarily through withholding taxes on gross payments or comprehensive taxation of net business profits. Gross-basis taxation through withholding taxes offers simplicity, immediate revenue capture, and administrative feasibility for developing countries with limited audit capacity. It ensures source countries receive revenue regardless of complex transfer pricing arrangements or profit attribution disputes. However, gross-basis taxation risks over-taxation of low-margin activities and creates potential double taxation concerns. Net-basis taxation aligns with traditional corporate tax principles and avoids over-taxation of legitimate business activities. It accommodates varying profit margins across different service categories and integrates more seamlessly with existing tax frameworks. However, net-basis taxation requires sophisticated audit capabilities, creates opportunities for profit manipulation, and may provide minimal revenue for source countries lacking administrative capacity. The optimal approach recognises that both mechanisms serve different purposes and should be available within the protocol framework. Withholding taxes provide backstop revenue collection whilst net-basis taxation ensures appropriate profit attribution for substantial business activities. The protocol should establish this dual approach rather than forcing an either-or choice that compromises effectiveness.

3. The Optionality Concern

Central to the protocol's effectiveness is whether participation remains optional or becomes mandatory. Historical precedent offers insights into the limitations of voluntary international instruments. The precedent of optional protocols in international law from climate change to human rights demonstrates their inherent limitations. The Kyoto Protocol's optional nature allowed major emitters to avoid binding commitments, whilst the Optional Protocol to the International Covenant on Economic, Social and Cultural Rights has achieved limited global adoption. In taxation, optionality would likely reproduce existing power asymmetries, with capital-exporting states declining participation whilst developing nations bear the compliance costs without reciprocal benefits. Nevertheless, the practical reality remains that member states consistently demand flexibility in international tax arrangements, viewing mandatory protocols as threats to fiscal sovereignty. This resistance reflects legitimate concerns about economic diversity, administrative capacity, and domestic political constraints that cannot be dismissed as mere obstructionism.

Countries argue that mandatory participation in tax protocols constrains their ability to respond to specific economic circumstances, negotiate advantageous bilateral arrangements, or maintain competitive tax policies that attract investment. For developing nations particularly, the fear exists that mandatory protocols could lock them into arrangements that favour more sophisticated tax administrations or established economic powers. The flexibility argument gains force when considering implementation realities. Countries with limited administrative capacity may prefer gradual adoption of complex tax coordination mechanisms rather than immediate compliance with comprehensive obligations. Optional participation allows for learning-by-doing and technical assistance programmes that build capacity before full engagement. More critically, optionality enables a two-tier system where developing countries adopt restrictive withholding tax obligations whilst developed nations maintain their residence-based advantages through selective non-participation. This would institutionalise rather than remedy current imbalances precisely the opposite of what the UNFCITC process seeks to achieve.

The resolution, therefore, lies in recognising that effective tax coordination requires mandatory participation but with built-in flexibility mechanisms that address legitimate sovereignty concerns. Rather than choosing between rigid mandatory obligations and ineffective optional participation, the protocol should establish mandatory participation with structured flexibility through:

i. Graduated Implementation Schedules: Countries could accept binding commitments with differentiated timelines based on administrative capacity and economic development levels. This maintains universal participation whilst acknowledging practical implementation constraints.
ii. Reservation Mechanisms with Limits: Allowing specific reservations to particular provisions whilst maintaining core obligations ensures participation without gutting the protocol's effectiveness. However, reservations should be subject to review and sunset clauses.
iii. Conditional Benefits: Countries refusing participation should face automatic exclusion from beneficial treaty provisions, creating genuine costs for non-participation whilst preserving formal sovereignty to choose.

However, the movement toward a UN Framework Convention represents a historic shift from OECD dominance toward genuinely multilateral tax governance that could overcome these traditional limitations. Unlike the ad hoc nature of bilateral treaties or OECD soft law, a framework convention creates binding international law with universal application principles. The precedent of successful mandatory frameworks, such as the UN Convention on the Law of the Sea, the Framework Convention on Climate Change's basic obligations, demonstrates that binding multilateral instruments can achieve what optional measures cannot. Given that cross-border services taxation affects fundamental state sovereignty over economic activity within territorial boundaries, the protocol should constitute a core obligation rather than an optional add-on. The digital economy's borderless nature makes fragmented, voluntary approaches particularly ineffective, creating the imperative for universal participation through binding commitments.

4. The Rates Dilemma

Even assuming binding participation, the question of rate specification presents equally consequential challenges. Member states' resistance to specified rates reflects legitimate concerns about sovereignty and economic diversity. However, their position reveals a profound misunderstanding of current realities and the dynamics that would emerge from undefined parameters. Without agreed parameters, we risk several obvious outcomes that would undermine the protocol's objectives:

i. Race to the bottom as competition for foreign investment will drive withholding rates toward zero, replicating the corporate tax rate decline witnessed over recent decades. African nations, desperate for capital, will systematically undercut each other's tax bases, recreating the destructive competition the protocol aims to prevent.
ii. Treaty shopping proliferation as sophisticated multinational enterprises will exploit rate differentials by routing transactions through the most advantageous jurisdictions. The Netherlands and Ireland's roles as conduit states would simply multiply across developing nations, negating any revenue benefits.
iii. Administrative arbitrage as complex rate variations across jurisdictions will advantage enterprises with sophisticated tax planning capabilities whilst disadvantaging smaller businesses and developing country tax administrations, exacerbating rather than addressing existing inequities.

These risks point toward the necessity of establishing global minimum thresholds rather than leaving rates entirely to national discretion. A global minimum withholding threshold represents the only viable approach to prevent these distortions. The precedent exists: the OECD's global minimum tax demonstrates that coordinated rate floors can achieve political consensus when framed appropriately around preventing harmful tax competition.

However, the minimum must reflect economic realities rather than political expedience. Research[1] indicates that effective withholding rates below 5-10% fail to deter profit shifting behaviours, whilst rates above 10% create genuine double taxation concerns. A differentiated approach perhaps 8% for technical services, 12% for digital services, 15% for royalties would acknowledge varying profit margins whilst preventing races to the bottom that benefit only multinational enterprises at the expense of all participating states.

5. Implementation Architecture

The protocol's success depends critically upon robust implementation mechanisms that create genuine incentives for compliance. The protocol should establish binding minimum thresholds whilst permitting higher rates, similar to the Basel banking framework's approach. For example, the Basel III Accord establishes minimum capital adequacy ratios that all participating banks must meet (currently 4.5% for Common Equity Tier 1 capital and 8% total capital ratio) whilst allowing individual countries to impose higher requirements based on their specific financial stability needs. This framework prevents a destructive 'race to the bottom' where countries compete by lowering capital requirements to attract banking business, while preserving national sovereignty to implement more stringent standards. Countries like Switzerland and the UK have adopted capital ratios significantly above Basel minimums without undermining the framework's effectiveness. Similarly, the cross-border services protocol should establish minimum withholding tax rates that prevent harmful tax competition whilst allowing countries to impose higher rates that reflect their revenue needs and policy preferences.

This preserves sovereignty whilst preventing destructive competition. Non-compliance should trigger automatic exclusion from treaty benefits creating genuine incentives for adherence rather than relying solely on goodwill. Furthermore, the protocol must include transition provisions for existing treaties. Automatic sunset clauses for conflicting bilateral provisions would prevent indefinite perpetuation of unfavourable arrangements negotiated under previous power imbalances, ensuring that the protocol delivers practical rather than merely theoretical change.

These technical design choices reflect deeper strategic considerations about power dynamics within international tax governance. Negotiators must recognise that technical complexity often serves political purposes. Member states' resistance to specific rates may reflect desires to maintain negotiating flexibility that historically disadvantages developing nations. Accepting vague principles over concrete commitments risks reproducing the OECD model's biases within UN structures achieving institutional change without substantive reform. The protocol's effectiveness depends ultimately upon its ability to alter power dynamics rather than merely codify existing imbalances. Optional participation with undefined parameters would achieve neither revenue enhancement nor administrative simplification the two primary justifications for reform that brought developing nations to support the UNFCITC process in the first place.

---

[1] CESifo Working Paper No.9757 (2022): https://www.ifo.de/en/cesifo/publications/2022/working-paper/global-profit-shifting-multinational-companies-evidence-cbcr-micro;
IMF (2019): https://www.imf.org/en/Publications/WP/Issues/2019/12/20/The-Impact-of-Profit-Shifting-on-Economic-Activity-and-Tax-Competition-48741

6. The Choice Before Negotiators

A binding protocol with minimum rate thresholds, automatic sunset provisions for conflicting treaties, and mandatory dispute resolution represents the only approach capable of delivering meaningful change for developing nations whilst providing certainty for international business. This approach addresses the structural inequities identified in the introduction whilst creating predictable frameworks for economic activity. The choice facing the UNFCITC negotiations is stark: genuine reform through binding obligations or cosmetic change through voluntary measures. History suggests that optional approaches to fundamental economic inequities serve primarily to legitimise rather than remedy existing arrangements. Given the stakes (billions in lost revenue, and perpetual fiscal disadvantage for developing nations) anything less than binding commitments with concrete parameters would represent a failure to match the ambition of the historical moment with the substance necessary to achieve meaningful reform.

Acknowledgement
CFS is grateful for the funding support provided by the House of Fiscal Wisdom

---

The Committee on Fiscal Studies was founded in Nairobi in 2016 as the Working Group on Tax with the support of leading intellectuals and scholars we represented a strong African voice in decision making circles which affected our continent's social, economic and financial security. In 2018, we became the Committee on Fiscal Studies dedicated to the reform and strengthening of tax systems in the global south generating research needed for knowledge transfer, policy advocacy, capacity building and trainings. We are based at the Faculty of Law, University of Nairobi.
Website: cfs.uonbi.ac.ke