SUBMISSION RELATED TO WORKSTREAM 1: PROTOCOL ON TAXATION OF INCOME FROM CROSS-BORDER SERVICES

SUBMITTED BY

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Abstract

On scope, we argue against a service-type taxonomy and for an activity-based approach agnostic to mode of delivery. On covered taxes, we propose a definition anchored to economic substance, capturing income, profits, and gross receipts however characterised under domestic law, ensuring digital services taxes are within scope. On collection mechanism, we consider withholding tax as the default, with proposed maximum rates of five per cent for automated digital services, twelve per cent for professional services, and eighteen per cent for related-party transactions. On MFN erosion, we propose a multilateral minimum floor. On prevailing effect, we draw on the Vienna Convention on the Law of Treaties Articles 30 and 59. On anti-avoidance and governance, we proposes specific drafting language.

I. Why This Protocol Matters

The majority of global trade is now in services. Developing countries are overwhelmingly net importers of services. The existing international tax architecture was designed for goods and physical commerce and systematically undertaxes cross-border service income in source jurisdictions. This is the single largest area of foregone revenue for developing countries in the current treaty system. The approximately three thousand bilateral tax treaties in force allocate primary taxing rights over service income to residence states, either by requiring physical presence through permanent establishment thresholds before source taxation is permitted or by capping withholding rates at levels that fail to reflect the economic value extracted from source-country markets. Technical service fees, management fees, consultancy charges, royalties, and digital platform revenues flow from developing to developed economies with minimal taxation at source. The OECD's Pillar One Amount A is not an alternative to this Protocol. It is a fundamentally different instrument designed to serve different interests, covering only the very largest multinationals with global revenues exceeding twenty billion euros, and addressing none of the service transactions that drive revenue loss in developing economies.

II. Scope: Activity-Based, Not Taxonomy-Based

▶ KEY DESIGN PRINCIPLE: The Protocol must not be organised around a taxonomy of traditional, digital, and hybrid services.

The distinction between these categories is increasingly artificial. A legal consultancy delivered over video conference, a software platform accessed remotely, and an engineering firm deploying personnel on site differ in mode of delivery but not in the fundamental question: which jurisdiction possesses the right to tax the income generated. If the Protocol is built around a service-type taxonomy, it will create classification disputes that MNEs will exploit. This is precisely what occurred during the Pillar One negotiations, which spent years attempting to define automated digital services as a distinct category before abandoning the approach because the boundaries proved unstable. Digitalisation is a characteristic of the modern economy as a whole, not a discrete sector.

The mode of delivery should not determine tax treatment. Treating a remotely delivered service differently from one delivered through physical presence effectively rewards the service provider for automating its delivery. The more a company replaces physical presence with digital infrastructure, the less tax it pays in the market jurisdiction. This creates a perverse incentive structure in which the most technologically sophisticated MNEs, overwhelmingly headquartered in developed economies, pay the least tax in the markets they serve. The Protocol should tax economic activity where it occurs regardless of how the service reaches the consumer.

The Protocol should adopt comprehensive coverage with narrow, defined exclusions rather than a positive list of covered services. Exclusions should be limited to international transport services already subject to existing conventions, services provided by governments in sovereign capacity, and services physically performed through personnel creating a permanent establishment, which fall under general business profits provisions. The burden of justification should rest on those proposing exclusions. Any further exclusion should be tightly defined, with the burden of proof on the taxpayer claiming it.

III. Covered Taxes: Defined by Economic Substance, Not Domestic Label

KEY PROPOSAL: A technology-neutral, model-agnostic definition that captures all instruments taxing income from services.

The covered taxes definition must be anchored to the object of taxation rather than the form of the domestic instrument. Digital business models evolve faster than legislative drafting cycles. A definition tied to specific instruments that exist today will be outdated within years as new models of value extraction emerge. The Protocol must therefore define coverage by reference to what is being taxed, not how it is taxed. If the definition captures the object, it remains durable regardless of whether states tax service income through withholding, corporate income tax, revenue-based levies, or instruments not yet devised.

PROPOSED DRAFTING LANGUAGE:

> *"Covered taxes means any tax imposed on a person by reference to income, profits, or gross receipts derived by that person from the provision of cross-border services, however characterised under domestic law. Value-added taxes, general sales taxes, and customs duties are excluded."*

This formulation brings digital services taxes within scope. A DST is a tax on income from digital services; it simply uses gross revenue as the base on which liability is computed rather than net profit. The distinction between a DST and a conventional withholding tax is one of computation method, not substance. If the definition is drawn too narrowly, states that have adopted revenue-based instruments will find those instruments outside the Protocol's framework, leaving them vulnerable to challenge under existing bilateral treaties whilst receiving no equivalent source taxing right under the Protocol. The definition must be broad enough to bring the full range of instruments within one coherent multilateral framework, so that the Protocol replaces the current patchwork rather than sitting alongside it. Indirect taxes are excluded on principle: they are consumption taxes operating through input-credit mechanisms, not taxes on a person's income from providing services.

IV. Collection Mechanism: Withholding Tax as the Default

CENTRAL SUBMISSION: WHT must be the principal collection mechanism, not a fallback.

Any protocol that does not establish withholding tax as the principal instrument for source-country revenue collection will be structurally incapable of delivering results for the majority of states that need it. The alternative is net-basis taxation, requiring the source country to audit the non-resident's actual profits, verify transfer pricing, verify cost allocations, access financial data held in other jurisdictions, and conduct cross-border investigations. That is a level of administrative capacity beyond most developing country revenue authorities. WHT operates at the point of payment. It is administratively simple, immediate, and does not depend on the cooperation of the non-resident enterprise. The UN Model Tax Convention moved in this direction with Article 12A on fees for technical services, preserving source-country WHT rights that the OECD Model had systematically eroded. The African Tax Administration Forum's model treaty goes further. The G-77 submissions to the Ad Hoc Committee have consistently prioritised WHT preservation. This Protocol must build on that foundation.

The gross-basis objection is a design concern, not a principled objection to WHT. It is addressed through de minimis thresholds, differential rates, the option for taxpayers to elect net-basis taxation where gross withholding would be confiscatory, and a binding credit or

exemption obligation on the residence state. The alternative, net-basis taxation, requires the source country to accept the non-resident's self-reported cost allocations, the very allocations that the OECD's own BEPS project has spent a decade demonstrating are routinely manipulated through transfer pricing.

PROPOSED DRAFTING LANGUAGE: Method and Rates

> *"1. When a Contracting State has taxing rights under this Protocol, it may impose taxation through: (a) gross-basis withholding at rates not exceeding those specified in paragraph 2; (b) net-basis taxation following taxpayer registration and return filing; or (c) permitting taxpayers to elect net-basis taxation where gross withholding would exceed net-basis tax liability."*
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> *"2. Maximum withholding rates shall be: (a) for automated digital services: 5 per cent of gross revenues; (b) for professional, technical, consultancy, and management services provided to unrelated parties: 12 per cent of gross payments; (c) for services provided to related parties: 18 per cent of gross payments."*
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> *"3. For purposes of paragraph 2(c), parties are related where one party owns or controls, directly or indirectly, 25 per cent or more of the other party, or where 25 per cent or more of both parties is owned or controlled by the same persons."*
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> *"4. The State of residence of the service provider shall allow a credit against its own tax for the tax paid in the source State, or shall exempt the relevant income, ensuring that source-country taxation does not result in juridical double taxation."*

The differentiated rates reflect varying profit margins across service categories. Automated digital services typically operate on high margins of thirty to fifty per cent due to scalability and minimal marginal costs; five per cent of gross revenue approximates net taxation at fifteen to twenty per cent. Professional services have lower margins after labour costs; twelve per cent of gross payments approximates net taxation at twenty to twenty-five per cent. Related-party services warrant the highest rate because pricing is not determined by arm's length negotiation and the base erosion risk is greatest.

V. MFN Cascading Erosion and the Multilateral Floor

KEY STRUCTURAL PROPOSAL: A minimum WHT rate below which no bilateral arrangement or MFN cascade can reduce.

Most favoured nation (MFN) clauses in bilateral tax treaties create a ratchet effect driving rates systematically downward. A developing country agrees to ten per cent on service fees with State B. Its treaty with State C contains an MFN clause. When it later concludes a treaty with State D at five per cent, the MFN clause is triggered and the State C rate drops without renegotiation, without reciprocal concession, and frequently without the developing country recognising the cascade has occurred. Every concession in one treaty ripples across the entire network. Brazil has forfeited substantial revenue through treaties with jurisdictions such as the Netherlands. Nigeria has experienced significant losses flowing to the United Kingdom and France. The Indian Supreme Court confronted this directly in its 2023 rulings in the Nestlé and Steria cases. That judicial intervention demonstrated the core difficulty: if domestic courts are struggling with MFN interaction across treaty networks, the problem cannot be resolved bilaterally. It requires a multilateral solution.

The Protocol should establish a minimum withholding tax floor below which no bilateral arrangement can reduce, whether through direct treaty negotiation or MFN cascade. This protects countries that have already experienced erosion and prevents smaller economies now building their treaty networks from replicating the same pattern. The Conference of States Parties should be empowered to set and adjust the floor rate.

VI. Prevailing Effect Over Bilateral Treaties

CRITICAL: Without this provision, the Protocol is neutralised on arrival.

Over three thousand bilateral treaties currently govern cross-border service taxation, most allocating primary taxing rights to residence states. If the Protocol defers to these treaties wherever they conflict, it changes nothing. The OECD's Multilateral Instrument of 2017 demonstrated this. The MLI adopted an opt-in architecture: states chose which provisions applied to which bilateral treaties. States opted in selectively, preserving precisely the provisions that maintained residence-state advantages. The MLI's impact on source-country revenue has been modest at best.

The Protocol must provide that its terms prevail over inconsistent bilateral treaty provisions. This is legally sound. Articles 30 and 59 of the Vienna Convention on the Law of Treaties expressly contemplate the modification of earlier treaties by later ones, provided parties consent through ratification. A protocol ratified by eighty states that changes the operative legal framework is worth more than one ratified by one hundred and fifty states with no effect over existing treaties.

PROPOSED DRAFTING LANGUAGE:

> *"The provisions of this Protocol shall prevail over provisions of bilateral or multilateral tax agreements between States Parties that are inconsistent with the taxing rights, collection mechanisms, or minimum rates established herein. A State Party that wishes to maintain inconsistent provisions in a specific bilateral agreement shall submit an affirmative declaration to the Depositary specifying the agreement and the inconsistency, and such declarations shall be subject to periodic review by the Conference of States Parties."*

VII. Nexus, Anti-Avoidance, and Excluded Services

The nexus rule must depart from physical presence. A significant economic presence test should operate through cumulative thresholds: revenue derived from in-market users, volume of transactions, and sustained engagement with the user base. Thresholds should be expressed in Special Drawing Rights (SDR) to avoid exchange rate distortions disproportionately affecting smaller economies, and a de minimis carve-out should be calibrated to GDP per capita rather than a flat figure. Revenue thresholds must be assessed on an aggregate annual basis, not per transaction, to prevent the artificial fragmentation of contracts into individually sub-threshold components.

KEY ANTI-AVOIDANCE PROPOSALS:

The Protocol should deny or limit deductions for service payments to related parties where payments exceed arm's length pricing, where services lack economic substance or duplicate locally performed functions, or where payments are made to entities subject to effective tax rates below fifteen per cent. Where service providers are interposed primarily to benefit from treaty provisions rather than for commercial substance, source states should apply taxation as

if payments were made to the ultimate beneficial owner. Where income from services is not subject to tax in the residence state due to exemptions, preferential regimes, or mismatches, source-state taxing rights under the Protocol are preserved notwithstanding any bilateral treaty provision to the contrary. The artificial distinction between royalties and service fees should be eliminated by treating intellectual property licensing as service provision subject to the same taxation rules, reflecting economic reality whilst constraining base erosion through intra-group royalty routing.