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Towards a UN Protocol for Taxing Cross-Border Services in a Digitalized Economy *

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ABSTRACT

This Policy Brief offers a way forward on the United Nations Framework Convention on International Tax Cooperation's (UNFCITC) protocol for taxing cross-border services in a digitalized economy. Such a protocol can provide a way to standardize and harmonize the existing plethora of widely varying Digital Services Taxes (DSTs), which can reduce political tension between the Global North and South, ease compliance costs and uncertainties for business, while providing a basis for the elimination of double taxation. The revenue generated can help bridge the Sustainable Development Goals (SDGs) financing gap and for the realization of human rights in the Global South. The Group of Twenty (G20) can act as a forum where key countries in the North and South can hammer out the architecture of the protocol for taxing cross-border services.

KEYWORDS: United Nations Framework Convention on International Tax Cooperation (UNFCITC), UN Protocol for Taxing Cross-border Services, Cross-border Services, Digital Economy, Digital Services Taxes (DSTs), Sustainable Development Goals (SDGs), Group of Twenty (G20)

Le présent rapport sur les politiques présente un certain nombre de propositions concernant le futur protocole à la convention-cadre des Nations unies sur la coopération fiscale internationale relatif à l'imposition des revenus tirés de la prestation de services transfrontaliers dans une économie de plus en plus numérisée et mondialisée. Ce protocole peut permettre d'unifier et d'harmoniser la pléthore de taxes sur les services numériques en vigueur et ainsi atténuer les tensions politiques entre le Nord et le Sud, diminuer les coûts de mise en conformité, réduire l'incertitude pour les entreprises, et servir de base à l'élimination de la double imposition. Les recettes générées contribueront à combler le déficit de financement des objectifs de développement durable (ODD) et ceux liés à la réalisation des droits de l'homme dans les pays du Sud. Le Groupe des Vingt (G20) peut constituer un espace de dialogue entre les principaux pays du Nord et du Sud pour mettre au point l'architecture de ce protocole.

KEY MESSAGES

- One of the first protocols under the United Nations Framework Convention on International Tax Cooperation (UNFCITC) will cover taxation of cross-border services in a digitalized economy.

- The protocol can 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.

- It is critical that the protocol includes Automated Digital Services (ADS) within its scope.

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MOTS-CLÉS: *La Convention-cadre des Nations unies sur la coopération fiscale internationale, La protocole à la convention-cadre des Nations unies sur la coopération fiscale internationale relatif à l'imposition des revenus tirés de la prestation de services transfrontaliers, Les services transfrontaliers, L'économie numérique, Les taxes sur les services numériques, Les objectifs de développement durable (ODD), Le Groupe des Vingt (G20)*

Este Informe sobre Políticas ofrece una vía para avanzar en el protocolo de la Convención Marco de las Naciones Unidas sobre Cooperación Fiscal Internacional (UNFCITC, por sus siglas en inglés) para gravar los servicios transfronterizos en una economía digitalizada. Dicho protocolo puede proporcionar una manera de estandarizar y armonizar la gran cantidad existente de Impuestos sobre los Servicios Digitales (DST, por sus siglas en inglés), que varían mucho de un país a otro, lo que puede reducir la tensión política entre el Norte y el Sur Global, aliviar los costes de cumplimiento y las incertidumbres para las empresas, al tiempo que proporciona una base para la eliminación de la doble imposición. Los ingresos generados pueden contribuir a colmar el déficit de financiación de los Objetivos de Desarrollo Sostenible (ODS) y a la realización de los derechos humanos en el Sur Global. El Grupo de los Veinte (G20) puede actuar como un foro en el que los países clave del Norte y del Sur puedan perfilar la arquitectura del protocolo para gravar los servicios transfronterizos.

PALABRAS CLAVES: *La Convención Marco de las Naciones Unidas sobre Cooperación Fiscal Internacional, El protocolo de la Convención Marco de las Naciones Unidas sobre Cooperación Fiscal Internacional para gravar los servicios transfronterizos, Los servicios transfronterizos, La economía digitalizada, Los Impuestos sobre los Servicios Digitales, Los Objetivos de Desarrollo Sostenible (ODS), El Grupo de los Veinte (G20)*

Introduction

Some of the notable efforts for taxing cross border digital services are treaty-based measures which include Amount A under Pillar One of the Organisation for Economic Co-operation and Development (OECD)'s Two-Pillar Solution, and Article 12B of the United Nations (UN) Model Tax Convention on taxation of income from automated digital services (ADS). Many countries have introduced national measures for taxing the digitalized economy, of which the most common is called a Digital Service Tax (DST). A few countries have also introduced another measure called Significant Economic Presence (SEP).

The urgency for a coordinated approach for the taxation of the digital economy has intensified with the delays and uncertainty in the implementation of Amount A due to lack of global consensus and unlikely adoption by key States, particularly the United States. The United States, which is home to most of the largest Big Tech companies, has in the past opposed DSTs and similar measures, perceiving them as discriminatory because they primarily impact US multinationals, and has usually responded by threatening to impose retaliatory tariffs on the implementing countries. However, the US has also been perceived to be opposed to the Amount A solution. Republicans in the US Congress in fact voted to defund the OECD for trying to tax US corporations. There is a widespread perception that whether Democrat or Republican, the US will remain opposed to allowing other countries to tax its multinational enterprises (MNEs).

For this reason, many countries, both OECD and non-OECD, including the United Kingdom, France, Italy, Spain, India, Kenya, Tanzania and Nepal, have already implemented different forms of DSTs in their domestic laws, and others are likely to follow with similar tax measures. These countries have already collected millions from DSTs, showing them to be a proven revenue generator. The European Union (EU) Council has made indications of introducing a digital levy in the event that Amount A fails.

Nevertheless, a plethora of uncoordinated and varying national measures can lead to increased compliance burden for businesses, double taxation, and disputes between countries and taxpayers. Keeping in mind the highly likely failure of the OECD solution of Amount A, the Terms of Reference for the United Nations Framework Convention on International Tax Cooperation (UNFCITC) indicates that one of the early protocols will address the taxation of income derived from the provision of cross-border services in an increasingly digitalized and globalized economy, expected to be concluded by 2027. In effect, this will be the UN's multilateral solution for taxing the digital economy.

Given that most countries who have initiated national measures have used DSTs, it is likely that the UN's solution will build on them. The Secretary of the UN Tax Committee said "they are here to stay" and suggested a "common approach" to DSTs as the way forward. For this reason, it is important to briefly examine their impact, especially when contrasted with the OECD solution of Amount A.

Digital Service Taxes vs Amount A

DSTs target highly digitalized activities like online advertising, platform intermediation, social media subscriptions, search engines, cloud storage, etc that derive incomes from market jurisdictions while paying no taxes on such incomes due to the nature of the activities. Some of the benefits of DSTs include: DSTs allow the market jurisdictions to tax the income earned by digital businesses within their borders, even without a physical presence; they are relatively simple to administer; they are considered efficient as they target companies that are often near-monopolies, whose behavior is unlikely to change significantly in response to the tax; DSTs generate additional revenue for the taxing jurisdiction without increasing the taxes for the local residents. Revenue estimates by the South Centre, in collaboration with the West African Tax Administration Forum (WATAF) and the African Tax Administration Forum (WATAF) show that the 85 combined Member States of the African Union and the South Centre can expect between EUR 20-34 billion from a 5% DST compared to EUR 7-10 billion in revenues from Amount A.[1]

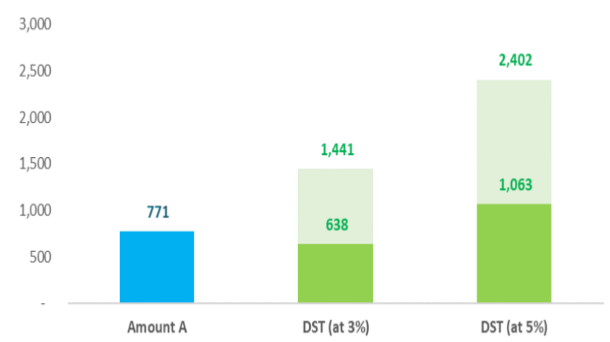

Figure 1: 2022 Tax Revenue Estimation under Amount A vs. DST Regimes for African Union Members (EUR Millions)

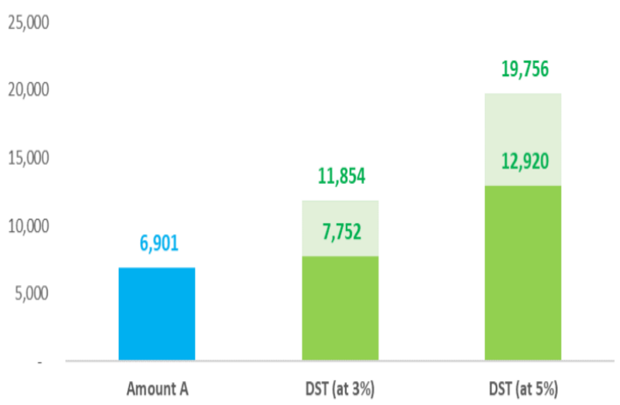

Figure 2: 2022 Tax Revenue Estimation under Amount A vs. DST Regimes for South Centre Members (EUR Millions)

Source: South Centre, WATAF & ATAF (2024)

Estimates by the EU Tax Observatory show that far from giving developing countries additional revenues, Amount A may actually lead to an erosion of taxing rights for some countries. For example, a country like India stands to *lose* EUR 89 million from Amount A, instead of gaining anything. Vietnam, Swaziland, Jamaica and several other countries face similar consequences.

While it is clear that developing countries can benefit up to more than three times on average from DSTs compared to Amount A, DSTs are not without criticisms. Critics argue that they discourage innovation and affect productivity, are discriminatory, may lead to multiple or double taxation, and are usually shifted to the consumers. These criticisms are often speculative without substantial data to back them up.

In any case, shifting DSTs to consumers may not always be feasible due to risk of reduced demand and competitive disadvantages.[2] For example, a report by the Computer & Communications Industry Association showed that if US companies passed on the UK DST to UK consumers, it would harm the US companies by $4.4 billion per year and lead to potential loss of 5,914 jobs in the US. Thus, passing on the tax to consumers can cause real damage to the economies of developed countries, and for that reason is to some extent an empty threat. This is something developing countries should be aware of.

Other analyses comparing Amount A and Article 12B have criticized Article 12B of the UN Model in favor of Amount A. Chand and Vilaseca critique Article 12B on several grounds, including its departure from the arm's length principle, its narrow focus on the digital economy, minimal revenue yield for developing countries, the potential for creating excessive administrative burdens, could discourage investment and may be passed on to consumers. They further argue that because Article 12B is embedded in bilateral agreements, many developing countries with limited treaty networks might not benefit. Báez challenges the restrictive definition of technical services under Article 12A, arguing that many countries have a broader domestic definition which already encompass ADS, making Article 12B redundant and creating unnecessary distinctions between the two types of services.

We wish to assert that Article 12B reflects a targeted approach to taxing income from digital services, offering a simpler and uniform approach that align with the realities of the digital economy which are not captured in Article 12A. Developing countries have for the longest time in history lacked the leverage to negotiate for source taxation including broader technical service definitions in bilateral tax treaties, leading to limited source taxation which are usually biased in favor of residence-based taxation. Article 12B ensures that countries where digital services are consumed have a clear right to tax the income from such services. The arm's length principle (ALP) has been widely criticized for its complexity and ineffectiveness in preventing profit shifting by MNEs, especially in developing countries. The failure of the ALP to tax income from digital services

1. The methodology and country level estimates are detailed in the document available here: https://www.southcentre.int/wp-content/uploads/2024/05/RP199_A-Toss-Up_EN.pdf.

2. Trevor Wagener & Kara Cade, "Impact of the Liberal Democrats Proposed Increase to the UK Digital Service Tax" (August 2024). Available from https://ccianet.org/research/reports/impact-liberal-democrats-proposed-increase-uk-digital-service-tax/.

led to the OECD itself eschewing its longstanding opposition to formulary apportionment and making that the basis of profit allocation under Amount A. Article 12B, while similarly departing from the ALP, uses a much simpler basis of fractional apportionment to compute net profits.

As mentioned previously, a standardized and harmonized approach to DSTs can ease the political tension between developed and developing countries, provide a viable multilateral solution and also reduce compliance cost for business. The following outlines what such an approach could look like.

Components of the UN Protocol on Cross-Border Services

Scope: Critical Importance of Including Automated Digital Services

The first and most important requirement is to ensure that the protocol includes ADS in its scope. The bulk of the revenues derived from Big Tech MNEs like Alphabet (Google), Amazon, Meta (Facebook), etc comes from ADS, such as online advertising, platform intermediation, search engines, social media, and other services requiring minimal human involvement from the service provider. These are the key services targeted by DSTs and must be covered by the first early protocol.

This will most likely be opposed by developed countries who will argue that it should be covered under the topic "taxation of the digitalized economy", which is one of the topics for consideration as the second early protocol. They will then try to ensure that another topic is chosen, for example taxation of High-Net Worth Individuals (HNWIs) or prevention of tax disputes.

This way, in effect the taxation of Big Tech multinationals will be removed from the scope of the UN Convention, leaving Amount A as the only multilateral solution on the table. The developed countries will then push for its early ratification and implementation.

Further, the developed countries will likely try to restrict the scope of the protocol to other kinds of service provision like design, software development, etc which will increase the tax burden on small firms while letting the Big Tech multinationals off the hook.

This must be prevented, and developing countries must insist that the scope of the protocol *includes* Automated Digital Services. This should be a non-negotiable if the UN is to provide a viable alternative to the OECD's solution.

This negotiation will likely take place in February 2025, during the organizational session of the intergovernmental negotiating committee of the UN FCITC. Developing countries therefore need to coordinate positions ahead of this in their various forums like the South Centre, African Union, Platform for Taxation in Latin America and the Caribbean (PTLAC), etc.

Paragraph 6 of Article 12B of the UN Model Tax Convention provides a definition of "automated digital services" and can be a good starting point for the negotiations. There can also be an option to use revenue threshold to reduce administration costs and focus on the big companies.

Once it is clarified in the February 2025 organizational session that the scope of cross-border services includes ADS, the rest of the negotiations can continue as planned until the deadline of September 2027.

Other Components

The remainder of the protocol can include a common understanding of:

1. **Applicable rates**. The protocol can prescribe an acceptable range of rates for DST, to prevent too high or too low rates. The Commentary on Article 12B suggests 3-4% which can be a good starting point for the negotiations. This rate can vary depending on the nature of digital services and their level of profitability.

2. **Taxable presence.** The protocol can also provide a mechanism for modifying the permanent establishment and business profits provisions in existing bilateral tax treaties to incorporate the principle of Significant Economic Presence (SEP), to create taxable presence for digitalized multinationals in the countries where they derive revenues. SEP can be implemented using a simplified approach such as based on a percentage of revenues generated, number of users, data collected in the source state, or any other metric depending on the nature of service or digital activity. Paragraph 3 of Article 12B which addresses the net basis method for taxing the digital economy can also be considered in the negotiations, with further simplifications.

3. **Elimination of double taxation.** Countries can establish mechanisms to eliminate double taxation. There can be a commitment by countries that if a company has paid a DST that meets the common understanding, then the taxpayer will be granted relief by exemption or credit method. For example, if a Big Tech firm is headquartered in a developed country and pays a DST to a developing country and the DST meets the conditions prescribed in the protocol, then the developed country can provide tax relief to eliminate double taxation. If a country chooses not to participate, its companies will suffer double taxation and could become less competitive. This approach can therefore incentivize the participation of all countries in the protocol.

   The taxes paid by MNEs, whether DST or SEP tax, are based on a proxy of profits and directly affect the shareholders' after-tax returns, hence they should be creditable against other tax liabilities in their residence country. This ensures that digital businesses contribute fairly to the economies where they derive their revenues without suffering double or multiple taxation.

4. **Standardized returns.** Countries should develop standardized returns and filing requirements for MNEs. This will reduce administrative burden for multinationals and tax administrations and increase certainty.

5. Mutual assistance in 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.

6. Dispute prevention and resolution mechanism for any disputes arising.

Convention or Political Commitment?

A critical question is how the above will be implemented. Two options can be considered.

Multilateral Convention: This would be an Amount A-style convention that would have to be signed and ratified by countries and be legally binding. This option is more stringent and may discourage developed countries from joining, especially given the commitment to provide tax relief, which in effect is an acceptance of giving up their taxing rights.

Political Commitment: This would be a Pillar Two-style non-binding "common approach" which is primarily a political commitment. The protocol would primarily provide a legal framework where countries can regularly discuss relevant issues like scope, applicable rates, dispute resolution, etc. This option is less stringent and can incentivize more developed countries to participate, albeit with reduced tax certainty for businesses.

Stakeholders

Barring the US, almost all Group of Twenty (G20) countries need an urgent solution for taxing digital services. The EU, African Union, Brazil, South Africa and India are key countries and regional groupings within the G20 that can prepare a common understanding of the protocol. The US will again try to oppose things, and given the G20 rule of consensus a formal G20 position is unlikely. However, it nevertheless provides a valuable platform for these key actors to hammer out a political agreement among them which can then be brought to the UN negotiations.

Conclusion

The upcoming negotiation of a UN protocol for taxing cross border services is a critical opportunity for developing countries to negotiate an alternative solution to the OECD's Amount A. For this to be successful, it is essential that automated digital services are in-scope of the protocol. The decision will be made in February 2025 at the organizational session of the UN Framework Convention on International Tax Cooperation, making early mobilization of the Global South on this topic a matter of urgency.

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