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Taxation of digital services – A Domestic Law Solution for Overcoming Tax Treaty Barriers

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Tax treaty treatment of source taxation of cross-border services continues to be an unresolved issue even fifteen years after it was recognized as a major issue within the Base Erosion and Profit Shifting (BEPS) Project. While the Organisation for Economic Co-operation and Development (OECD) Inclusive Framework's Amount A of Pillar One does not seem to be getting finalised, at the United Nations (UN) an Intergovernmental Negotiating Committee (INC) is working on a UN Framework Convention on International Tax Cooperation which will offer a solution to the issue. The success of the UN's initiative will depend on how many developed countries sign the Framework Convention and relevant Protocols.

This article evaluates a Domestic Law Solution to the issue which was presented at the February 2026 session of INC at New York. As per this solution, the domestic law of the source country can define the term "profits of an enterprise" to exclude consideration for digital services and thus bypass treaty restrictions on source taxation. As a result of this, the source country will be able to levy tax on such income in terms of Article 21(3) of the tax treaties signed by it provided the wording of Article 21(3) is identical to that in the UN Model Tax Convention.

Le traitement fiscal des services transfrontaliers dans les conventions fiscales reste une question non résolue, même quinze ans après avoir été reconnue comme un enjeu central dans le projet sur l'érosion de la base d'imposition et le transfert de bénéfices (BEPS). Bien que le Montant A du Pilier Un du Cadre inclusif de l'Organisation de coopération et de développement économiques (OCDE) ne semble pas sur le point d'être finalisé, aux Nations Unies (ONU), un Comité intergouvernemental de négociation (CIN) travaille à l'élaboration d'une Convention-cadre des Nations Unies sur la coopération fiscale internationale qui offrira une solution à cette question. Le succès de l'initiative de l'ONU dépendra du nombre de pays développés qui signeront la Convention-cadre et les Protocoles pertinents.

Cet article évalue une solution de droit interne à cette question qui a été présentée lors de la session de février 2026 du CIN à New York. Selon cette proposition, la législation nationale de l'État de la source peut définir le terme « bénéfices d'une entreprise » de manière à exclure la contrepartie des services numériques et ainsi contourner les limitations conventionnelles à l'imposition à la source. En conséquence, l'État de la source pourra imposer ces revenus en vertu de l'article 21(3) des conventions fiscales qu'il a conclues, à condition que la rédaction de l'article 21(3) soit identique à celle du Modèle de Convention fiscale des Nations Unies.

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El tratamiento fiscal de los servicios transfronterizos en los convenios fiscales sigue siendo una cuestión sin resolver, incluso quince años después de que se reconociera como un tema central en el proyecto sobre la erosión de la base imponible y el traslado de beneficios (BEPS). Si bien el Importe A del Pilar Uno del Marco Inclusivo de la Organización para la Cooperación y el Desarrollo Económicos (OCDE) no parece estar próximo a finalizarse, en las Naciones Unidas (ONU) un Comité Intergubernamental de Negociación (CIN) está trabajando en una Convención Marco de las Naciones Unidas sobre Cooperación Tributaria Internacional que ofrecerá una solución a esta cuestión. El éxito de la iniciativa de la ONU dependerá del número de países desarrollados que firmen la Convención Marco y los protocolos pertinentes.

Este artículo evalúa una solución de derecho interno a esta problemática, presentada en la sesión de febrero de 2026 del CIN en Nueva York. Conforme a esta propuesta, la legislación nacional del país de la fuente puede definir el término "beneficios empresariales" para excluir la contraprestación por servicios digitales y eludir así las restricciones convencionales a la imposición en la fuente. Como resultado, el país de la fuente podrá gravar dichos ingresos en virtud del artículo 21(3) de los convenios fiscales que haya suscrito, siempre que la redacción del artículo 21(3) sea idéntica a la del Modelo de Convenio Tributario de la ONU.

跨境服务来源地征税的税收协定处理问题，在被认定为税基侵蚀与利润转移（*BEPS*）项目中的重大议题十五年后，至今仍未得到解决。尽管经济合作与发展组织（*OECD*）包容性框架的"第一支柱金额*A*"条款似乎尚未最终敲定，但联合国政府间谈判委员会（*INC*）正在制定《联合国国际税务合作框架公约》，该公约将为解决这一问题提供方案。联合国倡议的成败取决于签署《框架公约》及相关议定书的发达国家数量。

本文评估了*2026*年*2*月政府间谈判委员会在纽约会议提出的国内法解决方案。该方案提出：来源国可通过国内法对"企业利润"进行定义，将数字服务对价排除在外，从而规避税收协定对来源地征税的限制。据此，只要来源国签署的税收协定第*21*条第*3*款措辞与《联合国示范税收协定》一致，该国即可依据该条款对相关收入征税。

1. Background

One hundred plus countries are negotiating a historical United Nations Framework Convention for International Tax Cooperation (Framework Convention) at the United Nations (Intergovernmental Negotiating Committee - INC) to address the current imbalances in global taxation. One of the major issues sought to be addressed is taxation of cross-border services. The current Tax treaty rules based on physical presence have become obsolete considering the advancements of technology. This note evaluates one of the potential solutions for overcoming Tax treaty restrictions on the source countries by amending domestic law – the ***Domestic Law Solution***.

2. Domestic law solution – How does it work?

The Domestic Law Solution can be applied by developing countries to their existing network of tax treaties as follows:

- Consideration for cross-border services is excluded from the scope of Business Profits, which is usually Article 7 of the Double Tax Avoidance Agreement (the ***Tax treaty***) signed by developing countries with various countries
- This exclusion from Article 7 of the Tax treaty is achieved by defining the term "profits of an enterprise" in the domestic law
- The term "profits of an enterprise" is used in the Tax treaty but is not defined therein and Article 3(2) of the Tax treaty is applicable in such situations
- If a Tax treaty has a provision identical to Article 21(3) of the United Nations Model Double Taxation Convention between Developed and Developing Countries (the ***UN Model***), then it becomes applicable when an item of income is not dealt with by other provisions of the Tax treaty
- Article 21(3) of the UN Model gives taxing right to the source country

The above aspects are explained in the subsequent paragraphs.

2.1 Profits of an enterprise - Article 7

Article 7 of the Tax treaty is applicable to "*profits of an enterprise*". The tax treaties, however, generally do not define the term "profits of an enterprise". The following observations can be found in the OECD Commentary on the previous version of Article 7:

"59. Although it has not been found necessary in the Convention to define the term "profits", it should nevertheless be understood that the term when used in this Article and elsewhere in the Convention has a broad meaning including all income derived in carrying on an enterprise. Such a broad meaning corresponds to the use of the term made in the tax laws of most OECD member countries."

The above paragraph is also adopted in the UN Commentary on Article 7.

If the income does not fall within the meaning of "profits of an enterprise", Article 7 will not be applicable.

2.2 Definitions - Article 3(2)

Article 3(2) of the UN Model is worded as follows:

"2. As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State." (emphasis added)

As per Article 3(2) of the Tax treaty, in absence of a specific definition in the Tax treaty, the meaning given to the term under the domestic law is to be applied.

2.3 Amendment to the domestic law

The domestic law of the source country can be amended to include a specific definition of the term "profits of an enterprise". This term may be defined as follows.

"for the purpose of tax treaties, no part of the consideration for "services" / "automated digital services" accruing or arising in [name of the Country] to a non-resident, shall be treated as "profits of an enterprise", unless the entire amount of such consideration is attributable to the permanent establishment of such non-resident in [name of the country]."

As a result of this definition, the consideration for services or automated digital services will not qualify as profits of an enterprise for the purpose of the Tax treaty.

2.4 Applicability of Article 21(3) (Other Income)

Article 21(3) of the UN Model is reproduced hereunder:

"Notwithstanding the provisions of paragraphs 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing Articles of this Convention and arising in the other Contracting State may also be taxed in that other State."

In terms of Article 21(3) of the UN Model items of income not dealt with by other provisions of the Tax treaty can be subjected to tax in the source country.

When the consideration for services does not fall within the scope of Article 7, Article 21(3) will be relevant. This provision gives taxing rights to the source country.

3. Rationale behind the Domestic Law Solution

The rationale for the Domestic Law Solution is not too difficult to explain. The physical presence test in Article 7 was designed almost a century ago when the digital business models simply did not exist. The countries never contemplated such digital business models because of advancement of technology and never intended to surrender taxing rights for such businesses. The physical presence test has become obsolete and is producing inconsistent results.

This problem is well recognised globally and more than 140 jurisdictions in the OECD Inclusive Framework attempted to address this. The OECD started work to address this problem way back in the year 2012 as a part of the Base Erosion and Profit Shifting (BEPS) Project. This was followed by Pillar 1, the construction whereof is not getting concluded. The problem remains unanswered even after 15 years from the commencement of the BEPS project.

4. Analysis

Certain nuances related to the Domestic Law Solution are further analysed in the subsequent paragraphs:

4.1 Issues related to applicability of Article 3(2)

The words "at any time" and "at that time" in the text of Article 3(2) clearly adopts an ambulatory approach. Thus, the meaning of the term "profits of an enterprise" prevalent in the domestic law at the time of application of the Tax treaty can be adopted for the purpose of the Tax treaty.

4.1.1 Where the text of Article 3(2) does not adopt an ambulatory approach

Some tax treaties may not contain the above text of Article 3(2). In those cases, one may still adopt ambulatory approach for the purpose of interpretation of Article 3(2) and apply the most recent definition of the term "profits of an enterprise" for the purpose of the Tax treaty.

4.1.2 Static approach

In a situation where a static approach is to be adopted for the purpose of article 3(2), it may still be possible to argue that when the tax treaties were signed, the business models did not adopt the current technology, digital businesses were not contemplated and hence even adopting the static approach, the term "profits of an enterprise" does not include consideration for automated digital services.

4.1.3 Unless the context otherwise requires

It needs to be examined whether the words "unless the context otherwise requires" contained in Article 3(2) can prevent adoption of the domestic law definition. It is possible to argue that the context certainly requires adoption of a domestic law definition. Article 7 is the most important article in the Tax treaty distributing taxing rights between two countries. This distribution is well thought through and not an unconditional surrender of taxing rights by the countries. The parties never contemplated digital businesses when the Tax treaty was signed and hence the profits from such businesses should not be treated as "profits of an enterprise" for the purpose of article 7. Thus, it is certainly not out of context to refer to the domestic law meanings in such situations.

4.1.4 Guidance from Vienna Convention

Reliance may be placed on Article 31(1) of the Vienna Convention on the Law of Treaties (VCLT) which provides that *"A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose."*

The object and purpose of the Tax treaty was never that the source country will surrender taxing rights on income from digital services.

Further, in terms of Article 32 of the VCLT, "preparatory work of the treaty and the circumstances of its conclusion" are supplementary means of interpretation. The circumstances in which treaties are concluded certainly did not involve digital businesses. Further, as per the same Article, *"a result which is manifestly absurd or unreasonable"* is to be avoided. Thus, an outcome wherein the source country is required to give up taxing rights over business models which were not on the horizon when the treaties were negotiated can certainly be said to be manifestly unreasonable and this needs to be avoided.

4.2 Potential tax disputes

If this Domestic Law Solution is implemented, the country of residence may deny relief from double taxation and the companies earning consideration for digital services may dispute applicability of Article 3(2) and the domestic law. The matter would reach the courts of the source country. It can be surmised that courts may adopt a purposive interpretation of the tax treaties, the rationale explained in ***para 3*** above and decide in favour of the revenue authorities.

4.3 Unilateral amendment of Tax treaty v. Restoring the original intent and purpose

The Domestic Law Solution may be treated as a unilateral amendment of the Tax treaty through changes in the domestic law, which is generally not accepted and appreciated. However, this case may be seen from a different perspective. It may be argued that the countries signing the tax treaties never contemplated digital businesses and never gave up taxing rights on such businesses. Thus, there is no "unilateral treaty override" but an attempt to ensure that the original intention of the parties to the tax treaties is restored.

4.4 Double taxation

It may be contemplated that the country of residence may not accept the Domestic Law Solution and would deny credit / exemption resulting in double taxation.

To avoid double taxation, the Multinational Enterprises (MNEs) may consider amending the business models. A simple approach for this could be that the MNE creates a permanent establishment in the source country and the business is conducted from the source country. When the business is conducted from a permanent establishment situated in the source country, the source country will get taxing rights as per Article 7 of the Tax treaty. The country of residence would in that situation be obliged to relieve double taxation by giving credit for the tax paid in the source country.

5. Will the Domestic Law Solution completely address the issue?

The clear answer is "no". Article 21 of the OECD Model Tax Convention on Income and on Capital (the ***OECD Model***) does not have para 3 and it does not give taxing right to the source country unless there exists a Permanent Establishment (***PE***). Thus, the tax treaties, which are based on the OECD model will not give taxing rights to the source country even when the definition of "profits of an enterprise" is adopted in the domestic law.

Similarly, even when the Tax treaty is based on the UN model, if the tax treaties are recently signed, it would be difficult to argue that when the countries sign the tax treaties, digital businesses were not contemplated. The counter argument could be that it was always the understanding that a solution would be found to the digital services businesses (e.g. Pillar A or Article 12B).

6. Conclusion and way forward

Domestic Law Solution is certainly an aggressive approach. However, these are exceptional times where the countries are struggling to solve this issue and, hence, exceptional solutions are required in such situations.

The Domestic Law Solution certainly requires further evaluation by various stakeholders for improvement - the INC may examine this in greater detail.

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