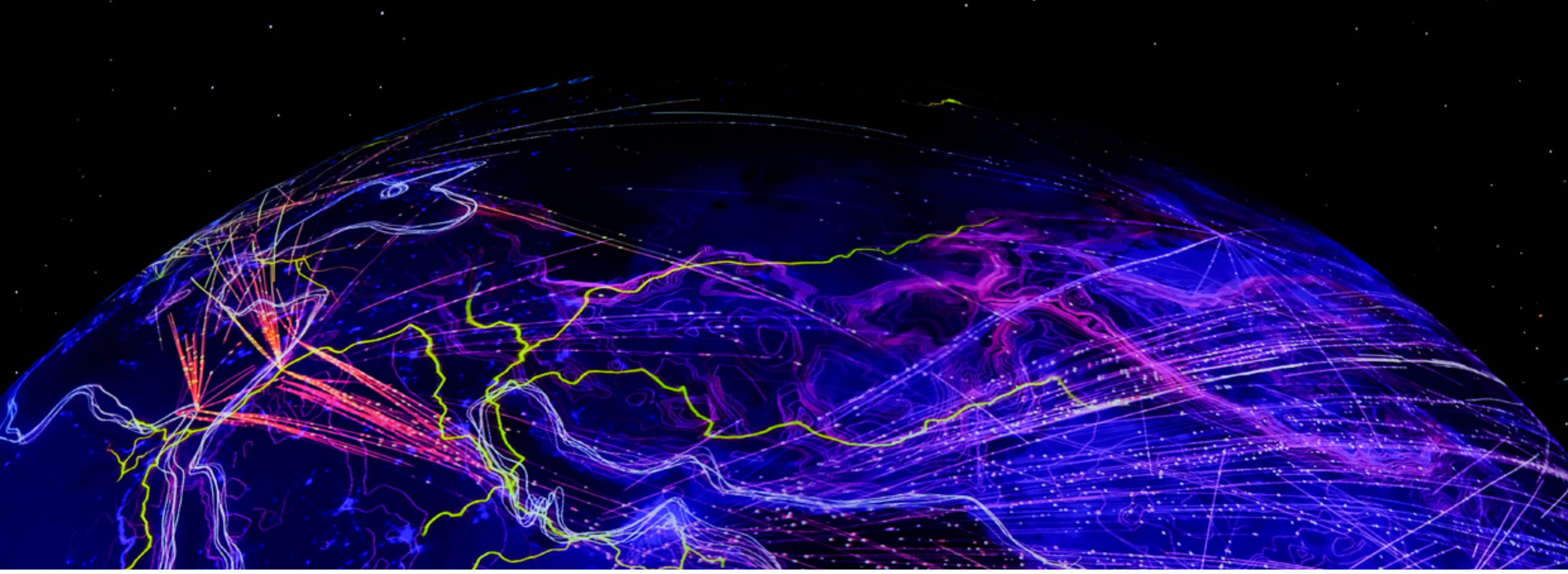

Appendix A. A protocol to address taxation of income derived from the provision of cross-border services in an increasingly digitalized and globalized economy

Why is this protocol important?

Recognition of widespread and continued tax avoidance by MNEs led G20 leaders in 2013 to support the OECD led project on Base Erosion and Profit Shifting (BEPS), to ensure that MNEs could be taxed 'where activities occur and value is created'. The first phase resulted mainly in a patch-up of existing rules, although a system of exchange of MNEs' country-by-country reports among jurisdictions was created, albeit only accessible for tax authorities and difficult for developing countries to join. This failed to resolve the fundamental flaws in the international tax system, due particularly to the priority given to the residence principle, which had been exacerbated by globalization and digitalization. Developing countries continued to try to protect the source tax base, mainly through withholding taxes; and many OECD countries adopted similar measures, although only on digital services.

This put pressure on the negotiations, and in 2019 the G24 group of developing countries proposed a new approach for taxing MNEs where they have a significant economic presence, based on fractional apportionment. This paved the way for agreement on a 'new taxing right', a key element of the '[Two-Pillar Solution]' proclaimed in October 2021 by the OECD/G20 Inclusive Framework (IF).

Amount A of Pillar One accepts the new approach of taxing MNEs on their global profits, with a formulary allocation of taxing rights to countries where they have a minimum threshold of sales, regardless of physical presence. However, Amount A is designed to apply only to the biggest and most profitable MNEs (those with global turnover of at least $20 billion and a profit margin of at least 10%) and re-allocates 25% of only the 'residual profit' (i.e. the profit above the 10% margin) to the countries where they have sales. This would add a new layer of rules, leaving in place the current dysfunctional rules for all other purposes, while adding further complexity and generating little additional revenue.

Moreover, the OECD IF formula uses only sales for reallocation of residual profits. This disadvantages countries with relatively small domestic markets, or those with substantial exports. As rich countries consume more, the allocation of profits by sales only is likely to result in an unequitable distribution between countries. There is no economic justification for this particular formula, and in many cases, it is clearly inappropriate.

Pillar One has still not been agreed, and even if it were, it is highly unlikely to be implemented. Its adoption would require ratification of a multilateral convention by a critical mass of states, including the United States that is the headquarters of most of the largest and most profitable multinationals. Given the two-thirds majority in the Senate required for ratification, the US Congress almost certainly will not ratify it any time soon.

Furthermore, signing and ratifying Pillar One's Amount A multilateral convention requires countries to give up their autonomous taxing rights. They must commit to not implementing digital services taxes, and other measures like withholding taxes would be contested. This ties the hands of governments on what taxes they can impose in future, in return for a very limited amount of expected revenue. The taxes forgone could be an increasingly important source of revenue for developing countries in the future as revenues from digital services continue to increase, making signing on to Pillar One even less attractive for developing countries.

Based on the above limitations, ICRICT's advice to countries is to not sign the multilateral convention required to implement Pillar One but proceed to introduce alternative measures such as withholding taxes or digital services taxes.

In this context, the call to negotiate 'A protocol to address taxation of income derived from the provision of cross-border services in an increasingly digitalized and globalized economy' as part of the UN FCITC represents an important opportunity. The problem of taxation of cross-border services reveals the defects of current rules perhaps more than any other. Services generally involve a close relationship with clients and customers, especially in the era of user-generated content and data collection. Yet due to globalization and digitalization they have become increasingly easy to deliver with little or no physical presence.

Services have become increasingly important for economic development, but international tax rules favouring delivery by non-residents act as a disincentive to the growth of local services providers, particularly disadvantaging developing countries which are mainly hosts to MNEs. The spread of tax treaties favouring the OECD model has been accompanied by a widening deficit in services trade of developing countries, with a weakening of their attempts to protect their tax base through withholding taxes resulting in increasing losses of tax revenue.

Consequently, two approaches would be possible in designing a protocol under UN auspices. One would be an agreement to strengthen source taxation, mainly through withholding taxes. In fact, a model for this has already been developed by the United Nations Committee of Experts on International Cooperation in Tax (UNTC) , which includes a **Fast Track Instrument** that would facilitate the incorporation of all the provisions in the UN tax model to protect source taxation for all services. Many countries, including OECD members, have adopted digital services taxes (DSTs), which are similar in nature to withholding taxes, and both the convention and a protocol could aim to standardize these. However, this would not resolve the wider problem of protecting the source tax base, which is more acute for developing countries. The alternative, which reflects ICRICT's long-standing position, would be for the protocol to agree the principle of unitary taxation of MNEs based on formulary apportionment. This would ensure taxation of income from all cross-border services, indeed it would resolve the problem of MNE taxation in a comprehensive and effective way.

The protocol itself should include the basic principles for unitary taxation and formulary apportionment, as well as procedures for its coordinated implementation by willing states. The more detailed technical standards for application of the approach should be formulated as model rules, as has been done for the global corporate minimum tax under Pillar Two. These standards could be based on those already formulated for Amount A of Pillar One, including (i) a quantitative threshold of sales revenue to define taxable presence; (ii) rules for the adjustment of MNEs' consolidated financial accounts to define their global net profit for tax purposes; (iii) rules to define the source of sales revenues particularly for services; and rules to define and quantify the other factors to be used for apportioning rights to tax (e.g. physical assets, employees and data presence / data extraction).

Key aspects to be included in the protocol to address taxation of income derived from the provision of cross-border services in an increasingly digitalized and globalized economy

This protocol should include, but not be limited to, taxation of Automated Digital Services (ADS) and ideally the scope should cover all services.

The protocol should set rules for coordinating the taxation of income from cross-border services ensuring coherence in treatment between comparable services. Therefore, the protocol should result in:

- Fair reallocation of taxing rights between countries, underpinned by the principle of unitary taxation and formulary apportionment of all profits of all multinationals across different jurisdictions. This would require the development of a nexus rule based on the principle of significant economic presence, whereby a taxable presence will be created in the country when a non-resident enterprise has a Significant Economic Presence (SEP), defined as purposeful and sustained interaction with the economy of that country.

- Simplification of the right to tax at source payments for services, regardless of whether they may be classified as technical or professional, or delivered by an independent person or an enterprise.

- Development of coordinated mechanisms for the taxation of digital services.

- Coordinated taxation of windfall or excess profits.

- The strengthening of anti-avoidance instruments and principles such as a 25% global effective minimum tax on the profits of multinational corporations.

To achieve this, the following alternatives should be considered in a protocol to address taxation of income derived from the provision of cross-border services in an increasingly digitalized and globalized economy:

- Withholding of income taxes on a deemed profit earned or on gross payments for all services (not just digitalized services).

- Formulary Taxation of Net Income from Sales (i.e. apply global profit margin to local sales revenue).

- Formulary Apportionment.

- Digital service taxes on gross revenues should be considered as a valid solution for the taxation of Automated Digital Services (ADS).

Further, the design of a protocol on the taxation of MNEs' profits should be based on a principle of allocating taxing rights based on location of real activities; but also based on an objective of minimising profit shifting. Criteria which take into consideration the use of data to extract profit should also be considered for the allocation of taxing rights. Some possible considerations in this regard could include allocating taxing rights based on sales (with due consideration of both location of final customers and country of origin in the case of natural resources, including agriculture), employees, location of physical assets and data presence / data extraction.

Enforcement and collection mechanisms should be kept simple and easy to administer.

In addition, this protocol should also address issues such as transparency and effective international cooperation for tax matters, including:

- Public country-by-country reporting of MNEs' economic activities based on the robust Global Reporting Initiative standard for public reporting on tax (**Tax:207**).
- Extend the reach and effective implementation of the automatic exchange of information on income derived through digital platforms.