



Options for a UN Protocol on Services in a Globalised and Digitalised Economy

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Significance of services

Digitalisation

- Traditionally **personal transactions**, continuous relationships, delivery **at client premises**
- 1960s+ **ICT revolution** analogue >> digital systems
- **Digital deliverability**; communication over ICT networks (excludes e.g. transport, construction, extractives, tourism)
- **Transformation** of economic activities: wide range of 'new' services; intangible services substitute for & 'cannibalise' physical activities (mining/hydrocarbons, fast food & hotels)
- **Paradox**: services 'depersonalised', but stronger ties to clients/ users (continuous contact, subscriptions, data collection)
- 1990s+ **world wide web** accelerates cross-border delivery of intangible services, advanced by the cloud, big data and AI
- 2024 Services **66% of GDP worldwide** (72% in high-income, 42% in low-income countries)

Servicification of the economy

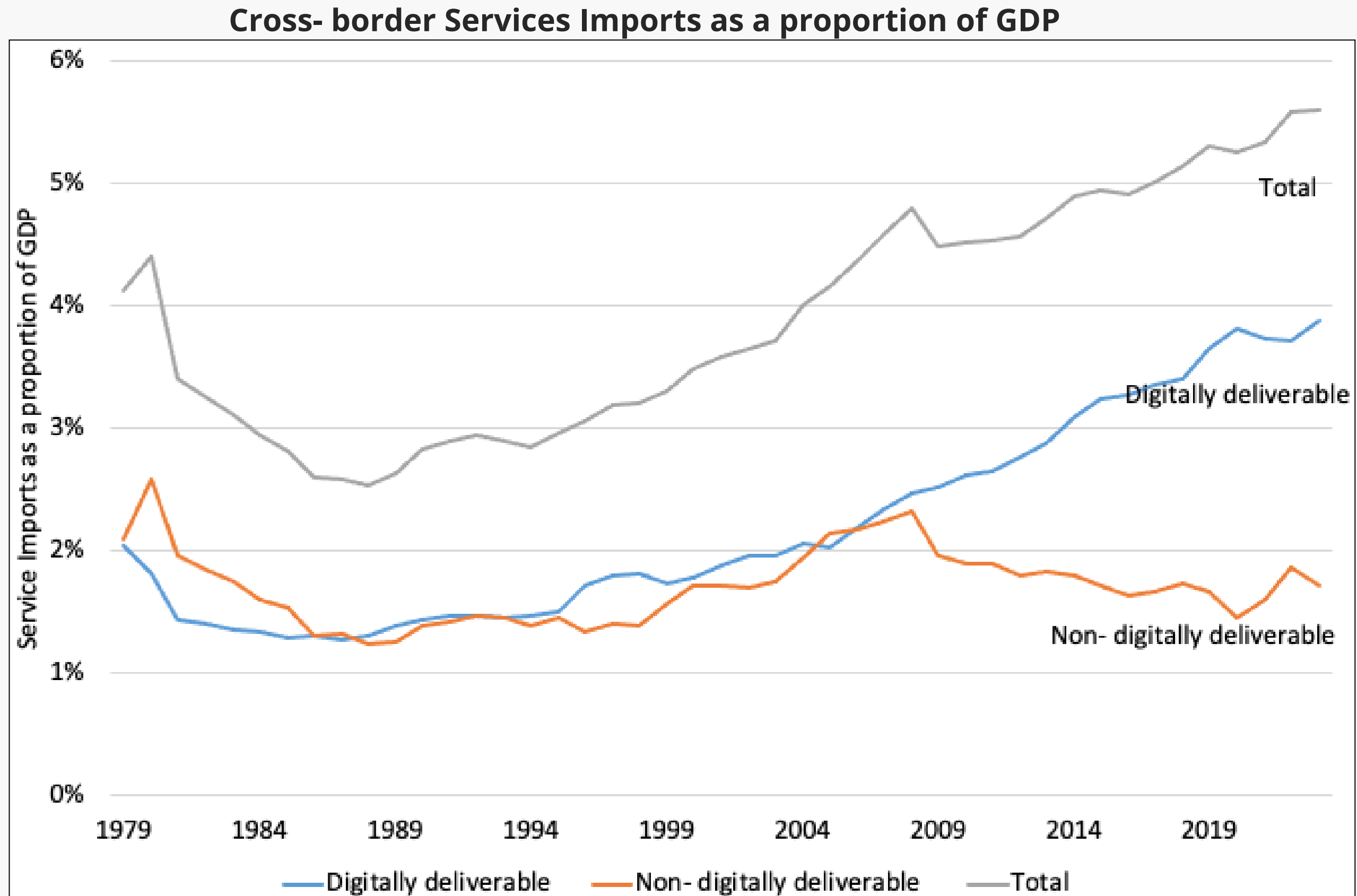
Globalisation

- Shaped by and interwoven with digitalisation
- Increased cross- border access to markets
- Non-residents derive profits with little/no physical presence
- International fragmentation of production: outsourcing and offshoring of services
- Globally integrated MNEs generate super-profits from access to global markets & economies of scale, technological monopolies via IPRs, exploit offshore system for finance & tax avoidance

Effects on international tax

- Separation of customer from provider reveals fundamental flaws of (i) physical presence test for taxing business profits (ii) independent entity/ arm's length principle for profit allocation

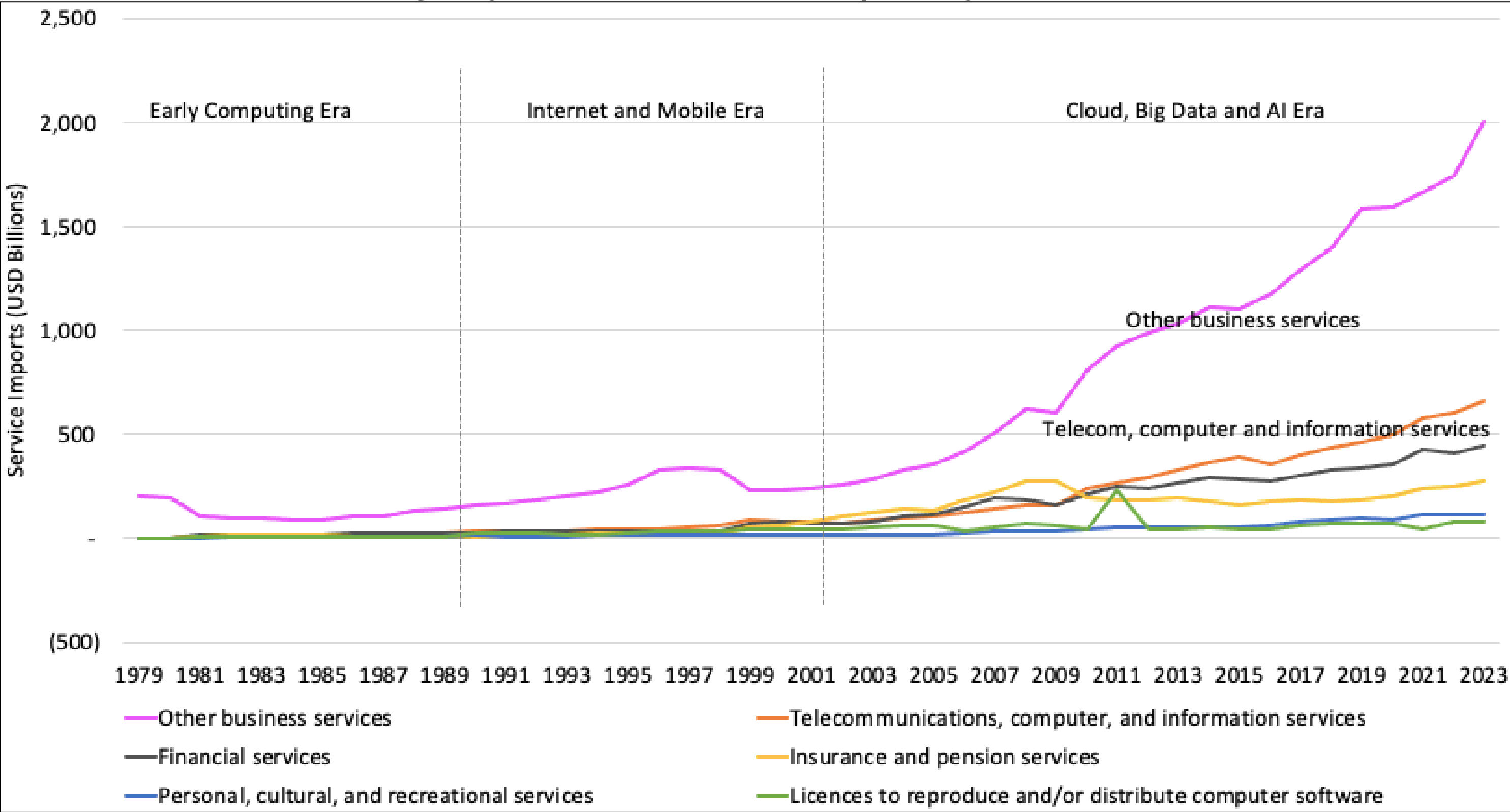
Rise of cross- border services



Source: Created by authors. Based on World Development Indicators and the OECD ITIS database. Excludes Mode 2 travel

Breakdown of digitally deliverable services

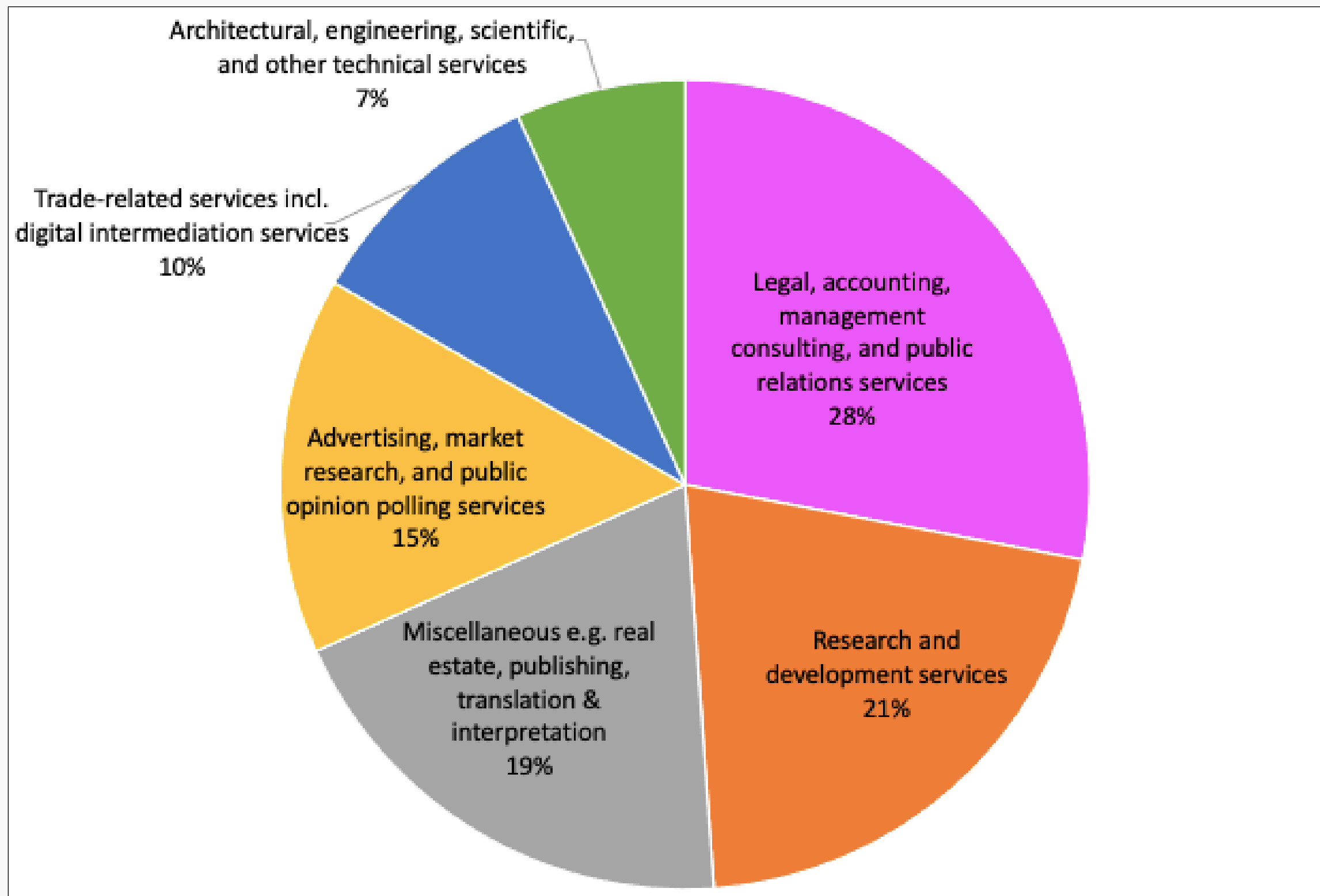
Digitally Deliverable Services Imports by Sector



Source: Created by authors. Based on World Development Indicators and the OECD ITIS database.

“Other business services”

Breakdown of ‘Other Business Services’ Digitally Deliverable 2023



Tax treaty restrictions, defects & reform

Prevention of 'double taxation'

All states tax income from activities at source, some also tax residents on worldwide income. Potential overlap: MNEs complain of 'double taxation'

States generally grant exemption/credit unilaterally

Treaties mainly ease coordination (Dagan)

Political impetus **vs** revenue impact

Rigidity of framework, difficult to revise

Taxable nexus 1920s-

Passive investor income: (limited) withholding tax (WT) at source on gross payment (net income)

Active business income: where activities take place (physical) 'fixed base'/ Permanent Establishment (PE)

Services: based on **place of performance** (usually where client is located)

OECD vs UN Models

OECD 1963-: residence state unless PE exists; 'fixed base' for Indep. personal services (art. 14); residence for transport, insurance; other income

UN 1980- Services:
art. 14: revenue >> agreed threshold
art. 5.3.b: services furnished 183 days through personnel
art. 7(4): net income via fractional apportionment

Exploitation of residence for profit shifting

MNEs can create entities resident in low tax countries, especially for intangible activities (services, IPRs)

Payments reduce source tax base, profit retained offshore

OECD/G20 Project on Base Erosion and Profit Shifting (BEPS) 2012- 'where activities occur and value is created'

Taxation of MNEs

Pillar 1 Amount A: Right to tax share of MNE's **total global profits** based on % of sales revenue

Taxes MNEs as unitary enterprises + apportionment of net global profits

BUT: only 25% of 'residual' profits of c.100 largest & most profitable MNEs

Current defective rules continue for all other purposes
Adds new layer of complexity

Attempts to strengthen source taxation

UN Model Convention

- WTs: 12A fees for technical services, 12B automated digital services, 12AA all services
- Apply to gross payments, but 12B option of fractional apportionment of net income
- 12A in 26% of treaties (varying rates), no treaties with 12B or 12AA yet in force

Digital Services Taxes (DSTs)

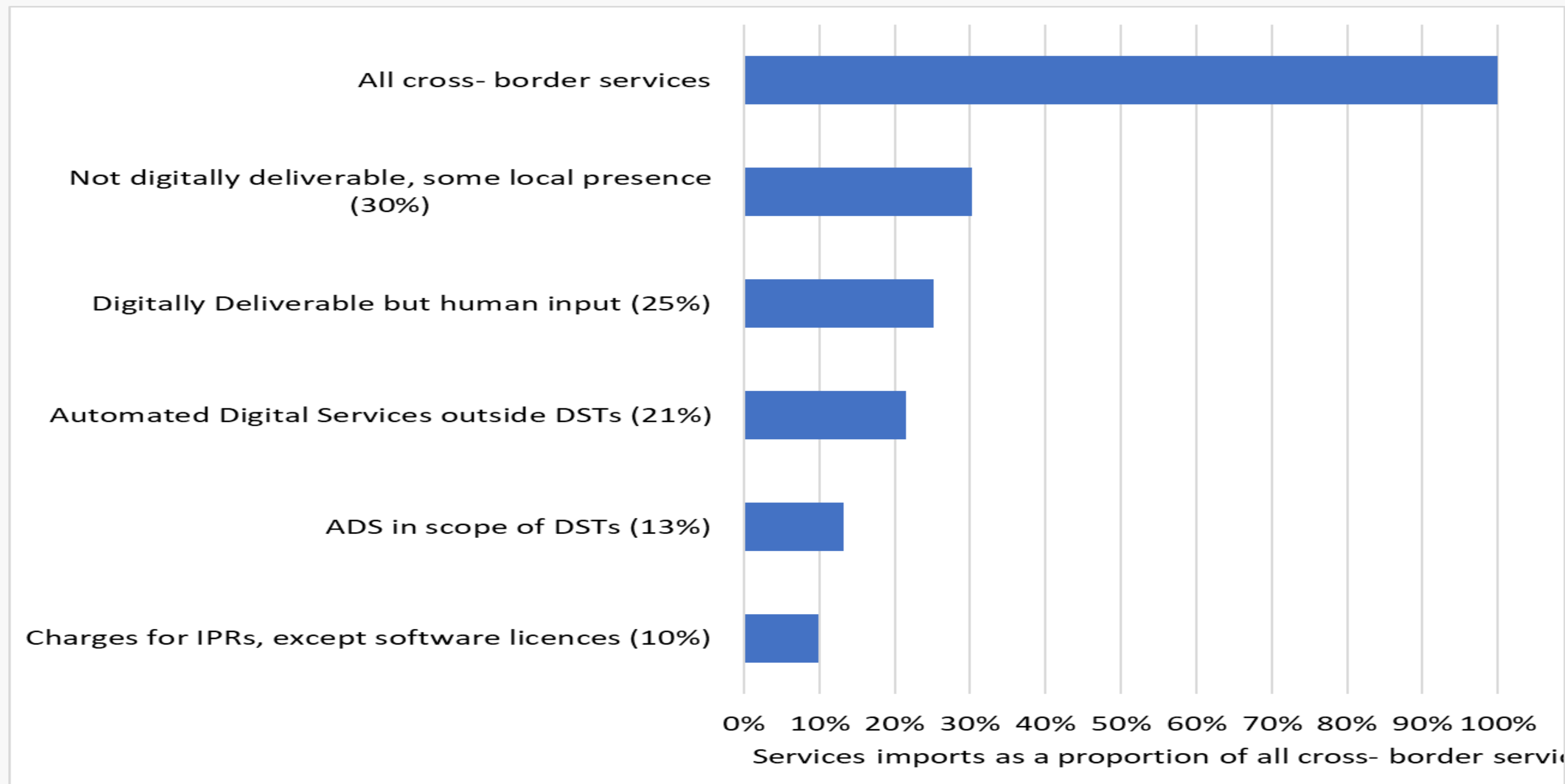
- Emerged 2015, from failure to progress on BEPS Action 1 Digital Economy
- WTs, but limited scope (adverts, platforms, streaming): **13% of cross-border services**
- Implemented by about 27 countries, including some OECD members
- Transaction tax: outside tax treaties, but US considers discriminatory, trade sanctions

Significant Economic Presence (SEP)

- New taxable nexus for services without physical presence, conflicts with existing treaties
- Scope: highly digitalised activities, some with quantitative threshold (Colombia, Kenya, Pakistan)
- Some potentially cover all services (India, Nigeria)
- Tax on (net) income: 'Deemed profit' rate applied to gross revenues to define net income
- Rate may vary for different businesses, categorisation issues, unrelated to profitability

Categories of cross- border services

Cross- Border Services Imports by Mode of Delivery 2023



Source: Created by authors. Based on OECD ITIS and BaTIS datasets, and analysis of the scope of DSTs

Tax and Economic Considerations

Tax revenue effects

- 70% of services deliverable with little/no physical presence, 13% covered by DSTs (platforms, users)
- 46% are B2B + 10% payments for IPRs – deductible from business profits, reduce source tax base
- Direct tax revenue losses for countries with net services trade deficits (most developing countries)
- Overall tax revenue losses globally since payments can be routed via conduits (profit-shifting)

Broader economic impact

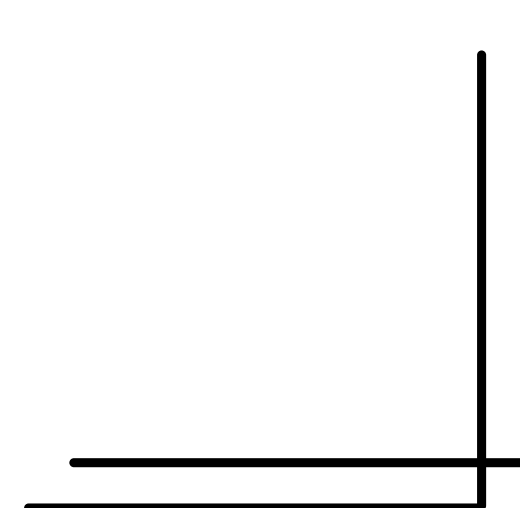
- Tax exemption of non-residents **discourages** local presence, disadvantages local services providers
- Economic benefits from specialized skills/technology/knowhow?
 - ICC/Oxford Economics (2026) – speculative modelling, assumes local provision would be uncompetitive
- Need to **balance** taxing rights between location of customer and services provider

Rights to tax (nexus)

- Physical presence of services provider: employees, physical assets (not just residence of entity)
- Customer/market: revenues/payments
- Should not be exclusive rights: need to coordinate, or share

Form of Tax

- Tax on (net) income/profits: directly related to profitability of both the activity & the firm
- Tax on gross revenues: collected by withholding from payment at source = excise tax



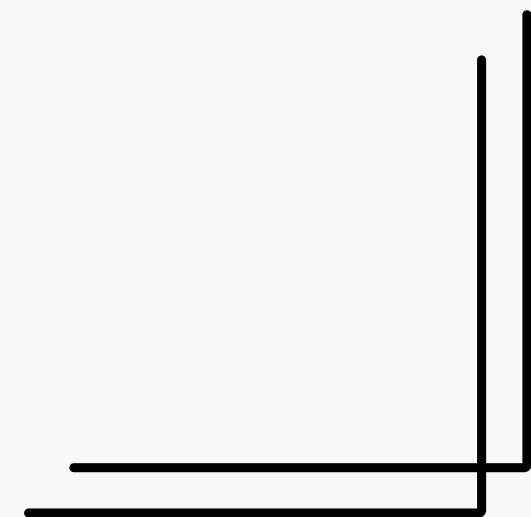
Possible Options

Withholding Tax on Gross

- Practical immediate solution, easy to administer
- Unless there is local competition would be passed on to customer, raising costs/reducing productivity
- Unrelated to profitability, but could be targeted, varied rates
 - e.g. 5% (equipment supply), 10% (engineering/infrastructure), 20% (general), 30% (ADS) (India, NITI-Aayog 2026)
- Unilateral? If designed as transaction tax no conflict with tax treaty, but may be considered trade barrier

Tax on Net Income/Profits

- Nexus/taxable presence?
 - Specified activities: Significant Economic Presence, or
 - All Revenues: Quantitative (de minimis) threshold
- Compatibility with tax treaties depends on model and its interpretation; developing countries mainly use UN model:
 - Services PE (5.3.b), Fractional Apportionment to PE (7.4.), Source right to tax Other Income (21)
- Mismatch of revenues and expenditures requires method to apportion/attribute net income
- **Combination: Gross WT with Net Alternative**
- In practice non-resident always has the option to create local nexus
- Specify option for taxpayer (e.g. UN model 12B)?
- Gross rate would need to be high for net income tax to be attractive
- Could also specify minimum rate (e.g. Nigeria 2025)



Apportionment Methods

Simplified (Fractional)

- Apply MNE's global profit rate to local sales revenues
- Standard CIT rate applied to apportioned share

India 2019: 3-factors

UN art 12B: 30% of revenues

• Advantages

- Simpler rules, easy to administer
- information available to tax administrations

Limitations

- Assumes payments = revenues attributable to country
- No sourcing rules
 - would not include e.g. sale/licensing user data
- MNE's global profit rate may not be appropriate for local revenues

Comprehensive - build on Amount A rules

- Global consolidated financial accounts adjusted for tax purposes
- Sourcing rules attribute revenues to physical location:
 - services: where used
 - licensing/sale of user data: user location
 - intermediation: 50:50 purchaser/ place performed
 - cargo transport: 50:50 origin: destination
 - passenger transport: destination
- Define % of total profit allocated to sales
- Balance of supply and demand factors (G-24 2019 proposal)

Advantages

- Balanced, comprehensive, sustainable solution

Limitations

- Challenging: needs coordinated implementation,
- Information from MNEs, voluntary if possible, or
 - Deemed amounts as a rebuttable presumption
 - Country by Country reports as a check

Implementation: Types of Instrument

Political Commitment

- Sets out program of coordinated action

Binding Agreement on Principles and Procedures

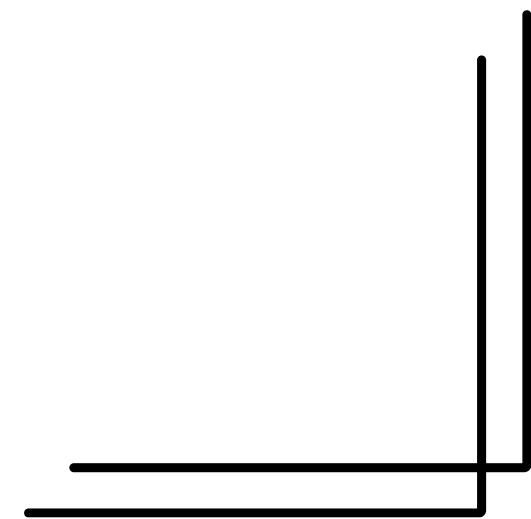
- Principles define basic approach
- Framework of procedures for coordinated implementation

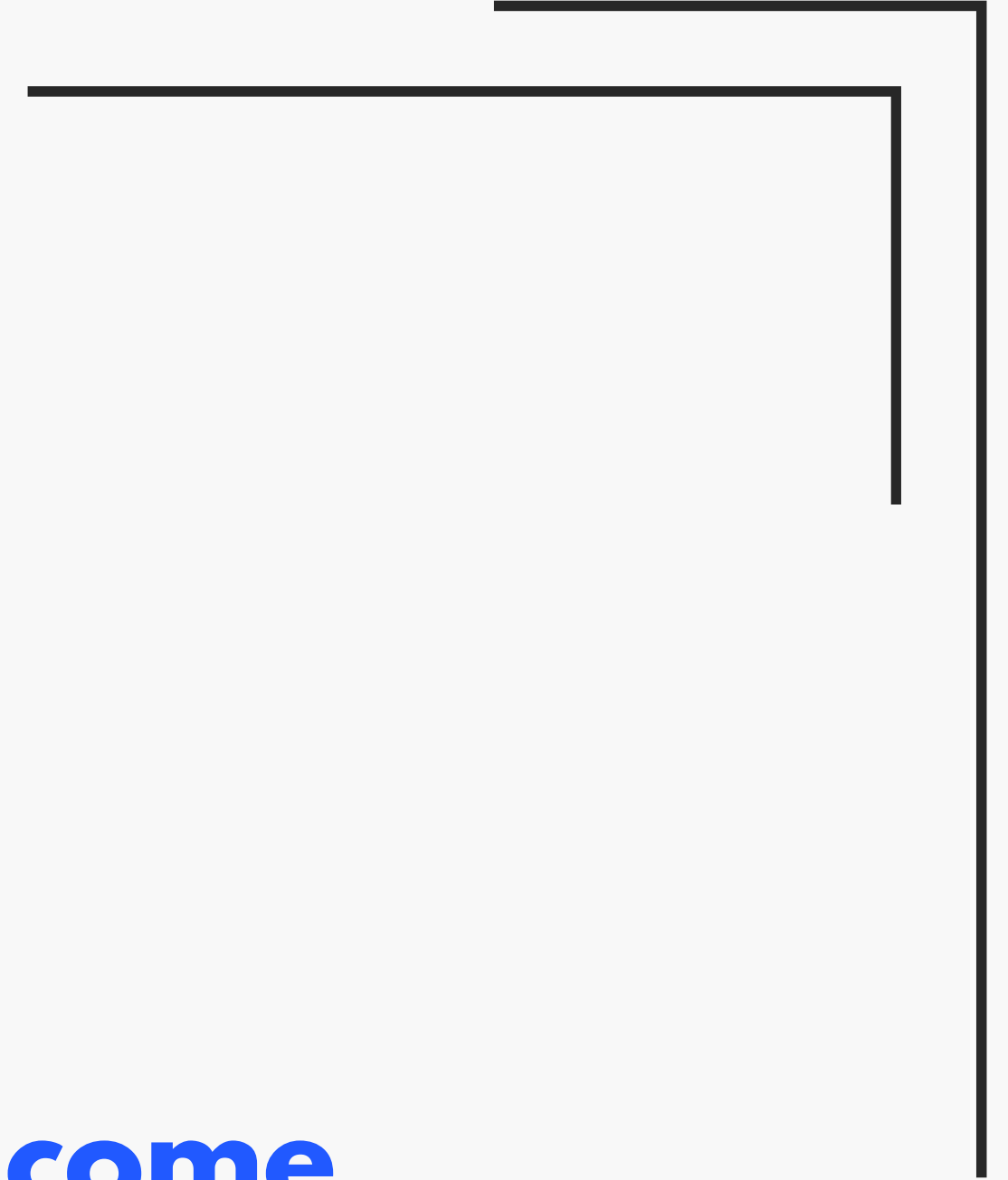
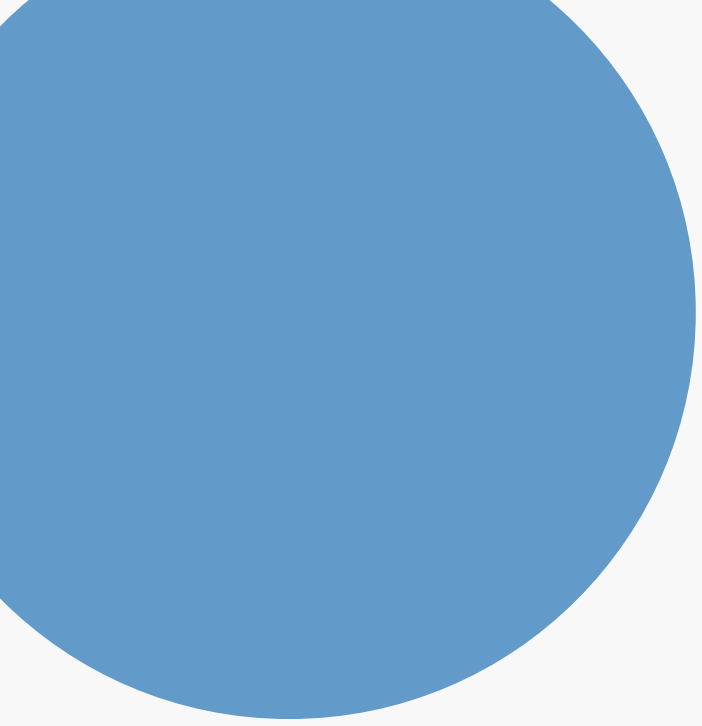
Soft Law Standards

- Flexible, adaptable, easy to implement
 - model treaty articles + commentary (cf OECD/UN Model Tax Conventions)
 - model rules for domestic law (cf Global Minimum Tax)
 - guidelines for implementation / interpretation (cf Transfer Pricing)
- Needs political momentum to reach adoption by critical mass of countries

Binding Multilateral Convention with Substantive Rules

- Rigid: very hard to amend
- Inflexible: may allow reservations (opt-out, opt-in), but these create complexity and patchwork
- Would need broad consensus, may need minimum number of ratifications to come into force
- Very hard to implement (cf multilateral convention for Pillar 1 Amount A)





Thank You!

Questions & comments welcome

