Preparatory Process for the Third International Conference on Financing for Development

Substantive informal session: "International tax cooperation"

9 December 2014, 3:00 p.m. to 4:30 p.m.
Trusteeship Council Chamber, United Nations, New York

Programme

Co-Chairs: **H.E. Mr. George Wilfred Talbot** (Guyana)
H.E. Mr. Geir O. Pedersen (Norway)

Keynote remarks: Setting the scene:

Mr. Vito Tanzi, former Director of the Fiscal Affairs Department, International Monetary Fund

Panel discussion:

Moderator:

- **Mr. Alexander Trepelkov**, Director, Financing for Development Office, Department of Economic and Social Affairs, United Nations

Panellists:

- **Mr. Eric Mensah** (Ghana), Member, United Nations Committee of Experts on International Cooperation in Tax Matters

- **Mr. Ruud de Mooij**, Deputy Division Chief, Tax Policy Division, Fiscal Affairs Department, International Monetary Fund

- **Ms. Marlies de Ruiter**, Head, Tax Treaty, Transfer Pricing and Financial Transactions Division, Center for Tax Policy and Administration, Organisation for Economic Co-operation and Development

International Tax Cooperation for Development

Briefing note

Taxation as a key driver of financing for sustainable development

As discussed in the substantive informal session on "Domestic Public Finance", held on 11 November 2014, domestic resource mobilization is at the crux of financing for development; it reinforces a country's ownership of public policy and allows countries to move toward financial autonomy. Taxation is one of the most important ways in which developing countries can mobilize resources for investment in sustainable development. Yet, public revenue remains insufficient to meet sustainable development needs, and gaps persist between developed and developing countries' capacity to raise public revenue. As discussed in the background note circulated in November 2014, tax revenues account for about 10-14 per cent of GDP in low-income countries, which is about one third less than in middle-income countries, and significantly less than in high-income countries, which achieve tax to GDP ratios of 20-30 per cent.[1]

Moreover, the external environment also influences countries' capacity to raise resources through taxation, especially given the growing concern about illicit financial flows (IFFs). While it is difficult to estimate the size of IFFs (one problem is that there is no agreed upon definition of what constitutes IFFs), all available evidence suggests that it is significant[2] and poses a systemic problem that interferes with the mobilization of resources needed for investment in sustainable development. It is also difficult to assess the relative sizes of the different components of IFFs accurately. Some researchers have argued that commercial tax evasion that involves cross-border activity is one of the main types of IFFs.[3] Others have suggested that corruption is a more important source of IFFs in developing countries and that the various types of IFFs are intrinsically linked.[4] However, differences in estimates partially reflect different definitions of IFFs being used. Given existing evidence on the high cost of IFFs, a lack of precise data should not be an excuse for delaying action.

The importance of raising tax revenues for development, including through international tax cooperation, has featured prominently in the outcomes of major United Nations conferences and summits in economic and social fields. Most recently, the General Assembly, in its resolution 68/204 of 20 December 2013 on Financing for Development, recalled the ongoing commitment of Member States to enhance and strengthen domestic resource mobilization and fiscal space, including, where appropriate, through modernized tax systems, more efficient tax collection, the broadening of the tax base and the effective combating of tax evasion and capital flight. It also reiterated that, while each country is responsible for its tax system, it is important to support national efforts in these areas by strengthening technical assistance and enhancing international cooperation and participation in addressing international tax matters.

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[1] Please see http://www.un.org/esa/ffd/wp-content/uploads/2014/11/11November_DomesticPublicFinance1.pdf

[2] One estimate of untaxed off-shore wealth holdings predicted that they range from $21 trillion to $32 trillion, and that if taxed, on the low end of that range, would yield $189 billion a year in new revenues globally (Henry, J. (2012). The price of offshore revisited. Tax Justice Network, July. Available from http://www.taxjustice.net/cms/upload/pdf/Price_of_Offshore_Revisited_120722.pdf)).
Other studies provide lower figures, with a peer reviewed academic paper finding off-shore wealth holdings of between $5.9 trillion and $8.5 trillion in different years (Zucman, G. (2013). The missing wealth of nations: Are Europe and the US net debtors or net creditors? Quarterly Journal of Economics, vol 128(3), pp.1321-1364).

[3] See for example Global Financial Integrity (2010). Illicit Financial Flows From Africa: Hidden Resource For Development.

[4] Chaikin, D. and Sharman, J. C. (2009). Corruption and Money Laundering: A symbiotic Relationship. Palgrave Macmillan, New York/London.

Towards development-oriented international tax norms and policy

While an efficient, transparent and fair tax system at the national level should be the aspiration of all countries, international rules and policies play an important role in ensuring that national governments have the ability to raise sufficient revenue domestically, while still securing needed foreign investment.

Double tax treaties

As international law places very few limits on the tax sovereignty of countries, income from cross-border investments and activities may generally be taxable both in the country where investment or other activity takes place, and in the country of the investor or trader, according to their respective domestic tax laws. Tax treaties are bilateral agreements between two countries, which allocate taxing rights over such income between these countries and thus prevent double taxation of this income. The prevention or elimination of international double taxation is a significant aspect of countries' investment climate, which is essential for investment flows between countries, the exchange of goods and services, the movement of capital and persons, as well as the transfer of technology.

In the negotiations of their bilateral tax treaties, countries usually follow double tax treaty models developed by international organizations. The two models most widely used are: (1) the United Nations Model Double Taxation Convention between Developed and Developing Countries (UN Model Convention); and (2) the Organization for Economic Cooperation and Development (OECD) Model Tax Convention on Income and on Capital (OECD Model Convention).

The key differences between these two models relate, in particular, to the issue of to what extent a country should forego, under bilateral tax treaties, taxing rights, which would be otherwise available to it under domestic law, with a view to avoiding double taxation and encouraging investments. In general terms, the UN Model Convention tends to preserve a greater share of taxing rights for the source country (i.e. the country where investment or other activity takes place). The OECD Model Convention, on the other hand, favours retention of a greater share of taxing rights for the residence country (i.e. the country of the investor or trader).

Thus, the UN Model Convention would normally allow developing countries more taxing rights on income generated by foreign investments in these countries. By protecting the specific interest of developing countries to retain a greater share of taxing rights over the income sourced in those countries, treaties based on the UN Model Convention effectively contribute to mobilizing domestic resources, which can be used to meet development needs. On the other hand, the provisions of the UN Model Convention take into consideration that taxation in the source country should not be too high in order not to discourage investment and recognize the appropriateness of the sharing of revenue with the country providing the capital.

Moreover, the UN Model Convention also favours outcomes that are more easily administered, reflecting the fact that many developing country administrations do not have sufficient resources to implement complex solutions. Compared to the OECD Model Convention, the UN Model Convention is more favourable to source country "withholding taxes", whereby a person paying an amount overseas, for instance in royalties, is required to withhold the relevant tax amount from the payee and remit it to the tax authorities.

Apart from the need for more development-oriented international tax norms and policy, it is also important that these norms are properly applied and observed.

Transfer pricing

Rapid advances in technology, transportation and communication have resulted in a large number of multinational enterprises (MNEs), highly mobile capital and global value chains. An increasing volume of international trade, capital flows, service provision and technology transfer takes place across national borders and within a MNE group.[5]

Transfer pricing refers to the mechanism by which cross-border intra-group transactions are priced. If the method used to determine the price of such transactions, for whatever reason, does not reflect their true value, profits might effectively be shifted to low-tax or no-tax jurisdictions and losses and deductions to high-tax jurisdictions. This unfairly deprives a country of tax revenue, reducing the amount of resources available for funding its development objectives. Apart from tax base erosion, it can also lead to double taxation, which might undermine the investment climate, which is a critical factor for the promotion of foreign direct investment. Both the UN Model Convention and the OECD Model Convention have essentially followed the same test of whether transfer pricing has occurred at a proper price or range of prices, namely whether it has occurred at an "arm's length price", the price that would be paid in a market with each participant acting independently in its own interest.

The pricing of intangibles, such as intellectual property rights, are particularly subject to transfer mispricing because of the ease of transferring ownership internationally and the difficulty in valuing unique intangibles. The provision of other intra-group services, including management, information technology and financial services, are also frequently the subject of transfer mispricing.

Developing countries face particular difficulty in applying the "arm's length principle" in practice, especially as many MNEs have unique and hard to value intangibles or engage in complex transactions involving many different elements that would not be replicated in any market. Addressing these practical complexities relies heavily on the availability of data and expert skills, often posing special difficulties for developing countries. Accordingly, in October 2012, the UN Committee of Experts on International Cooperation in Tax Matters adopted its *United Nations Practical Manual on Transfer Pricing for Developing Countries*. The Manual is a response to the need for clearer guidance on the policy and administrative aspects of applying the "arm's length principle" as well as some of the OECD Transfer Pricing Guidelines. Such guidance assists policy makers and administrators in dealing with complex transfer pricing issues, but also taxpayers in dealing with tax administrations.

Base erosion and profit shifting issues

Recently, there has been strong political momentum among developed countries to curtail so called "base erosion and profit shifting" (BEPS) by multinational enterprises engaged in a wide range of cross-border tax planning techniques allowing them to pay little or no tax anywhere in the world. At the request of the G20 Finance Ministers, in July 2013, the OECD prepared an action plan, which addresses those issues in a coordinated and comprehensive manner. Specifically, the Action Plan on BEPS[6] is to provide countries with domestic and international instruments that would better align rights to tax with

[5] UNCTAD estimates that the value added by MNEs now makes up about 11 per cent of world GDP and that by 2010 the number of MNE parent firms has trebled from 35,000 in 1992 to more than 103,000. Their foreign affiliates numbered over 890,000 (World Investment Reports 1993, 2011. Available from http://unctad.org/en/Pages/DIAE/World%20Investment%20Report/WIR-Series.aspx?Re=1,20).
The relative share of intra-firm trade is hard to estimate but it is generally regarded as comprising more than 30 per cent of global trade (See, for example, Antras, Pol (2003). Firms, contracts, and trade structure. Quarterly Journal of Economics, 118(4)). Some researchers estimate intra-firm trade to be as high as 60 per cent of world trade.

[6] OECD, Action Plan on Base Erosion and Profit Shifting, 2013 (Available at http://www.oecd.org/ctp/BEPSActionPlan.pdf).

economic activity. The Plan is organized around 15 actions, which are to be implemented by the specified deadlines during 2014-2015.

The BEPS Action Plan recognized that developing countries also face issues related to BEPS, though these issues may have a different impact on them, given the specificities of their legal and administrative systems. In follow up, at the request of the G20 Development Working Group (DWG), the OECD prepared a two-part report[7] on the main sources of BEPS in developing countries and how these relate to the BEPS Action Plan, based on the experiences of developing countries and international organisations.

In that context, wasteful tax incentives were identified as one of primary areas of concern for developing countries in addressing tax base erosion issues. If properly designed and implemented with a view to correcting market inefficiencies or generating positive externalities, tax incentives are a useful tool in attracting investments that would not have been made without the provision of tax benefits. However, tax incentives are often criticized on grounds that they erode the tax base without any substantial effects on the level of investment. Harmful tax competition among governments and the resulting "race to the bottom" are increasingly perceived as problematic and there have been calls for greater coordination among countries.

Transparency and exchange of information

Exchange of information is an important factor in the fight against tax evasion, tax avoidance and illicit financial flows. While the need for reliable information as the basis for effective and efficient tax administrations is well recognised, tax administrators and decision makers are asking questions about what information should be public, what information should be shared amongst tax authorities, and how information should be shared. The G20 has explicitly "committed to automatic exchange of [tax] information as the new global standard, which must ensure confidentiality and the proper use of information exchanged." The G20 countries and some other members of the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes expect to automatically exchange tax information amongst themselves by the end of 2017 or 2018 and have committed to try to make sure developing countries are able to benefit from these developments. The G20 is also "developing high-level principles on beneficial ownership transparency to improve the transparency of company ownership and control." Public transparency is supposed to help track and deter tax avoidance and evasion, but if introduced unilaterally may prove a competitive disadvantage to any individual country. A global standard and common introduction would mitigate the negative competitive effects of such a measure.

While exchange of information is an important factor in the fight against tax evasion, the rules of information exchange may not adequately reflect the reality of developing countries in terms of the capacity that is needed to administer such rules. Developing countries also may not have an equal opportunity to obtain the most relevant information nor the analytical capacity to make the best use of information received.

[7] OECD, Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries, July – August 2014 (Part 1 available at http://www.oecd.org/tax/part-1-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf; Part 2 available at http://www.oecd.org/g20/topics/taxation/part-2-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf).

Strengthening the institutional arrangements for international tax cooperation

In recent years, the Economic and Social Council has strived to strengthen the United Nations role in international tax cooperation, including the work of the Committee of Experts on International Cooperation in Tax Matters. This issue was addressed in a series of reports by the Secretary-General[8], which indicated that the existing norm-setting arrangements for international tax cooperation did not provide for enough voice and participation of developing countries. The lack of a truly global all-inclusive norm-setting body on tax matters at the intergovernmental level, which would offer developing countries a full "seat at the table", was perceived a fundamental gap in the area of international tax system. However, the possibility of establishing such a single norm-setting body has found little support in practice.

The UN Committee of Experts on International Cooperation in Tax Matters (Committee) currently plays a unique role in considering the policy and administrative aspects of international tax cooperation and in proposing solutions focused on needs and priorities of developing countries. However, because of its non-governmental status and limited resources, the Committee does not fully address the above-mentioned gap.

In his 2011 report[9] on this topic, the Secretary-General identified three options for the purpose of strengthening institutional arrangements to promote international tax cooperation, including the Committee: (a) Strengthening the existing arrangements within the United Nations while retaining the current format of the Committee of Experts; (b) Converting the Committee of Experts into an intergovernmental commission serving as a subsidiary body of the Economic and Social Council; (c) Creating an intergovernmental commission and retaining the current Committee of Experts as a subsidiary body of that commission. In the ensuing discussion, Member States did not agree on the proposed conversion of the Committee of Experts into an intergovernmental body. In a recent development, the synthesis report of the Secretary-General on the post-2015 agenda[10] has recommended again the "establishment of an intergovernmental committee on tax cooperation, under the auspices of the United Nations".

At the same time, the OECD continues making efforts to reach out to developing countries. For instance, the Global Forum on Transparency and Exchange of Information for Tax Purposes currently includes more than 120 jurisdictions. Also, within its Project on BEPS, the OECD is reaching out to seek views of developing countries, including through a series of regional consultations.

In addition, there have been advances in cooperation between international organizations. In a recent example, the G20 Finance Ministers in their Cairns Communiqué[11] requested the OECD, IMF, United Nations and World Bank Group to: (1) develop a new structured dialogue process for the engagement with developing countries with a view to providing input to the G20/OECD project on BEPS; (2) develop toolkits to assist developing economies in implementation of the BEPS action items; and (3) prepare in 2015 options on efficient and effective use of tax incentives in low income countries.

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[8] E/2011/76, E/2012/8 and E/2013/67.
[9] E/2011/76.
[10] See http://sustainabledevelopment.un.org/content/documents/5527SR_advance%20unedited_final.pdf
[11] See http://g20watch.edu.au/sites/default/files/docs/CAIRNS%20September%202014%20communique%20-%20FINAL.pdf

Capacity development

Skills and capacity gaps are large in the tax authorities of many developing countries, though not uniformly so.[12] The lack of capacity is a constraint on both domestic revenue mobilisation and participation in international tax cooperation. International assistance could help overcome these problems, for instance through increased official development assistance (ODA) for national tax systems. As discussed in November, ODA for tax administration is less than 0.1% of all ODA spending.

Guiding questions:

1. What are the biggest deficiencies in international tax cooperation at present? How do these shortcomings impact on different stakeholders in tax systems?

2. Are current international tax norms adequate to support sustainable development? If not, what are the most important areas requiring re-thinking, keeping in mind interests of developing countries?

3. Many developing countries consider that they are not afforded effective and equitable participation in the development of international tax norms. How can international tax cooperation lead to more inclusive and development-oriented approaches to the setting/updating of international tax rules?

4. More specifically, in a situation where there is a call for norms to be developed quickly to update and reduce uncertainties in the international tax environment (such as for instance emanating from BEPS), how can developing countries be best afforded an effective seat at the table?

5. How can international and regional organizations maximize their different comparative advantages while minimizing unnecessary duplication to overcome the biggest deficiencies in international tax cooperation?

[12] Supporting the Development of More Effective Tax Systems: A Report to the G-20 Development Working Group (2011). IMF, OECD, UN and World Bank.