COMMENTS BY LORRAINE EDEN ON 7 JUNE 2024 *ZERO DRAFT TOR* [1]

Thank you for the opportunity to provide comments on UN (2024): *Bureau's Proposal for the Zero Draft Terms of Reference for a United Nations Framework Convention on International Tax Cooperation* (for short, "FCITC"). My comments are organized according to paragraphs in *Bureau's Proposal.*

OBJECTIVES (PARAGRAPH 7)

I support the FCITC's inclusion of a clear statement of its objectives. However, I recommend that the objectives be limited in number because the more numerous the objectives, the more likely they are to conflict and more difficult to attain. Narrowing the number focuses attention and offers better chance of success.

I recommend the following as the FCITC's overarching objective:

> *The objective of the FCITC is to strengthen international tax cooperation among Member States in terms of its inclusiveness and effectiveness, in both substance and process, while respecting where feasible national tax sovereignty.*

My proposed objective inserts the phase "where feasible"[1] as a qualifier to national sovereignty. My reason is that unrestricted tax sovereignty by one or more countries could have large negative spillovers on other countries and impair the FCITC's effectiveness and inclusivity. Thus, some losses in tax sovereignty may be justified by gains in FCITC effectiveness and inclusivity.

PRINCIPLES (PARAGRAPHS 8-9)

I also support paragraph 8. The FCITC should provide a clear list, with definitions, of the fundamental principles that would satisfy its objective or objectives.

However, my concern with the bullet list in paragraph 9 is the number. While each item (and with sub-items) has validity on its own, there is no prioritization, the principles are likely to be in conflict, and some principles would be better met through other UN protocols. Instead, the FCITC should limit principles to those closely tied to its objective.

For example, decomposing my recommended FCITC objective, the principles should:

- Strengthen inclusiveness in (i) substance and (ii) process
- Strengthen effectiveness in (i) substance and (ii) process

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- Respect, where feasible, national tax sovereignty.

Effectiveness and inclusiveness in substance and process should next be defined. Those definitions should embody the FCITC's principles and be used to assess its success.

The prescriptive school of public finance [2] can offer useful advice to selection of principles because it takes a hands-on approach committed to applying theory to real world problems that have real-world constraints. The prescriptive school argues that tax architecture and tax engineering should select taxes appropriate for a country's economic and cultural conditions and institutions. As a result, the tax policy mix and tax rates will differ across countries.[3]

At the international level, the objective of international tax cooperation should reflect tax principles such as international and inter-nation equity, efficiency[4] and/or neutrality, transparency, and administrative feasibility. Policymakers must recognize the difficulties of putting principles into practice, given they are likely to conflict; opt for policy solutions that can be implemented in a world of mobile capital; and take account of differences across countries in their economic and social conditions and institutions.[5]

This last point is especially helpful in terms of creating a FCITC that is both inclusive and effective but also respects national tax sovereignty. Differences across countries matter and should be taken into account. My recommendations, building on WTO practices, are:

- The FCITC should include a "Special and Differential Treatment" section, where the least developed countries that sign the FCITC are given a longer time period, with a fixed endpoint, to meet their commitments.[6]
- Similar to preferential trading agreements, coalitions of like-minded signatories should be permitted to move faster, deeper and broader than FCITC commitments.
- Member States that refuse to meet FCITC commitments should be excluded from the FCITC and its benefits. [7]

SUBSTANTIVE AREAS (PARAGRAPHS 10, 14 AND 15)

In terms of the FCITC's substantive areas, I considered the three paragraphs together since they all deal with substantive elements.[8] I regrouped them into six topics and recommend focusing on the first three in the short term:

- transparency (10.4, 15.2)
- harmful tax practices (15.4) and tax-related illicit financial flows (14.3)
- taxing MNE profits in the digital economy (10.1, 14.1) and cross-border services (14.2)
- taxing high-net worth individuals (10.2, 14.5)
- dispute settlement (10.5, 14,4, 15.3)
- taxes for environmental concerns (10.3, 15.1)

Substantive area #1: Transparency

Transparency is a fundamental "building block" of a good tax system. More transparency increases the

likelihood of achieving other tax principles because it encourages compliance. Transparency "shines the light in the dark corners", identifying and discouraging illegal practices. Transparency builds trust, which fosters trade, FDI, and economic development.

MNEs should provide greater transparency on their ownership, activities and finances. This would also benefit substantive area #2 (harmful tax practices and tax-related illicit financial flows). Governments should also provide transparency in terms of their governance and management of national tax systems. Greater transparency would discourage government corruption, build trust in tax systems, enhance tax morale, encourage inward FDI, discourage illicit outflows, and increase domestic revenues.[9]

The FCITC should adopt the following transparency norms for MNEs and governments:

- Multilateral automatic exchange of information among tax authorities of financial information including financial accounts and other asset classes.[10]
- A UN public registry of beneficial ownership information of companies, trusts, partnerships, and other legal entities.
- Public reporting [11] by MNEs at the company level on a country-by-country basis, including financial and tax data, economic activities, and intra-group transactions.
- A UN public registry of national tax policies and practices, with attention to harmful tax practices, secrecy provisions, and low or no effective tax rates.

Substantive area #2: Harmful tax practices and tax-related illicit financial flows

I do not believe there is anything fundamentally wrong with the residence and source principles; however, comparisons of the OECD and UN model tax conventions[12] point to the greater importance of source-based taxes to developing countries, in terms of the corporate income tax (CIT) and withholding taxes. My recommendations, therefore, are to (i) build on the MLI, (ii) make a "back to basics" renewed commitment to international tax principles, and (iii) broaden UN protocols to cover tax.

Building on the MLI

Historically, bilateral tax treaties (BTTs) have been the primary method by which governments have applied the residence and source principles to different sources of MNE cross-border income.[13] Frequent criticisms of BTTs are that (i) preventing double taxation has been their primary goal while double non-taxation has been ignored; (ii) BTTs favor capital-exporting (residence) countries at the expense of capital-importing (source) countries [14]; and (iii) the "BTTs spaghetti bowl" has created tax loopholes that have encouraged significant base erosion and profit shifting (BEPS) activities by MNEs.[15]

After the 2007-2009 global financial crisis[16], governments realized that multilateral, not bilateral, efforts were needed to counteract BEPS activities. The OECD's BEPS project resulted in 15 Action Items, some of which were implemented through the BEPS Multilateral Instrument (MLI). The MLI was designed to apply alongside a country's existing BTTs and modify them by allowing the signatories to adopt the action item without having to renegotiate their BTT. However, the problem to date has been that many governments (including the US) have not signed the MLI and those that have signed, have opted out of many provisions.[17]

The MLI, although not an unqualified success, still provides a useful model for multilateral tax cooperation.[18] The FCITC should also take a multilateral, flexible, "fast track" approach that:

- enables revising multiple BTTs at the same time;
- adds or revises clauses that benefit developing countries; and
- encourages BTTs between developed and developing countries.

Back to basic principles

Aggressive tax practices by MNEs in the globalized digital economy have encouraged large financial flows – legal and illicit – into tax havens and investment hubs. Transfer pricing has often been blamed as the primary cause of BEPS activities, with recommendations that the arm's length principle (ALP) be replaced with global formulary apportionment (GFA). "Anti-ALP" views have had some success; e.g., OECD Pillar One Amount A would replace the ALP with GFA to allocate some profits of the largest MNEs to market jurisdictions.[19]

However, blaming profit shifting on transfer pricing is akin to "shooting the messenger." [20] The cause lies elsewhere. The problem is not transfer pricing but loopholes in the international tax regime, often placed there by governments, that encourage BEPS behaviors.[21] The solution is to fix the loopholes, not discard the ALP or replace it with the unprincipled method of GFA. The FCITC should re-commit to:

- basic tax principles of residence, source, separate entity, and ALP;
- ensuring that profits are declared where MNE activities take place and value is created; and
- source countries having "first crack" rights to MNE profits using CIT and withholding taxes.[22]

Expanding UN protocols to cover tax

Existing UN protocols could be expanded to cover BEPS activities. For example, the UN Global Compact[23] consists of 10 corporate sustainability principles. Principle #10 is anti-corruption: "Businesses should work against corruption in all its forms, including extortion and bribery." I propose revising its last clause as: "…, including extortion, bribery, abusive tax practices, and tax-related illicit financial flows." MNEs that sign the Global Compact would then commit to avoiding abusive and illicit tax practices.

Substantive area #3: Taxing MNE profits in the digital economy and cross-border services

A core problem that still needs attention, despite Pillars One and Two, is BEPS Action Item 1: Taxing the Digital Economy.[24] I have three recommendations:

A 21st century definition of a permanent establishment (PE)

Governments need a 21st century "fit for purpose" definition of the permanent establishment (PE), one that provides nexus to countries where digital activities take place so their governments can levy CITs and/or withholding taxes on those profits.

In my view, the problem is how to determine when digital activities are sufficiently permanent in a host country that governments and MNEs agree that the activities constitute inward FDI, and not trade flows.

As an example, should digital flows from country A to country B be classified as B's imports (so the appropriate tax by B is a customs duty or import services tax) or as inputs to the production process (a VAT) or as inward FDI (a PE with nexus for CIT and withholding taxes)? ICSID's definition of FDI (the Salini test) may be helpful here.[25]

DSTs and cross-border services

A PE definition that covers digital FDI would also help with DSTs and taxing income from cross-border digital services. Even if Pillar One Amount A were adopted, it is highly unlikely that DSTs – whether digital sales taxes or digital services taxes – will wither away. DSTs are a relatively easy and attractive source of tax revenue, especially for countries that have difficulty collecting income taxes. A benefit of creating a PE definition that covers digital flows and activities would be easier separation of:

- Digital FDI: Firms have a PE and nexus in the source country so pay CIT and withholding taxes.
- Digital trade: Firms export digital goods and services, where a tariff, DST or VAT on imports is the appropriate revenue-raising policy by the market jurisdiction.

International tax cooperation for the FDI group belongs to the domain of the FCITC. Tax cooperation for the trade group typically belongs at the WTO under the GATT (digital goods and electronic transmissions). MNE cross-border services (e.g., automated digital services) may fall under both the GATS and the FCITC since services are often intertwined with FDI.

Separating FDI (where residence and source principles apply) from international trade (where origin and destination principles apply) would be much easier with a PE definition that defines what is and what is not digital FDI.

Transfer pricing in the digital economy

Lastly, taxing the digital economy also requires the development of transfer pricing guidelines for 21st century firms and activities. UN (2021) should include a chapter on "Transfer Pricing of Digital Transactions." [26] The chapter should cover digital business models (e.g., digital platforms, automated digital services, Internet of Things, 3D printing, etc.), accurate delineation of the digital transaction or activity, comparability analysis, and application of transfer pricing methods.

Respectfully submitted by

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ENDNOTES

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[1] "Feasible" in the sense of being possible to accomplish in a realistic and practical manner, given existing facts and circumstances.

[2] For an overview of international tax cooperation as viewed by leading scholars of the prescriptive school of public finance (e.g., Richard and Peggy Musgrave, Carl S. Shoup, Richard Bird) see Eden (2023), Wilkie and Eden (2022), and their references for more details.

[3] Tax architecture involves the selection of the types of taxes and rates that that form the revenue system and the broad outline of essential features of each tax; whereas tax engineering involves the determination of the substantive issues with respect to each tax. See Shoup (1991) and Eden (2023).

[4] Tax efficiency and tax neutrality are often viewed as synonyms and used interchangeably. I find it helpful, however, to differentiate between the two principles. I define the neutrality principle as implying that taxes should be neutral and not interfere with private/economic decisions. The efficiency principle, on the other hand, permits taxes to be used to encourage or discourage particular activities where there are differences between private and social benefits or costs (e.g., provision of public goods, discouraging negative spillovers). In sum, the neutrality principle focuses minimizing the impact of taxes on economic decisions; whereas the efficiency principle focuses on optimizing the allocation of economic resources. As a result, the efficiency principle is more interventionist than the neutrality principle.

[5] While the principles of international equity, efficiency and neutrality are applied from the perspective of the investor in the home (residence) country, the inter-nation equity, efficiency and neutrality principles instead take the perspective of the investment made in the host (source) country. The literature on international versus inter-nation equity, efficiency and neutrality is voluminous; suffice it to say that both cannot be achieved simultaneously except in a world where every country had the same tax mix, rates and bases. See Musgrave (1991), Brooks (2009) and Ozai (2020).

[6] See Islam (2021) on the benefits of WTO special and differential treatment rules but the need for limit the benefits in terms of membership, scope, and time period.

[7] See, for example, the analysis of tax havens as "renegade states" in the international tax regime, and appropriate responses, in Eden and Kudrle (2005).

[8] Paragraph 10 lists five commitments that should be included in the FCITC: (10.1) fair allocation of tax rights, including of multinational enterprises (MNEs); (10.2) effective taxation of high-net worth individuals; (10.3) ensuring that tax measures contribute to addressing environmental challenges; (10.4) transparency and exchange of information for tax purposes; and (10.5) effective prevention and resolution of tax disputes. Paragraph 14 suggests early protocols under the FCITC should be developed in these areas: (14.1) taxation of the digitalized and globalized economy; (14.2) taxation of income from cross-border services; (14.3) tax-related illicit financial flows; (14.4) prevention and resolution of tax disputes; and (14.5) taxation of high-net worth individuals. Paragraph 15 suggests future protocols could be developed in the areas of: (15.1) tax measures on environmental and climate challenges; (15.2) exchange of information for tax purposes; (15.3) mutual administrative assistance on tax matters; and (15.4) harmful tax practices.

[9] https://www.worldbank.org/en/programs/the-global-tax-program.

[10] In addition, I recommend that automatic exchange should be implemented gradually for tax jurisdictions with limited capacities, taking account of "special and differential treatment."

[11] https://www.globalreporting.org/standards/standards-development/topic-standard-for-tax/

[12] See, for example, Lennard (2009) and Eyitayo-Oyesode (2020).

[13] In the international tax regime (see for example, Eden, 1998, Chapter 2) source and residence principles determined which country (home or host) had the primary right to tax different MNE revenue

streams (e.g., royalties, service fees). Where both countries had taxing rights (e.g., foreign affiliate profits) the "first crack" principle gave first taxing rights to the host country, with the home country (if it chose to tax foreign source income) having to provide tax room through a foreign tax credit or deduction.

[14] Net capital-exporters are usually assumed to be developed countries and net capital-importers developing countries. In the 21st century, however, most developed countries have two-way FDI flows and many are net capital importers, in both stock and flow terms. For example, in 2022, the stock of US inward FDI was $US 12.3 trillion while the stock of outward FDI was $9.3 trillion, on a market value basis, so the US is a net capital importer (CRS, 2024). Still, when considering FDI flows and stocks between pairs of countries, with certain exceptions (e.g., investment hubs, tax havens), the net capital exporter is typically the more developed economy.

[15]A common assessment of existing BTTs is that they have favored capital-exporting (residence) countries at the expense of capital-importing (source) countries. Eyitayo-Oyesode (2020), for example, argues that several articles in the OECD Model Tax Convention favor residence-based taxing rights and are therefore biased against developing countries.

[16] As capital-exporting countries shifted from worldwide to territorial taxation in the 1990s, the significant differences in tax rates and bases across countries provided many opportunities for sophisticated tax planning where MNEs used aggressive profit shifting strategies to move profits into tax havens and investment hubs. The 2007-2009 global financial crisis was the tipping point where the primary objective of international tax cooperation shifted from how to use BTTs to prevent double taxation to how to prevent double non-taxation of MNE profits. The new approach was multilateral, led by the OECD's 2013 BEPS (base erosion and profit shifting) project, which resulted in 15 Action Items that were designed to fill the loopholes in the international tax system that were seen as the primary factors causing base erosion and profit shifting. See Eden (2024) and references, in particular, Mason (2020), for more details.

[17] See Hohmann (2023) and Deloitte (2023). Current information on the signatories and which countries have opted in and out of the which articles is reported in the OECD's MLI database at https://www.oecd.org/tax/treaties/mli-matching-database.htm.

[18] On lessons from the MLI, see Avi-Yonah and Xu (2018), Bravo (2018), and Matabudul (2023).

[19] For a detailed analysis of the problems with Amount A see Eden (2022).

[20] See Eden (2020, 2019 2016) for more details.

[21] Four factors that encourage illegal and fraudulent tax behaviors by MNEs: motivation, opportunity, capability, and rationalization. See Eden and Smith (2022) on the fraud triangle as applied to tax avoidance and transfer pricing.

[22] Unlike the GLOBE proposal, which assigned first crack rights to the residence country under the IIR, and only belatedly permitted source countries to go first with a much-restricted QDMTT.

[23] https://unglobalcompact.org/what-is-gc/mission/principles.

[24] See Eden, Srinivasan & Lalapet (2019) and Srinivasan, Eden & Lalapet (2019) for more details on the digital economy and implications for international taxation and transfer pricing.

[25] Wilkie and Eden (2023) suggest using the ICSID criteria (the Salini test) for inward FDI as the basis for determining when digital inflows shift from trade flows (taxed as goods, services, intangibles) to FDI flows (taxed on a net profit basis with a CIT).

[26] See Eden (2023) and Eden, Srinivasan and Lalapet (2019) on taxing the digital economy. For an example of applying the existing transfer pricing methods to the digital economy, see the case study of the Internet of Things in Srinivasan, Lalapet and Eden (2019).

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