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Item 3(r) of the provisional agenda
Other Matters for Consideration

Note by Committee Member, Mr. Muhammad Ashfaq Ahmed, on Taxation and Foreign Exchange

Summary

The note annexed to this paper is *for discussion, and for decision* on whether to task a Subcommittee to examine the issues of how taxation and foreign exchange can be better addressed as a whole of government issue, and to develop guidance that would assist governments, especially in developing countries.

Background

1. At the Twenty-fifth Session of the Committee in October 2021, Mr. Muhammad Ashfaq Ahmed, a Committee Member, provided a short note on taxation and foreign exchange issues, proposing that a Subcommittee be formed to consider the issue and develop draft guidance. Time did not allow consideration of the paper at that session, and it was agreed that the issue would instead. be considered at the Twenty-sixth Session.

2. The note is annexed for discussion and decision on whether to task a Subcommittee to examine the issues of how taxation and foreign exchange can be better addressed as a whole of government issue, and to develop guidance that would assist governments.

ANNEX

Establishing a Subcommittee on International Taxes & Foreign Exchange

Note by Muhammad Ashfaq Ahmed, UN Tax Committee Member

Background

When money crosses borders, be that on account of illicit financial flows (IFF), base erosion (BE) or base loss (BL) – tax base bargained away in DTCs – it has direct implications for the foreign exchange position of the source state – contextually developing countries. What it implies is that, right at the time of the occurrence of outward remittance, an equal amount of foreign exchange gets liquidated from the remitting state. This should not be a worry in a situation where foreign inflows and outflows match or nearly match, but in situations of excessively lopsided bilateral settings, it can cause serious damage to the weaker partner in the equation.

2. The backdrop is that since 1981 – when the first UN Model Tax Convention was rolled out – developing countries have systematically been coaxed into signing DTCs with stronger economic powers based on the underlying principle of ostensible reciprocity. It goes without saying that the reciprocity rule would hold good in par economic relationships, but it becomes harmful for the weaker partner in an unequal bilateral setting. It has emphatically been remarked that:

> The concept of reciprocity underlying treaties between developed countries was not equally valid when the contracting States were at vastly different stages of economic and industrial development. A loss of revenue which might be of relatively less importance to a developed country could constitute a heavy sacrifice to a developing country. For many countries, the scarcity of foreign exchange was of even greater importance than sacrifices of revenue.[1]

3. The UN's preoccupation with developing countries' foreign exchange position has historically been of primary importance. In fact, the main focus of deliberations at its various organs throughout 1960s, and leading to the ECOSOC Resolution 1273/1967, which ended up creating the precursor to the UN Tax Committee (UNTC),

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[1] U.N., "Report of the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries," in *DESA* (New York: ECOSOC/DESA, 1969).

the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries, was improving the foreign exchange position of developing countries by (a) injecting foreign exchange into those economies through private foreign investment and official development assistance; and (b) capacitating them to be able to retain that foreign exchange and expend it prudently. This focus has only gained traction during the 2000s and 2010s.[2] Likewise, it has also been stipulated that from the lens of "developing countries, Article 26 is particularly important not only for curtailing cross-border tax evasion and avoidance, but also to abate the capital flight[3] that is often accomplished through such evasion and avoidance."[4]

4. Somehow, the UNTC has not been able to attend to this matter of looming importance and adequately focus on the relationship between international taxes and foreign exchange with particular reference to developing nations. There is little doubt that all countries – developed or developing – do apply withholding taxes on many types of outbound payments. Some countries may have efficient tax system oversight on outward remittance regime meshed well with operating foreign exchange regulations, but most countries need quantum improvement.

Cardinal Questions

5. It goes without saying that all states reserve an unbridled right not only to determine the credentials, but also the "remitability" of every single amount denominated in local or foreign currency that is sought to be transacted out of its jurisdiction. Theoretically speaking, the remitting state, with regard to every amount that is lined up for outward remittance, before the actual transaction takes place, poses and answers – explicitly or implicitly – five inter-related sets of 14 (in total) questions:

(A) Amount

(i) Is the remittable amount legal?
(ii) Has the remittable amount arisen from sources located within its own territory?

[2] *F.A.C.T.I. Panel Report - Report of the High Level Panel on International Financial Accountability, Transparency and Integrity for Achieving the 2030 Agenda*, Financial Integrity for Sustainable Development (New York: United Nations, 2021); "The Zedillo Report - Recommendations of the High-Level Panel on Financing for Development," (New York: ECOSOC, 2001); "The Monterrey Consensus of the International Conference on Financing for Development," (New York: DESA-FFDO, 2002).
[3] Emphasis supplied.
[4] U.N., *The Commentary - United Nations Model Taxation Convention between Developed and Developing Countries* (New York: DESA-FSDO, 2021), 752.

(iii) Does the quantum of the remittable amount match the sources claimed?
(iv) If the remittable amount carries the character of an income, has the tax thereon been charged and paid?
(v) Has the source discharged all liabilities vis-à-vis the remittable amount – Excise, VAT, sub-national taxes?
(vi) Is it the same amount on which tax is claimed to have been defrayed?

(B) Channel

(vii) Is it being remitted through legal channels?
(viii) Does the transaction leave enough of a trail of transparency?

(C) Purpose

(ix) Is the amount being remitted for a legal purpose?
(x) Does the amount being remitted have an economic rationale of an equal value?

(D) Remitter

(xi) Does the amount being remitted legitimately belong to the remitter?
(xii) Is the remitter legally authorized to undertake the remittance?

(E) Remittee

(xiii) Is the remittee entitled to receive the amount?
(xiv) Is the amount going, in actuality, to the person who is its purported recipient and in the same exact value?

6. Apparently, these are straightforward questions, but in a developing country context, answering them by one law enforcement outfit or a regulatory authority in isolation of others, in respect of every single transaction, becomes challenging, if not impossible. Therefore, states look to mobilize sets of policies, laws, and institutions that not only work together in combination but also interact dynamically, and complement each other so that no amount of resources unjustifiably gets remitted outside their jurisdictions.

7. Thus, when it comes to outward remittances, states weave institutional networks specializing in different areas of statecraft to target various questions that fall within their area of operations. This aspect is seriously lacking in developing countries in terms of (a) visible compartmentalization between tax administrations

and central banks; (b) a wide wedge and lack of synchrony between tax laws and foreign exchange regulations; and (c) digitalization and automation of systems being still in the far future. There is a predictable upside for the international community in terms of enhanced transparency, abatement of money laundering and curbing of terrorism financing if both tax systems and foreign exchange control systems are made to speak to each other – meaningfully. Work in this area should also address how to ensure timely and hassle-free profit repatriation to foreign investors.

Proposal

7. A Subcommittee of the UNTC should be established to study the subject matter as narrated above with a view to improving the capacity of developing countries to have standardized "whole-of-the-government" responses to this issue.

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