23rd Session of the Committee of Experts on International Cooperation in Tax Matters

Comments on the draft agenda for the Committee membership for the 2021-2025 term by Bob Michel and Tatiana Falcão. The authors can be contacted at michel.bob@gmail.com and Tatiana.falcao@yahoo.com.br.

In light of the call for public comments on Tax Committee's draft agenda, we strongly urge the Members to consider the following new issues which we believe should be considered by the Committee's work plan for the 2021-2025 membership. These issues are:

1. Source taxation of international transport income: revisiting Article 8 ('alternative B') of the UN Model.
2. Tax policy issues relating to cryptocurrencies and other virtual assets
3. Tax treaty aspects of EPC projects
4. Environmental taxation: outstanding issues to be considered

In what follows, we give a brief description of the issues underlying each proposed new area of work identified above and, in the case of the topic of environmental taxation, the outstanding issues that should be considered by the Subcommittee.

1. *Source taxation of international transport income: revisiting Article 8 ('alternative B') of the UN Model.*

Description of the issue:

Article 8 (Alternative B) was inserted in the UN Model (1980) as an alternative to the century old consensus reflected in Article 8 (Alternative A) of the UN Model and Article 8 of the OECD Model according to which international shipping profits should be taxed exclusively in the residence state of the owner of the ship. The consensus was mainly based on the practical consideration made in the 1920's that it was simply too cumbersome for shipping companies to keep track of their activities in the seaports around the world where their ships were calling. As a result, until the introduction of articles 12A ('fees for technical services') and 12B ('automated digital services'), international shipping profits were the sole type of business profits that were not covered by the standard PE threshold rule in articles 5 and 7.

As is reflected in the Commentary on Article 8 ('Alternative B') – which is almost entirely left untouched since its inception – the introduction in 1980 of the source taxation alternative for international shipping company did not enjoy consensus among the original drafters of the UN Model. Four decades later, Article 8 ('Alternative B') has not gained much more popularity among commentators, who often point to the low inclusion rate in tax treaties to conclude that 8B is simply bad policy. We believe this perception is strongly skewed. First of all, given that 8B only applies to a certain type of business activity – international maritime shipping – the provision is only relevant to source countries with sea access and seaport infrastructure. For developing countries that are land-locked, 8B is not a relevant policy option. Secondly, the international maritime shipping business is a heavily concentrated industry with a few very big players. The bulk of the ownership of the mercantile fleet business is concentrated in the hands of enterprises located in a hand full of states, mostly OECD member states. As such, 8B is mostly relevant in tax treaties signed with these shipowner countries. If we take these observations into considerations, it is clear that the (low) global inclusion rate of 8B in the entire tax treaty network is not a good benchmark to assess the relevance of the provision.

Furthermore, whereas the global inclusion rate of 8B on the total of tax treaties might be very low, the country concentration of treaties with 8B is remarkedly high. Our research shows that eight countries are responsible for 75% of the tax treaties that include article 8B. The eight countries – each of them located in South/Southeast Asia – are (in alphabetical order) Bangladesh, India, Indonesia, Myanmar, Pakistan, the Philippines, Sri Lanka and Thailand. For these countries, Article 8 ('Alternative B') is a standard feature of their past and current tax treaties, including those tax treaties with the major ship owning nations. In the region South/Southeast Asia, the taxation of non-resident shipping companies is the rule, rather than the exception.

Meanwhile in Sub-Saharan Africa, the situation is markedly different. Article 8 ('Alternative B') has not found its way into the tax treaty practice of most African countries. The 2016 ATAF Model Agreement for the Elimination of Double Taxation with respect to Taxes on Income and the Prevention of Tax Avoidance and Evasion' ('the ATAF Model') and its update in 2019 incorporate article 8 of the OECD Model and article 8 (Alternative A) of the UN Model, while entirely dismissing the alternative approach suggested in Article 8 (Alternative B) of the UN Model. Different signals are however heard from the individual ATAF member countries. No other provision of the ATAF Model has triggered as many country reservations than the ATAF Model's support for exclusive residence state taxation in article 8(1). 10 out of 38 ATAF members have indicated a preference for source taxation of profits from international transport.

The practice in South/Southeast Asia and the signals in African countries are in sharp contrast with the situation in the residence countries, the shipowner countries, who enjoy the benefit of exclusive taxing powers on international shipping income. However, on the residence country-side, the international shipping business was and is heavily exposed to the forces of tax competition. Through the adoption of defensive measures in the form of tonnage tax systems and other tax subsidies, the effective tax rates (ETR) in the industry are low and declining, even in times where society calls for fair tax burdens on corporate profits. Tonnage tax systems granted by the residence states (*i.e.* the shipowner nations) have nevertheless been declared compliant with the harmful tax practices standards set under BEPS Action 5. As such, these regimes under which residence states actively forego exercising their exclusive right to tax international shipping income, will continue keeping the effective tax rate on maritime transport low. Not only do these tax benefits risk creating artificial overcapacity in the business – as admitted by the industry itself and the OECD – it also results in the global failure to tax income generated by a business that has a notoriously big carbon footprint. Many of the consequences of this carbon footprint – like rising sea levels – are felt in the source countries, not in the shipowner countries. We believe source taxation could mitigate this blatant failure in international tax policy.

The upcoming Membership of the Tax Committee provides an excellent opportunity of revisiting Article 8 ('Alternative B') of the UN Model and its Commentary. With members from Pakistan, India, Indonesia and Myanmar, the Committee has never had more representatives from countries that have adopted 8B as a standard feature of their tax treaty policy. We believe the Tax Committee should be able to draw on the experience built up in these countries in Southeast Asia in relation to source taxation of non-resident shipping companies to update the guidance on the matter in the UN Model, which has not been revisited since 1980. The Tax Committee would thereby serve its ultimate purpose as a catalyst for south-south tax treaty policy design. And even if revised guidance on 8B would not lead to massive incorporation in tax treaties – it takes two to tango – revised guidance would certainly prevent opposing residence countries who, although they agree to source taxation in principle, do not want to incorporate 8B because the UN Model does not provide a workable application of the provision in practice.

Issues for consideration:

- Setting up of a Subcommittee on 'the source taxation of international shipping income' with members from 8B countries and representatives from the international transport sector.
- Update of the text of Article 8 ('Alternative B') model provision and Commentary to resolve the current technical glitches:
    - 'more than casual' threshold is not used in practice;
    - Definition of international transport income: wider definition needed? 8B merging with 12A?;
    - Source taxation of international air transport?
    - Articulation of a proper sourcing rule, only outbound traffic?
    - Articulation of proper profit attribution rules for net taxation
    - …
- Development of a paper on wider policy considerations in relation to source taxation of international shipping income.

2. Tax policy issues relating to cryptocurrencies and other virtual assets.

Description of the issue:

Cryptocurrencies are taking developing countries by storm. In 2020, the recorded *Bitcoin* trading volume on online cryptocurrency exchanges was markedly higher in many African and Latin American countries than in most OECD countries. The United States recorded the largest trading volume. Nigeria is tied for the second place with Russia, accounting for a *Bitcoin* trading volume of around USD 410 million, which is double the volume recorded all EU countries lumped together (about USD 205 million). Other African and South American countries in the top 15 are Colombia (about USD 147 million), Kenya (about 92 million) and Peru (about 45 million). If the *Bitcoin* trading volume is weighted against a country's GDP, the top 10 of countries with highest cryptocurrency penetration in 2020 looks as follows: (1) Kenya; (2) Colombia; (3) Nigeria; (4) South Africa; (5) Russia; (6) Peru; (7) Argentina; (8) the Philippines; (9) United States; and (10) Thailand. Or in other words, cryptocurrencies are quickly gaining ground in the global south, and they do so at a pace which far outweighs the adoption rate of this new virtual asset in OECD countries.

There are many reasons why cryptocurrencies are being embraced in low- and middle-income countries (LMICs). The ease of access to cryptocurrency technology has the potential to drastically improve the financial inclusion of the 'unbanked' part of the population. Cryptocurrencies have also drastically disrupted the traditional remittance industry. Overseas money transfers by migrant workers are an important source of revenue in many LMICs. As a decentralized means of payment/store of value, cryptocurrencies allow citizens in LMICs to hedge income and wealth from inflation. Finally, certain aspects of the cryptocurrency ecosystem like the 'mining of *Bitcoin*' has enticed certain LMICs to position themselves as cryptocurrency hubs for the purpose of attracting foreign investment by turning into cryptocurrency hubs.

The large-scale adoption of cryptocurrencies in LMICs also comes with serious risks which policy makers should consider. One of the most pressing risks is the (potential) pressure put by this development will put on the tax gap of a country. The tax gap is the difference between the total taxes owed to a state and the total taxes paid on time by its taxpayers. Without proper income tax rules that deal with taxable events resulting from cryptocurrency transactions, countries will forego income tax revenue. This will increase a country's tax gap and thereby lower its tax-to-GDP ratio. Even before the recent rise of cryptocurrencies, many of the relevant LMICs were already operating at around or below the 'tipping point' of 15%. The tipping point of 15% tax-to-GDP has been identified by the World Bank and the IMF as a crucial threshold to be met by a country so that it can generate sufficient domestic resources that can be invested in health, education and infrastructure, and ultimately to eradicate poverty. For this reason, controlling the impact of cryptocurrencies on the tax gap and improving the tax-to-GDP ratio are believed to be core elements to achieve the 2030 Addis Ababa Action Agenda for Sustainable Development Goals (SDGs), and SDG 17.1 which calls to "*strengthen domestic resource mobilization, including through international support to developing countries, to improve domestic capacity for tax and other revenue collection*."

Given that the tax policy issues faced with cryptocurrencies are more pressing in the Global South than it is in the OECD countries, we strongly urge the Tax Committee to take this matter in hands so that domestic resources can be pooled for the purpose of exploring suitable policy options and the development of a comprehensive strategy to deal with the tax consequences of the age of cryptocurrencies.

Issues for Consideration:

- Setting up of a Subcommittee on 'tax policy issues with regard to cryptocurrencies and other virtual assets'.
- Develop a guidebook in which the fundamental tax policy aspects of cryptocurrencies are explored:
    - Definition of taxable events (including the cryptocurrency *sui generis* events like 'initial coin offerings', 'fork coins', 'mining income', 'forging/staking income', 'airdrop income', 'yield from decentralized financing with cryptocurrencies' etc.
    - Development of cryptocurrency valuation rules for income tax purposes
    - Guidance for record keeping and compliance

3. *Tax treaty aspects of EPC projects*

Description of the issue:

During the previous session of the Committee, a note was presented by the Chinese delegate in relation to the application of the limited force of attraction rule of Article 7(1) of the UN Model to engineering, procurement and construction (EPC) contracts.[1] In the note it was suggested to amend the Commentary on Article 7 of the UN Model to make clear and without altering the meaning of the treaty provision that the force of attraction rule is to be interpreted strictly and cannot be used by source state to extent its taxing rights to income that is not derived from activities in the source state.

We agree with the drafter of the note that his suggested amendments to the Commentary reflect the only 'correct' interpretation of the model provision in question, as it stands today. We do want to emphasize this trend of 'incorrect' interpretation of the limited force of attraction principle in certain developing countries is symptomatic to a much more fundamental problem regarding the taxation of EPC projects. This problem is the fundamental unbalance that is perceived in many developing countries with regard to the allocation of taxing rights on profits generated from EPC project 'as a whole'.

It is common knowledge that international enterprises actively structure their EPC projects to reduce tax liabilities in the source state. The international tax practice has been to split the functions of such contracts into those pertaining to the onshore and offshore locations, according to where the activities take place, and to in fact, allocate as many functions as possible to the offshore state, *i.e.* the residence state of the service provider, in order to avoid paying taxes in the onshore location, where the construction activity actually takes place. In recent years, many residence countries have amended their tax treaties to safeguard this standard treaty practice against rising opposition in source countries.

As a matter of fact, many developing countries have domestic tax rules in place which capture more taxable profits from inbound EPC projects than these countries are allowed to tax under their tax treaties which comply to the standard practice of contract splitting. Currently, these countries do not find any guidance in the UN Model regarding alternative ways to allocate taxing rights on EPC projects which provide for a more balanced division of taxing rights. This lack of guidance pushes countries to interpretations of existing treaty rules which are at odds with the international practice, and thereby hamper legal certainty and damage the investment climate.

We believe the Tax Committee should take this matter into hands and study the tax consequences of EPC projects as a whole and the impact of EPC project with the purpose of formulating new alternative provisions, if deemed appropriate. Inbound EPC projects are crucial drivers for infrastructure development in many LMICs. But for the sake of domestic resource mobilization under SDG 17.1, hosting EPC projects should not imply an unfair surrender of the power to tax the economic rents generated by foreign enterprises carrying out these projects.

[1] United Nations (2020), Committee of Experts on International Cooperation in Tax Matters Twentieth session, Note by the Subcommittee on the UN Model Tax Convention between Developed and Developing Countries, E/C.18/2020/CRP.7, 8 May 2020.

Issues for Consideration:

- Setting up of a subcommittee on 'tax policy issues with regard to cryptocurrencies and other virtual assets'.
- Analyse EPC contracts in light of a "whole of contract" approach
- Survey LMICs on domestic practices regarding EPC contracts
- If considered appropriate, formulate alternative model provisions (possibly in the form of a specific anti-avoidance rule) which should be inserted in the Commentary to give guidance to those countries who are keen to change their tax treaty policies in this reard.

4. Environmental taxation: outstanding issues

Besides expanding the Handbook on Carbon Taxation, another area of potential subcommittee activity could be the development of a uniform conceptual legal framework for widely used terms such as (i) environmental taxation; (ii) carbon pricing; and (iii) fossil fuel subsidies. The lack of a common definition that is supported internationally opens the gate for countries to employ unilateral approaches to defining and quantifying those instruments. In the long-term, this could give rise to not just to tax, but also to trade conflicts, as countries will invariably be required to reconcile unilateral practices to recognize third country initiatives in the field of carbon pricing. The issues most commonly associated with those topics are:

(i) Within the field of environmental taxation, which taxes are in fact regarded to be environmental in nature. A harmonized understanding of what types of taxes qualify as environmental taxes could also assist countries in reporting, quantification and monitoring of environmental measures.

(ii) Carbon pricing: Most organizations agree that a carbon price will include at least the application of carbon taxes, ETSs and other environmental taxes such as fossil fuel and energy excises. In considering environmental taxes such as energy and fossil fuel taxes as integral parts of a carbon price approach, intergovernmental organizations such as the World Bank, the IMF, and the OECD, have suggested methodologies to derive a shadow carbon price from the application of these taxes. These organizations have been deriving economic models to compute what would be the inbuilt carbon price in energy and fossil fuel taxes employed by countries traditionally known not to promote an explicitly carbon price. There is still no agreement as to the mathematical formula that is to be used in computing the shadow carbon price. However, the recognition of an inbuilt carbon price in other environmental taxes, like energy taxes, could be beneficial over time to developing countries in meeting their NDC commitments under the Paris Agreement.[2]

[2] OECD, *Taxing Energy Use for Sustainable Development*, (2021), available at https://www.oecd.org/tax/tax-policy/taxing-energy-use-for-sustainable-development.pdf (accessed 25 Jul. 2021); OECD, *Taxing Energy Use 2019: Using Taxes for Climate Action*, (OECD Publishing, P2019), available athttps://dx.doi.org/10.1787/058ca239-en (accessed 25 Jul. 2021), and I. Parry, D. Hein ,E. Lis, and S. Li, *Getting Energy Prices Right: From Principle to Practice*, (IMF 2014), pg. 8, available at https://www.elibrary.imf.org/view/books/071/21171-9781484388570-en/21171-9781484388570-en-book.xml (accessed 25 Jul. 2021)..

(iii) There is further discussion as to whether a carbon price should consider the tax or price (via an ETS) of carbon and then deduct any fossil fuel subsidies and incentives employed at national level.[3] The fact of the matter is that the use of a wider or narrower scope for the term ‘carbon price’ will impact the tax rate of the carbon tax adopted at the national level if carbon taxation is the instrument of choice to reflect the carbon price.

(iv) Fossil Fuel Subsidies: At the intergovernmental level in 2019, the United Nations Environment Program[4] together with the OECD, IISD, and GSI developed a methodology to measure fossil fuel subsidies at the national, regional, and global levels. There is no globally accepted definition for fossil fuel subsidies which, in itself, hampers uniform interpretation of what they are regarded to be and how they are supposed to be reported. Therefore, the methodology relies on the WTO’s subsidies definition that is contained in the Agreement on Subsidies and Countervailing Measures (ASCM) and on certain sub-classifications expressed in the IEA Statistical Manual.[5]

(v) As the methodology does not make the commitment to uniformize the definition of FFSs binding, it relies on three sub-indicators for reporting on the FFS indicator: 1) direct transfer of government funds; 2) induced transfers (price support); and, as an optional sub-indicator, 3) tax expenditure, other revenue foregone, and underpricing of goods and services. It should be noted that the OECD and the World Bank also hold their own institutional definitions for FFSs, which many countries disagree with, hence leading them to employ their own domestic views on how FFSs should be interpreted and quantified.

The lack of a common definition in which to qualify FFSs hampers further unified international action to curb the widespread application of such policy. This is, in fact, the third area of conceptual lacune identified in these authors. Together with the other two – environmental taxation and carbon pricing – it clearly denotes the lack of legal (juridical) attention that the topic has historically received from the wider international tax community. Establishing a clear conceptual framework is no doubt crucial to the development of a robust legal archetype at domestic and international levels.

[3] See broad discussion in: IMF/OECD, supra n. 67, pg. 14.
Within this topic, there is also the fact that countries’ green fiscal policies are currently considering net zero emissions targets. Net zero emissions does not mean no emissions; it means that countries introduce measures to compensate for actual emissions that are released. Compensation measures can be administered nationally or internationally. Therefore, there is also a question as to whether the carbon pricing estimate will comprehend policies geared towards the release of voluntary emissions permits and carbon sinks, for example.

[4] UNEP, IISD, GSI and OECD, *Measuring fossil fuel subsidies in the context of the Sustainable Development Goals*, (2019), available at https://www.unep.org/resources/report/measuring-fossil-fuel-subsidies-context-sustainable-development-goals (accessed 2 Aug 2021).

[5] IEA, *Energy Statistics–Manual, International Energy Agency*, (OECD Publishing, 2004), available at https://www.oecd-ilibrary.org/energy/energy-statistics-manual_9789264033986-en (accessed 25 Jul. 2021).