

Input for Secretary General's Report on General Assembly Resolution on "Promotion of inclusive and effective tax cooperation at the United Nations" (77/244)

The historic resolution by the General Assembly to begin inter-governmental discussion on the ways to strengthen the inclusiveness and effectiveness of the tax cooperation is, in my view, the most significant step ever towards making the international tax system fairer, more equitable, and sustainable in the long term.

The gaps/problems with the International Tax System

02.The overwhelming support for the resolution is reflective of the general discomfort of the member states with the current international tax system and their concern on the lack of inclusivity in and effectiveness of existing bodies/processes to reform that system. In my view, the present international tax system is perceived to be less inclusive and less fair primarily because the existing rules which govern the international tax system were set in 1920s and these have now been rendered ineffective if not completely obsolete. These rules, particularly those relating to allocation of the taxing rights among member states, were designed at a time when international trade, primarily if not exclusively, constituted export and import of tangible goods. These rules have become inefficient and ineffective in the present world where services constitute a significant part of the international trade. In respect of trade in tangible goods, a physical presence rule for allocation of taxing rights has some relevance, but in respect of services it becomes ineffective and may be meaningless in certain situations. Second, the existing rules, primarily and in many cases exclusively, allocate taxing rights to the countries of residence of the taxpayer by default and only give taxing rights to source state in specified situations. Such a model can work reasonably well when the trade or income

flows between countries is balanced. Therefore, between advanced economies which are mostly resident countries, it can work perfectly well. However, it can become unfair when such a model is adopted for treaties between a capital exporting and a capital importing country or between a developed and developing country where there is a significant imbalance in flow of payments between them. Beyond the issue of allocation of taxing rights among countries, the present rules also allow Multinational Enterprises (MNEs) to minimize their tax liability, an area of concern for most countries- both developed and developing. The existing Arm's Length Principle (ALP) based profit allocation rules have been (mis)used by many MNEs to book their profits in the jurisdictions of their choice with the sole objective of reducing the effective tax rate of the group. Such low tax outcomes are achieved mostly through complicated structuring and multi-layering of transactions adding more complexity to the international tax system. A recent OECD report based on analysis of Country-by country Reports (CbCR) found that there exists significant misalignment between location where profits are reported and location where economic activities occur¹. Further, exploitation of rules to minimize tax incidence is also prevalent among many High-Net-worth individuals (HNIs). The citizens and civil society groups in various countries, including those in advanced economies, have justifiably raised their concerns on such HNIs and MNEs not paying their fair share of taxes.

The lack of inclusivity and effectiveness of recent/ongoing initiatives to reform International Tax System

03. Admittedly, after the financial crisis in 2008 which mainstreamed the international tax discussion in various international fora, there have been

¹ The Report shows that MNEs report a relatively high share of profits (29%) in investment hubs (typically low tax jurisdictions) as compared to their share of employees (4%) and tangible assets(15%). The report is available at <https://www.oecd.org/tax/tax-policy/corporate-tax-statistics-fourth-edition.pdf>

notable efforts towards making the international tax system fairer and more inclusive. This includes fundamental reforms in tax transparency architecture, BEPS 1.0 project of G20/OECD with 15 action points on fighting base erosion and profit shifting and finally, the ongoing work under the two-pillar package at OECD/G20 Inclusive Framework on BEPS (the work is now popularly referred to as BEPS.2.0). In respect of these efforts, particularly the two-pillar package with Pillar 1 ushering in fundamental reform in allocation of taxing rights and Pillar 2 ensuring certain minimum level of taxation for large and profitable MNEs, while the direction of travel is right, in my view, they do not travel enough in that direction². And that is why these reforms have not been perceived by many as enough or substantial in furthering the cause of inclusivity or effectiveness of the international tax system.

04. The primary reasons as to why the reforms so far have been perceived to be non-inclusive and less than fair particularly for the overwhelming majority who fully supported the resolution, in my view, are two— first, the agenda for these reforms have been primarily set, in both BEPS 1.0, BEPS 2.0, and even for exchange of information, by advanced/OECD countries consequent upon the financial crisis of 2008. The developing countries particularly the small, least developed countries had virtually no say in the setting of the agenda³ and in fact, most of them did not have any role in finalization of the action points under BEPS 1.0. Under BEPS 2.0, while the situation has substantially improved with the establishment of Inclusive Framework (by the way, Inclusive

² Pillar one reallocates only a miniscule 2% of total profits of MNEs- IMF Report on International Corporate Tax Reform February 2023, available at <https://www.imf.org/en/Publications/Policy-papers/Issues/2023/02/06/International-Corporate-Tax-Reform-529240>

³ For instance, Action 2 on Hybrid mismatch has relevance mostly for developed economies and hardly any for developing countries. Similarly, Action 4 on interest limitation addressed a legitimate concern of base erosion- but again there was no action point to discuss base eroding concern of developing countries in areas related to payment of service or management fees, royalty, fees for technical services.

Framework is not a formal body bound by any instrument of incorporation), still, the inclusivity of the Inclusive Framework (IF) is much less than the desired level. And second, decision making is based on consensus and not on voting. The consensus based approach means that countries are deemed to have opted in unless they specifically opt out. For example, in respect of the 2021 October Statement of Inclusive Framework, countries/jurisdictions were asked to say NO, if they so desire, by a deadline. A lack of response was deemed to be 'Yes'. Such process can create challenge for many, particularly for small developing countries, who may not have the time or resources to analyse a proposal to take a final view there on in a short time frame. So, the result is a default yes with such countries joining the package even if they are not fully convinced of the benefit. The problem with any such derived consensus where countries do not join wholeheartedly is that it makes such consensus unsustainable even in the short term.

Suggested Inputs for the Report of the Secretary General

05. Given the above background on the gaps in the present international tax system and the limitations of present standard setting bodies, the resolution is a much needed first step. The United Nations (UN) being the most inclusive body by its very nature is the place to have these international tax discussions which is expected to be a member led process. In this regard my suggestion for the next steps which can be considered for inclusion in the Secretary General's Report are as under: -

i) **The process**

The process is the most critical factor to ensure inclusivity. Only a member led process with universal participation of all members of the UN can ensure such inclusivity. Given the dynamic nature of business models, such discussions

should be a continuous one with member states having an annual round of discussion every year, either through dedicated session or preferably through a conference of parties (CoP) to be established by United Nations. The CoP shall be supported by the existing United Nations Committee of Tax Experts which should continue in its present form i.e. as a committee of experts working in their individual capacity. In addition to this committee, the conference of parties may constitute other committees and sub-committees to study and recommend on specific issues of international tax raised by the member states. There must be a permanent and well-staffed secretariat to provide technical support to the discussions. There should be comprehensive public consultations before any decision is made. The decision making should be by majority through voting. It needs to be acknowledged that decision by CoP shall be a recommendation only and shall not result in automatic implementation of that decision. Where such recommendations are soft rules or best practices and do not involve allocation of taxing rights among countries, the same shall be implemented by willing countries. Recommendation involving reallocation of taxing rights can only be implemented through a multilateral convention/bilateral modification of tax treaties. This process is expected to be long, and it may be particularly difficult to bring those countries on board who are expected to give up their existing taxing rights. However, if the recommendation is fair and principle based, the persuasive value of such recommendation by UN body will be helpful to bring most such countries on board over time.

ii) **Agenda for discussion**

For inclusivity and effectiveness, the agenda setting must be through a bottom-up process where every country, small and big, developing or

developed, should have a say in setting the agenda for discussion. The agenda items can be grouped into several categories based on the nature of the subject. One such category of agenda items can be those that are not in the nature of zero-sum game and hence, are expected to have broader support and quicker adoption. Examples of some such items are simplification of rules relating to transfer pricing by exploring a more formulaic/formulary approach,⁴ a minimum tax on HNIs, expanding (more countries) and deepening (more information) the exchange of information system or making country by country reports (CbCR) accessible to small developing economies. Another category can be of soft rules (expanding on BEPS 1.0 action points, for example) that target base erosion and profit shifting, a concern shared by most, but are best practices⁵ so that it is up to any country on whether to adopt/implement any such rule/practice. The items under this category can be rules limiting deductibility of service payments/ management fees. The final category can be revisiting the allocation of taxing rights, which is a zero-sum game and hence is likely to be the most difficult part of the discussions. While setting agenda items, it is necessary to ensure that there is no duplication of the efforts undertaken in other bodies like the IF.

iii) Beyond International Tax Reforms

Even the most comprehensive reforms in international tax system cannot result in meeting the revenue requirement of the developing and emerging economies for achieving sustainable development goals. It is, therefore, necessary for the proposed intergovernmental discussion to also focus on capacity building and bespoke technical advice programmes that can be

⁴ As being done in Amount B under Pillar 1. Low value-added services and DEMPE in Action 8-10 Reports of BEPS 1.0 project are other examples.

⁵ Like Action 2, 3 or 4 of BEPS 1.0 project

availed by willing member States so that, their own domestic tax system can become more efficient and effective. This will include for example, enabling smaller economies to benefit from the existing exchange of information network including CBCR reports so that they can tangibly benefit from these initiatives, help in designing a minimum tax, reorienting/dealing with tax incentives after implementation of Pillar 2 or taxation of economic rent/excess profit or net wealth among others.

Concluding Remarks

6. Inclusivity must be felt, and effectiveness must be visible. United Nations is the only forum where a member led process for international tax cooperation can ensure such inclusivity and effectiveness. While I have touched upon possible agenda items for such cooperation, the most important thing is to set up the process. Once we have the process, rest will follow.

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This input is submitted in my personal capacity as a Member of UN committee of Experts on International Cooperation in Tax Matters and do not necessarily reflect the views of the UN Tax Committee, the Inclusive Framework, or the Government of India.