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CALL FOR INPUTS: Ad Hoc Committee to Draft Terms of Reference for a UN Framework Convention on International Tax Cooperation

BMR Legal Advocates' Inputs for the Committee

Dear Chairperson,

Thank you for the opportunity to share our inputs on the Ad Hoc Committee to Draft Terms of Reference[1] for a United Nations Framework Convention on International Tax Cooperation's efforts towards the problems and challenges the Convention seeks to address.

In the interest of brevity we are refraining from waxing eloquent on the potential that the Convention has in shaping the international tax framework. Our suggestions largely pivot around improvisations to the existing work done under both the aegis of the OECD and the UN.

Backdrop:

The core goal of the UN solution is to effectuate a more cooperative and co-opted form of international taxation. The goal is indeed a pressing need for the world today. Integral to the history of human civilization is evolution. With evolution, comes the need to adapt existing rules and laws to make them fit for purpose, such that mankind benefits as a whole. The development of an international tax framework 100 years ago bears testimony to action taken for what was the need of the hour then. Just as widespread physical mobility of goods and labour changed the shape of global trade a 100 years ago, widespread digitalization has touched every sphere of human existence in the last 30 years.

While the fundamental principles of international taxation remain the same, it appeals to sheer common sense that all countries acknowledge the contours of what constitutes source taxing rights vs residence taxing rights, active income vs passive income, all of which are

[1] Terms of reference – a description of what must be dealt with and considered.

inextricably linked to the fundamental taxing concept of “economic allegiance”[1] needs to be revisited.

The right to source taxation for passive income (eg., royalty) has been accepted by developed and developing countries alike. Based on empirical evidence, a study[2] by Wijnen and de Goede at the request of the UN Committee of Experts on International Cooperation in Tax Matters (UN Tax Committee), concluded that many more countries follow the UN Model’s design on royalties than the OECD Model’s design. Under article 12(5) of the UN Model, royalties are deemed to arise in the contracting state in which the payer of the royalties is a resident. Consequently, the taxation right given to the country in which the payer is resident. he majority of tax treaties, including between OECD member countries, still allow for a withholding tax at source for royalties.[3]

A 100 years ago if one had to set up a store to sell products in a source country, the only way possible then was to have a physical presence in the source country. Today, the same business can be done by setting up a store in the cloud.

Countries need to acknowledge that it is the same income that source jurisdictions are seeking to tax, even though the means of earning it, no longer need a physical presence.

Thus, whether it is by way of an agreement on what constitutes presence in a country, or revisiting understanding on taxation of active vs passive income, or redefining passive income, countries must reach a common understanding on the allocation of taxing rights given the evolution of business models.

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[1] The key aspect of economic allegiance hence lies in the integration of the taxpayer into the economy of the state’s society that claims a right to tax. - D.W. Blum, Chapter 2: The Debate on How to Reform the International Tax System in Light of Digitalization in Normativity in International Tax Law: A Legal Theoretical Inquiry into Contemporary International Tax Discourse (IBFD 2023), Books IBFD (accessed 14 Mar. 2024).

[2] W. Wijnen & J. de Goede, The UN Model in Practice 1997-2013, 68 Bull. Intl. Taxn. 3, at 118 et seq. (2014), Journals IBFD.

[3] A. (Anna) Binder & S. Siller, Chapter 5: Passive Income in The UN Model Convention and Its Relevance for the Global Tax Treaty Network (M. Lang et al. eds., IBFD 2017), Books IBFD (accessed 14 Mar. 2024).

Our suggestions:

1. Building on the OECD work on Action Plan 1 - Our foremost suggestion is built upon the work undertaken by the OECD under the aegis of the BEPS Inclusive Framework, in which over 140 countries are today participating. We have pencilled-in on pressing issues that have remained unmitigated or have arisen on account of the OECD Two-Pillar Solution, which the Committee could consider while manoeuvring the terms of reference. The biggest bugbears in the Two-Pillar solution proposed by the OECD are (i) restricted applicability – the threshold of Euro 20 billion for seven years leaves all but a handful of companies out of scope (ii) complexity of the rules; and (iii) cost of implementation for taxpayers in what is a zero-sum game for taxpayers.

(i) Thresholds - It will be in the interest of developing countries that the economic threshold under the impending convention be low enough to include a substantial number of MNEs. A suggestion would be to consider lower thresholds applicable to "regional" MNEs that may be more important for a particular group of countries in the Global South if not a blanket reduction.

(ii) Complexity of the rules – An additional tax based on global profitability could be paid by all companies that have significant economic presence (SEP) in jurisdictions, based on consolidated financials. The contours of SEP could be agreed upon based on work already done at the OECD. Allocation of additional tax could be 25% of profits in excess of 10% (on which profits have already been computed), computed based on SEP ratios – a deduction to be available for profits already taxed in source markets for such income. Determination of SEP could be left to companies with jurisdictions retaining a right to audit the SEP ratio (all disputes on SEP ratio to be resolved via mandatory arbitration).

(iii) Cost of implementation – A simple formula would restrict the cost of compliance to determining SEP ratios.

2. Building on the UN Work on Article 12A / 12B - A grave characterization problem posed at the time by the introduction of Article 12A in the UN Model Convention was self-inflicted: the Commentaries to Article 12A, by excluding all "services of a routine nature from the scope of Fees for Technical Services (FTS), forced drawing a line between the latter – covered in principle by Article 7 of the DTC– and those other services that, due to their remarkable degree of customization, fell under the scope of application of Article 12A itself.

As already mentioned, the Commentaries, instead of elaborating a conceptual distinction between routine/non-routine or customized/non-customized services, illustrated this difficult distinction by using three examples referring to the development of databases, the provision of insurance services, and financial services. The fundamental problem lies in determining the degree of "customization" of a service that, in turn, allows it to be considered a “technical, managerial, or consultancy” service in the existing parlance.
To this already flared scenario, the new Article 12B added a layer of complexity by circumscribing its scope of application by reference to "automated digital services" that are defined as any service provided on the Internet or another electronic network, in either case requiring minimal human involvement from the service provider. This, in our opinion, is a generic definition, complemented by an exhaustive list exemplifying services that may constitute ADSs and a corresponding negative conflict rule providing that the provisions of Article 12B shall not apply if the payments underlying the income from automated digital services qualify as “royalties” or “fees for technical services” under Article 12 or Article 12A. The Committee must reexamine the tethers of this dilemma and understand that ADS is not the most effective or hands-on solution to wade through this proffered technicality, and the UN framework convention ought to be an enabler to streamline this.

3. Clarity on the UN STTR- The current UN provision has been designed as a model article which states can use as a basis when negotiating for inclusion in bilateral treaties. Because it is not prescriptive, negotiations can result in variations in the language and scope of the actual provision. It specifically leaves open for negotiation: (1) the minimum tax rate that triggers the source state’s right to tax, and (2) any exemptions that may be agreed to as applicable, like collective investment vehicles or pension funds. However, there is a persistent grey area on the matching procedure even in this model. The FTI should ideally have incorporated a matching procedure under which parties sign one or more of the protocols (including the STTR), to signify that they wish to include it in existing bilateral treaties and give the depositary a list of such treaties. The impending framework convention should be accompanied by an additional protocol that requires agreement on a tax rate or other terms (as for the STTR), and States should also be mandated to indicate in their notification list, the rates (or a range of rates) and/or terms of agreement (or alternative terms) they may be willing to accept to formalise the UN STTR. For developing countries

that are still expanding their tax treaty network, including the UN STTR should be a non-negotiable element.

4. Unilateral taxpayer / tax authority disputes- One of our main concerns with the OECD Two-Pillar Solution is the predominance of focus that is placed on how jurisdictions would engage with multilateral dispute resolution processes, with limited focus placed on the resolution of disputes between MNEs and a single tax authority. The UN must believe the potential for disputes over the interpretation and administration of dispute clauses for multilateral complications than a mere bilateral dispute between multiple jurisdictions, will be high. The Committee should endeavour to dedicate a specific section that explicates appropriate mechanisms on tax certainty and dispute prevention/resolution, even where the dispute does not involve multiple implementing jurisdictions.

5. Enhanced transparency on the procedural front- To begin with, developing jurisdictions are likely to be empowered in a UN system that is used to accommodate bloc positions. These could lead to optional protocols or shape the universal content of the framework convention itself through aligned voting. The involvement of diplomatic staff in UN missions is likely to redress some of the deficits in experience and capacity that countries face in OECD bodies. This is already demonstrated by the negotiations on the Resolution itself. Procedural transparency will make it clearer how all countries can influence the Convention's agenda, and give it the 'throughput' legitimacy that neither the current UN or OECD bodies enjoy.

6. Setting substance standards based on work done by the Forum on Harmful Tax Practices under the aegis of OECD Action Plan 5 - The OECD Forum on Harmful Tax Practices (FHTP) has been conducting reviews of preferential regimes since its creation in 1998 in order to determine if the regimes could be harmful to the tax base of other jurisdictions. The current work of the FHTP comprises inter alia the assessment of preferential tax regimes to identify features of such regimes that can facilitate base erosion and profit shifting, and therefore have the potential to unfairly impact the tax base of other jurisdictions and the review of substantial activities requirements in no or only nominal tax jurisdictions to ensure a level

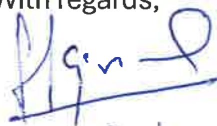
playing field[4]. The UN could build on the work done by the OECD while implementing substance-based exclusions for STTR.

7. Facilitating Reputation-Driven Compliance: A glance at the history of international taxation would reveal that States generally value their reputation for complying with international tax commitments. A bad reputation may discourage other states from concluding treaties with that State or from fulfilling their obligations under the treaty. The conditions required for reputation to actively promote compliance remain absent from the OECD IF and both Pillars. Information about a particular state's compliance with tax treaty obligations is required before reputation can become a constraint. If breaches of tax treaties are either contestable or not generally known, a state's reputation will matter less, relative to other factors. Compliance with tax treaties and other international tax instruments is, generally, not systematically and comprehensively monitored and recorded. The international tax regime does not provide for binding inter-state dispute resolution for most issues, even though such dispute resolution could clarify whether a state's actions are treaty compliant. The Committee has a great chance to resolve this anomaly and must endeavour for an addendum to enable greater, smoother compliances by States.

We look forward to the April session of the Committee and fervently hope for a more palatable, creditable, and incentive-driven stakeholder consultation, especially for States which join the UN bandwagon early during the implementation of the Convention.

We once again, sincerely thank you for the opportunity to present our views, and would be pleased to engage further, should the Committee deem so appropriate.

With regards,



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[4] https://www.oecd.org/tax/beps/beps-actions/action5/