

## COMMENTS BY LORRAINE EDEN ON 7 JUNE 2024 ZERO DRAFT TOR <sup>1</sup>

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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 phrase "where feasible"<sup>1</sup> 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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<sup>1</sup> Adjunct Professor of Law and Professor Emerita of Management, Texas A&M University, College Station, TX, USA, [leden@tamu.edu](mailto:leden@tamu.edu). My comments on UN (2024) are provided in my personal capacity and do not represent the opinions of my employer or other organizations with which I am affiliated. This submission with endnotes and references is available for download at: <https://www.voxprof.com/eden/eden-publications-tp-tax.html>.

- 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 <sup>2</sup> 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.<sup>3</sup>

At the international level, the objective of international tax cooperation should reflect tax principles such as international and inter-nation equity, efficiency<sup>4</sup> 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.<sup>5</sup>

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.<sup>6</sup>
- 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.<sup>7</sup>

## **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.<sup>8</sup> 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.<sup>9</sup>

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.<sup>10</sup>
- A UN public registry of beneficial ownership information of companies, trusts, partnerships, and other legal entities.
- Public reporting<sup>11</sup> 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<sup>12</sup> 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.<sup>13</sup> 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<sup>14</sup>; and (iii) the “BTTs spaghetti bowl” has created tax loopholes that have encouraged significant base erosion and profit shifting (BEPS) activities by MNEs.<sup>15</sup>

After the 2007-2009 global financial crisis<sup>16</sup>, 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.<sup>17</sup>

The MLI, although not an unqualified success, still provides a useful model for multilateral tax cooperation.<sup>18</sup> 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.<sup>19</sup>

However, blaming profit shifting on transfer pricing is akin to “shooting the messenger.”<sup>20</sup> 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.<sup>21</sup> 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.<sup>22</sup>

#### Expanding UN protocols to cover tax

Existing UN protocols could be expanded to cover BEPS activities. For example, the UN Global Compact<sup>23</sup> 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.<sup>24</sup> I have three recommendations:

#### A 21<sup>st</sup> 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.<sup>25</sup>

### 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 21<sup>st</sup> century firms and activities. UN (2021) should include a chapter on "Transfer Pricing of Digital Transactions."<sup>26</sup> 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

Lorraine Eden, PhD  
leden@tamu.edu  
21 June 2024