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ABSTRACT

Illicit Financial Flows generated due to the commercial activities of multinational enterprises are quantitatively the most important challenge faced by developing countries in achieving the Sustainable Development Goals. Current efforts for stemming these illicit flows and reforming the international tax system are however being led by developed countries, with developing country interests poorly reflected in the reform agenda. This research paper highlights the tax issues of great priority for developing countries and how international tax cooperation can contribute to preventing such illicit flows.

Les mouvements financiers illicites causés par les activités commerciales des entreprises multinationales représentent le plus grand obstacle, quantitativement parlant, que rencontrent les pays en développement pour réaliser les objectifs de développement durable (ODD). Les actions entreprises pour y mettre un frein et pour réformer le système fiscal international sont cependant dominées par les pays développés; les intérêts des pays en développement sont donc peu pris en compte dans les réformes. Le présent document de recherche présente les plus grandes priorités fiscales des pays en développement et montre que la coopération internationale en matière de fiscalité peut contribuer à endiguer les mouvements financiers illicites.

Las corrientes financieras ilícitas generadas por las actividades comerciales de las empresas transnacionales son desde el punto de vista cuantitativo el principal obstáculo que enfrentan los países en desarrollo para lograr los Objetivos de Desarrollo Sostenible (ODS).
Sin embargo, los países desarrollados lideran las iniciativas para contener estas corrientes ilícitas y reformar el sistema tributario internacional y el programa de reformas deja prácticamente de lado los intereses de los países en desarrollo. Este Documento de investigación pone de relieve las cuestiones tributarias de suma prioridad para los países en desarrollo y demuestra que la cooperación internacional en cuestiones de tributación puede contribuir a reducir estas corrientes ilícitas.

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I. INTRODUCTION

The concept of "illicit financial flows" (IFF) broke into the global policy consciousness in 2011 with the commissioning of a High Level Panel on Illicit Financial Flows from Africa (led by former South African President Thabo Mbeki) by the Conference of Ministers of Finance, Planning and Economic Development of the African Union and the United Nations Economic Commission for Africa. The panel officially submitted its report[2] in January 2015 – and was almost immediately referred to as "the Mbeki Report" – but consultations within Africa during the preparation of the report heralded the policy significance of the issue. As a result of the staunch effort on the part of African delegations in the United Nations (UN), "illicit financial flows" officially became a global policy concern in July 2015 in the Addis Ababa Action Agenda[3] (Addis Agenda), the outcome document of the Third International Conference on Financing for Development.

Since the end of the dominance of colonial economic relations, developing countries have exerted efforts to restrain the outflow of investible capital from and to ensure their productive placement in the domestic economy. Developing countries are by definition capital-deficient and must devote such limited resources to expand economic activity and employment. The exercise of controls to regulate capital flows (except on those related to current account transactions) is recognized as a sovereign right of member states under Article VI of the International Monetary Fund (IMF)'s Articles of Agreement[4]. The circumvention by private parties of such capital controls became a preoccupation of policy makers and analysts, especially in connection with balance of payments and external debt crises. Often enough, the capital flight[5] was diagnosed as being caused first by corruption or by bad governance and then, by policy errors[6], such as an insistence on fixed exchange rates, instead of relying on market-determined exchange rates.

The Mbeki panel's methodology in the framework of illicit financial flows took a completely different tack on the problem of the diversion of investible resources. Acknowledging the experience of developing countries, it was willing to recognize the problem of the unwelcome transfer of capital as being possible in "normal," non-crisis times, through economic transactions and through the tax system. In fact, developing countries have been experiencing capital diversion even during boom times, including when foreign capital is gushing inward. Under this approach, financial flows can be problematical even if the flows do not contravene regulations; in fact, financial flows can be problematical even if they

[2] Report of the High Level Panel on Illicit Financial Flows from Africa (hereinafter Mbeki report). Available from www.uneca.org/sites/default/files/PublicationFiles/iff_main_report_26feb_en.pdf.

[3] Addis Ababa Action Agenda of the Third International Conference on Financing for Development. Available from www.un.org/esa/ffd/wp-content/uploads/2015/08/AAAA_Outcome.pdf.

[4] International Monetary Fund Articles of Agreement, Article VI, Section 3. Available from www.imf.org/External/Pubs/FT/AA/index.htm.

[5] The Mbeki report (p. 15) differentiated its interest from that of analyses of capital flight, which is driven by governance and macroeconomic factors and "could be entirely licit."

[6] Economic analysis usually generates a "best practice" for every situation without regard to the actual policy context (which is very hard to incorporate in formal models). Not needing to be accountable to an actual policy context means that economic analysis does not need to examine pragmatic policy approaches - thus making it seem that both successful and crisis-ridden developing countries constantly violate best practice when applying practical economic approaches. When macroeconomic crises erupt, these best practices are ideal benchmarks against which to identify "errors," even if crises are of external origin (and, as such, a shared experience among all developing countries).

are legitimated by accounting and through agreements under international law. The ground for this policy viewpoint had been broken in the 2000s by research emanating from groups such as the Global Financial Integrity (GFI) and the Tax Justice Network (TJN). Building on this viewpoint, the Mbeki report, while empirically based on Africa, understood this issue as not specific to Africa and applicable to all other developing regions.

The Mbeki report chose the word "illicit" to designate its agenda, making it possible to add to the well-known evils of illegal transfers from crime, trafficking and corruption the unwelcome and possibly legal transfers of capital in its analytical scope. It defined IFF in Africa as "money illegally earned, transferred or used." This definition recognizes the multi-jurisdictional scope of the IFF issue. For example, a "legal act in one geographical location does not nullify the intent and purpose of such outflows, which is to hide money even if legitimately earned."[7]

The empirical results from the Mbeki report categorizes the scourge of IFF in Africa into three areas: (1) commercial activities, (2) criminal activities and (3) corruption. Existing estimates[8] suggest that quantitatively commercial activities account for 65 per cent of IFFs, criminal activities for 30 per cent and corruption for 5 per cent[9]. Commercial activities originate from business operations (elaborated more below); criminal activities involve illegal or fraudulent acts such as the smuggling of drugs and arms, trafficking of people, forgery, money laundering, and engaging in fraudulent borrowing and lending; corruption concerns proceeds from bribery and abuse of power by government officials. The high level panel classification associated the first source with enterprises and corporations, the second with criminals, and the third with government officials, though in any specific contexts there are interactions among the three.

The Mbeki report estimated that African countries forwent $50 billion annually in IFFs, about the same amount Africa received in Official Development Assistance (ODA) in the same period. Commercial activities constituted about $32.5 billion of this loss; resources that could have been applied to increase spending on education and health and for the expansion of infrastructure needed for development. The shifting of profits among tax jurisdictions using accounting, pricing, through managing flows among controlled subsidiaries are the key aspects of this kind of activity. The Mbeki report recognizes the complexity of differentiating between legitimate use and abuse of tax incentives. The purposes toward which commercial actions are organized help determine which acts generate IFFs. These purposes include the concealing of wealth and the transfer of profits to evade taxes and customs duties.

This paper will examine **only** the commercial activity dimension of IFF and its effects on developing country efforts to achieve the Sustainable Development Goals (SDGs) included in the 2030 Agenda for Sustainable Development (Agenda 2030). It will do so by analyzing the current state of play in the international tax policy and standard setting regime which currently focuses in standards and practices preferred by the Organisation for Economic Co-operation and Development (OECD) and contrast them with new efforts and

[7] Mbeki report, p. 23.

[8] Dev Kar and Devon Cartwright-Smith, 'Illicit Financial Flows from Africa: Hidden Resource for Development', Global Financial Integrity, 2010. Available from www.gfintegrity.org/wp-content/uploads/2014/05/gfi_africareport_web.pdf.

[9] Mbeki report, p. 24.

approaches proposed by the UN tax committee, and other innovations coming from the Global-South. It will also examine the developing countries' efforts to tackle the threats of IFFs in specific economic sectors, and it concludes by listing a number of policy advices developing countries could consider in order to shift the balance of decision making in the international tax regime towards a more inclusive and fair global agenda in the fight against IFFs.

II. The International Tax System, Illicit Financial Flows and Agenda 2030

In September 2015, the community of nations in the United Nations agreed on the adoption of Agenda 2030, which consists of a plan of action organized around 17 goals and 169 targets[10] denominated as the Sustainable Development Goals (SDGs). Target 16.4 of these SDGs aims to significantly reduce IFFs by 2030. Similarly, during the Third International Financing for Development Conference held in Addis Ababa from 13-16 July 2015 developed countries took the negotiating position that the Addis Ababa Action Agenda (AAAA)[11] should constitute the main and sole means of implementation (MoI) to achieve the SDGs, and therefore the outcome document did not feature new sources for financing for development, making mobilization of domestic financial resources even more vital for developing countries.

During negotiations that led to the outcome of Agenda 2030, countries recognized that each country has primary responsibility for its own economic and social development, and the means required for implementing the SDGs will include the "mobilization of financial resources as well as capacity building…"[12]. This means that in order to fund their developmental needs, countries need to generate resources through domestic revenue mobilization, including through increasing their tax base. IFFs erode the tax base of countries, which can be used for meeting the national development goals and therefore are one of the biggest challenges currently faced by countries in their national development efforts. There is a very real negative impact due to the IFFs on the development needs of a country, and its ability to provide much needed public services such as infrastructure and healthcare, which could be financed by the money that the country loses due to IFFs. For example, one study found that the revenue lost due to IFFs and tax incentives in Malawi would have been sufficient to provide the minimum public health package for all Malawians.[13]

1. Effects of IFFs in achieving SDGs

IFFs are the most visible indicator that the current international tax system is broken. The current system has been built on top of a system of taxing business enterprises that was created when most transactions occurred within imperial trading blocs. In this system, it did not matter very much to colonial powers whether they collected their levies in the home country or in their colonies. Now, these colonies have become independent countries and thus, independent tax jurisdictions. The structure of multiple tax jurisdictions provides the platform on which enterprises operating internationally are able to transfer their wealth and profits to reduce their tax liabilities. It is a system that is structurally unable to keep up with

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[10] United Nations General Assembly (UN GA) Resolution, *Transforming our world: the 2030 Agenda for Sustainable Development* (UN Doc A/RES/70/1), 21 October 2015.

[11] Outcome document adopted at the Third International Conference on Financing for Development endorsed by the General Assembly Resolution 69/313 (27 July 2015).

[12] UN GA Resolution on 'Transforming our world: the 2030 Agenda for Sustainable Development', A/RES/70/1, para. 41.

[13] B O'Hare and M Curtis, 'Health spending, illicit financial flows and tax incentives in Malawi', *Malawi Med J.* 2014 Dec; 26(4): 133–137. Available from www.ncbi.nlm.nih.gov/pmc/articles/PMC4325349/.

rapid globalization and rise of Multinational Enterprises (MNEs) in the 21st century, or to secure the resources that public authorities need to fulfill their obligations to improve the lives of their citizens. By avoiding having to pay their fair share of taxes in the countries where they make the profits, MNEs deprive countries, especially developing countries, of much needed revenue, which is in turn leading to rising global inequality, poverty and significant obstacles to ensuring sustainable development and growth.

It seems preternaturally optimistic to assume that a tax system created in the early 20th century would be able to foresee or adapt itself to a globalized world with deep economic linkages among countries. Current global economy is populated with vast corporate entities having business operations across many jurisdictions, and as research by Global Justice Now shows, out of the top 100 economies in the world, 69 are corporations.[14] With their annual revenues exceeding the gross domestic product (GDP) of many developing and even some developed countries, MNEs are in a very strong position to influence and even subvert the global rules that govern their business operations.

International rules were created by States primarily to avoid double taxation of the same income by all the territories in which the business operated. These rules are still enforced under bilateral tax treaties called Double Taxation Avoidance Agreements (DTAAs). However, these rules to prevent double taxation can, and have been abused by companies to ensure 'double non-taxation'[15]. Efforts aimed at fixing this 'broken international tax system' have gained a lot of attention in the last few years, with international organizations, groups of countries and non-governmental entities playing a role. The call has been for achieving 'global tax justice', with many options being put forth by various stakeholders towards its realization.

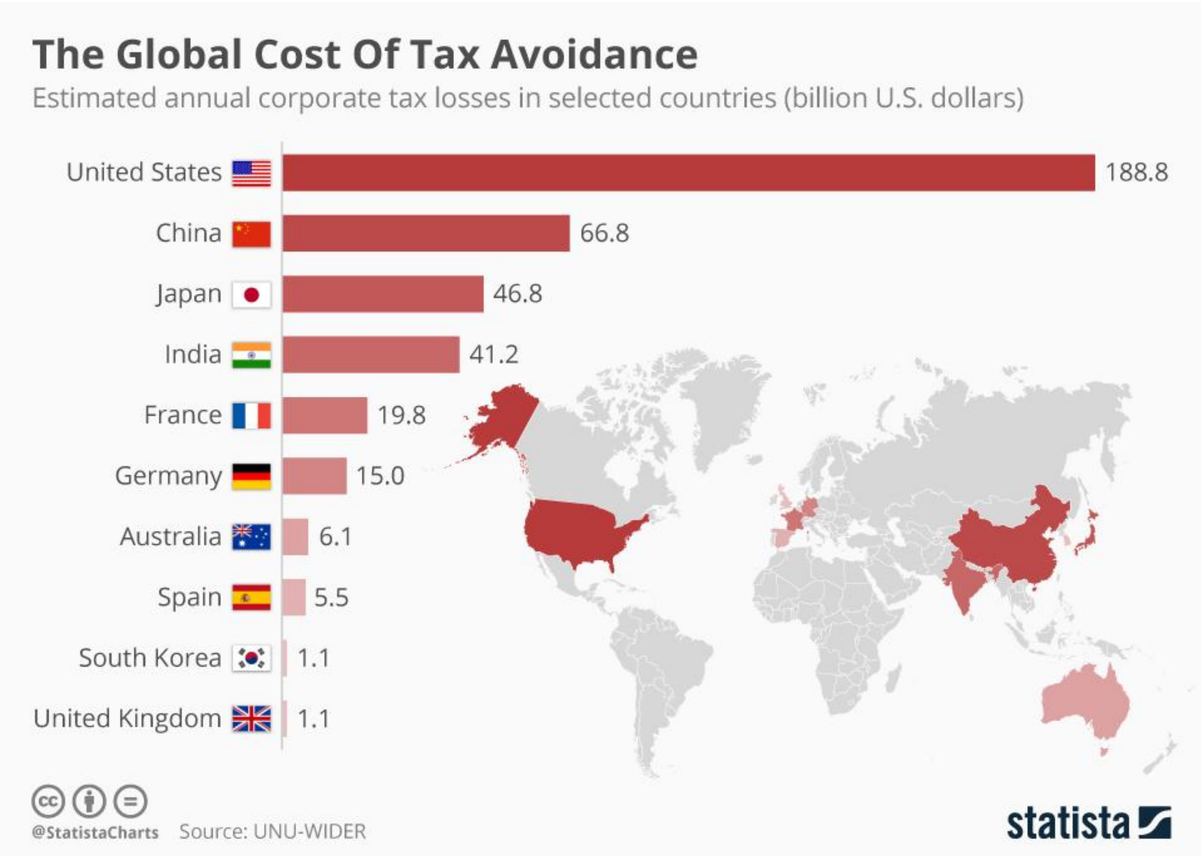
There are a multitude of factors which enable and facilitate IFFs in developing countries, least of which is the structure of the international financial system which makes it lucrative for participants to perpetuate it at the cost of urgent developmental concerns. In the name of business efficiency, MNEs can set up shell companies and other legal entities in offshore jurisdictions which provide preferential tax regimes to such enterprises. Tax planning is done depending on the business carried on by the MNE and the country where the profits are being made, and dummy entities are set up for the sole purpose of avoiding tax in the territory where the profits are generated. The proceeds from such activity however rarely directly benefits the tax haven, as the money is then shifted out to other countries to be used for making further investments. However, by routing it through the offshore jurisdiction, the money trail gets obfuscated, and it becomes next to impossible to trace the origin of the funds. When the flows are a result of corruption or illegal activities, there is an incentive to use and secure these channels. This is despite the fact that fully legitimate and publicly sensitive corporations are their biggest users; after all, there is honor among the highest corporate managers, corrupt government officials, and international criminals in the defense of these channels.

[14] Duncan Green, 'The world's top 100 economies: 31 countries; 69 corporations,' 20 September 2016. Available from https://blogs.worldbank.org/publicsphere/world-s-top-100-economies-31-countries-69-corporations.

[15] Out-law.com, 'EU to formally investigate 'double non-taxation' of McDonalds in Luxembourg,' 4 December 2015. Available from www.out-law.com/en/articles/2015/december/eu-to-formally-investigate-double-non-taxation-of-mcdonalds-in-luxembourg/.

Once these funds are funneled out of the country, there is very little scope of bringing them back. The unavailability of a mechanism for the repatriation of such funds has been also highlighted by UN experts as being harmful to human rights in the country where they originated from.[16] IFFs thus end up depriving governments of the resources they need to fund programs that contribute to the realization of economic, social and cultural rights, and to establish and strengthen the institutions for the protection and promotion of civil and political rights.

Estimated Corporate Tax Avoidance in Selected Countries[17]



'Commercial IFFs' tend to result from the abuse of generally accepted legal and accounting standards by MNEs looking to shift their profits across jurisdictions and erode their taxable base in the source country where the profits were made. While the effects of commercial IFFs are felt across all countries where the MNE has its business operations, their impact varies from country to country, with developing countries being particularly hard hit. The role of multinational companies in generating these IFFs thus merits a closer look for several reasons.

[16] UN, Report on the negative impact of the non-repatriation of funds of illicit origin on the enjoyment of human rights, A/HRC/25/52.

[17] Based on Alex Cobham and Petr Janský, 'Global distribution of revenue loss from tax avoidance: Re-estimation and country results,' UNU-WIDER Working Paper 2017/55. Available from www.wider.unu.edu/sites/default/files/wp2017-55.pdf. Chart available from www.statista.com/chart/8668/the-global-cost-of-tax-avoidance/.

First, there is an entire global industry that exists for the sole purpose of facilitating these kinds of capital flows. Composed of financiers, lawyers, accountants and administrations of specific territories with low taxes (or as they are popularly known, tax havens), this so called "tax planning" industry is structured to enable and facilitate financial outflows and hide the true identity of the ultimate beneficiaries.[18] Identifying and regulating commercial IFFs is especially problematic since many of the activities which create them also fall under the scope of regular activities of a multinational business enterprise, and are not illegal or illicit by themselves. While specific international regimes have been developed to combat IFFs due to corruption and criminal activities, the lack of similar relevant international regulations and the sheer scale of commercial IFFs require that more attention be specifically given to it.

There is a thin line which differentiates regular business activities from illicit ones, and this lack of clearness is very prone to abuse by the tax planning industry. For example, identifying and quantifying capital flows across a group of companies is exceptionally hard, since transfer mis-invoicing typically occurs when a company over-invoices its imports and under-invoices its exports, or sometimes simply fakes the trade invoices. Thus, any profits that were made get implicitly transferred to another jurisdiction, without such capital flight being recorded as part of the trade. While there are many ways in which the profits made by a MNE are shifted out, some of the more commonly practiced means for facilitating commercial IFFs include trade mis-invoicing, abuse of transfer pricing regulations, excessive interest deductions by thinly capitalized subsidiaries, inflated value of unique intangibles and use of offshore financial and banking facilities for tax evasion.[19]

Such IFFs are sometimes defended as being part of a legal strategy of tax avoidance or "aggressive tax planning", which would allow companies to minimize their tax burdens. The argument often brought out in its support is that it is completely in line with the law, and companies often use it to justify that they "pay all the taxes that they owe".[20] However, the disingenuousness of this argument becomes quickly apparent when one considers that corporate tax avoidance relies on an entire industry of highly paid experts to find loopholes in the tax laws and subvert their spirit and intention, if not the actual text. The effects of such tax avoidance practices were also highlighted by UK courts in the early 1980s when they laid down the *Ramsey Principle*[21].

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[18] Madison Marriage, 'Multinationals avoid up to £5.8bn in UK tax, HMRC finds', *Financial Times*, 24 October 2017. Available from www.ft.com/content/00de4f00-b754-11e7-8c12-5661783e5589.

[19] United Nations Economic Commission for Africa (UNECA), Illicit Financial Flows Factsheet. Available from www.regionalcommissions.org/ifffactsheet.pdf.

[20] Reuters, 'Tim Cook calls notion of Apple avoiding U.S. taxes 'political crap'', 18 December 2015. Available from www.reuters.com/article/us-apple-taxes-idUSKBN0U12C920151218.

[21] The Ramsey Principle essentially holds that in cases where a transaction has no commercial purpose other than to save tax, the proper approach is to tax the effect of the transaction as a whole, and not as it has been arranged. It was developed by the House of Lords in the cases of W. T. Ramsay Ltd. v. Inland Revenue Commissioners, Eilbeck (Inspector of Taxes) v. Rawling, [1982] A.C. 300 and Inland Revenue Commissioners v. Burmah Oil Co. Ltd., [1982] S.T.C. 30, H.L.(Sc.). The principle was further extended by the 1984 decision in Furniss (Inspector of Taxes) v. Dawson D.E.R., Furniss (Inspector of Taxes) v. Dawson G.E., Murdoch (Inspector of Taxes) v. Dawson R.S., [1984] A.C. 474; thereby effectively putting an end to the approach taken in the Duke of Westminster case (Inland Revenue Commissioners v. Duke of Westminster [1936] A.C. 1), which allowed minimizing taxes as long as the methods employed were legal.

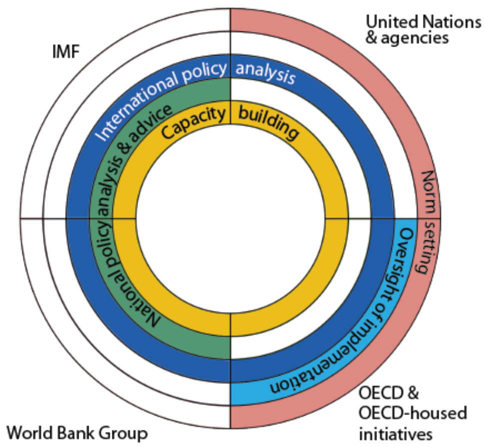
The other argument brought in support of these activities is that they promote business efficiency and by minimizing their tax burdens, companies would have more revenue to invest and create more jobs and economic growth. This line of thought however ignores certain vital issues. First, there is no general fiduciary duty on a business to minimize its taxes in any jurisdiction, thereby making tax avoidance a wilful choice made by the company. Second, small and medium enterprises generally cannot afford to engage the services of these expensive tax planners. As an UN Special Rapporteur has observed, "large corporations have a far greater ability to evade or avoid taxes as they are able to pay tax advisers or able to open undeclared foreign bank accounts in low-tax jurisdictions."[22] So achieving business efficiency, as put forth in the argument, is an exclusive domain of the rich MNEs.

2. Existing international efforts to reduce IFFs

One of the main messages from the Mbeki Report was that "IFFs are not only an African problem but are indeed a matter of global governance that calls for a wide range of actions, including at the level of the global financial architecture."[23] This message was also reiterated in the Addis Agenda, where governments agreed to "redouble efforts to substantially reduce illicit financial flows by 2030, with a view to eventually eliminating them, including by combating tax evasion and corruption through strengthened national regulation and increased international cooperation."[24]

There are several reform initiatives taking place at the multilateral, regional and national levels which are resulting in innovative tax policies which can help stem IFFs. At the multilateral level, work on creating norms for international tax policy is currently being undertaken at the OECD and the UN, while the Bretton Woods Institutions (World Bank Group and International Monetary Fund) play a role in policy analysis and capacity building.

Role of International Organizations in International Tax Cooperation[25]



[22] UN, Illicit Financial Flows, human rights and the post-2015 development agenda, A/HRC/28/60, para. 26.
[23] Mbeki Report, p. 21.
[24] Finance for Development (FfD) 3rd Conference Outcome Document, para. 23. Available from www.un.org/esa/ffd/wp-content/uploads/2015/08/AAAA_Outcome.pdf.
[25] From the website of the Inter-Agency Task Force on Financing for Development (IATF). Available from https://developmentfinance.un.org/international-tax-cooperation-overview.

For the OECD, a major focus area in international taxation is that of Base Erosion and Profit Shifting (BEPS), which refers to "tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity."[26] A significant impetus for its current work on international taxation was given by the endorsement of the Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan) by the Group of Twenty (G20) leaders in Saint-Petersburg in September 2013[27]. Subsequently, in 2015, the G20/OECD Project on Base Erosion and Profit Shifting (BEPS Project) came out with its 15 Action Points comprising the "BEPS Package" that "could act as standards applicable to all countries", and was given a ringing endorsement by the G20 countries. While a lot of international attention has been focused thereafter on the BEPS Project, IFFs have not been directly included in any of its listed Action points and have consequently not been specifically considered by the OECD in its policy recommendations.

It has been argued that BEPS cannot be equated to IFFs in terms of international tax law norms for several reasons, including their nature and the type of legal solutions required for resolving them.[28] However, because of its sheer scope, the BEPS Package may have the ability to influence the creation of norms that can help countries stem IFFs and preserve their tax base. The Package covers an array of issues within its 15 Action Points and creates four minimum standards on the topics of countering harmful tax practices more effectively, taking into account transparency and substance (Action 5); preventing the granting of treaty benefits in inappropriate circumstances (Action 6); transfer pricing documentation and country-by-country reporting (Action 13); and making dispute resolution mechanisms more effective (Action 14); all issues where inaction by some countries would have resulted in negative spillovers[29]. These minimum standards are sought to be implemented and monitored by the use of a peer review mechanism. The other issues covered under the Package includes the tax challenges of the digital economy (Action 1), hybrid mismatches (Action 2), Controlled Foreign Company (CFC) rules (Action 3), limiting excessive interest deductions and other financial payments (Action 4), permanent establishment (Action 7), transfer pricing (Action 8 – 10, 13), BEPS data analysis (Action 11), disclosure of aggressive tax planning (Action 12) and a multilateral instrument for the implementation of BEPS related treaty measures (Action 15).[30]

The implementation of the BEPS Package as a whole has been actualized through the formation of an 'Inclusive Framework on BEPS', which has the mandate to review the implementation of the BEPS minimum standards; gather data for monitoring other aspects of implementation; finalize the remaining work to address BEPS challenges; and support

[26] OECD, About BEPS.. Available from www.oecd.org/tax/beps/beps-about.htm.

[27] G20, Tax annex to the St. Petersburg G20 Leaders' Declaration, September 2013.. Available from www.oecd.org/g20/summits/saint-petersburg/Tax-Annex-St-Petersburg-G20-Leaders-Declaration.pdf.

[28] Annet Wanyana Oguttu, 'Tax Base Erosion and Profit Shifting in Africa – Part 1: Africa's Response to the OECD BEPS Action Plan', ICTD Working Paper 54, June 2016, p.15.. Available from http://www.ictd.ac/publication/tax-base-erosion-and-profit-shifting-in-africa-part-1-africa-s-response-to-the-oecd-beps-action-plan/.

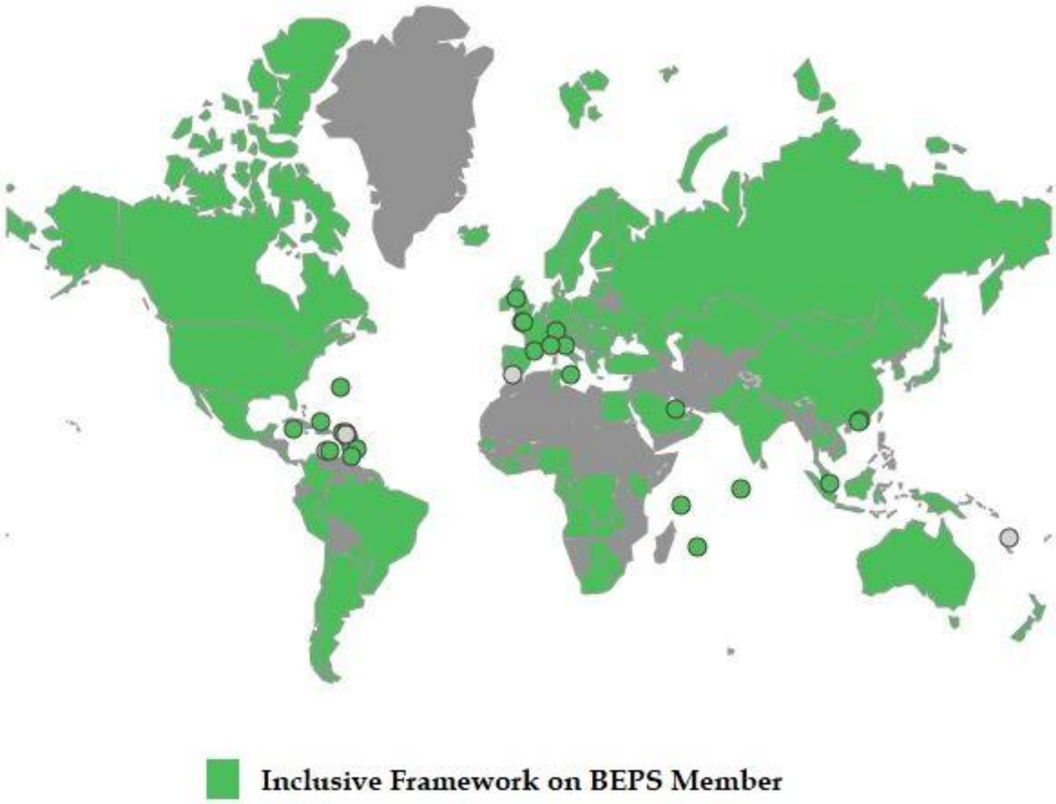
[29] BEPS Explanatory Statement, 2015, p. 6.. Available from www.oecd.org/ctp/beps-explanatory-statement-2015.pdf.

[30] For a discussion on BEPS issues in the context of developing country interests, see Marcos Valadao, International Tax Cooperation in an Interdependent and Unequal World: The Contemporary International Tax System, BEPS and Other Issues, South Centre Tax Cooperation Policy Brief (*forthcoming*).

jurisdictions in their implementation of the BEPS package.[31] The Inclusive Framework currently has 117 members and six Observers (August 2018).[32]

Developing countries have been invited to participate in the meetings of the Inclusive Framework as 'BEPS Associates', which requires them to agree to implement the comprehensive BEPS Package, as well as pay an annual member's fee to cover the costs of the framework, in exchange for being able to take part in the standard setting on an 'equal footing' with the BEPS-44 Group (consisting of OECD member states and non-OECD G20 members). However, at this stage of the process, it is questionable what standards still remain open for negotiations in which developing countries can participate as 'equals'. This has given rise to several legitimacy concerns[33] regarding the whole process, especially considering how these developing countries are now being asked to implement standards that were created without their input or participation.[34]

Global Membership in Inclusive Framework[35]



[31] OECD/G20 Inclusive Framework on BEPS Progress report July 2017-June 2018. Available from www.oecd.org/tax/beps/inclusive-framework-on-beps-progress-report-july-2017-june-2018.pdf.
[32] OECD, Members of the Inclusive Framework on BEPS. Available from www.oecd.org/ctp/beps/inclusive-framework-on-beps-composition.pdf.
[33] Sissie Fung, 'The Questionable Legitimacy of the OECD/G20 BEPS Project', *Erasmus Law Review*, 2, (2017):76-88.
[34] Irene Burgers and Irma Mosquera, 'Corporate Taxation and BEPS: A Fair Slice for Developing Countries?', *Erasmus Law Review*, 1, (2017):29-47.
[35] Available from http://compareyourcountry.org/tax-cooperation?cr=oecd&lg=en&page=2&visited=1#.

The United Nations also plays a vital role in maintaining standards for international tax policy, with its work being especially significant for developing countries. The UN Committee of Experts on International Cooperation in Tax Matters (UN Committee), which functions under the UN Economic and Social Council (ECOSOC)[36], is tasked with providing a framework for dialogue for promoting international tax cooperation considering the impacts of new and emerging issues. The Committee has a long history, having originally been set up in 1968 as the 'Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries'[37], and then as the 'Ad Hoc Group of Experts on International Cooperation in Tax Matters'[38], before arriving at its current avatar. The Committee is composed of 25 members, with 15 members from developing countries, who are tax experts and administrators nominated by their countries, but serving in their personal capacity.[39]

The Committee currently has 6 sub-committees, working on Article 9 of the UN Model Tax Convention; BEPS; negotiation of tax treaties; exchange of information; extractive industries taxation issues for developing countries; and tax treatment of services. In addition, it has also set up an advisory group on capacity development. The work of the Committee is of high importance to developing countries since its terms of reference require it to "give special attention to developing countries and countries with economies in transition…"

Under the UN system, the different components of IFFs, as delineated by the Mbeki report, have been considered under separate inter-governmental processes. The early 2000s saw the ratification of the UN Convention against Transnational Organized Crime, and the UN Convention against Corruption which included provisions enabling countries to fight IFFs occurring due to transnational criminal activities and corruption respectively. However, till date there have been no discussions for the creation of an international legal instrument which could help stem commercial IFFs.

The issue of IFFs as a whole remains significant within the UN system, considering its inclusion in the SDGs and specific resolutions being passed by the UN General Assembly for "Promotion of international cooperation to combat illicit financial flows in order to foster sustainable development"[40]. In the context of Financing for Development, the Inter-Agency Task Force[41] covers IFFs as part of its mandate.[42] Other UN agencies are also working in this area, with recent consultations being organized for developing possible statistical approaches for measuring the total value of inward and outward IFFs under the SDG Indicator 16.4.1.[43]

During the negotiations toward the outcome of the Addis Agenda, there was strong interest on the part of many developing countries for the IMF to apply its technical expertise

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[36] ECOSOC Resolution 2004/69
[37] ECOSOC Resolution 1273 (XLIII) of 4 August 1967
[38] ECOSOC Resolution 1980/13 of 28 April 1980
[39] Available from www.un.org/esa/ffd/tax/overview.htm.
[40] UN GA Resolution A/RES/71/213
[41] Inter-agency Task Force on the follow-up to the Financing for Development outcomes and the means of implementation of the 2030 Agenda for Sustainable Development (IATF on FfD)
[42] Available from https://developmentfinance.un.org/about-iatf.
[43] United Nations Office on Drugs and Crime (UNODC)-United Nations Conference on Trade and Development (UNCTAD) Expert Consultation on the SDG Indicator on Illicit Financial Flows. Available from www.unodc.org/unodc/en/data-and-analysis/statistics/expert-consultation-iff.html.

towards the identification and measurement of IFFs. However, both the IMF and World Bank have been extremely reticent on working on the issue since Addis. Given that the concept of IFFs is an official category within the UN's Financing for Development process, and that the Bretton Woods institutions work on issues of great interest to their developing country constituencies, they have so far been publicly 'missing in action' in engaging with the issue.

In addition to the ongoing processes at the UN and the OECD, many countries and regional groups have also been quite innovative in their efforts to enact policies to reduce IFFs, especially in the context of reforms on tax standards and practices. However, some analysts such as Raymond Baker[44] have raised concerns that tax reforms would be unable to solve the issue of IFFs, and instead recommend that strong domestic legislation and practice against trade mis-invoicing will be more effective in curbing IFFs. The next section therefore looks at the work being undertaken in some of the important issue areas at the multilateral, regional and national levels, and examines how this could help inform developing country efforts to fight and limit the negative impacts of IFFs on their economy and development.

[44] Raymond Baker et al, 'Hiding in Plain Sight, Trade Misinvoicing and the Impact of Revenue Loss in Ghana, Kenya, Mozambique, Tanzania, and Uganda: 2002-2011', May 2014. Available from www.gfintegrity.org/wp-content/uploads/2014/05/Hiding_In_Plain_Sight_Report-Final.pdf.

III. International Tax Policy and Developing Countries' Efforts to Tackle IFFs

In 1990, the South Commission clearly identified tax reform as one of the challenges facing the Global South, noting that "The amount of tax revenue a government can raise is clearly dependent on the productivity of the economy and is also influenced by its own administrative capabilities."[45] Over 25 years later, the Addis Agenda also recognized that "domestic resources are first and foremost generated by economic growth, supported by an enabling environment at all levels." But the scale of the challenges has increased manifold in the intervening years, and as it was famously observed, achieving the SDGs would require a movement from 'billions to trillions'.[46]

The ability of countries to achieve the SDGs will depend on how effectively they can mobilize their tax authorities for revenue generation. But this first requires stemming the losses that they incur due to IFFs and the broken international tax system. In the ongoing efforts on global tax reform, issues having a high priority for developing countries have not been adequately reflected in the international agenda or the discussions. This is further exacerbated by the fact that most of the reforms in international tax policy seem to be emerging from the OECD, rather than a multilateral platform which would allow for equal participation by developing and least developed countries (LDCs) in the agenda setting. Instead, developing countries and LDCs have been invited into these OECD hosted discussions only at the implementation stage, thereby losing out on the possibility of being able to influence and set the agenda and decision making processes. Without the active participation of developing countries in its discussions, the OECD is, as José Antonio Ocampo observes, "a weak surrogate for a globally representative intergovernmental forum."[47]

The OECD report to the G20 identified certain BEPS issues as being of most relevance to developing countries, which include excessive or unwarranted payments to MNE affiliates; supply chain restructuring to move profits to low tax jurisdictions; lack of relevant information to assess and fight BEPS; and abuse of bilateral tax treaties. The listed topics however disregard some priority areas of developing countries, including IFFs and demonstrate the need for having their greater participation in setting the agenda of the reform processes.

Beyond the people and legal entities involved in enabling IFFs, there are also several regulatory frameworks and practices hampering the development of effective mechanisms to fight them. Key facilitators of IFFs in this regard are the vast network of tax treaties; the commonly used transfer pricing methods, which fail to capture the reality of how modern MNEs function; the development of offshore territories as havens for corporate and financial

[45] South Commission, *The Challenge to the South* (Oxford University Press, 1990), p.124.
[46] "From Billions to Trillions: Transforming Development Finance, Post-2015 Financing for Development: Multilateral Development Finance". Available from http://siteresources.worldbank.org/DEVCOMMINT/Documentation/23659446/DC2015-0002(E)FinancingforDevelopment.pdf.
[47] José Antonio Ocampo, 'A Defeat for International Tax Cooperation', Project Syndicate, 4 August 2015. Available from http://cgt.columbia.edu/news/ocampo-a-defeat-for-international-tax-cooperation/.

secrecy; and the limited capacity in tax administrations to check the ongoing abusive practices.

Tax used to be a sovereign issue for individual states, but with globalization, it has gained intrinsically global dimensions. However, tax administration in developing countries has not evolved with the same pace, and this is imposing substantial losses in their efforts to mobilize domestic revenue. For developing countries, there is also an urgent need to stem IFFs from specific areas, such as the extractive industry and technical services sectors. In addition, development of new methods to curtail commercial IFFs, such as increasing the exchange of tax-related information between countries and transitioning towards single entity approaches would also deliver significant benefits for developing countries. The emergence of new technologies and the digitalization of the economy will be the big future challenge for revenue authorities, necessitating the creation of an entire new set of tax rules to ensure that a fair share of taxes is paid by the enterprises benefiting from the new digital economy.

The following sections explore some of the major areas which rank highly among developing country priorities, especially given that they can contribute to generating IFFs in these territories. They also explore some of the reform efforts that are being considered and undertaken at the national, regional and multilateral levels in order to stem revenue loss due to commercial IFFs.

1. International tax treaties

The different kinds of treaties governing international tax relations include bilateral treaties like DTAAs and Tax Information Exchange Agreements (TIEAs); and multilateral treaties such as the Convention on Mutual Administrative Assistance in Tax Matters, and the very recent 'Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS', which entered into force on 1st July 2018. The current bilateral treaty network of DTAAs spans more than 3000 treaties[48] that have been signed between countries since 1872.[49] Many of these treaties fail to reflect contemporary realities of how business enterprises operate, and remain open to abuse by MNEs engaging in 'profit shifting'[50]. Research[51] however shows that there has been a shift in the treaty models being followed by developing countries in recent years, with a move towards source based taxation, and lowering the threshold required for permanent establishment, thereby allowing host countries to broaden their tax base and facilitating greater mobilization of national resources.

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[48] Brian J. Arnold, An introduction to tax treaties. Available from www.un.org/esa/ffd/wp-content/uploads/2015/10/TT_Introduction_Eng.pdf.

[49] The first recorded international tax treaty was signed in 1872 between Great Britain and the Canton of Vaud, Switzerland. See Sunita Jogarajan, 'The Conclusion and Termination of the 'First' Double Taxation Treaty', *British Tax Review*, Vol. 3 (2012); U of Melbourne Legal Studies Research Paper No. 604. Available from https://ssrn.com/abstract=2154760.

[50] According to the OECD, profit shifting is the "Allocation of income and expenses between related corporations or branches of the same legal entity (e.g. by using transfer pricing) in order to reduce the overall tax liability of the group or corporation." Available from www.oecd.org/ctp/glossaryoftaxterms.htm.

[51] Martin Hearson, 'Measuring Tax Treaty Negotiation Outcomes: The ActionAid Tax Treaties Dataset', ICTD Working Paper 47, February 2016. Available from http://www.ictd.ac/publication/measuring-tax-treaty-negotiation-outcomes-the-actionaid-tax-treaties-dataset/.

In informing the content of the DTAAs, one of the main instruments relied upon by OECD members states is the OECD Model Tax Convention. In 1963, the final report of the OECD Fiscal Committee[52] gave a "Draft Double Taxation Convention on Income and Capital", which was subsequently published as the Model Convention in 1992. The standards in OECD models contained provisions which were used to negotiate many DTAAs by Member States of the OECD. This created an imbalance when these OECD Members signed treaties based on this model with developing countries, since the interests of developing countries were not adequately represented by it. According to the IMF, the network of treaties using OECD standards is twice as harmful to developing countries as they are twice as dependent on corporate income taxes as OECD countries for financing their development requirements.[53]

Treaties to avoid double taxation can significantly restrict the right of countries to tax business profits at their source, which is the economic activity being undertaken in their territory. This preference for residence based taxation has severely hampered developing country efforts to have fair taxation of the profits being generated there, since they largely remain net capital importers. These treaties can also be used by MNEs to facilitate IFFs out of the source countries, since these treaties allocate the right to tax the profits to the country of residence of the company, which can be a low or no tax jurisdiction. Thus, an instrument to prevent double taxation of the same profits is being misused in order to access 'double non-taxation' instead.

One possible reason why DTAAs proliferated between developed and developing countries was the suggestion that it would help bring more investment into developing countries.[54] However, there is very weak empirical evidence[55] to show that signing DTAAs brings any greater foreign investment inflows for developing countries. DTAAs do however tend to focus investors' attention to countries which have the most favorable tax treaties with the host country, and investments start being routed through those countries in order to benefit from such preferential terms. This is known as 'treaty shopping', whereby investments get routed through jurisdictions which have treaties offering the most beneficial terms. For example, in India, a large number of foreign investments were being routed through Mauritius to take advantage of the India – Mauritius DTAA. However, after the DTAA between both countries was renegotiated[56], Mauritius saw a decline in the number of company incorporations for investing into India, with investors increasingly preferring to go to the Netherlands instead.[57]

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[52] The Fiscal Committee was originally set up under the Organisation for European Economic Co-operation (OEEC) in 1956. The OEEC subsequently became the OECD in 1961.

[53] IMF Policy Paper, Spillovers in International Corporate Taxation, May 2014. Available from www.imf.org/external/np/pp/eng/2014/050914.pdf.

[54] IMF, Spillovers in International Corporate Taxation, May 9, 2014, p.25..

[55] See Manuel Montes, 'The Impact of Foreign Investor Protections on Domestic Inequality', Initiative for Policy Dialogue, Working Paper #311, January 2018. Available from http://policydialogue.org/publications/working-papers/the-impact-of-foreign-investor-protections-on-domestic-inequality-1/.

[56] The renegotiation of the bilateral treaty between Mauritius and India, in great part due to the initiative of Mauritius, speaks to the potential of developing countries resolving cross-jurisdiction pitfalls in tax policies among themselves.

[57] International Tax Review, 'Netherlands grows as preferred holding jurisdiction for hosting Indian investments', 4 July 2017. Available from www.internationaltaxreview.com/Article/3730074/Netherlands-grows-as-preferred-holding-jurisdiction-for-hosting-Indian-investments.html. See also Suraj Jaiswal, 'Is

In many cases, the domestic tax regime of the jurisdiction, rather than the treaty itself also plays a role in determining the investment route. This is due to the existence of the Most Favored Nation (MFN) clause, which allows an entity to benefit from the most preferential or favorable terms available to similar taxpayers under other DTAAs. For example, in a recent case in South Africa, a Swedish company was allowed to claim benefits from preferential terms included in the South Africa – Kuwait tax treaty, given that the South Africa – Sweden tax treaty included a MFN provision.[58] Since DTAAs are bilateral in nature, countries would have to renegotiate and update all of their existing DTAAs containing MFN clauses to prevent the misuse of this provision.

Thus, instead of targeting direct renegotiations of bilateral DTAAs, the OECD has pushed for a multilateral instrument which would be able to modify existing bilateral tax treaties without having to renegotiate each treaty individually. Under BEPS Action 15, the aim of this multilateral instrument is to "streamline the implementation of the tax-treaty related BEPS measures"[59]. With its entry into force, this instrument is expected to implement minimum standards for countering treaty abuse and improving dispute resolution mechanisms. As this is a multilateral legal instrument which will impact the working of bilateral DTAAs, it provides signatories with certain flexibilities, such as allowing them to specify the tax treaties to which the convention would apply, use different approaches to meet the minimum standard, and opt out of the complete or partial application of certain provisions[60]. In addition, the OECD has also proposed changes in its Model, which would prevent entities from claiming treaty benefits in inappropriate circumstances.

Assisting developing countries in their tax treaty negotiations has been part of the work undertaken by the UN Committee. To this end, it has produced extensive support materials to help developing country officials during treaty negotiations. The materials include the UN Manual for the Negotiation of Bilateral Tax Treaties and the Handbook on Selected Issues in Administration of Double Tax Treaties among others. These materials are instructional in nature, and allow countries to adopt better informed positions when negotiating tax treaties, especially with regard to the significant costs that such treaties can entail.

Countries as diverse as Uganda, Germany, Indonesia, Argentina and Mongolia have all terminated or renegotiated their tax treaties, noting the deliberate tax costs of such treaties, and the associated cost of such treaties being utilized for shifting profits and reducing the tax base in the country.[61] With the multilateral instrument coming into force, expanding

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Netherlands Becoming the New 'Mauritius Route' for FDI Flows Into India?', The Wire, 20 April 2018. Available from thewire.in/macro/is-netherlands-becoming-the-new-mauritius-route-for-fdi-flows-into-india.

[58] South Africa Revenue Service, Binding Private Ruling 276, 28 June 2017. Available from www.sars.gov.za/AllDocs/LegalDoclib/Rulings/LAPD-IntR-R-BPR-2017-20%20-%20BPR%20276%20Dividends%20tax%20and%20the%20most%20favoured%20nation%20clause%20in%20a%20tax%20treaty.pdf.

[59] BEPS Action 15 Final Report, p. 9.. Available from www.oecd.org/tax/developing-a-multilateral-instrument-to-modify-bilateral-tax-treaties-action-15-2015-final-report-9789264241688-en.htm.

[60] Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.. Available from www.oecd.org/tax/treaties/explanatory-statement-multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf.

[61] Martin Hearson and Jalia Kangave, 'A Review of Uganda's Tax Treaties and Recommendations for Action', ICTD Working Paper 50, March 2016.. Available from http://www.ictd.ac/publication/a-review-of-uganda-s-tax-treaties-and-recommendations-for-action/.

exchange of tax information and development of greater capacity among developing countries to better negotiate their tax treaties, it will be interesting to see if the DTAAs remain prone to abuse by MNEs in the coming years.

2. Transfer pricing methods

Transfer pricing (TP) refers to the setting of prices for cross-border, intra-firm transactions between associated enterprises involving the transfer of property or services.[62] TP has been a key concern for many developing countries fighting IFFs and BEPS issues, since trade mispricing and abusive transfer pricing account for the majority of commercial IFFs. The importance of TP is well reflected in the fact that four out of the 15 BEPS Actions are concerned with the issue.

The different methods of TP are necessitated by the application of separate entity concepts for auditing transactions between related or associated entities. The OECD approach works on the fiction that all corporate entities are independent economic units that can operate autonomously for generating maximum profits, whether or not the operations of these entities are fully controlled by associated entities. However, in instances where transfer prices between associated entities do not conform to internationally applicable norms, they can distort the allocation of profits among all the territories where the MNE operates.[63]

The discrepancies with this approach had been identified very early, but according to the OECD, their member countries chose a "separate entity approach as the most reasonable means for achieving equitable results and minimizing the risk of unrelieved double taxation, thereby making each individual group member subject only to the tax on the income arising to it (on a residence or source basis)".[64]

However, in order to make this approach work, countries had to evolve a mechanism to ensure that any transaction, whether between associated entities or unrelated entities, followed the same conditions which would exist for transactions among unrelated entities. The solution that was arrived at is now a key concept underpinning TP, known as the Arm's Length Principle (ALP), which is encapsulated in Article 9 of both the UN and OECD Models. Under this principle, "transactions within a group are compared to transactions between unrelated entities under comparable circumstances to determine acceptable transfer prices."[65] In simpler terms, it means that any transaction among related companies should be valued as if the transaction had taken place between unrelated entities in an open market, with each acting in its own best interests.

The implementation of ALP gave rise to the difficulties of finding appropriate comparable transactions between unrelated entities. This has been particularly difficult for developing countries in recent times, as "the high level of integration of international

[62] UN Transfer Pricing Practical Manual, Second Edition (2017), p. 24..
[63] Platform for Collaboration on Tax: A Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses, p. 15.. Available from http://documents.worldbank.org/curated/en/447901498066167863/The-platform-for-collaboration-on-tax-a-toolkit-for-addressing-difficulties-in-accessing-comparables-data-for-transfer-pricing-analyses.
[64] OECD Transfer Pricing Guidelines (2017), p. 16.
[65] OECD Transfer Pricing Guidelines (2017), p. 11.

enterprises, the proliferation of intra-group trading in intangibles and services and the use of sophisticated financing arrangements have increasingly made the arm's length principle difficult to apply in practice."[66] Other significant issues in its implementation include the difficulties that tax administrations face in gathering relevant data from the related companies; as well as the time and resource constraints that they face when conducting TP audits.

A comparability analysis forms the first step in the implementation of the ALP, and is often used to select the appropriate method for determining the arm's length price of a transaction. The major TP methods generally used are the Comparable Uncontrolled Price (CUP) method, Resale Price method, Cost Plus method, Transactional Net Margin method (TNMM) and Comparable Profits method. The UN also recognizes use of the Commodity Rule, or the so called 'Sixth Method', which is used by several developing countries and is applicable to commodity transactions.[67]

At the UN, TP is primarily dealt by the Subcommittee on Transfer Pricing, which had the mandate to update the commentary for Article 9 of the UN Model, and produce the 'Practical Manual on Transfer Pricing for Developing Countries', which aims to "provide clearer guidance to countries on the policy and administrative aspects of applying transfer pricing analysis to some transactions of multinational enterprises."[68] The Manual is "addressed at countries that are seeking to apply the 'arm's length standard' in their transfer pricing issues"[69], and provides practical solutions that reflect developing country realities.

The OECD has its own Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, which seeks to serve the "dual objectives of securing the appropriate tax base in each jurisdiction and avoiding double taxation".[70] These Guidelines are a strong votary of the separate entity approach, and reject global formulary apportionment in favor of maintaining the arm's length principle as the international consensus.[71]

The BEPS Actions 8-10 propose changes to the existing OECD TP Guidelines, since with the ALP's "perceived emphasis on contractual allocations of functions, assets and risks, the existing guidance on the application of the principle has also proven vulnerable to manipulation"[72]. The work on TP under the BEPS Project thus focuses on TP issues in transactions involving intangibles, contractual allocation of risks and profits, and other high risk areas which erode the tax base.

While IFFs can be effected through trade mis-invoicing, there has been some criticism of the use of import/export data to estimate their total value, since the data mismatches might

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[66] UN TP Practical Manual, Second Edition (2017), p. 58.
[67] For a discussion on the use of the Sixth Method in Argentina, see V. Grondona, 'Transfer Pricing: Concepts and Practices of the 'Sixth Method' in Transfer Pricing', South Centre Tax Cooperation Policy Brief No. 2, May 2018).). Available from https://www.southcentre.int/tax-cooperation-policy-brief-2-may-2018/.
[68] UN TP Practical Manual, Second Edition (2017), p. iii.
[69] UN TP Practical Manual, Second Edition (2017), p. vii.
[70] OECD TP Manual, p. 16.
[71] OECD TP Manual, p. 43.
[72] BEPS Action 8 – 10 Final Report, p. 9.. Available from www.oecd.org/tax/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports-9789264241244-en.htm.

just as well be due to "merchanting and transit trade along commodity supply chains"[73]. Thus, fighting abusive transfer pricing and trade mis-invoicing remains difficult in practice since the determination of whether a transaction is abusive has to be based on the specific circumstances of the transaction. This becomes even more complicated in the case of transfer of intangible goods and intellectual property, since obtaining appropriate comparables is extremely difficult in practice.

Countries are however innovating in their TP practices. Development of the 'Sixth method' and its use in Latin America shows that there is capacity among countries to curb abusive transfer pricing. In addition, the work being done for building the capacity of tax administrations to audit transactions effectively will also enable checking the outflows of commercial IFFs.

3. Tax havens and offshore finance centers

The use of specific jurisdictions by MNEs to structure and route their international business transactions is a well-known practice that fuels an increase in IFFs from all countries. These jurisdictions are variably called tax havens, offshore financial centers, 'secrecy jurisdiction'[74], 'low tax jurisdiction' and 'non-cooperative jurisdictions for tax purposes'[75]. While they have different names, a common characteristic is that these jurisdictions promise financial services with secrecy and anonymity (or lack of transparency). Indeed, as a UN study notes, "offshore financial centers, tax havens and bank secrecy jurisdictions attract funds partly because they promise both anonymity and the possibility of tax avoidance or evasion."[76]

The contribution of anonymity and tax mitigation facilities of 'tax havens' to the viability of global financial centers cannot be underestimated. The UK's London-based financial centre (known as 'The City') is the main destination for funds originating from its associated crown territories which are effectively developing countries in terms of level of development.[77] Tax havens offer severely limited possibilities for domestic investment and good returns and funds are thus mostly invested in global financial centers. Under the Queen's legal regime, the strong property rights[78] afforded by the crown territories are critical to their viability as tax havens, even for investments not placed in the City and instead, for example, in Wall Street. Hence, there is a clear co-dependent relationship between tax havens

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[73] Maya Forstater, 'Illicit Flows and Trade Misinvoicing: Are we looking under the wrong lamppost?', Bergen: Chr. Michelsen Institute (CMI Insight no. 5, 2016).). Available from www.cmi.no/publications/5979-illicit-flows-and-trade-misinvoicing.

[74] TJN, 'What is a Secrecy Jurisdiction'.. Available from www.financialsecrecyindex.com/faq/what-is-a-secrecy-jurisdiction.

[75] Council of the European Union, Council conclusions (adopted on 5/12/2017).). Available from www.consilium.europa.eu/media/33082/council-conclusions-non-cooperative-jurisdictions-5-december-2017.pdf.

[76] *Financial Havens, Bank Secrecy and Money Laundering* (United Nations Publications, Sales #: F.99.IV.2).

[77] Manuel F. Montes, 'Concealing Wealth and Ownership: Asset Management and Tax Havens', *Development and Change*, 49 (2018): 893-906 ,, p. 903; DOI:10.1111/dech.12408.

[78] Valpy FitzGerald and Erika Dayle Siu, 'The Effects of International Tax Competition on National Income Distribution', Initiative for Policy Dialogue, Working Paper #310, January 2018, p. 6.. Available from http://policydialogue.org/publications/working-papers/the-effects-of-international-tax-competition-on-national-income-distribution/.

and financial centers. Thus, it is not the case that developing country tax havens represent a clear and present danger to the integrity of developed country financial markets and tax regimes. 'Tax havens' exist not only at the sufferance of the world's oldest, largest and most sophisticated financial centers; the continuation of these global centers also depends on the enduring existence of developing country-based tax havens.

The lack of an international consensus on the defining characteristics of tax havens makes identification of such jurisdictions even more difficult, since there is no single set of agreed criteria that can been applied. There is no consensus on the definition of a 'tax haven' or Offshore Financial Centers (OFCs), since any territory seeking to promote itself as a hub for international financial services would provide services beyond merely 'tax planning'. Vlcek for example, describes tax havens as "as a jurisdiction offering special tax rates or tax concessions to attract foreign capital, though not necessarily for domestic investment purposes."[79], while "'offshore' may be any foreign jurisdiction which does not share taxpayer account information or withhold taxes on behalf of the taxpayer's home tax authority."[80] In case of the latter, the IMF suggests that, in practice, an "OFC is a center where the bulk of financial sector activity is offshore on both sides of the balance sheet, (that is the counterparties of the majority of financial institutions liabilities and assets are non-residents), where the transactions are initiated elsewhere, and where the majority of the institutions involved are controlled by non-residents."[81]

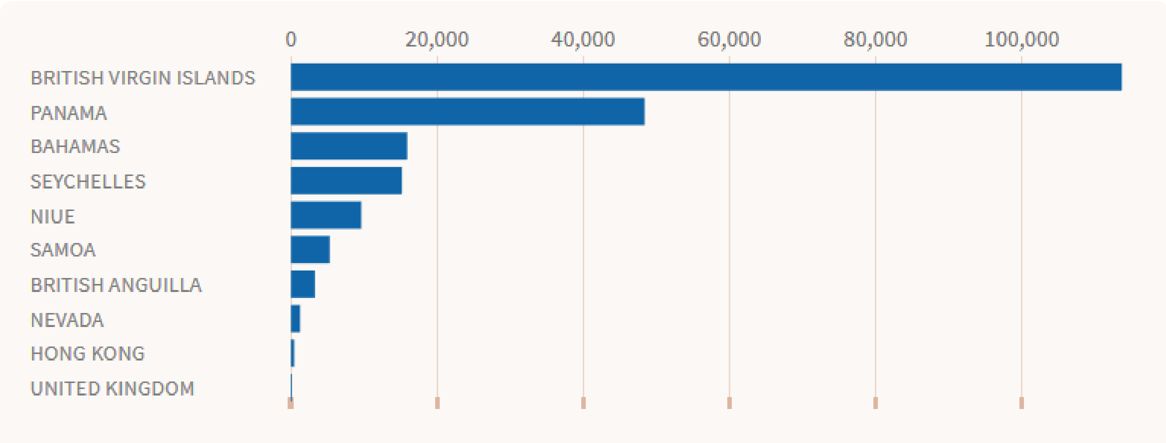
While there is no agreement on a definition, there is an international consensus on the role that these territories play in facilitating IFFs. The Independent Commission for the Reform of International Corporate Taxation (ICRICT), for example, states that "tax havens facilitate abusive tax practices with enormous negative effects on the global community."[82] Assessing the full scope of these negative effects is difficult, given the inherent opacity of tax havens. However, Zucman estimates that globally around 8% or $7.6 trillion of financial wealth is held in tax havens.[83] Other estimates suggest that this number can be anywhere between $21 – 32 trillion.[84] To keep that number in context, it is useful to note that in order to lift 700 million people out of extreme poverty, it requires only $1.4 trillion per year.[85]

In order to track IFFs across jurisdictions, States need to be able to access information from the countries where the parent company is located and the profits are being declared. However, in many cases, when the parent company is located in these 'preferential or low-tax jurisdictions', obtaining such information is next to impossible; especially since the key defining feature of such territories is their lack of transparency and secrecy about companies incorporated there. A 2011 report by World Bank staff showed that out of 40 such

[79] William Vlcek, *Offshore Finance and Global Governance: Disciplining the Tax Nomad* (Palgrave Macmillan UK, 2017), p. 11.
[80] ibid
[81] IMF Background Paper on Offshore Financial Centers. Available from www.imf.org/external/np/mae/oshore/2000/eng/back.htm.
[82] ICRICT Declaration. Available from www.icrict.com/icrict-documentsthe-declaration.
[83] Gabriel Zucman, *The Hidden Wealth of Nations: the Scourge of Tax Havens* (University of Chicago Press, 2015), p. 35.
[84] Reuters, 'Super rich hold $32 trillion in offshore havens', 22 July 2012. Available from www.reuters.com/article/us-offshore-wealth/super-rich-hold-32-trillion-in-offshore-havens-idUSBRE86L03U20120722.
[85] Mark Anderson, '$1.4tn a year needed to reach global goals for world's poorest', The Guardian, 18 November 2015. Available from www.theguardian.com/global-development/2015/nov/18/14tn-dollars-a-year-needed-to-reach-global-goals-for-world-poorest.

jurisdictions included in the study, only one required identification of the beneficial owner.[86] The widespread use of these jurisdictions for incorporating commercial entities specifically for tax purposes has been repeatedly exposed in the media in the recent few months. A prime example for this is the 'Panama Papers', released by the International Consortium of Investigative Journalists (ICIJ) on the basis of leaks from Mossack Fonseca, a Panama based law firm specializing in offshore financial services.[87]

Most Popular Tax Havens in the Panama Papers[88]



The G20 and OECD have released their proposals to determine which jurisdiction would qualify as non-cooperative jurisdictions with respect to tax transparency, but critics have pointed out that the standards used allow for several escape routes for countries.[89] The European Union (EU) has also published its own list of non-cooperative jurisdictions for tax purposes[90], which also includes elastic standards and allows any identified countries to easily move out of that list. The current EU blacklist includes 7 identified jurisdictions. Oxfam however notes that if the EU were to objectively apply its own criteria there would be at least 35 countries in that list.[91]

On the other hand, developing countries like Brazil and Ecuador have made substantial efforts to curb the use of tax havens by companies operating there and limit the harmful impact it has on their domestic economy. The efforts to have active lists of tax havens is particularly prevalent in Latin America, with Brazil, Mexico, Ecuador, Colombia,

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[86] E. M. Halter et al., 'The puppet masters: how the corrupt use legal structures to hide stolen assets and what to do about it', Stolen Asset Recovery (StAR) initiative, World Bank (2011). Available from https://star.worldbank.org/sites/star/files/puppetmastersv1.pdf.
[87] ICIJ, Panama Papers. Available from www.icij.org/investigations/panama-papers/.
[88] Available from www.icij.org/investigations/panama-papers/explore-panama-papers-key-figures/.
[89] Nicolas Shaxson, 'Will the OECD tax haven blacklist be another whitewash', TJN, 20 July 2016. Available from https://www.taxjustice.net/2016/07/20/oecd-another-go-hopeless-politicised-tax-haven-blacklisting/.
[90] Council of the European Union, Council conclusions (adopted on 5/12/2017). Available from www.consilium.europa.eu/media/33082/council-conclusions-non-cooperative-jurisdictions-5-december-2017.pdf.
[91] OXFAM Briefing Note, 'Blacklist or Whitewash? What a real EU blacklist of tax havens should look like', November 2017. Available from www.oxfam.org/en/research/blacklist-or-whitewash-what-real-eu-blacklist-tax-havens-should-look-0.

Peru and El Salvador all maintaining them.[92] Ecuador recently passed a national referendum on tax havens, which barred politicians and public officials from holding assets in tax havens.[93] Brazil maintains a system of imposing a higher rate of withholding taxes (25%) for any remittances or financial transactions with entities located in identified tax havens, in comparison to those in compliant jurisdictions (15%). The transactions undertaken with entities subject to privileged tax regimes must also observe transfer pricing rules regardless of the corporate relations between the parties, and are subject to stricter rules and limits of interest deductibility and payments in general.

> <u>Box 1 - Criteria used for tax havens lists by Ecuador</u>
>
> "Art. (...) - Those tax regimes or jurisdictions in which at least two of the following conditions are met will be considered as tax havens:
> 1. Have an effective tax rate on income or taxes of an identical or similar nature less than sixty percent (60%) to the corresponding one in Ecuador or that said rate is unknown;
> 2. Allowing the exercise of economic, financial, productive or commercial activities is not developed substantially within the respective jurisdiction or regime, in order to qualify for tax benefits of the jurisdiction or regime.
> 3. Absence of an effective exchange of information according to international standards of transparency, such as the availability and access to information by the competent authorities on the ownership of companies, including legal owners and effective beneficiaries, reliable accounting records and bank account information, as well as the existence of mechanisms that imply an effective exchange of information." …
>
> - Ecuador's *Ley Orgánica de Régimen Tributario Interno, Registro Oficial Suplemento 463 de 17 Noviembre 2014, modificada el 29 Diciembre 2017* (unofficial translation)

The issue with lists, as pointed out by the Tax Justice Network, is that they can be "frequently skewed due to political expediency", and tend to "exclude or downplay large, powerful nations and highlight small, weaker ones"[94]. In response, it has come up with its own 'Financial Secrecy Index', which utilizes 20 different indicators.

The tax haven properties of a foreign tax jurisdiction must correspond to the extent that its regulations and practices undermine the tax objectives of another jurisdiction. Thus, the most logical approach is for each tax jurisdiction to determine which other jurisdictions it considers to have approaches inimical to its interests. In this manner, the designation of tax

[92] Naomi Fowler, 'Tax Haven Blacklisting in Latin America', TJN, 10 April 2017. Available from https://www.taxjustice.net/2017/04/10/tax-haven-blacklisting-13-latin-american-countries/.

[93] For a discussion of Ecuador's experience, see Lorena Freire G., 'Ecuador and Its Fight Against Tax Havens', South Centre Tax Cooperation Policy Brief 1, May 2018. Available from www.southcentre.int/tax-cooperation-policy-brief-1-may-2018/.

[94] TJN, FAQs. Available from www.taxjustice.net/faq/.

havens is a unilateral act by a tax jurisdiction, for which the unilateral actor also is prepared to accept the negative consequences of such an action.

Another approach is to arrive at multilateral agreements which introduce disciplines and standards against unacceptable practices. These agreements would disallow such practices and identify sanctions that parties can apply to offending jurisdictions. Common good governance principles demand that such multilateral designations should be agreed among all affected parties.

Given the vast revenue loss faced by governments around the world due to the shifting of profits to tax havens, there is a need to combat these activities and preserve the domestic tax base. However, many developing countries cannot use a one-size-fits-all approach because of regional and political considerations. In such a scenario, a possible way forward is to develop a set of common indicators, which can be used as a base for developing countries to evolve their own set of relevant criteria for determining tax havens. This approach can also be adapted for the regional level since many regions have certain jurisdictions which function as the route for channeling IFFs in the region. Another possibility is to have a global financial registry[95] which would enable countries to assess actual distribution of revenues by MNEs and accurately identify the actual beneficial owner.[96]

Ultimately, the use of tax havens by MNEs continues to be instrumental in the rise of commercial IFFs, and efforts to curb their use will remain a fundamental priority for countries in the coming years.

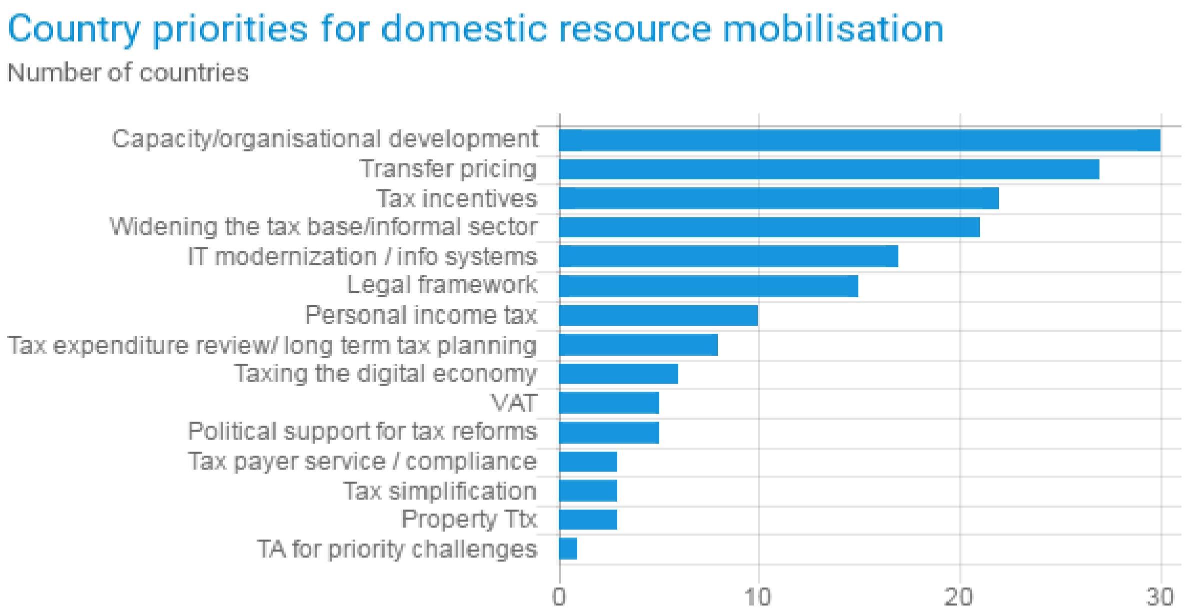
4. Domestic tax administration and capacity building

Under the Addis Agenda, the primary responsibility for mobilization of domestic resources lies with national authorities which are also tasked with the implementation and enforcement of domestic tax rules. This is even included in SDG 17.1 as the need to "strengthen domestic resource mobilization, including through international support to developing countries, to improve domestic capacity for tax and other revenue collection". Similarly, the SDG Indicator 17.1.2 lists the 'Proportion of domestic budget funded by domestic taxes' for evaluating the progress being made on the issue. However, many developing and least developed countries require strengthening their capacity and expertise in order to ensure compliance with their tax laws, particularly when facing challenges arising from the international tax regime. The Group of 77 (G77) and China also recognize this issue, stating that "capacity-building is an area of critical importance to developing countries, especially in the context of emerging policies aimed at strengthening transparency, which

[95] José Antonio Ocampo, 'A global financial registry to fight tax evasion', *The Hindu Business Line*, 25 June 2018. Available from www.thehindubusinessline.com/opinion/a-global-financial-registry-to-fight-tax-evasion/article24255127.ece.
[96] Gabriel Zucman, 'Taxing across Borders: Tracking Personal Wealth and Corporate Profits', *Journal of Economic Perspectives*—Volume 28, Number 4—Fall 2014—Pages 121–148. Available from https://gabriel-zucman.eu/files/Zucman2014JEP.pdf.

increasingly place significant demands on the human, technical and other resources of developing countries."[97]

Country Priorities for Domestic Resource Mobilisation[98]



This persistent gap has been an important concern for tax administrations from developing countries which frequently list capacity development as their biggest priority. Not having sufficient capacity and issues such as lack of expertise to deal with complex issues in international taxation means that tax administrations are often hampered in performing to the best of their ability. In addition to institutional limitations, other frequently cited concerns include gaining experience in tax treaty negotiations, and having regular updates to foresee some of the emerging tax challenges such as the taxation of intangibles and the digital economy. (See Box 2.)

For developing country authorities, another key priority is that capacity building should highlight approaches fitting to the situation of developing countries. Tax authorities in many developing countries, for example, operate in context with a very narrow range of companies and transactions. Often, approaches considered legitimate by the OECD assume that a wide diversity of data are available to authorities; insisting on applying methods applicable to advanced countries have proven to be unduly costly not only in terms of administrative costs but also in terms of the costs of legal challenges. More important, the outcomes of applying techniques applicable to developed countries in poor countries will often produce inaccurate or erroneous decisions.

[97] G77 and China, Statement on 22 April 2015. Available from www.g77.org/statement/getstatement.php?id=150422b.
[98] Based on data from World Bank Group; Chart available from https://developmentfinance.un.org/chart/1198.

<u>Box 2 – On improving tax administration</u>

"First, the institutions of tax administration and compliance mechanisms need to be strengthened; this effort would include enhancing the procedural and legal framework covering assessment, collection, audit, sanctions, appeals, record keeping, use of information technology, and reward and punishment structure of the civil service; the disclosure requirement of firms; and the accounting conventions used by them. Sometimes corruption and rent seeking hamper the performance of tax administration. Reorganizing and segmenting the tax administration to handle large, medium, and small taxpayers separately and improving the use of information technology may help to improve tax performance. Improving data management and analysis may help to lower the costs of compliance and to reduce the scope for corruption and collusion. Second, a capacity-building program for personnel of the tax administration at different levels and a sustained campaign of taxpayer service and taxpayer education and awareness may be necessary. Reducing compliance costs and adopting a customer-oriented focus are the key to better compliance and collection."

Source: Raul Felix Junquera-Valera et al., *Strengthening Domestic Resource Mobilization: Moving from Theory to Practice in Low- and Middle-Income Countries* (Washington D.C., World Bank, 2017), p. 11

The World Bank includes 'low tax effort' i.e. the ratio of actual tax collection to tax capacity, as one of the factors for persistent revenue gaps in developing countries.[99] Hence, several efforts are currently being undertaken by international organizations to help developing countries in building the effectiveness of their domestic tax administrations.

The UN Programme on Capacity Development[100] has been developed as a "unique collaborative engagement between government representatives from developing countries, members of the Committee of Experts on International Cooperation in Tax Matters, a diversified group of world-renowned experts, relevant international and regional organizations and the Financing for Development Office"[101]. The four focus areas of this initiative include tax treaties, transfer pricing, tax base protection and tax administration. The activities are demand-driven and are aimed at supporting developing countries.

The UN has also developed tools such as the 'Practical Portfolios on Protecting the Tax Base of Developing Countries', with the purpose of assisting developing country tax officials in recognizing "the main causes of tax base erosion in their countries and to identify relevant issues in the context of their domestic tax law and network of tax treaties".[102] These Portfolios contain various policy options that can be used by tax officials to effectively address BEPS issues in their countries.

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[99] Raul Felix Junquera-Valera et al., 'Domestic Resource Mobilization: Opportunities and Challenges,' in *Strengthening Domestic Resource Mobilization: Moving from Theory to Practice in Low- and Middle-Income Countries* (Washington D.C., World Bank, 2017), p. 11.

[100] UN IATF, Capacity Building for Domestic Revenue Mobilisation. Available from https://developmentfinance.un.org/capacity-building-domestic-revenue-mobilisation.

[101] UN Department of Economic and Social Affairs (DESA), Capacity Development: Tax Cooperation. Available from www.un.org/esa/ffd/topics/capacity-development-tax-cooperation.html.

[102] UN DESA, UN Practical Portfolios on Protecting the Tax Base of Developing Countries. Available from www.un.org/esa/ffd/tax-cooperation/practical-portfolios.html.

Another initiative, jointly operated by the OECD and UN Development Programme (UNDP) is Tax Inspectors Without Borders (TIWB), which supports countries in building tax audit capacity. It provides select developing countries with an ongoing bilateral capacity building support program and particular assistance on audits in response to specific country requests.[103]

At the regional level, there are several organizations which are actively engaged in capacity building for tax administrations.[104] For example, in Africa, many capacity building activities are carried out by the African Tax Administration Forum (ATAF), which has the specific mandate to "improve the capacity of African tax administrations to achieve their revenue objectives."[105] The Inter-American Center of Tax Administrations (CIAT, Spanish acronym) plays a similar role in Latin America, providing technical assistance services, studies and training for strengthening the tax administrations of its members.[106] The Exchange and Research Centre for Leaders of Tax Administrations (CREDAF, French acronym) also organizes regular exchanges between high level experts in domestic tax administrations of its members.[107]

Some developing countries also promote capacity building activities in international taxation on the basis of South-South cooperation. For example, the State Administration of Taxation in China helps build the capacity of developing country tax administrators via activities such as "legislative consultation, topical discussions, expert support, experience sharing and technical assistance" with participation of tax officials from Asia, Africa and Latin America.[108]

Building the capacity of tax administrators to effectively audit international transfer pricing issues is crucial to stemming IFFs from developing countries. However, building the required expertise often requires time and effort, with one developing country official noting that it can take up to four years for a tax administrator to build sufficient expertise on transfer pricing. Even when this is achieved, retaining and passing on such expertise remains as a challenge.

Too often, even with the required expertise, legislation and dispute resolution mechanisms in place, tax administrators still remain unable to catch tax evasion and IFFs due to simply not having enough financial or human resources. Thus, in addition to building their technical capacity, there is also an urgent need to consider the financial and personnel investments which are required to build a tax authority capable of stemming IFFs and generating the required revenues for the country.

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[103] Tax Inspectors Without Borders, FAQs. Available from www.tiwb.org/about/faq/.
[104] See Geerten Michielse and Victor Thuronyi, 'Overview of Cooperation on Capacity Building in Taxation', UN Committee. E/C.18/2010/CRP.11.
[105] ATAF, About Us. Available from www.atafax.org/overview.
[106] CIAT, About Us. Available from www.ciat.org/about-us/?lang=en.
[107] CREDAF, Presentation. Available from https://credaf.org/en/presentation-en/.
[108] State Administration of Taxation of The People's Republic of China, Exchanges and Cooperation. Available from www.chinatax.gov.cn/eng/n2367741/index.html.

5. Transitioning to single entity approaches

Some analysts, notably ICRICT, propose that the taxation of MNEs as a single entity should be a priority among developing countries, since it reflects the current economic reality of multinational conglomerate groups, rather than maintaining the separate entity fiction advocated by the OECD. Adopting a system of unitary taxation with formulary apportionment, along with Country by Country Reporting (CbCR) would enable developing countries to lower the risk of erosion of their tax base, stem IFFs, collect their fair share of tax revenue from MNE profits generated in their territory and protect their taxing rights.

Despite comprising countries whose regulations can generate data to operate it, the OECD does not favor a unitary tax system. It defines such a system as one in which "the profits of the various branches of an enterprise or the various corporations of a group are calculated as if the entire group is a unity. A formula is used to apportion the net income of the whole group to the various parts of the group. Usually a combination of property, payroll, turnover, capital invested, manufacturing costs, etc. are formula factors."[109]

The formula mentioned above has been the crux of most arguments against unitary taxation, with criticisms that States would not be able to agree on a common formula, and that enterprises could still profit from international tax competition by adjusting their operations based on the factors in the formula.[110] A multiple factor system is needed to limit such behavior. To the extent that sales often become the dominant allocation factor, developing countries could be vulnerable to being constrained from collecting as much as they could under the current system, because the proportion of total sales in these countries are often miniscule. If such a system were to become acceptable, developing countries must develop more intricate approaches to measuring value-added.

<u>Box 3 - ICRICT Roadmap</u>

The roadmap presented by the Independent Commission for the Reform of International Corporate Taxation makes a call for a paradigm shift in formulating rules for taxing MNEs by jettisoning separate entity taxation and the use of TP rules to determine profit allocation in favor of taxing them as unitary firms.

ICRICT believes that a system of multi-factor global formulary apportionment, with a minimum corporate tax rate would be the most effective and fairest version of unitary taxation. But this is a long term aim, and requires international convergence on the issue.

In the short term, ICRICT lists intermediate measures which can be used by countries, such as promoting the use of the profit split and the shared net margin method, developing a common consolidated corporate tax base, and enacting a domestic alternative minimum tax regime with unilateral adoption of formulary apportionment.

The move towards formulary apportionment will help curb profit shifting to low tax jurisdictions where no activities of economic substance occur. This is especially necessary considering that research shows nearly $12 trillion worth of global investment by MNEs, which is nearly 40 percent of all global foreign direct investment (FDI), is completely

[109] OECD Glossary of Tax Terms. Available from www.oecd.org/ctp/glossaryoftaxterms.htm.
[110] ICRICT Roadmap, p.7. Available from www.icrict.com/icrict-documents-a-fairer-future-for-global-taxation/.

artificial, and consists of financial investment passing through empty corporate shells with no real activity.[111] The United Nations Conference on Trade and Development (UNCTAD) has also reviewed the major role of offshore investment hubs in global investment, noting that some 30 percent of cross border corporate investments are routed through conduit countries before reaching their destination countries.[112]

The current system of international tax rules is still governed by the vast treaty network which includes the arm's length principle (ALP) operating on the separate entity fiction. The ALP was developed at a time when the integrated global MNE with vast supply chains had not been envisioned. The shortcomings of the arm's length principle has been starkly highlighted by Avi-Yonah and Benshalom, who emphasize that the "the problems with the current system do not derive from rules at its periphery, but instead from a fallacy that lies at the system's central core: namely, the belief that transactions among unrelated parties can be found and that they can be used as meaningful benchmarks for tax compliance and enforcement."[113]

The reliance on comparability for the application of the arm's length principle ignores the reality that contemporary MNEs would lose out if they did not exploit the competitive advantages of being an integrated entity. It further ignores the fact that any comparable firm would also have the same kind of vertical integration, thereby making it impossible to find a comparable independent value in the market for the application of the principle. Secondly, associated businesses may undertake, for reasons other than tax avoidance, transactions that no independent parties would reasonably undertake. This may also include any transactions involving unique intangibles belonging to the enterprise. While the transactional profit split method may be used in these circumstances, it would still necessitate a functional analysis by the tax administration before proceeding.

While the ALP is the *de facto* global standard, this does not necessarily prohibit countries from using unitary taxation and formulary apportionment within their domestic tax systems, if they can obtain legally defensible data on the global operations of foreign investors. This is one potential promise of the Country-by-Country proposal of the BEPS Project. Article 9 of the UN Model Convention currently governs transfer pricing, but unitary taxation could come under Article 7 instead. The obvious benefit to developing countries in adopting the unitary approach is that they will be able to claim a fair share of the profits made by the MNE in their territory, instead of having to see it be shifted to a low tax jurisdiction. However, there are many practical aspects which would also need to be resolved in the implementation of this approach, with countries having to agree on applying the same formula in their tax assessments.

Developing countries can also benefit from the experience of the EU with the Common Corporate Consolidated Tax Base (CCCTB), which is an attempt to create a single harmonized tax base for multinational companies with operations in Europe. The proposal was first launched in 2011, but faced considerable resistance then, leading to its

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[111] Jannick Damgaard, Thomas Elkjaer, and Niels Johannesen, 'Piercing the Veil', *Finance & Development*, IMF (June 2018).

[112] UNCTAD, *World Investment Report* (2015), p. 188.

[113] Reuven S. Avi-Yonah and Ilan Benshalom, 'Formulary Apportionment: Myths and Prospects - Promoting Better International Policy and Utilizing the Misunderstood and Under-Theorized Formulary Alternative', *World Tax J.* 3, no. 3 (2011): 371-98.

withdrawal.[114] It was re-launched in 2016 as part of a broader package of corporate tax reform within the Union.[115]

6. Exchange of Information (EoI)

A major reason why IFFs are difficult to trace is due to the existence of secrecy jurisdictions which refuse to share information about the individuals and corporations who use legal structures in their territories to route their business and finances. By exchanging taxpayer-specific information or more general tax-related information, countries would have access to information that could be used to determine if tax evasion or IFFs have taken place from within their territory.

Exchange of such tax related information can take place between two countries on the basis of an existing agreement, using various modes. It can take place on an 'on-request', a spontaneous or an automatic basis, and is generally embodied in Article 26 of the bilateral agreements (based on the Model Conventions), or in the Tax Information Exchange Agreements (TIEAs) signed between the countries. Increasing exchange of tax information is a priority area for developing countries looking to stem IFFs outflows, since it can help them in curtailing cross-border tax evasion and avoidance, as well as the capital flight that accompanies such activities.[116] The UN includes Article 26 on EoI in its Model Convention, which is similar in wording to the OECD Model, except for two significant differences. In the UN Model, the phrase "that would be helpful to a Contracting State in preventing avoidance or evasion" was inserted in 2011 in order to provide guidance on the proper interpretation of the Article, even though it was already implicit in the earlier text.[117] In addition, the UN Committee has also suggested guidelines regarding implementation of appropriate EoI, in the form of a "listing of suggestions to be examined by competent authorities in developing procedures for an effective EoI", which could be included in a handbook that deals with exchange mechanisms.[118]

Apart from the EoI mechanism in its Model, the OECD also hosts the Global Forum on Transparency and Exchange of Information for Tax Purposes, which currently is the largest such initiative with 153 members. The Global Forum began in 2000, but was restructured in 2009 to expand its membership to non-OECD countries. The premise that a forum on "transparency and exchange of information" being designated as the venue to oversee discussions on the reform of international tax cooperation is certainly questionable; OECD standards, for example, strike many developing country tax authorities as ill-disposed toward transparency over transactions between related companies. Logically, the rebalancing of international standards towards those which protect developing country interests should

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[114] The Commission notes that it "had originally proposed the CCCTB in 2011, but that proposal proved too ambitious for Member States to agree in one go". Available from https://ec.europa.eu/taxation_customs/business/company-tax/common-consolidated-corporate-tax-base-ccctb_en.

[115] European Commission Press Release, 'Commission proposes major corporate tax reform for the EU,' 25 October 2016. Available from http://europa.eu/rapid/press-release_IP-16-3471_en.htm.

[116] UN Model Commentary, p. 642.

[117] UN Model Commentary, p. 644.

[118] UN Model Commentary, p. 646, 675.

precede a priority on transparency and exchange of information. However, these are the cards that these authorities are dealt with, in the absence of an UN-based body.

The Global Forum conducts in depth peer review in order to monitor the implementation of the transparency and EoI standards by members. The first phase on review of the legal framework was conducted from 2010 to 2016, and the second phase on review of EoI on Request in practice is currently underway. Any recommendations following the reviews are expected to be followed, but there is no mechanism to ensure this. All participating countries in the Forum, including of course developing countries, have to pay a fee to be evaluated in terms of whether they are meeting the OECD standards. Moreover, countries must install specialized software to maintain their data to qualify to be evaluated.

In addition, the development of the Common Reporting Standard (CRS) for BEPS Action 13 on Transfer Pricing Documentation will have implications for many developing countries looking for solutions to combat domestic tax evasion. Many information sharing arrangements already exist at the bilateral level, but at the multilateral level, the Convention on Mutual Administrative Assistance in Tax Matters is the most widely accepted instrument dealing with the issue. After the amending protocol of 2010, many developing countries have also become part of the amended Convention.

Despite the work done to promote the inclusion of developing countries in this process, there are still considerable risks and hurdles that they face in achieving meaningful participation. Firstly, developing countries were only brought into the discussions at the implementation phase, when the rules and standards had already been set. Second, the peer reviews only assess the ‘upon request’ standard, which is preferred by the OECD, but has had mixed results for developing countries. Third, while the costs associated with the peer review are clear, the connected benefits are not.[119]

At the country level, a major push to increasing EoI was given by the Foreign Account Tax Compliance Act of 2009 (FATCA) passed by the USA, which required all foreign financial institutions to provide information about their customers with ‘U.S. person’ status to revenue authorities. This was a major step in opening up bank secrecy in offshore jurisdictions, and as the Swiss Bankers Association ruefully admitted, “With FATCA, there is practically no more banking secrecy for customers liable for American tax.”[120] However, FATCA cannot be readily used as a template by developing countries, as under this statute, jurisdictions found not in compliance risk punitive sanctions on their payment systems, which are critical to their external trade. There are also limited benefits for other States from FATCA, since the reciprocity component under the inter-governmental agreements for implementing the Act has not been operationalized as of date.

In order to stem IFFs, the next logical step is for all countries to move towards implementing Automatic EoI. This is especially important in light of a recent study which suggests that firms are less likely to set up affiliate companies in tax havens if they have mechanisms for information exchange with their home country. Looking at Germany, the study found that the number of investment in jurisdictions signing these agreements declined

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[119] Markus Meinze, ‘The Creeping Futility of the Global Forum’s Peer Reviews’, TJN, March 2012. Available from www.taxjustice.net/cms/upload/GlobalForum2012-TJN-Briefing.pdf.

[120] Armando Mombelli, ‘Swiss banks to tell all under FATCA’, Swissinfo.ch, 30 June 2014. Available from www.swissinfo.ch/eng/us-legislation_swiss-banks-to-tell-all-under-fatca/40473870.

by about 46%, showing that EoI mechanisms can be useful in enhancing transparency and limiting IFF outflows.[121]

While EoI mechanisms can go far in increasing transparency and stemming IFFs, there are still significant issues which could hamper their effectiveness, such as confidentiality laws, meaningful commitment by States to engage in EoI, capacity of a tax administration to benefit from EoI, and the costs involved therein.[122] Other practical difficulties that have been seen in the mechanism includes discussions around 'fishing expeditions', and power imbalances between countries leading to obstacles in information exchanges. As an example, one developing country tax administrator mentioned how, in case of upon-request EoI, developing tax administrations have to make extremely specific and detailed requests to their counterparts in developed countries in order to receive any information at all. Despite fulfilling all the necessary requirements, the requests made by developing countries were turned down in many cases on the basis that they were not sufficiently detailed yet, or that the requests were based on leaked information by whistleblowers.[123]

[121] Julia Braun and Alfons J. Weichenrieder, 'Does exchange of information between tax authorities influence multinationals' use of tax havens?', SAFE Working Paper Series, No. 89 (Frankfurt am Main, SAFE, 2015). Available from http://nbn-resolving.de/urn:nbn:de:hebis:30:3-371220.

[122] UN Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries, p. 346.

[123] For an account of India's experience with EoI, see Jahanzeb Akhtar, 'Exchange of Information: Indian Experience, Developing Country Implications', South Centre Tax Cooperation Policy Brief 4, September 2018. Available from www.southcentre.int/tax-cooperation-policy-brief-4-september-2018/.

IV. Tax Policy in Specific Economic Sectors

The lack of new arrangements for Financing for Development (FfD) coming from the AAAA lays more pressure in developing States' strategies and efforts to achieve inclusive and sustainable development. In such scenario, mobilization of domestic resources is a key requirement for developing countries to achieve growth and diversification of their economies[124] and fulfill Agenda 2030.

The taxation of extractive industries (EI) is one of the most important topics for developing countries, as they are still largely dependent on the commodities market[125]. Even in cases where countries have managed to increase their share of revenues from booms in commodities' prices by renegotiating royalties with MNEs, little investment in the non-traditional sectors have not reduced commodity dependence[126] making them vulnerable not only to the impact of commodities' price declines, but also to the detrimental effects of trade mispricing and abusive transfer pricing, abusive tax planning and the use of tax havens and offshore finance centers for tax evasion and avoidance by MNEs operating in their markets. This has led developing States to focus on the particular challenges and urgent needs to harness the profits generated from the extraction of natural resources in order to achieve the developmental goals of the host countries where these resources are located.

Similarly, although a number of developing countries are working to shift their economies away from commodities, focusing on infrastructure, business services, information and communication technologies, and manufacturing, transborder commercial activities, the size and complexity of MNEs' structure and profit shifting among such structures create a number of tax challenges that developing and developed States are striving to overcome by different means. Special attention is given to technical services and the digital economy, as two of the most relevant sectors for emerging and developing economies, particularly considering how the use of elaborate corporate structures in such sectors and their global scale of operations allow MNEs' profits to be reduced where the economic activity takes place and to "*legally*" avoid tax liabilities in such countries[127].

1. Taxation of extractive industries

It is evident that countries that are most reliant on raising rents from natural resources are developing countries located in Africa, South America and Middle East. However, as the UN notes, "designing appropriate tax regimes in resource-rich countries is far from easy", given their need to balance sustainable economic growth and development while attracting foreign investment.

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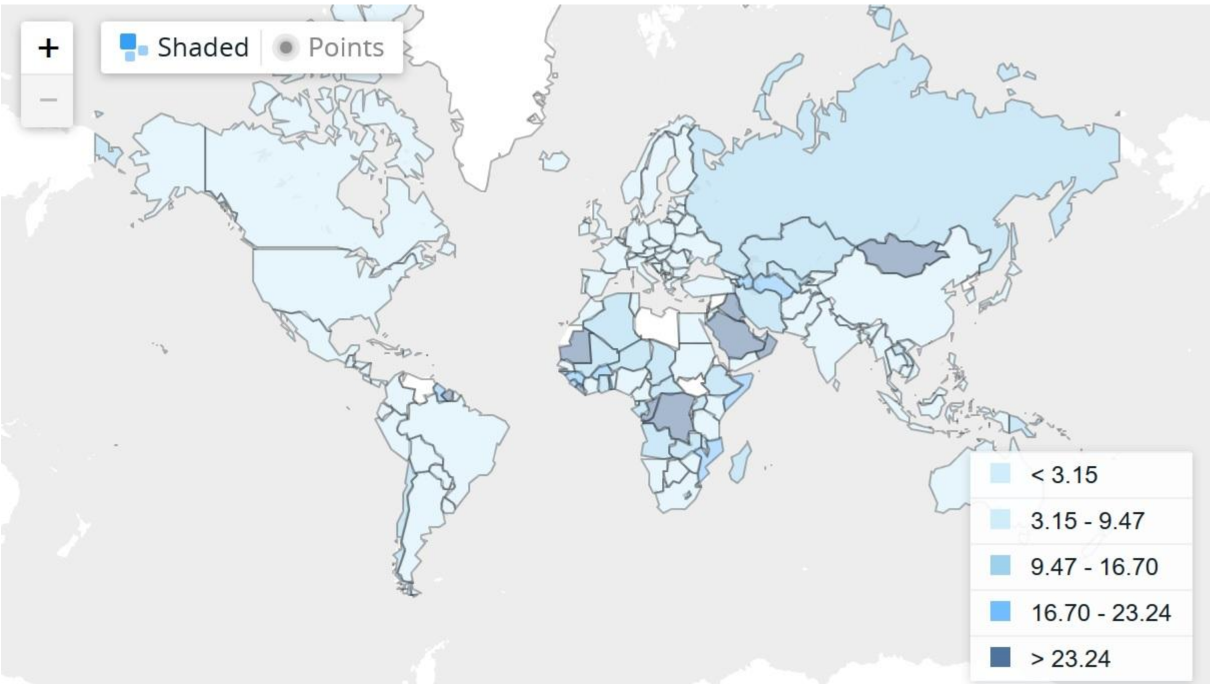
[124] United Nations Economic Commission for Africa, *Strategies for mobilizing domestic resources and investments for structural transformation* (2017). Available from https://repository.uneca.org/bitstream/handle/10855/23647/b11832575.pdf?sequence=5.

[125] UNCTAD, *World Investment Report* (2018).

[126] Yılmaz Akyüz and Vicente Paolo Yu III, 'The Financial Crisis and the Global South: Impact and Prospects,' South Centre Research Paper 76 (May 2017), p. 28.

[127] Manuel Montes, 'Concealing Wealth and Ownership: Asset Management and Tax Havens,' Review Essay in *Development and Change* 49(3), International Institute of Social Studies, p. 904.

Total Natural Resources Rents (% of GDP) - 2016[128]



The IMF notes that in case of extractive industries, taxation potentially affects decisions at all stages, i.e. exploration, development and production, in complex ways[129] and that it is important to consider tax effects over a full project cycle.[130] Further, it notes that while there is "no intrinsic reason for effective and transparent administration of extractive industry fiscal regimes to be harder than for other industries", administration is nonetheless often difficult and badly performed, with persistent challenges in the form of complex tax rules, inefficient royalty administration and fragmented administration, all the while lacking resources to recruit staff with the required expertise and experience.[131] This view is also echoed by the UNCTAD, noting the difficulty in optimizing a fiscal system for the extractive industries, observing that "if taxation is too low, it can result in foregone tax revenue for the host country; if it is too high, it may suffocate the industry and provide little incentive for companies to invest."[132] As a result, it is usually left to the country to decide upon the appropriate level of rent they can capture from exploitation of their resources. However, it further notes that in many cases, the fiscal regimes for extractive industries are regressive in nature, meaning that the government's share would fall as profitability increases. This can possibly be attributed to a number of challenges faced by States, for example difficulties

[128] World Bank staff estimates based on sources and methods described in "The Changing Wealth of Nations 2018: Building a Sustainable Future" (Lange et al. 2018). Available from https://data.worldbank.org/indicator/NY.GDP.TOTL.RT.ZS?type=points&view=map.
[129] IMF, Fiscal Regimes for Extractive Industries: Design and Implementation, August 15, 2012, para. 40.
[130] IMF, Fiscal Regimes for Extractive Industries: Design and Implementation, August 15, 2012, para. 44.
[131] IMF, Fiscal Regimes for Extractive Industries: Design and Implementation, August 15, 2012, paras. 51 — 52.
[132] UNCTAD, *World Investment Report 2007*, p. 163.

when negotiating with MNEs, fragile tax administrations or the need to implement more sophisticated forms of taxation.[133]

Extractive industries seem to be particularly prone to IFFs in comparison to other sectors, with the United Nations Economic Commission for Africa (UNECA) estimating that over a decade, more than half of the IFFs from Africa came from oil, minerals and precious metals.[134]

Discussions on EI taxation are primarily located at the UN Tax Subcommittee on Extractive Industries Taxation Issues for Developing Countries. The sub-committee has produced several Guidance Notes on the tax treatments that can be adopted by countries in relation to extractive industries. It has also produced the 'Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries' (Extractives Handbook), which aims to provide developing country governments with a "basic outline of the challenges they will encounter when seeking to compute the administrative, fiscal, environmental and other related costs of exploring natural resources, without affecting the quality of life of the citizens or the environment."[135]

The OECD has not been very active in developing EI taxation, with some limited work being done for increasing transparency, and limiting base erosion due to EI. In cooperation with the Intergovernmental Forum on Mining, Minerals, Metals and Sustainable Development (IGF), it has developed draft toolkits on the hidden costs of tax incentives in mining[136], and limiting the impact of excessive interest deductions on mining revenues[137]. Part of this work has also contributed to the toolkit produced by the Platform for Collaboration on Tax on 'Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses'.[138] Beyond the limited scope of BEPS Action 4, it is unlikely that the OECD would give much focus to the issue.

In comparison, the Bretton Woods Institutions have been quite active on EI taxation, with the World Bank issuing sourcebooks for 'Understanding the Extractive Industries'[139] and on 'How to Improve Mining Tax Administration and Collection Frameworks'[140].

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[133] UNCTAD, *World Investment Report 2007*, p. 166.

[134] UNECA, Statement by Vera Songwe, UN Under-Secretary-General and Executive Secretary of the Economic Commission for Africa, 25 January 2018. Available from https://repository.uneca.org/bitstream/handle/10855/24240/b1188308x.pdf?sequence=1.

[135] UN Extractives Handbook, p. 2.

[136] IGF-OECD Program to Address BEPS in Mining, 'The Hidden Cost of Tax Incentives in Mining', Consultation Draft, 18 June 2018. Available from www.oecd.org/tax/beps/hidden-cost-of-tax-incentives-in-mining-draft-toolkit-oecd-igf.pdf.

[137] IGF-OECD Program to Address BEPS in Mining, 'Limiting the Impact of Excessive Interest Deductions on Mining Revenues', Consultation Draft, 28 May 2018. Available from www.oecd.org/tax/beps/limiting-excessive-interest-deductions-discussion-draft.pdf.

[138] Platform for Collaboration on Tax: A Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses. Available from http://documents.worldbank.org/curated/en/447901498066167863/pdf/116573-REVISED-PUBLIC-toolkit-on-comparability-and-mineral-pricing.pdf.

[139] Peter Duncanson Cameron and Michael C. Stanley, *Oil, gas, and mining: a sourcebook for understanding the extractive industries* (World Bank Group, 2017). Available from http://documents.worldbank.org/curated/en/222451496911224999/Oil-gas-and-mining-a-sourcebook-for-understanding-the-extractive-industries.

[140] Pietro Guj, Boubacar Bocoum, James Limerick, Murray Meaton and Bryan Maybee, *How to improve mining tax administration and collection frameworks: a sourcebook* (World Bank, 2013). Available from

Similarly, the IMF has also produced research[141] and a handbook[142] on developing and administering fiscal regimes for EI. It has also produced an edited volume on 'International Taxation and the Extractive Industries'. While these publications are useful tools, there still remains a huge gap between the provided recommendations and their implementation in developing countries.

One problem with the World Bank's work is that these tend to be oriented toward attracting foreign investment. For example, these have not paid sufficient heed to the questionable practice of offering "fiscal stability" clauses to foreign investors which fixes the investment incentives sometimes for 99 years to investors in extractive industries.

In this context, it is interesting to explore the possible systems of taxation that can be used by developing countries, such as a progressive taxation and a unitary method of taxation for extractive industries. The use of progressive taxation can be used by governments particularly in the extractives industry. In cases where there is a windfall in the investment, the government is able to capture a fair share of the profits and not have to resort to unilateral measures such as windfall taxes.[143] The latter actions also possess risks in light of the investment treaties and their use (or misuse) by foreign investors. The example of Ecuador and its investment disputes with Perenco[144] and Burlington[145] show the international risks that come even from legitimate regulatory actions by States.

The second idea is that of having unitary taxation to apply to companies in the extractives sector. An International Centre for Tax and Development (ICTD) working paper[146] recommends the use of a unitary corporate income tax in combination with other rent/profit-related EI levies to better administer taxation of the EI. Based on the experience from the Canadian and US taxation of companies at the subnational level in the extractive sector, the paper suggests that the use of unitary taxation as a dominant source of revenue in this sector might not be in the interest of "source jurisdictions" which legitimately seek to capture revenues from rent incomes, including those occasioned by booms in commodity prices.[147]

2. Taxation of technical services

The expansion of technical services being provided across international boundaries, and their use to strip away the profits made by subsidiaries have prompted many developing

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http://documents.worldbank.org/curated/en/576391468330004326/How-to-improve-mining-tax-administration-and-collection-frameworks-a-sourcebook.

[141] IMF, Fiscal Regimes for Extractive Industries: Design and Implementation, 15 August 2012. Available from www.imf.org/~/media/Websites/IMF/imported-full-text-pdf/external/np/pp/eng/2012/_081512.ashx.

[142] Jack Calder, *Administering Fiscal Regimes for Extractive Industries: A Handbook* (IMF, 18 July 2014). Available from www.imf.org/en/Publications/Books/Issues/2016/12/31/Administering-Fiscal-Regimes-for-Extractive-Industries-A-Handbook-41040.

[143] Bryan Land, 'Capturing a fair share of fiscal benefits in the extractive industry,' *Transnational Corporations*, Vol. 18, No. 1 (April 2009).

[144] Perenco Ecuador Ltd. v. The Republic of Ecuador and Empresa Estatal Petróleos del Ecuador (Petroecuador), ICSID Case No. ARB/08/6

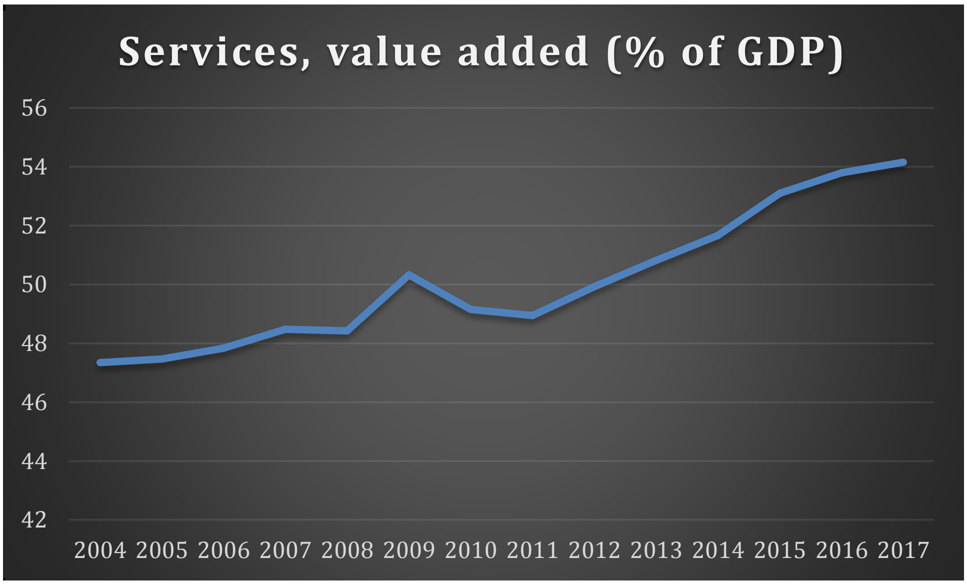
[145] Burlington Resources Inc. v. Republic of Ecuador, ICSID Case No. ARB/08/5

[146] E. Siu et al., 'Unitary Taxation in the Extractive Industry Sector', ICTD Working Paper 35, May 2015. Available from http://www.ictd.ac/publication/unitary-taxation-in-the-extractive-industry-sector/.

[147] Ibid.

countries to reevaluate the provisions in their tax treaties relating to services being provided or consumed within their territory. Older DTAAs allocated taxation rights between countries on the basis of permanent establishment (PE) or the residence of the service provider, with Article 7 of the Model Conventions providing limited rights to source countries to tax the net business profits accrued from cross border services. The increase in such services being provided digitally across borders has rendered the concept of permanent establishment somewhat redundant, since companies do not need to have any physical presence for supplying services in the country. Taxation of services is becoming a priority area for developing countries as growth in the services sector has been increasing its share in the national GDP. This also brings about a need to effectively generate fair revenue for the state from the supply of these services, whether within the country or across the border.

Graph - Services as % of GDP in Low and Middle Income Countries[148]



The issue has gained further importance for developing countries as MNEs use the fees for technical services as a means to shift their profits to the parent companies and erode their tax base in the source countries. By designating (perhaps, "disguising") the payments as fees for consultancy services made by entities without a permanent establishment or even physical presence, the fees fall outside the scope of taxation for source countries. Since these fees were typically made to entities in low tax jurisdictions, it has been legitimating double non taxation of profits.

The taxation of technical services has not been separately considered by the OECD for inclusion in its Model Convention. The discussions in OECD on the tax treatment of services has, since 2006[149], maintained that "until an enterprise sets up a permanent establishment in another State, it should not be regarded as participating in the economic life of that State to such an extent that it comes within the taxing jurisdiction of that other

[148] Graph by Authors, Data from World Bank; World Development Indicator: Services, value added (% of GDP)
[149] OECD, 'The Tax Treaty Treatment Of Services: Proposed Commentary Changes', Discussion Draft, 8 December 2006. Available from www.oecd.org/tax/treaties/37811491.pdf.

State."[150] However, given the high thresholds required for establishing a PE in a country, and the ability of services to be delivered without requiring physical presence, continuing with the OECD opinion is proving especially harmful to developing countries.

The 2017 update of the UN Model Convention includes a new article, 12A on fees for technical services (FTS), which strengthens source country taxation rights, and is expected to "lead to a significant change in the allocation of taxing rights of income from technical, managerial and consultancy services."[151] According to the revised commentary, the article was added to the UN Model Convention to "allow a Contracting State to tax fees for certain technical services paid to a resident of the other Contracting State on a gross basis at a rate to be negotiated by the Contracting States."[152] The new article is an application of the agreement among UN member states that "We will make sure that all companies, including multinationals, pay taxes to the Governments of countries where economic activity occurs and value is created, in accordance with national and international laws and practices."[153]

Because of the trailing "in accordance" phrase in the paragraph 23, the big challenge for developing countries will be incorporating the article on FTS in their tax treaties. This might prove especially difficult for the treaties with developed countries, which are usually based on the OECD model, and do not contain a similar provision. But some developing countries have already initiated their treaty renegotiations for including this. India, for example, has included this new provision in its new tax treaty with Mauritius. This was felt necessary given that some parties were making the argument that "since there in no clause of FTS in the treaty, FTS is not liable to tax in India."[154] However, the presence of the MFN clause in many of the existing DTAAs means that corporate entities will continue to be able to take advantage of the provisions of the older treaties, which do not contain a FTS provision. So countries will need to modify all their tax treaties to include the FTS provision or omit MFN.

Countries have also been exploring the use of domestic withholding taxes in transactions involving payments to non-residents for services rendered within their territory. Malaysia, for example, classifies service fee income of a non-resident as a special class of income, which would not be covered under Article 7 of its tax treaties. Thus, under Section 4A(ii) of the Malaysian Income Tax Act, 1967[155], the "amounts paid in consideration of technical advice, assistance or services rendered in connection with technical management or administration of any scientific, industrial or commercial undertaking, venture, project or scheme" is subjected to a withholding tax in Malaysia. The Malaysian Inland Revenue Board also clarified the scope of this provision, and included "the

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[150] OECD Model Convention Commentary, para. 132.
[151] UN Committee, 'The Taxation of Fees for Technical, Managerial and Consultancy Services in the Digital Economy With Respect To Art. 12A of the 2017 UN Model', E/C.18/2017/CRP.23, para. 66.
[152] UN Committee, 'Revised Commentary on Article 12A – Fees For Technical Services', E/C.18/2017/CRP.1
[153] Addis Ababa Action Agenda, para. 23.
[154] A. Magazine , S. Verma, 'India, Mauritius to tax fee for technical services through new article in pact', *Indian Express*, 13 May 2016. Available from https://indianexpress.com/article/business/business-others/india-mauritius-to-tax-fee-for-technical-services-through-new-article-in-pact-2797774/.
[155] Malaysia Income Tax Act 1967 (revised 1 January 2006). Available from https://s3-ap-northeast-1.amazonaws.com/dsa-library/Resources/2770/ASEAN_Malaysia_Income%20Tax%20Act%201967.pdf.

provision of marketing, consultancy and legal services, supply of technical and software personnel and inter-company technical services" as examples of activities covered under it.[156]

In the implementation of this provision, the Malaysian revenue authorities found that the taxes were being collected only when the services were being physically performed in Malaysia. By showing the location of the service being outside the country, the legitimate tax base was being eroded. This loophole was corrected in 2017, with Malaysia making the tax chargeable on the technical services regardless of where the service was physically performed.

Ghana follows a similar approach for the taxation of services provided by non-residents, and imposes a 20 percent withholding tax on such payments. Its Income Tax Act, 2015 requires the resident to withhold tax on a payment made to a non-resident person for the rendering of management and technical services, where the contract gives rise to income from the country.[157]

3. Digital economy challenges

The rise of the digital economy has brought several challenges and opportunities for developing countries, especially given the increasing irrelevance of the concept of PE for establishing taxation rights. With more businesses moving online, tax administrations around the world need to innovate new practices which would require digital enterprises to pay their fair share of tax in the countries where they operate and make their profits.

There are several difficulties that have been identified in effectively taxing the digital economy, which need to be resolved as a high priority concern for developing countries. Some of the biggest challenges have come in the form of application based services delivered over the internet, which do not require a physical presence in the territories where they operate. This makes it difficult for tax administrations to show the existence of a PE or a 'nexus' with the State where the economic activity is taking place, which can be necessary for establishing taxation rights of the source State. In addition, the scattered nature of digital enterprise operations means that the economic activity can take place in several jurisdictions simultaneously. This necessitates identification of the place of 'value creation' or where the real economic activity occurs in such transactions.

Another issue is the different kind of economic transactions and revenue models that are used by digital businesses for their online activities. For example, the kind of taxes that could be applied to a company which is primarily reliant on advertising revenue (such as Google) cannot be made directly applicable on a company which instead relies on providing an online merchandising platform (such as eBay or Amazon). Thus, there is a requirement to take a differentiated approach for different digital economic transactions and business models.[158]

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[156] Malaysia Inland Revenue Board, Public Ruling NO.1/2014, para. 8.2. Available from http://lampiran2.hasil.gov.my/pdf/pdfam/PR_1_2014.pdf.

[157] Ghana Income Tax Act, 2015 (Act 896), Section 116 (9)-(10). Available from www.gra.gov.gh/docs/info/dtrd/INCOME%20TAX%20ACT%202015%20(ACT%20896).pdf.

[158] See Kofler et al., Taxation of the Digital Economy: "Quick Fixes" or Long-Term Solution?, IBFD. Available from www.ibfd.org/sites/ibfd.org/files/content/pdf/et_2017_12_e2_1.pdf.

Other issues with wide ranging implications that are likely to arise in this context will be data localization requirements, determining the value of data and developing methodologies on how to characterize certain internet based transactions. In case of the data localization, many countries have already enacted regulations requiring companies to store data of citizens within their borders[159], which will have implications for fulfilling the 'nexus' requirement. Determining the revenue earned from the collection of data is another issue, since it is extremely difficult to determine how much profit could be generated from the subsequent use of collected data, especially since tax administrations would rarely have comparable transactions for measuring this. Finally, it is essential for countries to be able to accurately characterize revenue from internet transactions as business profits, royalties or fees for a technical service which would be treated differently under different treaty rules.[160]

While digital economy taxation has been included under the BEPS Project, the work under BEPS Action 1 on 'addressing the tax challenges of the Digital Economy' is still unfinished, with an interim report being released on March 16, 2018. This report provides a descriptive analysis of some of the main features usually observed in digitalized business models, and gives interim measures that countries can apply in this regard. While the members of the BEPS Inclusive Framework have agreed to work towards a consensus based solution by 2020, there are differing notions on the issue arising from the USA and the EU. For example, the European Commission proposal on "new rules to ensure that digital business activities are taxed in a fair and growth friendly way"[161] seeks to have Council Directives on corporate taxation of a significant digital presence and have a common system of a digital services tax on revenues resulting from the provision of certain digital services. These proposals will provide EU Member States the right to tax profits generated in their territory, even if a company does not have a physical presence there. Second, it would introduce a digital services tax at the EU level at the rate of 3% on gross revenue from digital services.[162]

Given that the OECD's Task Force on the Digital Economy is currently only clarifying the characteristics of the impact of the digital economy on international tax administration, there is no specific direct policy action being recommended. Noting this, the UN Tax Committee has also began its work on the issue, with a new sub-committee on 'Tax Challenges Related to the Digitalization of the Economy' being created at the 15th session of the Committee in October 2017.[163] This sub-committee is mandated to draw upon its own experience, as well as engage with other interested parties to *inter alia* suggest measures and draft provisions relating to the digitalization of the economy.

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[159] Information Technology Industry Council, Snapshot of Data Localization Measures. Available from www.itic.org/public-policy/SnapshotofDataLocalizationMeasures1-19-2017.pdf.
[160] UN Committee, *Tax Challenges in the Digitalized Economy: Selected Issues for Possible Committee Consideration*, E/C.18/2017/CRP.22, para. 47.
[161] European Commission, Fair Taxation of the Digital Economy. Available from https://ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en.
[162] PricewaterhouseCoopers, 'European Commission proposes new rules on the taxation of the digital economy', EU Direct Tax Newsalert, 21 March 2018. Available from https://www.pwc.com/gx/en/tax/newsletters/eu-direct-tax-newsalerts/eudtg/european-commission-proposes-new-rules.pdf.
[163] UN Committee, Report on the Fifteenth Session (17–20 October 2017), E/2018/45-E/C.18/2018/1, para. 29.

Countries themselves have also been very responsive to the challenge of taxing the digital economy. In 2016, the Indian finance minister introduced their 'Equalization Levy' proposal as follows:

> "*In order to tap tax on income accruing to foreign e-commerce companies from India, it is proposed that a person making payment to a non-resident, who does not have a permanent establishment, exceeding in aggregate 1 lakh in a year, as consideration for online advertisement, will withhold tax at 6% of gross amount paid, as Equalization levy. The levy will only apply to B2B transactions*."[164]

The implementation of this levy is done by the advertisers located in India, who have to deduct the amount and deposit it with the government. Since the onus of payment is on the advertiser, the PE or physical presence requirements are completely dispensed with. The levy also creates a level playing field among digital enterprises located within and outside the country, since even the foreign enterprises would be subject to this levy on their earnings in India. In the two years since it went into force, the levy has been quite successful in tapping into the growing digital advertising industry, with about $177 million being collected under it. With digital advertising almost worth $ 1 billion already; and estimated to grow to over $ 60 billion by 2020[165], this is set to be one of the most important revenue streams in the coming years. Given its success, the Indian government is also considering the expansion of the levy to cover business to consumer transactions, as well as increasing the rate from 6 to 8 percent.

Thailand is also in the process of enacting a new e-business tax, which would require foreign online businesses to pay Value Added Tax on transactions occurring in the country. According to the Thai Revenue Department, the new law "aims to provide fairness in tax collection and level playing field for all businesses and the entire economy because previously value added tax from the services of many foreign business operators have not been remitted to the Revenue Department."[166]

On the other hand, OECD countries have forcefully argued that developing countries should refrain from unilateral actions until the OECD process has borne fruit. However, there is no guarantee that this effort will be completed by 2020, as promised, because of the difficulty of reaching consensus among developed countries themselves whose companies are in intense competition over the monopolization of international markets. Moreover, the experiences from actual applications will be important in arriving at practical tax standards in this area.

Hence, initiatives for making digital corporations pay fair taxes on their profits are already underway in Latin America, Canada and Malaysia, and will likely proliferate further. Given that currently some of the biggest companies by market capitalization are all

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[164] 2016 Budget Speech of the Indian Finance Minister, para. 151. Available from www.indiabudget.gov.in/ub2016-17/bs/bs.pdf.

[165] S. Tandon and M. Balachandran, 'Aimed at the big boys, India's "Google tax" could end up hurting the small and vulnerable', Quartz India, 1 June 2016. Available from https://qz.com/696591/aimed-at-the-big-boys-indias-google-tax-could-end-up-hurting-the-small-and-vulnerable/.

[166] Thailand Revenue Department News No. 36/2018, 15 June 2018. Available from www.rd.go.th/publish/fileadmin/user_upload/news/englishnews36_2561.pdf.

technology based, taxation of digital goods and services will be a priority area for developing countries in the coming years.

V. The Long Game: Recommendations for Building International Tax Cooperation Among Developing Countries

It is necessary to recognize that international tax norms, standards and techniques embodied in DTAAs, model treaties and domestic legislation will continue to evolve. While this is not something that would happen overnight and there is a possibility that the discussions could go in a 'wrong direction' and not properly consider the interests of developing countries, it is also an opportunity for advancing these interests. The emergence and growth of the digital economy will also have implications for how States will need to adapt their tax policies to ensure fair taxation of these transactions and enterprises. Digital economy will likely create pressures toward more source-based taxation approaches, which will be more to the advantage of developing countries.

It is also necessary to recognize that capacity building for developing countries is not enough and can indeed be misleading and self-defeating if it continues to be based on the dominance of OECD norms. Instead, there is an overwhelming need to have a new set of rules in international taxation, which will be equitable and cognizant of the developmental needs of emerging economies.

There is an urgent need of a thorough reform of the international system, and this can only be achieved with the full and secure participation of developing countries in both agenda-setting and norm-setting. International tax cooperation will therefore have to play a vital role in ensuring that developing countries are not excluded from the discussions at the regional and multilateral levels.

International norm setting has always been a contentious issue, but in the case of tax, it is very noticeable that the role of States themselves has been sidelined, with secretariats of international organizations taking the lead instead. The Platform for Collaboration on Tax is one example of this paradigm shift that has occurred.[167]

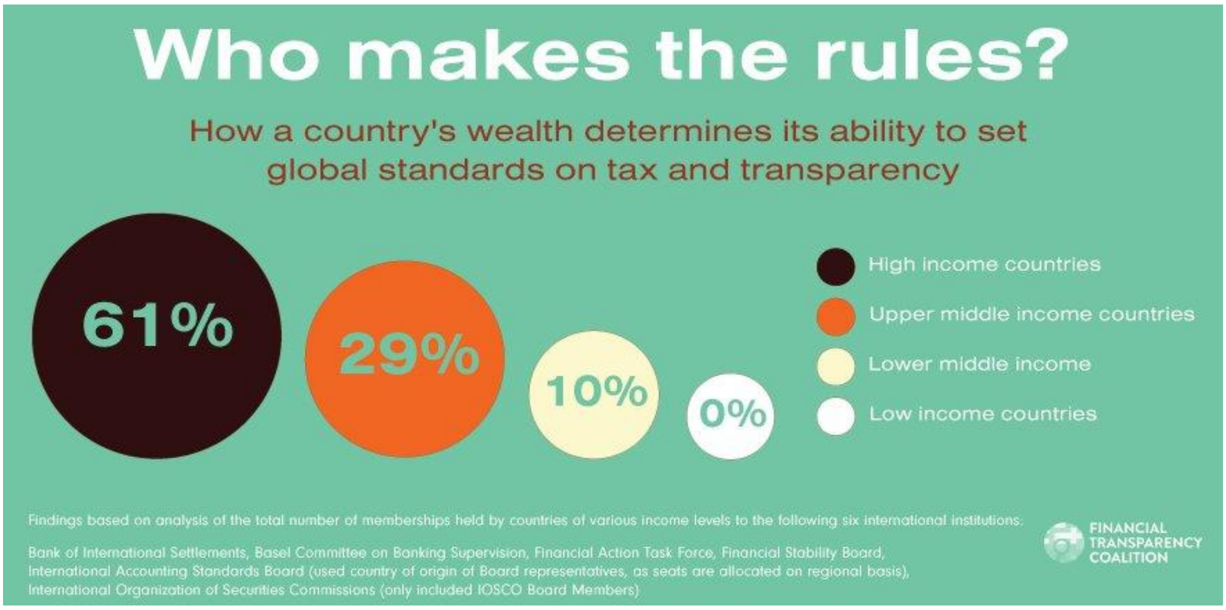
While the BEPS Project has the full support of the G20 countries, the process of development of these standards has come under scrutiny and criticism, since the standards were developed without the participation of the very countries which are now being encouraged to implement them. In addition, there are many questions on whether these OECD standards would reinforce existing developing country disadvantages. Some critics have also pointed out how the actions points are too narrow in scope, and concentrate too heavily on rich country interests, without challenging any of the underlying principles of the system.

Developing countries need to participate in international fora and multilateral processes as full and active participants. In the process of international tax reform, developing countries need to be proactive as Participants and not just Attendees; and be on an equal footing to developed countries in proposing and advocating for both agenda items and standards, and not just come into the process at the implementation stage. There is also a need

[167] See Manuel F. Montes & Pooja Rangaprasad, 'Collaboration or Co-optation? A review of the Platform for Collaboration on Tax', South Centre Policy Brief 48, June 2018. Available from https://www.southcentre.int/policy-brief-48-june-2018/.

to have the voice of the least developed countries heard in these fora, as they suffer from the highest rates of IFFs globally. However, as the graphic below shows, low income countries have very limited participation in the creation of global tax regulations.

<u>Who Makes the Rules?</u>[168]



At the national level, developing countries are looking for ways to curb IFFs, which includes reforming domestic tax legislations and customs rules. A report by Global Financial Integrity[169] argues that a significant constriction of the facility of trade mis-invoicing can help curb IFFs. It suggests that countries should introduce and enforce laws that prohibit the "deliberate manipulation" of prices of international transactions between related firms and require investors to sign a statement promising compliance to the legislation. This approach could serve as an alternative to more effective auditing of transfer pricing, as it has the advantage that it can be initiated unilaterally by countries. The effectiveness of enforcement will be greatly enhanced if all countries, or at least those whose investors undertake transactions among them, were to undertake the action in a concerted manner.

IFFs continue to be a global problem, and the industry that facilitates them manages to remain largely outside the scope of international regulation, and even the public spotlight. Recent investigations such as the Panama Papers, LuxLeaks[170], SwissLeaks[171] and others have brought this industry into global cynosure, and it is an invaluable moment for countries

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[168] Financial Transparency Coalition Policy Brief, 'Who Makes the Rules on Illicit Financial Flows?'; Image available https://financialtransparency.org/wp-content/uploads/2015/03/IIA.jpg.
[169] Global Financial Integrity et al, 'Accelerating the IFF Agenda for African Countries', January 2017, p. 7. Available from www.gfintegrity.org/wp-content/uploads/2017/03/Accelerated-IFF-Agenda-Final-Report-English_print.pdf.
[170] ICIJ Investigation, Luxembourg Leaks. Available from https://www.icij.org/investigations/luxembourg-leaks/.
[171] ICIJ, Swiss Leaks. Available from https://projects.icij.org/swiss-leaks/.

to galvanize public opinion and create binding rules which would limit its ability to facilitate IFF outflows out of developing countries.

There is a definite interest among some UN member states to create an international instrument for the regulation of commercial IFFs in a manner similar to other forms of IFFs. In a recent Resolution[172], the UN General Assembly has reiterated its concern on the impact of IFFs on the "economic, social and political stability and development of societies, and especially on developing countries", and called for, *inter alia*, "greater international cooperation and sustained dialogue to combat illicit financial flows and strengthen good practices on assets return to foster sustainable development…"[173]

The need for greater inclusion in international decision making was probably best captured by a slogan heard at the Third FfD Conference in Addis Ababa, that *"If you are not on the table, you are on the menu"*. The Group of 77 and China has been a strong supporter of increasing cooperation in tax matters, and has consistently called for the creation of a "single global inclusive forum for international tax cooperation at the intergovernmental level."[174]

Enhancing international tax cooperation is not the panacea which will resolve the pernicious effects that commercial IFFs have on the development of a country. Rather, it is the indispensable first step towards having a more equitable, inclusive system for international taxation.

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[172] Resolution adopted by the General Assembly on 20 December 2017; A/RES/72/207.
[173] Resolution adopted by the General Assembly on 20 December 2017; A/RES/72/207, para. 12.
[174] See G77 and China Statement on 7 April 2017, available from www.un.org/esa/ffd/wp-content/uploads/2017/04/2017-ICTM-Statement-Ecuador-G77.pdf; also see G77 and China Statement on 18 May 2018, available from www.g77.org/statement/getstatement.php?id=180518b.

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