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Climate Finance Withholding Mechanism:

Exploring a potential solution for climate finance needs of the developing countries

By Radhakishan Rawal *

Abstract

The developed countries' commitment to provide climate finance to the developing countries has remained unfulfilled. The Climate Finance Withholding Mechanism (CFWM) is a potential solution for addressing climate finance needs of the developing countries. The CFWM adopts the well settled "withholding mechanism" under the tax laws to provide a steady flow of funds to the developing countries.

Multinational enterprises' (MNEs) tax residents of developed countries earn income from the developing countries and pay tax on such income in the developed countries. The CFWM requires retention in the developing country, of the amount of tax so payable by the MNE, towards climate finance commitments of the developed countries. The CFWM does not result in additional tax outflow for the MNEs and also does not adversely impact taxing rights of the developed countries. The CFWM results in application of tax revenue of the developed countries towards their climate finance commitments. The CFWM does not address all the issues related to the climate finance problem but only attempts to speed up the flow of funds to the developing countries from where the relevant income originates.

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Le non-respect par les pays développés de l'engagement qu'ils ont pris d'allouer des fonds aux pays en développement afin de lutter contre les effets du changement climatique oblige ces derniers à devoir trouver d'autres sources de financement pour répondre à leur besoin dans ce domaine. Une solution potentielle existe sous la forme d'un mécanisme utilisant le principe bien connu de la retenue fiscale (CFWM), qui permettrait aux pays en développement de disposer d'une source stable de financement.

Les entreprises multinationales qui ont leur siège dans les pays développés sont assujetties à l'impôt dans ces pays alors même qu'elles tirent une partie de leurs revenus de pays en développement. Le CFWM a pour conséquence que le montant de l'impôt dû par l'entreprise multinationale fait l'objet d'une retenue dans le pays en développement, qui sert à financer les engagements des pays développés en matière de climat. Ce mécanisme n'entraîne pas de sorties d'impôts supplémentaires pour les multinationales et n'a pas non plus de répercussions négatives sur les droits des pays développés en matière d'imposition. Il ne fait qu'allouer une partie des recettes fiscales des pays développés au financement du changement climatique, auquel ils ont pris l'engagement de contribuer. Le CFWM ne permet pas de résoudre toutes les questions liées au problème du financement climatique. Son objectif est simplement d'accroître les flux de fonds vers les pays en développement, où sont générés les revenus concernés.

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Los países desarrollados no han cumplido su compromiso de proporcionar financiamiento climático a los países en desarrollo. El Mecanismo de Retención de Financiamiento Climático (CFWM, por sus siglas en inglés) es una solución potencial para atender a las necesidades de financiamiento climático de los países en desarrollo. El CFWM adopta el conocido "mecanismo de retención" bajo las leyes fiscales para proporcionar un flujo constante de fondos a los países en desarrollo.

Los residentes fiscales de las empresas multinacionales (EMN) de los países desarrollados obtienen ingresos de los países en desarrollo y pagan impuestos sobre dichos ingresos en los países desarrollados. El CFWM requiere que, en el país en desarrollo, se realice la retención del monto del impuesto pagadero por la MNE, para compromisos de financiamiento climático de los países desarrollados. El CFWM no provoca una salida de impuestos adicional para las empresas multinacionales y tampoco tiene un impacto adverso en los derechos fiscales de los países desarrollados. El CFWM da como resultado la aplicación de los ingresos fiscales de los países desarrollados a sus compromisos de financiamiento climático. El CFWM no aborda todas las cuestiones relacionadas con el problema de la financiación climática, sino que solo intenta acelerar el flujo de fondos hacia los países en desarrollo de donde se originan los ingresos correspondientes.

* Author is Mumbai, India based Chartered Accountant and a former member of a sub-committee of the United Nations Tax Committee. Views expressed if any in this article are personal views of the author and do not represent views of any organisation. Certain articles written by the author can be found at radhakishanrawal.com.

Introduction

US$ 100 billion per year by 2020, is what rich countries pledged as funding support for climate change activities to developing countries back in 2009 at the Copenhagen climate summit. This target has not been met because too few industrialized countries are paying too little in contributions. It is uncertain whether it can be met until 2025 as agreed at the Conference of the Parties (COP) 21 in Paris[1].

This document proposes a tried and tested mechanism of withholding tax for collection towards climate finance. The proposed mechanism can be termed as Climate Finance Withholding Mechanism (***CFWM***). Its salient features are summarized in the box below.

The CFWM proposal and its mode of operation is further elaborated below.

1. Withholding as a method of recovery

The easiest method of collection of taxes on income is withholding tax also known as deduction of tax at source. The payer of the income has to act as an agent of the government and is obliged to deduct tax from the amount payable by him and deposit with the government. Under the tax treaties between developed and developing countries[3], certain specific categories of income such as royalties, fees for technical services, interest and dividend are allowed to be taxed in the source country and taxing rights are generally exercised by withholding taxes at source. The same mechanism can be explored for collection of funds towards climate finance from the developed countries.

2. How will the Climate Finance Withholding Mechanism work?

The governments' revenue can be broadly divided in two parts viz. tax revenue and non-tax revenue. The government uses this revenue for various purposes. The government of a developed country is expected to use what would be a tiny portion of this revenue to comply with its commitments regarding climate finance to the developing countries. This is diagrammatically presented in the picture in the next page.

Under the suggested approach of the CWFM, the recoveries for climate finance can be done at the source of the tax revenue i.e. before the money flows from the developing country to the MNC. The payer of the income from the developing country to an MNC based in a developed country can deduct money towards climate finance at source from the amount payable by him and pay it to the government of the developing country. The amount to be recovered at source can be termed as Climate Finance Recovery (***CFR***).

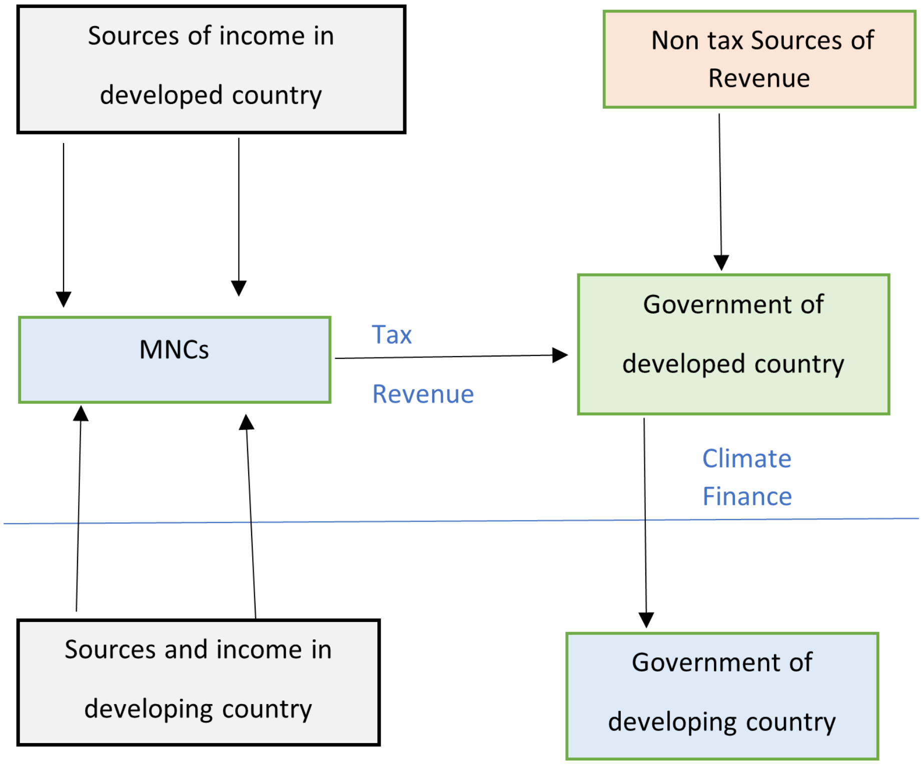
3. Does it result in additional tax outflow for the MNCs?

CFR payments under the CFWM to the developing country will not result in a higher tax outflow by the MNCs. Every sovereign country is entitled to levy tax on income earned by non-residents. In a cross-border transaction, the MNC could be liable to tax in the source country or in both the source country and the residence country.

When a bilateral double tax avoidance treaty exists between the two countries, the taxing rights are distributed between them and when the taxing rights are given to the source country, the country of residence has an obligation to mitigate double taxation. This could be either under an "exemption method" or a "credit method". The country of residence would generally mitigate double taxation even when a double tax avoidance agreement does not exist between two countries.

Salient features of the CFWM

- Every year international trade and commerce results in income worth millions of dollars flowing from the developing countries to the developed countries yet the funds which should flow from developed countries to developing countries towards climate finance commitments are not flowing. The Climate Finance Withholding Mechanism attempts to recover and redirect funds from international trade and commerce towards implementing the climate finance commitment with developing countries.
- Under the bilateral tax treaties, the developing countries are either not able to levy tax on the income generated/ funds flowing from their jurisdiction or are able to levy only a limited amount of tax. The CFWM requires that an amount equivalent to the tax[2] levied by the developed country is retained in the developing country towards the realization of the climate finance commitment. Illustrations A and B below explain this.
- The CFWM does not result in additional tax outflow for the Multinational Corporations (MNCs).
- The CFWM does not adversely impact taxing rights of any country.
- The CFWM adopts a soft approach to ensure compliance by MNCs. While the Climate Finance Recovery amount withheld is to be deposited with the tax authorities of the source country, the tax authorities of that country would not have the right to audit the MNC.
- The CFWM will be linked to Environmental, Social and Governance (ESG) obligations.
- A certificate from a(n) statutory / independent auditor and linkage with ESG obligations will ensure CFWM compliance by MNCs.



The country of residence generally has wider taxing rights as compared to the source country and MNCs generally will have an obligation to pay tax in the country of residence in addition to the tax payable in the source country. Under the CFWM this additional tax may be diverted to the source country as CFR. Thus, as against the MNC paying this additional tax in the country of residence, this additional tax amount will be withheld in the source country.

Accordingly, CFWM will not result in additional tax cost to the MNCs.

4. Does CFWM take away taxing rights of any country?

The CFWM does not take away or adversely impact taxing rights of any country in any manner. The rights of the developed country remain undisturbed under CFWM. All that happens under CFWM is that the amount of tax which the developed country could have gathered by exercising the taxing rights is allocated towards that country's climate finance obligations. This is essentially an application of the taxes accruing to the developed countries towards their international commitments (i.e. climate finance commitment) and does not reduce sovereign taxing rights of such countries. CFWM is only a cashflow management.

5. Illustrations

The Climate Finance Withholding Mechanism can be explained on the basis of the following illustrations.

5.1 Illustration A – When source country does not have taxing rights

Facts

- A Ltd. is a tax resident of Country R and derives royalty income of USD 100 from Country S.
- AB Ltd., a subsidiary of A Ltd. in Country S, pays royalties to A Ltd.
- Under the bilateral tax treaty between Country R and Country S, Country S does not have the ability to levy tax on the royalties derived by A Ltd.
- A Ltd. pays tax of USD 17 in Country R on the royalties earned from AB Ltd.

Application of CFWM

- Under the CFWM, AB Ltd. will deduct Climate Finance Recovery of USD 17 from the royalties payable to A Ltd. and pay this amount to the Government of Country S.
- A Ltd. will get a credit of USD 17 in Country R and hence will not have to pay additional tax there.

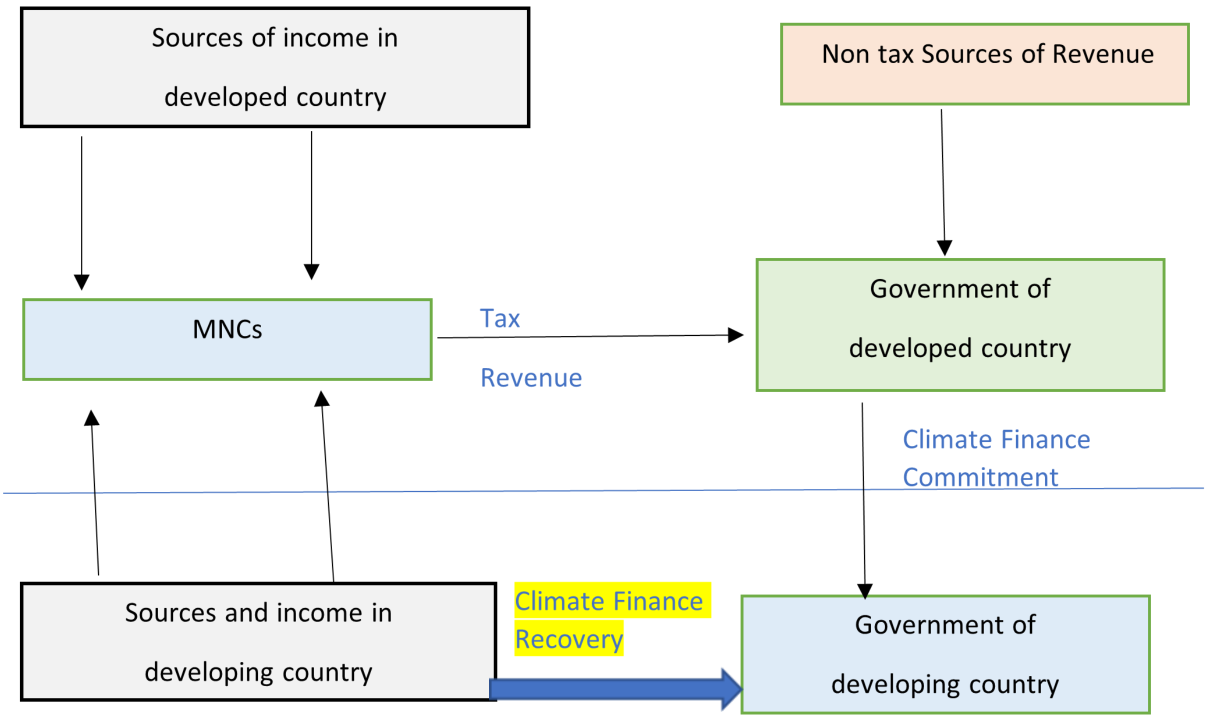
Analysis

Ordinarily A Ltd. would have paid additional tax of USD 17 in Country R and ideally the same may have travelled back to Country S towards climate finance commitment. Under CFWM, the same amount of USD 17 is retained in Country R towards climate finance commitment.

5.2 Illustration B – When source country does have taxing rights

Facts

- Z Ltd. is a tax resident of Country R and derives royalty income of USD 100 from Country S.



- ZZ Ltd., a subsidiary of Z Ltd. in Country S, pays royalties to Z Ltd.
- Under the bilateral tax treaty between Country R and Country S, Country S does have an ability to levy tax on the royalties derived by Z Ltd. to the extent of 5%.
- Z Ltd. is liable to pay tax of USD 17 in Country R on the royalties earned from ZZ Ltd.
- Z Ltd. gets a credit for USD 5 in Country R for the taxes paid in Country S. Z Ltd. pays incremental tax of USD 12 to the government of Country R as final tax liability.

Application of CFWM

- Under the CFWM, ZZ Ltd. will deduct Climate Finance Recovery of USD 12 from the royalties payable to Z Ltd. and pay this amount to the Government of Country S.
- Z Ltd. will get a credit of USD 12 in Country R for the amount withheld by ZZ Ltd. and hence will not have to pay additional tax there.

Analysis

Ordinarily Z Ltd. would have paid additional tax of USD 12 in Country R and ideally the same may have travelled back to Country S towards climate finance commitment. Under CFWM, the same amount of USD 12 is retained in Country S towards climate finance commitment.

ZZ Ltd. will collect USD 5 as normal withholding tax and USD 12 as CFR. These amounts may be deposited in separate accounts maintained by the government of Country S.

6. Quantification issues

The illustrations in the preceding paragraphs may appear very simple to implement but there would be practical issues related to quantification of tax payable by the MNC in the country of residence. The tax payable in the country of residence on an income derived from the source country is required to be determined as per the laws of the country of residence. At withholding stage this amount may not be available. Additionally, even when such an amount is available, it would be difficult for the person liable for withholding in the source country to verify the accuracy of such amount. This can be analysed on the basis of another illustration.

6.1 Illustration C – Absence of permanent establishment

Facts

- X Ltd. is a tax resident of Country R and derives business income of USD 100 from Country S.
- X Ltd. does not have a permanent establishment in Country S. XX Ltd. is X Ltd.'s business associate in Country S and X Ltd. derives income of USD 100 from XX Ltd.
- Under the bilateral tax treaty between Country R and Country S, Country S does not have the ability to levy tax on the business income earned by X Ltd. in absence of X Ltd. having a permanent establishment in Country S.

Issues

The following facts make quantification of amount to be withheld difficult:

- Under the CFWM, XX Ltd. will have the obligation to withhold amount of tax, which X Ltd. is liable to pay under the laws of Country R.

- Amount of USD 100 payable by XX Ltd. to X Ltd. is payable not for a single transaction but for various transactions between the parties through the year.
- X Ltd. will be liable to pay tax on its net income and hence deductibility of various expenses incurred by X Ltd. for earning income of USD 100 would also be relevant.

Solution

- The quantification of tax payable in Country R can be initially done only by X Ltd., which will be finalised / accepted by the tax authorities of Country R at a subsequent stage.
- X Ltd. can estimate the amount of tax payable by it on the income receivable from XX Ltd. and inform XX Ltd. the amount to be withheld towards CFR.
- XX Ltd. will withhold CFR based on the information received from X Ltd. and will deposit it with Country S' government.

6.2 Adoption of average rate of tax

Computation of net income specifically for the income earned from the source country (i.e. out of USD 100 in Illustration C) may be difficult for various reasons including the following:

- Total income of the MNC may consist of several sources of income and income from another developing country may be one of the sources.
- The MNE may have incurred common expenses and identification of expenses specifically incurred for earning income from the developing country could be difficult.
- Some businesses / transactions may result in losses.

Considering the above, average rate on the consolidated income of the entity may be adopted to determine CFR.

In Illustration C, if the gross total income of X Ltd. from all sources is USD 1000 and total tax on such income is USD 180, then the average rate of tax would be 18%. Tax payable under the domestic law of Country R by X Ltd. on income earned from Country S would be USD 18 and this amount will be payable by X Ltd. as CFR in Country S.

During the year, based on the information provided by X Ltd., XX Ltd. may withhold USD 10 as CFR from payments to X Ltd. At the year end when X Ltd. makes the final computation of income, the additional amount of USD 8 can be paid by X Ltd. to XX Ltd. for depositing with the government of Country S. Alternatively, the additional amount of USD 8 may be withheld from the subsequent years' payments to X Ltd.

7. Verification issues

Illustration C may be used for the purpose of analysing the verification issues as well.

The issue is verification of correctness of the amount of CFR determined by X Ltd. As analysed in the preceding paragraph the amount of CFR will be calculated by X Ltd. on its own and will be informed to XX Ltd. Which authority should audit the computation done by X Ltd.?

Two approaches for this issue are analysed in the ensuing paragraphs.

7.1 Approach A – Strict approach

Under this approach the tax authorities of Country S will examine the correctness of the computation of CFR computed by X Ltd. This is on the basis that under CFWM, Country S is entitled to receive CFR and accordingly it should also have the corresponding right to examine correctness of the computation and claim additional amount if the computation done by the MNC is not correct.

The difficulties with this approach include the following:

- Tax payable by X Ltd. in Country R is to be determined as per the tax laws of Country R. The tax authorities of Country S would not have the ability to do that determination or development of such capabilities could be difficult.
- It would be extremely difficult for tax authorities of Country S to verify various claims for deduction for expenses made by X Ltd.

7.2 Approach B – Soft approach

Under this approach the tax authorities of Country S will not be authorised to verify the CFR amount computed by the MNC.

- Under the Soft Approach the mechanism for verification and ensuring that the CFR is appropriately discharged will be as follows:
    - ◊ Verification of tax liability in Country R on the income earned from Country S will be done by the tax authorities of Country R as is ordinarily done.
    - ◊ During the year, the MNC will calculate CFR on estimated basis and discharge CFR liability through the person from whom it earns income from Country S (i.e. XX Ltd. in Illustration C).
- At the end of the year after filing its annual tax return in Country R, the MNC will determine whether any additional CFR is payable by it for the year and will address the shortfall if any by discharging the CFR liability in Country S.
- The annual return filed by the MNC may get audited by the tax authorities of Country R at a subsequent stage. If such audit results in any additional tax liability on the income derived from the source

country, the MNC will discharge such additional tax liability by paying CFR in the source country.

- Every year the MNC will obtain a certificate from its statutory auditor / independent auditor certifying that the MNC has appropriately determined and discharged its CFR obligation for the current as well as the earlier years.
- The companies are required to report various steps taken by it towards environment, sustainability and governance (ESG) obligations – ESG Reporting. Payment of CFR in the source country can be included in the ESG Reporting. Adverse ESG Report will adversely impact the operations of the MNC including its reputation.
- Adverse certificate by the statutory / independent auditor and adverse ESG Report will act as a deterrent for the MNC.

7.3 Continued interest for the country of residence

The issue to be addressed is, if the amount of tax determined in Country R is to be paid to the Country S, would the country of residence be interested in ensuring that the tax is appropriately determined?

The answer would be "yes". This is for the reason that although the tax on income is ultimately paid in Country S as CFR, such payment effectively reduces the climate finance commitment for Country R.

8. Does it result in more compliance by the MNCs?

The CFWM does not increase the total liability of the MNCs. Further, once the procedures related to CFWM are settled, CFWM will also not significantly increase the compliance burden for the MNCs. As analysed in ***part 7.2*** CFWM adopts a softer approach by relying on the statutory auditor's certification to ensure that the compliance burden on MNCs is kept minimum from the perspective of audit / assessment by the tax authorities of the source country. The company in either case has to compute the amount of final tax payable by it in the country of residence. Under CFWM the amount of incremental tax so determined will be paid to the government of the source country if that happens to be a developing country.

Various ESG initiatives suggest that some MNCs have taken climate issues seriously[4] and when reckoned against that the additional compliance for CFWM does not appear to be a challenge.

9. Why CFWM could be a better solution?

Undoubtedly a mechanism like CFWM cannot be introduced without acceptance by the developed countries. A question which may arise is, if the developed countries accept their obligation to contribute towards climate finance, why the withholding mechanism is preferable as against the developed country directly making the payment (direct payment method)?

The arguments in favour of CFWM will include the following:

- A commitment to contribute has not solved the problem. The developed countries made the commitment long back and the idea of CFWM has emerged only because it has not been fulfilled.
- Transferring large amounts of money from the developed countries could be difficult due to various processes and releasing such funds could be a difficult decision. CFWM automates the process and avoids discretion or decision making every time an instalment of money is to be released.
- As shown in the diagrams CFWM represents a short route for collection of funds.
- Withholding taxes at source has its own advantages; this is the reason why this method can be found in several matured tax systems.
- CFWM will also offer a steady and continuous flow of funds to the developing countries as against the direct payment method which involves discretion and has not given desired results.

It needs to be noted that the collection under CFWM will be directly dependent on the volume of international trade between the developed and developing country, particularly on the amount of funds flowing from the developing to the developed country. In the case such flow is small, the countries will have to rely more on other mechanisms of Climate Finance. CFWM does not promise to solve the financial gaps for all the countries but can be one of the complementary mechanisms for routing such finance to the developing countries.

10. Interplay between CFWM and STTR

The Subject to Tax Rule (STTR) is one of the four rules of the Inclusive Framework's Pillar Two. Under this Pillar Two STTR the source country is given taxing rights when income is not adequately taxed in the country of residence. The Pillar Two STTR is still a work in progress.

The United Nations (UN) Tax Committee is also developing a STTR (UN STTR) whose scope is broader than the Pillar Two STTR. The UN STTR is also a work in progress.

There is no overlap between the STTR and the CFWM. STTR will be triggered when the country of residence does not adequately tax MNC. CFWM can be applied when the country of residence is adequately taxing the MNC.

11. Conclusion

This note contains initial thoughts on how a Climate Finance Withholding Mechanism can be structured for channelling funds from the developed countries to developing countries to comply with climate finance commitments. There could be scope for significant improvement of this structure with the participation of various government authorities, international organisations and experts. CFWM only addresses the cash flow issue. However, the mechanism would be possible only if the concerned governments agree to put it in practice.

Annex

Comments by Dr. Muhammad Ashfaq Ahmed, Member, United Nations Tax Committee

1. This concept note contains initial thoughts on how the Climate Finance Withholding Mechanism (CFWM) can be structured for channelizing funds from the developed countries to developing countries towards climate finance commitments in order to fund developing countries' emission reduction plans. CFWM requires that amount equivalent to tax levied by the developed country is retained in the developing country towards climate finance commitment. Withholding method can be explored for collection of funds towards climate finance from the developed countries.

2. Under the suggested approach of CWFM, the recoveries for climate finance can done at the source of the tax revenue i.e., before the money flows from developing country to the MNC. The payer of the income from the developing country to the MNC in the developed country can deduct money towards climate finance at source from the amount payable by him and pay it to the government of the developing country. The amount to be recovered at source can be termed as Climate Finance Recovery (CFR).

3. The country of residence generally has wider taxing rights as compared to the source country and MNCs generally will have an obligation to pay tax in the country of residence in addition to the tax payable in the source country. Under the CFWM this additional tax may be diverted to the source country as CFR. Thus, as against the MNC paying this additional tax in the country of residence, this additional tax amount will be withheld in the source country. Accordingly, CFWM will not result in additional tax cost to the MNCs.

4. The CFWM does not result in additional tax outflow for the MNCs. All that happens under CFWM is that the amount of tax which the developed country could have gathered by exercising the taxing rights is diverted towards that country's climate finance obligations. Statedly, the CFWM does not adversely impact taxing rights of any country. Ostensibly, the CFWM would encounter the challenge of quantification, adoption of average rate of tax, and verification etc.

5. The CFWM adopts a soft approach to ensure compliance by MNCs. While the Climate Finance Recovery amount withheld is to be deposited with the tax authorities of the source country, the tax authorities of that country will not have the right to audit the MNC. Under the Soft Approach the mechanism for verification and ensuring that the CFR is appropriately discharged will be as follows:

- Verification of tax liability in Country R on the income earned from Country S will be done by the tax authorities of Country R as is ordinarily done.
- During the year, the MNC will calculate CFR on estimated basis and discharge CFR liability through the person from whom it earns income from Country S.
- At the end of the year after filing its annual tax return in Country R, the MNC will determine whether any additional CFR is payable by it for the year and will address the shortfall if any by discharging the CFR liability in Country S.
- The annual return filed by the MNC may get audited by the tax authorities of Country R at a subsequent stage. If such audit results in any additional tax liability on the income derived from the source country, the MNC will discharge such additional tax liability by paying CFR in the source country.

6. The CFWM will be linked to Environment, Sustainability and Governance (ESG) obligations. A certificate from the statutory / independent auditor and linkage with ESG obligations will ensure CFWM compliance by the MNCs. Adverse certificate by the statutory / independent auditor and adverse ESG Report will act as a deterrent for the MNC. There is no overlap between STTR and CFWM. STTR will be triggered when the country of residence does not adequately tax the MNC. CFWM can be applied when the country of residence is adequately taxing the MNC.

Critique

7. In the current dispensation (domestic law and double taxation agreements (DTAs)), there is no mechanism to withhold tax in respect of CFR for CFWM, therefore, there would have to be a standalone multilateral instrument to implement it, which would be of some size. Materially, it makes little difference as foreign exchange would not be flowing from developed countries although presumption is CFWM would result in lesser outflows from developing countries. One is also skeptical of the presumption (on the part of the author) that CFWM would "not adversely impact taxing rights of any country." In fact, when the MNC would end up paying tax in the source (developing) states, instead of the (developed) residence state, the latter's taxing rights would inevitably get compromised. However, if the underlying argument is that the developed country would willingly let go of its revenue, then why take the long and complicated route of CFMW; why not the developed country collects the amount itself and transfers it to the developing one. The proposal is expected to receive little support from developed countries since they would treat it as a hole in their sovereignty. Likewise, the developing countries that are already finding it difficult to exact actual tax recoveries from powerful MNCs due to capacity constraints would find it too hot to handle. The proposal, in its present shape, at least, has too many unknowns and loose ends.

Endnotes:

[1] See https://us.boell.org/en/2021/10/25/broken-promises-developed-countries-fail-keep-their-100-billion-dollar-climate-pledge. Also refer to https://unfccc.int/sites/default/files/resource/docs/2009/cop15/eng/11a01.pdf and https://webassets.oxfamamerica.org/media/documents/bn-climate-finance-short-changed-191022-en.pdf?_gl=1*11rhcuo*_ga*MTA1NTYzNzA5LjE2NjY3OTk5MTI.*_ga_R58YETD6XK*MTY2NjgwNTcwMi4yLjAuMTY2NjgwNTcwMi42MC4wLjA.

[2] Incremental tax in case the developing country is also able to levy tax on such income

[3] Such provisions can also be found in the tax treaties between developed countries.

[4] The annual financial statements of the listed companies give detailed account of steps taken by the company on reduction of emissions, adoption of new technology, replacement of old inefficient machinery, reduced reliance on fossil fuels etc.

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The South Centre
International Environment House 2
Chemin de Balexert 7-9
PO Box 228, 1211 Geneva 19
Switzerland
Tel.: +41 (0)22 791 8050
south@southcentre.int
https://www.southcentre.int

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