

What is at stake in the UN tax negotiations

Manuel F. Montes

At the fifth negotiating session of the United Nations Framework Convention on International Tax Cooperation (UNFCITC) in New York on 3–13 August, it became indisputable that genuine negotiations are underway towards a mechanism for sharing taxation rights among sovereign member states based in the United Nations. Delegates dealt with actual text as they debated the underlying principles and rights embodied in the proposed text.

A historic process to overturn a historical inequity

These negotiations could establish a new international tax cooperation institution where all sovereign countries have access to agenda setting and to the allocation of obligations and rights to be served by a secretariat that reports to all the UN member states, instead of just to OECD member countries. (It is a pity that at this conjuncture the resources of the secretariat to provide technical backstopping are severely constrained by UN budgetary restrictions.)

What is at stake in these UN negotiations towards an international treaty on taxing international profits and incomes?

The dominant tax system, put in place in a network of treaties under the auspices of the Organisation for Economic Cooperation and Development (OECD), allows multinational companies and rich citizens – who can easily create companies in other countries – to transfer profits they make in one country to other countries such as Switzerland, the Netherlands and the Bahamas so that they avoid taxes on the profits and income they make in the original country.

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Address: 131 Jalan Macalister, 10400 Penang, MALAYSIA Tel: 60-4-2266728/2266159 Fax: 60-4-2264505

Email: twn@twnetwork.org Website: www.twn.my

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The OECD system requires, among others, that profits can only be taxed when an international company has a physical presence in a country. For example, it has become customary that when riders use Uber, they pay Uber directly through their credit card, and the payment is remitted directly to a company in the Netherlands. The country where Uber provided the service has no access to the profits made there, except possibly to tax the income of the driver. Meanwhile Google, which provides its services to users for free, makes money from advertisements on its website; because it has no physical presence, its super-profits are not reachable by local tax authorities.

Profits transferred abroad mean that local taxpayers bear a greater burden of the cost of running the government than otherwise.

What is at stake in the UN negotiations is a change in the rules of the global tax system so that all governments have the means to tax profits and incomes made in their own territory.

Countries can choose not to tax those profits. But under the current system, many countries don't even have the chance to decide whether or not to tax those profits because the rules keep them out of reach.

The inequity in taxation rights has long been recognized by legal scholars and tax administrators. The prevailing rules that facilitated profit transfers to low- or no-tax jurisdictions became themselves an obstacle to revenue-raising efforts in rich countries, which sought the assistance of the OECD secretariat.

In 2014, one year before the first results of the G20-OECD Base Erosion and Profit Shifting (BEPS) project were announced, an International Monetary Fund (IMF, 2014) staff analysis suggested that 'the network of bilateral double taxation treaties based on the OECD model significantly constrain the source country's rights'. Conceptually, the 'source country' is the territory where profits are made and income is earned, as opposed to the 'resident country' where a corporation is headquartered.

The 'results' of the so-called 'Two Pillar' G20-OECD BEPS project did not make a meaningful dent in correcting these imbalances. 'Results' is in fact an overstatement, in light of the non-accessions, compromises and exemptions – even among OECD countries – to the outcome.

In the competition among developing countries to attract foreign investments from rich countries, local tax officials often have to contend with the strong preference of prospective investors for the use of OECD approaches to taxation. These approaches facilitate the transfer of profits out of the country – even when the country has no applicable double taxation treaty.

Where there is an OECD-style double taxation treaty in force, this invariably prohibits the collection of withholding taxes on profits. Withholding tax approaches place the onus of proving legitimate deductible costs against profits on the taxpayer. The Africa Group of countries, notably, seek a UN treaty that does not prohibit withholding taxes, a standard feature of many tax systems, even in OECD countries.

The arena of negotiations

In the ongoing textual negotiations, there is a distinct underlying difference between developed countries (mainly from Europe, the US having withdrawn from participating earlier) and many developing countries led by the Africa Group. The negotiations are a tale of two cities, or two planets. (There is a third group comprising developing countries which are presently seeking OECD membership and remain mostly silent.)

The difference can be traced to disparate starting points. The starting point of European negotiators appears to be as follows: Despite the failure of the BEPS process, there is nothing fundamentally wrong with the current system and decision-making processes in the matter of sharing sovereign taxing rights; the UN might as well import these standards and practices and avoid establishing new treaty obligations that will require renegotiation of existing agreements.

Same expertise, different positions

It is notable that member states have chosen to send their tax administration experts to represent them at the UNFCITC negotiations. It is useful to recognize the privileged niche the OECD tax system occupies in the minds and practices of this community of tax experts. This system has fostered lucrative international careers – paths available even to developing-country experts – in legal departments of multinational companies, in the Big Four global accounting firms and in private consultancies. The OECD Transfer Pricing Guidelines, for example, delineate the properties and standards by which international companies can justify transfer-pricing flavoured transactions among their ‘separate entity’ subsidiaries.

This niche lies behind the ‘legalese’ uttered by the participants in the negotiations. For the Africa Group negotiators, however, even as they partake of the same expertise, the OECD regime has systemically justified the transfer of considerable taxable profits out of the reach of domestic authorities. Thus, the contrast in negotiating positions, while rooted in the same expertise, reveals that what is really at stake in the negotiations are matters of sovereign capabilities in the pursuit of social objectives.

In contrast, the Africa Group appears to start from the view that the BEPS proposals floundered on the shoals of the OECD’s ‘separate entity’ presumption in the tax treatment of profits, which assumes that each commercial entity has an unadulterated incentive to maximize its separate profit, even if owned by another entity in another jurisdiction. This presumption transfers onto local tax officials the burden of proving that the local subsidiary is mispricing its transactions with external related entities.

African studies have documented the scourge of trade mispricing or misinvoicing. The first such study, in 2015, found that in Africa 65% of taxable income is lost in what it labelled as ‘commercial’ flows, meaning those that would be legal under the prevailing transfer pricing practices (Mbeki Report, 2015). Elsewhere, Montes and Lunenburg (2023) documented the same kind of mechanism in the trading of coal exports from Indonesia, through Singapore, with coal-fired plants in India as their final destination.

Developing countries have long sought recognition by the OECD of simpler and practical approaches to catching mispricing undertaken among supposedly ‘separate entities’ as a legal vehicle for avoiding tax liabilities (Montes, Danish and Bernardo, 2019). A UN-based process has been seen as having the potential to come up with a solution.

The negotiations are now joined in the UN, 11 years after the discovery of significant tax revenue losses in Africa under the prevailing OECD system of tax cooperation.

Manuel F. Montes is a Senior Advisor with the Society for International Development.

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