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Businesses Tax Liabilities Would Face Change Under UN Tax Treaty

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- *KPMG experts review the UN's efforts to create new tax treaty*
- *Businesses should monitor process for potential consequences*

Some have characterized the United Nations' recent move to create a multilateral treaty on international tax cooperation as a fight between developing and developed countries—or a power grab by the UN at the OECD's expense.

The UN talks also can be seen as part of a broader geopolitical conflict between China and the US. Chinese influence at the UN, seen in the correlation between Chinese investment and UN voting alignment, could enable China to shape future UN negotiations to its benefit.

Each of these narratives has some element of truth, but none answer the question of why businesses should care. The short answer is that these negotiations likely will lead to changes in international tax rules that will affect businesses' tax liabilities, including through increased withholding taxes and other source-based taxes.

OECD's Role

To understand why the UN initiative matters and where it's likely headed, we need to understand the role the Organization for Economic Cooperation and Development has played in creating the existing international tax system. Having grown out of the Marshall Plan after World War II, the OECD now consists of 38 members, primarily developed democracies. For much of its history, OECD discussions were limited to its members.

The OECD historically has tried to reduce double taxation on cross-border business and trade, founded on the belief that trade helps raise living standards around the world. But the way in which double tax is avoided under the OECD Model Tax Convention limits source country taxing rights, including by reducing the scope and rate of withholding taxes.

Economic theory supports the OECD's approach, because high withholding taxes lead to excessive taxation and so stymie economic development. However, some have questioned whether developing countries actually benefit from tax treaties that reduce their withholding taxes.

The OECD and G20 countries more recently brought into negotiations key emerging markets, such as Brazil, China, and India. This expanded participation was formalized in 2016 with the creation of the Inclusive Framework on BEPS, which now has almost 150 members.

Why the UN

OECD critics typically cite two core concerns. First, they say the OECD process for designing policy isn't inclusive or transparent and gives inadequate weight to the views of developing countries. Second, they say the current international tax system is inconsistent with needs of developing countries and has undermined their ability to collect tax revenue. Critics essentially claim that the OECD is still a rich country club that is run in the interests of rich countries to the detriment of developing countries.

Some see the UN as a solution because its membership and organizational structure give more weight to the views of developing countries.

The UN typically operates through majority decision-making, whereas the OECD generally operates through consensus. At the UN, the more numerous developing countries can outvote developed countries to adopt measures that reflect their interests.

The UN's draft terms of reference to negotiate the new tax treaty prioritize taxation of cross-border services in an increasingly digitalized and globalized economy. Other priorities include measures against tax-related illicit financial flows and effective taxation of high-net worth individuals. That means the negotiations are likely to lead to increased withholding taxes on cross-border services, and possibly more digital services taxes and wealth taxes.

Business Impacts

While it's too early to say exactly how the UN initiative will play out, there are a few key dynamics at play.

First, the negotiations at the UN are expected to result in a treaty that is ready to be signed by Q4 2027. Early protocols, such as on the taxation of the digitalized economy, could be finalized at the same time as the treaty or shortly thereafter. Countries that sign on to the treaty (and any protocol) will then undertake ratification procedures, so any treaty and protocols will take time to become effective.

Second, the direct impact on developed countries' existing tax treaties is likely to be limited in the near term. The US and several other countries voted against the draft terms of reference, and most OECD countries abstained. However, because consensus isn't required, the UN process can proceed without US or other developed countries' support.

Although the UN can't compel countries to adopt new tax measures or change their existing tax treaties, the new UN body will work on new tax measures and establish new international standards for decades to come—all which will come with the UN stamp of approval. Those measures are likely to include greater withholding taxes and wealth taxes. Over time, the UN, certain NGOs, and others will pressure countries to implement those new measures and standards.

Third, the impact of the UN negotiations will be greatest in promoting measures that countries can adopt in their domestic law. Countries' adopting new or higher withholding taxes on cross-border services, for example, could have a particularly significant impact on US businesses, given the US' limited treaty network with developing countries.

Given the potential impacts of the negotiations, businesses should monitor the UN process and engage to ensure policymakers in all countries understand the potential consequences of the different policy choices that are on the table.

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