Papers on Selected Topics in Negotiation of Tax Treaties for Developing Countries

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Why Negotiate Tax Treaties

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Why Negotiate Tax Treaties

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1. Introduction

Countries entering into tax treaty negotiations need a good understanding of why they are doing so, and the benefits and costs that arise from having tax treaties.

Developing countries will often negotiate tax treaties in order to attract foreign investment. In many cases there may be pressing diplomatic reasons, e.g. as a response to pressure from another country. Sometimes they are negotiated because an advisor has suggested that it would be a good thing to do. On the other hand, some developing countries may refuse to have tax treaties, either generally or with particular countries, because of a fear of reduced revenue as a result of the limitations on source taxation that such treaties impose.

The decision to enter into treaty negotiations with another country is not one to be undertaken lightly, especially for developing countries. There are both benefits and potential costs to developing countries from concluding a tax treaty, so it is desirable to have a comprehensive tax treaty strategy, agreed (if possible) across the whole of government (especially with foreign ministries), before embarking on tax treaty negotiations.

Having an understanding of the potential costs and benefits of tax treaties, and the ways in which treaties operate to achieve intended outcomes, will assist in ensuring that the right negotiations are given priority and that particular negotiations result in the most beneficial outcomes. By understanding the reasons for entering into a treaty, tax treaty negotiators, tax administrations and taxpayers will have a better understanding of the policy framework underpinning their own, and the other country's, tax treaties.

Tax treaties can benefit both developed and developing countries. For treaties between two developed countries, where the capital flows are approximately equal in both directions, the removal of tax obstacles to cross-border investment and the prevention of fiscal evasion provide clear benefits to both countries. Any reductions in source taxation are generally offset by increased residence-based taxation.

The benefits to developing countries of tax treaties with developed countries, where the capital flows are almost exclusively one way, are less obvious. Nevertheless, in 1967, the United Nations Economic and Social Council (ECOSOC) noted that it was "[c]onfident that tax treaties between developed and developing countries can serve to promote the flow of investment useful to the economic development of the latter, especially if the treaties provide favourable tax treatment to such investments on the part of the countries of origin, both by outright tax relief and by measures which would ensure to them the full benefit of any tax incentives allowed by the country of investment".[1]

The economic benefits of treaties between two developing countries, though relatively small, may encourage development more generally within a region and may be a valuable tool in preventing cross-border tax avoidance and evasion. Tax treaties may also have other benefits, such as political benefits.

Countries enter into tax treaties for a variety of reasons. For each country, and indeed for each treaty entered into by that country, the reasons are likely to be different, depending on the economic and political situation of the country and its relations with the potential treaty partner country.

This paper seeks to examine the most common reasons why a country would enter into a tax treaty with another country. These may include some or all of the following:

1. To facilitate outbound investment by residents by:
   - removing or reducing double taxation on investment in the other country;
   - reducing excessive source country taxation;
   - in the case of low tax countries, creating a competitive advantage for its residents by reducing or removing source taxation;
   - removing or reducing tax discrimination on investment in the other country;
   - providing certainty and/or simplicity with respect to taxation on investment in the other country on outbound investment by residents.

2. To facilitate and encourage inbound investment and inbound transfers of skills and technology by residents of the other country by:
   - removing or reducing double taxation on the inbound investment or transfers;
   - reducing excessive source taxation;

[1] ECOSOC Resolution 1273 (XLIII) Tax Treaties between Developed and Developing Countries, 4 August 1967.

providing certainty and/or simplicity with respect to taxation of the inbound investment or transfers;

developing a closer relationship between tax authorities and business e.g. through the mutual agreement procedure;

maintaining benefits of tax concessions and tax holidays provided with respect to inbound investment or transfers.

3. To reduce cross-border tax avoidance and evasion through:

    exchange of tax information;

    mutual assistance in collection of taxes.

4. Political reasons, e.g.

    to send a message of willingness to adopt international tax norms;

    to foster diplomatic or other relations with the other country;

    to strengthen regional diplomatic, trade and economic ties;

    to comply with international obligations e.g. under regional economic agreements;

    to respond to pressure from the other country.

The importance of each of these reasons will be different in each situation. Motivations may vary depending on whether a country is a net exporter of capital (typically a developed country) or a net capital importer (typically a developing country). It is important to understand all perspectives when considering a negotiation request from another councapital importer (typically a developing country). esignD.0008 apitg T

2. Facilitation of cross-border investment and transfer of skills and technology

Relief from double taxation and prevention of tax discrimination have as their main aim the removal or reduction of tax obstacles to cross-border trade and investment. Prevention of fiscal evasion serves to support and protect the revenues of the treaty partner countries, especially where cross-border investment or dealings are involved.

2.1 Relief of double taxation

The primary purpose of tax treaties is commonly stated or understood to be 'for the avoidance of double taxation' of income arising from cross-border transactions. Until recently (2011), the United Nations Model Double Taxation Convention between Developed and Developing Countries ('UN Model Convention') specifically referred to avoidance of double taxation in its title[2]. A similar reference was found in the title of the Organisation for Economic Co-operation and Development's Model Tax Convention on Income and on Capital ("OECD Model Convention") prior to 1992. The Commentary on the OECD Model Convention, while acknowledging that elimination of juridical double taxation is the main purpose of tax treaties, notes that this reference was deleted from the title because tax treaties also address other issues such as the prevention of tax evasion and non-discrimination[3]. Presumably, the reference was deleted from the title in the UN Model Convention for similar reasons. Nevertheless, many countries continue to include a reference to avoidance of double taxation in the title of their conventions.

Double taxation arises where the same income or capital is taxed in both treaty partner countries. Juridical double taxation i.e. taxation of the same income in the hands of the same person in more than one country, occurs where:

- the same income is taxed in the hands of a person in both the country where it arises and in the country of which the person deriving the income is a resident (source/residence double taxation); or
- the same person is treated by both countries as being its own resident and is taxed on worldwide income or capital in both countries (residence/residence double taxation); or

[2] 'Convention between (State A) and (State B) for the avoidance of double taxation with respect to taxes on income and on capital'.

[3] Introduction, paragraph 16.

- x a person is taxed in both countries because the income is treated by both countries as having a source in its jurisdiction (source/source double taxation).

Juridical double taxation of this kind is clearly undesirable. As noted in the Introduction to the UN Model Convention "the effects of (international double taxation in respect of the same income) are harmful to the exchange of goods and services and movements of capital and persons". [4] This is true irrespective of whether the countries are develope

are not available under domestic law, e.g. by providing for exemption of certain foreign income where domestic law may provide only for foreign tax credits.

Allocation of exclusive taxing rights to one or other country has the dual benefit for the recipient of the income, or the owner of the capital, of ensuring no double taxation and simplifying that person's tax affairs. However, such provisions will also have revenue effects for the treaty partner country. Where, as is generally the case, sole taxing rights are given to the country of residence, the provisions will result in a loss of revenue for the source country.

For countries where the economic flows are approximately equal, any loss of source taxation revenue on inbound investment is likely to be offs 8197 TDo te n a l.1(o)romailabhavt tp,ment is licr.

The most common form of economic double taxation arises where associated enterprises are treated in different countries as having accrued the same profits. By putting in place in Article 9 an 'arm's

2.3 Prevention of tax discrimination

Discriminatory tax rules can be a significant deterrent to foreign investment. For example, it would be difficult for a foreign enterprise carrying on a business in a country to compete with a local enterprise if the rate of tax, or tax-related requirements, imposed on the foreign enterprise are much higher or more onerous than those imposed on a comparable local enterprise that is carrying on the same activities. Similarly, tax rules may prove an obstacle to cross-border loans or transfers of technology if deductibility of interest or royalties by a resident to a non-resident is denied or limited in circumstances where there would be no such limitation where a similar payment is made to a resident.

Tax treaties aim to remove these obstacles to cross-border activities by addressing some common forms of tax discrimination. The OECD Commentary on Article 24 Non-Discrimination notes that while "All tax systems incorporate legitimate distinctions based, for example, on differences in liability to tax or ability to pay"[9], the non-discrimination rules provided in tax treaties "seek to balance the need to prevent unjustified discrimination with the need to take account of these legitimate distinctions"[10]. However, not all forms of tax discrimination are dealt with in tax treaties, as discussed in paragraphs 1 to 4 of the Commentary on Article 24 of the OECD Model Convention.

In broad terms, the treaty rules prohibit tax discrimination in certain limited situations:

1. Nationality: Countries cannot subject a national of a treaty partner country to more

5. Foreign-ownershipa resident enterprise that is foreign-owned cannot be subjected to more burdensome taxation than locally-owned enterprises.

Non-discrimination rules apply to all taxes, not just income taxes and capital taxes covered by the treaty[11].

Tax discrimination of the kinds addressed under tax treaties could be removed unilaterally by countries wishing to attract foreign investment, and many countries seek to ensure that their domestic tax laws are non-discriminatory. However, by including non-discrimination rules in tax treaties, countries are able to provide a measure of certainty to potential investors that they will not be subject to tax discrimination in the event of future changes to domestic law.

2.4 Providing certainty and simplicity

One of the main ways in which a developing country can attract foreign investment is by ensuring that the tax environment for investors is clear, transparent and certain. Tax treaties can assist in achieving this by setting well-recognised and widely-adopted rules for the allocation of taxing rights over different types of income and for the determination of profits attributable to a permanent establishment or in dealings between related enterprises. Such rules can help to reduce complexity for taxpayers with cross-border activities, particularly where the treaty provides for taxation only in one country.

Since tax treaties usually continue for an extended period (often 15 years or more), they also provide a level of comfort to taxpayers that the tax treatment afforded to the income from their activities or investments in the other country will be reasonably stable. In the absence of a treaty, tax treatment under domestic law can, and often does, change frequently. Tax treaties do not preclude such changes, but they do impose limits on source taxation of certain types of income, and provide certain protections such as relief from double taxation, the application of the arm's length principle and non-discrimination rules. (As discussed below, while this is an advantage for investors, it does restrict policy flexibility of the treaty countries.)

Importantly, tax treaties also provide a mechanism for tax administrations to agree on how to interpret or apply treaty provisions, and to resolve disputes. Article 25 of the OECD Model Convention and the two versions of Article 25 put forward in the UN Model Convention set out a

[11] Paragraph 6 of Article 24 Non Discrimination.

Paragraph 3 of Article 25 also authorises and requires the competent authorities to try to resolve any difficulties or doubts arising as to the interpretation or application of the treaty. It also allows them to consult together for the elimiTdg alloc6lloWle

On the other hand, many countries resist the inclusion of tax sparing provisions in their tax treaties. In 1998, the OECD published a report entitled *Tax Sparing: a Reconsideration* which identified a number of concerns with tax sparing. In particular, it considered that tax sparing is vulnerable to taxpayer abuse, and was not necessarily an effective tool for promoting economic development. The Report did not say that tax sparing should *never* be granted, but suggested that it should only be considered in regard to States the economic level of which is considerably below that of OECD Member States. It also recommended the use of 'best practices' to minimise potential for abuse[15].

In negotiations with some of the least developed countries, developed countries may be prepared to agree to tax sparing provisions, particularly if the provisions are drafted in a way that limits the potential for abuse. Examples of such limitations that are found in some tax treaties include:

1.

banks or other financial institutions or fiduciaries must generally also be exchanged, notwithstanding any domestic confidentiality rules.

Some developing countries, particularly those whose capacity to obtain and exchange information is limited, may be concerned that the administrative burden of complying with Article 26 will be excessively onerous. For this reason, these countries sometimes prefer to limit the scope of the article to taxes covered by the treaty and perhaps some key domestic taxes[17]

International or regional obligations or expectations may also influence decisions to enter into negotiations. These may be as a result of membership of international organisations, or economic or trade arrangements, or bilateral agreements.

OECD member countries, for example, are expected to enter into tax treaties with each other[21]. While there is no equivalent recommendation for UN countries[22], member countries are certainly encouraged to do so[23].

At a regional level, the European Community (EC) treaty, while not making specific reference to tax treaties, oblige member countries to "enter into negotiations with each other with a view to securing for the benefit of their nationals… the abolition of double taxation within the Community"[24]. Regional economic or trade communities involving developing countries express similar aims for tax co-operation. For example, in 2007 the Association of Southeast Asian Nations (ASEAN) Finance Ministers agreed to "accelerate the completion of bilateral agreements on avoidance of double taxation and co-operation on other tax matters"[25]. The Southern African Development Community (SADC) has agreed that "Member States will take such steps as are necessary to establish amongst themselves a comprehensive (tax) treaty network"[26].

Countries may also agree to enter into tax treaty negotiations as part of arrangements to enhance bilateral relations. These may be linked to bilateral trade or investment agreements, but may equally be driven by diplomatic or other considerations.

Frequently, developing countries commence negotiations for a tax treaty primarily because they feel pressured to do so by another country. The pressure may come in the form of diplomatic or political representations, or from the tax administration or revenue officials from the other country or directly from taxpayers resident in the other country. The fact that another country requests a treaty is not, of

[21] See Recommendation of the OECD Council on the Model Tax Convention on Income and on Capital, 1997, that Governments of member countries pursue their efforts to conclude bilateral tax conventions with other member countries.

[22] See paragraph 12 of the Introduction to the UN Model Convention.

[23] E.g. see ECOSOC Resolution 1273 (XLIII), 4 August 1967.

[24] Article 293 of the EC treaty.

[25] Joint Ministerial Statement of the 11th ASEAN Finance Ministers' Meeting, Chang Mai, Thailand, 5 April 2007.

[26] Article 5 Tax Treaties, Memorandum of Understanding on Co-operation in Tax-Related Matters, 2002.

itself, a good reason to commence negotiations. It is important to consider whether entering into a tax treaty with that country is in the best interests of the country receiving the request.

5. Summary of costs and benefits to developing countries of having tax treaties

5.1 Benefits

- Increased foreign investment

By providing a clear, transparent, non-discriminatory and predictable tax environment, developing countries may facilitate and encourage foreign investment. While it seems self-evident that taxpayers looking to invest in another country will be encouraged to do so when they have confidence in the tax system of that country, there is little empirical evidence to show the extent to which the entry into a tax treaty will result in increased foreign inv

Increased foreign investment can have many benefits for a developing country in addition to increased revenue, such as higher economic growth, transfer of knowledge and skills, infrastructure building, increased employment and higher living standards.

- Increased certainty

Foreign investors, and the tax administrations in their country of residence, welcome the certainty and stability that tax treaties provide. Even where there is little cross-border investment, e.g. in treaties between developing countries, especially those between neighbouring countries or members of a regional economic community, tax treaties can provide the benefits of increased certainty with respect to taxation, and may resolve particular problem issues that have arisen between the two countries. While there may be little likelihood of attracting significant additional foreign investment through such treaties, the existence of a treaty would be expected to facilitate and encourage cross-border investment flows and economic activity between the two countries.

- Protection for investment abroad

Although there may be little or no investment abroad by a developing country at the time at which a treaty is negotiated, such outbound investment may grow as the country's economy develops. Because tax treaties are usually of long duration (often 15 years or more), treaties will provide certainty, protection from tax discrimination and relief from double taxation for future investment by residents of a developing country into treaty partner countries.

- Avoidance of fiscal evasion

Tax treaties help tax administrations to ensure that taxpayers do not escape taxation by moving capital abroad, or by not declaring income earned abroad, or by participating in abusive tax avoidance schemes. Exchange of information and, where provided, assistance in the collection of tax debts, help to protect the revenue and to ensure the integrity of the tax system in both countries.

5.2 Costs

- Tax treaties have an immediate revenue cost.

Tax treaties limit source taxation of certain income derived by non-residents. This will have an immediate impact on revenue in the source country, especially with respect to withholding tax collections, if the treaty rate of withholding is significantly lower than the domestic law rate. Other

limitations on source taxation will also reduce revenue. However, to the extent that those limitations affect income in respect of which the tax liability is problematic to collect (e.g. tax on profits from mobile activities in the absence of a permanent establishment, fixed base or long-term presence), the actual revenue forgone may not be significant.

The revenue cost of source tax limitations imposed by tax treaties will largely depend on the capital flows between the countries. However, it is important to consider not just the existing flows, but also the potential for future growth, both in inbound investment and in the domestic economy. The short-term loss of revenue from reductions in withholding tax rates (or other limitations on source taxation) may be wholly or partly offset by increased revenue resulting from increased foreign investment, growth in the economy and/or reduced fiscal evasion. However, there is no effective methodology for accurately predicting the future revenue benefits that could result from tax treaties.

- Tax treaties may affect or limit the operation of certain domestic tax laws.

Tax treaties include certain rules that take precedence over domestic law, such as:

- rules for determining profits of related enterprises. These require the profits of a subsidiary or a permanent establishment of a foreign enterprise to be determined on an arm’s length basis, irrespective of whether this is consistent with domestic law calculation of profit;
- non-discrimination rules. These may prevent the operation of domestic law rules that have been designed to protect the revenue by taxing foreign enterprises in a particular way.
- treaties may also limit future tax policy options.

While tax treaties do not prevent changes to domestic law, such changes will not be effective where an inconsistent treaty provision exists. As a country’s treaty network grows, this will increasingly limit the effectiveness of future tax changes where those changes do not accord with the tax treaties. Where a developing country has not had significant experience in the application of its own cross-border tax laws (for example if those laws have only recently been introduced, or the country has only recently been integrated with international markets), it will be difficult to appreciate the extent to which policy freedom is being incrementally limited by new tax treaties.

- Risk of treaty-shopping and double non-taxation

Residents of third countries may be able to access treaty benefits intended only for residents of the treaty partner country. This may have the effect of reducing tax in the source country without the provision of reciprocal benefits by the third country. It means also that the revenue impacts of early treaties may be greater than the current level of investment from these countries may suggest. While these risks can be reduced by the inclusion of certain treaty provisions such as Limitation of Benefits articles or anti-avoidance provisions in Articles 10, 11 and 12, treaty-shopping is difficult to eliminate entirely.

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6. Conclusion

While tax treaties can be beneficial to developing countries, there are also significant costs to entering into such treaties. By understanding what outcomes are desired, and how treaties can assist in achieving those outcomes, countries are better able to determine whether or not to enter into treaty negotiations.

Understanding the reasons for entering into treaty negotiations will also help those countries to design treaty policies that are best suited to achieving their desired outcomes.