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Committee of Experts on International Cooperation in Tax Matters
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Manual for the Negotiation of Bilateral Tax Treaties
Between Developed and Developing Countries

Papers on Tax Treaty Negotiation

Summary

At its eight annual session, in its report, the Committee requested the secretariat "to seek additional resources to advance the work to strengthen the capacity of developing countries to negotiate tax treaties." Accordingly, FfDO contracted two consultants, namely Ms. Ariane Pickering, Former Chief Tax Treaty Negotiator, Australian Tax Office and Treasury, Australia; and Mr. Odd Hengsle, Former Director-General, Tax Treaties and International Tax Affairs, Ministry of Finance, Norway to develop five practical papers on selected topics in negotiation of tax treaties. The following papers are being presented to the Committee at its 9th session as possible input to the *United Nations Manual for the Negotiation of Bilateral Tax Treaties*:

1) Why negotiate tax treaties by Ariane Pickering

2) Tax Treaty Policy Framework and Country Model by Ariane Pickering

3) Preparing for Tax Treaty Negotiation by Odd Hengsle

4) How to Conduct Tax Treaty Negotiations by Odd Hengsle

5) Post-negotiation Activities by Odd Hengsle

BACKGROUND

At its eight annual session, in its report, the Committee of Experts on International Cooperation in Tax Matters (the Committee) requested the secretariat "to seek additional resources to advance the work to strengthen the capacity of developing countries to negotiate tax treaties."

Accordingly, the Financing for Development Office (FfDO) organized an expert group meeting on "Tax Treaty Negotiation and Capacity Development" (New York, 13-14 December 2012) with the participation of several members of the Committee, as well as current and former tax treaty negotiators representing both developed and developing countries. The purpose of the meeting was to discuss and identify the most suitable strategies and modalities for the development and implementation of tools aimed at strengthening skills of national tax authorities in developing countries in the area of double tax treaty negotiation.

The experts shared their experiences in the area of double tax treaty negotiation, with a focus on the needs of developing countries at different levels of development and with diverse macroeconomic conditions and goals. They also analyzed the existing knowledge on the subject, as well as available materials and capacity development tools, including those developed by the Committee. They then determined how and to what extent these resources could be effectively used and/or needed to be improved or complemented for the purposes of delivering capacity development initiatives in the above area. They also put forward proposals on content and implementation of such capacity development activities.

One of the proposals was to develop a number of practical papers on selected issues in the negotiation of tax treaties and offer them to developing countries free of charge. The experts identified tentative topics of these papers as well as potential authors who would be in the best position to draft them. In follow up, FfDO contracted the proposed authors and requested them to prepare outlines for the proposed papers.

These outlines were then discussed during a technical meeting on "Capacity Building on Tax Treaty Negotiation" (Rome, 28-29 January 2013), which was held with the participation of 25 representatives of the national tax authorities and ministries of finance from developing countries, representing all the regions of the world. This meeting was held as part of a joint project undertaken by FfDO and the International Tax Compact (ITC). The financial contribution for the project has been provided by the German Federal Ministry for Economic Development and Cooperation (BMZ).

The authors presented the outlines of their papers followed by interactive discussion facilitated by selected members of the Committee and representatives of several international and regional organizations. National participants were frank in sharing their countries' experiences and concerns. The discussion contributed to: (i) identifying the needs of developing countries in the area of tax treaty negotiation and taking stock of the available capacity development tools at their disposal; and (ii) determining the actual skills gaps and challenges faced by developing

countries in negotiating their tax treaties. Report of the Rome meeting summarizing the main findings is available at http://www.un.org/esa/ffd/tax/2013CBTTNA/Summary.pdf.

Following the Rome meeting the outlines were revised taking into account feedback received from representatives of developing countries. Subsequently, the authors drafted their papers.

The draft papers were then presented by the authors and discussed during the technical meeting on "Tax treaty administration and negotiation" (New York, 30-31 May, 2013) with the participation of 32 representatives of developing countries, several members of the Committee, as well as representatives of international and regional organizations.

Each paper was presented by the author and had a designated lead discussant, representing relevant authority in developing country, who commented on relevance of the given paper in view of the experience of his/her country and proposed specific revisions/additions to the paper. The comments by the lead discussant were followed by an interactive discussion among participants, chaired by a member of the Committee or a representative of an international organization during which additional revisions to the papers were proposed with a view to ensuring that they adequately address the actual skills gaps and challenges faced by developing countries. Report of the New York meeting summarizing the main findings is available at:
http://www.un.org/esa/ffd/tax/2013TMTTAN/Newsletter5_2013.pdf

Following the New York meeting, the authors revised and finalized their papers taking into account feedback received during the meeting.

These papers are attached to this note and are now presented to the Committee as possible input to the United Nations Manual for the Negotiation of Bilateral Tax Treaties.

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DRAFT UNEDITED DOCUMENT

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

Paper No. 1-N

Why Negotiate Tax Treaties

Ariane Pickering

International tax consultant, former Chief Tax Treaty Negotiator, Australia

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Why Negotiate Tax Treaties

Ariane Pickering

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, sometimes in conjunction with investment protection and promotion agreements. In many cases there may be pressing diplomatic reasons (for instance, 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. The priority that would be given to each reason will differ, depending on the circumstances prevailing in each country, and having regard to the relationship between the two countries. In some countries, the desire to attract foreign investment will be paramount, whereas in other countries, revenue or political considerations may be more important.

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;

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

- reducing excessive source taxation;
- providing increased certainty and/or simplicity with respect to taxation of the inbound investment or transfers (for instance, through non-discrimination rules, provision of international standards, inclusion of a mutual agreement procedure);
- developing a closer relationship between tax authorities and business (for instance, 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, such as:
   - 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 (for instance, 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 country or designing a broader tax treaty strategy.

In developing countries, there may be little outbound investment by its residents. For these countries, the main reasons for entering into treaty negotiations are commonly:

1. to attract foreign direct investment;
2. to attract inbound transfers of technology or skills;
3. to respond to political or other pressure from other countries.

The benefits of increased tax co-operation should also be taken into account by developing countries.

It should be noted that, even if one country has concluded that it would serve its interests to enter into a tax treaty with another country, that other country may not be willing or able to commence negotiations.

Before treaty negotiations can commence, both countries must consider that a tax treaty would benefit them, and must be in a position to commence negotiations.

The reasons for entering into tax treaties are explored further below.

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 ("United Nations 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 United Nations 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, that is to say taxation of the same income in the hands of the same person in more than one country, occurs where:

[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.

- 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
- 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 United Nations 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 developed or developing. Elimination of such double taxation will enhance the investment climate which will in turn assist in the growth of investment flows between countries.

Another type of double taxation occurs where the same income or capital is taxed by the two countries in the hands of different persons (so called "economic double taxation"). Typically this occurs in transfer pricing cases where enterprises in different countries are treated as having accrued the same profits.

Developing countries will frequently come under pressure from their own residents or from foreign investors to reduce double taxation on their cross-border transactions. Tax treaties seek to eliminate (or at least reduce) double taxation in a number of ways.

a) Source/residence double taxation

Source/residence double taxation is addressed under tax treaties by the allocation of exclusive taxing rights over income or capital to one of the treaty partner countries, or, where taxation is permitted in both countries under the treaty, by requiring the country of residence to provide relief for tax imposed by the source country.

Relief from source/residence double taxation was once seen as the most important function of a tax treaty. Although most countries these days will provide double tax relief, in the form of foreign tax credits or exemption of foreign income or capital located abroad, under their domestic laws, a few countries will only provide such relief under treaties. Even where double tax relief is provided unilaterally, the confirmation of such relief under tax treaties provides an additional level of certainty to taxpayers with

[4] Introduction, paragraph 5.

cross-border dealings. It may also clarify whether certain 'presumptive' income taxes - typically based on turnover and applying to small businesses - are to be credited by the other country. Tax treaties may also provide additional double tax relief benefits to taxpayers that are not available under domestic law (or are only available under domestic law where a treaty is in effect), for instance by providing for exemption of certain foreign income where domestic law would otherwise 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 offset by revenue gains resulting from not having to provide, in respect of outbound investment, foreign tax credits or exemption of foreign income or capital. There may even be an overall revenue gain for countries that are net exporters of capital, technology etc. However, developing countries will generally have little outbound investment to offset the loss of revenue from source taxation of inbound investment. Accordingly, such countries are likely to find that the provision of relief from double taxation through the allocation of exclusive taxing rights to the country of residence will result in an overall reduction of revenue, at least in the short term.

Any immediate loss of revenue may be ameliorated if entry into the tax treaty results in additional foreign investment that contributes to the growth of the recipient country's economy and/or leads to increased employment in that country. Measurement of such flow-on effects is, however, notoriously difficult and speculative.

b) Residence/residence double taxation

Residence/residence double taxation can occur where a person is taxed on worldwide income or capital in more than one country on the basis that the person is regarded as a resident for tax purposes in each of those countries. For example, an individual may be regarded by one country as its resident because that person ordinarily resides in that country, and is also regarded by another country as its resident because he or she has spent more than 183 days in that other country. Such double taxation is dealt with under tax treaties by the inclusion of tie-breaker rules that deem the person to be, for purposes of the treaty, a resident of only one of the countries.

This ensures that, at least between the two treaty partner countries, the person is taxed only on a source basis in one country with relief from double taxation being provided by the other country.

The revenue implications of the tie-breaker rules are generally not significant. While the effect of the tie-breaker rules is to limit one country's ability to tax the worldwide income of a person who would otherwise be regarded as a resident for tax purposes, cases of dual residence are relatively rare. However, the revenue of the 'losing' country may be adversely affected if the treaty includes tie-breaker rules that are easy to manipulate (such as those based on formalities such as place of incorporation).

c) Source/source double taxation

Double taxation may arise where more than one country regards the same income as having a source in their territory under domestic law. For example, one country may regard income from certain services as being sourced in their territory if the activities are performed in that country, while another country may treat the same income as sourced in their territory if the services are paid for by a resident of that country.

For certain categories of income, such as dividends and interest, a tax treaty will provide explicit rules for determining the source of income for treaty purposes. In treaties that follow the United Nations Model Convention, source rules are also provided for royalties in Article 12. These source rules not only clarify the circumstances in which the country where the income is deemed to arise may tax that income under the treaty; they also ensure that where that country does impose tax on that income in accordance with the treaty, the other country (that is to say the country of which the recipient is a resident) must provide double tax relief in accordance with Article 23.[5]

For other categories of income, such as business profits, there are no explicit source rules included in the treaty. However, by limiting the circumstances in which source taxation may be imposed (for instance, where the income is attributable to a permanent establishment situated in a country) and providing extensive guidance on when those conditions should be regarded as having been met, the United Nations and OECD Model Conventions will often provide solutions to problems of double taxation based on source.

d) Economic double taxation

Tax treaties seek to address problems of economic double taxation (where the same income or capital is taxed in more than one country in the hands of different taxpayers) only in certain limited circumstances.

[5] See paragraph 7 of the Commentary on Article 23 of the OECD Model Convention. This paragraph is endorsed in paragraph 14 of the Commentary on Article 23 of the United Nations Model Convention.

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 length' standard for transactions between the associated enterprises, tax treaties help to ensure that profits are subject to neither double taxation nor less than single taxation.[6]

Economic double taxation may also be dealt with under a treaty to the extent that Article 25 (Mutual agreement procedure) allows the competent authorities of the treaty partner countries to "consult together for the elimination of double taxation in cases not provided for in the Convention".[7]

2.2 Reducing excessive source taxation

Tax treaties can facilitate cross-border trade and investment by limiting source taxation that might otherwise act as a deterrent to that trade or investment. This may occur, for example, where the source country imposes a final withholding tax under its domestic law on a payment to a non-resident, irrespective of any expenses that may have been incurred in connection with the derivation of that income. In these circumstances, the effective tax rate on the income may be extremely high. Measures by the taxpayer's country of residence to relieve double taxation may not be effective in eliminating excessive levels of taxation, for instance where no relief is available for source taxation that exceeds the tax liability on that income in the country of residence.

For example, in many developing countries, income from certain services provided by non-residents is taxed on a gross basis. By limiting source taxation to "profits" from business activities, or by imposing a limit on the rate of source tax that may be imposed on gross amounts of income, tax treaties can help to ensure that excessive taxation in the source country does not provide an obstacle to cross-border investment and activities.

On the other hand the International Monetary Fund (IMF) has noted in the context of transfer pricing by multinational enterprises,[8] that "[s]ome argue, moreover, that present tax treaty norms are tilted against developing countries; the low withholding taxes common in double tax treaties . . . for instance, can weaken a last line of protection for weak administrations".

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6 See Commentary on Article 9 of the United Nations Model Convention.

7 See paragraphs 10-12 of the Commentary on Article 25 of the OECD Model Convention, quoted in paragraph 9 of the Commentary on Article 25 of the United Nations Model Convention.

8 IMF, Revenue Mobilization in Developing Countries, (Fiscal Affairs Department) March 8, 2011, p 36.

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 burdensome taxation than its own nationals who are in the same circumstances and have the same residential status for tax purposes.
2. *Stateless persons*: Similar rules apply to stateless persons, who must be provided equality of treatment to nationals of a country.
3. *Permanent establishments*: Permanent establishments of a treaty partner enterprise cannot be subjected to more burdensome taxation than a local enterprise carrying on the same activities.
4. *Disbursements*: a payment of interest, royalties or other disbursements by a resident enterprise to a resident of a treaty partner country must be deductible under the same conditions as if it had been paid to a local resident.
5. *Foreign-ownership*: a resident enterprise that is foreign-owned cannot be subjected to more burdensome taxation than locally-owned enterprises.

[9] Paragraph 1 of the Commentary on Article 24 of the OECD Model Convention, quoted in paragraph 1 of the Commentary on Article 24 of the United Nations Model Convention.

[10] Ibid.

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 United Nations Model Convention set out a procedure pursuant to which the competent authorities of the treaty partner countries can reach mutual agreement.

Under this procedure, a taxpayer who considers that the treaty has not been, or will not be, correctly applied may, in addition to any domestic law remedies, initiate the mutual agreement procedure. The competent authority in his country of residence would then review the case and, if the taxpayer's

[11] Paragraph 6 of Article 24 (Non-discrimination).

complaint appears to be justified and cannot be resolved in that country, the competent authority is obliged to "endeavour to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with this Convention".[12] In some tax treaties, access to the mutual agreement procedure may be denied where the transactions in question are abusive.

Although the provision does not oblige the competent authorities to reach agreement (it only requires them to endeavour to do so), the procedure has proved successful in resolving treaty issues in many cases. Many countries also use the mutual agreement procedure for advance pricing agreements, pursuant to which the competent authority enters into an agreement, either with the taxpayer alone or with both the taxpayer and the competent authority of the other country, on how transfer prices between parts of a multinational enterprise operating in the two countries will be determined. For taxpayers with cross-border dealings, access to the mutual agreement procedure is often a key benefit of tax treaties, particularly with respect to resolution of transfer pricing and profit attribution issues, or determination of factual matters such as residential status or the existence of a permanent establishment.

In an environment where cross-border transactions are rapidly increasing in both number and complexity, resolution of issues under the mutual agreement procedure can be drawn-out and sometimes unsuccessful. To ensure a timely outcome, provision has been included in paragraph 5 of Article 25 of the OECD Model Convention and alternative B of Article 25 of the United Nations Model Convention that provides for mandatory arbitration in certain cases where resolution is not reached within a given time period. While arbitration provisions in tax treaties are highly valued by taxpayers, it is recognised that in some countries, national law, policy or administrative considerations may not allow or justify the inclusion of the provision.[13]

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 elimination of double taxation in cases not provided for in the treaty.

[12] Paragraph 2 of Article 25 (Mutual agreement procedure).

[13] See footnote to paragraph 5 on Article 25 of OECD Model Convention, and paragraph 13 of the Commentary on Article 25 of the United Nations Model Convention.

2.5 Maintaining or accessing benefits of domestic tax concessions

One of the most important benefits that may be available to developing countries under a tax treaty is what is known as 'tax sparing'. Tax sparing occurs when another country gives foreign tax credits for tax that has been reduced or forgone in accordance with tax incentives provided in the source country.

Many developing countries seek to attract foreign investment by offering tax incentives, such as tax holidays or concessions (for instance, on income derived from investment in certain industries or in certain regions where the country wishes to encourage development). However, the benefits to the taxpayer of these incentives may be lost if the income is taxed in the taxpayer's home country. Where, for example, the income is taxed in full and a credit is allowed in the country of residence for the foreign tax paid, reductions in source taxation will merely result in increased revenue for the residence country, without any overall tax benefit to the investor. Accordingly, the tax incentives effectively result in a transfer of revenue from the source country to the country of residence of the investor.

In treaties with countries that use the credit method, or that make exemption of foreign income conditional on a certain level of taxation in the source country, the inclusion of tax sparing provisions under a tax treaty can ensure that the benefit of tax incentives of the source country is maintained. Under the tax sparing provisions, the treaty partner country would be obliged to recognise some or all of the tax foregone as if it had been paid, that is to say as if there had been no tax incentive in source country.

The Commentary on Article 23 of the United Nations Model Convention recognised that for some developing countries the inclusion of tax sparing provisions (or relief of double taxation by the exemption method) "is a basic and fundamental aim in the negotiation of tax treaties".[14] A discussion of tax sparing can be found in paragraphs 3 to 12 of that Commentary.

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

[14] See paragraph 4 of the Commentary on Article 23 of the United Nations Model Convention.

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. A precise description of the incentives for which tax sparing is sought (for instance, a reference to legislation which sets out which income or projects are eligible for the incentive);
2. Limitation of eligible incentives to certain types of investment or activities (for instance, genuine investments aimed at enhancing the domestic infrastructure of the developing country);
3. Application only to active business income (not passive income such as interest, royalties or leasing payments);
4. Inclusion of an anti-abuse provision (for instance, where the two competent authorities agree it would be inappropriate to grant tax sparing);
5. Inclusion of a 'sunset' clause (for instance, a provision that states that tax sparing will only apply for a limited period, or until a certain level of economic development is reached, unless further extended by agreement between the two countries).

Of course, if the home country of the enterprise exempts the income (either unilaterally or under domestic double tax relief provisions or under tax treaties that provide for relief by the exemption method), tax sparing provisions are not required in order to preserve the benefit of source country's tax incentives since the country of residence will not tax the income.

In some countries, certain favourable tax treatment (such as participation exemptions on dividends derived from abroad, exemption from the application of Controlled Foreign Corporation (CFC) rules, or reduced rates of withholding at source) is provided under domestic law, but such treatment is available only where a tax treaty is in force or where full exchange of information is available under a tax treaty or a Tax Information Exchange Agreement.

[15] See paragraphs 72 to 78.1 of the Commentary on Article 23 of the OECD Model Convention.

3. Prevention of fiscal evasion

One of the main reasons that a country may wish to enter into a tax treaty with another country is to improve co-ordination and co-operation between tax administrations in order to address tax avoidance or evasion. Through the exchange of information and, in some cases, assistance in collection of taxes, tax administrations are able to assist each other in ensuring the proper application of tax treaties, as well as enforcement of domestic laws.

While it is often developed countries that have the most to gain in terms of revenue from assistance provided under tax treaties, it is in the interests of both developed and developing countries to minimise cross-border tax evasion and avoidance. Both developed and developing countries are vulnerable to capital flight and erosion of their tax revenue bases.

Improved co-operation between tax administrations has been a key focus of international tax work in recent years. As noted in the OECD Manual on Exchange of Information,[16] "the efficient functioning of tax co-operation helps to ensure that taxpayers who have access to cross-border transactions do not also have access to greater tax evasion and avoidance possibilities than taxpayers operating only in their domestic market. Co-operation in tax matters also reflects the basic principle that participation in the global economy carries both benefits and responsibilities. The continued viability of an open world economy depends on international co-operation, including co-operation in tax matters".

Tax treaties authorise and require the competent authorities of both States to exchange tax information that is "foreseeably relevant" to the application of either the treaty or domestic tax laws. Such information may relate to a specific taxpayer, or may be more general (for instance, information about particular industries or abusive tax avoidance schemes). Article 26 (1) of the United Nations Model Convention states that "In particular, information shall be exchanged that would be helpful to a Contracting State in preventing avoidance or evasion". However, exchange is not limited to such information and often may be merely to assist in determining a factual situation, (for instance, the existence of a permanent establishment or the residential status of a person).

The obligation under Article 26 is broad, and is not limited to residents of the treaty partner countries or to income or activities in one or other country. Information must be exchanged even if it is not required for purposes of applying the domestic tax law of the requested State. Information held by banks or other

[16] OECD Manual on the Implementation of the Exchange of Information for Tax Purposes, 2006.

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] They may also (or alternatively) provide that extraordinary costs associated with a request for information be borne by the country that requests the information.[18] It should be noted, however, that the Article provides benefits to both countries, and that the article "does not allow a developed country to refuse to provide information to a developing country on the ground that the developing country does not have an administrative capacity comparable to the developed country".[19] Some countries may find it useful to develop, in consultation with their treaty partners, a Memorandum of Understanding on how exchange of information will be handled in their country.

Administrative assistance may also be provided under tax treaties in the form of assistance in collection of taxes. Article 27 of the United Nations Model Convention obliges each country to assist the other to collect taxes owed to the latter, as if it were a revenue claim of the first country. While this would clearly benefit the revenue of both treaty partners, and further support the prevention of fiscal evasion, it is recognised that in some countries, national law or policy, or administrative considerations, may preclude or limit the provision of such assistance.[20] For developing countries, the capacity of their tax administrations often limits their ability to undertake these obligations.

4. Political reasons

Sometimes political considerations may influence a country's decision to enter into tax treaties. For example, a country may want to signal to the global economy and potential investors that it is a responsible member of the international tax community that is willing and able to conform with widely-accepted tax rules and norms, such as the international standard for exchange of information or the arm's length principle for profit attribution within a multinational enterprise.

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17 See paragraph 8.1 of the Commentary on Article 26 of the United Nations Model Convention.

18 See paragraphs 29.3 and 29.4 of the Commentary on Article 26 of the United Nations Model Convention.

19 Paragraph 3.1 of the Commentary on Article 26 of the United Nations Model Convention.

20 See paragraphs 1 and 2 of the Commentary on Article 27 of the United Nations Model Convention.

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 United Nations countries,[22] member countries are certainly encouraged to do so.[23]

Regional economic or trade communities involving developing countries often require or encourage member countries to enter into tax treaties with each other. 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".[24] The Southern African Development Community (SADC) has similarly agreed that "Member States will take such steps as are necessary to establish amongst themselves a comprehensive (tax) treaty network".[25]

Countries may also agree to enter into tax treaty negotiations as part of arrangements to enhance bilateral relations or in the context of close trade or economic relations between the two countries. These may be linked to bilateral trade or investment promotion and protection 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 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.

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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 United Nations Model Convention.

23 For instance, see ECOSOC Resolution 1273 (XLIII), 4 August 1967.

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

25 Article 5, *Tax Treaties*, Memorandum of Understanding on Co-operation in Tax-Related Matters, 2002.

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 investment. Nevertheless, it would appear that, for developing countries, a link can be made between conclusion of a tax treaty and increased foreign direct investment.[26]

Provision for tax sparing under the treaty may be of particular benefit to developing countries to the extent that it prevents revenue forgone by the country under its tax incentives being soaked up by the country of residence of the foreign investor.

However, tax treaties alone will not ensure increased foreign investment if the underlying legal and economic infrastructure does not effectively support such investment. For example, a lack of suitable investment protection (for instance, where there is a significant risk of expropriation of the investment), an unstable economy or a lack of a robust regulatory framework may discourage inbound investment, irrespective of the existence of a tax treaty. Countries with a good infrastructure for investment, that is to say political and economic stability, robust regulatory framework, suitable workforce, and reliable and effective administration, are much more likely to attract foreign investment.

- Flow-on benefits to local economy from increased foreign investment

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 (for instance, between

[26] Sauvant and Sachs, The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties and Investment Flows, 2009, Chapter 23 - Do Double Taxation Treaties Increase Foreign Direct Investment to Developing Countries?

developing countries, especially 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 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.

- Improved consistency of tax treatment

By negotiating tax treaties that conform to international tax norms, a developing country may reduce the likelihood of inconsistent or inappropriate tax treatment of income or capital that can occur where tax issues are dealt with in non-tax treaties, such as bilateral investment or trade agreements, or in agreements with private enterprises.

- 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 (for instance, 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 treaty abuse

Taxpayers may enter into transactions designed to abuse the benefits provided by tax treaties (for instance, by the use of artificial legal constructions such as conduit companies, or by exploiting differences in tax treatment in the treaty partner countries). Residents of third countries may also 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 abuse and treaty-shopping are difficult to eliminate entirely.

- Risk of double non-taxation

Tax treaties can create unintended double non-taxation where a treaty provision precludes taxation in one country of income or capital that is not taxed in the other country. For example, the treaty may preclude source taxation of certain capital gains. If the other country does not impose capital gains tax, the result will be that the capital gain is not taxed in either State. While in some cases the contracting States may deliberately provide that certain income is not subject to tax in either country (for instance, in the case of short-term visits by foreign teachers), tax treaties are generally not intended to create double non-taxation.

Tax treaties with low-tax countries may also result in double non-taxation and/or in reductions in revenue without reciprocal benefits in the other country. Tax treaties with low tax countries may provide a competitive advantage to investors from such countries over domestic investors or investors from other treaty partner countries, since the overall tax burden on investors whose income is not subject to tax (or is subject only to very low tax rates) in their country of residence will be significantly lower than the tax burden on investors who have to pay ordinary tax rates. Treaties with low-tax countries are also likely to encourage treaty-shopping through those countries. For these reasons, and in the absence of a risk of significant double taxation of cross-border investment from low-tax countries, developing countries should carefully consider whether tax treaties with such countries are in their best interests. Any tax administration concerns with these countries might be better addressed through Tax Information Exchange Agreements.

- Changes and/or clarifications to domestic law

Certain changes to, or clarifications of, domestic law may be required to ensure that the treaty can be properly applied and administered. It may be necessary to enact law that provides that, in the event of any inconsistency between the treaty and domestic law, the treaty obligations prevail. Changes may be necessary to ensure that treaty obligations can be met (for instance, to ensure that the competent authority has the legal and practical ability to collect and exchange bank information if requested by treaty partner country).

To simplify the application of treaty profit allocation, transfer pricing and non-discrimination rules, it may also be desirable to review domestic law to minimize any inconsistency with the treaty provisions.

- Tax administration capacity

Negotiation of tax treaties is a protracted, resource-intensive task. Furthermore, negotiation, interpretation and administration of tax treaties requires highly skilled staff. Developing the necessary expertise, and ensuring that sufficient numbers of trained staff are available to undertake these tasks, is likely to divert scarce resources within the revenue authorities of developing countries away from other important tax priorities.

Tax administrations of these countries may also need additional resourcing and/or technical assistance to meet obligations under tax treaties, such as:

- development of binding Rulings system to ensure consistent application and interpretation of treaties. Inevitably this also requires access to (sometimes costly) international research services. Often there is an additional layer of difficulty for tax administrators if these international documents are not discussed in their native language;
- establishment of processes to undertake mutual agreement procedure with tax administrations from treaty partner countries;
- capacity to collect and exchange information with tax administrations from treaty partner countries;
- capacity to collect tax debts owing to treaty partner governments (where assistance in collection provisions are included).

Countries will need to appoint competent authorities for purposes of their tax treaties. These will usually be senior officials from the revenue administration or the Ministry of Finance.

6. Conclusions

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.

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

Paper No. 2-N

Tax Treaty Policy Framework and Country Model

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Tax Treaty Policy Framework and Country Model

Ariane Pickering

1. Introduction

All countries would find it beneficial to develop a tax treaty policy framework and a model treaty before entering into negotiations. You have to 'know what you want'.

The policy framework should set out the main policy outcomes that your country wishes to achieve under its tax treaties. It should identify:

- policy outcomes that are most beneficial to your country;
- outcomes that must be achieved in any negotiation; and
- how much flexibility negotiators have on other issues, including what is their 'bottom line' (that is to say, the minimum outcome that must be achieved).

The model treaty should reflect the country's key policy and drafting preferences, having regard to international treaty norms and to domestic law.

This paper seeks to provide guidance to developing countries on how to develop a tax treaty policy framework and their own model tax treaty.

2. Policy framework for developing countries

2.1 General

i. As far as practicable, countries should follow the international norms for tax treaties, with respect to structure and policy positions.

For developing countries, these international norms are mainly set out in the United Nations Model Double Taxation Convention between Developed and Developing Countries ("United Nations Model Convention"). The Organisation for Economic Co-operation and Development's Model Tax Convention on Income and on Capital ("OECD Model Convention") is also important and, for some countries, a

regional model such as the Andean Community Model, the Southern African Development Community (SADAC) Model or the Association of Southeast Asian Nations (ASEAN) Model[27] may also be relevant.

ii. It is important for developing countries to strike the right balance between protecting revenue (by maintaining source taxing rights) and encouraging inbound investment (by reducing tax barriers). To achieve this, tax treaties of most developing countries generally follow the United Nations Model Convention, rather than the OECD Model Convention.

- The United Nations Model Convention is better suited to developing countries in that it seeks to preserve a higher level of source taxation than the OECD Model Convention, which has been designed by and for developed countries. While the OECD Model Convention is most beneficial to business, and therefore is most effective in attracting foreign investment, the revenue balance is generally best suited to capital exporting countries, and to situations where the balance of investment between the two treaty partner countries is approximately equal. The United Nations Model Convention modifies the OECD Model Convention to better suit the circumstances of developing countries.

iii. The policy framework of a country should take account of key aspects of that country's economy, including its main sources of revenue and areas of current or potential foreign investment.

- If, for example, a developing country has significant natural resources such as oil reserves, it may wish to ensure that its tax treaties do not unduly restrict its ability to tax the income from activities relating to the exploitation of such resources. Similarly, if there are significant road or rail transport activities between two neighbouring countries, those countries may wish to extend the operation of Article 8 to those forms of transport.

iv. Tax treaty policy should take account of domestic law. The interaction between domestic law and treaties is important.

- Treaties generally have priority over domestic law so that, to the extent that the treaty is inconsistent with domestic law, the treaty will prevail. It is unrealistic to expect that treaties will be wholly consistent with domestic law, but nevertheless domestic law may be a relevant consideration in designing tax treaty policies and models. In particular, countries should consider whether and how a taxing right allocated in a treaty would be exercised under domestic law. For example, a treaty right to tax fees for technical services on a net basis at source may be difficult to apply in practice if such fees are taxed on a withholding basis under domestic law. In this case,

[27] Intra-ASEAN Model Double Tax Convention on Income, 1987.

the country may prefer to include a provision that provides for source taxation on a gross basis, even if the tax rate provided under the treaty is lower than the domestic law rate.

- A right to tax under a treaty that cannot be exercised under domestic law, or that cannot be collected in the ordinary course of tax administration is likely to be of little value to a country. For example, there would be little revenue benefit to be gained by providing for source taxation of pensions (in accordance with Article 18 (2) (Alternative B) of the United Nations Model Convention), if such pensions are not taxable under domestic law. There may however be circumstances in which a country would wish to preserve a taxing right that cannot currently be exercised under existing domestic law (for instance, where it is anticipated that future governments may wish to change that domestic law).
- In some circumstances, non-tax laws may be relevant. For example, social security pensions may not be payable to non-residents. If this is the case, that country will not pay cross-border social security payments and negotiators should not insist on source taxation of these payments.

v. Countries should take into account the ability of their tax administrations to comply with treaty obligations.

- For example, some treaties require tax administrations to collect taxes on behalf of a treaty partner. If the tax administration does not have the legal or practical ability to do so, that country may wish to consider not including the article, or amending it, or delaying its implementation.

2.2 International norms

- Coverage

Tax treaties apply to individuals and entities that are residents of one or both of the treaty partner countries. Generally, residential status will be determined by the domestic law of each country. However, for treaty purposes, the United Nations Model Convention (like the OECD Model Convention) specifies that the person must be "liable to tax" in the country by reason of particular criteria.

Treaties apply to all income taxes, including capital gains taxes, taxes on profits, withholding taxes and tax on salaries. In some circumstances, other taxes such as tonnage taxes, or minimum taxes may also be covered.

The United Nations and OECD Model Conventions also apply to taxes on capital, such as wealth taxes.

- Distributive rules

One of the main effects of a tax treaty is to allocate taxing rights over different categories of income derived by a resident of one treaty partner from sources in the other treaty partner country.

The distributive rules of the United Nations Model Convention broadly allocate source country taxing rights as follows:[28]

- *Income from immovable property*: Income such as rents, agricultural or forestry profits, or other income derived from immovable property is seen as having a very strong economic link with the country in which it arises. Accordingly, the source country is allocated unlimited taxing rights over this income.
- *Business profits*: Such profits are generally only subject to source taxation where the foreign enterprise has established a strong economic connection with the source country, for instance by establishing a fixed place of business in that country or by performing services in that country for an extended period. Profits from short-term activities (generally less than 6 months), or preparatory or auxiliary activities may not be taxed in the source country.

  Treaties include rules that determine the profits attributable to the enterprise, or the part of an enterprise, operating in the source country. Under the United Nations Model Convention, as under the OECD Model Convention, profit allocation between a permanent establishment and the rest of the enterprise of which it is a part, and between related enterprises, must be made on an arm's length basis (that is to say, as if they were separate and independent entities). However, the United Nations Model Convention provides limits on the extent to which dealings between parts of an enterprise will be recognised. Article 7 of the OECD Model Convention, on the other hand, was amended in 2010 to give full effect to the arm's length principle.
- *International transport*: Taxation of profits from international air and sea transport is generally not permitted in the source State. However, for income from certain shipping operations in the source country, one of the two alternative provisions in the United Nations Model Convention provides for limited source taxation. Source taxation is not provided for under the OECD Model Convention.
- *Dividends, interest and royalties*: This income is usually taxed on a withholding basis in the source country. To prevent excessive taxation and to achieve a sharing of revenue from such income between the two countries, source taxation is limited to a percentage of the gross amount of the income. In most treaties entered into by developing countries, the agreed rates are

[28] Note: the description of the operation of the provisions is only intended to be broadly indicative of the allocation of taxing rights. The descriptions are not comprehensive.

commonly between 10 and 20%. The OECD Model Convention specifies withholding tax rates of 5 and 15% for dividends and 10% for interest, while royalties may not be taxed at source.

- *Capital gains*: Gains on disposal of immovable property or assets of a permanent establishment may be taxed in the source country, as may some gains on the alienation of shares in resident companies or companies whose assets consist mainly of immovable property. Source taxation of most other capital gains is generally not permitted. The OECD Model Convention does not provide for source taxation of gains from the alienation of shares in resident companies.
- *Independent personal services*: Income from professional services and other independent personal services is permitted in the source country only if the services are performed through a fixed base in the source country, or if they are provided in the source country for more than 183 days. Such income is dealt with as business profits under the OECD Model Convention.
- *Employment income*: Source taxation is generally permitted for employment activities performed in that country. However, an exemption is provided for certain short-term employment activities undertaken in a country on behalf of a foreign employer.
- *Directors' fees*: Remuneration paid to directors and other top-level managers of a local company may be taxed in the country of which the company is a resident. Under the OECD Model Convention, remuneration of top-level managers is treated in the same way as other employment income.
- *Entertainers*: Income of entertainers and sportsmen may be taxed in the country where the entertainer or sportsman performs those activities.
- *Pensions*: For pensions paid in respect of past employment, two alternatives are found in the United Nations Model Convention: 1) taxation only in the country of which the recipient is a resident; or 2) source taxation if the pension is paid by a resident or permanent establishment. Pensions paid under the social security system of a country may be taxed at source. Under the OECD Model Convention, pensions are taxable only in the country of residence.
- *Government service*: Salaries paid to government employees are generally taxable only in the paying country.
- *Students*: Taxation of payments from abroad for the education and maintenance of a visiting student is not permitted.
- *Other income*: Income that is not otherwise specifically covered by the above articles may be taxed in a country if it arises in that country. The OECD Model Convention provides for taxation only in the country of residence.

- *Capital*: The allocation of taxing rights over capital generally mirrors the allocation of rights to tax income.

- Elimination of double taxation

Where source taxation is permitted under the tax treaty, the country of which the taxpayer is a resident is required to relieve any resulting double taxation. This may be achieved by exempting the income that is taxed at source (exemption method), or by providing a credit for the foreign tax against the tax liability of the taxpayer in the country of residence (credit method).

Though not included in the United Nations Model Convention itself, some treaties entered into by developing countries include tax sparing provisions. Developing countries may seek to attract foreign investment by offering tax incentives with respect to certain activities. However, if the country of residence of the investor provides relief using the credit method, the benefit of the tax incentives may be effectively passed to the foreign treasury instead of the investor. To preserve the benefit of the source country tax incentives, tax sparing provisions provide relief from taxation in the country of residence as if tax had been paid in the source country.

- Non-discrimination

International tax treaty rules prevent either country from applying discriminatory tax rules in certain circumstances. These are:

- nationals of the other country may not be taxed more harshly than the country's own nationals;
- tax discrimination against stateless persons is not permitted;
- a permanent establishment of an enterprise resident in the treaty partner cannot be taxed less favourably than a local enterprise;
- payments to a resident of the other country must be deductible under the same conditions as if paid to a local resident;
- foreign-owned resident companies cannot be taxed more harshly than locally-owned resident companies.

- Mutual agreement procedure

A key benefit of tax treaties is that they allow the tax administrations to consult together on the application and interpretation of the treaty and to reach agreement on how best to achieve the aims of the treaty, especially removal of double taxation. The mutual agreement procedure is most commonly

invoked in the context of transfer pricing and profit allocation. The two tax authorities may agree on the allocation of profits within a multinational enterprise operating in both countries.

In the case of disputes as to the proper attribution of such profits, taxpayers themselves may seek agreement between the tax authorities of the two countries under the mutual agreement procedure.

A recent addition to the United Nations and OECD Model Conventions is a provision for binding arbitration in treaties (for instance, paragraph 5 of the Mutual agreement procedure Article of the United Nations Model Convention).

- Exchange of information

A tax treaty authorises and requires tax administrations to exchange relevant tax information, including information held by financial institutions. This is a very powerful tool in preventing fiscal evasion by taxpayers.

Some countries seek to include an article in their treaties that provides for reciprocal assistance between the two tax administrations in collecting outstanding tax liabilities. This helps to ensure that revenue claims in both developed and developing countries can be enforced.

2.3 Designing a policy framework

A developing country's tax treaty policy framework should take into account international norms. At a minimum, the treaty should cover elimination of double taxation on income, non-discrimination, mutual agreement procedure and exchange of tax information. The OECD Model Convention and United Nations Model Convention provisions on these aspects of a tax treaty should be accepted as representative of the international standard by any country if it wishes to enter into tax treaties, although there may be room for negotiation with respect to certain details (which are discussed further below).

Other aspects of a tax treaty may be open to negotiation, such as coverage of capital taxes, and levels of source taxation permitted under the treaty. Departures from the international models will almost always increase the difficulty of negotiating a satisfactory treaty. Accordingly, countries, especially those with limited negotiating capacity, should deviate from the international norms only sparingly (for instance, where there is a clear national interest in doing so). On these aspects, each country should determine:

a. its preferred position;
b. the priority the country places on achieving that position; and

c. the degree of flexibility available to negotiators and any fixed 'bottom line'.

2.4 Distributive rules

The allocation of taxing rights between the source and residence countries is generally the most controversial part of tax treaty negotiations. The distributive rules of a treaty, which are set out in the United Nations Model Convention in Articles 6 to 22, determine how the taxing rights will be allocated with respect to different categories of income. In developing its tax treaty policy framework, it is important that each country decide its preferred position on the balance of source and residence taxation, the priority it gives to maintaining that preferred position and, where flexibility is appropriate, the bottom line for negotiators.

A developing economy with minimal outbound investment may feel that it should protect its revenue by retaining the maximum possible source taxation. However, this must be balanced against the primary objective for entering into tax treaties, that is to say to make the country a more attractive destination for foreign investment by removing or reducing tax barriers to inbound investment.

Tax treaties inevitably involve some reductions in source taxation. Under the international Models, the reductions generally occur where:

- source taxation may result in excessive taxation that cannot be relieved by the country of residence (for instance, where high rates of withholding tax are likely to result in source tax that exceeds the tax on profit in the residence country);
- the economic link between the derivation of the income and the country where it arises is not strong (for instance, in case of casual or temporary business operations or employment activities); or
- the compliance burden on taxpayers is very high or is administratively difficult or inefficient (for instance, in the case of international transport).

The distributive rules in the United Nations Model Convention are generally the starting point for developing countries, often with the addition of a provision that allows source taxation of fees for technical services. Regional models reflect rules that are acceptable between countries within that region, which may be different to those that would be acceptable in treaties with other countries. For example, the ASEAN Model is indicative of the reductions in source taxation that are likely to be found in a tax treaty between countries in the South East Asian region. Much more significant reductions in source taxation may be required in a tax treaty between an ASEAN member and another country.

In negotiations with developing countries, even countries that follow the OECD Model Convention will usually (though not always) agree to allow source taxation to the extent provided in the United Nations Model Convention. It must be kept in mind, however, that deviations from the United Nations Model Convention or, where relevant, a regional Model, to provide for increased source taxing rights over a particular category of income will almost inevitably be achieved only by making concessions on other aspects of the treaty (for instance, a lower rate or a higher threshold for source taxation with respect to another category of income). It is therefore extremely important for a country that wishes to provide for additional source taxing rights, over and above those found in the United Nations Model Convention or its regional Model, to decide how much priority should be given to achieving that outcome. For example, if it is a high priority for a country to provide for source taxing rights over fees for technical services in its treaties, then that country may be requested to forgo source taxation over other categories of income in order to achieve this result.

With respect to each category of income, developing countries may find it helpful to analyse the distributive rules of the United Nations and OECD Model Conventions in the context of their own circumstances. In particular, they may wish to consider:

1) *Category of income*

   Does the treaty classification of income give rise to difficulties in applying the treaty, or to unacceptable policy outcomes?

   Example 1: A payment is treated under domestic law as a royalty to which withholding tax applies. If that payment is regarded as business profits rather than a royalty as defined for tax treaty purposes, payers and recipients of the payments, as well as tax administrations, may find it difficult to apply the rules of Article 7 in respect of that payment.

   Example 2: Fees for technical services are often treated under domestic law in developing countries as a separate category of income from other business profits and are subject to different tax treatment. Article 7, if applied to such income, may give rise to outcomes that, from a policy perspective, are unacceptable to those countries.

2) *Tax treatment*

   Can taxing rights allocated under a tax treaty be exercised in your country? If not, consider whether this is an outcome that your country wishes to provide for under a treaty.

Example: Article 16 of the United Nations Model Convention provides for taxation of directors' fees in the country in which the company is a resident. Some countries may not be able to exercise this taxing right unless the director's activities are performed in that country.

Is the proposed source taxation treatment consistent with the method of taxation of that category of income under domestic law (for instance, net taxation by assessment, withholding, etc.)?

Example: Article 7 of the United Nations Model Convention provides for net taxation of business profits. However, certain payments that are classified for treaty purposes as business profits (for instance, fees for technical services) are taxed on a withholding basis under the domestic law of some countries. Such countries may wish to consider whether to adopt a different approach under their treaties.

3) *Ease of administration*

Does the proposed treatment present any particular difficulties for the tax administration of your country? Such difficulties may include issues relating to administrative burden, especially where tax liability is determined by assessment by tax authorities (rather than self-assessment or withholding), or relating to interpretation or application of treaty provisions.

Example: Difficulties can arise where an undefined term used in the United Nations Model Convention (for instance, "paid" in Article 11) is interpreted in the Commentary in the way that is contrary to the established meaning of the same term for purposes of domestic law.

Is relevant information that is necessary for the administration of the provision readily obtainable?

Example: Article 8 (alternative B) of the United Nations Model Convention allows a country to tax "an appropriate allocation of the overall net profits" of a non-resident shipping enterprise. Determination of such profits may be difficult, particularly if non-resident shipping enterprises are taxed under the domestic law of that country on a deemed profit calculated by reference to the fares or freight received by the enterprise in that country.

4) *Ease of compliance*

Does the proposed treatment place an onerous compliance burden on taxpayers? This can be a particular problem where taxpayers are required to keep detailed records that they would not ordinarily keep, or meet strict information disclosure requirements in order to obtain treaty benefits.

Example: Many countries choose to simplify compliance by taxpayers by not including the 'force of attraction' provisions of the United Nations Model Convention in Article 7(1). Others may consider that the provisions of Article 5(3)(b) of the United Nations Model Convention relating to the existence of a deemed services permanent establishment create an undue compliance burden on taxpayers.

Countries are well advised to follow the provisions of the United Nations or OECD Model Conventions as closely as possible for the reasons outlined above. However, having regard to their particular circumstances, countries may determine that the United Nations or OECD Model Conventions do not fully meet their needs, or that certain provisions of one or other of these Models cause them unacceptable difficulties. By developing a policy framework, these countries will be able to decide in advance what rules will best serve their country's interests, and how important those rules are to that country.

In deciding to move away from a policy position endorsed in the United Nations Model Convention, or the OECD Model Convention, countries should, in relation to each policy issue, consider the matters raised above. In addition, they should consider:

1) *Reason*

   What is the reason for the departure from the policy position found in the international models? For example, is the proposed approach intended to protect a significant source of revenue in your country (for instance, income from natural resources, manufacturing profits, fees for technical services, etc.)?

   Is the departure intended to attract investment in an area of your country's economy that your government is seeking to develop (for instance, building technical expertise, financial services, etc.)?

   Is the usual approach found in the international models too difficult for the tax administration or taxpayers to administer in the context of your domestic law?

   Is the departure necessary in the context of the bilateral relationship, especially having regard to the other country's tax system? For example, while a developing country's model may include tax sparing provisions, such provisions would not be required to protect domestic law concessions if the tax-spared income is exempt from tax in the other country, either under the treaty or under the other country's domestic law.

2) *Priority*

How much of a priority is it for your country that this outcome be achieved, vis-à-vis other issues? Is this an outcome that must be achieved, or something that is highly desirable but not essential, or is achieving this outcome not of particular importance to your country?

As far as possible, departures from the international norms should only sought for important issues. If a policy outcome is preferred, but not important, countries with limited negotiating skills and experience may be better off focussing those resources on achieving key outcomes.

3) *Achievability*

Is this treatment likely to be readily accepted by the treaty partner country? Is it consistent with regional norms? Have other countries sought or accepted this approach in their treaties?

4) *Flexibility*

Is your government prepared to allow negotiators any flexibility on this issue? Is this a deal-breaker? Is there scope for compromise (for instance, different time threshold, different rate limit, exclusion/inclusion of certain provisions)?

If no flexibility is possible at the time of negotiation, would negotiators be permitted to agree to a Most-Favoured-Nation provision? Such a provision could create an obligation to provide similar treatment if a more favourable position is agreed in a treaty with another country.

5) *Fall-back positions*

If there is scope for compromise, what fall-back positions would be acceptable to your government? What is the bottom line?

Finally, countries should be forward-looking in designing their policy framework and Model. Treaties usually last for many years – often decades. Renegotiation of a treaty is time-consuming and expensive, so it is worthwhile to consider policies that are robust and sustainable in the long term, and that have regard to likely developments within the country and in the international tax context.

If possible, the policy framework and Model should be agreed on a whole-of-Government basis. In particularly, the support of the Ministry of Finance or Treasury is important in ensuring that the treaty policy is consistent with the Government's objectives. Other ministries, such as those responsible for foreign policy or trade, may also be relevant.

Policy concerns that are commonly encountered by developing countries, and the issues that they raise for designing a model tax treaty, are discussed in more detail below.

3. Designing a Model Tax Treaty

Countries should develop a model tax treaty (Model) that reflects the key aspects of their policy framework. For ease of negotiation, and to maximise the likelihood of designing effective provisions that achieve the desired outcomes, developing countries would be well-advised to base their Models as far as practicable on the United Nations Model Convention.

Certain features of the United Nations and OECD Model Conventions are found in virtually all modern tax treaties, such as:

- provision for elimination of double taxation;
- inclusion of non-discrimination rules;
- provision for mutual agreement between tax administrations; and
- most importantly, provision for exchange of tax information between tax administrations, including information held by banks and other financial institutions.

It is highly recommended that any country's Model should include these fundamental provisions. In addition, most treaties adopt the basic structure of the United Nations and OECD Model Conventions, that is to say:

I. Scope of the Convention (Articles 1 and 2)
II. Definitions (Articles 3 to 5)
III. Taxation of Income (Articles 6 to 21)
IV. Taxation of Capital (Article 22)
V. Methods for the Elimination of Double Taxation (Article 23)
VI. Special Provisions (Articles 24 to 28)
VII. Final Provisions (Articles 29 to 30)

In designing a Model, developing countries are strongly advised to use not only the structure and principles but also the text of the United Nations or OECD Model Conventions wherever possible. Although the meaning of the text of the Models may not always be abundantly clear, especially where the language of the United Nations or OECD Model Conventions is not the first language of the reader, the terms of those Models are found in thousands of tax treaties and are interpreted in accordance with the Commentaries and/or in jurisprudence around the world.

Developing countries would be well-advised to avoid making minor drafting changes, notwithstanding that those changes might better align the text of their treaties to terms used in their local language or in

their domestic law. Deviations from the text of the United Nations or OECD Model Conventions may well be taken to signal that the negotiators intended to achieve a different outcome to that provided under the Models. By adopting the text used in the relevant Model, countries are able to demonstrate their intention to achieve the outcomes provided in that Model as interpreted in the Commentaries. As far as possible, drafting changes should only be used where a different result is sought.

In cases where, in accordance with their policy framework, countries want to achieve a different outcome to that provided in the United Nations Model Convention, different provisions will need to be used. In these circumstances, if no suitable text can be found in the OECD Model Convention or in the Commentary to either the United Nations or OECD Model Conventions, it is advisable to search for examples of provisions used in other treaties to achieve the same or a similar outcome. These may be found in regional Models or on the OECD Tax Treaty Website for Tax Officials.[29] The OECD website sets out many alternative provisions from existing treaties and is an extremely valuable free resource for treaty negotiators. If no suitable precedent is available, drafting of a new provision in a country's Model should seek to follow the style and text of the United Nations and OECD Model Conventions as closely as possible.

Countries should regularly review their Model to ensure that it remains up to date in the light of international developments and changes in the country's circumstances. In particular, changes to the United Nations or OECD Model Conventions should be considered and, where appropriate, incorporated into a country's model tax treaty.

Issues commonly encountered by developing countries in designing their Model

3.1 Persons covered

Tax treaties apply to persons who are residents of one or both contracting States (Article 1). "Person" is defined in Article 3 of the United Nations and OECD Model Conventions to include "an individual, a company and any other body of persons". Issues commonly arise as to how treaties apply to different types of entities and arrangements, such as partnerships and pension funds. While some of these issues are discussed in the Commentaries on the Models (for instance, there is an extensive discussion of the application of treaties to partnerships in the Commentary on Article 1 of the OECD Model Convention), countries should consider how treaties would apply to entities and arrangements existing in their country.

[29] Tax officials from all countries may register with the OECD Centre for Tax Policy and Administration Secretariat.

Where doubt exists, it may be useful to clarify in the country Model whether such entities are to be regarded as a "person" or a "resident" for treaty purposes.

3.2 Taxes covered

Capital taxes

While both the United Nations and OECD Model Conventions cover capital taxes, some treaties do not. The decision whether to include capital taxes in a tax treaty depends on whether such taxes are imposed in both treaty partner countries. If both countries impose capital taxes, then double taxation can arise where capital belonging to a resident of one country is taxed by the other country. In these circumstances, provisions to eliminate such double taxation should be included in any treaty between the two countries.

However, not all countries impose capital taxes under their domestic law. In designing their Model, countries that do not themselves impose capital taxes will need to consider whether they wish to cover capital taxes.

Double taxation of capital will not arise if one of the treaty partner countries does not impose capital taxes, or if neither does. In this case, it is a policy decision whether a country that does not impose capital taxes would want to include a Capital Taxes article in its treaties. Such an article may encourage outbound investment by residents of that country by limiting the circumstances in which the other country could impose tax on the capital of residents of the first country. However, this may not be seen as particularly desirable by developing countries that want their residents to keep their capital at home.

Coverage of capital taxes would ensure that, if a country subsequently introduces such taxes, any double taxation arising in respect of those taxes would be relieved. However, the imposition of such taxes in the future would be limited in accordance with the treaty provisions.

Taxing rights over capital taxes are generally allocated in accordance with Article 22 of the United Nations or OECD Model Conventions. These provisions allow taxation of capital represented by immovable property situated in a country, or movable property of a permanent establishment (or a fixed base, under the United Nations Model Convention) situated in that country. Capital represented by ships and aircraft used in international traffic may only be taxed in the country where the place of effective management is situated. Under the OECD Model Convention, all other elements of capital are taxable only in the country of residence. The United Nations Model Convention leaves the question open to negotiations.

If a developing country that does not currently impose capital taxes decides to include this Article, and is concerned about limitations on future policy options with respect to capital taxes, one option may be to provide, in respect of capital that is not otherwise specifically dealt with under the article, for taxation in the country where the capital is situated. This would ensure that, if in the future that country introduces capital taxes, the treaty would not limit their application (other than with respect to capital represented by ships and aircraft used in international traffic).

Some treaties provide, for example, that all other capital may be taxed in both countries. If double taxation arises as a result, the country of residence of the taxpayer would be required to provide relief. An alternative approach is to provide for taxation only in the country where the capital is located. However, this is likely to be more difficult to negotiate since few countries are prepared to give up taxing rights over their own residents.

3.3 Distributive rules

Treaties provide for different methods of source taxation and for certain minimum thresholds for taxation of income derived by non-residents. The method and threshold depends on the category of income derived.

Business activities

Treaties generally provide an exemption from source taxation for income derived from temporary or preliminary business activities of non-resident enterprises. The aim of these provisions is to reduce the tax compliance burden of such enterprises unless they have a substantial participation in the economy of the host country. The relevant thresholds for source taxation are as follows:

Fixed place of business

Business profits of a non-resident will be taxable in the source country only if the non-resident enterprise has a permanent establishment (PE) in that country and the profits are attributable to that PE. A PE is primarily defined as a fixed place of business through which the enterprise conducts its business. A place of business will generally be regarded as 'fixed' if that place is at the disposal of the non-resident enterprise for at least 6 months.

This threshold for source taxation is widely accepted by both developing and developed countries for most non-service business activities (for instance, manufacture, hotels, mining, retail, etc.). For service activities, the United Nations Model Convention includes an additional time threshold (see below).

Countries with significant natural resources, especially off-shore resources such as gas or petroleum reserves, may consider that a lower threshold is appropriate. These countries often include special provisions in the definition of "permanent establishment" (such as provisions to deem substantial equipment or natural resource activities to be a PE) or include an Offshore Activities Article which provides a shorter time threshold in respect of such activities.

Some treaties also provide an exception to the fixed place of business threshold in respect of insurance activities. For example, countries that impose tax on the basis of gross premiums paid to non-resident insurers under domestic law may preserve the operation of this law under tax treaties, sometimes with the rate of tax being capped to a certain percentage (for instance, 5% or 10%) of the gross amount of the premiums.

Construction sites

While the OECD Model Convention provides for a 12-month threshold for construction and assembly projects, a 6 month threshold is provided under the United Nations Model Convention and is widely accepted internationally. Some developing countries seek a shorter time threshold in their treaties (for instance, 90 days).

In designing a Model, the time threshold should not be less than any domestic time threshold for taxation of such activities. Doing so could lead to double non-taxation of income of non-resident construction or assembly enterprises in treaties with countries that apply an exemption system (that is to say, where the income that may be taxed in the host State under the treaty is exempted from tax in the other State). This is because, while the treaty accords the host State the right to tax the income, that State would not be able to exercise that right if the construction site lasts less than the domestic law time threshold.

Services

Income from services is commonly dealt with under a number of different articles of a tax treaty. Under the United Nations Model Convention, services are deemed to constitute a PE (and therefore be taxable under Article 7 unless dealt with under another specific article) where:

- Supervisory activities in connection with a building site or assembly project etc. are carried on in the State for more than 6 months; or
- Services are performed in a State for the same or connected project for more than 6 months.

These additional threshold provisions, though not part of the OECD Model Convention, are widely accepted in treaties with developing countries.

Another threshold that is not found in either the United Nations or OECD Model Conventions, but is found in a few treaties, deems a PE to exist where substantial equipment is used in a State. This additional threshold is particularly relevant to countries with off-shore natural resources, since large mobile equipment such as oil rigs may not meet the criteria for being a fixed place of business. As noted above, a lower time threshold is provided where the equipment is used for natural resource activities. The substantial equipment provision may also be relevant to domestic transport operations.

Specific types of services are dealt with under the following provisions. Where these provisions apply, they will have priority over the general rules provided in respect of services income in Article 7.

Profit Attribution

Treaties seek to avoid the double taxation that can arise as a result of differing attribution by the two countries of profits to a permanent establishment under Article 7 (Business profits) or to a related enterprise under Article 9 (Associated enterprises). While the arm's length standard is common to virtually all tax treaties, countries need to decide the extent to which dealings between different parts of an enterprise should be taken into account. In this regard Article 7 of the United Nations Model Convention differs from the OECD Model Convention in that it generally disallows deductions for amount "paid" by a permanent establishment to another part of the enterprise such as the head office.[30] Countries that wish to adopt the more limited approach to profit attribution should be careful to follow the wording of the United Nations Model Convention Article 7.

The United Nations Model Convention also provides for limited 'force of attraction', which allows the source country to tax, in addition to profits attributable to a permanent establishment, profits arising in that country from sales of the same or similar goods, or the provision of the same or similar services. Although this approach is not commonly found, even in treaties of developing countries, those countries that wish to provide for such force of attraction should include in their Model the additional wording found in the United Nations Model Convention.

International traffic (Article 8)

Article 8 of the United Nations and OECD Model Conventions deal with income from international transport separately from other business profits, primarily because the usual rules for taxation of business profits would be difficult to apply in the context of international transport operations since airlines and shipping operators would be likely to have a PE in many countries. Furthermore, the calculation of the

[30] See discussion in paragraphs 1–3 of the Commentary on Article 7 of the United Nations Model Convention.

profits attributable to each PE is very difficult, since much of the income derives from activities carried out on or above international waters.

International treaty practice is to provide for profits from international transport by air, or by boat in inland waterways transport, to be taxed only in the country where the place of management of the enterprise is situated. The OECD Model Convention Article 8 and United Nations Model Convention Article 8 (alternative A) provide for similar treatment of profits from international shipping. United Nations Model Convention Article 8 (alternative B) provides a different approach which allows the source country to tax a percentage of the overall net profits from the shipping operations if such operations in that State are more than casual.

Another approach found in some treaties is to allow the source country to tax income from international shipping in accordance with domestic law, but to reduce the tax payable by 50 percent. This allows those countries that apply source taxation on a gross basis to the freight payable on goods or passengers shipped in that country to continue to do so, albeit at a reduced rate of taxation.

Developing countries will need to decide which approach they should adopt for international shipping, having regard to their policy preferences, administrative capacity and their domestic law. They may also want to consider whether profits from international road and rail transport should be dealt with under this Article, or in accordance with the usual rules of Article 7 for business profits.

Income from independent personal services (Article 14)

Under the United Nations Model Convention, income derived by a resident from professional services or other independent activities would be taxable in the country in which the services are performed if:

i. the non-resident service provider has a fixed base in that country through which the services are provided; or
ii. the service provider is present in that country for more than 183 days.

The OECD Model Convention no longer includes a specific article dealing with independent personal services. Such income is dealt with under Article 7, which requires that the income be attributable to a PE of the non-resident service provider.

Although the majority of countries take the view that Article 14 applies only to personal services provided by individuals, the use of the term ‘resident’ leaves the scope of the article open to interpretation. For this

reason, some countries like to clarify that this article applies only to individuals, while others extend its scope to activities performed by entities such as companies.

Since Article 14 refers to 'income', countries that tax independent personal services incomes on a gross basis under their domestic law are not precluded from doing so under this article. However, as the majority of countries apply Article 14 to net income, countries that wish to apply gross basis taxation should clarify this during negotiations.[31]

Some treaties include a third threshold which allows a country to tax income from independent personal services where income exceeding a monetary threshold is paid by a resident of that country or a PE situated in that country. Such a threshold was previously found in the United Nations Model Convention but was deleted in 1999. Countries considering whether to include such a provision should note that monetary thresholds are difficult to administer and the amount becomes meaningless over time.

Independent personal services income may also be dealt with under provisions dealing with fees for technical services (see below). Where a treaty includes technical services provisions, the relationship between the two articles should be clarified, for instance by excluding such fees from the scope of Article 14.

Fees for technical services

Under their domestic law, many developing countries collect withholding tax on fees for technical services paid by one of their residents or borne by a PE situated in their country. The application of the usual tax rules for business profits provided under Article 7 may present an administrative problem for fees that are taxed on a withholding basis under domestic law, since there may be no mechanism for reporting this income or allowing deductions against it. Accordingly, these countries often wish to include a provision in their treaties that allows them to continue to apply their withholding taxes.

Provisions to allow withholding on fees for technical services generally extend similar treatment to such fees as is provided in respect of royalties. This is achieved either by including fees for technical services in the definition of 'royalties' in Article 12, or by including a separate article dealing specifically with such fees and drafted along similar lines to the royalties article of the United Nations Model Convention. A limit (generally around 10 - 15 percent of the gross amount of the fees) is imposed on source taxation.

Although such a provision is not currently included in either the United Nations or OECD Model Conventions, it can be found in a significant number of treaties of developing countries. The United

[31] See paragraphs 10 and 11 of the Commentary on Article 14 of the United Nations Model Convention.

Nations Committee of Experts on International Cooperation in Tax Matters ("The United Nations Committee of Experts") is currently considering whether to add a provision to the United Nations Model Convention to deal with fees for technical services.

Since this provision is not consistent with current international treaty norms (which would require a PE or fixed base threshold, or at least a minimum time threshold), it may be resisted, particularly by countries that follow the OECD Model Convention. If it is a high priority for a developing country to include this provision in its treaties, it must be recognised that some treaty partner countries are likely to insist on concessions on other articles of the treaty (for instance, reductions on withholding taxes or other reductions in source taxation).

For this reason, it would be prudent for any country that includes a provision for technical services fees to have fall-back positions. For example, inclusion of the article may be strongly resisted by some treaty partners because it does not include a requirement that the income be from services performed in that State. Including a requirement that the services be performed in the State would also be consistent with taxation of services income under Article 5/7 and under the Independent personal services Article. Consideration could also be given to including a minimum time or monetary threshold, at least as a fall-back position.

Income from technical services that is effectively connected with a PE is excluded from the scope of this article, and will fall under Article 7 pursuant to which only the profits from such services may be taxed in the source country. This may encourage non-resident service providers to establish a PE in order to obtain the benefit of net taxation (which may result in less tax imposed at source).

The relationship between the fees for technical services provision and Article 14 dealing with income from independent personal services should be clarified. It may be expected that the technical services provision, being more specific, would have priority over Article 14. Nevertheless, it would be useful to put this beyond doubt by, for example, excluding fees for technical services from the scope of Article 14.

Countries that include a provision dealing with fees for technical services should ensure that the meaning of "technical services' (or other term used) is clear. Some countries define these services as services of a "technical, managerial or consultancy nature", while others consider that all services involving a technical element are covered, while yet others will only apply the provision to services connected to a transfer of technology.

Entertainment (Article 17)
In international tax treaty practice, unlimited source taxation of income derived by artistes and sportsmen from their entertainment activities is permitted. Taxation on a gross basis is not precluded under this article, but countries should consider whether they wish to include in their Model, or would be prepared to agree in negotiations to, provision for:

- net taxation only;
- a minimum monetary threshold; and/or
- an exemption from source taxation for remuneration of entertainers who participate in a cultural exchange funded by Government.

Professors and Teachers
Although neither the United Nations nor OECD Model Conventions includes a separate provision dealing with income derived by visiting teachers or professors, a limited exemption is often found in treaties of developing countries that wish to attract the services of foreign educators.

The Commentary on Article 20 of the United Nations Model Convention includes a discussion on issues that should be considered in preparing a provision dealing with remuneration of teachers and professors, including:

- the possibility of creating double exemption (for instance, if the teacher ceases to be a resident for tax purposes in the other country);
- the inclusion of a time limit (normally 2 years) and the application of that limit;
- the possibility of limiting the exemption to teaching services performed at 'recognised' institutions or research performed in the public (v. private) interest;
- whether an individual should be entitled to benefits under the article in respect of more than one visit.

Since these provisions are often difficult to administer and the same benefit could be achieved with more precision through domestic law, consideration should be given to whether any benefit or exemption for such remuneration should be provided under domestic law.

Withholding taxes on dividends, interest and royalties

Dividends and Branch Profits Tax
Most countries impose withholding tax on some or all dividends paid by a resident company to its foreign shareholders. Treaties generally provide that the country of residence of the paying company may tax

dividends paid to a resident of the other country, but if that person is the beneficial owner of the dividends, the rate of tax is limited to a certain percentage of the gross amount of dividends.

Treaty withholding tax rate limits on dividends often differentiate between non-portfolio inter-corporate dividends (that is to say, where the shareholder is a company that owns a significant holding in the paying company) and other dividends. The United Nations Model Convention Article 10 does not specify percentage rates, but the OECD Model Convention Article 10 provides a rate limit of 5% for non-portfolio inter-corporate dividends, and 15% for all other dividends. There are however many different approaches and rate limits found in existing treaties, ranging from a single rate for all dividends, or split rates ranging from 0% to much higher rates.

In designing their Model, developing countries should take into account the total tax that will be imposed on corporate profit, including tax at the company level and tax imposed on successive levels of shareholders. A high level of dividend withholding tax, while it may operate to defer repatriation of profits by local companies to foreign owners, is also likely to discourage foreign investors from establishing or investing in local companies in the first place.

Most treaties provide lower rates of withholding on non-portfolio inter-corporate dividends to reduce the incidence of recurrent taxation. However, some countries may find it difficult to administer the dual rates under their domestic law and may prefer to provide in their Model a single rate applicable to all dividends.

Under their domestic law, some countries impose an additional tax on the profits of a local branch of foreign enterprises. This tax is intended to provide broad equivalence between methods of conducting business so that, regardless of whether a foreign enterprise conducts business in the source country through a branch or a subsidiary, similar levels of source tax are payable. The additional tax may take many forms, including the imposition of a higher rate of tax on branch profits of foreign enterprises, or a tax on the after-tax profits of the branch at a similar rate to dividend withholding taxes, or a tax on remittances of branches to their head office.

Neither the United Nations nor OECD Model Conventions provide for any additional branch profits tax. However, provision for branch profits taxation in tax treaties is not uncommon, particularly in treaties of developing countries. If such a provision is included, the additional tax should be limited to the same rate as that applicable to non-portfolio inter-corporate dividends, and should apply to the after-tax amount of

the branch profits, to ensure maximum consistency between taxation of profits of subsidiaries and branches.

Interest

The United Nations Model Convention does not provide specific figures for limits on interest withholding tax rates. However, treaties with developing countries generally limit withholding tax on interest beneficially owned by a resident of a treaty partner country to 10 or 15 percent. Some regional models such as the ASEAN Model specify 15 percent.

Developing countries should decide what rate they would consider appropriate for their Model, bearing in mind that high rates of withholding may deter investment or may result in the tax cost being passed on to resident payers through increased interest rates.

Consideration should also be given to whether, either as part of their Model or as a concession as part of the treaty negotiation process, a lower rate could be accepted in certain circumstances. Such lower rate, or exemption, could apply to all interest, or to certain categories of interest, such as those discussed in paragraphs 12 to 17 of the United Nations Commentary on Article 11.

In particular, consideration should be given to the withholding tax rate on interest derived by financial institutions. Given the cost of funds to financial institutions, and the narrow margins of profit obtained on funds lent by those institutions, even a low rate of withholding on the gross amount of the interest will frequently absorb (or even exceed) the whole amount of the profit on the lending activities.

Royalties

The United Nations Model Convention differs from the OECD Model Convention in that the former allows source taxation of royalties, while the latter provides for exclusive residence taxation. Unsurprisingly, treaties of developing countries almost invariably provide for source taxation. The United Nations Model Convention Article 12 does not specify a withholding rate limit on royalties that are beneficially owned by residents of the other country, but in practice limits in developing country treaties range between 10 and 25 percent. When setting the rate limit in their Model, countries are advised to take into account the considerations set out in paragraphs 4 to 11 of the Commentary on Article 12 of the United Nations Model Convention.

One issue that commonly arises is the treatment of income from equipment leasing. Payments for the use of equipment are excluded from the definition of royalties in the OECD Model Convention, but remain in the United Nations Model Convention definition. Countries may wish to consider providing a lower rate for income from equipment leasing, either in their country Model or as a fall-back. Leasing income will

have costs associated with it, and even a fairly low withholding tax rate imposed on the gross amount of the income may well result in excessive taxation which would discourage cross-border equipment leasing or may be passed on to resident lessees. A limit of about half of the general rate for royalties may be appropriate.

Capital gains

Treaties generally ensure that tax imposed on capital gains on alienation of immovable property located in a country, and movable property which is part of business property of permanent establishment or a fixed base in that country, may be taxed in that country. Capital gains arising from the disposal of ships or aircraft used in international traffic, and boats used in inland waterways transport, are generally taxable only in the country in which the place of effective management of the enterprise is situated.

For other gains, treaty practice varies. Some countries provide for exclusive residence country taxation. However others, including most developing countries, prefer to retain source country taxing rights over a broader range of capital gains, especially gains from the disposal of shares in a resident company or interests in an entity of which the assets consist mainly of immovable property.

In designing their Model provisions on capital gains, countries should consider, in particular, which gains are taxable under their domestic law, and the extent to which their tax administration is able to enforce tax liabilities of non-residents on such gains.

Pensions

While the OECD Model Convention Article 18 and the United Nations Model Convention Article 18 (alternative A) provide that pensions paid in consideration of past employment are generally taxable only in the country in which the recipient resides, the United Nations Model Convention Article 18 (alternative B) allows source taxation of such pensions if they are paid by a resident of the source country or a permanent establishment situated in that country. The United Nations Model Convention also provides that pensions paid in respect of government service and social security payments are taxable only in the paying country. In practice, many countries seek source taxing rights over pensions in their treaties. Examples of different provisions are found in the OECD Commentary on Article 18.[32]

Countries should make a policy decision as to which alternative they prefer (or indeed, whether they would prefer another alternative such as a single tax treatment for all pensions). This decision should take into

[32] See paragraphs 12-21 of the Commentary on Article 18 of the OECD Model Convention.

account, inter alia, the ability of the tax administration to collect source taxation on pensions paid to non-residents. Countries that tax pensions by withholding under domestic law, for instance, are more likely to be able to collect source tax in accordance with Article 18 (alternative B).

3.4 Relief of double taxation

- Elimination of double taxation

The United Nations and OECD Model Conventions require the country of residence to relieve double taxation that arises in cases where source taxation is permitted under the treaty. The residence country has the option of relieving such double taxation either by the exemption method or the credit method.

A policy decision should be made as to which of these methods is preferred in relation to the different categories of income. Most countries prefer to align the method of relief to their domestic law relief provisions. However, some countries that relieve double taxation by the credit method under domestic law may provide for exemption of certain categories of income under a tax treaty in order to simplify compliance and administration.

- Tax Sparing

Tax sparing is an arrangement under which one country will agree to provide a credit for another country's tax, notwithstanding that the tax has not actually been imposed because of tax incentives provided by that other country. The purpose of tax sparing is to ensure that the benefit of the incentive is not 'soaked-up' by the country of residence of the taxpayer.

The treaties of many developing countries include a tax-sparing provision to protect the application to residents of the treaty partner country of tax incentives.

While some countries are prepared to agree to such provisions with their least developed treaty partners, others are more resistant, especially since the OECD published a report recommending caution in agreeing to tax sparing provisions in treaties.[33] Nevertheless, this can be an important benefit to developing countries of entering into tax treaties with countries that provide relief from double taxation through the credit method.[34] Developing countries that wish to seek tax sparing would be well advised to consider how important the inclusion of such provision is to them, and the extent to which they might be prepared to consider limitations such as limitations on the activities to which the tax sparing provisions would apply, or limitations on the duration for which the provisions would apply.

[33] OECD *Tax Sparing: A Reconsideration,* 1997.

[34] See the discussion of Tax Sparing provisions in section 2.5 of Paper No. 1-N on *Why Negotiate Tax Treaties?*

3.5 Non-discrimination

Rules to prevent tax discrimination are designed to encourage inbound foreign investment in a State and protect investment abroad. The non-discrimination rules in the United Nations and OECD Model Conventions apply to all taxes, including national and sub-national level taxes, income tax, VAT, property taxes, petroleum taxes etc. In some countries, there may be constitutional or other barriers to applying the non-discrimination rules to all taxes. While it is desirable that the rules apply as widely as possible, these countries may need to limit the application of these rules in their treaties to taxes covered by the treaty, or to those taxes and other major taxes imposed in the two countries.

Countries should review their domestic tax law to determine whether discrimination of the kind precluded by tax treaties exists. In conducting this review it should be noted that different treatment of residents and non-residents exists in most countries and is not prohibited, provided that there is no discrimination of a type that would breach the tax treaty non-discrimination rules.

If a domestic law would potentially breach the non-discrimination rules, and for good policy reasons (such as the prevention of tax avoidance or evasion) the country considers that the law must be maintained, the country Model should clearly specify the laws that are to be excluded from the operation of the treaty rules.

3.6 Mutual agreement procedure and arbitration

In accordance with usual tax treaty practice, a country's Model should provide an avenue for taxpayers to seek solutions to tax issues arising out the treaty, such as transfer pricing issues, through the mutual agreement procedure. Under this procedure, the taxpayer can request the Competent Authority of his country to try to resolve such problems, either alone or in consultation with the Competent Authority of the other country. The second sentence of paragraph 4 of United Nations Model Convention Article 25 allows the competent authorities to develop 'appropriate bilateral procedures, conditions, methods and techniques' for the implementation of the mutual agreement procedures. Developing countries should consider the procedural issues discussed in Section C of the United Nations Commentary on Article 25, having regard, in particular, to the administrative capacity and resources of their tax administration and competent authorities.

The United Nations and OECD Model Conventions also includes an optional provision[35] that provides for binding arbitration procedures to resolve issues that the Competent Authorities are unable to resolve under the mutual agreement procedure. While the benefits of providing taxpayers with the certainty of arbitration procedures are beyond doubt, arbitration in the context of tax treaties is a relatively recent development and few tax treaties of developing countries currently include such an article. As noted in the United Nations Commentary on Article 25, countries with limited experience in the mutual agreement procedure could have difficulties in determining the consequences of adding arbitration.[36] Developing countries should consider whether their tax administrations have the legal and practical ability to support arbitration procedures and whether, as a matter of policy, they wish to do so.

3.7 Anti-abuse provisions

Some countries, particularly those with only a small tax treaty network, may be concerned that the reductions in source taxation offered through their treaties may expose them to abusive arrangements designed to obtain those benefits in unintended circumstances. They may also be concerned that residents of third countries with which they do not have a treaty may try to obtain the benefits of a treaty (treaty-shopping).

The Commentary on Article 1 of the United Nations Model Convention contains an extensive discussion of potentially abusive situations and suggests a number of possible solutions to combat such arrangements. In designing their Model, countries should consider whether to include any specific anti-abuse rules[37] or general anti-abuse rules[38] in their treaties.

3.8 Administrative assistance

Exchange of information

In accordance with modern tax treaty practice, and with a view to joining the worldwide push to stamp out harmful tax practices, the Model that any country develops should adopt the wide exchange of information provisions in accordance with Article 26 of the current United Nations and OECD Model Conventions.

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35 Paragraph 5 of United Nations Model Convention Article 25 (alternative B), OECD Model Convention Article 25 (5).

36 Paragraph 3.

37 See paragraphs 31 – 33 of the Commentary on Article 1 of the United Nations Model Convention.

38 See paragraphs 34 – 37 of the Commentary on Article 1 of the United Nations Model Convention.

These provisions authorise and require exchange of relevant information on all taxes, whether or not they are taxes covered by the treaty. The tax administration, if requested by the other tax administration, is required to collect and exchange all relevant information, even if that information is not required for its own purposes or is held by a financial institution. Countries should ensure that their tax administrations have the legal and administrative ability to obtain and exchange such information notwithstanding, for instance, domestic bank secrecy laws.

Paragraph 6 of Article 26 of the United Nations Model Convention provides that the competent authorities shall develop, through consultation, "appropriate methods and techniques" concerning exchange of information. Countries should consider what procedures are appropriate for the competent authority of their country to provide effective exchange of information, including exchanges made on request, or automatically, or spontaneously.

Some developing countries may have concerns about the administrative burden placed on their revenue agencies by the obligation to exchange tax information. These countries may wish to include in their Model a provision requiring extraordinary costs incurred in providing information to be borne by the party requesting the information.[39]

Assistance in collection

While the current United Nations and OECD Model Conventions include an article (Article 27) which requires the tax administrations of both countries to provide assistance to each other in collecting taxes outstanding in the other country, it is recognised that not all countries will be in a position to accept such a provision.[40]

Having regard, in particular, to the administrative burden this could place on the tax administration, developing countries may want to consider whether they are in a position to include such provisions in their Model.

3.9 Protocol

Some countries like to append a Protocol to their tax treaties, which sets out important interpretations and/or administrative provisions. Such Protocols are generally negotiated at the same time as the tax treaty and have the same legal status as the tax treaty.

[39] See paragraphs 29.3 and 29.4 of the Commentary on Article 26 of the United Nations Model Convention.

[40] See footnote to Article 27 of the United Nations Model Convention.

Interpretive provisions are particularly useful where there might otherwise be doubt as to the intended operation or application of a tax treaty provision in one or both countries. This may occur, for example, where domestic law or jurisprudence in one country requires an interpretation that would not be followed in the other country. In this case, the two countries may agree during negotiations on a particular interpretation and set this out in the Protocol.

4 Conclusions

By developing a tax treaty policy framework, countries will be in a much better position to 'know what they want' out of treaty negotiations and to achieve outcomes that are in the best interests of the country. Such a framework will also assist countries in designing their country Model, which should reflect the policy outcomes sought.

Both the policy framework and the country Model should be reviewed regularly to ensure that future tax treaties continue to provide beneficial and appropriate outcomes for the country and remain up to date with international developments.

ADVANCE UNEDITED DOCUMENT

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

Paper No. 3-N

Preparing for Tax Treaty Negotiation

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Contents

Preparing for Tax Treaty Negotiation

Odd Hengsle

1. Introduction

Preparations are an extremely important part of the negotiation process. Without adequate preparations the team will be at a disadvantage during the negotiation and will most probably not achieve an optimal result for the country they are representing. In the following paragraphs some of the important aspects of the negotiation preparations are detailed.

2. Prepare your model treaty

When the decision to negotiate tax treaties has been made, the first step will be to prepare a model treaty. Before drafting a model treaty it will be necessary to agree on policy in order to decide on important issues that have to be taken care of in the treaty.[41] Study the United Nations Model Double Taxation Convention between Developed and Developing Countries ("United Nations Model Convention"), the Organisation for Economic Co-operation and Development's Model Tax Convention on Income and on Capital ("OECD Model Convention"), regional model (if any) and models made by countries you would prefer to be compared with. When drafting your model's provisions, it is advisable to follow the recognised wording used in international models unless you have good reasons to use alternative wording. Such good reasons can for example be found in relation to industries where the employees are working on a rotation basis. For example, activities on the continental shelf is usually based on people staying at a platform for two weeks at a time, then spending the next four weeks in their home country. In such a case the 183 days test in Article 15 of the United Nations and OECD Model Conventions will not work properly and new wording may be necessary either by reducing the number of days or look at the days of employment rather than the days of presence.

If a provision in your model deviates from recognized wording used in international models, such provision may nevertheless be introduced in your model unless there is good and valid reason to have the wording introduced in an additional protocol. A protocol is mainly used to set out important interpretation or administrative provisions. One should, however, be ready to explain the reasons behind such deviations.

[41] See Paper No. 2-N, Tax Treaty Policy Framework and Country Model, by Ariane Pickering.

However, different wording can create issues, such as arguments over whether the commentaries to that provision will apply. It may also create uncertainty whether a new wording is supposed just to be an improvement or introducing a new meaning. Be aware that both the United Nations and OECD Model Conventions have drafted alternative optional provisions in their commentaries that can be very useful if the model articles themselves do not give a satisfactory solution.

When creating a model some countries will set up a study group consisting of representatives from relevant ministries and the private sector while others will hire consultants as advisers when preparing their model treaty. Such consultants can be private persons with experience in international tax matters and treaty negotiations, or agencies dealing with international tax questions.

A special issue to be aware of when creating a model is to clearly state the area to which the treaty shall apply. Neither the United Nations nor OECD Model Convention has a definition of the two Contracting States. However, in the commentaries to Article 3 (Definitions) of the United Nations Model Convention it is stated that:

"The parties to a convention are left free to agree bilaterally on a definition of the terms "a Contracting State and "the other Contracting State. They may also include in the definition of a Contracting State a reference to continental shelves."

It is important to be aware that the main purpose of the definitions of the Contracting States is to define the scope of the application of the treaty, not to make a definition of the country as such. There may be several reasons for having a definition of a Contracting State that deviates from a definition of the country itself. One reason could be to exclude an area with a special tax regime, for example areas with favourable tax incentive legislation. Another reason may be to include an area which is not regarded as part of the country itself, but may be an area where a country may exercise certain taxation rights, for example the continental shelf which may encompass an area beyond the territorial sea.

Taking the purpose of the definition of a Contracting State into consideration, it may well be good reasons why the definition may vary from one treaty to another. However, it is important that the Ministry of Foreign Affairs is explained that the purpose of making a definition of a "Contracting State" in a treaty is to decide on the scope of application, not to define the country as such. The Ministry of Foreign Affairs should be informed and asked to agree on any definition of a Contracting State that has not been agreed upon before. They may also, if necessary, be consulted on the definition of "the other Contracting State".

3. Obtain authority to negotiate

Familiarity with your country's constitutional and legal requirements for negotiating and giving effect to treaties is essential. The process varies from country to country. In some cases an approval from the Ministry of Foreign Affairs is required. In some cases it is the prerogative of the Ministry of Finance or Treasury. Some countries prefer to submit a priorities report to the Ministers that seeks approval for the negotiation work programme for the next year or for the next few years. This really comes down to what will work within your country's legal and political framework. An approval of the work program may then replace an individual approval. In other countries an authority to negotiate is given in response to individual requests either from other countries or from industries in your home country. Even if the government has decided that the country as a general policy should enter into tax treaties with other countries and has decided on an approved negotiation programme, it will usually in each individual case be necessary to get an authority to negotiate. Such authority will usually be given when the Ministry of Finance or Treasury has agreed on the content and policy framework of the individual treaty. Even if the relevant authority to give approval for negotiations may vary, the Ministry of Foreign Affairs should be consulted before any decision is made. It may also be advisable to consult with the ministries responsible for trade. Some countries prefer in addition to consult with the private sector to ascertain whether there are any particular problems that need to be resolved.

An authority to negotiate should be obtained before any final decision on negotiation with another country is made and is necessary whether one is considering approaching another country asking for negotiations or deciding on a request from another country.

There may be several reasons for not entering into negotiations at a specific point of time and it may be necessary to prioritise among several countries. In some cases, treaties with neighbouring countries will have first priority. In other cases treaties with countries with which important economic relations exist will be prioritised. It may also be that a request is received from a country with which there is no economic or political reason to enter into a treaty. However, in some cases it may also happen that there are important political or economic reasons why a tax treaty should not be negotiated. Such reasons could, for instance, be diplomatic tensions between the two countries. If the other country has no tax, or is a tax haven, that could be a reason not to have a tax treaty. Another reason could be that the balance of benefits between the two countries is heavily in favour of only one of them.

4. Logistics

When a decision to proceed with negotiations is made, there are several issues that have to be decided.

- *How to communicate.* The initial approach requesting negotiations will usually be made through diplomatic channels or by a request made directly from the Minister in charge for negotiation of tax treaties in one country to the relevant Minister in the other country. To continue to approach each other only through diplomatic channels should be avoided. The aim should be to open a more informal dialogue between lead negotiators through email and/or phone calls so that the logistics can be more easily worked through. Most countries have an updated directory of persons that are allowed to act as competent authorities in relation to tax treaties. It is always useful to obtain such a directory from the other country, even if such directory does not tell who will be part of the forthcoming negotiation team. Such updated directory will, however, be more useful after the treaty has become effective and you for some reason need to get in direct contact with persons that are allowed to act as competent authorities. However, during the preparation period, direct contact with persons in the other country that are responsible for the preparation of the treaty at hand is preferable.

- *When will the negotiations take place?* A date for the negotiations to commence has to be agreed. Since all negotiations require preparation, time for such preparation should be allowed. A minimum of 6 weeks for preparation is desirable to enable a comprehensive study of the other country's tax system and treaty practice to be undertaken. Additional time may be required if the public is invited to provide submissions on issues that should be addressed in negotiations.

- *Where will the negotiations take place?* Since it is regarded as a disadvantage to travel, it should in principle be the country that asks for negotiations that should be prepared to do the travelling. However, this is by no means firm policy. If a country with limited economic resources asks for the negotiations to take place in their country, a developed country may be willing to do the travelling for the first round of negotiations. If, as it is usually the case, the negotiations require more than one round, it could be agreed to continue on a rotation basis.

  The country hosting the negotiation should be prepared to offer suggestions to the visiting delegation about suitable hotels within easy travel of the venue as well as other information that is relevant.

The advantages of having the negotiations "at home" lie in having easy access to reference materials, the possibility to consult with other officers in the department or even having access to the relevant policy makers. By having negotiations at home you will also avoid travel costs, jet lag and other inconveniences of travel. It is also customary that the host country tables its model and asks for negotiations to proceed on the basis of that model, a request that is usually accepted. It is always an advantage to have one's own model as a working document. On the other hand it will be difficult to escape from your other duties, such as treaty interpretation issues or other urgent matters, which you are required to deal with on a daily basis.

- *In which language will the negotiations be performed?* If both countries speak the same language, there is of course no problem. However, if the two countries speak different languages, it will be necessary to agree on the language to be used during the meeting. Since the English language is the language most commonly used, it is advisable that the negotiating team members have good knowledge of English. If the team members of the two countries are unable to carry out the negotiations in the same language, it will be necessary to have an interpreter present during the meeting. This should be agreed upon in advance. In some cases both countries would prefer to have their own interpreter in order to facilitate discussions within each team. However, there will in many cases be difficulties in finding interpreters with adequate knowledge in treaty language. Such lack of knowledge may create difficulties and unnecessary misunderstanding during the discussions. It is advisable that the interpreters have learned and understand terms used in tax treaties prior to the meeting. This can be done by insisting that they study terms used in other treaties you have entered into or used in internationally recognised models such as the United Nations or OECD Model Conventions. In this context, it is important to remember that the United Nations and OECD Model Conventions have been translated into several different languages, which will hopefully make it easier to find what terms are commonly used in the language you are looking for.

  The two teams will also have to agree upon which language the two draft treaties should be prepared.

- *How many members should the negotiating team consist of?* In most cases there should be at least three members; one to lead the negotiations, one to provide advice to the leader, and

one to take comprehensive notes. One team member needs to be made responsible for maintaining the agreed text. This matter is made easier if the text can be electronically displayed on a screen. If that is not possible, accurate paper drafts need to be kept. In countries where the tax administration is separate from the policy department, it is advisable to include members from both areas. The number may vary depending on where the meeting is to take place, but should not exceed six people (including any interpreter). If the negotiations are taking place at home, it could be beneficial to have more people present in the room in order for them to gain experience. However, these additional people would be present merely as observers, and would generally not participate in the negotiations.

- *Who should be members of the team?* The team should, if possible, consist of people with experience and knowledge of tax treaties, international tax issues and domestic tax legislation. In some cases, an official from the Ministry of Foreign Affairs will also be a member of the team. The reason for this is that entering into treaties with other countries is often the responsibility of the Ministry of Foreign Affairs, and they can give advice on important questions such as the definition of the country, the entry into force and the termination provisions of the treaty, as well as advice on constitutional issues. If acting as competent authority for the treaty lies with a different authority from that which is responsible for negotiations, or if administration or interpretation of treaties is the responsibility of another authority, it is advisable that members from that authority are included. When deciding on the members of the team it is also advisable to remember that there may be more than one round of negotiations and that there also will be much work to be done when the negotiations are finished.[42] It is advisable, if possible, not to include members that at present are in the process of moving to other positions.

  Some countries prefer to have persons from the private sector present during the negotiations. This is a very sensitive question since the negotiations are between States and the agreement in most cases will be confidential until signed. The same applies to hired consultants. Whether such persons should be present during negotiation should be a matter that is discussed and agreed with the other country in advance of the negotiations.

- *Other preparations.* The country where the negotiations are taking place has to find suitable meeting rooms. If at all possible, the room should be set up with a projector to display the draft treaty text as it is negotiated on a screen that is visible to both teams. Arrangements

[42] See Paper No. 5-N, Post-negotiation Activities, by Odd Hengsle.

should be made for the provision of suitable refreshments, such as water, tea and coffee and light snacks for morning and afternoon breaks. Printing facilities are also very helpful. As many delegations like to bring their own laptop computers to the negotiations, adequate power outlets are preferable. The same applies to Internet connectivity, if available.

If the meeting room is in a secured building, the necessary security passes or escorts to the meeting room should be arranged in advance for members of both teams. For this reason, and as a matter of courtesy, each team should advise the other of the number of people in their team, their names, role and contact details, and who is the leader of the team. It is also advisable to make the gender of each team member clear (e.g. by giving them a gender-specific title such as Mr or Ms), since this may not be readily apparent to the other team from the name alone.

The host country should also provide an agenda for the meeting which is forwarded to the other team for approval. Such agenda should, in addition to the time set aside for discussions, contain information about coffee breaks, invitations for possible lunch and/or dinners and possible cultural programs. The host country should also inform the other team where the meeting is going to take place and of possible transportation to/from airport and to/from meeting place.

The team that has to do the travelling has to remember to apply for travel permission and, if necessary, visas. This should be done early to avoid unnecessary delays. For a team to wait until the last minute before having final confirmation of the arrival of a treaty partner may create a bad impression and may not be conducive to the negotiation.

Some countries like to provide gifts to the other delegation, either to each member of the delegation or just to the delegation leader. Other countries have public sector policies against accepting gifts. One should therefore be careful with gifts and they should always be of small value. Always be aware that gifts are subject to airport inspections, and some countries impose restrictions on the import on some products. It is also advisable to avoid bulky or heavy gifts.

5. Define roles of each member of the team

In the preparations for the negotiations, as well as during the negotiations, it is important that all members of the team know which duties they are allocated.

There is much work to be done during the preparations and it is important that each member of the team, as early as possible, knows what will be his/her responsibility in the preparations.

The leader of the team should be a senior official with the authority to make important decisions during the negotiations. Such decisions include accepting or rejecting the other team's proposals, making his or her country's own proposals, and finding and accepting compromises, even if they are ultimately subject to approval by senior authorities. A senior official should always lead the team; otherwise the other country may get the impression that the negotiation is regarded as of little or no importance. This may create misunderstanding and a negative atmosphere.

It is preferable that the leader has comprehensive knowledge of domestic tax legislation and the interaction of domestic legislation and tax treaties. If not, at least one of the other members of the team should have such knowledge. Experience in tax treaty negotiations is also highly desirable.

It is the leader who should lead the discussion and present the team's arguments. However, the leader may decide to ask one of the other members of the team to present an argument, explain a position or a special feature in domestic legislation. In such a case this should, if possible, be agreed on within the team beforehand. It could, from time to time, be advisable to let a junior member of the team to do some presentation, as this will help him/her to gain experience and to give him/her a more direct feeling for being responsible for the final result. The senior officer should use all opportunities to train his/her team to negotiate. In general, it is advisable that members of a negotiating unit take part in training courses organised either by the country itself or by international organisations. It is important that the whole unit doing tax treaty negotiations achieve experience and knowledge. It could mean a serious setback for the unit if the unit is dependent on one senior officer and he/she for some reason leaves, either because he/she moves to a different position, leaves for private practise or retires.

In some countries the team is sometimes led by the most senior official of the negotiating authority who may not necessarily have the specific expertise required. This can create problems during the negotiations and it may be advisable for that person to indicate that the majority of the discussion will be led by a team member who has the relevant expertise.

It is important that at least one of the members of the team has the responsibility for taking notes of the discussions and any agreements reached during the meeting. Notes are important if a second round of negotiations is needed, and when preparing the treaty for signature and subsequent ratification. It is also important to have such notes when the competent authority at a later stage may

need to interpret issues arising from the treaty. The responsibility for taking notes should not be given to a junior without experience, because such a person will often have difficulties in understanding and deciding on what is important and what is of less significance. It is unusual to record the discussions, and it should never be done without agreement in advance with the other team in advance.

It is advisable to take note of the reaction of the members of the other team during discussions to see how they react to arguments put forward in the discussion and also when proposals are put on the table. Body language, as well as verbal responses, can give valuable insights into how the members of the other team view a proposal. Their response may give an indication of the relative importance to them of the issue, which may facilitate finding acceptable compromises.

6. Consult with business and relevant ministries and agencies

When preparing for negotiations with another country it is wise to consult with business and relevant ministries and agencies. In most cases there will be business in one or both countries that has initiated the decision to proceed with the negotiation of a tax treaty. This may be due to problems they have met or are anticipating when engaged in cross-border activities. Such problems will usually arise from domestic legislation in one or both of the countries preventing or hampering the desired economic activity or creating a barrier to the desired cooperation between industries in the two countries. It may also be that one of the countries has entered into a tax treaty with a third country giving business in that other country a competitive advantage.

Consultation with business will in most cases provide the team with important information of economic areas which it will be important to address during the negotiations. Such consultations could be done by approaching business associations and asking them to consult with their members to establish if there are particular points of importance to be aware of during the negotiations. Depending on their remarks, a meeting could be arranged.

Relevant ministries and agencies may also have information of importance for the negotiations. For example, they may have information on areas where they would like to encourage or make investments or areas where they would like to attract investments. When the relevant ministries and agencies are asked for information, experience tells that it can be difficult to get a feed back. To get an answer in time for preparations, it is advisable to stress the importance of a feedback and at the same time set a time limit for an answer which allows sending a reminder. It may also be advisable

to consult with your embassy in the other country. They may have important information in economic as well as non-economic areas that can be of value in the preparations.

7. Prepare the draft model used for a particular negotiation

Many countries will always use their general model treaty without making any changes. Although this indicates what they will regard as their preferred treaty, it should always be open for negotiations. Other countries will take into consideration particular inputs they have received from different sources, such as previous negotiations or public submissions. Some developed countries may even have prepared a specific draft for negotiations with developing countries, allowing more taxation rights for the source State.

Whether a country uses a general model treaty or a draft specially prepared for the negotiation at hand, the team must have a clear understanding of all the articles in the draft model they have prepared for the negotiation. It is important to understand all the articles and how they interact. The model may have been changed in some areas subsequent to previous negotiation and the team should be aware of where and why such changes have been made, and the effects of these changes.

The team should have a clear understanding of why the articles have been drafted the way they are and be able to explain them. The articles may be derived from the United Nations Model Convention, the OECD Model Convention, a regional model, or be specifically drafted by the ministry. They may also be found as alternatives in the commentaries to the models mentioned above. However, it is vital that the team is aware of and can explain any provisions that do not follow the United Nations or OECD Model Conventions. Such deviations may be due to domestic legislation or to important economic areas that need special attention.

8. Prepare alternative provisions

Many countries have provisions in their models, which they know from experience the other country may find difficult to accept in negotiations. To facilitate negotiations it is advisable to draft alternative provisions, which, through experience, are perhaps more likely to be accepted by the other country. These may be provisions that have been accepted in negotiations with third countries, or provisions that the other country has previously accepted in treaties with other countries. They could also be unique provisions intended to specifically address concerns expressed by the other country. When realising that a preferred provision is not acceptable, such drafted alternative

provisions can be presented and explained. It will be easier to have alternative provisions accepted when they can be presented in writing rather than orally.

9. Non-negotiable provisions

Some countries have non-negotiable provisions in their model. This position can be due to certain business activities or industries such as mining or extraction of natural resources. It may also be related to economic incentive legislation or other areas of great importance to that country. It may also relate to policy issues such as exchange of information. Most countries have difficulty in accepting that exchange of information may be prevented by bank secrecy legislation.

Non-negotiable positions may be found in the Commentaries to the OECD Model Convention. OECD member countries that disagree with the text of the Model lodge Reservations to the Model expressing their view, while disagreements with the interpretations found in the Commentaries are reflected as Observations. A number of non-OECD member countries have also set out their positions on the Model and Commentaries. Although these Reservations, Observations and Positions do not always indicate a non-negotiable position, they are a very valuable indicator of strongly held positions.

It is important to distinguish between provisions that are really non-negotiable and provisions for which the other country has a strong preference, but which, under certain circumstances can be flexible. Provisions that are only a strong preference should not be presented as completely non-negotiable.

Some countries prefer to list their non-negotiable provisions and present them to the other country during the preparations either in writing or in a pre-meeting. Presenting such provisions in a pre-meeting will give the team the possibility of explaining the reason for its standpoint. By presenting the non-negotiable provisions during the preparations one may avoid unnecessary discussions or entering into negotiations that are doomed to fail.

Other countries are of the opinion that such pre-presentation of non-negotiable provisions may deter the other country from entering into what might otherwise be a successful negotiation. By looking at what is achieved on balance in relation to all the other provisions of the treaty during the negotiation, and by explaining why some provisions are of such importance that a superior authority or the parliament will not accept any deviation, these countries hope, based on earlier experience, that their standpoint would be accepted. If experience has shown that some non-negotiable provisions have

been a hindrance to achieve an agreement, it would be advisable to consult with a senior policy maker, the Minister or even the Parliament to see whether compromises may be acceptable.

10. Interaction between domestic legislation and treaty provisions

It is important to have a clear understanding of the interaction between domestic legislation and treaty provisions. During negotiation a team may be asked how the domestic legislation interacts with the provisions proposed in the draft model. One reason for such knowledge is to understand to what extent the proposal deviates from the domestic legislation and to understand what kind of benefits are offered. One simple example is the withholding taxes on dividends, interest and royalties. If what is being proposed is strictly in line with the domestic legislation, there are no treaty benefits and the treaty partner will be less interested in having a tax treaty with you.

For the same reason it is advisable for a team to study the interaction between the provisions of the domestic legislation of the other country to have a clear understanding of the benefits offered in its proposed draft treaty.

11. Send a short explanation of your domestic tax system and your model to your treaty partner

Many countries prepare a brief summary of their domestic tax system with a special focus on areas relating to the treaty and including an explanation on any area which may require special attention. A short explanation of the main points in your legislation will make it easier to understand why some articles need special drafting and will also identify issues that need to be considered.

To facilitate the negotiations this summary of the domestic legislation and a draft model should be sent to the treaty partner well in advance of the meeting. At the same time one may ask for a similar summary and a draft model from their side.

If such explanations and models are received in good time before the meeting the two teams will have sufficient time to prepare and time will be saved during the negotiations.

If no summary is received from the other country, it is advisable to look for such information in other places. Such information may be obtained from the web site of the other country, in outlines prepared by the major international accounting firms or by searching on the Internet. It could also be a good idea to subscribe to tax treaty services. Some firms provide treaty services where they publish the text of all treaties entered into between different countries. In addition to provide the text of all

treaties, they also provide information about the entry into force and the termination of treaties, additional protocols, new legislation, court decisions and mutual agreements entered into by competent authorities (if made public). All very valuable information.

12. Prepare a comparison of the respective models – identify issues

After having received the draft model from a treaty partner it is important to prepare a comparison between the two drafts. This may be done in several ways, see examples enclosed in Annex 1 and Annex 2. In Annex 2 two colours are used. The use of colours simplifies the identification of the differences.

All differences between the two drafts should be identified because the small and less important textual differences have to be agreed upon during the negotiation as well as the major items. If some differences are overlooked, difficulties will arise at the time of signature, or even worse, after the treaty has entered into force. In the last case a protocol to the treaty has to be prepared and the laborious work of bringing the protocol into force has to be done.

During the comparison and identification of the differences it is advisable to decide what differences are important and what differences are of less importance. It will facilitate negotiation to concentrate more on the important issues. It will be these important issues where difficulties will be met during the negotiation. Having identified the important issues, such issues should be discussed internally to find arguments to be used, and what tactic should be followed, in the process of trying to convince the treaty partner to accept your proposal. By identifying the important issues early in the comparison process there will also be time enough to draft compromises and also to consult with a superior authority for acceptance of different anticipated solutions. If a compromise solution could be acceptable, a prepared draft may be easier for the other team to consider and accept than a compromise proposed orally at the meeting. A briefing note where the origin of the draft is set out (for instance, internationally recognised models, examples found in your own or the other country's tax treaties or drafted by you specifically for this negotiation) should be included with the prepared draft. This will ensure that all members of the team are aware of and can explain its origin.

13. Identify provisions proposed in the two draft models that deviate from provisions agreed in treaties with third countries

When preparing for negotiations a team should be aware of treaties their country has entered into with third countries, since they have to be prepared for the fact that the other country has studied such treaties. If the other team finds provisions in those treaties that are either identical to their own proposals, or are regarded as more favourable than the proposal put forward in the draft they have received from you, they will most likely ask for the same treatment. To avoid unexpected surprises during the negotiations, it is advisable to be prepared either to accept the same solution or be prepared to explain why such solution was acceptable when negotiating with the third country, but not now. There may be many reasons for different solutions with different countries, including a change of policy or a compromise accepted to achieve favourable treatment in other areas of greater importance.

For the same reason as a knowledge of your own treaties already entered into is important, it is important for a team to study the treaties the other country has already entered into with countries which are comparable (economically or regionally) to your own. If the treaties used as a comparison are not too old, these will give an indication of their current policy and what the other team may be willing to accept. They may also indicate how strongly the other team is likely to argue for their own position. For example, if the other country has never agreed to a provision allowing withholding tax on fees for technical services, or has never agreed to tax sparing provisions, it is unlikely that it will agree to include such provisions in negotiations with your country. Conversely, if a provision is always included in the other country's treaties (for instance, certain anti-avoidance provisions) you can expect that they will insist on a similar provision being included in any treaty with your country.

If the negotiation at hand is with a developed country, a comparison with treaties that country has entered into with other developing countries will be of great value since provisions found in such treaties may indicate what may be acceptable also in relation to your preferred solutions.

However, treaties between two developed countries may also be of great interest since provisions found in such treaties may indicate that there are special issues to be aware of. An example of such a provision could be an article on limitation of relief. If a country according to its domestic legislation uses a remittance basis of taxation whereby foreign-source income is taxed only when it is actually received in the country of residence, it could be advisable to have a provision that states that relief to be allowed in your country should be restricted to so much of the income as is taxed in the other

country. An example of such provision can be found in the tax treaty of 12 October 2000 between Norway and the United Kingdom:

"Article 33
Limitation of relief
1. Where under any provision of this Convention income is relieved from Norwegian tax and, under the law in force in the United Kingdom, an individual, in respect of the said income is subject to tax by reference to the amount thereof which is remitted to or received in the United Kingdom and not by reference to the full amount thereof, then the relief to be allowed under this Convention in Norway shall apply only to so much of the income as is taxed in the United Kingdom.

2. Where under Article 13 of this Convention gains are relieved from tax in Norway and, under the law in force in the United Kingdom, an individual is subject to tax in respect of those gains by reference to the amount thereof which is remitted to or received in the United Kingdom and not by reference to the full amount thereof, then the relief to be allowed under this Convention in Norway shall apply only to so much of the gains as are taxed in the United Kingdom."

Treaties entered into many years in the past are also of less value than new treaties. Recent treaties entered into by the other country may also help the team to develop drafting that is likely to be acceptable to that other country.

During this preparation process it is important to have in mind, and never forget, that you have to look at the overall balance of the treaty and not at specific issues.

14. Study culture and habits in the other country

When preparing the draft model or when studying the draft received, it is advisable to have some background knowledge about the country you are going to negotiate with. It may be in relation to their economic situation, their Gross National Product (GNP), important industries or their relations with other countries.

If the negotiation is with a country with which you are not familiar, it is advisable to check whether there are issues you should be aware of and take into consideration. It could be related to food, alcohol, religious beliefs or what is regarded as bad behaviour. The timing of the negotiations is one example. Do not propose negotiations during important religious holidays in the other country. Awareness of the dress code when visiting the other country is another example. This may relate to

the way women dress, but also to men. Never dress too informally unless there is a special reason for doing so.

It may harm an otherwise good atmosphere between the two teams if is considered that there has been bad behaviour or someone feels offended due to the lack of knowledge of local customs. A consultation with your embassy in the other country may prevent such incidents. In general, it is advisable to have enough information not to seem ignorant or uninterested.

15. Conclusions

As you will see from this paper, preparations are essential. It may be the most important part of the whole negotiation process. If you do not come to the discussions fully prepared, what you may achieve is a treaty that is not as beneficial to your country as it might otherwise have been. It is easy to miss possibilities. It is advisable not to rush into negotiations, but take the necessary time to come prepared.

Annex 1 Example on the comparison of draft treaties

Article 15 Dependent Personal Services (B's Article 14 Income from Employment)

Nr	Country A	Country B	B's treaties with country C and D	Comments
1.	Reference to Article 16 (Directors' fees) and Article 19 (Government service)	B has reference to the same Articles, but numbered Articles 15 and 18. In addition, a reference to Article 17 (Pensions and Annuities)	B has a reference to the Article on pensions in treaties with C and D	
2.	a) "period of twelve months" b) "...an employer who is a resident of the State of which the recipient is a resident, ..." b) hiring out of labour c) reference to "fixed base"	"twelve-month period" b) "...an employer who is not a resident of the other State ..." ----------	 B's proposals are contained in treaties with C and D No such provision	
3.	International traffic - "....employment exercised aboard a ship or aircraft may be taxed in that State."	International traffic - "....may be taxed in the Contracting State in which the place of effective management is situated.	Taxation in the State where the shipping company is a resident in both the treaties with C and D	

Annex 2 Example on the comparison of draft treaties

Red: Proposal from State A

Blue: Proposal from State B

Article 13

Capital Gains

1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.
2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.
3. Gains derived by an enterprise of a Contracting State from the alienation of ships or aircraft operated in international traffic, or movable property pertaining to the operation of such ships or aircraft shall be taxable only in that the Contracting State in which the place of effective management of the enterprise is situated.
4. Gains derived by an enterprise of a Contracting State from the alienation of containers (including trailers and related equipment for the transport of containers) used for the transport of goods or merchandise shall be taxable only in that State, except insofar as those containers or trailers and related equipment are used for transport solely between places within the other Contracting State.
5. Gains from the alienation of any property, other than that referred to in the preceding paragraphs, shall be taxable only in the Contracting State of which the alienator is a resident.

Article 14

Income from employment

1. Subject to the provisions of Articles 15, 17 and 18, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.
2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve months period commencing or ending in the fiscal year concerned, and

b) the remuneration is paid by, or on behalf of, an employer who is a resident of the first-mentioned State not a resident of the other State, and

c) the remuneration is not borne by a permanent establishment which the employer has in that other State.

3. Paragraph 2 of this Article shall not apply to remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State and paid by, or on behalf of, an employer who is a resident of the first-mentioned State if:

a) the recipient renders services in the course of that employment to a person other than the employer who is a resident of that other State or has a permanent establishment in that other State, and who directly or indirectly, supervises, directs or controls the manner in which those services are performed; and

b) the employer is not responsible for carrying out the purposes for which the services are performed.

4. Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic by an enterprise of a Contracting State may be taxed in that the Contracting State in which the place of effective management of the enterprise is situated.

5. Where a resident of a Contracting State derives remuneration in respect of an employment exercised aboard an aircraft operated in international traffic, such remuneration…

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

Paper No. 4-N

How to Conduct Tax Treaty Negotiations

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How to Conduct Tax Treaty Negotiations

Odd Hengsle

1. Introduction

The object of a tax treaty negotiation is to achieve a treaty that is beneficial to both countries and meets the interests of each side as far as possible. A treaty that favours only one country will not be beneficial in the long run. If one country feels that it has been overwhelmed and possibly cheated that country may resist applying the treaty, or may not apply it in the way intended, and may create a bad relationship between the competent authorities. The treaty may even be terminated, or that country may ask for renegotiations.

It is important that the negotiations are conducted in a co-operative atmosphere with a willingness from both teams to achieve the best result for both countries. Consequently, it is important that both teams negotiate in good faith.

The treaty needs to work smoothly in practice and should be effective and not create undue difficulties in compliance issues. As a tax treaty will in most cases last for many years, it is important that it is drafted to stand the test of time.

Reaching a good agreement is dependent on many factors, including research, planning and preparations, the conduct of the negotiations and the management of the process. Preparations are very important.[43]

When the two teams meet for the first time, the first issue to decide is which draft model should be used as the working document. It is always an advantage to have one's own draft model accepted as the working document, because any change to that model has to be argued and explained by the other team and, in many cases, less important differences will be accepted without difficulty.

The host team will usually ask for its draft to be the working document. In many cases, the visiting team will accept this request. However, both drafts will be on the table and should be taken into consideration during the discussions. It is advisable to use a projector to display the working draft on a screen. If possible, a merged document which shows the text of both drafts could be screened to facilitate a full discussion. This is then updated to make it easier to see what is actually agreed.

[43] See Paper No. 3-N, Preparing for Tax Treaty Negotiation, by Odd Hengsle.

When the two teams have solved all outstanding issues there are two Articles that have to be drafted, that is to say the "Entry into force" and the "Termination" Articles. These two Articles are important since there should be no doubt as to which income year the treaty should be applied for the first time, or if terminated, which income year would be the last year in which it should be applied. However, these Articles are discussed in the paper on "Post–negotiation Activities".[44]

2. Negotiation style

Negotiation style is very important. The style can vary from soft to aggressive.

A soft negotiator may have as his objective to reach agreement on all articles as soon as possible. He may search for solutions that are acceptable to the other side and try to avoid conflicts. However, a soft negotiator may easily make unnecessary concessions.

An aggressive negotiator will have as his objective to defeat the other side on all issues. He will insist on his proposals and demand concessions. However, such an aggressive style will easily create an unfriendly atmosphere and should be avoided. In the worst case the other team will feel offended or bullied and may react by ending the discussions without further negotiation, or by insisting that the other team use a different leader.

A negotiation style somewhere in between is obviously desirable. A negotiator should be consistent in his approach, but always polite. He should be prepared for the negotiation knowing what is important for his country and proposing and explaining his preferred solutions without being aggressive.

Whatever his or her approach, a negotiator must remember that his or her style should take into account the goal of the negotiations, which is to achieve a mutually beneficial treaty. It is important to have in mind that you have to look at the overall balance of the treaty and not be blinded by specific issues.

3. Trust

To achieve a productive atmosphere during the negotiation process, it is necessary to gain the trust of the other team. Losing credibility may lead to negotiating difficulties if the other team does not trust the validity of arguments put forward and becomes sceptical of everything said.

[44] See Paper No. 5-N, Post-negotiation Activities, by Odd Hengsle.

It is important that what a team explains is correct. If a team is asked to explain its domestic legislation or its position on a certain issue, the answer should be truthful. If the leader is not familiar with the issue, there may be others in the team that can give a satisfactory explanation. If the team cannot respond immediately, or is in doubt, it is advisable to say so and promise to find out and provide an answer. On the other hand, it is not always necessary to give more information than is asked for.

One should always be transparent and never lie. The other team may already know the answer, but may be checking if the answers received are correct. The other team may also check the explanation it has received after returning home. For example, it is easily ascertainable if a team is giving incorrect information in relation to what has been accepted with third countries.

Poor disclosure can be very harmful. It is wise to remember that negotiators are a small group and form a closed circle. If you spoil your reputation with one party, that will soon be known to others and may put you at a disadvantage in relation to later negotiations with other countries. One should always be aware that it is easier to lose than to gain credibility.

4. Building a relationship

If the negotiation is with a country that you are not familiar with, it is advisable to check whether there are issues to be aware of and to take into consideration. They could be related to food, alcohol, religious beliefs or what is considered to be bad behaviour. The timing of the negotiations is one example. Do not propose negotiations during important religious holidays of the other country. Awareness of the dress code when visiting the other country is another example. This may relate to the way women dress, but also to how men should be dressed. Never dress too informally unless there is a special reason for doing so.

At the negotiation table, formality is appropriate even if you already know the members of the other team. However, remember that informal discussions or contacts taking place during a break, at lunches or dinners also play a part in building a good relationship and perhaps make negotiations more fruitful. It is important to remember that all interactions, formal or informal, play a part in the negotiations. The way any member of the team behaves during the meeting or after hours may have an influence on the relationship you are trying to build.

Remember always to meet on time. Nothing can be more irritating than wasting time waiting for the other team to arrive. If you are late for some reason, excuse yourself and give an explanation.

The two team-leaders lead the negotiation. To prevent confusion or offence, no other member of the team should take the floor without being invited to by the leader. It is the leader who decides what to say and by whom it should be said. If any member of the team feels he has a valuable contribution, he should address his leader. In order for a junior member of a team to gain experience in negotiations, it could advisable to let him/her present an issue. However, this should be agreed in advance as part of the preparations.

When speaking, always address and look at the other party's leader unless it is obvious that it is correct to address someone else.

When the leader (or someone else from the other team) is presenting his arguments, listen and show respect for the arguments put forward - even if you disagree. It is bad behaviour to interrupt, shake your head or tell the other team that they are wrong. It is important to be polite in explaining to the other team why you are of a different opinion or prefer a different solution. It is your argument that should convince the other team and not by way of obvious disrespect.

5. Discussion

When time and place for negotiations are agreed, a list with the names and titles of the participants of the two teams should be exchanged, also naming the leader. In addition, when the two teams meet for the first time, both leaders should introduce themselves and their team so that both teams know who is present and what the role of each team member is. For example, the leader might introduce a team member as "Peter Smith from the revenue agency" or "Linda Jones, who is a member of the Treaties team in the Ministry of Finance". This will also be the time to hand over business cards. This makes it easier to identify the members of the team. Most countries provide business cards for their negotiators. And it shows good manners to provide them when the two teams meet for the first time.

The leader of the host country should also ask if the proposed agenda is acceptable.

Who leads the discussion may vary. Usually it will be the leader from the host country, but there are no set rules. Sometimes it will be the leader from the stronger team that would lead. It may also vary from one article to another depending on whose proposal is being discussed.

From time to time the question of naming the treaty a "Convention" or an "Agreement" arises. Most countries will use the word "Convention" throughout the treaty. However, to some countries there is

a difference between an "Agreement" and a "Convention". These countries use "Agreement" in relation to a bilateral treaty and "Convention" in the context of a multilateral treaty. It is wise to check with the Ministry of Foreign Affairs if they have any preference. However, this is a minor issue and should be solved easily. If one country has a preference to use the term "Agreement", the other team should agree where possible and move on.

It is wise to agree on the process of the discussions. If it is the first round of negotiation between the two teams, one can agree to work through all the articles one by one without a deep discussion on each article. In this way issues of less importance to both parties can be settled. However, some countries prefer to deal with linked provisions at the same time (for instance, the taxation of shipping in Article 3 (Definitions), Article 8 (Shipping), Article 13 (Capital gains) and Article 22 (Capital).

By working through all the articles one by one it will be easy to ascertain where the difficult issues are and to identify the most important issues for one or both countries. It is also important to understand the value of the issue under discussion. What is important to one country may not be important to the other. Understanding the value of the issues both to you and to the other side is essential when trying to reach a compromise or doing a trade-off.

When all the articles have been worked through, it is time to concentrate on solving the remaining difficult issues. This may be done during the first round of negotiation but, depending on time, may be postponed to a second round.

Another way to begin negotiations is to initially identify which items are most important to the teams and begin by discussing them. However, this method is probably best used after the teams have had their first round of discussion of the draft as such. Deciding to begin with the two countries' important issues when the teams meet for the first time may prove a disadvantage for the teams. It is not always wise to identify very early in the negotiations what are the most important issues to each of the teams. Even if the other team has no serious objections to a proposal (for instance, because the item is not important for them), they may defer acceptance of the proposal in the hope of achieving something in return at a later stage in the negotiations.

If a provision mostly relates to one of the countries or is a clarification of the wording of an article, it may be better to include the provision in a protocol rather than trying to draft wording to that effect in the treaty itself.[45] This might simplify the reading of the treaty text. However, if a protocol is used,

[45] See Paper No. 2-N, Tax Treaty Policy Framework and Country Model, by Ariane Pickering.

it is important to draw attention to the protocol in an explanatory note to the treaty. Otherwise the provision in the protocol can be easily overlooked.

Negotiators should remember that even if the issues, which are not agreed, are important, it is not necessarily difficult to find solutions. It may be that the two teams identify the same issues as important. In such cases it may be easy to find common solutions if both teams can reach agreement on what solution is preferable or at least acceptable. However, if both teams regard an issue as important, but disagree on the solution, a compromise may be difficult (but not impossible) to find. It may also be that an issue, which is regarded as important to only one of the teams, is not contrary to what can be accepted by the other team provided the arguments advanced are satisfactory.

For an effective discussion to take place one should introduce the item and present one's position clearly. It is not necessary to present all arguments at once. In fact, it may be wise to hold some arguments back, to be used if the other team does not agree and has explained why.

After the arguments for a position have been presented, it is wise to note carefully the reactions from other team. Sometimes it may be difficult to understand the response. In such a case one should always ask for clarification, and continue to ask until the response is clearly understood. One should never move to a new provision without having got the necessary clarification. To accept or reject a proposal without a clear understanding of the proposal put forward by the other team may lead to an unpleasant surprise in the future.

By listening carefully to the arguments put forward by the other team, you will from time to time find that the proposal they are making is actually advantageous and better than your own proposal. If this is the case, accept the proposal and make the necessary amendments to improve your own model.

A team may resist a proposal and the arguments used in its favour. When this team is arguing for a different solution, listen, and be prepared to counter. It is for this reason that is not wise to present all the arguments at the first presentation, but use them as the discussion continues. If it seems difficult to get acceptance for the proposal that is being discussed, it is time to look for alternatives, which may have been prepared before the negotiations, or may be developed during the negotiation. Alternatives may also be found in the Commentaries to the United Nations Model Double Taxation Convention between Developed and Developing Countries ("United Nations Model Convention") and the Organisation for Economic Co-operation and Development's Model Tax Convention on

Income and on Capital ("OECD Model Convention") or on the OECD official's website, where commonly used alternative provisions may be found. Such alternatives may be easier to be accepted since they indicate internationally accepted solutions. Alternatives may also be found in one of the countries' treaties with other countries. Careful preparation before the meeting may enable the teams to settle their differences more quickly and effectively.

One way to try to solve a difficult issue is to propose a *"most favoured nation clause"* (MFN). The purpose of such a clause is to ensure that if a team accepts a less satisfactory proposal put forward by the team from the other country, and that country at a later stage agrees to a more favourable provision with a third country, the latter provision should also be applied in relation to them. MFN-clauses can for instance be found in relation to withholding taxes on interest and royalties. In relation to royalties, such provision may be drafted, for example, as follows:

> *"2. However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the royalties is a resident of the other Contracting State, the tax so charged shall not exceed X per cent of the gross amount of the royalties. For the purpose of this paragraph, if a lower rate of State A tax is agreed upon with any other State than State B after the entry into force of this Convention such rate shall automatically be applied".*

A MFN-clause may also be included in a protocol to the treaty and may be further restricted to treaties entered into with a group of countries, such as an OECD member country or a country within a region. Such a provision might read:

> *"Protocol.*
>
> *If after the date of signature of the Convention State A concludes a double taxation Convention with a State that is a member country of the Organization for Economic Co-operation and Development which limits the taxation in State A of dividends as referred to in Article 10, interest as referred to in Article 11 or royalties as referred to in Article 12, the lower rate shall automatically apply for the purposes of this Convention from the date of entry into force of the first-mentioned Convention".*

If a negotiation is preferred to an automatic entry into force, a third alternative might be to introduce the following provision into a protocol:

For the purpose of Articles 11 and 12 if a lower rate of State A tax is agreed upon with any other State than State B after the entry into force of this Convention, State A shall without undue delay inform the Government of State B in writing through diplomatic channels and shall enter into negotiations with the Government of State B with a view to include a similar provision in the present Convention".

A different way to deal with difficult issues is to propose a *"sunset clause"*. Such a provision can for instance be found in relation to tax sparing provisions in the article on the elimination of double taxation. A sunset clause will then usually be inserted as a last sentence in the tax sparing provision and may for instance be drafted as follows:

"……..This provision shall apply for the first ten years for which the Convention is effective, but the competent authorities may consult each other to determine whether this period shall be extended".

A third proposal to deal with difficult issues may be a *"grandfathering clause*". Such a clause can be a solution when renegotiation of a treaty takes place. If the existing treaty gives a more favorable treatment for a person than the one proposed in the new draft treaty, a solution might be to let the old provision apply to persons already benefiting from the existing provision. Such a clause can be applied without limitation, or limited to a certain period of time. Grandfathering clauses can be inserted in a protocol to the treaty or in the termination article. A drafting example is to insert a paragraph in the termination article reading as follows:

"2. Notwithstanding the termination of this Convention in accordance with paragraph 1 of this Article, this Convention shall in any event continue to apply to persons receiving income as mentioned in Article X. However, this provision shall only apply to persons receiving such income at the time this Convention becomes effective".

A fourth proposal to deal with difficult issues may be to agree that a provision or an article shall become effective, not at the same time as the rest of the treaty, but at a later date to be agreed between the competent authorities.

One country may be prepared to accept a proposal from the other country, but at the time of negotiations does not have the legislative instruments in place to give effect to the provisions. An example could be where the government is considering the introduction into its treaties of an article on the assistance in the collection of taxes as that proposed in Article 27 of the United Nations and

OECD Model Conventions. However, since the necessary legislation has not been passed by the parliament at the time of negotiations, an article on the assistance in collection of taxes could not become effective until the necessary legislation has been approved. If the legislation is expected to be in place within a reasonable period of time a solution might be to accept the article but defer its entry into force. This avoids the time consuming work of introducing the article in the treaty through an amending protocol to the treaty at a later stage. To achieve a deferral, one solution is to add a paragraph or sub-paragraph in the article on the entry into force reading:

"Article 29

Entry into force

1. The Contracting States shall notify each other in writing, through diplomatic channels, that the legal requirements for the entry into force have been complied with.

2. This Convention shall enter into force upon the later of these notifications and shall thereupon have effect:

a. In State A in respect of taxes on income for any year of income beginning on or after …… (date and month) next following that in which this Convention enters into force;
b. In State B in respect of taxes on income relating to any calendar year next following that in which the Convention enters into force;
c. *For the purposes of Article 27 (Assistance in the collection of taxes), from a date to be agreed in an exchange of notes through the diplomatic channels"*.

Even if a team does not accept a proposal at once, it does not mean that it will not be accepted at a later stage during the negotiations. The team may have understood that the solution argued for is of great importance to the other team and is holding back to see what it may receive in return. If a team during the discussions indicates in its response that it may be willing to accept a proposal if certain conditions are met, try to establish what conditions the other team have in mind. If the conditions are not quite clear, try to clarify them.

During the discussions, compromises will often be suggested. Unless the compromises represent well-known positions and drafting, it is advisable to be very careful. Compromises drafted across the table are not always of the best quality. They may lead to unexpected results and can in worst cases scenarios be harmful to one or both countries. Unless one is very experienced, it can be difficult to foresee all implications of an unfamiliar wording. Even if the proposed wording seems to solve a

problem, the best way to handle such compromises is to put them in brackets for further consideration. If the issue is not too important and the wording not too difficult it may be enough to have studied the wording during a break or in the evening after that day's session has ended. Depending on the importance of the issue, it may also be prudent to take it home for consultation with qualified persons.

During the discussions a team may realise that the other team has misunderstood the effect of a proposal that is made. Due to that misunderstanding, the other team may have accepted a proposal they otherwise would not have agreed to.

For example, a country is of the opinion that its domestic legislation regarding the taxation of money transmitted from a branch of a foreign company to its headquarters in the other country (branch profit tax) is not in conflict with its obligations under the non-discrimination article. The other country may be of a different opinion. In such cases it will be wise to deal with the problem either in the relevant article or in a protocol. One way to solve the problem mentioned in the example above is to clarify the common understanding in the non-discrimination article itself:

> *"3. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. However, branch profits tax levied on income repatriated by a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be regarded as being contrary to the provisions of this paragraph. This provision shall not be construed……."*.

It may also be that a team realises that the other team has an understanding of the interpretation of an article that differs from its own understanding. An example of such different interpretation may be the interpretation of Article 14 (Independent personal services) of the United Nations Model Convention. This article was deleted from the OECD Model Convention on 29 April 2000 on the basis of an OECD report entitled "Issues related to Article 14 of the OECD Model Convention". The reason was that the report stated as a fact that there were no intended differences between the concept of "permanent establishment" in Article 7 (Business profits) and the concept of "fixed base" in Article 14 (Independent personal services) of the OECD Model Convention. The report also

concluded that there were no differences in how the profits were computed and the tax calculated.[46] However, there are countries, which disagree with the report and maintain that an interpretation allows for including both individuals and companies and allows for a gross taxation.

It may also be that, during the discussions, a team realises that the other team has a different understanding of its own proposal than what is the general international understanding or that their proposal will not give the intended result.

If one team believes that the other team has misunderstood the meaning or effect of a proposal or that different interpretation of an article exists, the issue should be raised. If the issue is important to the other team and that other team realises later in the negotiation that they have misunderstood a proposal to which they have agreed, they may feel misled and want to reopen the issue. They may even lose faith in the integrity of the other team and therefore be reluctant to agree on new issues. If the misunderstanding is not realised during the negotiations, but before signature, a delicate situation may arise when the country refuses to sign the treaty or insists on renegotiation.

If a team at any time during the negotiation wishes to clarify issues or discuss arguments within the team, they should do so and ask for a time-out. It is better to take a time-out than make a wrong decision. All countries, developed as well as developing, have been in situations where a time-out has been necessary. Such internal discussion within a team does not require that a separate meeting room is available. In most cases it will be sufficient that the other team leave the meeting room during the internal discussion. However, even if the two teams speak different languages, it is not advisable to believe that someone in the other team does not understand your language. Be careful with internal discussions with the other team present.

If an issue is agreed, accept it and move forward. It is not advisable to restate the issue by informing the other team how important the solution was, or to begin repeating the arguments. Restating the issue may result in the other team changing its mind or asking for further reflection before deciding.

To avoid unnecessary misunderstanding it is important that both teams send correct signals on their attitude to the proposals put forward. One should avoid a situation when a team at the end of a discussion has got the understanding that an agreement has been reached, but the other team at a later stage claims that it never had meant to agree, but had just signalled a positive attitude to agree provided that all other issues in the treaty had been resolved acceptably.

[46] See Commentaries on Article 14 (Independent personal services) of the OECD Model Convention (2010).

One should always take notes during the meeting. Notes are extremely important if a second round of negotiations is needed. Some time usually elapses between the first and the second round of negotiations. Members of the team during the first round of negotiations may have left or moved to other positions. The team preparing for the second round will therefore often be dependent on what they can read from the notes. The notes are also useful when drafting compromises, discussing positions with qualified persons or producing proposals for approval.

The notes are also important when preparing the treaty for signature or explaining the solutions agreed upon to your minister or at a hearing in the parliament. They can also be of great interest when the competent authority at a later stage may need to interpret issues arising from the treaty.

6. Arguments

During the discussion the teams should be prepared to present relevant arguments to explain the proposal put forward in the different articles of the draft it has presented. This is true of all articles, but essential where the wording of an article deviates from what is common wording in international models such as the United Nations Model Convention, the OECD Model Convention or any commonly used regional models. This is why preparations are so important. Without having done the "homework" before the negotiations take place, a team may not be able to convince the other team why special wording is an improvement on recognised international models. Special wording may be considered necessary to take care of certain economic activities, such as mining or the extraction of natural resources. It may also be related to activities in the financial sector like banks or drafted to remove uncertainty in relation to the use of new financial instruments.

Different wording from the international models can often be found in the Commentaries to those models. In such a case the Commentaries will usually explain the wording and relevant arguments can be found there. However, the team should be able to explain where the wording can be found and why that wording is the preferred approach. With respect to the OECD Model Convention such wording can for instance be found in relation to the taxation of services, pensions or the taxation of dependent personal services.

There are different kinds of arguments commonly used such as policy, protection of revenue, precedent, anti-abuse, not effective or firm policy.

The policy argument plays on reason and sound policy. It is often based on *economic arguments* and closely linked to *a revenue argument*. In many cases it will be difficult to tell which it is.

An example is the situation where a foreign company, for bona fide reasons, establishes a branch in your country through which it performs all its economic activities in your country. Any profit made will be taxed according to Article 7 (Business profits). However, any transfer of money (after tax) to the headquarters will be transferred without further taxation in your country. If the foreign company instead had established a daughter company (subsidiary company) in your country, any transfer of money after tax would have been in the form of dividends and taxed in accordance with the provisions of Article 10 (Dividends). To avoid such different treatment a country may wish to tax the transfer of money from the branch in the same way as taxing a dividend distribution (Branch profits tax). The argument for the introduction of a branch profits tax will be based on both the economic and the revenue arguments.

Another example is the taxation of royalties. For the same reason as for interest payments, a country that imports a lot of know-how from abroad may use similar explanations to argue for a withholding tax, or to widen the definition of royalties to include for instance fees for technical services.

A third example may be that a certain economic activity in a country is of such economic importance to that country that special provisions have to be introduced in the treaty to prevent revenue losses. To achieve this, a country may want to introduce provisions enabling that country to tax any activity performed there by a foreign enterprise no matter the length of their stay. Such provisions will often be linked to mining or the extraction of natural resources.

A further example is when a country has a lot of building or renovation activities taking place and is dependent on services performed by foreign enterprises. To avoid having loss of revenue, such services rendered by foreign enterprises may necessitate the introduction of a provision on the rendering of services. Examples of such provisions can be found in the United Nations Model Convention, as well as in the Commentaries to both the United Nations and OECD Model Conventions.

The policy argument can also be based on *mutual benefit* reasoning, for instance to introduce provisions to prevent abuse or tax avoidance or evasion. It may be also be an argument for having an article on assistance in collection of taxes.

A different reason often used in support of a proposal is the *precedent argument*.

Alone or in addition to other arguments a team may show that other countries have accepted the wording of an article. For a developing country negotiating with a developed country, such an

argument will be of greater value if they can show that other developed countries have accepted the wording.

It may also be the other way around. The team of one country may be asking for wording the other country has accepted in treaties with third countries. They may point to those treaties and ask the other team why such wording is no longer acceptable.

A further argument in this regard arises when the other country has accepted a certain provision with a country to which you prefer to be compared, business in your country will be disadvantaged unless you get the same benefits. This will often be the case when discussing the rates in the dividend, interest and royalties articles.

It will always give your argument increased value if you can show that your provision is found in the United Nations or OECD Model Conventions or proposed as an alternative in the commentaries to the respective models.

In several cases a provision may be asked for to *prevent abuse*.

When negotiating a tax treaty it is important to have in mind that the purpose of a treaty is to avoid double taxation and to stimulate cross border activities. The purpose is never to create a situation of double non-taxation. It is also important for a country to be aware of provisions in a treaty that business can misuse to avoid taxation in the country of source or even in the country of residence.

In the Commentary on Article 1 of the United Nations Model Convention there is a discussion on the use of general anti-abuse rules found in domestic legislation.[47] A similar discussion is found in the Commentary on Article 1 of the OECD Model Convention. It is generally accepted that such anti-abuse rules found in domestic legislation are not contrary to tax treaty provisions and could be used to combat improper use of tax treaties.[48]

However, despite the good arguments in the United Nations and OECD Model Conventions for using domestic legislation to combat the improper use of tax treaties, it may in certain cases be

[47] See Improper use of tax treaties, tax avoidance and tax evasion, by Phillip Baker, in United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries, New York, 2013.
[48] See paragraphs 21-23 of the Commentaries on Article 1 of the United Nations Model Convention (2011).

advisable to introduce specific anti-abuse provision in these treaties. Both the United Nations and the OECD Model Conventions discuss the use of specific anti-abuse rules found in tax treaties.

When prevention of abuse is used as an argument, it is important to use examples to illustrate why a certain wording is necessary.

An example could be the introduction of thin capitalisation rules in domestic legislation. Depending on the wording of such legislation, the rules could be argued to be contrary to the non-discrimination article in the tax treaty. To avoid a discussion of legislation to combat the use of excessive debt capital instead of equity capital to finance the establishment of a daughter company in your country, it might be useful to propose a sentence either in the non-discrimination article or in a protocol to the treaty that such provision is not in breach of the provisions of non-discrimination article.

If your domestic legislation contains other provisions that could be argued to be contrary to the article on non-discrimination, it could be wise, after you have carefully explained the domestic law provision, to propose a provision in a protocol to the treaty reading as follows:

> *" Ad Article…*
>
> *Nothing in the domestic legislation in State A at the time of the entering into force of this Convention shall be regarded as being contrary to the article on non-discrimination".*

Another example may be that a country may want to include a paragraph in the article on dependent personal services to deal with international hiring out of labour. Such a provision could be introduced to prevent the situation whereby a local company, in order to avoid taxation of its employees, hires them through a foreign company. Such wording and an explanation can be found in the Commentaries to that article both in the United Nations and OECD Model Conventions.

A third example could be a provision added as a new paragraph in the articles on dividends, interest and royalties, stating that the provisions of those articles should not apply if a dividend, interest or a royalty payment was created mainly for the purpose of taking advantage of the respective articles and not created for bona fide reasons. An example of such a paragraph in Article 11 might be:

> *"The provisions of this Article shall not apply if the debt-claim in respect of which the interest is paid was created or assigned mainly for the purpose of taking advantage of this Article and not for bona fide commercial reasons".*

Similar provisions could be inserted in the articles on dividends and royalties.

Another possibility could be to add an article on the limitation of benefits. An example of such drafting might be:

> *"Article ……..*
>
> ***Limitation of benefits***
>
> *Benefits of this Convention shall not be available to a resident of a Contracting State, or with respect to any transaction undertaken by such a resident, if the main purpose or one of the main purposes of the creation or existence of such a resident or of the transaction undertaken by him, was to obtain the benefits under this Convention that would not otherwise be available".*

Some countries have introduced comprehensive Limitation of Benefits rules (LOB) in their models. The United State of America (USA) is an example of a country that has introduced such an Article in all their recent treaties. Such rules are in many cases complex and difficult to understand. It is not advisable to introduce such rules in your own model unless you are very experienced. When negotiating with countries that have such rules in their models, ask them to clarify the provision and take the time necessary to understand the implications.

An argument one frequently meets is that a proposal is based on *firm policy***.** However, the question is how firm is firm?

A country may have found that a certain provision is not effective in relation to what they have tried to achieve. However, an argument based on this kind of experience should be illustrated by examples.

Some countries have non-negotiable provisions in their model. That can be due to certain business activities or industries such as mining or extraction of natural resources. It may also be related to incentive legislation or other areas of great importance, or it may be for policy reasons such as exchange of information. If experience has shown that some non-negotiable provisions have been a hindrance to achieve an agreement, it would be advisable to consult with a senior policy maker, the Minister or even the Parliament to see whether compromises may be acceptable.

It is, however, important to distinguish between provisions that are really non-negotiable and provisions which are only strongly preferred. Provisions that are only strongly preferred should not be presented as non-negotiable.

When an argument of firm policy is used, it does not mean that the provision in question is not negotiable. The argument should be understood to mean that a provision or a wording is regarded as of great importance, but which, under certain circumstances, may be open for discussion. However, it will not easily be given up and you may in return be prepared to accept something that is of importance to the other team. It may be a provision to be put in brackets and dealt with in the final bargaining process. However, it is never advisable to use the argument of firm policy too often. Doing so will weaken the argument or make the whole negotiation more difficult. It may even encourage the other team to use the same argument in cases where they otherwise would not. It may in many cases be better to tell the other team that an issue is important, rather than based on firm policy.

When using the argument of firm policy, it is advisable to remember that by looking at other treaties that the country has entered into, it can easily be ascertained how firm that policy really is. If other treaties show that a firm policy argument is not sustained, that country would need to give a good explanation as to why the policy does not seem as firm as has been claimed. One possible explanation may be that a change of domestic legislation has taken place or that experience from earlier treaties has made a change of policy necessary.

There are at least two arguments that are of little or no value unless they are substantiated. One is "We need this wording because we are a developing country". Another argument is "We need this wording because we have such a provision in our domestic legislation". It may be true that a country is a developing country and because of that needs a special provision. It may also be true that a special provision in domestic legislation necessitates a special provision in a treaty. But in both cases it is important to explain clearly why a special provision is needed.

7. Use of protocols, exchange of notes and memorandum of understanding

A "protocol" to a treaty may be negotiated at the same time as the tax treaty itself to set out important interpretations or introduce administrative provisions. It may also deal with issues mostly related to only one of the countries. A protocol to a treaty may also be negotiated at a later date to provide changes to an existing treaty. To have a protocol in force, you have to follow the same legal procedures as for having the treaty itself in force.[49] The Protocol will be a legally binding document.

[49] See Paper No. 5-N, Post-negotiation Activities, by Odd Hengsle.

An "exchange of notes" is a record of an agreement to clarify a common understanding of an issue where agreement has been reached between governments during the negotiations of a treaty. The agreement consists of the exchange of two documents, each of the parties being in possession of the one signed by the other party. Under the usual procedure, the accepting State repeats the text of the offering State to record its assent. The signatories of the letters may be government Ministers, diplomats or departmental heads. The letters will usually be signed and exchanged at the same date as the treaty. This is a very formal document and the interpretation will usually be followed even if the document is not legally binding.

A Memorandum of Understanding (MoU) is a document of less formal kind. It is often used for detailed or technical matters which may not easily be set out in the treaty or a protocol. It may also clarify an understanding of a provision or an issue. Such MoU is usually drafted at the end of the negotiations and signed by the negotiators at the same date as the agreed draft is initialled. It may also be made at a later date, but in such cases it would probably be more correct to follow the procedures laid down in Article 25 (3) (Mutual agreement procedure) of the United Nations and OECD Model Conventions. The document is not legally binding, but should be taken into consideration when interpreting the treaty.[50]

8. Records of discussions

During the discussions it is advisable to have the working draft electronically projected on a screen that is visible to both teams. One team member needs to be made responsible for maintaining the agreed text. In this way everybody can check that the changes made are correct. When going through the working draft, article by article, all wording that is not agreed should be put in brackets. One way of doing this is to use colours. The preferred wording for both teams should be put in brackets using different colours. This would make it easier to identify where agreement is not achieved and what the position is for each of the teams. By using brackets it will also be clear to both teams what is agreed and what is not. What is not put in brackets should be regarded as agreed and closed. If there is no screen it is important to read the text before moving on to the next issue. One example of using brackets and colours might be:

> (3. Gains derived by an enterprise of a Contracting State from the alienation of ships or aircraft operated in international traffic or movable property pertaining to the operation of

[50] See Paper No. 5-N, Post-negotiation Activities, by Odd Hengsle.

such ships or aircraft shall be taxable only in that the Contracting State in which the place of effective management of the enterprise is situated.)

Alternatively:

(3. Gains derived by an enterprise of a Contracting State from the alienation of ships or aircraft operated in international traffic or movable property pertaining to the operation of such ships or aircraft shall be taxable only in that the Contracting State in which the place of effective management of the enterprise is situated.), or

(1. Profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State.

(2. Notwithstanding the provisions of paragraph 1, profits of an enterprise of a Contracting State derived from the operation of ships or aircraft may be taxed in the other Contracting State to the extent that they are profits derived directly or indirectly from ship or aircraft operations confined solely to places in that other State.)

The black letters will be the same for both countries while one colour will be the proposal for country A and the other colour will be the proposal for country B.

If no colours are used letters should be used to mark the different proposals:

(3. Gains (AP derived by an enterprise of a Contracting State) from the alienation of ships or aircraft operated in international traffic or movable property pertaining to the operation of such ships or aircraft shall be taxable only in (AP that) (BP the Contracting) State (BP in which the place of effective management of the enterprise is situated.).

However, the last example should clearly indicate that the use of colours simplifies the understanding of the differences.

If colours are not used, it will in many cases be a better solution to present the two proposals this way:

(AP: 3. Gains derived by an enterprise of a Contracting State from the alienation of ships or aircraft operated in international traffic or movable property pertaining to the operation of such ships or aircraft shall be taxable only in that State.)

(BP: 3. Gains from the alienation of ships or aircraft operated in international traffic or movable property pertaining to the operation of such ships or aircraft shall be taxable only

in the Contracting State in which the place of effective management of the enterprise is situated.)

At the end of the meeting it is important to ensure that there is agreement on which issues have been resolved, and which are postponed for a second or subsequent round of negotiations. Both teams should have a printed version of the working draft as it stands at the end of discussion and one should always leave enough time to read it and check for mistakes. When the draft is based on a merged text that has been on a screen, there will be fewer possibilities for serious mistakes. Misprints can always be corrected in later correspondence between the two teams.

If it is not possible to have the working draft projected on a screen, accurate paper drafts need to be kept. This requires very careful organisation. All paper drafts should be dated so that it is clear which text is the latest.

When the two teams have agreed that the working draft is in accordance with what has been agreed, the two leaders should initial each page of the draft. Even if there are still brackets and a second round is necessary, initialling the working draft is advisable. Since several drafts may have been on the table, an initialled draft proves what has been agreed and which draft is the correct one.

When initialling a draft, begin by initialling on the left side of the page. Your initials should be found just below the last line on each page, which is not necessarily on the bottom of the page. The theory behind this is to avoid that anything should be added or removed in the text without being discovered. When all pages are initialled, exchange draft and initial on the right side. When both leaders have initialled the two drafts there will be one initialled draft for each country. The copy to bring home is the one where your initials are found first (initials on the left side of the page). However, if the initialling is done differently, it is of no importance as long as the two leaders have a draft that shows what has been agreed. The initialling of the draft has no binding effect on the countries. It shows what the two leaders have agreed and are prepared to take home to be presented for approval by the relevant authority.

Before ending the meeting it is advisable to produce an Agreed Minute. In this document all major outstanding issues should be noted. In Annexes 1 and 2 there are examples on the drafting of such Minutes.

If the understanding of a provision has been discussed and agreed on during the meeting or one of the teams has stated how it will interpret a provision, this understanding or interpretation should be noted.

If there is to be a second round of negotiation, the open issues should be in brackets, indicating either in colours or otherwise, the positions of the two countries. It is also wise to agree on a (tentative) date for future negotiations and note this date in the minute. That date should not be too far into the future. If it takes too long between the first and second round of negotiations the members of the teams from the first round of negotiations may not be present for the second round. The result could be that issues agreed during the first round will be reopened by a new leader, which may harm the process of finalizing the treaty and create irritation and confusion.

Even if the second round of negotiations is supposed to continue with discussions on the outstanding issues as reflected in the Agreed Minute, there may be valid reasons why a team has to reopen issues agreed upon during the first round of negotiations. One reason could be a change in domestic tax legislation followed by a change of policy. An example could be that a country has introduced a withholding tax on pension payments made to non-residents and accordingly wants to change from an agreed resident taxation to source taxation. Another example could be that the parliament has clearly stated that a certain provision no longer will be accepted.

When a country for any reason reopens an agreed provision, the other country should not reject to discuss the issue once more. The other country would then, however, be free to reopen other issues, especially if the agreed issue was based on a compromise made during earlier discussions. To reopen former agreed issues should, however, as far as possible, be avoided and the country that asks for such discussion should be ready to apologize and explain the reasons for doing so.

9. Conclusions

It is during the discussions you will realise how important preparations are. Be aware of your country's policy and your own model. It is essential to meet prepared and be ready to explain your proposals and the reasoning behind. Behave respectfully and listen carefully to arguments put forward. Be careful to take notes during the discussions. To achieve a treaty that is beneficial to your country, it is important to be patient and be prepared to propose alternatives and compromises to solve what may seem as a deadlock. If necessary, be prepared for a second round of negotiations.

Annex 1

AGREED MINUTE

A first round of negotiations of a Convention between State A and State B for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income was held in ….. from …. through…..Date and Year. The delegation from State A was headed by Mr ……., Director in the Ministry of Finance. The delegation from State B was headed by Mr……. Director in the Ministry of Finance. A list of both delegations is attached as Annex I.

The negotiations were conducted in a friendly atmosphere of mutual understanding and cordiality. While most Articles of the Convention were discussed in depth and agreed, some provisions were left pending and these are indicated in brackets and marked in colour. Yellow for State A and green for State B. The pending issues include Article 5, paragraph 3, Article 8, Article 11, Article 12, Article 13, Article 19, Article 21 and Article 26. These pending issues are set out in the joint draft text attached as Annex II which will be used in the future negotiations to be held in …….., at a date to be agreed.

Done in State A on Date and Year.

For the delegation from State A:

Mr ……..

(Head of delegation)

For the delegation from State B:

Mr ……..

(Head of delegation)

Annex 2

AGREED MINUTE

A second round of negotiations for the conclusion of a Convention between State A and State B for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income was held in ……. from … through … Month and Year. The delegation from State A was headed by Mr…… Director, Ministry of Finance, while the delegation from State B was headed by Mr. …….., Director, Ministry of Finance. A list of both delegations is attached herewith as Annex I.

The negotiations were conducted in a friendly atmosphere of mutual understanding and cordiality. The provisions of the Convention that were left open after the first round of discussions in ….., as well as a number of other provisions previously accepted, were discussed in depth. The discussions led to an agreement at official's level on all issues and an agreed text was initialled on .. Month and Year. The agreed text is attached herewith as Annex 2.

Done in …. on … Month and Year

For the delegation from State A:	For the delegation from State B:
Mr …….	Mr ……..
(Head of delegation)	(Head of delegation)

DRAFT UNEDITED DOCUMENT

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

Paper No. 5-N

Post-negotiation Activities

Odd Hengsle

Former Director General, Tax Treaties and International Tax Affairs, Norway

Contents

Post-negotiation Activities

Odd Hengsle

1. Introduction

This paper deals with several issues that have to be dealt with after agreement is reached on all major issues. The first issue regards the drafting of the two Articles on "Entry into force" and "Termination" where several problems may be met. The paper then continues with a discussion of how to proceed with the preparation for signature, including translation (if necessary), getting the authority to sign and the actual signing. Also issues related to post signing activities necessary to bring the treaty into force and obligations after the treaty has entered into force are discussed. However, questions related to the fulfilment of obligations laid down in the Articles on "Exchange of Information" and "Assistance in the Collection of Taxes" are not discussed in this paper.

2. Entry into force and termination

When the two teams have resolved all outstanding issues, two remaining Articles must be drafted: the "Entry into force" and the "Termination" Articles. These two Articles are important since there should be no doubt as to when the treaty could be applied for the first time, or if it is terminated, which income year would be the last year for which it should be applied.

When drafting the "Entry into Force" article it is wise to consult the Ministry of Foreign Affairs to make sure that the domestic law for the entering into force and ratification of a treaty has been complied with.

Some States have a requirement that instruments of ratification must be exchanged before a treaty can enter into force. However, most States will only ask for a notification that the legal requirements for the entry into force are complied with. To avoid any misunderstanding or confusion it should be stated in the treaty provision that the notification should be in writing and sent through the diplomatic channel. An exchange of e-mails between competent authorities will not provide for the necessary clarity or possible legal certainty. One example of such drafting is:

> *"1.The Contracting States shall notify each other in writing, through diplomatic channels, that the legal requirements for the entry into force of the Convention have been complied with.*

2. The Convention shall enter into force on the date of the later of these notifications and shall thereupon have effect in both Contracting States in respect of taxes on income relating to any calendar year next following that in which the Convention enters into force."

The two States may also agree that the treaty shall enter into force when a certain period of time has elapsed after the exchange of instruments of ratification, or after the later confirmation that each State has completed the procedures required for the entry into force. One way to deal with this kind of requirement is to draft paragraph 1 as follows:

"1.The Contracting States shall notify each other in writing, through diplomatic channels, that the legal requirements for the entry into force of the Convention have been complied with.

2. The Convention shall enter into force on the thirtieth day after the day of the later of these notifications and shall thereupon have effect in both Contracting States in respect of taxes on income relating to any calendar year next following that in which the Convention enters into force."

If the initialled draft also contains an article on capital taxes, these taxes should also be covered by the entry into force provision. Some States may regard their capital gains taxes as being different to ordinary taxes on income. For those States, it is necessary to make a reference to such taxes as well. Normally, however, a capital gains tax is considered to be a tax on income.

It may also happen that the two States have different income years. If that is the case, the Article on "Entry into force" has to be drafted accordingly. One example of such drafting might be:

"1.The Contracting States shall notify each other in writing, through diplomatic channels, that the legal requirements for the entry into force of the Convention have been complied with.

2. This Convention shall enter into force upon the date of the later of these notifications and shall thereupon have effect:

a. In State A in respect of taxes on income for any year of income beginning on or after …… (date and month) next following that in which this Convention enters into force;

b. In State B in respect of taxes on income relating to any calendar year next following that in which the Convention enters into force."

If the two States have an existing Convention in force, the existing Convention should be terminated at the same time as the new Convention enters into force. One example of drafting is to add a third paragraph in the Article on "Entry into force":

> *"3. The Convention between State A and State B for the ……(name of Convention) signed at …… on …….. shall be terminated and shall cease to have effect in respect of the taxes to which this Convention applies in accordance with the provisions of paragraph 2 of this Article."*
>
> Or (and adding the solution in case of a later Protocol to the existing treaty):
>
> *"3. The Convention between State A and State B for the…… (name of Convention) signed at …… on ……., with Protocol, signed at…… on……., shall be terminated with effect from the date of entry into force of this Convention and shall cease to have effect for any period thereafter for which the provisions of this Convention shall apply."*

When the "Entry into force" article has been finalised, the "Termination" Article has to be drafted. To avoid any uncertainty it is wise to consult the Ministry of Foreign Affairs. It is important that there is no doubt as to the last period for which the Convention should be applied.

The purpose of a tax treaty is to improve the economic relations between the two countries concerned. The negotiations have been given priority, time has passed and compromises made to reach an agreed wording of the treaty. If a treaty should be terminated before it has been tested, time and efforts would have been wasted. To leave enough time to see if the treaty fulfils its purpose, some States are of the opinion that the Convention should remain in force for at least a certain period of time. If this is agreed, wording to that effect should be inserted into the Article on "Termination" and might read:

> *"This Convention shall remain in force until terminated by a Contracting State. Either of the Contracting State may after the expiration of a period of five years from the date of its entry into force, terminate this Convention, by giving written notice of termination to the other Contracting State through the diplomatic channels at least six months before the end of any calendar year. In such event, this Convention shall cease to have effect:*
>
> 1. *a) ……;*
> 2. *b……..*

The termination notice should be in writing and sent through diplomatic channels.

It is important to have in mind that the two articles on the entering into force and the termination operate with a difference between the date the treaty enters into force or is terminated and the date from which the treaty shall be applied or eventually no longer be applied.

Depending on the wording, a treaty enters into force on the date of the exchange of the instruments of ratification or the date of the later of the notifications that all legal requirements have been complied with. However, the treaty becomes effective and shall only be applied from 1 January in the year next following the year the treaty enters into force. Since the treaty should be of great benefit to both countries it is important that the instruments of ratification or notification of legal requirements are made as soon as possible. A delay may eventually result in an unnecessary delay of the date from which the treaty shall be applied.

As for the termination of a treaty, it is important to remember that a treaty usually shall be terminated (in writing) at least six months before the end of a calendar year. A notice of termination delivered before the end of June in a year will have the effect that the treaty will cease to have effect and should not be applied on or after 1 January in the year next following. However, a notice of termination delivered in July in a year will have the effect that the treaty will not cease to have effect from 1 January in the year next following, but from 1 January a year later, a delay of one year.

If a country has a different income year than the calendar year, the date a new treaty becomes effective or an existing treaty no longer shall be applied will change accordingly.

Special problems related to Article 24 (Non-discrimination), Article 26 (Exchange of information) and Article 27 (Assistance in the collection of taxes) of the United Nations and OECD Model Conventions

In Article 24 (Non-discrimination) of the United Nations Model Double Taxation Convention between Developed and Developing Countries (“United Nations Model Convention”) and the Organisation for Economic Co-operation and Development’s Model Tax Convention on Income and on Capital (“OECD Model Convention”), it is stated that the provisions of that Article shall also apply to persons that are not resident of one or both of the contracting States and that the provisions of that article shall apply to taxes of every kind and description. The same applies to Article 26 (Exchange of information)

and Article 27 (Assistance in the collection of taxes). Since the application of these Articles is not restricted to persons (Article 1) and taxes (Article 2) covered by the Convention, it is important to have a clear understanding of the entry into force and the termination of the obligations laid down in these articles.

If the Article on "Entry into force" only refers to income taxes covered by the Convention, or refer to income taxes in general without referring to the other taxes referred to in Articles 24, 26 and 27, uncertainty may arise as to the entry into force or the termination of taxes of all kind and description covered by the three Articles referred to above. It is hard to find examples where this issue has been solved in existing conventions. On the other hand, there are only few examples where this "uncertainty" has created problems.

One way to deal with this issue is to add a paragraph in the Articles on the entry into force and the termination stating that taxes covered by Articles 24, 26 and 27 shall enter into force or be terminated on the same date as taxes covered by Article 2 (Taxes covered). If such addition is problematic or seems unnecessary, the entry into force or termination of these Articles could be clarified in an Agreed Minute or a Memorandum of Understanding.[51] Such clarification can be made in connection with the signing of the convention or in writing at a later date if or when the problem is raised. Even if such statements are not binding on the courts, it is stated in Article 31 (General rule of interpretation) in the Vienna Convention on the Law of Treaties[52] that such statements should be taken into consideration when interpreting the treaty even if the statements are made at a later date.

Even if the date of the entering into force of the articles on exchange of information and assistance in collection is clarified, the question arises if exchange of information or assistance in collection of taxes may be asked in relation to income years prior to the year the treaty enters into force and is applicable. Some countries are of the opinion that allowing an exchange of information or assistance in collection of taxes for income years prior to the entry into force of the treaty would give the treaty retroactive effect and should be denied. However, the general opinion is that, unless otherwise stated, such information should be exchanged and assistance given also in relation to income years prior to the entry into force of the treaty and should not be regarded as giving the treaty a retroactive effect. It is advisable to have this issue clarified during the negotiations.

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51 See Paper No. 4-N, How to Conduct Tax Treaty Negotiations, by Odd Hengsle.

52 Vienna Convention on the Law of Treaties, signed in Vienna on 23 May 1967 and entered into force on 27 January 1980.

As for termination, when the treaty is terminated and no longer has effect, you may no longer ask for information or assistance in collection even if such information or assistance relate to income years when the treaty was still in force.

3. Preparing for signature

3.1 Introduction

When the two leaders of the teams have initialled the agreed draft,[53] the next step is to prepare the treaty for signature.

When preparing the treaty for signature it is important to note that in relation to the Title of the treaty, the Preamble and the signature block, your country should be mentioned first in your own copy or copies (if more than one language). The other country should be mentioned first in their copy or copies. In the rest of the treaty there should be no alternation, but leave the paragraphs or subparagraphs in the order agreed upon in the draft treaty.

The time gap between initialling and signing should be as short as possible. The industries in the two States will usually be aware that negotiations have taken place and are eager to know the result. The result may be of great importance to the industries when decisions on investment are made. Any delay may result in a situation whereby industries in the two States, due to time delays and uncertainty, make investments in third States instead.

However, the draft treaty is normally confidential, at least until it has been signed. To avoid the situation that treaty provisions are made public in one country while they are still confidential in the other country, it is advisable that the two negotiating teams discuss and agree on the time for publication. If one or both countries, immediately after initialling, wish to issue a press release informing the public that an agreement has been reached and is being prepared for signing, it may be advisable that the two teams agree on the wording of such press release. However, if some countries have legislation that obliges them to make the treaty public at an earlier date than signature, it may be advisable to inform the other country of such commitment.

In some countries the procedures before signing are comprehensive and time-consuming. There are examples that years have passed between initialling and signature. This is unfortunate, but is sometimes unavoidable due to these comprehensive procedures.

[53] See Paper No. 4-N, How to Conduct Tax Treaty Negotiations, by Odd Hengsle

Most countries must submit the initialled draft for comments or approval by a legal authority before they can begin the preparations for signature. Such an authority may be the Ministry of Foreign Affairs, the Ministry of Justice, the Supreme Court or an authority established for the purpose of commenting on new tax legislation proposals as well as initialled tax treaties. This authority may have comments on the drafting or on the content, which have to be presented and discussed with the other country. Even if the authority has no comments to make, a review by such an authority could easily delay the signature process. The other country may even decide to defer completion of its own processes until it is clear that the relevant authority has given its approval.

If several years pass by before signing, the initialled treaty may in some respects be obsolete. One or the other country may be reluctant to sign and may ask for redrafting of some of the agreed articles. To get an idea of the time usually required in preparing the treaty for signature, it is recommended that information be exchanged during the negotiations on the procedures that are needed to get approval for signing.

3.2 Translation

When the initialled draft treaty is not negotiated in the official language of one or both States the first step will be for each country to translate the draft into its own language.

If, due to time constraints, a thorough proofreading was not done at the time of initialling, it should be done before the translation takes place. The articles in the initialled draft should read exactly the way the negotiators have agreed. If errors are discovered later, they may easily delay the signature process, especially if there are disagreements on the correct content or wording of a provision. On the other hand, minor misprints can easily be corrected in writing or by e-mails at any time before signature.

Who carries out the translation may vary from one State to another. In some States the negotiators themselves do the translation, in other States an office in a Ministry or a governmental agency undertakes that task, or a private translation office is engaged. In all cases it should be remembered that the initialled draft is confidential. When someone unfamiliar with the international terms used in tax treaties does the translation, it is also highly advisable that the translation is proofread to check that the terms used are consistent with international standards used in the United Nations and OECD Model Conventions. It is therefore helpful if the translator is provided with existing treaties in order to ensure that he is aware of these specific terms. In this connection one should be aware of the fact that the United Nations and OECD Model Conventions have been translated into several languages, which could be a great benefit during the translation process.

When the treaty has been translated into an official language, it should be transmitted to the other country for approval. It is important that the translation is correctly done and that all official versions of the treaty have similar wording and have the same result, even if the languages are different. If the persons checking the translation are not familiar with the other country's language, they should consult with the translation office in the Ministry of Foreign Affairs or any other office established for the purpose of translations. If the office checking the translation is not satisfied with the wording in the translated version, the two countries should negotiate to find wording accepted by both countries. More serious differences between the two texts may also occur, for instance, when a paragraph in an article is missing. When both countries agree that the translated drafts completely and accurately reflect the initialled draft text, the next step for the signing of the treaty will begin.

When the two States do not have a common language, the initialled draft may not necessarily be in the official language of either of the two States, or the language of the negotiated draft may be in the official language of only one of the States. When more than one language is involved, it is necessary to decide in which language the treaty will be signed. Depending on the domestic regulations in a State, it may be agreed that the treaty will be signed in one, two or three languages. To clarify the domestic regulations, it is important to consult with the Ministry of Foreign Affairs.

Only the languages used for the signed treaty are regarded as constituting the official text. However, in all States a translation into the official language(s) is normally necessary even if the treaty is not going to be signed in that language, but it will then only be an unofficial translation.

A treaty may be negotiated in the English language even if the two countries are not English speaking countries. To avoid a problem with translation errors, the two countries may agree to have the treaty signed in the English language only and have two unofficial translations. Alternatively, they may agree to have three official languages where the English language shall prevail in case of differences of interpretation. An example of a Convention signed in three official languages can be found in the treaty between Norway and Georgia signed on 10 November 2011:

> *"In witness whereof the undersigned, duly authorized thereto by their respective Governments, have signed this Agreement.*
>
> *Done in Duplicate at Tblisi this 10th day of November 2011, in the Norwegian, Georgian and English languages, all three texts being equally authentic. In the case of divergence of interpretation, the English text shall prevail."*

It is important to remember that a country will always have its official language mentioned first, the language of the other treaty partner mentioned second and the prevailing language last.

If signed in several languages, remember there will be one copy of the text in each language to be signed. Each country should have a signed version of the treaty in all official languages.

Even if there is only one language, there are always *two* copies to be signed, one of which will be retained by each State.

If a treaty is signed in two languages, both languages will be equally authentic. If there are differences discovered after the signing, but before the entry into force of the treaty, the two countries may consult in order to agree on the necessary corrections. Such consultations will usually be made through diplomatic channels. It will be the Ministries of Foreign Affairs that will decide on the procedure and if a new signature process is necessary.

Differences discovered after the treaty has entered into force may create a more difficult situation, especially if these differences lead to a different understanding. Unless the differences are minor, a protocol to the treaty will be necessary to correct the mistakes. Such protocol will have to follow the same legal procedure as the original treaty.

3.3 The signing of the treaty

When any necessary translation is complete and agreed by the two countries, the next step will be to ask for approval from your government to sign the treaty. To get approval, the (translated) treaty and a technical explanation will normally have to be submitted to the Minister of Finance or an approved authority.

The procedure for approval may vary from one country to the other.

In some countries the Minister is required to present the treaty to the Cabinet for approval. When approval to sign the treaty is given, the text will normally be transmitted to the Ministry of Foreign Affairs, which is usually the government agency responsible for arranging the signing ceremony and for deciding who will sign the treaty on behalf of the State.

According to Article 7 (Full Powers) in the Vienna Convention on the Law of Treaties, it will in most cases only be the Head of State, Head of Government and the Minister of Foreign Affairs that have full powers to bind a country by signing a treaty without having to produce full powers. If the Minister

of Finance or any other minister or person is the person signing the treaty, that person will need a power of attorney signed by the Minister of Foreign Affairs stating that they have been given the appropriate full powers to sign. Many countries also consider that the Vienna Convention accepts that heads of diplomatic missions have the power of attorney to sign a convention, though other countries do not agree.

Some States that have not ratified the Vienna Convention recognise it as a statement of customary international law and binding upon them as such. If there is doubt about the authority of the person that is going to sign the treaty, the Ministry of Foreign Affairs should be consulted. There have been several examples of embarrassment at the signing ceremony when a document of full powers has not been presented. If the document of full powers is missing at the signing ceremony, the signing may be delayed until the document of full powers is produced. Another possibility is that the treaty will be signed, but the signature is not recognised until the document is produced. To avoid all kinds of embarrassment and delays it is wise to be aware of this potential problem.

To avoid delays in the entry into force of a treaty, it is important that the treaty is signed as soon as possible. It is generally not desirable to delay entry into force of a treaty unnecessarily, for example waiting for an official visit by a Minister. The treaty is expected to be of economic advantage to the countries concerned and any delay is a disadvantage to the economic relations between the two States. One way to avoid such delays is to remind the relevant ministers of the importance of an early signature.

Some States are of the opinion that a treaty initialled in one country should be signed in the other country or if a new treaty replaces an old treaty, the signing of the new treaty should not occur in the same country as the existing treaty was signed, but rather in the other country.

3.4 Post signing activities

In almost all countries the signed treaty has to be presented to the Parliament for final approval and ratification.

When the treaty has been signed, the Ministry of Foreign Affairs should report back to the Ministry of Finance or the authorised agency. A technical explanation will then be prepared. The explanation and the treaty will then be sent to the Parliament, where the treaty in most cases will be received by a committee, which will study it and make its comments. If necessary, the Minister or the person or persons designated thereto will be called by the committee to explain the provisions.

After the Parliamentary Committee has received all the explanations they have asked for, the treaty will, at least in most States, be presented to the Parliament with a recommendation to approve it. In the rare case where the treaty is not approved, the other country has to be informed and advised of the problems raised by the committee or Parliament. The negotiators will then meet to see if there is an easy way to solve the problem. Since the treaty is usually a result of several compromises, a solution may not easily be found. The question of renegotiating one article might lead to the reopening of all articles in the initialled treaty and previous compromises or concessions may be lost.

The mode of dealing with the treaty in the Parliament may differ from one country to the other. A consultation with the Prime Minister's office or the administrative office of the Parliament is advisable. In many countries the approval of a tax treaty will follow the same procedures as the approval of a change in the tax legislation.

The last step in the process of the entry into force of a tax treaty is to inform the Ministry of Foreign Affairs that all legal procedures for the entry into force have been dealt with and ask the Ministry to inform the other State in accordance with the article on entry into force. If the treaty provisions require an exchange of instruments of ratification, a meeting between representatives from the two countries will take place and the relevant instruments will have to be prepared for exchange. However, in most cases the last procedure before the treaty enters into force will be a notification in writing, sent through diplomatic channels, informing the other State that all legal requirements for the entering into force of the treaty have been complied with. The treaty will then enter into force either on the receipt of the later of these notifications or at a date specified in the article.

Occasionally, a long time may pass between the approval by the Parliament and the exchange of instruments of ratification or the exchange of notes. A delay of this kind may have as an undesired result that the application of the treaty is delayed by a year because the treaty will normally only come into effect from the income year next following the year in which it enters into force. There have been occasions where the Ministries of Foreign Affairs have not been aware of this effect and have exchanged instruments of ratification or sent notes in the beginning of January of a year rather some time in the previous year. In this respect it is important to know whether the two countries have agreed that the treaty shall only come into effect after a certain period (say 30 days) after the exchange of instruments of ratification, or after the confirmation that each State has completed the procedures required for the entering into force of the treaty. The Ministry of Finance (or other relevant authority) and the Ministry of Foreign Affairs should therefore be reminded of the importance of an early

exchange of instruments of ratification or exchange of notes and should cooperate in order to avoid this kind of unintended delay.

3.5 Post entering into force

It may be advisable to ensure that the tax administration is aware of the new treaty and this can be done by way of an explanatory note. Whether this should be done in a separate paper or merely be a reproduction of earlier explanatory notes, will differ from one country to another. It is also important that the industries and other taxpayers are made aware of the new tax treaty. Such information can be furnished in several ways. Usually countries publish a press release with information detailing where to look for details. Most countries publish their treaties on their web site and in many countries the law requires that the treaty also be publish in a government gazette.

3.6 New legislation

In the first sentence of Article 2 (4) (Taxes covered) in both the United Nations and OECD Model Conventions it is stated that:

> *"The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention, or in addition to, or in place of, the existing taxes".*

However, it is not to be expected that new taxes will automatically be accepted and applied by treaty partners. When new taxes are introduced, all treaty partners must be informed as soon as possible and asked if they can agree that the new taxes are of an identical or substantially similar nature, either replacing or supplementing the taxes referred to in the treaty in force. If the answer is affirmative, there is no problem and the tax administrations in both countries should be informed. However, if the answer is negative, the problem could be resolved through the mutual agreement procedure. If no agreement is achieved, a change in law or a protocol to the treaty may be the only solution.

When, after the entry into force of a treaty, a State makes changes in its domestic tax legislation, it will usually be obliged to inform its treaty partners of such changes, at least if they may have an impact on the treaties in force. This obligation follows from the last sentence of paragraph 4 of the article mentioned above where it is stated that:

> *"The competent authorities of the Contracting States shall notify each other of significant changes made to their tax law".*

The treaty partner should inform its treaty partner of the new legislation, which may have an impact on how the treaty is applied. If the changes are significant enough, the treaty partner may even ask for negotiations with a view to proposing changes to the treaty.

In some cases it may be wise to get an explanation from the other team on the interaction between their domestic legislation and their conventions in order to avoid surprises in the future. In cases where a convention deviates from domestic legislation it is important to have established whether the domestic legislation or the treaty provisions will prevail. There are no current examples that domestic legislation in force at the time of negotiations, will prevail. However, there are examples that later changes in domestic legislation, at least in theory, may prevail over existing conventions. If a State, according to its domestic legislation, may override an existing convention in certain cases, this should be clarified. Many countries claim that such overriding will be contrary to Article 27 (Internal law and observance of treaty) of the Vienna Convention of the Law of Treaties, where is stated:

> *"A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty. This rule is without prejudice to article 46".*

Even if countries are not signatories to the Vienna Convention, most countries will regard it as representing customary international law and will object to any overriding of the treaty through domestic law. Other countries may disagree, but will in almost all cases avoid an interpretation of domestic law that sets aside a provision in a tax treaty already in force. It must be remembered that an international treaty imposes obligations on the treaty partners to perform as set out in the treaty.

3.7 Changes to the provisions of a treaty

When the treaty is approved by the Parliament and has entered into force, the only legal procedure to make changes to the provisions of a treaty is by a protocol carefully following all the procedures described above. Any changes made by exchange of notes or any other written statements will not be legally binding and may be rejected by the courts. It is important to follow the constitutional and legal requirements for negotiating and giving effect to a treaty, which is laid down in the legislation of the two States.

4. Conclusions

When agreement is reached on all major issues, it is important not to loose momentum in preparing the initialled draft for signature and the entry into force. There are several obstacles to pass before the

treaty becomes effective. It may be easy to give priority to other important work put on your table by ministers. But one should remember the purpose of the treaty, which is to improve the economic relations between the two countries. Businesses in the two countries may be planning and waiting for a treaty in force to take advantage of the possibilities the treaty offers. If years pass before the signature of the treaty, the whole exercise of negotiation may be a waste of opportunities.

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