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Why Negotiate Tax Treaties

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

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

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

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

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

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

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

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

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

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

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

   - providing certainty and/or simplicity with respect to taxation of the inbound investment or transfers;
   - developing a closer relationship between tax authorities and business e.g. through the mutual agreement procedure;
   - maintaining benefits of tax concessions and tax holidays provided with respect to inbound investment or transfers.

3. To reduce cross-border tax avoidance and evasion through:
   - exchange of tax information;
   - mutual assistance in collection of taxes.

4. Political reasons, e.g.
   - to send a message of willingness to adopt international tax norms;
   - to foster diplomatic or other relations with the other country;
   - to strengthen regional diplomatic, trade and economic ties;
   - to comply with international obligations e.g. under regional economic agreements;
   - to respond to pressure from the other country.

The importance of each of these reasons will be different in each situation. Motivations may vary depending on whether a country is a net exporter of capital (typically a developed country) or a net capital importer (typically a developing country). It is important to understand all perspectives when considering a negotiation request from another 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 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 ('UN Model Convention') specifically referred to avoidance of double taxation in its title[2]. A similar reference was found in the title of the Organisation for Economic Co-operation and Development's Model Tax Convention on Income and on Capital ("OECD Model Convention") prior to 1992. The Commentary on the OECD Model Convention, while acknowledging that elimination of juridical double taxation is the main purpose of tax treaties, notes that this reference was deleted from the title because tax treaties also address other issues such as the prevention of tax evasion and non-discrimination[3]. Presumably, the reference was deleted from the title in the UN Model Convention for similar reasons. Nevertheless, many countries continue to include a reference to avoidance of double taxation in the title of their conventions.

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

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

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

[3] Introduction, paragraph 16.

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

Juridical double taxation of this kind is clearly undesirable. As noted in the Introduction to the UN Model Convention "the effects of (international double taxation in respect of the same income) are harmful to the exchange of goods and services and movements of capital and persons".[4] This is true irrespective of whether the countries are 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 ('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. However, 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. Nevertheless, the confirmation of such relief under tax treaties provides an additional level of certainty to taxpayers with 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

[4] Introduction, paragraph 5.

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

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

For countries where the economic flows are approximately equal, any loss of source taxation revenue on inbound investment is likely to be 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

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 UN Model Convention Article 12, source rules are also provided for royalties. 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 (i.e. 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 (e.g. where it 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 UN 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 UN 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, e.g. 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 UN 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 UN 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.

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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 UN Model Convention.

10 Ibid.

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

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

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

2.4 Providing certainty and simplicity

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

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

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

[11] Paragraph 6 of Article 24 *Non Discrimination.*

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 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 on Article 25 of the OECD Model Convention and alternative B of Article 25 of the UN 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].

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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 UN Model Convention.

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.

2.5 Maintaining 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, e.g. 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, i.e. as if there had been no tax incentive in source country.

The Commentary on Article 23 of the UN 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.

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

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

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

1. A precise description of the incentives for which tax sparing is sought, e.g 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, e.g. 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, e.g. where the two competent authorities agree it would be inappropriate to grant tax sparing;
5. Inclusion of a 'sunset' clause, e.g. 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.

[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, e.g. information about particular industries or abusive tax avoidance schemes. Article 26(1) of the UN 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, e.g. 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

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

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

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

[18] See paragraphs 29.3 and 29.4 of the Commentary on Article 26 of the UN Model Convention.

[19] Paragraph 3.1 of the Commentary on Article 26 of the UN Model Convention.

[20] See paragraphs 1 and 2 of the Commentary on Article 27 of the UN 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 UN countries[22], member countries are certainly encouraged to do so[23].

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

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

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

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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 UN Model Convention.

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

[24] Article 293 of the EC treaty.

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

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

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

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

5.1 Benefits

- Increased foreign investment

By providing a clear, transparent, non-discriminatory and predictable tax environment, developing countries may facilitate and encourage foreign investment. While it seems self-evident that taxpayers looking to invest in another country will be encouraged to do so when they have confidence in the tax system of that country, there is little empirical evidence to show the *extent* to which the entry into a tax treaty will result in increased foreign 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[27].

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 (e.g. 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, e.g. 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

[27] 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?

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

- Increased certainty

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

- Protection for investment abroad

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

- Avoidance of fiscal evasion

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

5.2 Costs

- Tax treaties have an immediate revenue cost.

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

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

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

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

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

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

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

- Risk of treaty-shopping and double non-taxation

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

- 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 (e.g. 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, e.g. 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, e.g.
- 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. Conclusion

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

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