The role of double-tax treaties in promoting international investment

International law places very few limits on the tax sovereignty of countries. As a result, income from cross-border investments and activities may generally be taxable both in the source country, which is the country where investment or other activity takes place, and in the residence country, which is the country of the investor or trader, according to their respective domestic tax laws. Double-tax treaties are bilateral agreements between two countries, which allocate taxing rights over such income between these countries and thus prevent double taxation of this income. The prevention or elimination of international double taxation is a significant aspect of countries’ investment climate, which is essential for investment flows between countries, the exchange of goods and services, the movement of capital and persons, as well as the transfer of technology.

Over the past decade, the relationship between the mobilization of financial resources for development and international tax cooperation featured prominently in the outcome documents of major United Nations conferences and summits on economic and social matters, including the 2002 Monterrey Consensus, the 2008 Doha Declaration on Financing for Development, as well as the outcomes of the 2009 Financial Crisis Conference and the 2010 MDG Summit.

Double-tax treaty models

Double tax treaty models, as developed by international organizations, are generally used by countries as a basis for negotiations of their bilateral tax treaties. The two models most widely used as part of the continuing international efforts aimed at eliminating double taxation are: 1) the United Nations Model Double Taxation Convention between Developed and Developing Countries (the UN Model); and 2) the OECD Model Tax Convention on Income and on Capital (the OECD Model). These models formed the basis for most of the several thousands tax treaties currently in force, thus providing a profound influence on international tax treaty practice.

The similarities between these two leading models reflect the importance of achieving consistency where possible. On the other hand, the divergences between them reflect the different membership and priorities of the two Organizations. The key differences relate, in particular, to the issue of to what extent a country should forego, under bilateral tax treaties, taxing rights, which would be otherwise available to it under domestic law, with a view to avoiding double taxation and encouraging investments.

In general terms, the UN Model tends to preserve a greater share of taxing rights for the source country, which is the country where investment or other activity takes place. The OECD Model, on the other hand, favours retention of a greater share of taxing rights by the residence country, which is the country of the investor or trader. Thus, the UN Model would normally allow developing countries more taxing rights on income generated by foreign investments in these countries. This has long been regarded as an issue of particular importance for developing countries in view of their development goals. Nevertheless, it is also a position that some developed countries seek in their bilateral tax treaties.

How do double-tax treaties work?

In a hypothetical scenario (see Figure 1), R-Corporation, a steel company which is a resident of developed country R, wishes to license S-Corporation, a manufacturing company which is a resident of developing country S, to produce and market a new line of cheap but sturdy prefabricated housing. S-Corporation will pay royalties in return for the rights to manufacture and
The UN Model aims at both encouraging investments and in -
Advantages of the UN Model

The main objective of this revision of the UN Model has been to take into account recent developments in the area of international tax policies of both developing and developed countries. Moreover, the updated UN Model further clarifies and improves the operation of its provisions aimed to prevent double taxation over income from cross-border investments and activities, and offers improved explanations to help countries make their own decisions on these important issues of tax policy and practice.

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