PART ONE

ANALYTICAL AND HISTORICAL REVIEW OF INTERNATIONAL DOUBLE TAXATION AND TAX EVASION AND AVOIDANCE

I. INTERNATIONAL DOUBLE TAXATION

A. Concepts and issues

1. The jurisdiction to impose income tax is based either on the relationship of the income (tax object) to the taxing state (commonly known as the source or *situs* principle) or the relationship of the taxpayer (tax subject) to the taxing state based on residence or nationality. Under the source principle, a State's claim to tax income is based on the State's relationship to that income. For example, a State would invoke the source principle to tax income derived from the extraction of mineral deposits located within its territorial boundaries. Source taxation is generally justified on the ground that the State has contributed to the creation of the economic opportunities that allow the taxpayer to derive income generated within the territorial borders of the State. Of course, jurisdiction to tax is also about power, and a State generally has the power to tax income if the assets and activities that generated it are located within its borders.

2. Income itself does not have a geographical location. It is a quantity, calculated by adding and subtracting various other quantities in accordance with certain accounting rules. By long standing convention, however, income is assigned a geographical location by reference to the location of the assets and activities that are used to generate the income. When all of those assets and activities are located in one State, that State may be considered to be the unambiguous source of the income. For example, wages paid to an employee stationed in a State that represent compensation exclusively for work performed in that State would have a source exclusively in that State. When some of the assets or activities generating income are located in more than one State, the source of the income is less clear. For example, business profits derived from the manufacture of goods in State A and their sale in State B have a significant relationship to State A and to State B. In these circumstances, some rules for determining source are needed. Those source rules might apportion the income between the two claimant States, or they may assign it to one State exclusively. In some cases, States may adopt inconsistent source rules that result in both States exercising source jurisdiction over the same item of income.

3. Under the residence principle, a State's claim to tax income is based on its relationship to the person deriving that income. For example, a State would invoke the residence principle to tax wages earned by a resident of that State without reference to the place where the wages were earned. In general, a State invokes the residence principle to impose tax on the worldwide income of its residents. Basing the tax on the taxpayer's overall capacity to pay, without reference to the source of income, is consistent with most theories of distributive justice. Whatever the theory, a State cannot tax the worldwide income of its residents unless in practice it has the power to do so. A State typically has some degree of power to compel tax payments from its residents, but only if it has reliable information about the amount of income they have earned. Bilateral tax treaties containing appropriate exchange of information provisions or a multilateral agreement on exchange of information for tax purposes may assist a State in determining the foreign source income of its residents. A bilateral or multilateral treaty with an assistance-in-collection provision may also be helpful to a State in collecting taxes due with respect to foreign-source income.

4. The reach of a State's residence jurisdiction depends on how a taxpayer's residency is determined. Physical presence in a State for an extended period is an important indicator of residence. Some States also determine residency of an individual by reference to a variety of other indicators of allegiance to the State, such as the location of the individual's abode, his family, and his fiscal interests. In other States, physical presence in the State 183 days of the year is enough to establish residence for that year. Conflicts in residency rules can result in an individual being a dual resident — that is, a resident of two different States. Tax treaties generally do an excellent job at resolving problems of double taxation resulting from conflicting residence rules.

5. When income is derived within a State by a resident of that State, both the source principle and the residence principle can be invoked to support a tax on that income. A State can invoke only the source principle to tax income derived within its territorial boundaries by a non-resident. It can invoke only the residence principle to tax income derived by a resident from activities conducted outside the State's territorial boundaries. Most States utilize both the residence principle and the source principle. All States utilize the source principle.

6. A few States tax on the basis of the source principle alone (so-called territorial system).[1] The number of States using a territorial system has diminished, because countries have recognized that the failure to tax residents on income derived from foreign activities undermines the fairness of the tax system and provides residents with a tax incentive to invest abroad. Such an incentive is almost certainly contrary to the national interests of a State in need of capital for domestic investment. Nevertheless, if only a tiny percentage of the population of a State derives any foreign source income, the residence principle may have little practical importance to that State.

7. States that invoke only the source principle are typically concerned about the ability of their tax department to determine the amount of foreign source income derived by their residents. In some cases, an exemption for foreign source income can complicate tax administration, due, for example, to legal disputes that may arise over the source of particular items of income or to the difficulties the tax administration may encounter in determining whether a deduction claimed by a taxpayer properly relates to domestic or foreign income. In some cases, a State exercising only source jurisdiction may be tempted to adopt source rules that may conflict with the source rules of other countries in order to tax income that does not present them with significant enforcement problems. They may be inclined, for example, to treat the income of government employees earned abroad as domestic source income.

8. A few States consider nationality as establishing a sufficient relationship between the taxpayer and the taxing State to justify taxation on worldwide income. Because it is based on the connection of the tax subject to the taxing State, this principle is best understood as a variation on the residence principle. The overwhelming majority of citizens of a State are also residents of that State. As a result, residence jurisdiction and nationality jurisdiction overlap considerably. The United States of America is the only State where tax jurisdiction based on nationality is important, although

[1] Taxing jurisdictions continuing to use the territorial system include: Bolivia, Costa Rica, El Salvador, Guatemala, Hong Kong SAR, Kenya, Malaysia, Nicaragua, Panama, Paraguay, Singapore and Uruguay.

a few other States, including Bulgaria, Mexico and the Philippines, have used citizenship as a basis for taxation in the past. The United States of America generally does not tax its citizens on foreign earnings below a high threshold amount if they have established a foreign residence. Many countries take an individual's citizenship into account in determining whether that person is a resident. Tax treaties, including Article 4.2.c of the United Nations Model Double Taxation Convention between Developed and Developing Countries, use citizenship as a tie-breaker in resolving problems of dual residency.

9. The jurisdictional principle based on the tax object (source, *situs*) and tax subject (residence, nationality) were developed initially for individuals in the context of the personal income tax. States also invoke those principles, at least by analogy, in asserting the right to tax juridical persons or other entities, such as corporations and trusts. All States invoke the source principle in taxing corporations and other taxable legal entities. Many States also invoke an adapted version of the residence or nationality principle to tax certain corporations and other legal entities on their worldwide income. A corporation taxable by a State on its worldwide income is sometimes referred to as a domestic corporation.

10. Some States determine the residence or nationality of a corporation based on its place of incorporation.[2] Other States determine the residence of a corporation by reference to its place of management.[3] As a practical matter, most States using a place of management test employ some objective standard, such as the place where the board of directors meet, to determine place of management. Otherwise, the place of management would be indeterminate in many important situations. Some States use both a place-of-incorporation test and a place-of-management test.[4] A corporation that is subject to tax on its worldwide income may be able to avoid taxation on foreign-source income by creating an affiliated foreign corporation and arranging for that affiliated corporation to earn the foreign-source income it otherwise would have earned. Most developed countries and some developing countries have adopted rules to tax their domestic companies on certain categories of income deflected to a foreign affiliated corporation for tax avoidance purposes.

1. The concept of international double taxation

11. International double taxation, narrowly defined, occurs when two States impose a comparable income tax with respect to the same item of income on the same taxable person. The concept has been defined more broadly, but with less precision, as the result of overlapping tax claims of two or more States.[5] The concept of international double taxation that bilateral tax treaties seek to remove is broader than the narrow definition. It includes some types of economic double taxation — that is, taxation that has the effect of imposing multiple burdens with respect to the same item of income

[2] e.g., United States of America, Sweden, France.

[3] e.g., United Kingdom (before 1988).

[4] e.g., United Kingdom (since 1988), Canada, Australia, Germany, The Netherlands.

[5] International Fiscal Association: The Revised OECD Model Double Taxation Convention on Income and Capital: Proceedings of a Seminar held in Vienna in 1977 during the Thirty-first Congress of the International Fiscal Association, Introduction by Dr. M. Widmer, page 9.

whether or not the income item is formally subject to multiple levels of taxation. For example, many tax treaties operate to provide tax relief to a corporate group when a State has imposed an income tax on profits earned by a subsidiary corporation and another State otherwise would impose an income tax on its parent corporation when those profits are distributed as a dividend. In general, tax treaties attempt to eliminate most forms of international double taxation, narrowly defined, and various other forms of international double taxation when a failure to do so would have a demonstrably harmful impact on international trade and investment.

12. A major goal of bilateral tax treaties is to remove impediments to international trade and investment by reducing the threat of double taxation that can occur when both Contracting States impose tax on the same income. This goal is advanced in four distinct ways. First, a bilateral tax treaty generally increases the extent to which exporters residing in one Contracting State can engage in trading activity in the other Contracting State without attracting tax liability in that latter State. Second, when a resident of a Contracting State does engage in a sufficient activity in the other Contracting State for that State to have the right to tax, the treaty establishes certain guidelines on how that income is to be taxed. For example, those guidelines may assign to one Contracting State or the other the primary right of taxation with respect to particular categories of income. They may, in certain cases, provide for the allowance of deductions in measuring the amount of income subject to tax. They may require a reduction in the withholding taxes otherwise imposed by a Contracting State on payments made to a resident of the other Contracting State. Third, a bilateral tax treaty provides a dispute resolution mechanism that the Contracting States may invoke to relieve double taxation in particular circumstances not dealt with explicitly under the treaty. Fourth, where income or gains remain in principle taxable in both Contracting States, the State of residence of the taxpayer will relieve the double taxation that results either by allowing a credit for the tax paid in the other State or by exempting the income or gain from its own tax in practice.

13. Although a State may address the issue of double taxation unilaterally through domestic tax laws, it typically cannot achieve unilaterally many of the goals of a bilateral tax treaty. Domestic legislation is a unilateral act by a State. Such a unilateral act can reduce or eliminate double taxation only if the State is prepared to bear all of the financial cost of granting that relief. A bilateral tax treaty, by definition, is a joint act of two Contracting States, typically resulting from some negotiations. In that context, the financial costs of relieving double taxation can be shared in a manner acceptable to the parties. In particular, the domestic legislation of a State typically addresses tax issues without reference to the particular relationship that the State may have with another State. In a bilateral tax treaty, that relationship can be taken into account explicitly and appropriately. For example, a State may use a bilateral tax treaty to fashion a particular remedy for double taxation when the flows of trade and investment with the other Contracting State are in balance. It may adopt a different remedy, however, when the trade and investment flows favour one State or the other.

14. Bilateral tax treaties help to reduce the risk of double taxation by establishing the minimum level of economic activity that a resident of one Contracting State must engage in within the other State before the latter State may tax the resulting business profits. The bilateral tax treaty lays out ground rules providing that one State or the other, but not both, will have primary taxing jurisdiction over income derived from the branch operations in one Contracting State by a corporation that is

resident in the other Contracting State. Similarly, the treaty may specify which Contracting State may tax income derived from the performance of services in one Contracting State by an individual who is a resident in the other Contracting State. In general terms, the tax treaty may assign primary (but not exclusive) jurisdiction to tax to the Contracting State in which the economic activities occur if those activities have substance and continuity that exceed some threshold level. When the economic penetration is relatively minor, however, exclusive jurisdiction to tax may be assigned to the Contracting State where the corporation or individual is a resident.

15. The scope of a bilateral tax treaty typically is not limited to commercial and business activities. Treaties may remove tax impediments to desirable scientific, educational, cultural, artistic and athletic interchanges. In addition, a treaty may address issues arising in the tax treatment of pension plans and Social Security benefits, of contributions to charitable organizations, of scholarships and stipends paid to visiting scholars, researchers, and students, and even of alimony and child support payments.

16. A bilateral tax treaty cannot anticipate every income tax issue that is likely to arise between Contracting States. Some issues, such as issues relating to the growth of electronic commerce, are difficult to address currently by tax treaty because the international community has not yet reached a consensus on the appropriate standard for taxation. The international community generally recognizes that the current treaty rules relating to the definition of a permanent establishment were based on premises about how commerce is conducted that may not hold for electronic commerce. What is not yet well understood is the changes, if any, that the development of electronic commerce will require in the treaty definition of a permanent establishment. To deal with such emerging issues, the parties to a bilateral tax treaty may wish to agree to consult on those issues within a stipulated period after the treaty enters into force. The length of the period with respect to a particular issue might be chosen so as to allow time for an international standard on that issue to emerge, for example, from the Organization for Economic Cooperation and Development (OECD).

17. The typical tax treaty provides a mechanism enabling the tax authorities of the two States to adopt ad hoc rules to eliminate double taxation when it occurs. In tax treaty parlance, the tax authorities responsible for negotiating a solution to particular cases of double taxation are the Competent Authorities. Each Contracting State appoints one or more Competent Authority in accordance with its domestic laws. The Competent Authorities are particularly useful in relieving double taxation that occurs because the States do not agree on the facts underlying the imposition of their taxes. States may disagree, for example, on whether a particular deduction claimed by a taxpayer relates to income earned in one or the other Contracting State. In some cases, the factual dispute might arise because the taxpayer himself took inconsistent positions on the tax returns filed in the two countries as part of a plan to minimize its taxes. In many cases, the potential for double taxation arises because States do not agree on how prices should be established on transfers or other transactions between related persons.

18. A multinational enterprise, more than any other taxpayer, may be able to minimize its taxes in a State by manipulating the prices charged in transactions between its affiliates in different countries. Consider, for example, two related companies: Company A, resident in State A, and

Company B, resident in State B. Company A manufactures goods in State A at a unit cost of 40, sells the goods to Company B, and Company B sells the goods to unrelated customers in State B at a unit price of 90. Under these conditions, the multinational enterprise has total unit profits of 50. The location of those profits depends on the price charged on the sale by Company A to Company B. If the sale is made at a price of 40, then all of the profits end up in Company B presumably taxable in State B. If the price is set at 90, the profits end up exclusively in Company A presumably taxable in State A. At any sales price between 40 and 90, a portion of the profits will be taxable in both countries. Under these conditions, the multinational enterprise controls where the profits will be taxable, assuming that State A and State B do not have in place a set of rules to prevent transfer-pricing abuses. All other things being equal, the multinational enterprise would plan its transactions in such a way to ensure that its income is reported in the jurisdiction with the lowest effective tax rate. The prices set on transfers between related persons are referred to as transfer prices. The possibility that multinational corporations will systematically use transfer prices to avoid taxes has made transfer pricing one of the most important international tax issues.

19. To limit the potential for transfer-pricing abuses by multinational corporations, a State must include in its domestic tax legislation detailed rules on how prices are to be established on sales and other transactions with related persons. To develop such rules, it is necessary to establish a benchmark by which to evaluate the prices charged. The benchmark adopted by most developed and developing countries is the arm's length standard. Under the arm's length standard, the price charged to a related person should be similar to the price as it would have been had the parties to the transaction been unrelated to one another — in other words, similar as if they had bargained at arm's length.

20. In some cases, it is relatively easy to find benchmark prices to be used in estimating an arm's length price. For example, if the multinational corporation is selling a commodity that regularly trades on a commodity exchange, the prices on that exchange provide good evidence of the appropriate price. In other cases, an extensive analysis may be required to determine an appropriate arm's length price. This analysis requires an examination of the functions performed by the related persons, the resources employed, and the risks assumed by each party. For each task performed, the related person should be adequately compensated or remunerated in accordance with prevailing market prices for comparable tasks. This analysis may be performed in a variety of ways. If a State conducting such an analysis comes to a different set of conclusions than the multinational enterprise, it may determine that additional taxes are due. If that analysis is also conducted by another State where the multinational enterprise is conducting business, that State may also reach a set of conclusions that differ from those reached by the other State and by the multinational enterprise. In such circumstances, the risk of double taxation is quite real. One of the important functions of income tax treaties is to minimize that risk.

21. In many cases, multinational corporations engage in transactions with related parties that are not closely comparable to transactions conducted at arm's length by unrelated persons. In some cases, the transactions between related parties are highly specialized or involve unique intangibles. For example, assume that a pharmaceutical enterprise has developed a medical process that it is able to use in manufacturing a product it can sell for a high profit. A parent corporation may be prepared

to license that process to a related subsidiary corporation, with the understanding that the subsidiary would not reduce the overall profits of the multinational enterprise by competing with its parent corporation in the same market. It is quite unlikely, however, that the parent corporation would give up its monopoly position by licensing the product to an unrelated corporation that would constitute a potential competitor. In such circumstances, a State probably would not be able to locate a comparable sale of comparable technology to an unrelated person. To prevent transfer-pricing abuses, therefore, it must employ some pricing method that is not dependent on finding comparable sales of comparable products by unrelated persons. During the late 1980s and early 1990s, the tax authorities in the United States of America developed various pricing methods that were not dependent on finding such comparables. These methods included the use of multi-factor formulas and profit splits in appropriate cases. Most of these methods make reference to the overall profitability of unrelated persons performing comparable functions. They do not, however, depend on finding comparable transactions. The United States' methods, promulgated by regulation in 1994, were developed in consultation with the OECD. The profit split methods, however, were found to be acceptable only as a method of last resort.

22. Traditional arm's length pricing methods are quite often ineffective in determining arm's length prices in highly integrated industries that do not exist in unintegrated segregated form. Global securities trading is an example of such an industry. Many local firms do engage in securities trading. So-called 24-hour trading of securities, including innovative financial instruments such as derivatives, is conducted, however, only through integrated multinational financial firms. These firms have branch operations and affiliated companies all over the world. The profits earned by separate branches or affiliates depend heavily on the combined operations of the multinational firm and only partially on activities having a significant relationship to a particular geographical location. Traditional transactional methods work quite well for global trading in those instruments. The most global of all securities markets is the market for U.S. Treasury Bonds. Trading in physical securities is not at all integrated and results in commissions being paid. Those commissions are usually calculated on the basis of a comparable uncontrolled price (CUP) or a resale price or cost plus method. In this context, it may be nearly impossible to apply traditional pricing methods and traditional methods for determining the source of income.[6] In 1998, the OECD published a paper on global trading that explored various ways of allocating and taxing the profits in each country where global trading is conducted. This publication describes the factual background to global trading and discusses a range of policy options to tackle the problems it presents to tax administrators.[7] The OECD report suggests that those problems are becoming more common in other industries with the spread of globalization and the communications revolution.

23. Most multinational businesses having substantial operations in a State typically incorporate a separate affiliated corporation in that State. That separate entity is taxable by the State on its income. Tax treaties provide that the remaining part of the multinational enterprise is not taxable in that State because of its ownership of the domestic affiliate. If the domestic affiliate engages in transactions

[6] The United States does not, and never did, use formulary apportionment for global trading. The formulas used are intended to provide an arm's length allocation of income. Those who adopt and rely on formulary apportionment methods generally accept that they do not provide an arm's length allocation of income.

[7] OECD: The Taxation of Global Trading of Financial Instruments (1998).

with the remaining part of the enterprise, its income is determined by application of the arm's length standard. In some cases, however, a multinational enterprise will operate in a country through a branch. This form of organization is commonly used by international banks and global trading corporations, due in part to the capital requirements that many States require such firms to meet. If the activities of a branch are substantial, as they typically would be for a bank or other financial services provider, the branch will constitute a permanent establishment of the multinational corporation of which it is a part. Under tax treaties, a taxpayer having a permanent establishment in a State is taxable in that State on the income properly apportioned to the permanent establishment. The rules for determining the income of a permanent establishment, however, are far less developed than the rules applicable to affiliated corporations. Various governments and international organizations are now actively engaged in the development and refinement of the rules for taxing branches that constitute a permanent establishment.[8] No consensus has yet emerged, however, on how profits should be attributed to a permanent establishment.

24. Tax treaties have traditionally provided only a general framework for determining the income of taxpayers. Each State provides its own rules for computing income in domestic legislation, and those rules prevail unless they are inconsistent with the framework provided in the applicable tax treaty. Treaties generally do contain some language dealing with the computation of branch profits of a permanent establishment. In general, a State agrees by treaty to allow a branch to take appropriate deductions, with some limitations, if that branch constitutes the permanent establishment of an enterprise of the other Contracting State. A State also agrees to determine the profits of a branch by reference to "the profits which it might be expected to make" if it were a separate entity dealing at arm's length with unrelated persons.[9] In many cases, it is fairly easy to extrapolate from agreed rules for taxing affiliated companies to rules for taxing branches. In other cases, special problems arise. For example, assume that Company P manufactures goods in State A through a manufacturing branch and sells them in State B through a sales branch. Under these facts, should the sales branch be entitled to the profits that would have been earned by a commission agent or by a distributor? If Company P had organized the manufacturing branch and the sale branch as separate entities, those entities would have been required to specify the nature of their relationship. In operating through branches, however, Company P has no business need to specifying one form or the other. In addition, the form chosen typically would have no legal effect because Company P would bear any risk of loss no matter how the transactions were specified. For another example, assume that Company P owns a valuable trademark that it affixes to goods that it manufactures through its manufacturing branch in State A. If Company P sells those goods in State B through a sales branch, should the sales branch be required to pay an arm's length price for the use of that trademark? The problem in assigning a charge for the trademark is that the trademark is owned as much by the sales branch as by any other part of Company P. If the sales branch is treated as the owner of the trademark, then a charge is inappropriate under an arm's length standard. The UN Model treaty suggests that an imputed charge for the trademark would be inappropriate in these circumstances.[10]

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[8] See, e.g., OECD, Discussion Draft on Attributing Profits to a Permanent Establishment.

[9] United Nations Model Double Taxation Convention between Developed and Developing Countries (2001), Art. 7(2).

[10] op. cit. Art. 7(3).

25. Special problems arise in determining the appropriate interest expense attributable to a branch of a multinational bank or other financial intermediary. Banks generally earn their profits by borrowing money under a variety of circumstances and lending out that money to customers. The interest rates that multinational banks pay on their various loans may vary considerably. Some loans may be denominated in a depreciating currency and have a high nominal interest rate associated with them. The reverse situation may prevail with respect to loans denominated in an appreciating currency. Some loan funds are obtained at very low interest rates from customers making deposits in a demand savings account or checking account. These customers may be compensated for the low rate, however, by the provision of financial services of substantial value. Loans may also be made at long-term, medium-term, and short-term rates. Some may have a high interest rate due to high risk, whereas other loans may have no risk premium. Some loans may have a low or nonexistent nominal interest rate but may have been made by issuing debt instruments at a deep discount. Due to the fungibility of capital, a linkage of a particular loan at a particular interest rate with lending activities in a particular geographical region may be difficult or even pointless.

26. There are two basic methods that might be employed to determine the appropriate interest expense of a branch of a multinational bank. One method would be to determine the actual interest expense incurred by the bank and then to allocate that expense among its many branches in accordance with their actual or deemed use of the bank's borrowed capital. The allocation might be done through some formula or through some mechanism that included tracing of borrowed funds to their particular use. For example, a formula might allocate all of the bank's debt and equity capital to the branches in proportion to their use of that capital in making loans to customers. The appropriate interest deduction would be determined by calculating the bank's average interest expense for all its loans, and treating that interest rate as the rate attributable to each loan.

27. A second method for calculating the branch profits of a bank would be to treat each branch as if it were a separate legal entity and then calculate its interest expense by reference to the interest expense that a separate entity would have incurred in engaging in comparable business activities. Numerous assumptions must be made in order to apply this second method. For example, assumptions must be made about the percentage of equity capital and loan capital that would be attributed to a branch, the currencies in which its loans would be denominated, the period over which its deemed loans had been made, the risks associated with those loans, the deemed entities from which the loans were made and so forth. Comparisons with comparable entities probably would not be possible because multinational banks normally operate through branches, not affiliated companies. A State's tax administration might develop guidelines for making all of the necessary assumptions, or it might accept the various assumptions made by the banks on their books of account. If the latter approach is taken, the expectation should be that the banks would be tempted to make assumptions that would minimize their tax liability. It may be relevant to mention that the OECD has done a great deal of work on this issue and has recently released a discussion draft regarding the proper attribution of profits to permanent establishments.

28. Not all the tax treaties that States have entered into provide explicitly that banks should be allowed to compute the profits of a branch by treating the branch as if it were a separate entity and taking an interest expense deduction for hypothetical interest payments to some assumed parent company with respect to a hypothetical loan for which it is not legally liable. (Special attention is

invited to the new U.S –U.K. tax treaty and specifically to the notes regarding the provisions of Article 7 thereof). Some commentators have asserted, however, that the right of banks to use a separate entity approach can be read into the language of Article 7(2) of the OECD and UN Model Conventions, which provide that "there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise." This language does not necessarily support the position for which it is asserted. The simple fact is that "separate and distinct enterprises" do not make payments on hypothetical loans for which they have no legal liability. Another plausible reading of the above language is that the profits of a branch from transactions that actually occurred should be measured by reference to market prices.[11]

29. Double tax conventions are an established way for States to agree at the international level on a method for reducing or eliminating the risk of double taxation. Double taxation may occur for any of the following reasons:

(a) Two States may tax a person (individual or company) on his world-wide income or capital because they have inconsistent definitions for determining residence. For example, a corporation may be treated by State A as its resident because it is incorporated therein, whereas State B may treat that corporation as its resident because it is managed therein. As another example, State A may treat an individual as its resident for a taxable year under its domestic tax rules because that individual was present in the State for 183 days during that year. That same individual may be treated as a resident of State B under its domestic laws because the individual has lived in that State for many years and maintains close financial and social ties to that State. Residence-residence conflicts can occur rather frequently with respect to corporations, unless a corporation has intentionally made itself a dual resident to obtain the benefit of a loss in more than one State.

(b) One State may tax income derived by a person by application of the residence or nationality principle, whereas another State may tax that same income by application of the source principle. For example, Company A, a resident of State A, may earn income in State B from extensive activities therein. State A would tax Company A on its worldwide income, which would include the income earned in State B. State B would tax the income arising from the activities conducted within its territorial boundaries. A major objective of bilateral tax treaties is to provide for relief from such source-residence double taxation, typically by requiring the residence State either to give up its claim to tax or to make its claim subordinate to the claim of the source State.

[11] In 1999, a United States court held that the tax treaty between the United States of America and the United Kingdom should be interpreted to provide for separate entity treatment of branches. See National Westminister Bank v. United States, 44 Fed. Cl. 120 (1999). For analysis of that case and related issues, see Michael J. McIntyre, *The International Income Tax Rules of the United States,* Lexis Publishing (2nd edition 2000) at § 4/B.1.2.

(c) Two States may invoke the source principle to tax the same item of income, due to conflicts in the way the source of income is determined under their domestic legislation. For example, the domestic tax laws of State A may provide that sales income of a non-resident corporation is taxable in that State if the sale was made through an office located in that State. In contrast, the tax laws of State B may tax income derived from sales by a non-resident corporation if the transfer of possession of the goods sold takes place within that State. Given this conflict in the tax rules of State A and State B, income derived from a sale made through an office located in State A for delivery in State B would be taxed in both States. Tax treaties may address cases of such source-source conflicts.

(d) In some cases, a State may have a source-residence conflict with one State and a source-source conflict with another State. For example, assume that Company A is a corporation resident in State A. It has an office in State B and makes sales from that office into State C. Under their domestic laws, State A taxes income from those sales under the residence principle and State B and State C both tax that income under the source principle. A bilateral tax treaty between State A and State B is likely to solve the residence-source conflict but probably would not solve the source-source conflict. If State B and State C also have a bilateral tax treaty, however, the source-source conflict may also be solved.

2. Methods of relief from international double taxation

30. Two main methods, the exemption method and the credit method, have commonly been used to mitigate international double taxation. These methods may be applied on a unilateral basis, or within the framework of bilateral tax treaties.

(a) The exemption method

31. Under the exemption method, a State exempts from taxation certain items of income derived by its residents in another State. It may do so in accordance with its domestic legislation or by treaty. Domestic legislation typically would grant the exemption without reference to the State where the income is generated, whereas an exemption granted by treaty would be limited to treaty States. The typical effect of the exemption method is that the State where an item of income is generated, that is, the source State, has the exclusive right to tax that item of income. As a rule, exemptions granted to residents for foreign-source income are confined by statute or treaty to profits derived through foreign permanent establishments and income from real property situated abroad or wages earned abroad. The policy goal of this limitation is to confine the exemption to income that the source State would have jurisdiction to tax, although the source State may choose to exempt the income as an investment incentive.

32. Under a variation of the exemption method, called exemption with progression, a State exempts its residents on certain income arising in another State but requires the residents to take that income into account in applying the progressive rate schedule. Assume, for example, that R is a

resident of State A. R earns wages of 800 in State A and 200 in State B. Under the rate schedule applicable in State A, income below 100 is taxed at 20 per cent and income above that amount is taxable at 30 per cent. State A is required, by treaty or domestic legislation, to exempt 100 of income. In determining the tax on the remaining 900 of income, however, it is permitted to tax 900 of income at 30 per cent, just as it would have done if all of R's income had been taxable. The effect of exemption with progression is to take the exempt income into account in determining a resident's ability to pay but applying a zero tax rate to that income. The exemption with progression method has been used in many treaties, including treaties concluded by Austria, Belgium, Germany, Finland, France, Iceland, Luxembourg, The Netherlands, Spain and Switzerland.

33. States using the exemption method ordinarily do not extend the exemption to foreign dividends, interest and royalties. Many countries, however, grant special relief for domestic intercorporate dividends in order to eliminate or mitigate recurrent corporation taxation, first at the level of a subsidiary and then again at the level of the parent company. Some of these States, either by domestic law or by treaty, extend this special relief to dividends paid by a foreign subsidiary to a domestic parent. Other States do not provide this special relief. These States may be reluctant to give relief to avoid recurrent taxation when the foreign profits may not have been previously taxed anywhere. States normally do not give relief for interest and royalties because those items typically would be deductible expenses in the source State.

34. By granting a full exemption to its residents with respect to their foreign-source income, a residence State may put its foreign investors in a position of tax equality with residents of the source State. Whether this equality of position actually occurs depends on the actions of the source State. If the source State provides tax incentives targeted at foreign investors, as frequently occurs, then the foreign investors may be treated more favourably than residents of the source State. In any event, a source State that is granting tax concessions to foreign investors favours a full exemption system on the part of the residence State because its concessions are not reduced or cancelled by the tax of the investor's country of residence. As a result, the full benefits of the concession go to the intended beneficiary, the foreign investor.

(b) The credit method

35. The essential feature of the credit method, whether granted unilaterally or by bilateral tax treaty, is that the residence State treats a foreign income tax paid to the source State by its residents, within certain statutory limitations, as if it were an income tax paid to itself. When the foreign tax rate is lower than the domestic rate, only the excess of the domestic tax over the foreign tax is payable to the residence State. When the foreign tax is the higher one, the residence State does not collect any tax. The effective overall tax burden is the higher of the domestic tax or the foreign tax.

36. States using the credit method reduce their normal tax claims on their resident taxpayers by the amount of the tax that those residents have already paid to the source State on profits derived from that State. The source State could thus raise its tax rate on the foreign resident to the level of the tax of the residence State without imposing an additional tax burden on the foreign resident. It must be stressed, however, that a source State may not be free to manipulate its tax rules to take

advantage of this feature of the credit. For example, if the source State applied a higher tax rate on corporations residing in a State granting a credit, it might be held to have violated a non-discrimination provision in a tax treaty. In addition, a rate that discriminates against credit States might endanger the allowance of a credit if the residence State has adopted domestic legislation that disallows the credit for foreign taxes imposed in a discriminatory manner.[12]

37. In general, when a source State grants special tax concessions to a foreign investor resident in a State using the credit mechanism, the foreign investor has a corresponding increase in the amount of tax due to its State of residence. With some exceptions, the benefit of the concession accrues to the treasury of the resident State, not to the foreign resident. One exception applies if the source State otherwise imposes taxes at an effective rate higher than the effective rate in the residence State and the concessions merely reduce the level of taxation in the source State to the level charged by the residence State. In addition, a corporation resident in a State employing the credit mechanism may use a number of tax planning techniques to benefit from a tax concession granted in a source State. Most capital exporting States do not tax the normal business profits of a foreign affiliate of a resident corporation until the profits have been repatriated in the form of a dividend. By operating in the source State through a foreign affiliate, therefore, a resident corporation may be able to utilize a tax concession granted by the source State to indefinitely postpone any residence tax on the profits derived from the source State. In addition, the resident company may be able to utilize various tax-planning strategies for reducing its taxes that would not be available without the tax concession. A company may also benefit from tax concessions due to operation of the foreign tax credit limitation in its State of residence.

38. Every State that grants a foreign tax credit imposes some limitations on that credit. There are many different types of limitations, some applicable to all of the income derived in a particular country (per country limitation) and some applicable to specific types of income (separate basket limitations). A common feature of those limitations is that the credit allowable with respect to the relevant category of income cannot exceed the tax that the residence State would have imposed on that income if it had been earned domestically. In computing the limitation, the residence State typically computes income according to its own concepts, not according to the tax rules applicable in the source State. As a result, limitation problems may arise from differences in the definitions of taxable income used by the residence State and by the source State. For example, assume that Company P, a resident of State A, earns 100 in State B, computed under the tax rules of State B. State B imposes a tax of 30 on that income. Under the tax laws of State A, however, Company P has taxable income of only 60, due to differences in the way depreciation deductions are calculated in the two States. If the tax rate in State A is 40 per cent, the limitation on the credit will be 24 (40% of 60). Thus, only 24 of the tax paid of 30 will be allowed as a credit, notwithstanding the fact that State B's nominal tax rate of 30 per cent is lower than the nominal tax rate of 40 per cent imposed by State A.

[12] e.g., sec. 6 AB(6), Income Tax Assessment Act 1936 (Australia) (credit absorption tax); United States Treasury Regulation sec. 1.901-2(c) (soak-up tax); Income Tax Act sec. 126(4) (Canada).

39. Countries applying the credit method normally deduct from their own tax only the foreign tax levied directly on the income of their residents. Assume, for example, that R, an individual resident of State A, receives a dividend of 100 from Company S, a resident of State B. State B imposes a withholding tax on the dividend of 10. State B also imposed a tax of 30 on the business profits of Company S, out of which the dividend was paid. If State A allows a credit for foreign taxes paid by its residents, it would allow Company P to claim a credit of 10 for the withholding tax imposed by State B. It would not allow a credit, however, for the 30 of taxes paid by Company S. Some States, nevertheless, do allow their resident corporations to claim a credit for taxes paid by a foreign affiliate when the profits with respect to which the tax was paid are distributed to the resident corporation as a dividend. A credit for the taxes paid by a foreign affiliate is referred to as indirect credit.

40. States may grant the credit by domestic legislation and also by treaty. The credit granted by treaty may be somewhat broader than the unilateral credit and may be fine tuned to accommodate the particular circumstances of the Contracting States. For example, a Contracting State may by treaty specify that certain taxes levied by the other Contracting State qualify for the credit, although the credit might not be allowable, or its status might be uncertain, under domestic rules. A treaty may provide that one Contracting State will grant a foreign tax credit and the other Contracting State will use the exemption method to relieve double taxation. This mix of methods typically occurs when one Contracting State grants the credit unilaterally and the other Contracting State provides exemption relief unilaterally.

41. Proponents of the credit method generally consider it to be superior to the exemption method in two respects. First, they claim that it is more effective in promoting fairness because it generally causes residents of a State to pay the same amount of income tax without reference to the source of their income. Second, they claim that the credit method promotes an efficient allocation of investment capital by treating income from foreign and domestic investment equally. The credit method cannot overcome the unequal treatment of comparably situated taxpayers that results from the imposition of taxes in the source country at effective rates above the rate in the residence country. The exemption method, however, also is ineffective in this regard. Some commentators contend that the credit method may be more complicated to administer than the exemption method. That may be true in some respects, but it is not true in all respects. For example, use of the credit method tends to reduce the tax benefits obtained in the source country from transfer pricing abuses and from the improper allocation of deductions, thereby reducing practical complexity.

42. States that wish to use tax incentives to attract foreign investment would prefer that capital exporting States use the exemption method. Although the credit method does not eliminate the benefits of tax concessions in the source State, it may weaken the incentive effects in many cases. Because the credit method tends to reduce the impact of tax incentives on investment decisions, it also tends to reduce harmful tax competition among developing countries. States that doubt the wisdom of using tax concessions to attract foreign investment, therefore, might prefer that capital-exporting States adopt the credit method.

(c) Tax-sparing methods

43. Tax-sparing credits is the practice of a residence State using the credit method of adjusting the taxation of its residents to permit those residents to receive the full benefits of tax concessions provided to them by a source State. It often takes the form of a credit for taxes that would have been paid but for a tax incentive. For example, assume that Company A, a corporation resident in State A, is investing and earning income in State B. State A and State B have entered into a tax-sparing agreement. Company A earns 100 in State B. Under their normal rules, State A and State B impose taxes at a rate of 35 per cent. Thus, Company A normally would owe taxes of 35 to State B. State B, however, has provided Company A with a tax holiday that reduces its taxes to zero. In the absence of the tax-sparing agreement, State A would impose a tax of 35 on Company A, thereby wiping out the benefit to Company A of the tax holiday. Under the tax-sparing agreement, State A may grant Company A a credit for the taxes that would have been paid (that have been spared) but for the tax holiday. In that way, Company A receives the intended benefits of the tax holiday.

44. Most developed countries have provided tax-sparing credits in their tax treaties with developing countries. The list of countries providing tax-sparing credits by treaty includes Canada, France, Germany, Japan and the United Kingdom. In its initial report on harmful tax competition, however, the OECD has expressed some concerns about tax-sparing agreements, due to the possibility that they foster harmful tax competition.[13] The United States of America has opposed tax-sparing for nearly half a century and has never ratified a tax treaty that included a tax-sparing provision.[14] The United States' position is based, in part, on its strong commitment to the principle of capital export neutrality and to the principle that residents with equal taxable incomes should pay equal amounts of tax.

45. Tax-sparing credits is a practice designed to promote the effectiveness of local tax incentives for foreign investment. Developing countries are often willing to provide foreign investors significant fiscal incentives in order to encourage foreign direct investment. It is generally accepted, by developed and developing countries, that investment in productive activities is generally highly beneficial to economic growth and national wealth. As a result, States often find themselves in competition for foreign investment. Tax incentives are one way for a State to conduct that competition. Popular incentives offered by some developing countries include lengthy tax holidays, the allowance of rapid cost-recovery, including expensing of capital investments, and special tax credits for investment. States offering tax concessions to prospective investors want to maximize the potential benefits of those concessions to those investors. Tax-sparing credits is a technique for achieving that goal.

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[13] OECD, Harmful Tax Competition: An Emerging Global Issue (1998). OECD, Tax Sparing: A Reconsideration (1998).

[14] The United States of America and Brazil negotiated a tax treaty in the late 1960s in which the United States agreed to give a special tax credit for certain investment in Brazil. The United States Senate refused to ratify that aspect of the treaty, and it never went into force. Similarly, the United States' tax treaty with Pakistan, which included a tax-sparing credit, was rejected by the Senate.

46. An evaluation of the merits of tax-sparing credits cannot be divorced from an evaluation of the tax incentives that they encourage. Proponents of tax incentives for investment in developing countries contend that the incentives are a cost-effective way of directed investment to countries badly in need of such investment. They also contend that many developing countries have few alternative methods available to them to encourage needed foreign investment. Critics of tax incentives contend that the costs of tax incentives are routinely understated and the benefits overstated. In assessing costs, they note that many countries that have employed incentives to attract foreign investment have been forced by economic and political considerations to extend the incentives to local investment as well, thereby magnifying the costs substantially. They also contend that well-managed businesses — the type that make attractive investment partners for developing countries — base their investment decisions primarily on factors unrelated to tax concessions. Finally, they contend that the overall impact of tax incentives in directing investment to developing countries is probably smaller than generally recognized, due to the widespread availability of self-help tax avoidance through the use of tax havens. For a detailed discussion of the "tax-sparing credits" mechanism, please see pages 265-268 of the *United Nations Model Double Taxation Convention between Developed and Developing Countries* (June 2001).

(d) Implications for developing countries of the various methods for the provision of relief from international double taxation

47. Whatever the merits of tax incentives generally, developing countries that offer tax incentives to attract foreign investment obviously want the benefits of those incentives to go to the prospective foreign investors and not to the State where that investor is a resident. In treaty negotiations, therefore, a developing country is likely to press its prospective treaty partner to provide relief for double taxation in a way that supports rather than undermines the developing country's tax incentive programme. In theory, an exemption system or a credit system with tax sparing could be designed to support a developing country's tax incentive programme. In practice, a developing country is unlikely to have sufficient bargaining power in treaty negotiations to influence the way its prospective treaty partner provides double tax relief. If the developed country generally provides double taxation relief by using the credit method, it almost certainly will insist upon using that method in its treaty with a developing country. Similarly, a developed country that uses the exemption method is highly unlikely to switch to the credit method as a result of its treaty negotiations with a developing country. However, an alternative approach would be to specify the type of income subject to the incentive to demonstrate a particular focus in the negotiations for tax incentives. The only practical issue for negotiation is whether the developed country is willing to tailor its relief mechanism to accommodate the developing country's tax incentive programme.

48. Policy makers in developing countries have somewhat greater freedom to design tax incentives according to their own preferences if the foreign investors that they are hoping to attract are residing in a State employing a full exemption method. For those investors, the only tax that matters is the tax in the source State. Thus, the source State can design its local tax rules to have an extraterritorial impact on investment decisions made in the residence State without fear that its actions will provoke the residence State to take countervailing measures. In contrast, when the residence State is using the credit method with tax sparing, it typically grants the tax sparing credit

only if it has specifically agreed to do so after negotiations with the source State. If the resident State concludes that a particular type of tax concession is unwise or contrary to its national interests, it may decline to give the tax-sparing credit with respect to that concession. Even if it ultimately agrees to give the credit, the process of negotiations may have delayed implementation of a particular tax concession for an extended period of time.

49. The flexibility that an exemption system affords to developing countries comes with significant costs. First, tax incentives may not be effective in attracting foreign investment if they are available everywhere. To attract foreign investment through tax concessions, a developing country must be able to offer the prospective foreign investor a benefit not available in other countries competing for that investment. The freedom that the exemption system gives to a particular developing country, however, is also given to all of the countries with which that country is competing. The likely result is a tax competition that benefits the foreign investor without affecting the location of its investment. Second, many developing countries have so little leverage over prospective foreign investors that they feel compelled to grant whatever tax concessions an investor demands. As a result, the control ceded by the resident State is exercised not by the source State but by the foreign investor. In general, a tax concession designed to satisfy terms set by a residence State will be more cost effective than a concession designed by the foreign investor.

50. One of the objectives of tax treaties is to strengthen the ability of States to impose taxes fairly and effectively on taxpayers engaged in cross-border activities. That purpose is defeated if a method intended to relieve double taxation promotes the elimination of all taxation. The persistent trend towards a global economy is putting pressure on all tax systems, but especially on the tax systems of developing countries. To flourish in the global economy, developing countries need to develop both their private and public sectors. They have a common interest with developed countries, therefore, in promoting measures that prevent multinational corporations from exploiting their market power and their ability to shift investments around the world to avoid a reasonable level of taxation on their profits. It is only through the cooperation of sovereign States that the sovereign power to tax can be protected from the corrosive powers of the marketplace.

B. Historical overview

~~51. The international efforts to deal with the problems of international double taxation, which were begun by the League of Nations and have been pursued in the Organisation for Economic Cooperation and Development and regional forums, as well as in the United Nations, have in general found concrete expression in a series of model bilateral tax conventions. The Fiscal Committee of the League of Nations gave the following rationale for the elaboration of these conventions:~~

~~"The existence of model draft treaties has proved of real use ... in helping to solve many of the technical difficulties which arise in [the negotiation of] tax treaties. This procedure has the dual merit that, on the one hand, in so far as the model constitutes the basis of bilateral agreements, it creates automatically a uniformity of practice and legislation, while, on the other hand, inasmuch as~~

~~it may be modified in any bilateral agreement reached, it is sufficiently elastic to be adapted to the different conditions obtaining in different countries or pairs of countries."~~[15]

~~1. The 1928 Model Bilateral Tax Conventions~~

~~52. In October 1928, the General Meeting of Government Experts on Double Taxation and Tax Evasion convened by the Council of the League of Nations adopted a Bilateral Convention for the Prevention of Double Taxation in the Special Matter of Direct Taxes, together with three other model bilateral conventions dealing respectively with the succession duties, administrative assistance in matters of taxation and judicial assistance in the collection of taxes. The work of the General Meeting was based on draft model conventions prepared by a group of high-level tax officials. Composed of officials from seven European countries when originally established in 1922, the group was enlarged in 1925 to include officials from two more European countries and Japan and from Argentina and Venezuela. The United States of America joined the Group in 1927. The group had prepared only one text, relating to direct taxes, but the General Meeting found it advisable to prepare two new additional draft model conventions on the same matter, because the first draft, intended primarily for Contracting States whose tax systems consisted of impersonal taxes on income from domestic sources and a general income tax on income from all sources, foreign as well as domestic, was felt to be not easily adaptable to the many tax systems based on a single graduated income tax which applied both to income derived by non-residents from domestic sources and to income derived by residents from all sources. The two new texts drew no distinction between impersonal and personal taxes; the first of these texts was to be applied particularly to relations between countries in which taxation by reference to domicile predominated, and the second to relations between countries possessing different fiscal systems.~~

~~53. Although the 1928 model bilateral tax conventions in theory granted considerable taxing power to the source countries, that power was limited in practice by the pattern of international flows of private capital in the era preceding the Great Depression. Most foreign investment in capital-receiving countries at that time took the form of portfolio investment, and under the conventions the income from these investments was taxable in the country of the investors' fiscal domicile, which the conventions defined as the normal residence of the taxpayer. There was relatively little direct investment, which, under the newly formulated concept of permanent establishment, would have been liable, to a large degree, to taxation in the source country.~~

~~2. The 1935 Draft Convention for the Allocation of Business Income between States for the Purposes of Taxation~~

~~54. During sessions held at the end of the 1920s and the beginning of the 1930s, the Fiscal Committee of the League of Nations~~[16] ~~devoted considerable attention to formulating, for tax~~

[15] League of Nations, Report of the Fiscal Committee to the Council on the work of the fifth session of the Committee (C.252.M.124.1935.II.A), p. 4, paragraph II.B.4.

[16] The Fiscal Committee had been set up in 1929 pursuant to a recommendation of the General Meeting of Government Experts on Double Taxation and Tax Evasion.

~~purposes, rules for the allocation of business income of undertakings operating in several countries (the term 'undertakings' being understood as making no distinction between natural and legal persons). A Draft Convention for the Allocation of Business Income between States for the Purposes of Taxation was formulated, first at meetings of a Subcommittee held in New York and Washington D.C. under the auspices of the American Section of the International Chamber of Commerce, and then at the full meeting of the Fiscal Committee in June 1933. The Draft Convention, which was revised by the Fiscal Committee at a session held in June 1935, was never formally adopted, but was of great significance because of the importance of the issues with which it dealt.~~

~~55. The Draft Convention contained a definition of business income which excluded from such income all items of income allocable to specific sources such as dividends and interests; the remaining items of income were grouped together as business income, which was taxable on the basis of the accounts of each permanent establishment from which the income had originated. The underlying purpose of the definition was to assimilate the permanent establishment that an enterprise had in other Contracting States to independent legal entities doing business with each other on the same or similar conditions as with independent enterprises and to permit the determination of the net income of each establishment on the basis of the separate accounts pertaining to such establishment. The Draft Convention authorized the tax authorities of the Contracting States to rectify the accounts produced, notably to correct errors or omissions, or to restate the prices or remunerations entered in the books at the value that would prevail between independent persons dealing at arm's length. If the envisaged rectification could not be effected in that way or if an establishment could not produce an accounting showing its operations, or if the accounting produced did not correspond to the normal usages of the trade in the country where the establishment was situated, the tax authorities might determine business income by applying a percentage to the turnover of that establishment and by comparing the results with those of similar enterprises operating in the country. If the foregoing methods of determination were found to be inapplicable, the net business income of the permanent establishment might be determined by a computation based on the total income derived by the enterprise from the activities in which such establishment might be determined by a computation based on the total income derived by the enterprise from the activities in which such establishment had participated. The determination was made by applying to the total income coefficients based on a comparison of gross receipts, assets, number of hours worked or other appropriate factors, provided such factors were so selected as to ensure results approaching as closely as possible to those that would be reflected by a separate accounting.~~

~~3. The 1943 Mexico Model Bilateral Tax Conventions~~

~~56. At the June 1939 session of the Fiscal Committee of the League of Nations, it was suggested that the three 1928 Model Conventions dealing with direct taxes should be revised in the light of the technical improvements embodied in the various bilateral tax treaties concluded during the 1930s, taking into account the new trends and problems which had arisen in the fields of international trade and investment and the views and recommendations expressed by the Fiscal Committee itself at its various sessions.~~

~~57. The work of revision was begun by a Subcommittee that met at The Hague in April 1940 and continued by two Regional Tax Conferences held under the auspices of the League of Nations at Mexico City in June 1940 and July 1943. The Regional Conferences were attended by representatives of Argentina, Bolivia, Canada, Chile, Colombia, Ecuador, Mexico, Peru, the United States of America, Uruguay and Venezuela. The Second Regional Conference had before it the Draft Model Convention for the Prevention of Double Taxation of Income, which had been prepared by the First Regional Conference, as well as documents submitted by the Secretariat of the League of Nations and various experts on the prevention of double taxation of successions, the establishment of reciprocal cooperation between national tax administrations for the assessment and collection of direct taxes and on post-war fiscal problems. At the conclusion of its deliberations, the Second Regional Conference adopted a Model Bilateral Convention for the Prevention of the Double Taxation of Income and a Protocol thereto, a Model Bilateral Convention for the Prevention of the Double Taxation of Successions and a Protocol thereto, and a Model Bilateral Convention for the Establishment of Reciprocal Administrative Assistance for the Assessment and Collection of Direct Taxes and a Protocol thereto.~~

~~58. The Model Bilateral Convention for the Prevention of the Double Taxation of Income, which was to replace the three 1928 Model Conventions dealing with direct taxes and also incorporate the provisions of the 1935 Draft Convention for the Allocation of Business Income, advocated the taxation of income derived by non-residents almost exclusively at source. Although at the Mexico Conferences Canada aligned its position with those of the Latin American countries, the Mexico Model Bilateral Convention for the Prevention of the Double Taxation of Income has nevertheless been viewed as representing "the first attempt by the developing countries to write a model treaty reflecting their particular problems."[17] However, the positions embodied in the Mexico Model were similar to those taken earlier by the representatives of capital-importing countries at the 1928 General Meeting of Government Experts on Double Taxation and Tax Evasion. At that Meeting, widely divergent views were expressed by the representatives of capital-exporting and capital-importing countries as to whether the source country or the country of residence should be empowered to tax dividends and interest.~~

~~4. The 1946 London Model Bilateral Tax Conventions~~

~~59. In March 1946, the Fiscal Committee of the League of Nations convened in London for its tenth session, at which it reviewed the Mexico Model Bilateral Tax Conventions. The Fiscal Committee was of the opinion that the models represented "a definite improvement on the 1928 Model Conventions", but that "nevertheless, since the membership of the Mexico City and London meetings differed considerably, it was natural that the participants in the London meeting held different views on various points from those which inspired the model conventions prepared in Mexico". The general structure of the model conventions drafted at the tenth session was similar to that of the Mexico models, although a certain number of changes were made in the wording and some articles were suppressed because they contained provisions already contained in other clauses.~~

[17] Manila Conference on the Law of the World, *The Emerging International Tax Code: Report of the Committee on Taxation of the World Association of Lawyers* (August 1977), p. 4.

~~The Committee observed that virtually the only clauses where there was an effective divergence between the views of the 1943 Mexico meeting and those of the London meeting were those "relating to the taxation of interest, dividends, royalties, annuities and pensions." The Committee added that it was aware that the provisions of the 1943 model conventions might appear more attractive to some States, in Latin America for instance, than those which it had agreed to during its current sessions, and that it thought "that the work done both in Mexico and in London could be usefully reviewed and developed by a balanced group of tax administrators and experts from both capital-importing and capital-exporting countries and from economically-advanced and less-advanced countries, when the League work on international tax problems was to be taken over by the United Nations."~~[18]

~~60. With regard to the Fiscal Committee's remarks concerning the taxation of interest, dividends and royalties by the country of source, it is the taxation of such items of income which has always been in dispute. In the case of taxes on business profits and income from immovable property, the primary right of the source country to tax has never been questioned, has been recognized in all model conventions, and has been a constant feature of treaty practice. According to the Committee on Taxation of the World Association of Lawyers at the Manila Conference on the Law of the World, on the occasion of the London meeting, "the capital-exporting countries reasserted themselves, and the London model [Model Bilateral Convention for the Prevention of the Double Taxation of Income and Property] sought to encourage the outflow of capital from industrialized countries into developing countries by limiting taxation to the country where income was ultimately received."~~[19]

~~61. The Fiscal Committee of the League of Nations, which held its tenth session in London from 20 to 26 March 1946, was gratified to note the recommendation of the Preparatory Commission of the United Nations set forth in paragraph 34 of the Report of that Commission in regard to the desirability of establishing a Fiscal Commission of the Social and Economic Council. The recommendation read as follows:~~

> ~~"Fiscal Commission.~~
>
> ~~34. This Commission would make studies and advise the Council on matters related to:~~
> ~~(a) International taxation problems;~~
> ~~(b) Exchange of information among States on the techniques of Government finance and on their social and economic effects;~~
> ~~(c) Fiscal techniques to assist the prevention of depressions or inflation; and~~
> ~~(d) Such functions of the Fiscal Committee of the League of Nations as the United Nations may decide to assume.~~
>
> ~~(a) International tax problems:~~

[18] League of Nations, *Fiscal Committee: Report on the Work of the Tenth Session of the Committee* (C.37.M.37.1946.II.A), p. 8.

[19] Manila Conference on the Law of the World, op. cit., p. 12.

~~These tax problems may be mainly considered under the following headings:~~

~~1. Double taxation of income, estates and successions, property and capital, etc.;~~
~~2. Extraterritorial taxes;~~
~~3. Discriminatory and special taxes on foreigners and on capital invested abroad;~~
~~4. Special taxes on international transactions, such as taxes on the purchase of foreign exchange and remittances abroad;~~
~~5. Taxes on international communications and transport; and~~
~~6. Mutual assistance between national tax administrations in connection with the assessment and collection of taxes, including the prevention of fiscal evasion."~~[20]

~~62. The tax experts who have met under the auspices of the League of Nations since 1923 have considered most of these problems in their major aspects and the Model Conventions which they drafted have exercised an influence as previously indicated, especially in the field of the prevention of international double taxation and fiscal evasion, by facilitating the conclusion of numerous bilateral tax treaties. Much remains to be done, however, especially on account of the constant increase of tax burdens and also with a view to assisting the desired revival of international trade and investment. Indeed, efforts to remove these obstacles on international economic intercourse which result from tariffs, preferences and other restrictive trade practices can be largely frustrated through the operation of tax laws.~~

~~63. The Fiscal Committee therefore desires to emphasize its belief that further studies should be made with a view to solving these tax problems in the interest of world rehabilitation. The importance of international tax problems is illustrated by the fact that, since the beginning of the 1920s, well over sixty general treaties have been concluded for the prevention of double taxation and that nearly 250 special agreements on various international tax matters were signed, not counting the treaties of friendship and establishment, the commercial treaties and other international instruments that contain incidental clauses on tax matters.~~

~~64. The Committee wishes to draw attention to the fact that, among the topics relating more especially to the prevention of international double taxation, there are two which seem to require prompt consideration. First, it is desirable to arrive at a comprehensive set of rules regarding the determination and allocation of taxable income in the case of business enterprises carrying on their activities in more than one country. The provisions suggested by the Fiscal Committee for that sound purpose embody principles that are generally recognized as sound. These principles may, however, require some elaboration as regards the manner in which they should be applied to the various types of enterprises. Second, there persists a difference of opinion between capital-importing and capital-exporting countries as regards the taxation of interest and dividends. Such divergences might be more easily reconciled in the negotiation of tax treaties if studies were undertaken of the various legal, administrative and economic aspects of this problem.~~

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[20] League of Nations: *Fiscal Committee: Report on the Work of the Tenth Session of the Committee held in London from March 20 to 26, 1946.* (Geneva, April 25, 1946) Official No. C.37.M.37.1946.II.A.

65. ~~The structure and incidence of a country's tax system have a direct influence on the capacity and willingness of domestic concerns to do business abroad as well as on the ability of the country to attract foreign capital and enterprises. It would be difficult to remove the obstacles which taxation may oppose to international trade and investment without determining the manner in which the different types of taxes, considered separately and together, can be adapted to the social and economic conditions of the various countries."~~ .

5. OECD Model Bilateral Tax Conventions

66. Like the 1928 model bilateral conventions, which never won wide acceptance, the model conventions of Mexico and London were never fully accepted. However, the principles contained therein were followed with certain variants in numerous bilateral tax treaties between developed countries until the Organisation for European Economic Cooperation (OEEC, which subsequently became the OECD) created its Fiscal Committee in 1956 and entrusted it with the task of working out a draft model bilateral tax convention "which would effectively resolve the double taxation problems existing between OECD member countries and which would be acceptable to all member countries."[21] The need for a new draft bilateral tax convention on income and capital which would facilitate the extension of the network of bilateral tax treaties to all member countries of OEEC arose from the fact that the Mexico Model Bilateral Convention for the Prevention of the Double Taxation of Income and Property presented in respect of several essential questions "considerable dissimilarities and certain gaps." It arose more particularly from "the increasing economic interdependence of the member countries of OEEC in the post-war period, and the economic cooperation established among them showed increasingly clearly the importance of measures for preventing international double taxation."[22]

67. The Fiscal Committee used as its main reference text the London Model Bilateral Convention for the Prevention of the Double Taxation of Income and Property and revised it extensively taking into account practices embodied in bilateral tax treaties which had been negotiated on the basis of that model convention. Originally published in 1963, the OECD Model Double Taxation Convention on Income and Capital was revised from 1967 onwards and was published in its revised form in 1977. Revisions continued thereafter, and a new model was published in 1992, again to be revised in 1994, 1995, 1997 and 2000.[23]

68. The OECD Model Double Taxation Convention on Income and on Capital rests essentially on two premises: (a) the country of residence would eliminate double taxation through the credit method or the exemption method; and (b) the country of source, in response, would considerably restrict the scope of its jurisdiction to tax at source and reduce the rates of tax where jurisdiction was retained.

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[21] Organisation for Economic Cooperation and Development, *Model Double Taxation Convention on Income and on Capital, Report of the Committee on Fiscal Affairs* (Paris, 1977), p. 8..

[22] Ibid., p. 7.

[23] OECD Committee on Fiscal Affairs, *Model Tax Convention on Income and on Capital* (Paris, 1992 and periodic supplements).

69. Recognizing that the effort to eliminate double taxation between Member countries' needs to go beyond the field of periodic taxes on income and capital, OECD in July 1963 instructed its Fiscal Committee to work out a draft convention which would provide a means of settling on a uniform basis the most common problems of double taxation of estates and inheritances. The Draft Convention for the Avoidance of Double Taxation with Respect to Taxes on Estates and Inheritances was published in 1966.

6. United Nations Model Double Taxation Convention between Developed and Developing Countries

70. The United Nations in 1980 published the *United Nations Model Double Taxation Convention between Developed and Developing Countries*[24] (UN Model Convention). During its Eighth Meeting, the Ad Hoc Group of Experts on International Cooperation in Tax Matters (Group of Experts) established a Focus Group to revise and update the UN Model Convention in view of the significant changes which had taken place in the international economic, financial and fiscal environment since 1980. The Focus Group in its meetings in New York in December 1998 and Amsterdam in March 1999 discussed the comments and suggestions of the members of the Group of Experts on the articles and commentaries of the UN Model Convention, and presented a draft revised UN Model Convention before the Ninth Meeting of the Group of Experts held in New York in May 1999. The Group of Experts adopted the revised version of the UN Model Convention, subject to editorial changes of a non-substantive nature. The comments and suggestions of members of the Group of Experts on these editorial changes were examined by the Steering Committee in its meeting held in New York in April 2000, and the final text of the UN Model Convention was adopted on a consensual basis by the Steering Committee. After being approved by the members of the Group of Experts, the final version of the *United Nations Model Double Taxation Convention between Developed and Developing Countries* was published by the United Nations in 2001.

[24] United Nations publication: ST/ESA/102: Sales No. E.80.XVI.3.

II. INTERNATIONAL TAX EVASION AND AVOIDANCE

A. Concepts and issues

71. Various features of the globalized economy have enabled an increasing number of individuals and companies to resort to tax evasion or tax avoidance. These features include the ease and rapidity of communications, the progressive elimination of obstacles to the movement of persons and property, the expansion of international economic relations, the differences in national tax systems and hence in the tax burden from country to country, and the growing sophistication and aggressiveness of taxpayers and their advisers in developing legal and illegal techniques for taking advantage of weaknesses in national tax systems.

1. The concepts of tax evasion and tax avoidance

72. The terms "tax evasion" and "tax avoidance" have not always been used precisely or with a uniform meaning.[25] Strictly speaking, tax evasion is considered to consist of wilful and conscious non-compliance with the laws of a taxing jurisdiction. Tax evasion is an action by which a taxpayer tries to escape legal obligations by fraudulent or other illegal means. The illegal conduct might involve simply failing to report income or fabricating deductions, or it may involve highly sophisticated tax planning that is premised on false or intentionally deceptive representations to the tax authorities. Tax evasion may arise as a result of a failure to properly report income that is legally earned. It may also result from the evasion of tax on income that arises from illegal activities, such as smuggling, drug trafficking, and money-laundering. In a broader sense, tax evasion may encompass a reckless or negligent failure to pay taxes legally due, even if there is no deliberate concealment of income or relevant information.

73. Tax avoidance, in contrast, involves the attempt to reduce the amount of taxes otherwise owed by employing legal means.[26] However, the borderline between evasion and avoidance in specific cases may be difficult to define. For one thing, the criminal laws of countries differ, so that behaviour that is criminal under the laws of one country may not be criminal under the laws of another.[27] In addition, the definitions of civil and criminal tax fraud may overlap, so that it is within administrative discretion whether or not to pursue a criminal fraud case in a specific instance. In reality, there is a continuum of behaviour, ranging from criminal fraud on one extreme, to civil fraud, to tax avoidance that is not fraudulent but which runs afoul of judicial or statutory anti-avoidance

[25] Part of the problem is a linguistic one. In English, "tax evasion" is synonymous with tax fraud, and means criminal activity. In French, "evasion" means avoidance. Tax evasion should therefore be translated into French as "fraude fiscal". Even within the same language, the term "tax evasion" has sometimes been used with a different meaning. For example, section 482 of the United States Internal Revenue Service Code refers to allocation of income that "is necessary to prevent evasion of taxes," but the intended concept is one of avoidance.

[26] Black's Law Dictionary (Fifth Edition) has defined 'tax avoidance' as: "The minimization of one's tax liability by taking advantage of legally available tax planning opportunities. Tax avoidance may be contrasted with tax evasion, which entails the reduction of tax liability by using illegal means".

[27] While most countries define criminal tax fraud fairly broadly, there are some exceptions. For example, Switzerland has a narrow concept of "tax fraud", which is an offence subject to imprisonment, defining it as the use of "forged, falsified or substantially incorrect documents". See Direct Federal Tax Law, art. 186.

rules and therefore does not succeed in minimizing tax according to law, and finally to tax-planning behaviour which is successful in legal tax reduction. The compound expression "tax avoidance and evasion" is therefore often used to encompass a whole range of activity along this spectrum.

74. Courts in most countries have consistently recognized the right of taxpayers to avoid taxes by means that are within the law.[28] However, courts in many countries have also found that the tax laws should be interpreted so as to prevent their avoidance by the use of transactions that have no business purpose, although there is considerable variety in the approaches of courts in different countries.[29] Tax laws also typically include a variety of specific or general anti-avoidance rules. Tax avoidance is a less precise concept than tax evasion, as the discussion above suggests. Put very broadly, tax avoidance may be considered to occur when persons arrange their affairs in such a way as to take advantage of weaknesses or ambiguities in the law to reduce taxes, without actually breaking the law. Although tax avoidance may be regarded as immoral in some circumstances, the means employed are legal and not fraudulent.

75. Depending on the existence of judicial or statutory anti-avoidance rules, tax avoidance may or may not be successful if a case is audited and litigated. However, to apply anti-avoidance rules, the tax authorities typically must (1) discover the relevant transaction in a tax audit, and (2) obtain and analyse the information necessary to apply the anti-avoidance rules. This may be difficult in a cross-border situation where information is located abroad.

76. Globalization and the removal of impediments to the free movement of capital and exchange controls have promoted sustainable economic development. However, they have also increased the scope for tax avoidance and evasion with consequential substantial loss of revenue. International tax avoidance and tax evasion cause many problems. Governments lose significant amounts of revenue

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[28] In the United Kingdom the classic statement of this principle was made by Lord Tomlin in *IRC vs. Duke of Westminster* [1936] AC: "Every man is entitled, if he can, to order his affairs so that tax attaching under the appropriate Acts is less than it would otherwise be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax."

For the United States of America, see *Helvering vs. Gregory*, 69 F 2d 809, 810 (2nd Cir. 1934): "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes" (per Learned Hand, J.).

For Belgium, see Judgment of February 27, 1987, Cour de Cassation, 1987 Pas. Be. 1, No. 387, at 777 (taxpayer allowed to choose "the lesser taxed way").

[29] For example, in the United Kingdom, the leading case of the modern era is *WT Ramsay Ltd. vs. CIR* [1981] 1 All ER 449, where the House of Lords held that, where there is a composite transaction, the court is entitled to determine the tax liability by looking at the end result rather than the individual steps in the transaction. The effect of *Ramsay* has been clarified in subsequent cases, most recently in *McNiven vs. Westmoreland Investments Limited* [2001] STC 237, in the House of Lords in February 200. Lord Nicholls' opinion in *McNiven* stated that *Ramsay* made three points: "First, when it is sought to attach a tax consequence to a transaction, the task of the courts is to ascertain the legal nature of the transaction. If that emerges from a series or combination of transactions, intended to operate as such, it is that series or combination which may be regarded…. Second, this is not to treat a transaction, or any step in a transaction, as though it were a 'sham'…. Nor is this to go behind a transaction for some supposed underlying substance. What this does is to enable the court to look at a document or transaction in the context to which it properly belongs…. Third, having identified the legal nature of the transaction, the courts must then relate this to the language of the statute."

and hence the honest taxpayers who do not escape their liability to pay tax must bear an additional burden to plug the gap. Countries where the tax compliance is the highest lose out, since the trade flows are diverted elsewhere.

(a) International cooperation

77. Tax authorities in the Member States of the OECD have responded to concerns about avoidance and evasion by taking on new powers to collect information from taxpayers. Delegates to the Working Party on Tax Avoidance and Evasion systematically inform other countries about the means at their disposal for countering avoidance. These reports cover legislation, court decisions and audit techniques. It is through this exchange of experiences that the Committee is able to develop and promote the adoption of practices that should enable tax authorities to administer their tax laws in an effective and equitable manner. An example of the results of such discussions is the OECD recommendation on the use and disclosure of Tax Identification Numbers (TINs) to increase compliance on cross-border income flows.

78. Ways of increasing compliance in cross-border financial transactions and on access to bank information for tax purposes are the focus of current work. Additional work will also be carried out to identify and address other barriers to the identification of beneficial ownership and exchange of such information.

79. The Committee has promoted exchange of information between tax authorities as the best way of fighting non-compliance in transactions across borders. For this reason, the OECD Model Convention contains an article on exchange of information. Current work to improve exchange of information includes looking not only at barriers to effective exchange of information but also at how better use of the latest information technology can help. OECD countries have adopted a standard magnetic format for exchange of information. The Working Party is also considering how technology can be used to improve and expedite procedures for the certification of residence for purposes of granting treaty benefits. A pilot study on the exchange of TINs is being conducted. The Committee is also exploring the relationship between money-laundering and tax-related crimes. In particular, it is examining how tax authorities can obtain access to information gathered by anti-money laundering authorities both to pursue tax offences as well as to exchange that information with foreign tax authorities.

80. A major objective of bilateral tax treaties, apart from avoidance of double taxation, is to prevent tax avoidance and evasion and to ensure that treaty benefits flow only to the intended recipients. Bilateral tax treaties achieve this objective in several ways. Firstly, they provide for exchange of information between the tax authorities of the Contracting States. Secondly, they contain provisions designed to ensure that treaty benefits are limited to *bona fide* residents of the other treaty country and not to treaty shoppers. Under the tax treaties, the competent authorities are authorized to exchange information, as may be necessary for the proper administration of the countries' tax laws. The information that is exchanged may be used for a variety of purposes. For example, the information may be used to identify unreported income or to investigate a transfer pricing case. If a country has bank secrecy rules that prevent or seriously inhibit the exchange of

information under the tax treaty, it may not be desirable to conclude a bilateral tax treaty with it. In fact, it is necessary to first discuss the issue of information exchange with the other Contracting State before beginning formal negotiations, because it is one of the very few issues that should be considered as non-negotiable. This may even prevent a country from entering into treaties with some countries with which it may have significant economic ties, but this may be treated as the right policy.

81. Recent technological developments which facilitate international, thus anonymous, communications, and commercial and financial activities can also encourage illegal activities.[30] Over the past several years there has been a marked change, as many of the industrialized nations have recognized the importance of exchange of tax information; the absence thereof serves to encourage not only tax avoidance and evasion but also criminal tax fraud, money-laundering, illegal drug trafficking, and other criminal activity.

(b) Tax planning and treaty shopping

82. Another aspect of the bilateral tax treaty policy to deal with tax avoidance and evasion is to include in all treaties comprehensive provisions designed to prevent "treaty shopping". This abuse of the treaty can take a number of forms, but it generally involves a resident of a third state C that has either no treaty with the country A or a relatively unfavourable one, establishing an entity in a treaty partner B that has a relatively favourable treaty with the country A. This entity is used to hold title to the person's investments in country A, which could range from portfolio stock investments to major direct investments or other treaty-favoured assets in country A. By placing the investment in the treaty partner, the resident of country C is able to withdraw returns from the country A investments subject to the favourable rates provided in the tax treaty with country B, rather than the higher rate that would be imposed if the person had invested directly into the country A. Of course, the tax imposed by the treaty partner on the intermediate entity must be relatively low, or the structure will not produce tax savings that justify the added transaction costs.

83. Bilateral tax treaties should endeavour to give benefits to the residents of the Contracting States alone. Treaty shopping represents an abusive attempt to siphon off benefits to others. Moreover, if treaty shopping is allowed to occur, then there is less incentive for the third country, with which the country has no treaty, to negotiate a treaty with it. The third country can maintain inappropriate barriers to the first country investment and trade, and yet its companies can obtain the benefits of lower first country tax by organizing its first country transactions so that they flow through a country with a favourable first country treaty. Every country should develop anti-treaty-shopping provisions and encourage other countries to adopt similar provisions that limit the benefits

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The Interamerican Center of Tax Administrations has a Model of Exchange of Information developed in 2001 which has some differences and similarities with the OECD Model. This Model has been taken as reference for some CIAT member countries. i.e. Argentina and Brazil signed an agreetment in 2005 based on this Model.

[30] United States Treasury International Tax Counsel Mr. Philip R. West's testimony before the Senate Committee on Foreign Relations (October 27, 1999).

of the treaty to *bona fide* residents of the treaty partner. These provisions cannot be uniform, as each country has its own characteristics that make it more or less inviting to treaty shopping in particular ways. Consequently, each provision must to some extent be tailored to fit the facts and circumstances of the treaty partners' internal laws and practices. Moreover, the provisions need to strike a balance that avoids interfering with legitimate and desirable economic activity.

84. In addition to the treaty-shopping abuses, there are an increasing number of other types of transactions that seek to use treaties to achieve inappropriate results. Anti-abuse rules are generally complementary to the anti-treaty-shopping rules. Anti-treaty-shopping rules take the broad approach of denying all treaty benefits to persons who are not *bona fide* residents of the treaty country. Anti-abuse rules are more targeted in the sense that they are not blanket exclusions from all treaty benefits; they deny specific treaty benefits in abuse cases. It is relevant to mention that the last paragraphs of the commentaries on articles 10, 11, 12 and 21 in the United Nations Model Double Taxation Convention between Developed and Developing Countries refer to the artificial devices entered into by persons to take advantage of the provisions of those articles through creation or assignment of rights in respect of the income specified in those articles. Contracting States which may wish to specifically address the issue are advised to include the specified clause in their bilateral tax treaties.

85. It is necessary to include anti-abuse rules in bilateral tax treaties in view of several concurrent developments in international tax law. Firstly, although an overwhelming majority of taxpayers who avail themselves of treaty benefits are entitled to those benefits and are not engaged in abusive transactions, aggressive abuse of treaties has increased. It is relevant to point out that both the commentary to Article 1 of the OECD Model Tax Treaty and the OECD Report on Harmful Tax Competition make clear that countries can impose their domestic anti-abuse rules to claims for treaty benefits. In fact, concerns about the adequacy of current treaty rules to prevent abuses have stimulated work in the OECD on this subject.

86. The increase in treaty abuses has unfortunate results for both the treasury of the country and the taxpayers; it requires the treasury to divert resources to fighting abuse that it might otherwise devote to improving the treaty network. The emergence internationally of anti-abuse rules addresses the abuse problem, while at the same time frees up the treasury resources to provide greater benefits to the taxpayers. Most bilateral tax treaties contain only benefits for taxpayers and no provisions that increase tax burdens. As such, it is appropriate to impose reasonable limits on those benefits to curb abusive transactions that may be developed in the future.

(c) Tax avoidance through low-tax jurisdictions

87. In the most general terms, a low-tax jurisdiction can be defined as a jurisdiction which imposes little or no tax on companies, trusts or other entities organized there. By forming a company in such a jurisdiction and arranging for that company to derive income from third countries, a multinational enterprise may be able to shelter income from taxation both at the source and in its residence country. By forming a holding company or a trust in a tax haven, an individual or institution may similarly be able to shelter investment income from taxation. The OECD has

distinguished between two types of low-tax jurisdictions – those that simply offer a low-tax environment and those it has identified as "non-cooperative jurisdictions". The OECD has sought to combat the threat of non-cooperative jurisdictions to the legitimate tax-policy objectives of its Member States by putting economic pressure on those jurisdictions to cooperate in the prevention of tax fraud and evasion.

88. Non-cooperative jurisdictions may also be defined as jurisdictions which do not participate in effective exchange of tax information between tax authorities. A lack of effective exchange of tax information may occur where bank secrecy or other laws prohibit the disclosure of information concerning financial transactions carried out in the country, or where there is inadequate information available regarding the beneficial ownership of accounts, financial instruments and other assets held in the country. The likelihood of international tax avoidance utilizing non-cooperative jurisdictions is increased in situations where non-cooperative jurisdictions have lower or no tax on one or more types of income earned by non-resident individuals and corporate entities. By way of example, a multinational enterprise may be able to shelter income from taxation both at source and in its residence country by forming a company in a non-cooperative jurisdiction which has lower or no tax on relevant income. Similarly, an individual may be able to shelter income by forming a holding company or trust in a non-cooperative jurisdiction which has lower or no tax on relevant income. Examples of both tax avoidance and evasion follow.

(i) Practices resorted to in order to reduce taxes imposed on international income

89. These practices, generally speaking, fall into four categories: a) practices resorted to in order to reduce income taxes imposed by the country of residence or citizenship; b) practices resorted to in order to evade or avoid taxes imposed by the country of source; c) institutional devices and arrangements that facilitate the evasion or avoidance of taxes imposed on international income; and d) the use of related tax-haven entities to reduce such taxes.

a. Practices resorted to in order to reduce taxes imposed by the country of residence or citizenship

90. Many countries impose taxes on income received from abroad by residents or non-resident citizens. The practices resorted to in order to reduce payment of these taxes include the following:

a. Failure to file a return

91. One of the most common practices resorted to in order to reduce payment of taxes on international income consists in the deliberate failure of resident aliens to file tax returns in the country in which they are residing. Persons who spend a portion of each year in each of two or more jurisdictions often make inconsistent claims of residence. When a country taxes the worldwide income of its citizens, a citizen who is residing abroad may fail to file a return in the country of his citizenship.

a. Failure to report all income subject to tax

92. Another important practice in this category is the wilful or negligent failure to report all items of international income that are subject to tax. The items most often omitted are salaries, wages and non-commercial income, interest and dividends, business income, income from real estate, gains on the disposition of property and royalties.

Salaries, wages and non-commercial income

93. Persons receiving remuneration from abroad in payment for services or in the form of pensions and annuities frequently fail to report this income in tax returns to their country of residence. Consequently, such income, if not taxed at the source, is apt to escape taxation both in the country where it is acquired and in the country in which the recipient is resident.

Interest and dividends

94. In the view of many tax administrators, tax evasion or avoidance is probably most prevalent in connection with this type of income, since interest and dividends can easily be collected anonymously at a financial institution in a third country where the securities are held in custody. This type of income also lends itself to many fraudulent practices through the skilful use of certain special provisions of domestic laws. Thus, certain institutions whose prime purpose is economic or financial are frequently used to facilitate tax evasion or avoidance.

95. Investment trusts and holding companies are of particular concern in this connection. The anonymity of the owners of the securities held by an investment trust is normally assured by the form of their holdings in the trust and also by the fact that often the trust has no tax liability or obligation to report information to the tax administration of the country where it is established. Where the trust is not itself a taxable entity, it pays no tax on profits from its dealings or on income. The owners of the securities who are the true recipients of the profits and income may not be subjected to personal taxation, if the tax administration is not aware of their identity. That identity may be concealed, for example, by holding the securities in bearer form or, if registered, in the name of nominees. As for holding companies, the preferential tax regime applied to them in some countries likewise encourages the creation of legal structures, which may facilitate tax evasion or avoidance with respect to the income from holdings in companies anywhere in the world. As in the case of investment trusts, this situation results first from the fact that no tax, or very little, may be payable by the holding company in respect of the income which it receives and redistributes, and second from the lack of information as to the identity of the individuals or companies receiving distributions of profits from the holding companies.

Business income

96. Taxes on business income are reduced at times by means of deliberate failure to keep accurate books and records within the taxing jurisdiction. A second set of books, which is accurate, may be maintained outside the taxing jurisdiction, and beyond the reach of the authorities of that country. In some instances, the maintenance of false books within the taxing jurisdiction is

facilitated by limitations in domestic law on the extent to which the taxpayer's books and records may be examined by the tax authorities. With the advent of electronic bookkeeping, it may be easier to keep two sets of paper records or to falsify paper records, since a computer keeps a record of all changes made to a file. Those changes can in many cases provide an audit trail that is much harder to destroy than physical documents.

97. Business profits properly allocable to the source country may be shifted to other countries by such devices as the establishment of artificial transfer prices for imports and exports, the improper allocation of costs, and licensing agreements under which the user of technology is obliged to purchase imported inputs, equipment and spare parts at inflated prices. Such devices, which transnational corporations are particularly well situated to use, are of great concern to developing countries, whose tax officials often lack the time and expertise to challenge effectively the prices set between affiliated companies.

Thin capitalization

98. Many countries allow corporations to take a deduction for interest expenses but do not allow a deduction for the payment of dividends. This differential treatment of interest and dividends creates a bias in favour of debt finance over equity finance. The bias is particularly strong when the dividends or interest would be paid to an affiliated company. For example, if Company P owns all the stock of Company S, it is generally indifferent, aside from tax considerations, as to whether it receives dividends of interest payments from Company S. To prevent corporate taxpayers from distributing their profits to their parent corporation mostly in the form of deductible interest, many countries have adopted so-called "thin capitalization" rules. Under these rules, a corporation that has what is deemed to be an excessive amount of debt capital will be prevented from taking a deduction for payments made with respect to that excessive debt capital. The amount of debt capital of a corporation typically would be characterized as excessive if the ratio of debt to equity exceeded some number. For example, if the debt:equity ratio for a corporation exceeded 2:1, the interest payments on the excess debt might be classified for tax purposes as a non-deductible dividend. Many countries would use a high debt:equity ratio as an indicator of thin capitalization, but would look at all the facts and circumstances of the particular case before characterizing an interest payment as a dividend for tax purposes.

Income from real estate

99. If a resident of one country owns real property in another country, this person may fail to report rents (and amounts that may be assimilated to rent) as income in the country of his fiscal domicile or residence. Such income may also escape taxation in the country in which the property is situated if the tax authorities are not aware of the identity and domicile of the recipient.

Royalties

100. Royalties paid abroad for the use of or the right to use patents, trademarks, know-how or other intangible property may be used to shift profits out of high-tax countries into low-tax or into

no-tax countries by fixing the royalties at artificially high rates. Such devices are facilitated by difficulties in estimating the arm's length value of monopoly rights. In addition, multinational firms may transfer intangible property to an affiliated corporation under conditions that would not occur between unrelated persons. For example, a multinational corporation might transfer highly profitable know-how that it would never share with an unrelated person to a corporation organized in a tax haven simply for the purpose of generating a deduction in the country where the intangible property is located.

Technical assistance

101. Affiliated corporations may charge improper technical fees as a way of minimizing taxes for the corporate group. In some cases, they may set the fees too high. For example, a corporation engaged in business in a country may pay an excessive technical assistance fee to a related corporation located in a low-tax jurisdiction in order to take an excessive deduction. The source country may have difficulty determining a proper price for technical assistance because those services tend to be unique and difficult to value. In other cases, a corporate group may set the technical assistance fees too low. For example, a foreign corporation making sales of goods into a country may provide technical assistance in conjunction with those sales. Under its tax treaty, the sales income would be exempt if the foreign corporation has no permanent establishment in the country, whereas the fees for technical assistance may be the subject to a withholding tax. To minimize the withholding tax, the foreign corporation may claim that the technical assistance has little value.

iii. Fictitious deductions

102. In a variety of circumstances, a taxpayer may claim fictitious or inflated business expenses as deductions. In employing this tactic, the taxpayer may claim that the purported payment was made to a person located outside the taxing jurisdiction, thereby making an audit of the expenses difficult for the tax authorities. For example, if the taxpayer purchases goods outside the taxing jurisdiction, false invoices may be prepared to show a purchase price greater than the actual amount paid by the taxpayer.

103. Payments characterized as commissions, royalties, technical service fees and similar expenses are sometimes paid by a resident of the taxing jurisdiction to a related non-resident and claimed as a deduction, even though the related non-resident has done nothing to earn these payments.

iv. Credit for fictitious tax

104. A taxpayer who resides in a country that allows a foreign tax credit as a method of relieving double taxation and receives income from another country may seek to reduce tax in the residence country by claiming fictitious or excessive credits for taxes allegedly paid to the other country.

v. Improper characterization of income or expense items

105. Tax may be reduced by improperly characterizing an income or expense item in order to make use of an exemption or reduced rate.

vi. Inconsistent characterizations

106. A taxpayer may characterize a particular transaction in one way in country A, and in a contrary way in country B, in order to obtain tax benefits in both countries. For example, advances by a parent in country A to a subsidiary in country B may be treated as equity in country A (in order to avoid the necessity for reporting interest income to country A), but as debt in country B (in order to avoid capital stock taxes in country B). Payments made by a subsidiary in country A to its parent in country B may be treated as the purchase price of goods in country A but as royalties or dividends in country B. In some cases, however, inconsistencies of this type may be justified by differences in the internal laws of the two jurisdictions.

vii. Utilizing temporary taxpayer status

107. Where taxation is based on a temporary status, tax evasion or avoidance may occur through transactions that take advantage of that temporary status. For example, because a borrower is not liable to tax on the proceeds of a loan, a foreign national may arrange an ostensible loan while he is a resident of the taxing jurisdiction, and then sell the collateral for the alleged loan to the lender following his departure from the taxing jurisdiction (when he is no longer taxable on sales profit within that jurisdiction), with the "loan" being credited against the sale price.

viii. Flight to evade payment of tax

108. When a taxing jurisdiction determines that a resident alien has taxable income or assesses a tax against him, the individual may flee the jurisdiction to escape tax. Even though the authorities of the taxing jurisdiction have properly assessed the tax, it is collectible only to the extent of the taxpayer's property within the reach of the administrative and judicial collection power. Generally, that power is limited to the taxing country and its possessions. Thus, when property is removed from the taxing jurisdiction, a tax department may be unable to levy against it because the courts of one country generally will not enforce a judgement for taxes rendered by the courts of another country in the absence of a treaty that provides for mutual assistance in collection.

ix. Improper allocation of expenses

109. When a foreign corporation operates both within and without a country, it often must allocate certain expenses between its branch operations within the country. In some cases, the allocation rule to apply is quite obvious. For example, if Company P has a branch in country B and makes sales in that country through its branch, the expenses associated with the sale should be allocated to the branch. In many other cases, however, the proper allocation rule is less obvious. For example, it is not obvious how the interest expenses of a corporation should be allocated between a domestic and foreign branch. Other expenses creating problems of allocation include head office expenses, certain legal fees, deductible charitable contributions and certain taxes.

b. Practices resorted to in order to evade or avoid taxes imposed by the country of source

110. Tax on non-business income derived from sources within the taxing country by non-residents is generally collected by requiring the payer of the income to withhold the tax before remitting the balance of the payment to the non-resident. There are a number of common techniques for evading the payment of these withholding taxes.

i. False withholding certificates

111. Tax may be evaded by providing false information to withholding agents. For example, a payer of dividends having no definite knowledge of the status of a shareholder may not be required to withhold tax if, under the laws of the taxing country, dividend payments to resident shareholders are not subject to withholding. Accordingly, a non-resident alien recipient may establish a false address within the country, in order to escape withholding. This method of evasion depends on the willingness of the nominee to violate the law by failing to withhold tax when he makes remittances to the true owner outside the country.

ii. Use of bearer securities

112. In many instances, withholding taxes can be avoided by holding securities in bearer form, particularly if they are in the custody of a broker, nominee or agent within the country of the issuing corporation. Again, this method of avoidance assumes that the person holding the bearer securities is prepared to violate the law by failing to withhold when remittances are made to the true owner.

iii. Erroneous characterization of income items

113. Where the withholding rates on certain types of income are lower than the rates on other types of income, related entities may disguise the true character of a payment in order to take advantage of the lower rate. For example, dividends may be paid in the guise of fees or commissions.

iv. Unreported income and fictitious expenses

114. An individual who is temporarily present in the taxing jurisdiction, but is neither a resident nor a citizen, may evade tax on income earned while he was in the jurisdiction by either understating income or overstating expenses.

c. Institutional devices and arrangements that facilitate evasion

115. A variety of institutional devices are used to conceal the existence of international income or to generate fictitious deductions thereby facilitating international income tax evasion.

i. Dummies, nominees and numbered bank accounts

116. Salaries, investment income, business profits and other items of international income are frequently concealed by having these items paid to dummies, nominees or numbered bank accounts inside or outside the taxing jurisdiction. For example, an official of country A may state that he will permit a subsidiary in country A to make certain remittances to its parent in country B only if the parent makes an unreported payment in funds of country B to a nominee of the official (or a numbered bank account maintained by him) in country B or C. Similarly, a resident of country D who sells property at a gain to a resident of country E may stipulate that the sales proceeds are to be deposited in a numbered bank account inside or outside country D.

117. Once an item of international income has been concealed in a numbered bank account or in the name of a nominee, the concealed amount can be used to generate investment income, which may likewise be concealed from the taxing authorities of the country in which the true owner of the account is residing.

ii. Bearer securities

118. In order to conceal the receipt of dividend or interest income, international investors frequently place investments in bearer form. The use of bearer securities also facilitates the transfer of investments from one owner to another without reporting the transaction and paying the tax due by reason of the transfer. It is difficult to police such transactions from a tax standpoint because the use of bearer securities is widespread and entirely legal in many countries.

iii. Foreign holding companies and trusts

119. Under the laws of some countries, a resident may legally avoid tax by placing income producing property in a foreign corporation or trust which he controls. However, under the laws of other countries, the investment income is taxable by the country of residence whether or not it is actually distributed by the foreign corporation or trust to the resident owner. In cases of the latter type, tax is frequently evaded by illegally concealing the existence of the foreign holding company or trust from the tax authorities of the country or residence.

iv. Artificial bank loans

120. A major technique for international tax evasion consists of purportedly borrowing funds that are actually owned by the borrower. This practice not only enables the “borrower” to make open use of funds previously concealed in the name of a nominee or in a numbered bank account, but it also gives the borrower a pretext for claiming fictitious interest deductions. For example, a resident of country A who has deposited unreported international income in a numbered bank account in country B arranges to “borrow” an equivalent amount from that bank at 82 per cent interest. If the bank is paying 8 per cent interest to him on his numbered account, he is actually out of pocket only 2 per cent, but on the return which he files in country A he will treat the receipt of the unreported income as a “loan” and will claim a deduction for the entire 82 per cent interest charge that he pays to the bank.

121. To further disguise the true facts, a resident of country A with a numbered bank account in country B may arrange to have the bank in country B forward funds to an unrelated bank in country C from which he will then "borrow" an equivalent amount.

v. Investment trusts

122. An international investment trust, by concentrating funds from many different sources in a single investment pool, may be utilized by numerous investors as a tool for tax evasion. In many cases, an international investment trust will be used to obtain tax treaty benefits for its investors without the tax authorities in their country of residence learning about the income.

d. Use of related tax-haven entities to reduce taxes

123. Taxpayers sometimes utilize entities organized in tax-haven countries to reduce taxes legally, the legality of the transactions depending on the laws of the country where taxpayers are located. The presence of tax-haven countries, however, invites tax evasion activities that initiate essentially false or illegal relationships with the tax-haven country. Some of the latter situations are described below.

i. Transfer of income-producing assets to a tax-haven entity

124. Tax is sometimes avoided or evaded by transferring income-producing assets at an artificially low cost from the taxing jurisdiction to a controlled entity in a foreign tax-haven country where income from the assets will be taxed at a lower rate or escape tax entirely. The assets transferred to the foreign tax-haven company may consist of:

- Stocks, securities, rental properties, and intangibles such as licensed patents, trademarks and copyrights that will generate passive income; or
- Property of any kind which will be resold by the tax-haven entity to unrelated third parties at a gain.

In many cases, there is no limitation on the amount of income which may be accumulated tax free in the foreign tax-haven entity.

ii. Nominal transfer of income-producing functions to a tax-haven entity

125. An entity in a high-tax country may avoid or evade tax in that country by rendering, or appearing to render services to unrelated persons through a controlled entity in a tax-haven jurisdiction. In the typical case, the controlled entity is a shell corporation that is incapable of performing the services unless it uses personnel or property of the controlling entity.

iii. Payment of deductible expenses to a tax-haven entity

126. An entity in a high-tax jurisdiction may pay management fees, technical service fees, or other deductible fees to a related entity in a tax-haven jurisdiction, although the related entity has not actually earned those fees and will not pay significant taxes on them.

iv. Payment of deductible expenses which benefit a tax-haven entity

127. An entity in a high-tax country may incur deductible expenses in acquiring or developing property which is then made available without adequate reimbursement to a related entity in a tax-haven country. For example, the entity in the high-tax country may take interest deductions with respect to borrowed funds which are re-lent to the related entity interest free. Similarly, the entity in the high-tax country may take depreciation deductions for tangible property that is leased or licensed to the related entity for an artificially low consideration.

128. As previously stated, some of the techniques described above may be legal methods of reducing tax, rather than illegal methods of evading tax, depending on the law of the particular countries involved.

B. Historical overview of international tax avoidance and evasion

~~129. The question of international tax evasion has been a matter of international concern for well over a century and a half. The first tax treaty was an agreement on reciprocal administrative assistance between Belgium and France signed on 12 August 1843. Shortly thereafter, in 1845, Belgium signed similar agreements with two other States, the Netherlands and Luxembourg.~~

~~130. Both the 1920 International Financial Conference at Brussels and the 1922 International Economic Conference at Genoa emphasized the desirability of international action for the prevention of tax evasion. The Brussels Conference stated that it would be desirable to draw attention to the advantages of making progress in this area. "An international understanding which, while ensuring the due payment by everyone of his full share of taxation, would avoid the imposition of double taxation which is at present an obstacle to the placing of investments abroad."[31] The Genoa Conference expressed itself in the following way:~~

> ~~"We have considered what action, if any, could be taken to prevent the flight of capital in order to avoid taxation, and we are of the opinion that any proposals to interfere with the freedom of the market for exchange, or to violate the secrecy of bankers' relations with their customers are to be condemned. Subject to this proviso, cooperation to prevent tax evasion might be usefully studied in connexion with the problem of double taxation."[32]~~

~~131. The 1928 General Meeting of Government Experts on Double Taxation and Tax Evasion adopted a separate bilateral model convention on administrative assistance in matters of taxation.~~

[31] *Recommendations of the Brussels Conference*, resolution proposed by the Commission on International Credits, No. 12.

[32] *Recommendations of the Genoa Conference*, resolution proposed by the Financial Commission, No. 13.

~~That assistance was to consist of the exchange of fiscal information available in either of the Contracting States and in cooperation between their administrative authorities in carrying out certain procedural measures. The exchange of information was to take place following requests concerning specific cases or on a routine basis (i.e., without any special request) in the case of particulars (name, surname, domicile or residence, family responsibility) with reference to immovable property, mortgages or other similar claims, industrial, commercial or agricultural undertakings, earned income and directors' fees, transferable securities, claims, deposits and current accounts and successions. The 1928 General Meeting also approved a separate bilateral convention on judicial assistance in the collection of taxes, the word 'collection' covering not only measures of execution but also preliminary measures such as the serving of the documents of execution. These two conventions, together with the two double taxation conventions, adopted at the same time (dealing respectively with income and property taxes and succession duties), did not win significant acceptance.~~

~~132. Pursuant to a request by the Assembly of the League of Nations, the Fiscal Committee of the League studied the question of tax evasion at its sixth session, held in 1936. In its report on that session, the Committee dealt with existing tax evasion practices with particular reference to income from securities. It proposed a new solution based on a system for the exchange of information and asked the Governments of Members of the League, and also non-members, whether they would approve a general convention establishing such a system.[33] The response was not encouraging and the Assembly asked the Committee to resume its discussion of the question. The Committee proceeded to draft a questionnaire with a view to determining what could be done to combat tax evasion on the basis of existing tax laws. In the light of the replies to the questionnaire, the Committee expressed the view that~~

> ~~"the administrations have shown great ingenuity in combating evasion in every form. But the efforts of the various administrations were of so special a character that it appeared to be difficult to employ the methods used by one country in other countries, and it was clear that any proposal for a general scheme would have been received with serious hesitation."[34]~~

~~The Committee was therefore of the opinion that "for the problem of fiscal evasion as for the problem of double taxation, bilateral conventions are the only possibility, as they can be adapted to circumstances and the nature of the results aimed at."[35]~~

~~133. Consequently, at the two Regional Tax Conferences held under the auspices of the Fiscal Committee at Mexico City in June 1940 and July 1943, and at the tenth session of the Fiscal Committee itself held in London in March 1946, emphasis was placed on the need for bilateral conventions for the prevention of tax evasion. Two special model bilateral conventions were prepared, one in Mexico and the other in London, dealing with the establishment of reciprocal~~

[33] League of Nations, Report of the Fiscal Committee to the Council on the work of the sixth session of the Committee (C.450.M.266.1936.II.A).

[34] League of Nations, Report of the Fiscal Committee to the Council on the work of the eighth session of the Committee (C.384.M.II.A), p. 2, paragraph I.3.

[35] Ibid., paragraph I.4.

~~administrative assistance for the assessment and collection of taxes on income, property, estates and successions. Both conventions contain an identical clause under which if the competent authority of a Contracting State considered information concerning particular cases to be necessary for the assessment of taxes covered by the convention, it could obtain that information through direct correspondence with the competent authority of the other Contracting State without having to use diplomatic channels. The conventions also indicated in identical language the kind of information which should be supplied and specified in the cases in which special requests for information or assistance in enforcing tax laws might be refused. Those cases related to requests for information not procurable under domestic laws, to requests implying administrative or judicial action incompatible with domestic laws and practices, to requests compliance with which would involve violation of a professional, industrial or trade secret, and to requests compliance with which might compromise the security or sovereign rights of the other State.~~

~~134. The Nordic countries have taken a leadership role in promoting mutual assistance among governments for the prevention of international tax evasion and for mutual assistance in assessment and collection of taxes. The efforts in the field of administrative assistance in tax matters has been pursued by the Nordic countries since the early 1940s. A bilateral agreement on such assistance was signed by Finland and Sweden in 1943; its main purpose was to facilitate the enforcement of taxes in cases in which taxpayers had left one of the Contracting States for the other. It was recognized that the agreement would help prevent tax avoidance. The agreement covered both reciprocal assistance for the enforcement of tax claims and the exchange of information (service of documents and procurement of information on tax matters). The agreement was followed by other agreements in the same field between Norway and Sweden (1949), Denmark and Sweden (1953), Finland and Norway (1954), Denmark and Finland (1955) and Denmark and Norway (1956).~~

~~135. The question of the revision of those agreements was taken up by the representatives of the Nordic tax administrations at a meeting held in Helsinki in 1967, at which it was found that the provisions of those agreements and of the relevant legislation of those countries were similar. For that reason, the representatives of the Nordic tax administrations decided at a meeting held in Copenhagen in 1970 that a multilateral convention on administrative assistance in tax matters between Denmark, Finland, Iceland, Norway and Sweden should be prepared. The convention was signed on 9 November 1972, supplemented by a special agreement in 1973 and amended by an additional agreement in 1976. The Nordic Convention on Income and Capital entered into by Denmark, Finland, Iceland, Norway and Sweden, which was concluded in 1983, was replaced in 1987, 1989 and 1996. The Convention on Mutual Administrative Assistance in Tax Matters was drawn up within the Council of Europe on the basis of a first draft prepared by the Committee on Fiscal Affairs. This Convention entered into force on 1 April 1995.~~

~~136. International organizations have also been taking increasing interest in the question of international tax evasion. The European Economic Community adopted on 10 February 1975 a resolution[36] on the measures to be taken by the Community with a view to combating international tax evasion and avoidance, which is reproduced below.~~

[36] European Union: Community Legislation in Force; Document 375 Y0214 (01) Official Journal C035, 14

~~**THE COUNCIL OF THE EUROPEAN COMMUNITIES**~~

~~**Having** regard to the communication of 22 November 1974 from the Commission on the problem of international tax evasion and avoidance;~~

~~**Whereas** practices of tax evasion and tax avoidance reaching beyond national borders of Member States lead to budget losses, violations of the principle of fiscal justice and distortions of capital movements and of conditions of competition;~~

~~**Whereas** the international nature of the problem means that national measures, whose effect does not extend beyond State boundaries, are insufficient;~~

~~**Whereas** several national tax administrations are already collaborating to this end on the basis of bilateral agreements, and whereas such collaboration both within the Community and third countries should be strengthened and adapted to new forms of tax evasion and avoidance;~~

~~**Whereas** care must be taken to ensure that information exchanged in such collaboration is not disclosed to unauthorized persons, to safeguard within Member States the basic rights and procedural guarantees of citizens and undertakings and to take account of the requirements of those States to preserve secrecy in certain matters. The Member States receiving such information must undertake to use it only for the purpose of making correct assessment for taxes on income or profits or to support a prosecution for failure, by the person concerned, to observe the fiscal law of the receiving State. It must also afford to the information the degree of confidentiality which it had in the State from which it arose;~~

~~**Considers** that it is desirable for action to be taken initially on the points set out below:~~

~~(a) the mutual exchange between Member States, whether on request or not, of all information that appears to be of use for making correct assessments for taxes on income or profits, and in particular of information in every case where there appears to be artificial transfer of profits between undertakings in different countries, or where transactions are carried out between undertakings in two Member States through a third country in order to obtain tax advantages, or where the tax has been or may be evaded for any reason whatever;~~

~~(b) the need, in order to make this exchange of information more effective, to study possibilities of harmonizing the legal and administrative means available to tax administrations for collecting information and exercising their rights of investigation;~~

February 1975, pp. 0001-0002.

~~(c) the carrying out of investigations, for making correct assessments for taxes on income or profits, by one State, in compliance with national laws, on behalf of another when the latter State requests it to do so;~~

~~(d) the study of the possible provision of facilities for officials of one State to assist within another State in the work of establishing and exploiting facts that will be of use for making correct assessments for taxes on income or profits owed in the first State;~~

~~(e) the collaboration with the Commission necessary for the permanent study of cooperation procedures and the exchange of experience in the fields considered, and in particular in the field of artificial transfer of profits within groups of undertakings, with the aim of improving them and of preparing regulations suitable for the Community.~~

~~**Take** note that the Commission will, within the scope of its powers, take appropriate steps in this sector.~~

~~Furthermore, the Council of the European Economic Community adopted on 19 December 1977 a directive concerning mutual assistance by the competent authorities of Member States with regard to direct taxes.~~

~~137. In this connection, it would also be desirable to reproduce the OECD Council's Recommendation on Tax Avoidance and Evasion:~~

~~1. **RECOMMENDS** the Governments of Member Countries:~~

~~a) To strengthen, where necessary, their legal, regulatory or administration provisions and their powers of investigation for the detection and prevention of tax avoidance and evasion, with regard to both their domestic and international aspects, and to exchange experiences with respect to such action;~~

~~b) To facilitate, improve and extend exchanges of information between their national tax administrations, with a view to combating tax avoidance and evasion, notably by making more intensive use of international conventions or instruments in force and by seeking new arrangements of a bilateral or multilateral character, with due regard to the provision of adequate safeguards for taxpayers;~~

~~c) To exchange experiences on a continuing basis on tax avoidance and evasion practices, on techniques for detecting and preventing them and on ways and means of improving tax compliance in general.~~

~~2. **INSTRUCTS** the Committee on Fiscal Affairs to pursue its work with a view to facilitating the achievement of the above aims and to submit to the Council, as appropriate, specific proposals for increased cooperation between Member countries in this field.~~

138. The OECD Committee on Fiscal Affairs has been devoting considerable attention to international tax evasion and avoidance, and one of its working parties is specifically responsible for investigating the related issues. The OECD adopted on 21 September 1977 a recommendation[37] requesting Member States to strengthen their machinery for combating international tax evasion and avoidance, to encourage the exchange of information between national tax administrations and to compare their experience with regard to the practices and techniques used. Also, on 29 June 1979, the Committee on Fiscal Affairs adopted a Model Convention for Mutual Administrative Assistance in the Recovery of Tax Claims.

C. Mutual administrative assistance

139. Increasingly, tax treaties are stipulating assistance in collecting taxes. So far, a similar provision has not been included in the United Nations tax treaty model. Such an article would have two main advantages. Firstly, it increases the chance of collecting taxes from taxpayers living abroad. Secondly, it reduces tax evasion possibilities through emigration. It goes without saying that a State has to be sure that the aim of assistance in collection of taxes is suitable and desirable within its treaty policy before it inserts such a provision in a treaty.

140. A State which wishes to introduce such an article has to consider at least the following issues. In the first place, a State needs to possess a legislative framework which allows the implementation in practice of this provision. Secondly, the tax administration should be capable and able to collect the tax revenues. Furthermore, it should be considered whether the mutual advantages would justify the new obligations between the two Contracting States. It should be noted, in this respect, that reciprocity with equal revenue is not necessary. However, it might be an element a State might try to obtain. Other important aspects to consider are the size of the economic relationships, the efficiency to collect the tax revenue in both States and the legal protection of the taxpayer.

141. If two States would like to insert a similar article, it would be desirable to include the following issues. Firstly, the scope of the article of assistance in the collection of taxes. To which direct taxes and persons will it apply? For persons, the scope could be stretched to residents instead of just citizens. Secondly, the legislation which can be used to collect the revenue. Usually the legislation of the requested State will be applied. This will normally imply that the requested State will be limited in its measures to collect the revenue on the basis of its own law. Further, the requested State has normally no obligation to use executorial instruments, if the requesting State does not have these instruments at its disposal. The time limit of appeal to court will usually be found in the legislation of the requesting State. It should be considered that the taxes of the requesting State may not have the same preferential status as in the requested State. Exceptions on the obligations to assist can be found in the argument that the requesting State has not used all possible measures of collecting the revenues or that the request interferes with the interest of the requested State. Thirdly, the settlement of the costs which have been made for the collection. The requested State will have to pay normally for the ordinary costs. Unreasonably high costs are likely

[37] Described in paragraph 55.

to be paid by the requesting State. A settled currency rate can be a useful tool to help settle these costs. Fourthly, the exchange of information concerning the collection of the revenue should be considered as well. Finally, the notification of the documents requesting a collection abroad have to be worked out.

142. Moreover, a Multilateral Convention on Mutual Administrative Assistance in Tax Matters has been developed within the Council of Europe, based on a first draft prepared by the OECD Committee on Fiscal Affairs. The multilateral convention was opened for signature on 25 January 1988 and is open to the Member States of the Council of Europe and the Member Countries of the OECD. The Convention has been signed by only a few countries, including several of the Nordic countries, and it has not been ratified by some of the countries that signed it. A sufficient number of signatures has been obtained, however, to bring the Convention into force in 1995. The current signatories include Denmark, Finland, Iceland, the Netherlands, Norway, Poland, Sweden and the United States of America.

143. The Multilateral Convention generally requires that each Contracting State provide administrative assistance in tax matters to each other Contracting State. The Convention provides for three basic categories of assistance, with regard to a wide range of taxes: exchange of information, assistance in the collection of taxes, and service of documents. With respect to the first category, each Contracting State is required to make available to the other States all information in its possession that is "foreseeably relevant" to the other States' tax administration and collection efforts. Each State must also utilize all means available to it in administering and enforcing its own tax laws to obtain foreseeably relevant information not in its possession if so requested by other States. Also, subject to various procedural limitations, the Convention requires each State to enforce tax claims of the other States as though the taxes were those of the enforcing State. The Convention's provisions on service of documents require each State to utilize its domestic laws for this purpose, as though the tax liability were owed to the serving State. A copy of the Convention may be seen in the Annexes.