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Revision of the UN Manual for the negotiation of tax treaties between developed and developing countries*

*The views and opinions expressed in the present note are those of the author and do not necessarily represent those of the United Nations.

REVISION OF THE UNITED NATIONS MANUAL FOR NEGOTIATING OF BILATERAL TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES

Report of the working group

History of the Manual

- In 1978 the Secretary General recognized the need to familiarize tax official in developing countries with the basic approaches and methods used in the field of international tax by way of a treaty negotiation manual

- Integral to the Manual are the treaty and commentaries found in the UN Model Treaty derived from the detailed annual reports of the Experts
- The Manual is intended to be used together with the Model treaty and commentaries

History

- In response to the Secretary General's charge, the Experts Groups through the past 30 years have produced:
- Guidelines for Tax Treaties-1974
- First Manual- 1979
- Current Manual-2003

- At the 10th meeting of the Group of Experts it was decided that because of its great importance to developing countries, revisions to the Manual should be an ongoing activity

Charge to the Committee

- Prepare an updated and revised version of the Manual

Recommendations

- Eliminate historical overviews
- ■See-pg18-24; 39-43
- ■If appropriate a historical discussion can be added as an annex

Treatment of the Model Treaty

- Current version has the model treaty followed (Article by Article) by "observations"
- The observations were written by the Ad Hoc Group of Experts
- As the Model Treaty is being revised as well as the commentaries, this portion of the Manual requires wholesale revision

BASIC APPROACHES TO TAX TREATY NEGOTIATION

- Part III will be replaced with a new section entitled:
- BASIC APPROACHES TO TAX TREATY NEGOTIATION

● this new Part will contain instructions on the different approached that can be taken during treaty negotiations on different articles.
●SEE Handout sample discussing Article 2 and 4

●This new part of the Manual is to provide the treaty negotiator with interpretations, application, and/or suggestions pertaining to an Article

Portions to be retained

●ANALYTICAL AND HISTORICAL REVIEW OF INTERNATIONAL DOUBLE TAXATION

●TAX EVASION AND AVOIDANCE

●PROCEDURAL ASPECTS OF MUTUAL AGREEMENT PROCEDURES PROVIDED FOR IN ARTICLE 25

●SUGGESTED ARRANGEMENTS BETWEEN COMPETENT AUTHORITIES REGARDING THE EXCHANGE OF INFORMATION

Annexes

●The current version contains the following Model's:
■Mexico Draft
■London Draft
■Andean Model
■OECD-2000
■EC-OECD Administrative Assistance in Tax Matters
■UN Model

Suggested Annex

●UN Model Convention
●OECD Model Convention
●Brazil India Convention
●China US Convention
●Mexico Australia Convention
●NZ-RSA Convention
●Purpose of the new annex is to be illustrative of current treaty structures between developed and developing countries
●Add additional useful references

Special Appendix

●Items included in this section are those which have been identified, through discussions of the Committee and it's constituents.

■An example of such an item would arise in the context of the discussion on Monday of Paragraph 21.4 of CRP 2 on Improper Use of Treaties.
■That paragraph referred to rules dealing with specific types of income and provided an exemplary provision.

■One element of the discussion addressed the inclusion in the commentary of examples of how the provision was applied.
■The discussion evolved to the position that such presentation of examples and an expanded discussion be placed in the Manual.

■Such items will no doubt be identified in the discussion of other provisions, as they occur, and through specific recommendation of the Committee and its constituents.

Where Do We Go From Here

●Complete new Part III-obtain examples and suggestions from committees working on revisions.
●Create a standing committee to oversee the ongoing Manual revision.

BASIC APPROACHES TO TAX TREATY NEGOTIATION

Introduction

Income tax treaties (technically "conventions") begin with the recitation that they are entered into between countries for the purpose of avoiding double taxation of international income flows. The problem of potential international double taxation arises each time an enterprise enters inter-country transaction or an individual steps across an international boundary. Taxing conflicts arise in these situations when the countries involved each lay claim to an income tax on resulting income or profits. Historically, the initial measures invoked to alleviate international double taxation were unilateral in nature. Some countries employ a foreign tax credit or offset mechanism. Other countries use an exemption mechanism whereby foreign source income earned by their residents is exempted from domestic taxation. Alternatively, some countries use either the tax credit or exemption methods in different tax contexts. Each of the foregoing tax relief measures recognize the primacy of other countries source taxation structures.

Nevertheless, many countries have found it necessary to supplement unilateral measures by entering into a network of bilateral tax treaties with their principal commercial partners and other countries with which their taxpayers are involved in trade or investment. A principal goal of tax treaties is agreement on common definitions of income source, residency and a sufficient nexus (permanent establishment) to subject commercial and industrial profits to source country taxation. Other important goals include reduction of source country withholding rates on passive income such as interest, dividends and royalties, elimination of double taxation, tax administration cooperation, and a mechanism for resolving tax disputes between the treaty partners. Tax treaties between developed and developing countries frequently take into account differing levels of economic development, fiscal administration resources and tax structure complexities.

Any tax treaty negotiator must be aware that two major model treaties are used by most countries as a starting point for tax treaty negotiations. The model treaties are:

1. OECD Model Convention on Income and on Capital
2. United Nations Model Double Taxation Convention between Developed and Developing Countries

Additionally, the United States employs its own U.S. Treasury Model Convention as a treaty negotiation starting point in particular with developing countries.

The following discussion highlights the considerations involved in tax treaty negotiation and the differences in approach between the most recent drafts of the OECD and UN model treaties.

Article 2 TAXES COVERED

The model treaties each contain 4 paragraphs, the first two of which broadly define what taxes, both income and capital, are covered by the treaty. However, most negotiated treaties dispense with inclusion of the first two paragraphs and move immediately to include the third paragraph of the model treaties. The third paragraph specifies exactly which taxes of each treaty partner are to be subject to the treaty. (See the treaties in the Appendix)

EXAMPLE: New Zealand – South Africa

1. The existing taxes to which this Agreement shall apply are:
   (a) in New Zealand

   the income tax

   (hereinafter referred to as "New Zealand tax")

   (b) in South Africa

      (i) the normal tax

      (ii) the secondary tax on companies; and

      (iii) the withholding tax on royalties

Many treaties also contain a provision similar to paragraph 4 of the model treaties which provides that the treaty will also apply to any identical or similar taxes which are imposed after the treaty is in force. The paragraph requires the competent authorities of the Contracting States to notify each other within a reasonable time of any significant changes that have been made in their tax laws.

SIGNIFICANCE: The definition of taxes covered relates directly to which taxes are to be accorded unilateral tax relief via the credit or exemptions mechanisms pursuant to Article 23 of the model treaties, titled Methods for the Elimination of Double Taxation. Specificity in defining the taxes to be covered by the treaty is therefore critical as taxes of either country not included in the definition of taxes covered by the treaty will not qualify for foreign tax credit purposes. This is especially important where a tax is not a pure income tax, e.g. a trade tax or net worth tax.

Article 4 RESIDENT

The treaty term "resident of a Contracting State" as defined in Article 4 of the UN model treaty (which varies slightly from the OECD model) means any person who, under the laws of the State, is liable to tax therein by reason of his domicile, residence, place of incorporation, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. However, the term does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein. Moreover, it should be emphasized that under Article 3 of the model treaties the term "person" includes not only individuals, but also a company or any other body of persons.

Most negotiated treaties follow the model treaties by looking first to the internal law definition of residence of each State. However, where there is a conflict in those definitions Article 4 of the model treaties lists, in decreasing order, the relevance of a number of subsidiary criteria to be applied when an individual is a resident of both countries under their internal laws to determine which State the individual is considered to a resident for purposes of the treaty. If none of these criteria (See Article 4(2)) is determinative of an individual's residence status, determination of residence is settled by the competent authorities of the Contracting States.

EXAMPLE: Assume X maintains permanent homes in both Australia and Mexico. However, X, a Mexican citizen, keeps his bank accounts and investments in Mexico. Under the Australia-Mexico Treaty (See Annex), Article 4 (b) X is deemed to have closer ties to Mexico (his centre of vital interests) and would be deemed a resident of Mexico for purposes of the treaty.

Note: Some treaties such as the China – United State Treaty (See Annex) dispense with the use of any subsidiary criteria in the event of a residence conflict and instead immediately invoke the competent authority procedure to determine residency.

SIGNIFICANCE: The concept of "resident of a Contracting State" is important in determining a treaty's scope of application, e.g. reduction in source country withholding rates – See UN Model, Articles 10-12 dividends, interest and royalties. An objective determination of residence is also effective in solving cases where double taxation arises from double residence under internal laws of the Contracting States. Finally, the concept is employed in treaties to solve cases where double taxation arises as a consequence of taxation in both the residence and source countries.