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Revision of the Manual for the Negotiation of Bilateral Tax Treaties

Note on the Revision of the Manual for Negotiation of Bilateral Tax Treaties

Summary

This note comprises the third part of the draft revision of the Manual for Negotiation of Bilateral Tax Treaties prepared by the Subcommittee on revision of the Manual. It addresses the application of the Articles of the UN Model Convention and procedural aspects of tax treaty negotiations.

PART THREE

**SUGGESTIONS RELATING TO THE APPLICATION
OF THE ARTICLES OF THE UN MODEL CONVENTION
AND PROCEDURAL ASPECTS
OF TAX TREATY NEGOTIATIONS**

IV. PROCEDURAL ASPECTS OF TAX TREATY NEGOTIATIONS

The objectives of this section are to provide tax treaty negotiators with the tools required to conduct successful negotiations and to cover all of the practical procedural aspects of negotiating a tax treaty. These include the identification of the need for a treaty, the establishment of contacts with a potential treaty partner, the appointment of a delegation with the requisite skills and experience, the preparations for negotiations, the conduct of the negotiations and the procedures for bringing the treaty into force.

A. Identification of need for a treaty

In determining whether a need exists for a tax treaty with a particular country, a country should examine the nature and extent of the existing economic relationship between the two countries as well as the potential and desire for growth in that relationship. In particular, there should be an intelligent assessment of the nature of the future economic relationship.

The assessment should include an examination of whether the interrelationships between the tax systems of the two countries are inhibiting economic relationships. These inhibiting effects may, for example, be the results of excessively high levels of tax on international income flows, inadequate statutory relief from double taxation, and differing definitions of terms or concepts. An attempt should be made to determine whether, to what extent and for what reasons the tax systems of the two countries result in double taxation on residents of the two countries.

It is often prudent to consult with relevant stakeholders including, for example, other government agencies (e.g. investment agencies, government marketing boards etc.) and the local business community. The needs of citizens who may be resident in the other country should be considered and, in this regard, a diplomatic mission located in the other country may be able to provide some insight. Consideration may also be given to the likelihood and ramifications of attracting foreign direct or portfolio investment from the other country, the possibility of the technical or managerial personnel from the other country visiting the country or migrating for the purpose of employment, and the setting up of branches, offices or subsidiaries within the country by residents of the other country.

In addition, given that many developing countries have limited resources available to conduct treaty negotiations, it is important to prioritise the acceptance of requests for negotiations in order to make efficient use of the available resources. Treaty negotiations can require an intensive use of resources, and pursuing an unnecessary tax treaty, or one that is unlikely to be successfully concluded, reduce the resources available to negotiate other treaties or that can otherwise be used. It is therefore important to have a clear policy about what treaties will be pursued, and to keep that policy under regular review. This also helps justifying the treaty negotiation policy to legislators.

B. Initial contacts

Once a country has identified the need for entering into a treaty with a particular country, it must communicate to that country its desire to open negotiations. As a general rule, such contacts are made initially through diplomatic channels. When a relationship exists between tax officials in the two countries, however, it may be helpful to utilize that relationship. In that event, the official

diplomatic contacts should be supplemented by informal contacts through these personal channels. In any event, the policy and practices of the other country should be respected as far as possible.

A draft model treaty may be forwarded together with the invitation to commence negotiations, or a copy of the other country's model or draft treaty may be requested. Further information or materials on the other country's tax system and tax treaty network may also be requested at this time.

As most countries have fairly full negotiation programmes, a statement of why the treaty would benefit their taxpayers, and the wider relationship, may be useful. Providing a draft Model helps the other country in making its decision whether and when to negotiate, as it gives them a clear view of your current treaty policy.

C. Appointment of a negotiation team

If the other country responds in favour of negotiations, a negotiation team will have to be formed. A negotiation team typically consists of a lead negotiator and one or more team members possessing relevant competencies (preferably including a representative of the competent authority). The lead negotiator should be a senior official with responsibility for tax matters, having the authority to make independent negotiating decisions, even if they are "ad referendum" in that they are subject to higher level approval.

The team should be comprised of individuals who collectively have the ability to assess the impact, including the economic impact, of the decisions made over the course of the negotiations, and should be familiar with:

- The relevant domestic tax laws and the draft treaty provisions;
 - The United Nations Model Convention, the OECD Model Convention and any relevant regional model treaties, including any recent changes that may be addresses in the negotiations;
 - The recent treaty policy of both countries, and especially the positions like to be argued for by the other country.
 - The administrative aspects of tax treaties and the administration of the international aspects of domestic law;
 - The economic relationship between the two countries (including the investments of each country in the other and the flows between them); and
- ; The country's priority considerations to be addressed in the negotiations, especially as required by Ministers or the legislator. This will often involve broader country approaches to encouraging investment, including its attitude to investment protection and trade treaties.

D. Preparation for negotiation

Once it has been agreed that negotiations will commence between two countries, countries may find it useful to issue press releases or other public statements to that effect. The purpose of such a statement is to solicit comments from interested parties. This procedure may serve two purposes. It may bring to light issues that tax officials had not previously been aware of. Also, those in the private sector appreciate the opportunity to participate in the treaty process. It is usual to notify the other country that such an announcement will be made, if it has not already made a similar announcement.

The negotiation team should prepare for the negotiations by reviewing the tax system of the other country, and its existing tax treaties (which may provide an indication of the range of positions acceptable to the other country, especially the more recent treaties) and by consulting with relevant government agencies. As with any negotiation, you should try to establish what has driven the other side to agree to negotiation, and in particular what their business interests seeking to invest in your country will be seeking, such as lower withholding tax rates, reduced source country taxation, a mutual agreement procedure to resolve disputes and so forth. Understanding the positions being put to negotiators of the other country will help you to predict what they will find acceptable - their “bottom lines” in negotiation, and help you to establishing a negotiating approach which meets the needs of both countries.

A draft treaty should be prepared for transmission to the other country’s negotiators. It should show the initial proposals on the major issues, and may be geared particularly toward the negotiations with the other country. However, a country may prepare its own model treaty for use as a starting point for treaty discussions with all other countries. Either approach would be a useful exercise for the negotiation team, which would be required to focus clearly on its own positions.

Alternatively, the negotiation team should be prepared to review and make comments on the other country’s draft or model treaty, if one will be requested during the initial contact phase. However, the other country may have no draft or Model treaty, or may prefer to work with a submission from its potential treaty partner.

Before the negotiations, there should be a clear understanding between the negotiation team as to who will speak on what item, and what the positions should be. You should have a clear sense of which are the most important items that you need to achieve if the treaty is to be acceptable to your “political masters” and which ones you can forego to receive something in return. It is inevitable that you will have to make concessions in negotiations, and the impact of those on your treaty network need to be considered - for example reducing withholding tax rates in the negotiations may trigger a “most favoured nation” clause with other countries that will dictate your negotiation programme for some years to come, or may encourage business to route investment through that country, rather than other countries.

E. Arrangements for conducting negotiations

Negotiations may be conducted in face-to-face meetings, via teleconference or by correspondence, the exchange of documents and comments at a distance (digitally or by hardcopy). Agreement should be reached between the countries on which approach to use. Preferences may vary, based on time, cost or resource constraints.

Negotiations usually require more than round of discussions or exchanges; and face-to-face meetings may be hosted on an alternating basis by the two countries. In arranging for face-to-face meetings, the host delegation should make certain that there will be a common language for the negotiations, or that interpreters will be available, who have the ability to deal with tax concepts and terminology in both languages.

F. Conduct of the negotiations

It is helpful, as a first order of business, to make certain that each side understands the tax system of the other, particularly as it relates to the taxation of international income flows. If there are particularly complex aspects of a country's tax law that are relevant for a tax treaty, it is often helpful for that country to prepare a brief explanation in written form for the other delegation. These can be formally passed to the other country and that can be recorded, so that there is no doubt about whether, for example, your country treats a particular tax as an income tax covered by the treaty.

Once there is a general understanding of the two tax systems, the negotiations may begin with an article-by-article review of the draft or drafts previously prepared, or comments may be exchanged. If neither side has its own model or draft, the United Nations Model Convention may be used for this purpose. A familiarity with the differences between that Model and the Model used by the other country, especially the OECD Model is very helpful at this point, as often the negotiation will come down to which of the Models should apply in each case. During the initial review, agreement may be reached on relatively easy points. Meanwhile, clarification or a narrowing of the differences on the remaining points may be achieved. On subsequent reviews of the draft, greater effort should be devoted to reaching agreement.

By the end of the first rounds of discussions or first few rounds of exchanges, there is usually an accumulation of issues that require careful consideration (and perhaps consultation with other relevant agencies or principal officials) before final decisions can be made. For face-to-face meetings, it may be useful to prepare an agreed statement of the open issues remaining at the conclusion of the week's discussions and, if possible, to schedule the next meeting. It is noted that negotiations are normally treated as confidential until the treaty is signed.

It should be agreed, at the conclusion of the first round of discussions that one side will prepare a draft showing the "agreed" (at officer level - subject to final approval of the package as a whole) language and, by use of brackets and alternative language or other suitable symbols, the open issues. Negotiations can take some years, and personnel change, so stating what has been achieved and what remains unresolved after each negotiation helps prevent issues being unnecessarily re-opened in the course of negotiations. Notes of the discussions should be recorded and distributed to members of the delegations at the earliest opportunity.

Between rounds of discussions, the heads of delegation should correspond in order to exchange drafts, to indicate tentative conclusions on major open issues, and to confirm the schedule for the next round of discussions.

It is important to maintain both momentum and continuity in treaty negotiations. Thus, the time between discussions and exchanges should be minimised, and the composition of the negotiation teams should be maintained, to the extent possible. You will need to keep a well maintained file of developments.

It may also be useful for the negotiators to inform and advise relevant diplomatic officers of the progress of the negotiations. This may facilitate the role of such officers when diplomatic channels must be used for communication. Further, these officers may be called upon or required to attend

discussions or to facilitate signing ceremonies that are held in the city or country where they are stationed. Foreign Ministry officers will usually participate in negotiations, because they have responsibilities for treaty policy generally, and expertise in issues such as bringing treaties into effect. They will also ensure, for example, that definitions of the territorial scope of a treaty do not raise international issues - such as apparently recognising the other country's ownership of a disputed area.

At the commencement of the second round, the countries should discuss any changes occurring in the context of either country (including tax laws) which may affect the conduct or outcomes of the negotiations. The review of the draft should continue with further rounds of discussions or exchanges, with the aim of reaching agreement on the outstanding points or at least further narrowing any remaining differences.

If full agreement has not been reached after a second round of face-to-face meeting, it may yet be possible to reach agreement and conclude the negotiations by correspondence.

On occasion, in the course of negotiations, agreements are reached that do not readily lend themselves to inclusion in the treaty, but that may be made public at some time. There may be, for example, an agreed interpretation of a treaty provision, which is too detailed to be added to the treaty text. This interpretation may be spelled out in a side agreement or exchange of letters that may be signed at the same time as the treaty. The side agreement or exchange of letters may or may not be subject to ratification, and may or may not form part of the public record. Ministry of Foreign Affairs guidance on such issues will often be needed.

When full agreement has been reached, the treaty should be initialled by the lead negotiators or heads of delegation. Initialling indicates that the draft reflects the agreement reached at the technical level, but does not bind the country to the text. Decisions at this stage are generally subject to further policy review and approval according to the internal procedures of each country.

G. Preparation for signature of the treaty

Once agreement has been reached at the technical level, the initialled treaty should be reviewed by senior officials and policy makers such as Ministers, according to the internal procedures of each country. In some countries there may be scrutiny at the Parliamentary level before a country can become a party to such a treaty. At this stage, if a strong reason for proposing a change to the initialled draft is perceived, this information should be communicated immediately to the other country. Such changes should be kept as far as possible to a minimum, of course, since the other side will expect that your negotiators were in tune with the approach of the "decision-makers" during the course of negotiations, but an unexpected court decision or policy change may, in particular, require some issues to be re-opened.

Once the internal procedures for approval of the initialled treaty are completed in each country, arrangements should be made, under the appropriate procedures in each country, for signature of the treaty at the earliest opportunity. The need to conform texts in multiple languages can make this stage a time-consuming process; and the printing, binding and sealing of agreed texts for signature may need to be handled in consultation with foreign ministries.

H. Ratification of the treaty

After the treaty has been signed, arrangements should be made for the ratification of the treaty at the earliest possible date thereafter. Experience has shown that the differences in the process that must be followed in order to ratify the treaty can result in considerable delays in ratifying the treaty. It is important that the treaty negotiators play an active role in trying to ensure that delays in ratification of the treaty is minimised. The third step will be the coming into force (or “effect”) of the treaty, the point at which it enters into law at the domestic level and taxpayers can rely on it.