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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 first part of the draft revision of the Manual for Negotiation of Bilateral Tax Treaties prepared by the Subcommittee on revision of the Manual. It provides an introduction to international double taxation. Other parts of the draft Manual are *presented* as addenda to this paper.

PART ONE

INTRODUCTION TO
INTERNATIONAL DOUBLE TAXATION AND
TAX EVASION AND AVOIDANCE

I. INTERNATIONAL DOUBLE TAXATION

A. Concepts and issues

1. International taxation issues revolve around two main concepts th fpts and issues

2.1. Income derived from sources in the country and received by taxpayers classified as non-residents would most often be defined as "income from sources in the country". This definition would be quite an important part of international tax rules, since in absence of such definition, one could argue that the tax liability on non-resident may not arise. The list of items of income having source in the country can be both exhaustive or only indicative. Generally such definition would mention: "Income from sources in Contry Z includes the following items of income: (an exhaustive or indicative list would follow)". The sourcing rules may also indicate that the income from sources would also include income, which was not physically paid from the country in question, but earned there in a way of provision of services, corresponding expense was claimed as a deduction in this country or otherwise connected to the taxing jurisdiction.

Concept of Residence

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. The same issues arise in respect of legal entities. Legal entity can be considered a resident in the country of its incorporation, place of its head office or based on other criterion – such as place of effective management or control. Tax treaties generally do an excellent job at resolving problems of double taxation resulting from conflicting residence rules – using the tie-breaker rules in Article 4 paragraphs 2 and 3.

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
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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 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 ith signi9f Ameriii9.-rime sdica ce.9(l)0--1(m)8(e)-t-1( )-95(s-1( )a)-1(l)-1()-1wp n-1(l)-1()-1( )60()-1(i)-1(t
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(b) Source - Residence Conflict: 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. This type of double taxation can be eliminated by the tax treaties, either on the basis of the exclusive taxing right - where the treaty permits only one country to tax the income, or on the basis of the methods for double taxation relief, where the country of residence will have the obligation to provide the relief (exemption or credit) in the way prescribed by the treaty to eliminate double taxation.

(c) Source-Source Conflict: Two States may invoke the source principle to tax the same

> 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.

14. 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.

15. 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

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).

18. 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. This area of issues is addressed in more detail in the Transfer Pricing Manual – see XXX.

3. Methods of relief from international double taxation

19. International double taxation may be eliminated either by concession by one state, that is unilaterally (on the basis of domestic law), or bilaterally (on the basis of tax treaties) in several ways:

- Bilaterally - Allocation of exclusive taxing right to one country only – this means that the tax treaty will allow only one country to tax the particular item of income and the double taxation will be thus eliminated, because only country will tax this income. This is usually the country of residence, which will have the exclusive taxing right of a particular item of income, but it may be also agreed that certain items of income will be taxed exclusively in the country of residence – e.g. income from government employment.

Bilaterally and Unilaterally – based on the special method for elimination of double taxation – credit or exemption – described in further detail below.
Bilaterally – using the mechanism of Mutual Agreement Procedure – see further description in XXX

20. 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. There are significant implications from the choice of the method for the domestic and tax treaty policy that a country should carefully consider, depending

28. Every State that grants a foreign tax credit imposes some limitations on that credit. There are

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.

32. 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 credit

33. Tax-sparing credit 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 (notional 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.

34. In the past, some developed countries have provided tax-sparing credits in their tax treaties with developing countries. Some of the countries which historically agreed to include tax-sparing credit in some of their treaties include 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.[6] Some countries – e.g. the United States of America has never ratified a tax treaty that included a tax-sparing provision.[7] Such treaty position refusing the tax sparing credit may be based, in part, on the

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

[7] 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-

principle of capital export neutrality and the principle that residents with equal taxable incomes should pay equal amounts of tax.

35. 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

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. 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.

38. 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.

39. 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.

40. 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 posg(e)-1(c1(u)-1(r)-cle)-1(n)-1(g)-1(i51(a)-1(l)-)a-1(e)-1( )45(p)-1(e)-1(r)-1(s)