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Tax Treaty Policy Framework and Country Model

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Tax Treaty Policy Framework and Country Model

Ariane Pickering

1. Introduction

All countries would find it beneficial to develop a tax treaty policy framework and a model treaty before entering into negotiations. You have to 'know what you want'.

The policy framework should set out the main polic

Development Community (SADAC) Model or the Association of Southeast Asian Nations (ASEAN) Model[1] may also be relevant.

ii. It is important for developing countries to strike the right balance between protecting revenue (by maintaining source taxing rights) and encouraging inbound investment (by reducing tax barriers). To achieve this, tax treaties of most developing countries generally follow the UN Model Convention, rather than the OECD Model Convention.

The UN Model Convention is better suited to developing countries in that it seeks to preserve a higher level of source taxation than the OECD Model Convention, which has been designed by and for developed countries. While the OECD Model Convention is most beneficial to business, and therefore is most effective in attracting foreign investment, the revenue balance is generally best suited to capital exporting countries, and to situations where the balance of investment between the two treaty partner countries is approximately equal. The UN Model Convention modifies the OECD Model Convention to better suit the circumstances of developing countries.

iii. The policy framework of a country should take account of key aspects of that country's economy, including its main sources of revenue and areas of current or potential foreign investment.

If, for example, a developing country has significant natural resources such as oil reserves, it may wish to ensure that its tax treaties do not unduly restrict its ability to tax the income from activities relating to the exploitation of such resources. Similarly, if there are significant road or rail transport activities between two neighbouring countries, those countries may wish to extend the operation of Article 8 to those forms of transport.

iv. Tax treaty policy should take account of domestic law. The interacti under domestic law. For example, a treaty right to tax fees for technical services on a net basis at source may be difficult to apply in practice if such fees are taxed on a withholding basis under domestic law. In this case, the country may prefer to include a provision that provides for source taxation on a gross basis, even if the tax rate provided under the treaty is lower than the domestic law rate.

A right to tax under a treaty that cannot be exercised under domestic law, or that cannot be collected in the ordinary course of tax administration is likely to be of little value to a country. For example, there would be little revenue benefit to be gained by providing for source taxation of pensions (in accordance with Article 18(2) (Alternative B) of the UN Model Convention), if such pensions are not taxable under domestic law. There may however be circumstances in which a country would wish to preserve a taxing right that cannot currently be exercised under existing domestic law, e.g. where it is anticipated that future governments may wish to change that domestic law.

In some circumstances, non-tax laws may be relevant. For example, social security pensions may not be payable to non-residents. If this is the case, that country will not pay cross-border social security payments and negotiators should not insist on source taxation of these payments.

v. Countries should take into account the ability of their tax administrations to comply with treaty obligations.

For example, some treaties require tax administrations to collect taxes on behalf of a treaty partner. If the tax administration does not have the legal or practical ability to do so, that country may wish to consider not including

Treaties apply to all income taxes, including capital gains taxes, taxes on profits, withholding taxes and tax on salaries. In some circumstances, other taxes such as tonnage taxes, or minimum taxes may also be covered.

The UN and OECD Model Conventions also apply to taxes on capital, such as wealth taxes.

Distributive rules

One of the main effects of a tax treaty is to allocate taxing rights over different categories of income derived by a resident of one treaty partner from sources in the other treaty partner country.

The distributive rules of the UN Model Convention broadly allocate source country taxing rights as follows:

Income from immovable property: Income such as rents, agricultural or forestry profits, and mining income is seen as having a very strong economic link with the country in which it arises. Accordingly, the source country is allocated unlimited taxing rights over this income.

Business profits: Such profits are generally only subject to source taxation where the foreign enterprise has established a strong economic connection with the source country, e.g. by establishing a fixed place of business in that country or by performing services in that country for an extended period. Profits from short-term activities (generally less than 6 months), or preparatory or auxiliary activities may not be taxed in the source country.

Treaties include rules that determine the profits attributable to the enterprise, or the part of an enterprise, operating in the source country. Under the UN Model Convention, as under the OECD Model Convention, profit allocation between a permanent establishment and the rest of the enterprise of which it is a part, and between related enterprises, must be made on an arm’s length basis (i.e. as if they were separate and independent entities). However, the UN Model Convention provides limits on the extent

Dividends, interest and royalties: This income is usually taxed on a withholding basis in the source country. To prevent excessive taxation and to achieve a sharing of revenue from such income between the two countries, source taxation is limited to a percentage of the gross amount of the income. In most treaties entered into by developing countries, the agreed rates are commonly between 10 and 20%. The OECD Model Convention specifies withholding tax rates of 5 and 15% for dividends and 10% for interest, while royalties may not be taxed at source.

Capital gains: Gains on disposal of immovable property or assets of a permanent establishment may be taxed in the source country, as may some gains on the alienation of shares in resident companies or companies whose assets consist mainly of immovable property. Source taxation of most other capital gains is generally not permitted. The OECD Model Convention does not provide for source taxation of gains from the alienation of shares in resident companies.

Independent personal services: Income from professional services and other independent personal services is permitted in the source country only if the services are performed through a fixed base in the source country, or if they are provided in the source country for more than 183 days. Such income is dealt with as business profits under the OECD Model Convention.

source. Under the OECD Model Convention, pensions are taxable only in the country of residence.

Government service: Salaries paid to government employees are generally taxable only in the paying country.

Students: Taxation of payments from abroad for the education and maintenance of a visiting student is not permitted.

Other income: Income that is not otherwise specifically covered by the above articles may be taxed in a country if it arises in that country. The OECD Model Convention provides for taxation only in the country of residence.

Capital: The allocation of taxing rights over capital generally mirrors the allocation of rights to tax income.

Elimination of double taxation

Where source taxation is permitted under the tax treaty, the country of which the taxpayer is a resident is required to relieve any resulting double taxation. This may be achieved by exempting the income that is taxed at source (exemption method), or by providing a credit for the foreign tax against the tax liability of the taxpayer in the country of residence (credit method).

Though not included in the UN Model Convention itself, some treaties entered into by developing countries include tax sparing provisions. Developing countries may seek to attract foreign investment by offering tax incentives with respect to certain activities. However, if the country of residence of the investor provides relief using the credit method, the benefit of the tax incentives may be effectively passed to the foreign treasury instead of the investor. To preserve the benefit of the source country tax incentives, tax sparing provisions provide relief from taxation in the country of residence as if tax had been paid in the source country.

Non-discrimination

International tax treaty rules prevent either country from applying discriminatory tax rules in certain circumstances. These are:

nationals of the other country may not be taxed more harshly than the country's own nationals;

tax discrimination against Stateless persons is not permitted;

a permanent establishment of an enterprise resident in the treaty partner cannot be taxed less favourably than a local enterprise;

payments to a resident of the other country must be deductible under the same conditions as if paid to a local resident;

foreign-owned resident companies cannot be taxed more harshly than locally-owned resident companies.

Mutual Agreement Procedure

A key benefit of tax treaties is that they allow the tax administrations to consult together on the application and interpretation of the treaty and to reach agreement on how best to achieve the aims of the treaty, especially removal of double taxation. The mutual agreement procedure is most commonly invoked in the context of transfer pricing and profit allocation. The two tax authorities may agree on the allocation of profits within a multinational enterprise operating in both countries.

In the case of disputes as to the proper attribution of such profits, taxpayers themselves may seek agreement between the tax authorities of the two countries under the Mutual Agreement Procedure.

A recent addition to the UN and OECD Model Conventions is a provision for binding arbitration in treaties (e.g. paragraph 5 of the Mutual Agreemen although there may be room for negotiation with respect to certain details (which are discussed further below).

Other aspects of a tax treaty may be open to negotiation, such as coverage of capital taxes, and levels the economic link between the derivation of the income and the country where it arises is not

Example 1: A payment is treated under domestic law as a royalty to which withholding tax applies. If that payment is regarded as business profits rather than a royalty as defined for tax treaty purposes, payers and recipients of the payments, as well as tax administrations, may find it difficult to apply the rules of Article 7 in respect of that payment.

Example 2: Fees for technical services are often treated under domestic law in developing countries as a separate category of income from other business profits and are subject to different tax treatment. Article 7, if applied to such income, may give rise to outcomes that, from a policy perspective, are unacceptable to those countries.

2) Tax treatment

Can taxing rights allocated under a tax treaty be exercised in your country? If not, consider whether this is an outcome that your country wishes to provide for under a treaty.

Example: Article 16 of the UN Model Convention provides for taxation of directors' fees in the country in which the company is a resident. Some countries may not be able to exercise this taxing right unless the director's activities are performed in that country.

Is the proposed source taxation treatment consistent with the method of taxation of that category of income under domestic law, e.g. net taxation by assessment, withholding, etc?

Example: Article 7 of the UN Model Convention provides for net taxation of business profits. However, certain payments that are

Example: Article 8 (alternative B) of the UN Model Convention allows a country to tax ‘an appropriate allocation of the overall net profits’ of a non-resident shipping enterprise. Determination of such profits may be difficult, particularly if non-resident shipping enterprises are taxed under the domestic law of that country on a deemed profit calculated by reference to the fares or freight received by the enterprise in that country.

4) Ease of compliance

Does the proposed treatment place an onerous compliance burden on taxpayers? This can be a particular problem where taxpayers are required to keep detailed records that they would not ordinarily keep, or meet strict information disclosure requirements in order to obtain treaty benefits.

Example: Many countries choose to simplify compliance by taxpayers by not including the ‘force of attraction’ provisions of the UN Model Convention in Article 7(1). Others may consider that the provisions of Article 5(3)(b) of the UN Model Convention relating to the existence of a deemed services permanent establishment create an undue compliance burden on taxpayers.

Countries are well advised to follow the provisions of the UN or OECD Model Conventions as closely as possible for the reasons outlined above. However, having regard to their particular circumstances, countries may determine that the UN or OECD Model Conventions do not fully meet their needs, or that certain provisions of one or other of these Models cause them unacceptable difficulties. By developing a policy framework, these countries will be able to decide in advance what rules will best serve their country’s interests, and how important those rules are to that country.

In deciding to move away from a policy position endorsed in the UN Model Convention, or the OECD Model Convention, countries should, in relation to each policy issue, consider the matters raised above. In addition, they should consider:

1) Reason

What is the reason for the departure from the policy position found in the international models? For example, is the proposed approach intended to protect a significant source of revenue in your country, e.g. income from natural resources, manufacturing profits, fees for technical services, etc?

Is the departure intended to attract investment in an area of your country's economy that your government is seeking to develop, e.g. building technical expertise, financial services, etc?

Is the usual approach found in the international models too difficult for the tax administration or taxpayers to administer in the context of your dom

3. Designing a Model Tax Treaty

Countries should develop a model tax treaty (Model) that reflects the key aspects of their policy framework. For ease of negotiation, and to maximise the likelihood of designing effective provisions that achieve the desired outcomes, developing countries would be well-advised to base their Models as far as practicable on the UN Model Convention.

Certain features of the UN and OECD Model Conventions are found in virtually all modern tax treaties, i.e:

provision for elimination of double taxation;
inclusion of non-discrimination rules;
provision for mutual agreement between tax administrations; and
most importantly, provision for exchange of tax information between tax administrations, including information held by banks and other financial institutions.

It is highly recommended that any country's M local language or in their domestic law. Deviations from the text of the UN or OECD Model Conventions may well be taken to signal that the negotiators intended to achieve a different outcome to that provided under the Models. By adopting the text used in the relevant Model, countries are able to demonstrate their intention to achieve the outcomes provided in that Model as interpreted in the Commentaries. As far as possible, drafting changes should only be used where a different result is sought.

In cases where, in accordance with their policy framework, countries want to achieve a different outcome to that provided in the UN Model Convention, circumstances, provisions to eliminate such double taxation should be included in any treaty between the two countries.

However, not all countries impose capital taxes under their domestic law. In designing their Model, countries that do not themselves impose capital taxes will need to consider whether they wish to cover capital taxes.

Double taxation of capital will not arise if one of the treaty partner countries does not impose capital taxes, or if neither does. In this case, it is a policy decision whether a country that does not impose capital taxes would want to include a Capital Tax

Some treaties provide, for example, that all other capital may be taxed in both countries. If double taxation arises as a result, the country of residence of the taxpayer would be required to provide relief. An alternative approach is to provide for taxation only

Some treaties also provide an exception to the fixed place of business threshold in respect of insurance activities. For example, countries that impose tax on the basis of gross premiums paid to non-resident insurers under domestic law may preserve the operation of this law under tax treaties, sometimes with the rate of tax being capped to a certain percentage (e.g. 5% or 10%) of the gross amount of the premiums.

Construction sites

While the OECD Model Convention provides for a 12-month threshold for construction and assembly projects, a 6 month threshold is provided under the UN Model Convention and is widely accepted internationally. Some developing countries seek a shorter time threshold in their treaties, e.g. 90 days.

In designing a Model, the time threshold should not be less than any domestic time threshold for taxation of such activities. Doing so could lead to double non-taxation of income of non-resident construction or assembly enterprises in treaties with countries that apply an exemption system (ie. where income that may be taxed in the host State under the treaty is exempted from tax in the other State). This is because, while the treaty accords the host State the right to tax the income, that State would not be able to exercise that right if the construction site lasts less than the domestic law time threshold.

Services

Income from services is commonly dealt with under a number of different articles of a tax treaty. Under the UN Model Convention, services are deemed to constitute a PE (a.f.02 s aree U

interpretation. For this reason, some countries like to clarify that this article applies only to individuals, while others extend its scope to activities performed by entities such as companies.

Since Article 14 refers to 'income', countries that tax independent personal services incomes on a gross basis under their domestic law are not precluded from doing so under this article. However, as the majority of countries apply Article 14 to net income, countries that wish to apply gross basis taxation should clarify this during negotiations.[4]

Some treaties include a third threshold which allows a country to tax income from independent personal services where income exceeding a monetary threshold is paid by a resident of that country or a PE situated in that country. Such a threshold was previously found in the UN Model Convention but was deleted in 1999. Countries considering whether to include such a provision should note that monetary thresholds are difficult to administer and the amount becomes meaningless over time.

Independent personal services income may also be dealt with under provisions dealing with fees for technical services (see below). Where a treaty includes technical services provisions, the relationship between the two articles should be clarified, e.g. by excluding such fees from the scope of Article 14.

<u>Fees for technical services</u>

Under their domestic law, many developing countries

Although such a provision is not currently included in either the OECD Model Convention or the UN Model Convention, it can be found in a significant number of treaties of developing countries. The UN Committee of Experts on International Cooperation in Tax Matters ("The UN Committee of Experts") is currently considering whether to add a provision to the UN Model Convention to deal with fees for technical services.

Since this provision is not consistent with current international treaty norms (which would require a PE or fixed base threshold, or at least a minimum time threshold), it may be resisted, particularly by

advised to take into account the considerations set out in paragraphs 4 to 11 of the Commentary on Article 12 of the UN Model Convention.

One issue that commonly arises is the treatment of income from equipment leasing. Payments for the use of equipment are excluded from the definition of royalties in the OECD Model Convention, but remain in the UN Model Convention definition. Countries may wish to consider providing a lower rate for income from equipment leasing, either in their country Model or as a fall-back. Leasing income will have costs associated with it, and even a fairly low withholding tax rate imposed on the gross amount of the income may well result in excessive taxation which would discourage cross-border equipment leasing or may be passed on to resident lessees. A limit of about half of the general rate for royalties may be appropriate.

Capital gains

Treaties generally ensure that tax imposed on capital gains on alienation of immovable property located in a country, and movable property which is part of business property of permanent establishment or a fixed base in that country, may be taxed in that country. Capital gains arising from the disposal of ships or aircraft used in international traffic, and boats used in inland waterways transport, are generally taxable only in the country in which the place of effective management of the enterprise is situated.

For other gains, treaty practice varies. Some countries provide for exclusive residence country taxation. However others, including most developing countries, prefer to retain source country taxing rights over a broader range of capital gains, especially gains from the disposal of shares in a resident company or interests in an entity of which th permanent establishment situated in that country. The UN Model Convention also provides that pensions paid in respect of government service and social security payments are taxable only in the paying country. In practice, many countries seek source taxing rights over pensions in their treaties. Examples of different provisions are found in the OECD Commentary on Article 18.[5]

Countries should make a policy decision as to which alternative they prefer (or indeed, whether they would prefer another alternative such as a single tax treatment for all pensions). This decision should take into account, inter alia, the ability of the tax administration to collect source taxation on pensions paid to non-residents. Countries that tax pensi

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While some countries are prepared to agree to such provisions with their least developed treaty partners, others are more resistant, especially since the OECD published a report recommending

Convention Article 25 allows the competent authorities to develop 'appropriate bilateral procedures, conditions, methods and techniques' for the implementation of the mutual agreement procedures. Developing countries should consider the procedural issues discussed in Section C of the UN Commentary on Article 25, having regard, in particular, to the administrative capacity and resources of their tax administration and competent authorities.

The UN and OECD Model Conventions also includes an optional provision[7] that provides for binding arbitration procedures to resolve issues that the Competent Authorities are unable to resolve under the mutual agreement procedure. While the benefits of providing taxpayers with the certainty of arbitration procedures are beyond doubt, arbitration in the context of tax treaties is a relatively recent development and few tax treaties of developing countries currently include such an article. As noted in the UN Commentary on Article 25, countries with limited experience in the mutual agreement procedure could have difficulties in determining the consequences of adding arbitration[8]. Developing countries should consider whether their tax administrations have the legal and practical ability to support arbitration procedures and whether, as a matter of policy, they wish to do so.

3.6 Anti-abuse provisions

Some countries, particularly those with only a small tax treaty network, may be concerned that the reductions in source taxation offered through their treaties may expose them to abusive arrangements designed to obtain those benefits in unintended circumstances. They may also be concerned that residents of third countries with which they do not have a treaty may try to obtain the benefits of a treaty (treaty-shopping).

The Commentary on Article 1 of the UN Model Convention contains an extensive discussion of potentially abusive situations and suggests a number of possible solutions to combat such arrangements. In designing their Model, countries should consider whether to include any specific anti-abuse rules[9] or general anti-abuse rules[10] in their treaties.

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7 Paragraph 5 of UN Model Convention Article 25 (alternative B), OECD Model Convention Article 25(5).

8 Paragraph 3.

9 See paragraphs 31 – 33 of the Commentary on Article 1 of the UN Model Convention.

10 See paragraphs 34 – 37 of the Commentary on Article 1 of the UN Model Convention.

3.7 Administrative assistance

Exchange of Information

In accordance with modern tax treaty practice, and with a view to joining the worldwide push to stamp out harmful tax practices, the Model that any country develops should adopt the wide

Having regard, in particular, to the administrative burden this could place on the tax administration, developing countries may want to consider whether they are in a position to agree to such provisions.

3.8 Protocol

Some countries like to append a Protocol to their tax treaties, which sets out important interpretations and/or administrative provisions. Such Protocols are generally negotiated at the same time as the tax treaty and have the same legal status as the tax treaty.

Interpretive provisions are particularly useful where there might otherwise be doubt as to the intended operation or application of a tax treaty provision in one or both countries. This may occur, for example, where domestic law or jurisprudence in one country requires an interpretation that would not be followed in the other country. In this case, the two countries may agree during negotiations on a particular interpretation and set this out in the Protocol.

4 Conclusion

By developing a tax treaty policy framework, countries will be in a much better position to ‘know what they want’ out of treaty negotiations and to achieve outcomes that are in the best interests of the country. Such a framework will also assist countries in designing their country Model, which should reflect the policy outcomes sought.

Both the policy framework and the country Model should be reviewed regularly to ensure that future tax treaties continue to provide beneficial and appropriate outcomes for the country and remain up to date with international developments.