Papers on Selected Topics in Negotiation of Tax Treaties for Developing Countries

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# **How to Conduct Tax Treaty Negotiations**

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## **How to Conduct Tax Treaty Negotiation**

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## 1. Introduction

The object of a tax treaty negotiation is to achieve a treaty that is beneficial to both countries and meets the interests of each side as far as possible. A treaty that favours only one country will not be beneficial in the long run. If one country feels that it has been overwhelmed and possibly cheated that country may resist applying the treaty, or may not apply it in the way intended, and may create a bad relationship between the competent authorities. The treaty may even be terminated, or that country may ask for renegotiations.

It is important that the negotiations are conducted in a co-operative atmosphere with a willingness from both teams to achieve the best result for both countries. Consequently it is important that both teams negotiate in good faith.

The treaty needs to work smoothly in practice and should be effective and not create undue difficulties in compliance issues. As a tax treaty will in most cases last for many years, it is important that it is drafted to stand the test of time.

Reaching a good agreement is dependent on many factors, including research, planning and preparations, the conduct of the negotiations and the management of the process. Preparations are very important.<sup>1</sup>

When the two teams meet fo

When the two teams have solved all outstanding issues there are two articles that have to be drafted, i.e. the "Entry into force" and the "Termination" articles. These two Articles are important since

## 3. Trust

To achieve a productive atmosphere during the negotiation process, it is necessary to gain the trust of the other team. Losing credibility may lead to negotiating difficulties if the other team does not trust the validity of arguments put forward and becomes sceptical of everything said.

It is important that what a team explains is correct. If a team is asked to explain its domestic legislation or its position on a certain issue, the answer should be truthful. If the leader is not familiar with the issue, there may be others in the team that can give a satisfactory explanation. If the team cannot respond immediately, or is in doubt, it is a

lunches or dinners also play a part in building a good relationship and perhaps make negotiations more fruitful. It is important to remember that all interaction, formal or informal, plays a part in the

not important for them, they may defer acceptance of the proposal in the hope of achieving something in return at a later stage in the negotiations.

If a provision mostly relates to one of the countries or is a clarification of the wording of an article, it may be better to include the provision in a protocol rather than trying to draft wording to that effect in the treaty itself. This might simplify the reading of the treaty text. However, if a protocol is used, it is important to draw attention to the protocol in an explanatory note to the treaty. Otherwise the provision in the protocol can be easily overlooked.

Negotiators should remember that even if the issues, which are not agreed, are important, it is not necessarily difficult to find solutions. It may be that the two teams identify the same issues as important. In such cases it may be easy to find common solutions if both teams can reach agreement on what solution is preferable or at least acceptable. However, if both teams regard an issue as important, but disagree on the solution, a compromise may be difficult (but not impossible) to find. It may also be that an issue, which is regarded as important to only one of the teams, is not contrary to what can be accepted by the other team provided the arguments advanced are satisfactory.

For an effective discussion to take place one should introduce the item and present one's position clearly. It is not necessary to present all arguments at once. In fact it may be wise to hold some arguments back, to be used if the other team does not agree and has explained why.

After the arguments for a position have been presented it is wise to note carefully the reactions from other team. Sometimes it may be difficult to understand the response. In such a case one should always ask for clarification, and continue to ask until the response is clearly understood. By listening carefully to the arguments put forward by the other team, you will from time to time find that the proposal they are making is actually advantageous and better than your own proposal. If this is the case, accept the proposal and make the necessary amendments to improve your own model.

A team may resist a proposal and the arguments used in its favour. When this team is arguing for a different solution, listen, and be prepared to counter. It is for this reason that is not wise to present all the arguments at the first presentation, but use them as the discussion continues. If it seems difficult to get acceptance for the proposal that is being discussed, it is time to look for alternatives, which may have been prepared before the negotiations, or may be developed during the negotiation. Alternatives may also be found in the Commentaries to the United Nations Model Double Taxation Convention between Developed and Developing Countries ("UN Model Convention") - and the

For the purpose of Articles 11 and 12 if a known at a few rate of State A tax is agreed upon with any other State than State B after the entry introcecof this Convention, State A shall without undue delay inform the Government of State Revriting through diplomatic channels and shall enter into negotiations with Government of State B with a view to include a similar provision in the present Convention."

A different way to deal with difficult issues is to propose a "sunset clause." Such a provision can for instance be found in relation to tax sparing provisions in the article on the elimination of double taxation. A sunset clause will then usually be inserted as a last sentence in the tax sparing provision and may for instance be drafted as follows:

".....This provision shall apply for the first ten years for which the Convention is effective, but the competent authorities manuscrit each other to determine whether this period shall be extended."

A third proposal to deal with difficult issues may be a "grandfathering clause". Such a clause can be a solution when renegotiation of a treaty takes place. If the existing treaty gives a more favorable treatment for a person than the one proposed in the new draft treaty, a solution might be to let the old provision apply to persons already benefiting from the existing provision. Such a clause can be applied without limitation, or limited to a certain period of time. Grandfathering clauses can be inserted in a protocol to the treaty or in the termination article. A drafting example is to insert a paragraph in the termination article reading as follows:

"2. Notwithstanding the termination of this Convention in accordance with paragraph 1 of this Article, this Convention shall in an expent continue to apply to persons receiving income as mentioned in Article X. However provision shall on apply to persons receiving such income at the timesticonvention becomes effective."

A fourth proposal to deal with difficult issues may be to agree that a provision or an article shall become effective, not at the same time as the rest of the treaty, but at a later age to be agreed between the competent authorities.

One country may be prepared to accept a proposal from the other country, but at the time of negotiations does not have the legislative instruments in place to give effect to the provisions. An example could be where the government is considering the introduction into its treaties of an article on the assistance in the collection of taxes as that proposed in Article 27 of the UN and OECD

Model Conventions. However, since the necessary legislation has not been passed by the parliament at the time of negotiations, an article on the assistance in collection of taxes could not become effective until the necessary legislation has been approved. If the legislation is expected to be in place within a reasonable period of time a solution might be to accept the article but defer its entry into force. This avoids the time consuming work of introducing the article in the treaty through an amending protocol to the treaty at a later stage. To achieve a deferral, one solution is to add a paragraph or sub-paragraph in the article on the entry into force reading:

#### "Article 29

#### **Entry into force**

- 1. The Contracting States shall notify each other in writing, through diplomatic channels, that the legal requirements for the entry into force have been complied with.
- 2. This Convention shall enter into force upon the later of these notifications and shall thereupon have effect:
  - a. In State A in respect of taxes on income for any year of income beginning on or after
     ..... (date and month) next following that in which this Convention enters into force;
  - b. In State B in respect of taxes on income relating to any calendar year next following that in which the Convention enters into force;
  - c. For the purposes of Article 27 (Assistance in dollection of taxes), from a date to be agreed in an exchange of notes through the diplomatic channels."

Even if a team does not accept a proposal at once, it does not mean that it will not be accepted at a later stage during the negotiations. The team may have understood that the solution argued for is of great importance to the other team and is holding back to see what it may receive in return. If a team during the discussions indicates in its response that it may be willing to accept a proposal if certain conditions are met, try to establish what conditions the other team have in mind. If the conditions are not quite clear, try to clarify them.

During the discussions, compromises will often be suggested. Unless the compromises represent well-known positions and drafting, it is advisable to be very careful. Compromises drafted across the table are not always of the best quality. They may lead to unexpected results and can in worst cases

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scenarios be harmful to one or both countries. Unless one is very experienced, it can be difficult to foresee all implications of an unfamiliar wording. Even if the proposed wording seems to solve a problem, the best way to handle such compromises is to put them in brackets for further consideration. If the issue is not too important and the wording not too difficult it may be enough to have studied the wording during a break or in the evening after that day's session has ended. Depending on the importance of the issue, it may also be prudent to take it home for consultation with qualified persons.

During the discussions a team may realise that the other team has misunderstood the effect of a proposal that is made. Due to that misunderstanding, the other team may have accepted a proposal they otherwise would not have agreed to. It may also be that, during the discussions, a team realises that the other team has a different understanding of its own proposal than what is the general international understanding or that their proposal will not give the intended result.

For example, a country is of the opinion that its domestic legislation regarding the taxation of money transmitted from a branch of a foreign company to its headquarters in the other country (branch profit tax) is not in conflict with its obligations under the non-discrimination article. The other country may be of a different opinion. In such cases it will be wise to deal with the problem either in the relevant article or in a protocol. One way to solve the problem mentioned in the example above is to clarify the common understanding in the non-discrimination article itself:

"3. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be

negotiations, but before signature, a delicate situation may arise when the country refuses to sign the treaty or insists on renegotiation.

If a team at any time during the negotiation wishes to clarify issues or discuss arguments within the team, they should do so and ask for a time-out. It is better to take a time-out than make a wrong decision. All countries, developed as well as developing, have been in situations where a time-out has been necessary.

If an issue is agreed, accept it and move forward. It is not advisable to restate the issue by informing the other team how important the solution was, or to begin repeating the arguments. Restating the issue may result in the other team changing its mind or asking for further reflection before deciding.

To avoid unnecessary misunderstanding it is important that both teams send correct signals on their attitude to the proposals put forward. One should avoid a situation when a team at the end of a discussion has got the understanding that an agreement has been reached, but the other team at a later stage claims that it never had meant to agree, but had just signalled a positive attitude to agree provided that all other issues in the treaty had been resolved acceptably.

One should always take notes during the meeting. Notes are extremely important if a second round of negotiations is needed. Some time usually elapses between the first and the second round of negotiations. Members of the team during the first round of negotiations may have left or moved to other positions. The team preparing for the second round will therefore of

regional models. This is why preparations are so important. Without having done the "homework" before the negotiations take place, a team may not be able to convince the other team why special wording is an improvement on recognised international models. Special wording may be considered necessary to take care of certain economic activities, such as mining or the extraction of natural resources. It may also be related to activities in the financial sector like banks or drafted to remove uncertainty in relation to the use of new financial instruments.

Different wording from the international models can often be found in the Commentaries to those models. In such a case the Commentaries will usually explain the wording and relevant arguments can be found there. However,ng an-n relati

A third example may be that a certain economic activity in a country is of such economic importance to that country that special provisions have to be introduced in the treaty to prevent revenue losses. To achieve this, a country may want to introduce provisions enabling that country to tax any activity performed there by a foreign enterprise no matter the length of their stay. Such provisions will often be linked to mining or the extraction of natural resources.

In several cases a provision may be asked for to prevent abuse

When negotiating a tax treaty it is important to have in mind that the purpose of a treaty is to avoid double taxation and to stimulate cross border activities. The purpose is never to create a situation of double non-taxation. It is also important for a country to be aware of provisions in a treaty that business can misuse to avoid taxation in the country of source or even in the country of residence.

In the Commentary to Article 1 in the UN Model Convention there is a chapter on the improper use of tax treaties, which discusses the use of legislative anti-abuse rules found in domestic legislation. A similar chapter is found in the Commentary to Article 1 in the OECD Model Convention. In both models it is argued that anti-abuse rules found in domestic legislation are generally not contrary to tax treaty provisions and could be used to combat improper use of tax treaties.

However, despite the good arguments in the UN and OECD Model Conventions for using domestic legislation to combat the improper use of tax treaties, it may in certain cases be advisable to introduce specific anti-abuse provision in these treaties. Both the UN and the OECD Model Conventions discuss the use of specific anti-abuse rules found in tax treaties.

When prevention of abuse is used as an argument, it is important to use examples to illustrate why a certain wording is necessary.

An example could be the introduction of thin capitalisation rules in domestic legislation. Depending on the wording of such legislation, the rules could be argued to be contrary to the non-discrimination article in the tax treaty. To avoid a discussion of legislation to combat the use of excessive debt capital instead of equity capital to finance the

Some countries have non-negotiable provisions in their model. That can be due to certain business activities or industries such as mining or extraction of natural resources. It may also be related to incentive legislation or other areas of great importance, or it may be for policy reasons such as exchange of information.

It is, however, important to distinguish between provisions that are really non-negotiable and provisions which are only strongly preferred. Provisi

## 7. Records of discussions

During the discussions it is advisable to have the working draft electronically projected on a screen that is visible to both teams. One team member needs to be made responsible for maintaining the agreed text. In this way everybody can check that the changes made are correct. When going through the working draft, article by article, all wording that is not agreed should be put in brackets. One way of doing this is to use colours. The preferred wording for both teams should be put in brackets using different colours. This would make it easier to identify where agreement is not achieved and what the position is for each of the teams. By using brackets it will also be clear to both teams what is agreed and what is not. What is not put in brackets should be regarded as agreed and closed. If there is no screen it is important to read the text before moving on to the next issue. One example of using brackets and colours might be:

(3. Gains derived by an enterprise of a Contracting State from the alienation of ships or aircraft operated in international traffic or movable property pertaining to the operation of such ships or aircraft shall be taxable only in that the Contracting State in which the place of effective management of the enterprise is situated.)

(3. Gains derived by an enterprise of a Contracting State from the alienation of ships or

#### Alternatively:

aircraft operated in international traffic or movable property pertaining to the operation of such ships or aircraft shall be taxable only in that the Contracting State in which the place of effective management of the enterprise is situated. Wed. Working draft ele8 shouldienationrect. t&T1t i&Shall(be taxable)

If no colours are used letters should be used to mark the different proposals:

(3. Gains (AP derived by an enterprise of a Capting State) from the alienation of ships

When initialling a draft, begin by initialling on the left side of the page. Your initials should be found just below the last line on each page, which is not necessarily on the bottom of the page. The theory behind this is to avoid that anything should be added or removed in the text without being discovered. When all pages are initialled, exchange draft and initial on the right side. When both leaders have initialled the two drafts there will be one initialled draft for each country. The copy to bring home is the one where your initials are found first. (Initials on the left side of the page). However, if the initialling is done differently, it is of no importance as long as the two leaders have a draft that shows what has been agreed. The initialling of the draft has no binding effect on the countries. It shows what the two leaders have agreed and are prepared to take home to be presented for approval by the relevant authority.

Before ending the meeting it is advisable to produce an Agreed Minute. In this document all major outstanding issues should be noted. In Annexes 1 and 2 there are examples on the drafting of such Minutes.

If the understanding of a provision has been discussed and agreed on during the meeting or one of the teams has stated how it will interpret a provision, this understanding or interpretation should be noted.

If there is to be a second round of negotiation, the open issues should be in brackets, indicating either in colours or otherwise, the positions of the two countries. It is also wise to agree on a (tentative) date for future negotiations and note this date in the minute. That date should not be too far into the future. If it takes too long between the first and second round of negotiations the members of the teams from the first round of negotiations may not be present for the second round. The result could be that issues agreed during the first round will be reopened by a new leader, which may harm the process of finalizing the treaty and create irritation and confusion.

## 8. Conclusion

It is during the discussions you will realise how important preparations are. Be aware of your country's policy and your own model. It is essential to meet prepared and be ready to explain your proposals and the reasoning behind. Behave respectfully and listen carefully to arguments put forward. Be careful to take notes during the discussions. To achieve a treaty that is beneficial to your country, it is important to be patient and be prepared to propose alternatives and compromises to solve what may seem as a deadlock. If necessary, be prepared for a second round of negotiations.

## Annex 1

#### **AGREED MINUTE**

A first round of negotiations of a Convention between State A and State B for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income was held in ..... from .... through.....Date and Year. The delegation from State A was headed by Mr ......., Director in the Ministry of Finance. The delegation from State B was headed by Mr....... Director in the Ministry of Finance. A list of both delegations is attached as Annex I.

The negotiations were conducted in a friendly atmosphere of mutual understanding and cordiality. While most Articles of the Convention were discussed in depth and agreed, some provisions were left pending and these are indicated in brackets and marked in colour. Yellow for State A and green for State B. The pending issues include Article 5, paragraph 3, Article 8, Article 11, Article 12, Article 13, Article 19, Article 21 and Article 26. These pending issues are set out in the joint draft text attached as Annex II which will be used in the

## Annex 2

Done in .... on ... Month and Year

#### **AGREED MINUTE**

A second round of negotiations for the conclusion of a Convention between State A and State B for
the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income
was held in from through Month and Year. The delegation from State A was headed by
Mr Director, Ministry of Finance, while the delegation from State B was headed by Mr,
Director, Ministry of Finance. A list of both delegations is attached herewith as Annex I.

The negotiations were conducted in a friendly atmosphere of mutual understanding and cordiality. The provisions of the Convention that were left open after the first round of discussions in ....., as well as a number of other provisions previously accepted, were discussed in depth. The discussions led to an agreement at official's level on all issues and an agreed text was initialled on .. Month and Year. The agreed text is attached herewith as Annex 2.

For the delegation from State A:	For the delegation from State B:
Mr	Mr
(Head of delegation)	(Head of delegation)