# PART ONE

# ANALYTICAL AND HISTORICAL REVIEW OF INTERNATIONAL DOUBLE TAXATION AND TAX EVASION AND AVOIDANCE

# I. INTERNATIONAL DOUBLE TAXATION

## A. Concepts and issues

1. The jurisdiction to impose income tax is based either on the relationship of the income (tax object) to the taxing state (commonly known as the source or *situs*

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 presen

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

whether or not the income item is formally subject to multiple levels of taxation. For example, many tax treaties operate to provide tax relief to a corporate group when a State has imposed an income tax on profits earned by a subsidiary corporation and another State otherwise would impose an income tax on its parent corporation when those profits are distributed as a dividend. In general, tax treaties attempt to eliminate most forms of international double taxation, narrowly defined, and various other forms of international double taxation when a failure to do so would have a demonstrably harmful impact on international trade and investment.

12. A major goal of bilateral tax treaties is to remove impediments to international trade and investment by reducing the threat of double taxation that can occur when both Contracting States impose tax on the same income. This goal is advanced in four distinct ways. First, a bilateral tax treaty generally increases the extent to which exporters residing in one Contracting State can engage in trading activity in the other Contracting State without attracting tax liability in that latter State. Second, when a resident of a Contracting State does engage in a sufficient activity in the other Contracting State for that State to have the right to tax, the treaty establishes certain guidelines on how that income is to be taxed. For example, those guidelines may assign to one Contracting State or the other the primary right of taxation with respect to particular categories of income. They 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.

13. 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.

14. 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

resident in the other Contracting State. Similarly, the treaty may specify which Contracting State may tax income derived from the performance of services in one Contracting State by an individual who is a resident in the other Contracting State. In general terms, the tax treaty may assign primary (but not exclusive) jurisdiction to tax to the Contracting State in which the economic activities occur if those activities have substance and continuity that exceed some threshold level. When the economic penetration is relatively minor, however, exclusive jurisdiction to tax may be assigned to the Contracting State where the corporation or individual is a resident.

15. The scope of a bilateral tax treaty typically is not limited to commercial and business activities. Treaties may remove tax impediments to desirable scientific, educational, cultural, artistic and athletic interchanges. In addition, a treaty may address issues arising in the tax treatment of pension plans and Social Security benefits, of contributions to charitable organizations, of scholarships and stipends paid to visiting scholars, researchers, and students, and even of alimony and child support payments.

16. A bilateral tax treaty cannot anticipate every income tax issue that is likely to arise between Contracting States. Some issues, such as issues relating to the growth of electronic commerce, are difficult to address currently by tax treaty because the international community has not yet reached a consensus on the appropriate standard for taxation. The international community generally recognizes that the current treaty rules relating to the definition of a permanent establishment were 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

to license that process to a related subsidiary cor

with the remaining part of the enterprise, its income is determined by application of the arm's length standard. In some cases, however, a multinational enterprise will operate in a country through a

25. Special problems arise in determining the appro

invited to the new U.S –U.K. tax treaty and specifically to the notes regarding the provisions of Article 7 thereof). Some commentators have asserted, however, that the right of banks to use a separate entity approach can be read into the language of Article 7(2) of the OECD and UN Model Conventions, which provide that "there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise." This language does not necessarily support the position for which it is asserted. The simple fact is that "separate and distinct enterprises" do not make payments on hypothetical loans for which they have no legal liability. Another plausible reading of the above language is that the profits of a branch from transactions that actually occurred should be measured by reference to market prices.[11]

29. Double tax conventions are an established way fhayAn
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(c) Two States may invoke the source principle to tax the same item of income, due to conflicts in the way the source of income is determined under their domestic

resident of State A. R earns wages of 800 in State A and 200 in State B. Under the rate schedule applicable in State A, income below 100 is taxed at 20 per cent and income above that amount is taxable at 30 per cent. State A is required, by treaty or domestic legislation, to exempt 100 of income. In determining the tax on the remaining 900 of income, however, it is permitted to tax 900 of income at 30 per cent, just as it would have done if all of R's income had been taxable. The effect of exemption with progression is to take the exempt income into account in determining a resident's ability to pay but applying a zero tax rate to that income. The exemption with progression method has been used in many treaties, including treaties concluded by Austria, Belgium, Germany, Finland, France, Iceland, Luxembourg, The Netherlands, Spain and Switzerland.

33. States using the exemption method ordinarily do not extend the exemption to foreign dividends, interest and royalties. Many countries, however, grant special relief for domestic

advantage of this feature of the credit.  For examp

### (c) Tax-sparing methods

43. Tax-sparing credits 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 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.

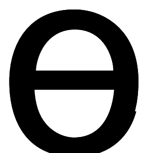
44. Most developed countries have provided tax-sparing credits in their tax treaties with developing countries. The list of countries providing tax-sparing credits by treaty includes Canada, France, Germany, Japan and the United Kingdom. In its initial report on harmful tax competition, however, the OECD has expressed some concerns about tax-sparing agreements, due to the possibility that they foster harmful tax competition.[13] The United States of America has opposed tax-sparing for nearly half a century and has never ratified a tax treaty that included a tax-sparing provision.[14] The United States' position is based, in part, on its strong commitment to the principle of capital export neutrality and to the principle that residents with equal taxable incomes should pay equal amounts of tax.

45. Tax-sparing credits is a practice designed to promote the effectiveness of local tax incentives for foreign investment. D,56( )9.016 Td [(t.8996(m)-)3.17onpaby tave 0 0 1 529.92 38.4 Tm [(1)-7.0015789(t)

~~it may be modified in any bilateral agreement reached, it is sufficiently elastic to be adapted to the different conditions obtaining in different countries or pairs of countries."~~[15]

### 1. The 1928 Model Bilat

purposes, rules for the allocation of business in
(the term 'undertakings' being understood as
persons). A Draft Convention for the All



57. The work of revision was begun by a Subcommittee that met at The Hague

~~The Committee observed that virtually the only clauses where there was an effective divergence~~
be

~~These tax problems may be mainly considered under the following headings:~~

1. Double taxation of income, estates and successions, property and c

65. ~~The structure and incidence of a country's tax system have a direct influence on the capacity and willingness of domestic concerns to do business abroad as well as on the ability of the country to attract foreign capital and enterprises. It would be difficult to remove the obstacles which taxation may oppose to international trade and investment without determining the manner in which the different types of taxes, considered separately and together, can be adapted to the social and economic conditions of the various countries."~~ .

### 5. OECD Model Bilateral Tax Conventions

66. Like the 1928 model bilateral conventions, which never won wide acceptance, the model 79431( )-40.55

# II. INTERNATIONAL TAX EVASION AND AVOIDANCE

## A. Concepts and issues

71. Various features of the globalized economy have enabled an increasing number of individuals and companies to resort to tax evasion or tax avoidance. These features include the ease and rapidity of communications, the progressive elimination of o

rules and therefore does not succeed in minimizing

and hence the honest taxpayers who do not escape their liability to pay tax must bear an additional burden to plug the gap. Countries where the tax compliance is the highest lose out, since the trade flows are diverted elsewhere.

### (a) International cooperation

77. Tax authorities in the Member States of the OECD have responded to concerns about avoidance and evasion by taking on new powers to collect information from taxpayers. Delegates to the Working Party on Tax Avoidance and Evasion systematically inform other countries about the means at their disposal for countering avoidance. These reports cover legislation, court decisions and audit techniques. It is through this exchange of experiences that the Committee is able to develop and promote the adoption of practices that should enable tax authorities to administer their tax laws in an effective and equitable manner. An example of the results of such discussions is the OECD recommendation on the use and disclosure of Tax Identification Numbers (TINs) to increase compliance on cross-border income flows.

78. Ways of increasing compliance in cross-border financial transactions and on access to bank information for tax purposes are the focus of current work. Additional work will also be carried out to identify and address other barriers to the identification of beneficial ownership and exchange of such information.

79.

information under the tax treaty, it may not be desirable to conclude a bilateral tax treaty with it. In fact, it is necessary to first discuss the issue of information exchange with the other Contracting State before beginning formal negotiations, because it is one of the very few issues that should be considered as non-negotiable. This may even prevent a country from entering into treaties with some countries with which it may have significant economic ties, but this may be treated as the right policy.

81. Recent technological developments which facilitate international, thus anonymous, communications, and commercial and financial activities can also encourage illegal activities.[30] Over the past several years there has been a marked change, as many of the industrialized nations have recognized the importance of exchange of tax information; the absence thereof serves to encourage not only tax avoidance and evasion but also criminal tax fraud, money-laundering, illegal drug trafficking, and other criminal activity.

### (b) Tax planning and treaty shopping

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of the treaty to *bona fide* residents of the treaty partner. These provisions cannot be uniform, as each country has its own characteristics that make it more or less inviting to treaty shopping in particular ways. Consequently, each provision must to some extent be tailored to fit the facts and circumstances of the treaty partners' internal laws and practices. Moreover, the provisions need to strike a balance that avoids interfering with legitimate and desirable economic activity.

84. In addition to the treaty-shopping abuses, there are an increasing number of other types of transactions that seek to use treaties to achieve inappropriate results. Anti-abuse rules are generally complementary to the anti-treaty-shopping rules. Anti-treaty-shopping rules take the broad approach of denying all treaty benefits to persons who are not *bona fide* residents of the treaty country. Anti-abuse rules are more targeted in the sense that they are not blanket exclusions from all treaty benefits; they deny specific treaty benefits in abuse cases. It is relevant to mention that the last paragraphs of the commentaries on articles 10, 11, 12 and 21 in the United Nations Model Double Taxation Convention between Developed and Developing Countries refer to the artificial devices entered into by persons to take advantage of the provisions of those articles through creation or assignment of rights in respect of the income specified in those articles. Contracting States which may wish to specifically address the issue are advised to include the specified clause in their bilateral tax treaties.

85. It is necessary to include anti-abuse rules in bilateral tax treaties in view of several concurrent developments in international tax law. Firstly, although an overwhelming majority of taxpayers who avail themselves of treaty benefits are entitled to those benefits and are not engaged in abusive transactions, aggressive abuse of treaties has increased. It is relevant to point out that both the commentary to Article 1 of the OECD Model Tax Treaty and the OECD Report on Harmful Tax Competition make clear that countries can impose their domestic anti-abuse rules to claims for treaty benefits. In fact, concerns about the adequacy of current treaty rules to prevent abuses have stimulated work in the OECD on this subject.

86. The increase in treaty abuses has unfortunate results for both the treasury of the country and the taxpayers; it requires the treasury to divert resources to fighting abuse that it might otherwise devote to improving the treaty network. The emergence internationally of anti-abuse rules addresses the abuse problem, while at the same 3.15789(e)3.15789( [illegible]

distinguished between two types of low-tax jurisdictions – those that simply offer a low-tax environment and those it has identified as "non-cooperative jurisdictions". The OECD has sought to combat the threat of non-cooperative jurisdictions to the legitimate tax-policy objectives of its

92. Another important practice in this category is the wilful or negligent failure to report all items of international income that are subject to tax. The items most often omitted are salaries, wages and non-commercial income, interest and dividends, business income, income from real estate, gains on the disposition of property and royalties.

*Salaries, wages and non-commercial income*

93. Persons receiving remuneration from abroad in payment for services or in the form of pensions and annuities frequently fail to report this income in tax returns to their country of residence. Consequently, such income, if not taxed at the source, is apt to escape taxation both in the country where it is acquired and in the country in which the recipient is resident.

*Interest and dividends*

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facilitated by limitations in domestic law on the e

no-tax countries by fixing the royalties at artificially high rates. Such devices are facilitated by difficulties in estimating the arm's length value of monopoly rights. In addition, multinational firms

b. Practices resorted to in order to evade or avoid

121. To further disguise the true facts, a resident of country A with a numbered bank account in country B may arrange to have the bank in country B forward funds to an unrelated bank in country C from which he will then "borrow" an equivalent amount.

v. Investment trusts

122. An international investment trust, by concentrating funds from many different sources in a single investment pool, may be utilized by numerous investors as a tool for tax evasion. In many cases, an international investment trust will be used to obtain tax treaty benefits for its investors without the tax authorities in their country of residence learning about the income.

d. Use of related tax-haven entities to reduce taxes

123. Taxpayers sometimes utilize entities organized in tax-haven countries to reduce taxes legally, the legality of the transactions depending on the laws of the country where taxpayers are located. The presence of tax-haven countries, however, invites tax evasion activities that initiate essentially false or illegal relationships with the tax-haven country. Some of the latter situations are described below.53414(a)3.160330.958863(d)-0.9564Ta6033(a)3.160621915(.53414(a)5886-1002.39(T)-0.167556(a478(r

~~That assistance was to consist of the exchange of fiscal information available in either of the~~ Contracting States and in co

~~administrative assistance for the assessment and collection of taxes on income, property, estates and successions. Both conventions contain an identical clause under which if the competent authority of a Contracting State considered information concerning particular cases to be necessary for the assessment of taxes covered by the convention, it could obtain that information through direct correspondence with the competent authority of the other Contracting State without having to use diplomatic channels. The conventions also indicated in identical language the kind of information which should be supplied and specified in the cases in which special requests for information or~~ assistance in enforcing tax laws might be refused. Those cases related to requests

~~(c) the carrying out of investigations, for making correct assessments for taxes on income or profits, by one State, in compliance with national laws, on behalf of another when the~~ latter State reques

138. The OECD Committee on Fiscal Affairs has been devoting considerable attention to international tax evasion and avoidance, and one of its working parties is specifically responsible for investigating the related issues. The OECD adopted on 21 September 1977 a recommendation[37] requesting Member States to strengthen their machinery for combating international tax evasion and avoidance, to encourage the exchange of information between national tax administrations and to compare their experience with regard to the practices and techniques used. Also, on 29 June 1979, the Committee on Fiscal Affairs adopted a Model Convention for Mutual Administrative Assistance in the Recovery of Tax Claims.

### C. Mutual administrative assistance

139. Increasingly, tax treaties are stipulating assistance in collecting taxes. So far, a similar provision has not been included in the United Nations tax treaty model. Such an article would have two main advantages. Firstly, it increases the chance of collecting taxes from taxpayers living abroad. Secondly, it reduces tax evasion possibilitiyersaog t

to be paid by the requesting State.  A settled currency rate can be a useful tool to help settle these