E/C.18/2008/CRP.5

Distr.: Restricted
20 October 2008

ENGLISH ONLY

Economic and Social Council

Committee of Experts on International Cooperation in Tax Matters

Fourth session

Geneva, 20-24 October 2008

Item 4 (f) of the provisional agenda

Discussion of substantive issues related to international cooperation in tax matters

Revision of the United Nations Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries

Revision of the United Nations Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries*

Note by the coordinator of the working group

* The present paper was prepared by Professor Jon Bischel, a member of the working group on Revision of the United Nations Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries (Coordinator: Professor Brunetti). The views and opinions expressed are those of the authors and do not necessarily represent those of the United Nations.

GE.08-63525

BASIC APPROACHES TO TAX TREATY NEGOTIATION

Introduction

Income tax treaties (technically "conventions") begin with the recitation that they are entered into between countries for the purpose of avoiding double taxation of international income flows. The problem of potential international double taxation arises each time an enterprise enters into an inter-country transaction or an individual steps across an international boundary. Taxing conflicts arise in these situations when the countries involved each lay claim to an income tax on resulting income or profits. Historically, the initial measures invoked to alleviate international double taxation were unilateral in nature. Some countries employ a foreign tax credit or offset mechanism. Other countries use an exemption mechanism whereby foreign source income earned by their residents is exempted from domestic taxation. Additional countries use either the tax credit or exemption methods in different tax contexts. Both of the foregoi

liable to taxation therein on the basis of domicile, residence, place of management or any other criterion of a similar nature.

SIGNIFICANCE: A primary purpose of tax treaties is to promote international commerce by eliminating bilateral international double taxation between treaty partners. However, the scope of a tax treaty is not limited to commercial and business activities. In broad terms, Article 1 defines the outer scope of potential treaty benefits with regard to the imposition of both source and residency income taxing jurisdiction. Yet, unintended third country benefits may still potentially be derived through the use of bilateral tax treaties. In some cases the "beneficial owner" rules are inserted in treaties to limit the improper use of treaties. As some countries view domestic anti-avoidance rules to conflict with treaty provisions, treaty negotiators may wish to consider the effect of other treaty and domestic anti-tax avoidance measures.

EXAMPLE: United States treaties contain a "saving clause" which provides that the United States in determining its taxes of U.S. citizens, residents or corporation may, regardless of other treaty provisions, include all items of income taxable under U.S. revenue laws on the basis upon which the United States imposes taxes. Thus, U.S. citizens, residents and corporations may expect a benefit from a tax treaty only to the extent the foreign treaty partner makes concessions with respect to its own taxes not otherwise creditable for foreign tax credit purposes.

Article 2 – Taxes Covered

The model treaties each contain 4 paragraphs, the first two of which broadly define what taxes, both income and capital, are covered by the treaty. However, most actually negotiated treaties dispense with inclusion of the first two paragraphs and move immediately to include the third paragraph of the model treaties. The third paragraph specifies exactly which taxes of each treaty partner are to be applicable to the treaty. (See the treaties in the Appendix).

EXAMPLE: New Zealand – South Africa

1. The existing taxes to which this Agreement shall apply are:

   (a) In New Zealand, the income tax (hereinafter referred to as "New Zealand Tax")

   (b) In South Africa

      (i) The normal tax

      (ii) The secondary tax on companies; and

      (iii) The withholding tax on royalties

Many treaties also contain a provision similar to paragraph 4 of the model treaties which provides that the treaty will also apply to any identical or similar taxes which are imposed after the treaty is in force. The paragraph requires the competent authorities of the Contracting States to notify each other within a reasonable time of any significant changes that have been made in their tax law.

SIGNIFICANCE: The definition of taxes covered relates directly to which taxes are to be accorded unilateral tax relief via the credit or exemptions mechanisms pursuant to Article 23 of the model treaties, titled Methods for the Elimination of Double Taxation. Specificity in defining the taxes to be covered by the treaty is therefore critical as taxes of either country not included in the definition of taxes covered by the treaty will not qualify for foreign tax credit purposes. This is especially important where a tax is not a pure income tax, e.g. a trade tax or net worth tax.

Article 3 – General Definitions

The model treaties use Article 3 to group a number of general definitions required for interpretation of the terns used in a treaty. They are “person”, “company”, “enterprise of a Contracting State”, “international traffic” and “national”. Actually negotiated treaties with countries which use place of incorporation to define corporate residence (e.g. United States, Mexico) may contain the term “resident” instead of “place of effective management” in the definition of “international traffic”.

Space is also left for the designation of the “competent authority” of each Contracting State which is important for the settlement of treaty disputes under the mutual agreement procedure set forth in Article 25 of the model treaties. The terms “resident” and “permanent establishment” are defined in Articles 4 and 5 respectively, while the interpretation of certain terms used in the articles on special categories of income (e.g. immovable property, Article 6 and dividends, Article 10) is clarified in the articles concerned. Treaty negotiators are free to agree bilaterally on definitions of the terms “a Contracting State” and “the other Contracting State”. Negotiators may also wish to include a reference to continental shelves in the definition of a Contracting State. Some existing treaties also include a definition of natural resources.

Under Article 3, paragraph 2, any treaty term not defined within the treaty takes its meaning from the domestic law of the Contracting State imposing the tax whether or not a tax law, unless the context demands otherwise. Where a term is defined differently for the purposes of different laws, the meaning given to that term for the purposes of the laws imposing the taxes to which the treaty applies predominates over all other laws, including those stated for purposes of other tax laws.

As paragraph 2 states, the foregoing rule applies only if the context does not require another interpretation. The context consists of particular of the intention of the Contracting States when signing the treaty as well as the meaning given to the term in question in the legislation of the other Contracting State which is an implicit reference to the principle of reciprocity upon which a tax treaty is based, thereby allowing the competent authorities some interpretative leeway.

The question arises as to which legislation must be referred to in order to determine the meaning of terms not defined in a treaty, the choice being between the legislation in force when the treaty was signed or that in force when a tax is imposed under the treaty. Both model treaty commentaries were recently clarified to specify that in the event of a conflict the law in force when a tax is imposed will prevail.