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DOMESTIC POLICIES ON NEGOTIATING TAX TREATIES

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Summary

This policy brief describes the need to have domestic policies on negotiating tax treaties and provides some insight into what this policy should incorporate.

Key words: treaty negotiation, tax policy

Introduction

Since the beginning of the twentieth century, there has been an exponential growth in cross-border trade and investment, resulting today in a highly integrated, mobile and complex global economy. All countries are involved in international trade and investment, whether it is cross-border trade in goods or services, foreign investment, transfer of technology or movement of workers. All countries, whether developed or developing, require rules to address the ever-increasing number of international tax issues that arise from such activities.

Differences in the domestic tax law criteria used to determine residence for tax purposes mean that individuals and legal entities that have links to more than one country may be regarded as tax residents of more than one country, and hence liable to tax on their worldwide income or capital in more than one country.[1] This has implications for taxation, therefore negotiation of tax treaties is crucial towards advancing international tax cooperation through which to secure domestic resource mobilisation (DRM). DRM is central to achieving sustainable development. Taxes represent a stable source of finance which when complemented by other sources, is critical to financing Agenda 2030 on Sustainable Development.

Taxation is essential to providing public goods and services, increasing equity and helping manage macroeconomic stability. Taxes seen alongside SDG 17 on the means of implementation and global partnership for sustainable development calls on the international community to strengthen domestic resource mobilisation, including through international support to developing countries, to improve domestic capacity for tax and other revenue collection.[2] This can be done through negotiating tax treaties either through

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[1] Department of International Economic and Social Affairs, *Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries*, United Nations Publications, New York, 1979.

[2] Vitor Gaspar, Laura Jaramillo and Philippe Wingender, T*ax Capacity and Growth: Is there a Tipping Point?* IMF Working Paper WP/16/234, November 2016, p.30.

a UN Multilateral Instrument (MLI) which can provide a speedy manner for updating multiple tax treaties through a single negotiation process or through a country's own domestic tax treaty policy.

Tax treaty policy framework and country's model tax treaty

All countries would find it beneficial to develop their own policy on negotiating tax treaties and a model tax treaty. A country has to "know what it wants". Such a tax treaty policy framework should establish and explain the main policy outcomes that a country wishes to achieve when negotiating tax treaties. It should identify:

- The treaty negotiation outcomes that would be the most beneficial to the country;
- The outcomes that must be achieved in any negotiation; and
- How much flexibility negotiators have on other issues, including whether there is a "bottom line" (that is to say, a minimum outcome that must be achieved to reach agreement).

The model treaty should reflect the choices made when developing the country's tax treaty policy framework and should take the form of a draft treaty showing the different provisions that the country would ideally want its tax treaties to include.

Countries should be forward-looking in designing their tax policy framework and model. Treaties usually last for many years often decades. Renegotiation of a treaty is time-consuming and expensive; it is worthwhile to consider policies that are robust and sustainable in the long term.[3]

If possible, the tax policy framework and the model should be agreed on a whole-of-government basis. In particular, if treaties are negotiated by the tax administration rather than by the ministry in charge of finance, the support of the latter is important in order to ensure that the treaty policy is consistent with the government's economic objectives. The input of other ministries, such as those in charge of foreign affairs or trade, may also be important.

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.[4]

Designing a tax treaty policy

Several factors should be taken into account when developing a country's tax treaty policy framework. These include:

1. The income categories. Developing countries may find it helpful to develop their treaty policy framework on the basis of an analysis of the distributive rules of the UN and OECD models in the context of their own circumstances. In particular, they may wish to consider:

    - Category of income
    - Tax treatment
    - Ease of administration

Countries would be well advised to follow as closely as possible the treaty policy options

[3] Department of Economic and Social Affairs, Division for Public Administration and Development Management, *Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries*, United Nations, New York, 1979, document ST/ESA/ PAD/SER.E/37.

[4] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries 2017,* (New York: United Nations, 2018).

reflected in the UN and OECD models. Having regard to their particular circumstances, however, countries may determine that these options do not fully meet their needs or may create unacceptable difficulties for them. 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.[5]

2. In deciding to move away from the policy choices endorsed in the UN and OECD models, countries should consider:

   - Reason
   - Priority
   - Achievability
   - Flexibility
   - Fall-back positions

In designing its tax treaty policy, a country should also be mindful of the commitments related to tax treaty provisions that it has made as a participant in regional groupings and international organizations. For instance, countries that are members of regional groupings may have agreed to follow a common approach when negotiating tax treaties. Also, countries that have joined the Inclusive Framework on BEPS have committed to follow certain minimum standards when negotiating treaties.

3. Departures from the international models will almost always increase the difficulty of negotiating a satisfactory treaty. Accordingly, countries, especially those with limited negotiating capacity, should deviate from the international norms only sparingly, that is to say, where there is a clear national interest in doing so. On these aspects, each country should determine:

   - Its preferred position;
   - The priority the country places on achieving that position; and
   - The degree of flexibility available to negotiators and any fixed "bottom line".

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 policy will also assist countries in designing their country's tax model, which should reflect the policy outcomes sought.[6]

Preparing for tax treaty negotiation

Once a country has developed its tax treaty policy and its country tax model, and has determined an order of priority of the countries with which it intends to have tax treaties with, it will be in a position to start preparations for actual negotiations with those countries.

Treaty negotiators may be approached by officials of another country for the purposes of having "exploratory" discussions related to a possible tax treaty. To avoid any misunderstanding, it should be made clear, before such discussions take place, whether this will involve an article-by-article discussion or whether the entire draft treaty is to be discussed based on its substance.

Preparations are an extremely important part of the negotiation process. Without adequate preparations, the negotiating team will be at a disadvantage during the negotiations and will most probably not achieve an optimal result for the country it is representing.

In most countries, treaty negotiators require authorization from appropriate authorities to negotiate with another country. Sometimes a

[5] Available at http://www.un.org/esa/ffd/publications/papers-ntt.html.

[6] See http://www.oecd.org/tax/beps/beps-about.htm

new authorization is required for each round of negotiations. Practice, however, varies among countries. Regardless of the process for authorization, the ministry in charge of foreign affairs should be consulted before any decision is made to undertake negotiations with another country.

The main benefit in negotiating tax treaties is that they remove or reduce double taxation, tax discrimination, complexity, and uncertainty which, constitute barriers to cross border investment and the transfer of knowledge and skills. For developing countries, however, there may be other benefits to be gained from tax treaties. For example, negotiation of treaties by a developing country may be seen by other countries as an expression of its willingness to conform to the international tax norms.

It may also signal a close political and/or economic relationship between two countries, or form part of a network of relationships, for example, within a region. Sometimes, a tax treaty may be negotiated as part of a suite of bilateral treaties aimed at closer ties between the countries.

Developing countries, however, may be legitimately concerned about entering into tax treaties, either generally or with particular countries, because of a fear of losing revenues as a result of the limitations on source taxation that such treaties impose and the risks of treaty abuse, including treaty-shopping, that they present.

The decision to enter into a tax treaty with another country is therefore not one to be undertaken lightly, especially for developing countries. Countries entering into tax treaty negotiations need a good understanding of the benefits and costs that arise from having tax treaties. Regardless of the reasons for entering into a tax treaty, tax policy considerations should play a key role in the decision of whether to do so. While a country may wish to have a tax treaty with a particular country to facilitate foreign investment, it must understand how a tax treaty will interact with the tax systems of both treaty partners to assess whether and to what extent it is realistic to expect a tax treaty to meet that objective.

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