
Summary of the Proceedings of an Invitational Seminar on Tax Treaties in the 21st Century

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INTRODUCTION

The importance of tax treaties has increased significantly in recent years as a consequence of the globalization of the economy and the liberalization of cross-border trade and investment. The number of bilateral tax treaties currently in force exceeds 2,500. The model tax convention of the Organisation for Economic Co-operation and Development (OECD),¹ on which virtually all bilateral treaties are based, is now revised on a regular basis. The United Nations (UN) model convention² was revised in 2001. Despite their importance and their phenomenal growth in recent years, tax treaties are often criticized for their fundamental deficiencies. Therefore, the time seems appropriate for a fundamental review of the role of tax treaties in facilitating international trade and investment.

From October 23 to 25, 2001, an invitational seminar on the future of tax treaties was held in the new premises of the International Bureau for Fiscal Documentation (IBFD) in Amsterdam. This article summarizes the discussions during the seminar. It is being published in the *Bulletin for International Fiscal Documentation* and the *Canadian Tax Journal*. The seminar was jointly sponsored by the Canadian Tax Foundation, Harvard Law School's International Tax Program, the IBFD, Maisto e Associati, Milan, and the OECD. The following 29 tax treaty experts participated in the seminar:

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The participants were government officials, including several treaty negotiators, representatives of international organizations, academics, and practitioners from countries around the world. To encourage free discussion, the participants attended the seminar as individuals acting in their personal capacity rather than as representatives of their firms, governments, or organizations. The following summary of the discussions held during the seminar does not attribute comments to specific participants. The summary has been prepared by the three authors listed above, who are solely responsible for its content. An earlier draft was made available to the participants for their review.

The purpose of the seminar was to stimulate broad-ranging discussion of the nature, role, and operation of tax treaties, with a view to enhancing the understanding of tax treaties and to identifying ways in which they might be improved. In keeping with this broad objective, the participants were encouraged to discuss fundamental theoretical and structural issues involving tax treaties rather than technical details. On the other hand, to narrow the scope of the discussion, the participants were asked to assume that income taxes on individuals and corporations would continue to exist, that countries would continue to impose tax on both a residence and a source basis, and that some international mechanism to coordinate or bridge national income tax systems would continue to be necessary and desirable.

The agenda for the seminar, reproduced in appendix 1, was divided into 10 major topics. The seminar started with several fundamental topics, such as the need for and the appropriate goals of tax treaties and a comparison of the respective merits of multilateral and bilateral treaties, and then moved on to more specific and practical topics, such as the treatment of business profits and the elimination of double taxation. To focus the discussions, a brief background note was prepared for each session. These background notes, reproduced in appendix 2, sought to identify the major issues for discussion and, if appropriate, possible solutions for problems. Each of the authors of the notes made a brief presentation at the beginning of the session addressing his topic.

Tax treaties do not “belong” to the OECD or the United Nations, although the OECD and UN models have had enormous influence on the development and wording of bilateral treaties. Nor do tax treaties “belong” to the governments that are the contracting states. Tax treaties have important consequences for governments, international organizations, and taxpayers. This seminar and the summary of its proceedings are intended to initiate and stimulate a broad international debate concerning the future of tax treaties. It is anticipated that a series of future meetings will be held to deal with specific aspects of bilateral tax treaties.

THE ROLE OF TAX TREATIES IN THE 21ST CENTURY

The first session of the seminar was intended to address the general background and environment of tax treaties. The background note by Jacques Sasseville³ raised three major issues for discussion:

1. the need for bilateral tax treaties,
2. the structural deficiencies of existing treaties, and
3. the appropriate goals of tax treaties.

There was little discussion of the deficiencies of existing tax treaties because most of these deficiencies were the focus of subsequent sessions. For example, the difficulty of revising the network of bilateral tax treaties to deal with new developments is one of the reasons for considering a multilateral treaty, and was discussed in the second session.

The need for tax treaties and their goals are obviously closely related topics. Inevitably, given the nature of the issues, the discussions were wide-ranging and somewhat unfocused. Nevertheless, they went well beyond the platitudes that tax treaties are intended to eliminate double taxation and to prevent tax avoidance and evasion. Participants recognized that tax treaties serve many purposes and that their negotiation is driven by a complex set of factors.

There was general agreement that tax treaties are necessary, although some participants indicated that countries could address some aspects of treaties in a unilateral manner. For example, many countries provide relief for double taxation unilaterally. Also, to the extent that source countries use tax treaties to attract foreign investment, in the absence of treaties they would design their tax systems to accomplish the same objective. For example, source countries could unilaterally reduce their statutory withholding taxes on dividends, interest, and royalties paid to non-residents. Participants noted that this approach assumes that countries maintain high rates of withholding tax in part to have something to give up in treaty negotiations. It was pointed out, however, that the unilateral reduction or elimination of withholding taxes presented a problem because of the existence of tax havens. The benefits of any such reduction or elimination would accrue to the residents of tax havens as well as to residents of countries that imposed significant taxes on dividends, interest, and royalties. Tax treaties provide a useful means of avoiding this problem.

It was also generally acknowledged that there are several aspects of tax treaties that cannot be replicated by a country's unilateral actions. These include the protection against discrimination, exchange of information, and the mutual agreement procedure.

The discussion of whether tax treaties for income taxes are necessary led to a consideration of why, to date, treaties for consumption taxes have not been considered necessary. Some participants expressed the view that consumption tax treaties could be useful to address issues such as mismatches in place-of-supply rules, but that such treaties are not in place mainly because consumption taxes are generally dealt with by a different part of a country's tax administration. Other participants, however, suggested that treaties dealing with value-added taxes are not necessary because such taxes tend to be relatively uniform from country to country. The allocation of taxing rights under consumption taxes, it was pointed out, is based on a clear economic principle, whereas there is no clear principle to govern the allocation

of taxing rights for purposes of income tax. National income taxes vary enormously, and their application to cross-border activities causes serious problems that require solutions.

It was suggested that if national income tax laws were harmonized, tax treaties would not be necessary; therefore, in a sense, tax treaties could be seen as a means of achieving greater harmonization of income tax systems through a network of bilateral rules. Another means of promoting harmonization would be through the work of existing or new institutions. The OECD's work on transfer pricing and harmful tax competition was cited as an example of this alternative process. It was also argued that even if nothing were done at an international level, national tax systems would converge over time.

Some participants reiterated the view that the fundamental purpose of tax treaties is to eliminate double taxation in all its forms. Others thought that this is a secondary objective because, as noted earlier, it can be, and is primarily, achieved by countries unilaterally. A related purpose of tax treaties, which was generally considered to be very important, is the reduction of excessive taxation by a source country. For example, a source country may levy a 25 to 30 percent withholding tax on the gross amount of interest or royalties when the net income is a much smaller amount. In this situation, there is no double taxation in the conventional sense if the residence country either exempts the income or gives a credit for the source-country tax.

For many developing countries, relief of double taxation is relatively unimportant because their residents do not have substantial foreign-source income. For these countries, the fundamental purpose of tax treaties is to promote investment from abroad. In this regard, tax treaties are not really essential, at least with respect to their substantive provisions, because countries could revise their tax systems unilaterally to make foreign investment more attractive. However, several participants noted that, from the perspective of developing countries, tax treaties are important as a symbol of good commercial relations between two countries. They could also be considered helpful in attracting foreign investment because they reassure foreign investors about the stability of the framework within which they will be taxed.

Some participants expressed the view that the most important purpose of tax treaties is to allocate taxing rights for income from cross-border activities between the two countries. By definition, this allocation could not be made on a unilateral basis. Nor could it be made on the same basis for all countries with which a country had commercial relations. For example, the allocation of taxing rights is a source of considerable tension in tax treaties between developing and developed countries because of the large imbalance in the flow of trade and investment. This tension emerged several times in subsequent seminar discussions.

The tax treaty networks of most capital-exporting countries are largely driven by their multinational enterprises. If a resident multinational makes or proposes to make a substantial investment in a country, that may be sufficient justification for entering into a tax treaty with that country. In this regard, it is important to

remember that tax treaties are generally relieving in nature. They have the effect of reducing a country's tax revenues. Therefore, in most cases, the residents of a country, rather than the country's treasury, are the direct beneficiaries of the tax reductions provided in treaties. Taxpayers benefit not only from the substantive provisions of a tax treaty (which, as discussed earlier, may be of limited significance because of the provisions of domestic law), but also from the establishment of ties between the tax administrations of the two countries. These ties, which would be difficult or impossible to establish in the absence of a tax treaty because of diplomatic issues, serve an important role in terms of smoothing the way for cross-border activities and the resolution of disputes.

Some participants suggested that, although the elimination of double taxation is not as important today as previously because of unilateral relief measures, international cooperation is still necessary to deal with the prevention of fiscal evasion, or what is sometimes referred to as double non-taxation. There was some debate about the definition of the problem because the term "double non-taxation" can mean many things. In some cases, the source and residence countries may both decide not to tax a particular amount for legitimate policy reasons. Therefore, it was agreed that the term should be restricted to situations in which the absence of taxation by either the residence or the source country is considered to be inappropriate or abusive.

In conclusion, there was general agreement that tax treaties, or at least significant aspects of a typical tax treaty, are still necessary for a complex variety of reasons. The obvious but easily overlooked point was made that bilateral tax treaties are well established and generally accepted. The widespread acceptance of existing tax treaties provides a solid base from which to enhance the role of tax treaties in facilitating international trade and investment.

OPTIONS FOR GREATER INTERNATIONAL COORDINATION AND COOPERATION WITH RESPECT TO TAX TREATIES

The second session dealt with two major questions:

1. Is some type of multilateral tax treaty desirable or feasible?
2. What are the most appropriate institutional arrangements for dealing with tax treaties and other international tax issues?

With respect to the first question, as the background notes by Kees van Raad and Michael J. McIntyre⁴ indicate, a multilateral treaty may be used either to replace or to supplement existing bilateral treaties. Most participants thought that, although a multilateral treaty to replace existing treaties might be desirable, it would be impossible to negotiate and keep up to date. The participants were reminded that the existing tax treaties work well for most transactions. It was noted that the interests of countries with respect to income tax matters are too varied to be addressed

in a multilateral treaty, even, for example, for countries in the European Union (EU). Even the existing multilateral treaty among the Nordic countries, with all its specific country exceptions and bilateral rules, is better viewed as a consolidation of bilateral treaties. Some participants suggested that a multilateral treaty would be feasible if it were restricted to countries with common interests and to certain issues (for example, inheritance tax). The EU Convention on Arbitration was raised as an example of this type of multilateral treaty. Participants then discussed the feasibility of a multilateral treaty among members of the EU. It was pointed out that EU member countries have a defensive attitude with respect to their individual tax-treaty-making powers, and that EU involvement in tax treaty matters is an extremely sensitive issue.

According to some participants, a multilateral treaty could be used to deal with new developments and issues (such as triangular issues and treaty shopping) not currently addressed in existing treaties, although triangular cases and treaty shopping would still occur as long as there were countries outside the multilateral agreement. Other participants argued that many issues are inherently bilateral and countries need to be able to take different positions with respect to different treaty partners, especially with respect to the allocation of taxing rights. A multilateral treaty could not be used to achieve greater harmonization of national tax systems; national tax systems must achieve greater harmonization before a multilateral treaty would become feasible.

In conclusion, although some type of multilateral treaty might be desirable in principle, the group generally agreed that multilateral tax treaties are not feasible in the foreseeable future, except perhaps on limited issues such as tax administration and dispute resolution. It was noted, however, that some type of multilateral forum, rather than a treaty, could be useful to address such issues as harmful tax competition and transfer pricing.

With respect to the institutional arrangements for dealing with tax treaties, the basic problem, as pointed out in the background notes, is the limited membership of the OECD. Although the OECD has taken steps recently to involve non-member countries and the private sector in its work on the model convention and commentary, there is a need for much broader participation. There was not much enthusiasm for the suggestion that the UN take over exclusive responsibility for tax treaties, because of concerns about resources and efficiency. However, it was recognized that developing countries need to be more involved in the development of the OECD model convention and in work on emerging international tax issues.

Several participants noted that any new institutional arrangements must enable a quick response to new problems and developments. They expressed concern that even the OECD, with its limited membership, has difficulty responding to new issues, and that involving even more countries would further slow down the process. Other participants argued that the current institutional arrangements for handling tax treaty issues give disproportionate influence to large capital-exporting countries. In response, it was argued that it is inevitable that such countries, being the source of most cross-border investments, would have significant influence on tax treaty and other international tax issues.

Several participants alluded to the possibility of establishing a world tax organization to resolve tax disputes, to ensure standardization in the interpretation and application of tax treaties, and to develop international tax policy on new issues. There was little discussion of this complex issue because of time constraints.

Concern was also raised that some member countries of the OECD have agreed to interpretations in the commentary but have not implemented those interpretations with respect to their treaties. This raised the general issue of agreements of a non-binding nature at the international level and the implementation and enforcement of those agreements in the absence of a world tax organization.

THE INTERACTION OF TAX AND NON-TAX TREATIES

The third session examined the interaction of tax and non-tax treaties. The background note by Robert A. Green⁵ identified the two basic questions that provided the framework for discussion:

1. Should trade agreements cover tax matters?
2. Should tax disputes be resolved using the dispute resolution procedures in trade agreements?

The seminar participants expressed differing views about whether international trade and other non-tax agreements should cover tax issues. Some noted that the distinction in trade agreements between direct taxes (which relate to persons) and indirect taxes (which relate to goods and services) is not analytically valid. Direct tax measures can have the same trade-restrictive effects as indirect tax measures. Therefore, it is not logical for trade agreements to include carveouts for direct tax measures. Linkages between direct taxation and the international trading system are inevitable, and it is necessary to have guidelines for dealing with these linkages. It was suggested, however, that the different treatment of direct taxes and indirect taxes is justified to the extent that trade agreements (as opposed to investment agreements and the subsidies and countervailing measures agreement) seem to ignore issues related to investors or producers and to focus primarily on the goods and services traded.

Some participants specifically noted that withholding taxes could have effects similar or identical to those of tariffs. For example, some countries impose gross-basis withholding taxes on payments to non-residents for goods and services delivered through electronic commerce ("e-commerce"). These withholding taxes are equivalent to tariffs on imported goods and services. In spite of this equivalence, however, withholding taxes might be justified on the ground that it is difficult for source countries to assess and enforce net-basis taxes on non-residents.

Some participants argued that the separation between trade and tax agreements can best be explained by institutional factors. In both the public and the private sectors, different persons and institutions specialize in tax and trade matters. Since

persons specializing in one area often lack expertise in the other, the two areas develop separately. In terms of institutional dynamics, bureaucracies tend to seek to expand their scope and influence, as well as to defend their jurisdiction against incursions by other bureaucracies. Thus, for example, during the Uruguay round of negotiations on the general agreement on tariffs and trade (GATT), the Swedish Ministry of Foreign Affairs, with the support of the business community and trade representatives of some countries, wanted the World Trade Organization (WTO) agreement to cover income tax measures, while tax officials of the Ministry of Finance wanted the WTO agreement to include a carveout for income taxes, so that income tax measures would continue to be covered exclusively by tax treaties. Similarly, the US trade representatives to the Uruguay round initially were willing to have the WTO agreement cover income taxes, but when the US Treasury department studied the draft agreement, it insisted on a tax carveout.

Other participants argued that the development of the international tax regime separate from the international trade regime should be viewed in a positive light. They noted that the international tax system has been developing for over 80 years, and has achieved great success in alleviating problems of double taxation and reducing tax obstacles to international trade and investment. In the area of dispute settlement, the international tax system has developed innovative methods for avoiding disputes through advance rulings, rather than resolving them only after the fact through adjudication. Given the success of the existing international tax system, it would not make sense to start over and attempt to redesign the system as an integral part of the international trading system. To the extent that there are pressures to do so, these exist, it was argued, largely because tax experts have not devoted enough attention to articulating and explaining the principles underlying the international tax regime to the broader international economic policy community.

It was also noted that countries might have difficulty managing their tax treaty programs if they started engaging in cross-concessions between the international tax regime and the international trade regime. Also, taxation raises more acute sovereignty concerns than does trade.

The participants expressed differing views about the desirability of having tax disputes adjudicated using the dispute settlement procedures of the WTO/GATT or other trade agreements. Some participants argued that the mutual agreement procedure in tax treaties often works poorly, particularly in ordinary, low-profile cases involving small taxpayers. Small taxpayers often have difficulty accessing the competent authority process. Even when the process applies, it often takes too long to resolve disputes and sometimes fails to result in a resolution. Some competent authorities appear to be so driven by the need to maximize revenues that they refuse to follow the plain language of the treaty, rendering the competent authority process pointless.

Other participants disagreed with this pessimistic view of the mutual agreement procedure and argued that, notwithstanding the problems with that procedure, it would not be an improvement to turn to a WTO-style adjudication process. In trade disputes, one country typically has imposed a measure to protect a specific

domestic industry, and the measure results in harm to competing foreign firms in that industry. The resulting dispute is typically very specifically focused. It involves clearly opposing sides and a specific protectionist measure. In contrast, tax disputes tend to be more complicated. The measure at issue is part of a larger system that, in its overall design, is intended broadly to promote national welfare, but necessarily involves thousands of individual policy decisions and departures from “ideal” income tax treatment. WTO-style adjudication would tend to view the specific tax measure in isolation. In contrast, under the mutual agreement procedure, the competent authorities are able to look at the bigger picture, to take into account how the tax provision at issue relates to other provisions and how one case affects other cases. Thus, it was argued, the mutual agreement procedure is likely to lead to better results than WTO-style adjudication.

Some participants noted that arbitration might be a more useful adjunct to the mutual agreement procedure than WTO-style adjudication. Arbitration could provide a quick and inexpensive mechanism for ensuring that double taxation is eliminated in specific cases. It might be particularly beneficial in fact-specific cases, such as transfer-pricing disputes. WTO-style adjudication would not serve the same function.

Finally, some participants argued that dispute settlement in the international tax context should provide for taxpayer participation. WTO-style adjudication does not provide for participation by non-governmental parties.

One participant noted that the non-discrimination principle in international taxation is closely related to the tax treaty article on elimination of double taxation. Under the OECD model convention, countries may adopt either the exemption method or the credit method for eliminating double taxation. The exemption method implements the principle of capital import neutrality (CIN), which requires non-discrimination between foreign and domestic suppliers of capital. The credit method implements the principle of capital export neutrality (CEN). Although CEN does not directly require a rule of non-discrimination between foreign and domestic suppliers of capital, such a rule is nevertheless necessary in order to prevent opportunistic governmental behaviour in response to the credit method. In particular, if one country adopts the credit method, other countries have an incentive to impose “soak-up” taxes on residents of the first country who invest in the other countries, since these taxes ultimately will be borne by the first country’s treasury rather than by the investors themselves. The non-discrimination principle restrains this opportunistic governmental behaviour by prohibiting treaty partners from raising taxes on residents of the credit country unless they also raise taxes on their own residents.

The coverage of tax matters in the treaty establishing the European Community (“the EC treaty”) was raised several times in the course of the discussions. Some participants argued that the EC treaty is not well suited to dealing with tax matters. The EC member states did not anticipate that the EC treaty would cover direct taxes. The existing non-discrimination provisions in the treaty are too vague to be suitable in the tax context. If the EC treaty were to cover direct taxes, it would be preferable to draft new treaty provisions that deal specifically with direct taxation issues.

Other participants argued, however, that, despite the inherent difficulty in the incremental application of the broad EC treaty freedoms to direct tax rules, the European Court of Justice (ECJ) did not have any choice about whether to interpret the EC treaty to cover direct taxes. Direct tax measures can be as effective an obstacle to the freedoms in the EC treaty as indirect tax measures or non-tax measures may be. If the court had interpreted the EC treaty not to constrain direct tax measures, the member states could have used such measures to undermine the freedoms.

According to these participants, criticisms of the case law in the tax area tend to relate mainly to the details of the ECJ's reasoning rather than to the results themselves. The court often fails to explain clearly the reasons underlying its tax decisions. As a result, the scope of its decisions is sometimes unclear, and it is difficult for member states to implement those rulings. The ECJ has not, however, adopted a rigid approach to tax measures. In particular, it has not required member states always to treat non-residents exactly the same as residents for income tax purposes. Instead, it has required member states to justify treatment that is apparently discriminatory and to ensure that their tax measures are no more restrictive than necessary to achieve bona fide objectives.

Finally, it was argued that the member states would probably find it difficult to agree on specific tax provisions for the EC treaty. A more feasible approach would be for member states to attempt to develop a framework for taxation (through non-legislative initiatives such as communications and recommendations) that could inform the decisions of the ECJ in particular cases.

ALTERNATIVES TO THE EXISTING ALLOCATION OF TAX REVENUES AMONG COUNTRIES

The fourth session examined several issues relating to the current regime for taxing cross-border transactions. As described in the background note by Eric Zolt,⁶ compromises reached during the 1920s still form the basis of the international tax regime. The note raised four basic issues for discussion:

1. Does the current regime for separate treatment of different types of income make sense?
2. Should domestic tax rules governing cross-border transactions continue to allow taxpayers effectively to elect the tax regime that applies to foreign operations by continuing to respect the separate existence for tax purposes of wholly owned or substantially owned subsidiaries?
3. Are there alternatives to the current regime of allocating taxing rights with respect to active business income primarily to the source country and passive investment income primarily to the residence country?
4. What role, if any, should redistribution play in determining the allocation of tax revenues among countries?

Several participants noted that the separate treatment of different types of income arises primarily from the domestic tax rules of the various countries rather

than from treaty provisions. Without some type of coordination or harmonization of the internal tax rules governing cross-border transactions, it would be difficult to achieve more uniform treatment in the international tax setting.

There was general consensus that the current cubbyhole approach has become less successful over the past several decades. Globalization, financial innovation, and the increased reliance on services and intangibles to generate business profits often provide taxpayers with much flexibility to structure arrangements to minimize aggregate tax liabilities. Participants noted that rules applicable to different types of income differ as to source rules, exemptions, withholding rates, and treaty consequences. In particular, participants mentioned the different treatment of royalties and business profits, as well as interest and dividends.

The prospect of more uniform treatment of different types of income would help eliminate several of the arbitrage opportunities available under current law. This issue was discussed further in the next session on the schedular nature of tax treaties.

Some participants noted the importance of considering the role of withholding taxes in addressing alternatives to the current tax regime. In particular, for developing countries, withholding taxes provide substantial revenue and are subject to limited treaty relief. In contrast, developed countries often provide for total or substantial elimination of withholding taxes in bilateral treaties. In addition, several participants called for increased consideration of alternatives to the current withholding on gross amounts—either through withholding on net amounts or through some type of elective net basis taxation. Reference was made to the UK practice of seeking to include a provision in its treaties allowing a taxpayer to elect to be treated as having a permanent establishment (PE) in the source country with respect to services in order to obtain net basis taxation.

Some participants asserted strongly that the importance of corporate form for tax purposes is based on the implicit and incorrect assumption of a tax regime in which residents are taxed on their worldwide income. In contrast, it was argued, the question of corporate form would be immaterial under an exclusive source-based taxation regime. It was pointed out in response, however, that most developed countries are committed to taxing at least foreign-source investment income. Also, the arm's-length principle presupposes that related corporations are treated as separate entities. Some type of formulary apportionment taxation would reduce the importance of separate legal entities within a related group of corporations. A hybrid approach would involve ignoring the separate existence of controlled foreign subsidiaries (which is, in effect, the result under most countries' controlled foreign corporation [CFC] rules) but treating all other foreign corporations as separate entities.

Many participants noted the difficulty of classifying entities in both the domestic and the international contexts. Without workable rules for classifying entities in the domestic law of many countries, it is difficult to imagine a consensus emerging for characterizing entities for treaty purposes. In addition, several participants noted that the recognition of the separate existence of related corporations for tax purposes often simplifies the determination of taxable income on a country-by-country basis.

The discussion of alternative regimes for allocating passive and active income among countries with competing claims focused primarily on the desirability and workability of formulary apportionment approaches. Some participants noted that the growth of e-commerce and continued frustration with arm's-length transfer-pricing determinations have increased the need to consider formulary apportionment alternatives. It was suggested that advance pricing agreements are implementing formulary apportionment indirectly. Not surprisingly, there was criticism of any attempt to move to formulary apportionment. Several participants noted the lack of clear principles underlying existing formulas to allocate income among competing jurisdictions. In particular, it is unclear what role the traditional factors of payroll, sales, and assets would play in a formulary apportionment scheme for the new business environment.

Finally, there was discussion about the use of international tax rules to “redistribute” tax revenues among different countries. Participants recognized that no clear “baseline” approach to the allocation of tax revenues exists. Several participants pointed out that the real problem is a fair allocation of tax revenues between the source and residence countries. Developing countries are determined to somehow get a greater share of tax revenues from cross-border activities. There was general agreement that the claims of source countries are legitimate, but the key is how to satisfy those claims in a reasonable way. Some participants suggested that a formula-based approach may provide for a “fairer” distribution between developed and developing countries. However, it is unlikely that a consensus could be achieved on determining a framework for equitable allocations in an international setting.

SCHEDULAR STRUCTURE OF TAX TREATIES

The fifth session examined the schedular nature of tax treaties. The background notes by Klaus Vogel and David Rosenbloom⁷ explained the derivation of the schedular approach of tax treaties, and set out the considerations involved in distinguishing between active business income and passive investment income, different types of investment income, and different types of business income. The notes also examined whether a global approach could replace the existing schedular pattern found in tax treaties.

In general, countries have approached the treaty process by distinguishing among different types of income and then allocating the primary right to tax each type of income to a particular country. The original 1920s compromise was strongly influenced by the schedular nature of the income tax systems of the European countries.

Some participants noted that a schedular structure was necessary to provide the opportunity for some types of income to be taxed primarily on a source basis. If the residence country were given the exclusive right to tax, the importance of distinguishing among different types of income would be greatly diminished. However, as Vogel's background note indicated, this approach is clearly unacceptable in the current situation.

Many participants expressed dissatisfaction with the current schedular treaty regime. One participant argued that it is necessary to categorize income because it is necessary to determine the source of various types of income for treaty purposes. Other participants noted that the present distinctions lack a logical foundation and provide for arbitrage opportunities. However, it was pointed out that arbitrage opportunities are caused primarily by the differences in the treatment of various types of income under countries' domestic laws, rather than by the schedular nature of tax treaties. Also, the different categories of income constitute a useful checklist for treaty negotiators.

The participants differed about whether treaties should have more or fewer categories of income. Some participants suggested that it might be useful to segregate income into either two categories (income from capital and income from services) or three categories (portfolio income, income from active business, and income from labour). More categories might reduce reliance on article 3(2) (of treaties based on the OECD model) to resolve definitional conflicts between treaty partners. In particular, questions were raised about whether separate treatment is necessary for entertainers, students, directors, or persons providing government services.

Some participants noted that the categories of income should be determined by reference to the fundamental purpose of treaties, namely, the allocation of types of income between source and residence countries. The existing categories of income under tax treaties, it was argued, are not appropriate for this fundamental purpose.

With respect to the distinctions between active and passive income and between various types of business and investment income, it was agreed that financial innovation has severely blurred distinctions among different financial claims. Similarly, it is often difficult to distinguish between active and passive income. Further, taxpayers can often easily convert income from one category to another. Certain types of income, such as leasing income, film royalties, and royalties from e-commerce activities, might be treated as either business profits or passive income subject to gross withholding regimes.

ISSUES RELATED TO THE IDENTIFICATION AND CHARACTERISTICS OF THE TAXPAYER

The sixth session focused primarily on new challenges to the application of the residence concept in tax treaties. The background note by Hugh J. Ault⁸ examined the historical role of the residence concept, the absence of rules to attribute items of income to particular taxpayers, the role of limitation-of-benefits provisions, and the challenges resulting from the increased use of hybrid entities.

At the outset, it was noted that the principal function of the residence concept has been to determine eligibility to claim benefits under treaties. It was pointed out that taxpayers (both individuals and corporations) have considerable flexibility in structuring their affairs to seek or avoid residence status under both domestic law and tax treaties. Also, because individual taxpayers have greater mobility today, dual residence cases and changes in residence arise more frequently. Several participants

noted that difficulties may arise where there is a change of residence between the time at which certain types of income accrue and the date on which the income is received. One participant raised the issue of whether the residence concept should be replaced with a citizenship concept, in particular to stem the “brain drain” out of developing countries by extending their tax jurisdiction over citizens who transfer their residence to other countries. Other participants questioned whether the traditional treaty tiebreaker rules are adequate in a world in which individuals are so mobile.

The determination of residence for corporations has always been problematic. Participants remarked that both the place of incorporation and the place of management tests are subject to manipulation by taxpayers. Traditionally, in developed countries, the shareholders of a corporation were generally resident in the same country as the corporation. Therefore, corporate residence could be used as a proxy for determining the residence of shareholders. With increased mobility of capital and increased tax planning, however, the tie between corporate residence and individual residence has become weaker. Participants generally agreed that it is increasingly difficult to associate many multinational enterprises with a particular tax jurisdiction, although the international tax regime continues to be based on the concept of residence. Some participants speculated about the continuing viability of the traditional corporate tax regime. In particular, there was discussion of whether it may be desirable to move to some type of passthrough integration regime or a cash flow corporate tax. There was also a brief discussion of the possibility of extending treaty benefits to non-resident taxpayers with PEs.

The nature and role of limitation-of-benefits provisions was also discussed. Participants noted that limitation-of-benefits provisions are necessary to ensure that the beneficiaries of tax treaties have sufficient nexus to the treaty partner. Such provisions also serve to protect the domestic tax base and to obtain reductions in withholding taxes from treaty partners. There was some discussion as to whether an international consensus on an approach to limitation-of-benefits is emerging. However, some participants thought that there remains serious disagreement between countries concerning the role and structure of limitation-of-benefits provisions. These participants argued that limitation of benefits was appropriate only in abusive situations; in other words, any changes dealing with the issue should be made in the context of article 1 rather than article 4, or in a special limitation-of-benefits article.

Participants noted that some tension has always existed in treaties between taxing income and taxing persons. There are often no specific treaty rules for attributing income to particular taxpayers, although some provisions refer to income received or derived, which implies a connection between the income and a particular taxpayer.

Some participants speculated whether it was possible to develop simplified treaty rules for small businesses. It was generally agreed that the existing treaty regimes and dispute resolution mechanisms make it difficult for small businesses to take advantage of treaty benefits. It was noted, however, that special treatment for certain taxpayers might violate the non-discrimination article.

There was a brief discussion of the problems caused by hybrid entities. Participants noted that many of the problems are caused not by treaty provisions, but rather by inconsistent treatment under the domestic laws of different countries. The possibility was raised of using the approach in the OECD partnership report⁹ to ensure the proper application of tax treaties to hybrid entities generally. Under this approach, the source state would be required to follow the characterization of the entity in the residence state.

TAXING BUSINESS PROFITS

The seventh session examined the provisions of tax treaties dealing with the taxation of business profits. As Brian J. Arnold pointed out in the background note,¹⁰ these provisions involve three basic issues:

1. the establishment of a threshold concerning the activities of a non-resident in the source country as a precondition for source-country taxation;
2. the determination of the income derived by the non-resident that the source country is entitled to tax (that is, source rules); and
3. the rules for the computation of the non-resident's business income subject to tax by the source country.

These three issues are intimately related and overlap considerably. Probably because of time constraints, the discussion focused primarily on the first issue.

As a preliminary matter, there was some discussion about the concept of a business for purposes of tax treaties. In particular, the distinction between business profits and investment income was considered to be problematic. In some countries, all the income earned by a corporation is considered to be business income. In many civil law countries, the profits of an entity for income tax purposes are determined, not on a source-by-source basis, but by reference to the financial statements of the entity. For other countries, income is determined by reference to various sources, of which business is only one. Tax treaties use a similar approach, as discussed in the session on the schedular structure of treaties.

Therefore, although the distinction between business and investment income may not be particularly important from the perspective of the residence country, it was very important for the source country because of the distinction in tax treaties between the two types of income. Amounts characterized as business profits are taxable by the source country generally on a net basis, while investment income is taxable on a gross withholding basis. It was also pointed out that even residence countries that do not generally differentiate between business and other types of income find it necessary to make that distinction in their CFC rules.

It was suggested that tax treaties should move away from reliance on the identification of business income or a distinction between active and passive income. The use of the concept of a business leads inevitably, it was argued, to a determination of where the activities of a business take place as the threshold for source-

country taxation. Given modern forms of doing business, various aspects of a business could be carried on almost anywhere. It would be preferable, it was argued, to have a threshold for source-country taxation based on the level of income derived, not the type of income. To avoid excessive gross basis withholding by the source country, it would be necessary to institute some form of net basis withholding or to rely on collection of tax by the country of residence coupled with some type of tax-sharing arrangement.

The real issue, according to several participants, is when and how source countries should tax non-residents. One real-life example, discussed briefly, was the use of a non-resident-owned satellite by the domestic television network of a developing country. Because the non-resident did not have a PE in the developing country, that country could not tax the non-resident's business profits. However, by characterizing the payment for the use of the satellite as rent or royalty, the developing country levied a gross basis withholding tax, which was excessive having regard to the amount of net income derived by the non-resident. Other examples were cited where the PE concept had been extended by source countries well beyond its central core meaning of a fixed place of business. Two approaches are available to deal with problems of this type: either existing concepts such as PE may be abandoned and new rules adopted, or existing concepts may be retained and supplemented by new rules to deal with new commercial developments such as e-commerce.

One possible alternative to the PE concept is a level-of-income threshold. A source country would be entitled to tax a non-resident only if the non-resident's income from the source country exceeded a certain level. It was pointed out that value-added taxes use the concept of a fixed establishment supplemented by a level-of-income test. Several participants argued that a level-of-income threshold was not feasible because of collection issues. In the absence of some type of physical presence in a country, tax liability imposed on a non-resident could not be enforced effectively. Thus, the concept of a PE was more about collection of tax than entitlement to tax. There was significant support for the proposition that, as a matter of tax policy, a source country would be justified in taxing non-residents who were selling goods or services to consumers in the country (that is, taking advantage of the country's market). However, it was emphasized that the source-country tax should be levied on a net basis; tax on a gross basis could not be justified.

The level-of-income threshold was also criticized as inappropriate because it would apply differently to different taxpayers. It would be preferable, it was suggested, to use a level-of-activity test, which would be sufficiently flexible to accommodate different forms of carrying on business. Assuming that sales of goods or services were considered to be activities, such a test could accommodate situations in which such sales were the only activity taking place in the source country.

The foregoing discussion served as a springboard for a theoretical discussion about what existing treaty rules concerning the taxation of business profits are trying to accomplish, what source countries are taxing now, and how to achieve a fair and reasonable allocation of tax revenues between the source and residence countries. Some participants argued that the source country's right to tax is simply based on

the source of income, and the real question is enforceability of the tax. Other participants argued that the source country's right to tax has to be based on some threshold, and the existing PE concept is just a proxy for this threshold. Also, it was pointed out that business enterprises need a threshold for source-country taxation because exposure to source-country tax on *any* income derived in the source country would impose too great a compliance burden and discourage international trade.

The analysis is further complicated, it was argued, where the flow of cross-border activity between two countries is disproportionately one-way. Where the flows are relatively equal between developed countries, taxation of residents on their worldwide income is an effective backstop for source-country taxation. Where the flow is primarily one-way, however, the source country will not be willing, nor can it reasonably be expected, to give up its tax to the residence country. The challenge for source countries is to establish some effective mechanism to collect tax from non-residents without resorting to gross basis withholding taxes. It was emphasized that even with effective exchange of information and administrative assistance in collection, many developing countries have limited capacity to enforce income taxes on non-residents who do not operate through a PE in the country. In response, one possibility raised was some type of refundable tax system.

RELIEF OF DOUBLE TAXATION

The eighth session focused on a number of policy and technical issues related to treaty provisions for relief of double taxation. The background note by Robert Couzin¹¹ addressed the policy basis for double taxation relief and queried whether CEN and CIN are useful concepts for framing the nature of residence taxation and the methods of relief of double taxation. It also raised the issue of economic double taxation, asking why tax treaties do not address the basic issue of corporation/shareholder taxation and do not provide for an indirect credit or participation exemption, given that a substantial proportion of cross-border income is derived through corporations. Although the discussions generally avoided these policy questions, some participants expressed the view that a provision obliging the residence country to provide an underlying tax credit for direct dividends would be a useful addition to article 23 of the OECD model.

The issue of tax sparing (a significant policy issue during discussions between developed and developing countries) was not directly discussed. One participant, however, raised the issue of soak-up taxes and expressed the view that these are really income taxes with respect to which residence countries should grant a foreign tax credit.

The technical issues raised in the background note attracted more attention. The background note identified two different approaches for treaty provisions on the elimination of double taxation. Under the first approach, referred to as "the OECD approach," a country agrees to provide relief by exemption or credit without subordinating that relief to domestic law. Under the second approach, referred to as the "domestic law approach," the country commits itself to apply its domestic

double taxation relief to income from sources in the other country. Given the complexity of elimination of double taxation, there was wide agreement that some reference to domestic law, either through the modification of the treaty provision or through an explicit reference to the domestic law rules, is necessary. On that basis, one participant suggested that it might be better not to include the type of provisions currently found in treaties, but rather to include minimum standards or a checklist that internal relief of double taxation should comply with.

One of the main technical issues raised during the discussion was the problem created by mismatches in the timing of taxation between the source and residence countries. One participant expressed the view that the OECD should work on timing issues related to relief of double taxation. Various examples of timing mismatches were offered. It was also noted that this issue is particularly important with respect to the taxation of capital gains in light of the domestic provisions of some countries that trigger recognition of capital gains upon cessation of residence. Further, it was pointed out that timing mismatches arise under both the OECD and the domestic law approaches to the elimination of double taxation. It was remarked that the OECD model does not include any time limit for the provision of relief from double taxation, so that any problems in this area may be attributable to domestic law provisions.

Sourcing issues also provoked discussion. It was suggested that, in general, the sourcing rule for the purpose of relief of double taxation should follow the sourcing rules contained in the distributive provisions of tax treaties. When one participant questioned whether that view was shared by the United States, it was noted that some recent US treaties have expressly provided for that result.¹² One participant encouraged the OECD to follow the example of some countries and include a sourcing rule in article 23 of the OECD model.

Several participants noted that the absence of commonly agreed rules for allocating income and expenses between domestic and foreign sources causes significant practical difficulties. These difficulties are particularly important as regards the deduction of interest expenses. One participant remarked that the interest allocation rules of US domestic law could have pernicious effects and that interest allocation creates difficulties for both credit and exemption systems. Another participant added that allocation is also a significant practical issue as regards the determination of profits of PEs, particularly in the case of financial institutions. It was noted that the only way to solve all difficulties in this respect would be for the residence and source countries to have a common set of rules for the determination of the tax base, though this is an unrealistic proposal at this time. One participant suggested, however, that some problems could be avoided if article 7 of the OECD model limited the profits to be attributed to a PE to the profits of the whole enterprise, so that no profits could be attributed to a PE if the enterprise as a whole sustained a loss.

The discussion also focused on characterization issues. Relief of double taxation, like many other treaty benefits, is complicated by conflicts in the characterization of income, instruments, or entities by countries. One participant expressed the view that the recent changes to the commentary on article 23 of the OECD model

concerning conflicts of qualification (which resulted from the OECD partnerships report)¹³ could be drafted more clearly. Another participant, however, questioned the validity of these changes (a point that was debated at length during the next session on the relationship between domestic tax systems and tax treaties) and argued that amendment of the article itself would be required to solve the problems of conflicts of qualification in the manner put forward by these changes.

The discussion of characterization issues led another participant to discuss the extent to which the treaty provisions on relief of double taxation deal with income (as do the distributive treaty rules) as opposed to taxpayers. One practical aspect of that question was whether a taxpayer should be able to claim credit for taxes paid by another entity (for example, a partnership) on the same income on which the taxpayer is taxable in the taxpayer's country of residence.

THE RELATIONSHIP BETWEEN DOMESTIC TAX SYSTEMS AND TAX TREATIES

To frame the discussion in the ninth session, the background note by John F. Avery Jones¹⁴ discussed three different aspects of the relationship between domestic tax systems and tax treaties:

1. the tension between common interpretation and interpretation according to domestic law as mandated by article 3(2) of the OECD model;
2. changes in domestic law and treaty overrides; and
3. the relationship between domestic anti-abuse rules and treaties.

Most of the session was spent discussing the first issue, although discussion did expand to include the issue of treaty override.

Most participants expressed agreement with the approach (recently endorsed by the OECD partnerships report¹⁵ and now reflected in the commentary) described in the background note as follows: "The source state applies its internal law to determine whether the treaty permits it to tax; the residence state gives relief if on this basis the source state is permitted to tax without asking whether it agrees with the source state's interpretation."¹⁶ This approach implies that, for purposes of relieving double taxation, the residence country must accept the interpretation of certain treaty terms in accordance with the domestic law of the source country. A few participants either disagreed with this approach or wanted to restrict as much as possible the extent to which domestic law can be referred to pursuant to article 3(2).

One participant acknowledged that treaties leave to domestic law the identification of taxpayers and the measurement of the income or profits to be taxed, but thought that the terms used in tax treaties should generally be read independently of their domestic law meanings. According to this participant, the approach described in the background note and endorsed in the commentary presents difficulties. First, it is not clear that, for the purposes of article 3(2), the country applying the treaty is

normally the source country. Second, it is also unclear when and to what extent the context requires a meaning different from the meaning under domestic law. Therefore, it was argued, a better approach would be to delete article 3(2) and rely on a common interpretation of treaty terms.

A few examples were put forward of cases where interpretation according to the domestic law of the source country arguably produced the wrong result. For example, in one case, a country referred to its domestic law to decide that income from the operation of slot machines was income from immovable property. In other cases, income of visiting professors was considered to be income from governmental services. Another participant referred to a case where a country had changed its definition of capital gains to treat a gain from the redemption by a company of its own shares as a dividend. Other participants, however, questioned the relevance of these examples, either because they saw nothing wrong with the interpretations adopted by the source countries in these cases or because they considered that recourse to the domestic law meaning was not the real issue in these cases.

As these examples show, there was a concern by some participants that giving too much importance to the domestic law meaning of a treaty term might allow some countries to circumvent their treaty obligations. The link with the treaty override issue was made expressly when one participant asked what principles should be used to distinguish between a treaty override and a legitimate reference to the domestic law of the source country. According to this participant, it is not desirable to leave each country to decide, for example, what a royalty should be for purposes of its treaties.

Some participants, however, argued that the good faith requirement recognized in article 26 of the Vienna Convention on the Law of Treaties¹⁷ constitutes a limit to the misuse of article 3(2), as already implied in the commentary on that provision. For these participants, if a country were to modify its domestic law for the purpose of altering the application of a tax treaty through the application of article 3(2) in a way that could not have been intended, that country would not be applying article 3(2) in good faith. The issue of treaty override was not further discussed.

Some participants observed that the tension between seeking a common interpretation of a treaty and referring to domestic law is not restricted to article 3(2). For example, the determination of the profits attributable to a PE requires reliance on the domestic law of each country; otherwise, treaties would have to contain detailed computational rules setting out each and every step (including, for example, depreciation rates and rules) of the determination of taxable profits. Therefore, it was argued, recourse to domestic law is necessary wherever the treaty is silent or unclear, whether or not article 3(2) is included in the treaty. It was also argued that, in the absence of reliance on domestic law, tax treaties or the commentary on the OECD model would have to be transformed into a complete tax code.

IMPROVING THE FLEXIBILITY OF TAX TREATIES

For the topic of the final session, the background notes were prepared by Jacques Sasseville and Guglielmo Maisto.¹⁸ Sasseville identified six general issues for consideration:

1. How can treaties better address tax developments and, in particular, tax issues arising from corporate reorganizations?
2. How can the time to negotiate or renegotiate tax treaties be reduced?
3. How might conflicts of interpretation and application between countries be reduced?
4. Should the status of the commentary be enhanced?
5. Can the bilateral advance ruling process be extended to tax treaty issues?
6. What mechanisms might be developed for improving dispute resolution?

The discussion focused primarily on the first two issues and dealt more briefly with the rest.

With respect to the ability of tax treaties to accommodate new developments, some participants raised the preliminary question whether, and to what extent, tax treaties should adapt to changing circumstances. In addressing that question, one participant distinguished between adapting to the frequent changes that are made to domestic tax systems and adapting to changing circumstances such as changes in trade balances. For this participant, the stability of tax treaties was an advantage when compared to domestic tax law, which is modified very frequently. It is paradoxical that the business community values the stability of tax treaties but often lobbies for the frequent changes that are made to domestic tax law.

It was generally agreed that new developments or issues could often be dealt with through flexible interpretation of existing treaty provisions and did not require changes to the provisions themselves. However, many participants cautioned that there was a limit to how much the language of existing treaty provisions could be stretched to accommodate new developments. Some participants suggested that, in some respects, the commentary on the OECD model was already going too far in this regard, and that it would be preferable to amend the articles of the convention. One participant suggested that if the principles underlying treaty provisions were stated more clearly in the treaties, those provisions could be applied more effectively to a larger variety of individual cases without the need for more detailed rules. The elimination of double taxation and the allocation of taxing rights were cited as two areas where this approach would be useful.

One participant remarked that efforts to adapt treaties should focus on the development of a process that would permit global discussion of possible alternatives with a view to a coordinated change. The example of changes to the PE concept to deal with e-commerce and other developments was raised in this regard.

The particular case of cross-border corporate reorganizations was discussed briefly as an example of the need for treaties to deal with new developments. Maisto's background note raised several cross-border tax issues resulting from

corporate reorganizations—in particular, conflicts of timing (as regards the availability of foreign tax credits), conflicts of characterization of income, and non-discrimination issues. Maisto referred to various possible solutions, including some that have been adopted in a few treaties. One participant argued that tax treaties should not only seek to solve the problem of timing mismatches for foreign tax credit purposes, but also require neutral and non-discriminatory treatment of corporate reorganizations. It was objected, however, that there is no international consensus on neutral treatment of corporate reorganizations.

The corporate reorganization provision found in article 13(8) of the Canada-US treaty¹⁹ was briefly discussed. One participant expressed concern that the approach underlying that provision, which is to give the competent authorities the discretion to allow a deferral of tax in certain circumstances, would be difficult to apply. It was pointed out, however, that there was no perfect solution to the problem. On the one hand, a broad statement of principles would be inadequate; on the other hand, a more detailed provision would be very complex.

Since there are cases that clearly require new treaty provisions or amendments to existing ones, any attempt at improving the way that tax treaties adapt to changing circumstances must examine the process through which treaties are negotiated or amended. It was generally agreed that the long period frequently required to conclude or amend tax treaties is a problem. One participant suggested that it is particularly difficult to understand why changes that have been agreed to at the OECD are sometimes not reflected in the bilateral tax treaties concluded by member countries.

Various suggestions for addressing the problem were discussed. First, some participants asked whether it would be possible to adopt some form of multilateral process for making technical and relatively uncontroversial changes to tax treaties. This possibility raised the difficulties involved in the negotiation and ratification of multilateral conventions that had been discussed earlier.

Second, since a change to domestic law can usually be adopted more quickly than a change to a tax treaty, one participant raised the possibility of making greater use of reciprocal provisions in domestic law as substitutes for treaty provisions. An example is the US provision granting a reciprocal exemption with respect to shipping income.

Third, it was suggested that countries should undertake to quickly conclude limited protocols to implement technical changes that are generally agreed to (for example, in the context of the work of the OECD). Participants who had been involved in treaty negotiations acknowledged that the negotiation of a protocol is generally seen as an opportunity to obtain new concessions or to review all the existing problems arising from a particular treaty; consequently, the negotiation of a protocol can be difficult and long. One participant observed that changes to domestic law are sometimes useful in convincing other countries to agree to negotiate changes to a tax treaty.

Fourth, the possibility was raised of having sunset clauses in tax treaties to force countries to renegotiate periodically. This suggestion was generally opposed because

of practical concerns. An alternative suggestion was to require the parties to meet to review the treaty after a certain period, say, five years.

Finally, one participant observed that article 25(3) (mutual agreement procedure) of the OECD model already provides for considerable flexibility by authorizing the competent authorities to resolve through mutual agreement any difficulties or doubts arising as to the interpretation or application of the treaty, and to consult on the question of elimination of double taxation in cases not provided for in the treaty. Several reasons were put forward as to why competent authorities are not making more frequent use of that provision. For instance, it was noted that, in many countries, the competent authorities are not the officials who negotiate tax treaties; perhaps it is for this reason that they tend to focus more on the wording of treaty articles than on their underlying purposes. It was also suggested that, in some countries, the flexibility of competent authorities is constrained by revenue considerations that make it difficult for the authorities to agree with interpretations that result in tax refunds. That view was supported by another participant who indicated that there is sometimes strong political pressure to increase the collection of tax, which forces the competent authority to take an aggressive stand on treaty issues. Also, some participants indicated that, in some countries, there are constitutional difficulties with using article 25(3) to give the competent authorities authority to address cases not specifically dealt with by the treaty.

The commentary on the OECD model plays a pivotal role in ensuring a certain uniformity in the interpretation of tax treaty provisions, at least among OECD member countries. There was some discussion about how to enhance the role of the commentary as a means of ensuring that tax treaties are interpreted uniformly by all countries. One suggestion was to include in tax treaties a specific provision to the effect that the treaty should be interpreted according to the commentary. In this regard, it was noted that Austria asks its treaty partners to agree in writing that the commentary will govern the interpretation of its treaties.

Concern was expressed, however, that such an approach may raise political and constitutional problems and might not be welcomed by the courts. One participant also indicated that such a provision was unnecessary since courts already refer to the commentary in accordance with articles 31 and 32 of the Vienna convention. According to this participant, the real issue is not whether the commentary should be used to interpret treaties, but rather to what extent the provisions of treaties can be adapted through modifications to the commentary. The same issue was raised indirectly by another participant who asked whether a provision requiring reference to the commentary should be restricted to the commentary as it read at the time of the conclusion of the treaty.

The main problem with the mutual agreement procedure is that it is not a binding process. For many years, commentators have suggested arbitration as a means to resolve disputes arising under tax treaties. Tax authorities, however, have frequently replied that the lack of a binding process for solving treaty disputes does not matter in practice because almost all mutual agreement cases between OECD

countries are resolved by the competent authorities. They have also argued that the widespread use of arbitration would hamper the mutual agreement procedure because it would lead the competent authorities to refuse to compromise during the procedure.

One participant observed that, contrary to the view sometimes expressed, arbitration does not result in any loss of sovereignty if both competent authorities are required to agree that an issue will be submitted for arbitration. Another participant expressed the view that the time for arbitration has come. For example, an arbitration provision was included in the recent Germany-Austria treaty,²⁰ and the US tax administration seemed to have adopted a favourable attitude toward arbitration. It was noted that support from the private sector was the key to getting the US Congress to agree to include arbitration provisions in tax treaties.

APPENDIX 1 AGENDA: TAX TREATIES IN THE 21ST CENTURY

An invitational seminar jointly sponsored by the Canadian Tax Foundation, the Harvard Law School International Tax Program, the International Bureau of Fiscal Documentation, Maisto e Associati, Milan, and the Organisation for Economic Co-operation and Development, held in Amsterdam, October 23-25, 2001.

Objective of the Seminar

The purpose of this invitational seminar is to allow tax treaty officials from developed and developing countries, academics, and practitioners to discuss basic tax treaty policy issues and explore alternative solutions to current international tax problems.

Scope of the Discussions

In order to keep the issues to be discussed manageable, the seminar will proceed on the assumption that, in the foreseeable future, income taxes will continue to exist at both the corporate and individual levels, some form of residence and source taxation will continue to co-exist, and some instrument for the coordination of tax systems will be necessary and desirable at the international level. Despite these constraints, the discussions are intended to focus on the big picture rather than technical minutiae.

Format

The number of participants will be restricted to 20-30 persons, thereby allowing each participant to fully participate in the discussion of each issue referred to in the program set out below.

For each segment of the program, a short background paper (2-3 pages) will be prepared by designated participants. These background papers, which will be sent to all participants a few weeks before the seminar, will present the main problems to be discussed and, where appropriate, possible solutions.

No other written contributions or formal presentations are expected from participants. The discussion of each issue will start with a brief introduction by the drafter of the background note and will be followed by an open discussion.

All participants will be participating in their personal capacity. Also, while a written summary of the proceedings of the seminar will be prepared and published, comments made during the seminar will not be attributed to specific participants.

Followup

It is expected that the seminar will be followed by other similar events aimed at further exploring fundamental issues related to tax treaties or international taxation. At the end of the meeting, participants will therefore be invited to discuss what subsequent action may be appropriate.

Practical Aspects

The seminar will take place at the new offices of the International Bureau of Fiscal Documentation, H.J.E. Wenckebachweg, 210 Amsterdam, the Netherlands (tel.: 31-20-554 0108; e-mail: l.stapel@ibfd.com).

A registration form must be sent by each participant before July 31, 2001.

There is no charge for participation in the seminar. Participants are expected to pay their own travel and accommodation expenses, but limited funding is available for participants who cannot otherwise finance these costs.

Lunches on Wednesday and Thursday and dinners on Tuesday and Wednesday will be provided free of charge.

A block of hotel rooms has been reserved at the Hotel Bilderberg Garden—Dijsselhofplantsoen 7 - 1077 BJ AMSTERDAM—Tel. 0031.20.6642121—Fax 0031.20.5705654. In order to get one of these rooms, reservations should be made through the seminar organizers by completing the relevant part of the registration form. Participants should make their own travel arrangements (except where funding is provided by the organizers).

The seminar will start at 14:00 on Tuesday, October 23, 2001 and finish at 17:30 on Thursday, October 25.

Any queries as the practical aspects of the seminar should be directed to Liz Ward (OECD—France); telephone +33 1 45 24 81 89; fax: +33 1 45 24 18 84; e-mail liz.ward@oecd.org.

Any queries concerning the substantive issues to be discussed should be directed to Jacques Sasseville (OECD—France); telephone +33 1 45 24 91 07; fax: +33 1 44 30 63 13; e-mail jacques.sasseville@oecd.org.

Program

Tuesday, October 23

- 14:00** Welcome and introduction of participants
- 14:15-15:30** **The role of tax treaties in the 21st century**
- the need for tax treaties
 - fundamental deficiencies with respect to existing tax treaties
 - evolving challenges for existing tax treaties
 - the appropriate goals for tax treaties
- 16:00-17:30** **Options for greater international coordination and cooperation with respect to tax treaties**
- the pros and cons of a multilateral tax treaty
 - the involvement of non-OECD member countries
 - the appropriate institutional structure

Wednesday, October 24

- 9:00-10:30** **The interaction of tax and non-tax treaties**
- should tax issues be carved out of trade and investment treaties?
 - protection against discrimination
 - dispute settlement mechanisms and forum-shopping issues
- 11:00-12:30** **Alternatives to the existing allocation of tax revenues among countries**
- the importance of legal form with respect to entities and types of income and transaction-based income taxes
 - allocation based on economic principles
 - redistribution as a goal of international tax arrangements
 - the concept of reciprocity
- 14:00-15:30** **Schedular structure of tax treaties**
- problems and alternatives
 - distinguishing between active business and passive investment income
 - distinguishing between different types of investment income
 - can a global approach for the definition of income work in the context of tax treaties?
- 16:00-17:30** **Issues related to the identification and characteristics of the taxpayer**
- residence as a nexus for treaty benefits
 - rules for identifying the proper taxpayer
 - should the same treaty rules apply to individuals, small and large businesses?
 - hybrid entities

Thursday, October 25

9:00-10:30 Taxing business profits

- threshold(s) for taxing business profits
- rules for the division of the tax base between countries (e.g., different rules for different businesses)
- rules for the computation of the tax base

11:00-12:30 Relief of double taxation

- the blurring of the dividing line between exemption and credit methods
- relationship between treaty and domestic rules for relief of double taxation: sourcing and override issues
- indirect credit and exemption for dividends from foreign corporations

14:00-15:00 The relationship between domestic tax systems and tax treaties

- recourse to domestic law meanings
 - promoting a common interpretation of tax treaties
- accommodating changes in domestic law and treaty overrides
- tax avoidance and tax treaties

15:30-17:00 Improving the flexibility of tax treaties

- how can tax treaties better address tax developments?
 - the specific case of cross-border tax issues arising from corporate reorganizations
- how can we speed up the negotiation/renegotiation of tax treaties
- reducing conflicts of interpretation and application between states (e.g., by enhancing the status of the commentary, bilateral advance rulings for treaty issues)
- dispute resolution

17:00-17:30 Discussion of followup; closing remarks

APPENDIX 2 BACKGROUND NOTES

The Role of Tax Treaties in the 21st Century

Jacques Sasseville²¹

This note seeks to address the broad environment of tax treaties.²² While some of the issues to be discussed under that topic may be examined in more detail in other notes, duplication should be avoided to the extent that this note addresses the general background of tax treaties rather than their particular provisions.

The Need for Bilateral Tax Treaties

The need for tax treaties has to be judged at the most fundamental level by the answers to a series of questions:

- What should be the goals of the international tax system?
- Which of these goals can be achieved unilaterally?
- Which of the goals requires coordinated action by countries?
- Which of the goals does not require coordinated action but is unlikely to be solved by unilateral action?

The League of Nations started the history of the current bilateral treaty network with the Group of Experts who addressed the first question. Even then, it was not possible to get unanimous agreement on a detailed prescription, and that probably remains true today. The league was motivated to address this question by the problem of double taxation generated by the levy of income taxes on both a residence and a source basis, and by the general agreement that double taxation was something to be eliminated.

The basic agreements and disagreements on basic issues remain today. Nonetheless, it may be possible to get reasonably general agreement on two fundamental premises: that both international double taxation and international double non-taxation²³ are undesirable on neutrality and fairness grounds. In this regard, the international cooperation question becomes whether it is possible to eliminate both through domestic law. Even though double taxation to a considerable extent can be dealt with in domestic law, prevention of double non-taxation requires the cooperation of countries at the basic level of exchange of information since taxpayers will not draw attention to the issue (unlike double taxation).

When the bilateral treaty network developed, double taxation was the focus because many countries did not deal with the issue in domestic law (and some countries are still in this category). Even though domestic laws make this much less of an issue nowadays, double non-taxation arguably remains as a fundamental issue requiring international cooperation.

At a more technical level, it may be noted that restrictions to domestic source rules and reductions of withholding taxes, which are often the most tangible results

of tax treaties, can be offered unilaterally. In fact, some countries have, in the past, taken the position that they did not need to enter into tax treaties and could unilaterally offer to foreign investors the same guarantees as those available under treaties (for example, Chile in the early 1990s). Also, in many countries, particularly in Africa, the tax consequences of major investments are often dealt with in specific investment agreements (“establishment agreements”) rather than through the general rules of tax treaties. One has to recognize, however, that enshrining rules in tax treaties seriously restricts a country’s ability to modify these rules, and that such restriction carries both benefits (primarily for investors) and disadvantages (primarily for tax authorities).

The bilateralism of tax treaties is hardly consistent with the principle of not discriminating against foreigners, at least to the extent that it directly conflicts with the most-favoured-nation principle. Yet, the differences in tax systems and the jealousy with which countries protect their tax sovereignty explain, if they do not justify, the fact that bilateralism remains the norm in international tax. Attempts to develop multilateral international tax rules have sometimes conflicted with bilateral tax treaties (such as negotiation of the general agreement on trade in services, and the multilateral agreement on investment), and in those cases, the existing tax treaty network has proven a powerful argument against the development of such multilateral rules.

On the basis of the preceding comments, the following issues should be discussed:

- whether tax treaties are really needed (since, arguably, a country could more easily grant the same benefits unilaterally without encroaching on its tax sovereignty);
- whether tax treaties are counterproductive to the extent that they prevent the development of multilateral tax rules; and
- whether tax treaties should remain the instrument of choice to address international tax issues and what alternatives exist to bridge domestic tax systems.

Fundamental Deficiencies with Respect to Existing Tax Treaties

Many of the structural problems affecting tax treaties are discussed in other notes. The following are some of the most well-known difficulties:

- *Bilateralism.* As explained above, the bilateral nature of tax treaties raises most-favoured-nation concerns. It also creates triangular cases and treaty-shopping opportunities.
- *Schedular approach of tax treaties.* Apart from being inconsistent with most countries’ domestic concept of global income, the schedular approach used by tax treaties, which has different rules for more than 14 categories of income, creates ample arbitrage opportunities, as well as difficult classification issues and conflicts of qualification.

- *Limited scope of tax treaties.* Most tax treaty provisions deal only with income taxes. There are, however, various taxes and levies that act as proxies for income taxes or that raise similar international tax issues (such as social security contributions).
- *Reciprocity.* While reciprocity is a basic feature of tax treaties, many aspects of tax systems, such as the treatment of savings for retirement and imputation systems, would in fact require different rules for each country.
- *Difficulty of amendment or correction.* Tax treaties remain unchanged for long periods of time (15 years is the average in OECD countries). While this stability provides foreign investors with tax certainty, it is problematic for countries (which adopt changes in their tax laws on a yearly basis). Also, it creates significant difficulties when courts adopt unintended interpretations.
- *Standardization.* The standardization of tax treaties, which is due to the influence of the OECD model and explains the large number of treaties in existence, makes it difficult for countries to justify specific provisions even when these are obviously needed for bilateral reasons. It also makes it difficult to address new issues until a majority or core group of countries has gained experience with these issues (for example, treaty issues related to controlled foreign companies, cross-border reorganizations, and derivative financial instruments). Also, because of the negative inference that a change to the model or to a particular treaty could create for all existing treaties, small drafting improvements are difficult to adopt.
- *Relieving nature of tax treaties.* Tax treaties do not impose tax but merely relieve tax imposed under domestic law (although, in some cases, the tax levied under domestic law is determined by reference to taxing rights allocated by tax treaties). This can create difficulties, such as non-taxation situations arising particularly with exemption systems.

To what extent are these significant practical problems? Do tax treaties present other important structural deficiencies?

Evolving Challenges for Existing Tax Treaties

Interpretations of the European Court of Justice and the development of the single market in the European Union have put pressure on the traditional role and structure of tax treaties in European countries. What should be the long-term outcome for tax treaties concluded by these countries?

Apart from the issues discussed elsewhere in this note, and developments, such as e-commerce, which will be discussed in other sessions, are there other emerging significant tax issues that could affect tax treaties in the future?

The Appropriate Goals for Tax Treaties

While “goals” and “purposes” are often used interchangeably, tax treaties may be said to have different purposes with the ultimate goal of removing cross-border tax

obstacles for both taxpayers and tax authorities, thereby ensuring less-distorted trade and investment worldwide.

Bilateral tax treaties were originally developed to prevent double taxation of income, primarily double taxation arising from the combination of residence and source taxation. Avoidance of double taxation is still the main purpose of tax treaties. Looking at treaty provisions, other purposes appear to include the prevention of tax evasion and avoidance²⁴ (article 26 and provisions on assistance in collection) and the prevention of some forms of tax discrimination (article 24).²⁵ While the sharing of tax revenues and the resolution of tax disputes (article 25 and arbitration provisions) are sometimes presented as separate purposes, these can be related to the avoidance of double taxation.

Arguably, tax treaties thus serve relatively narrow purposes in the international tax environment. It could be argued that other international tax problems need to be addressed and that tax treaties should be dealing with these. Examples include the following:

- *International redistribution of income and wealth.* Are there ways through which bilateral tax treaties could perform a redistributive function between developed and developing countries? Should that be encouraged?
- *Promotion of international tax convergence or even harmonization.* Some treaty provisions have the effect of imposing on a country certain rules for the computation of the tax base (for example, provisions in Russian conventions that deal with the deduction of certain expenses). Should tax treaties seek to promote a more common set of rules for taxing income (and capital)?
- *Addressing international tax obstacles that do not strictly involve double taxation.* The example of the European Court of Justice's interpretation of the fundamental freedoms shows that some general rules may be used to address cross-border tax obstacles that do not directly involve double taxation.
- *Preventing creeping expropriation through taxation.* Some bilateral and multi-lateral trade or investment agreements include prohibitions against expropriation of foreign investors without appropriate compensation and due process. These rules often cover "creeping" expropriation through taxation. Should bilateral tax treaties address that issue?
- *The distortive effect of tax subsidies, particularly in the area of services.* In many respects, tax subsidies are the reverse side of tax discrimination. Should tax treaties seek to address this issue? (While the WTO subsidies and counter-vailing measures agreement has rules prohibiting some forms of tax subsidies for trade in goods, these rules do not apply to trade in services.)
- *Facilitating compliance.* Procedural and compliance issues are typically not addressed in tax treaties. Should provisions be included to, inter alia, promote automatic application of treaty relief (as opposed to refunds), international advance rulings, the use of standard forms, etc.?

Are there other international tax issues that tax treaties should seek to address?

The Role of the OECD Model as Regards Treaty Negotiations

The OECD model was developed for the main purpose of expanding the network of tax treaties by providing standard provisions that facilitated negotiations. It may be argued that the “one-size-fits-all” approach of the model is now outdated since treaties are increasingly tailored to take account of particular circumstances (as evidenced by the large number of reservations on the model). This would suggest that the model could usefully evolve from a set of standard provisions to a catalogue of treaty provisions that countries could simply choose from. This could help bridge the differences with the UN model. Should that evolution be encouraged?

Options for Greater International Coordination and Cooperation with Respect to Tax Treaties

Kees van Raad

The Pros and Cons of a Multilateral Tax Treaty

DEFINITION OF THE ISSUE

Are we discussing (1) a multilateral convention to replace a series of bilateral conventions, or (2) a multilateral convention to amend (update) existing bilateral conventions with OECD model changes and additions approved by the OECD?

A MULTILATERAL CONVENTION TO REPLACE BILATERAL CONVENTIONS

Preliminary Observation

The feasibility of such a multilateral convention will depend much on the size of the group of countries that conclude such a convention. For a small group of countries with similar tax systems (such as the Nordic countries), a multilateral convention seems to be more feasible than, for example, for all countries in the world that have tax treaties.

Advantages

- Uniformity of the treaty rules that apply to countries with respect to the taxation of cross-border income has definite advantages over the variety (that is, non-OECD-model type) among the rules of the existing bilateral tax treaties. In practice, special rules that countries include in their bilateral tax treaties and that have not been tested before not rarely give rise to interpretation and/or application problems. In theory, the uniformity provided by a multilateral convention can, of course, also be accomplished through bilateral treaties.
- Triangular issues that may arise as a result of the strict bilateral approach of the existing (bilateral) treaties can be solved more effectively by a multilateral treaty.

Disadvantage

- The more special rules countries add on a bilateral basis to the multilateral text, the more complex the multilateral treaty text becomes in comparison with a set of bilateral texts.

A MULTILATERAL CONVENTION TO AMEND EXISTING BILATERAL TREATIES WITH CHANGES AND ADDITIONS PRODUCED BY AN UPDATE OF THE OECD MODEL

Currently, the OECD attempts to extend the changes and additions resulting from an update of the OECD model to existing treaties by presenting these changes and additions as updates of the OECD commentary rather than of the OECD model itself, and by insisting that such updates of the commentary apply to the existing treaties. As in recent years the OECD commentary updates increasingly seem to strain an ordinary interpretation of the OECD model text, the (national) courts—if not the states themselves (note the reservations made in respect of the April 2000 update of the commentary)—may refuse to read the updates of the OECD commentary as improved interpretations of existing treaties.

A legally more sound result would arise if substantive changes that went beyond the ordinary interpretation of the OECD commentary were effected by laying down these changes in a multilateral convention through which the signatory states in a wholesale fashion would amend their existing bilateral treaties.

*Institutional Issues***INTRODUCTION**

Traditionally, model tax treaties have been developed by the OECD (and its functional predecessor the League of Nations). As the group of countries that conclude tax treaties has grown far beyond the group of OECD member countries, the question arises whether the prominent role played by the OECD (through its Committee on Fiscal Affairs [CFA]) in developing model bilateral texts can still be considered appropriate.

The issue has various aspects: fairness (appropriateness), efficiency, and technical adequacy.

FAIRNESS (APPROPRIATENESS)

At first sight, it appears that a larger, globally wide organization would be a more appropriate forum for discussing and agreeing on models for tax treaties. At the same time, as the experience with the UN model shows, a wider forum may seriously reduce the efficiency of the preparation of the necessary updates of such models. The OECD's CFA has been quite efficient in producing updates of the model text (and commentary) on which countries base their bilateral tax treaties. And the recent standard consultations with selected non-member countries on the text of the OECD model and commentary, resulting in reservations and observations that these countries file with the OECD, has substantially widened the involvement of

these countries in the OECD model and commentary. Still, as these countries do not participate in the preparation of the changes and additions to the OECD model and commentary, they cannot directly contribute to the deliberations that produce these changes and additions.

EFFICIENCY AND TECHNICAL ADEQUACY

The inefficiency and inadequacy of the current way in which the United Nations prepares on behalf of developing countries adjustments of the OECD model texts illustrate the problems that arise when the forum is widened to a much larger group of countries with widely divergent economic positions and technical tax treaty expertise. If the current thinking about the creation of a world tax organization were to materialize, the creation of a special tax treaty division within such an organization (which perhaps could be set up through a conversion of the secretariat of the OECD's CFA) could provide a wider basis from which tax treaty models are developed.

In view of the efficiency problems that may result from such a wide forum, better mechanisms for producing consensus should be considered (such as weighted voting).

FURTHER IMPROVEMENT OF THE PROCEDURES PRODUCING MODEL TEXT AMENDMENTS

Over the past decade, the OECD's CFA has dramatically opened up the process of preparing changes and additions to the model and commentary by publishing advance reports that are open for public comments and by consulting outside experts. It appears that further actions may be taken to provide even wider and more effective input from outside the OECD.

Status of the OECD Commentary

While this issue is dealt with in connection with another topic at this seminar, it also of relevance for the discussion here.

Options for Greater International Coordination and Cooperation with Respect to Tax Treaties

Michael J. McIntyre²⁶

The point of a model tax convention is to promote cooperation and coordination among sovereign states with respect to certain fiscal matters. Some people may object to such cooperation and coordination, believing that governments should engage in a high level of tax competition and should eschew most cooperative efforts. This segment of the seminar, however, is not the proper place for a discussion of those views. The issue addressed here is how to promote greater intergovernmental cooperation and coordination on the assumption that those twin goals are worthy ones for governments to pursue.

Institutional Issues

The most important model tax conventions have been developed by the OECD, beginning with its draft model issued in 1963 and followed by its first full model convention issued in 1977. Many previous models were developed, however, by other agencies, the most influential being the model developed by the League of Nations in 1928. The UN published a model convention in 1980 that drew heavily from the 1977 OECD model. In 2001, the UN published a revised model and has committed itself to periodic updates of that model. The OECD issued a revision of its 1977 model as a looseleaf volume in 1992. Several amendments have been made to the 1992 model, and the OECD has committed itself to periodic updates.

The OECD model convention is ostensibly intended as a model to be used by an OECD member country when it enters into a bilateral convention with another OECD country. The influence of the OECD model convention, however, extends far beyond the group of OECD member countries. The issue arises as to whether the prominent role played by the OECD, through its Committee on Fiscal Affairs (CFA), in developing the text of a model convention can be considered appropriate in light of the practical use of the model by non-members of the OECD. More generally, what is the proper institutional arrangement for developing and maintaining a model convention that will form the basis for the negotiation of treaties around the globe over the next several decades?

The issue has various aspects, including (1) political and (2) technical adequacy.

POLITICAL

Taxation is part of a political process and cannot be addressed with any hope of realism without reference to politics. The following political considerations are relevant in deciding (1) what organization should be in charge of the treaty process and (2) how that organization should function.

Fair Representation

The OECD represents only 30 countries, all at relatively high levels of development. It may appear that a larger, globally wide organization would be a more appropriate forum for discussing and agreeing on model tax conventions, especially in light of the expectation that those conventions would be used outside the OECD. The UN Ad Hoc Group of Experts on International Cooperation in Tax Matters is substantially more representative, having members from 15 developing countries (or countries with economies in transition) and 10 developed countries. Its membership is not determined, however, by a democratic process in which all countries participate.

The UN General Assembly, in collaboration with the governing bodies of the World Bank, the International Monetary Fund (IMF), and the World Trade Organization (WTO), has organized the International Conference on Financing for Development, Monterrey, Mexico, March 18-22, 2002, to find ways to strengthen the financing of development and the stability of the global financial system. One issue to be addressed at that conference is the possible establishment of a world economic

body, under the aegis of the UN, to address various economic issues of particular importance to developing countries. This body (prematurely named the “World Tax Organization”) may seek some role in the tax treaty process if it is established. Presumably an organization established by the UN would have some claim to being fairly representative of the nations of the world. Significant opposition has developed, however, to the formation of such a body.

The issue of fair representation cannot be divorced from the intended users of the model convention. If the convention is intended only for use by some limited group, then representation is properly limited to that group. In the case of the OECD, the original intent of its model convention may have been for use only by its members. The UN group was formed when it became apparent that the OECD model convention was having an influence beyond the members of the OECD. Because developed and developing countries frequently have different objectives in entering into tax treaties, the question of fair representation is a critical one.

■ *Reform of Existing Entities*

Can the OECD and the UN ad hoc group be reformed in some ways to be more representative?

Is the effort of the OECD to allow representatives from developing countries to participate in some aspects of treaty development an important step in the right direction merely window dressing designed to preserve the hegemony of the OECD countries over tax treaty matters, or something in the middle?

Has the OECD been successful in enhancing fair representation by allowing selected countries outside the OECD to make comments and observations with respect to certain provisions of the OECD model convention? Is this enhanced openness a useful step or has it opened the OECD to lobbying by private interests? Has it been useful for the UN group to invite the OECD and other observers to participate in its meetings? What, if any, are the disadvantages?

■ *Decision-Making Mechanism*

Should the organization responsible for treaty development operate under a consensus rule or by vote? If by vote, should some supermajority be required? Or should some weighted voting be required that would give increased influence to heavily populated countries or countries having a large share of the world’s international trade?

Agreement by consensus legitimizes decisions and makes for a harmonious working atmosphere. It can give undue influence, however, to particular countries, such as those that promote various harmful tax practices that they want protected, or at least not attacked, in tax treaties. This undue influence was apparent when the OECD prepared its first draft model tax treaty in 1963.

■ *Size of Treaty Organization*

In principle, the organization responsible for drafting texts of a model convention should be small enough to be effective and large enough to be representative. What is the best size? Can a larger body be used for representational purposes with an executive committee to enhance effectiveness? What is the experience of the UN group with 25 members and the OECD with 30 members (with more members anticipated)? Are these bodies too large? Have they effectively addressed the size problem with steering committees, working groups, etc.?

■ *Consultative Efforts*

An organization, such as the OECD, that is not widely representative of the countries of the world may compensate to some degree by adopting procedures for consulting with other governments. Prior to the 1990s, the OECD did almost nothing to consult outside its core group. It has now opened up its procedures somewhat, offering opportunities for countries to sit as observers in some circumstances and inviting comments from outside tax specialists. These efforts, and other efforts that might be made in the future, may mitigate the lack of representation within the OECD itself. If some alternative organization were to take over the tax treaty work of the OECD, a similar issue would arise about its proper use of consultative techniques.

Independence from Inappropriate Influences

Any organization that is assigned responsibility for drafting texts of a model tax convention should act in the public interest and in ways that promote world welfare rather than the welfare of powerful states or powerful interest groups. In looking at possible alternatives to the OECD as the major force in drafting these texts, it is useful to attempt some fair assessment of its successes and failures in promoting public welfare and resisting inappropriate influences. For example, do government representatives to the OECD use their position to obtain an unfair share of tax revenues from international operations for their country? Do they seek to protect some of their country's leading taxpayers from proper taxation? Has there been a similar pattern with the UN group? Would some alternative organization be better equipped to resist improper influences?

Legitimacy

A model tax convention has limited utility unless it is widely used by countries in negotiating tax treaties. A model convention cannot achieve wide acceptance, however, unless it enjoys some legitimacy. The OECD model convention obviously has achieved a high level of legitimacy among developed countries and has far less legitimacy among other countries. An organization is more likely to get legitimacy for its model convention in the eyes of the world if it is fairly representative and is free from undue influences. Legitimacy also depends, however, on the quality of the work product and on other factors.

A search for legitimacy can have costs. For example, an organization may attempt to enhance the legitimacy of its model by avoiding certain difficult or controversial matters. At various times over the past several decades, the OECD might be faulted in this regard. Or an organization may inhibit innovations in order to preserve the texts of a model convention, however outmoded, that has achieved legitimacy in the past.

TECHNICAL ADEQUACY

An organization cannot function well as the developer and reviser of a model convention unless it is capable of doing the technical work required. In assessing technical adequacy, the following issues are relevant:

Resources

Developing and revising a model tax convention and preparing relevant commentary on the model require significant resources. Although the OECD has been heard to complain of inadequate resources from time to time, it certainly devotes far more resources to the tax treaty process than any other international agency. Some of those resources come from contributions in money and services from member countries, and some come from other sources, including contributions from the private sector in exchange for access to certain OECD procedures. Relative to the OECD, the keepers of the UN model convention have a minuscule budget and obviously are strapped for resources. It is unclear whether any new organization, such as a world tax organization formed under the aegis of the UN or some consortium of organizations, would have a sufficient resource base to serve as the major developer of model tax conventions. Still, in absolute terms, the amounts involved in developing and maintaining a model tax convention are not large.

Professional Staff

To develop and maintain a model tax convention, an organization will require an adequate professional staff, augmented perhaps by consultants engaged for special projects. Having a good professional staff obviously requires some resources. In addition, an organization must develop an appropriate working culture and must be free to select its staff based primarily on technical competence.

Making Frequent Revisions

Tax treaties must be revised almost constantly to keep abreast of the almost constant changes in national tax laws and in the ways in which multinational companies and international financial institutions conduct their business affairs.

■ *Major Revisions*

A model tax convention should be revised periodically to deal with major new issues or to deal with old issues not addressed in the prior model. For example, over the past three decades, the OECD and UN models might have been revised to

deal with such issues as assistance in collection, new financial instruments, new forms of business, such as e-commerce and global trading, controlled foreign corporation regimes, corporate integration schemes, corporate mergers, dual-function entities, financial leases, and so forth.

Beginning in the 1990s, the OECD has made significant strides in updating its model convention. The UN came out with a new model convention in 2001. Still, neither model addresses many important contemporary issues, including most of the issues mentioned above. The prospects of their doing so in the near future appear dim.

The question arises, therefore, as to whether some alternative arrangements can be developed, either within the current organization framework or outside it, for getting prompt and effective revision of model treaties and the accompanying commentaries.

■ *Minor Revisions*

A tax treaty needs to be revised frequently to deal with the unintended tax-avoidance opportunities that taxpayers discover within it. Treaty negotiations, however, are slow, and many countries have been unwilling to revise a tax treaty to block tax avoidance when their own tax revenues are not implicated.

The OECD has attempted in some cases to close loopholes in treaties through amendment of its commentary. That approach raises issues relating to the legal impact of the commentary on existing (and even future) treaties. Another approach followed by some governments has been to close the loophole through domestic legislation. That approach raises issues about the compliance of those governments with their treaty obligations, as set forth in the Vienna Convention on the Law of Treaties.

The question arises whether some alternative mechanisms might be developed for dealing effectively with the inevitable loopholes that are discovered in tax treaties. (See the discussion of a multinational convention below.)

ASSESSMENT OF PAST PERFORMANCE OF ORGANIZATIONS RESPONSIBLE FOR DEVELOPING MODEL CONVENTIONS

A realistic assessment of changes that might be made in managing and developing model tax conventions depends in part on an assessment of the past performance of the OECD and the UN with their model tax conventions. In making such an assessment, the following issues are relevant:

- Has there been significant progress over the past three decades in eliminating undesirable international double taxation, and, if so, is that progress due primarily to the model conventions, or, for example, to domestic legislation or international tax planning by multinational firms? Is it not at least a plausible hypothesis that most progress in eliminating double taxation has come from domestic efforts, with the treaty process mostly addressing fringe issues?
- Has there been significant progress over the past three decades in preventing fiscal fraud, tax evasion, and tax avoidance, or have those harmful activities

- proliferated. If they have proliferated, how much, if any, of the blame is fairly placed on the model conventions and the organizations that promote them?
- Have the various articles of a tax treaty that provide for cooperative measures, such as exchange of information, been effective? In particular, have governments been meeting their obligations to exchange information freely, or have they refused to do so or done so with such delays as to make the exchange provision nearly meaningless? Can a government generally rely on its treaty partner country to provide it with a full accounting of the investment income that its residents earn in that country? If compliance by governments with their exchange-of-information obligations is exceedingly low, as some commentators allege, can it fairly be said that tax treaties, in practice, have been promoting tax evasion and fiscal fraud?
 - Has the OECD or UN model convention promoted a fair sharing of tax revenues among governments, especially with respect to new forms of revenue, such as revenue from income generated through new financial instruments and income from e-commerce? Or has the treaty process resulted in less revenue going to the developing countries?
 - Has the success of the 1977 OECD model inhibited reforms of the treaty process? Have some of the allegedly unworthy political compromises made in 1977 to accommodate OECD members involved in fostering harmful tax practices been institutionalized under the OECD model convention?

Development of a Multilateral Tax Convention

DEFINITION OF THE ISSUE

A multinational convention might be considered (1) as a full or partial replacement for the series of bilateral conventions now used by many countries; or (2) as a mechanism for amending (updating) existing bilateral conventions to reflect changes in or additions to the OECD model convention or the UN model convention (or some other model), as approved by the body in charge of that model.

POLITICAL ASPECTS

The political feasibility of a multilateral convention as a replacement for bilateral treaties may depend significantly on the size of the group of countries that conclude such a convention. For a small group of countries with similar tax systems (such as the Nordic countries), a multilateral convention seems to be more feasible than a multinational convention applicable to all countries in the world that have tax treaties. A multinational tax convention that is limited in scope also may be more acceptable politically. It may be possible, for example, to have a multinational agreement that dealt with many issues arising in a tax treaty but that left a small number of sensitive issues for bilateral negotiations. A multinational agreement among a small number of countries with closely integrated economies might also permit greater experimentation.

POSSIBLE ADVANTAGES OF A MULTINATIONAL CONVENTION

Mechanism for Revising Treaties Promptly

If a multinational tax convention is developed by an international organization, that organization could make periodic revisions of the convention to deal with the inevitable emerging issues and the inevitable tax-avoidance schemes. Presumably some procedure would have to be established for ratifying the revised treaty because most countries would not forfeit their right to reject a revised convention.

Currently, the OECD attempts to update and revise existing tax treaties based on the OECD model by amending the OECD commentary and treating the changes in the commentary merely as interpretations of the model convention. In recent years, the commentary updates increasingly seem to some observers to strain an ordinary interpretation of the OECD model text. As a result, the courts of some countries may refuse to read the updates of the commentary as improved interpretations of existing treaties. This problem is avoided if the updates of the model convention are included in a multinational treaty that is revised and then ratified.

Simplification

A uniform tax convention applicable to many countries may be easier to interpret and apply than the current non-uniform bilateral conventions. There is also likely to be increased consistency in interpretation and increased certainty in application. In some cases, novel rules inserted into a bilateral convention can give rise to interpretation and/or application problems. In theory, the same degree of uniformity might be achieved through a series of identical bilateral treaties.

Solving Triangular Issues

Some triangular issues that may arise as a result of the strict bilateral approach of the existing (bilateral) treaties can be solved more effectively by a multilateral convention.

Reduced Negotiating Time

Bilateral treaties take a year or more to negotiate. A multinational convention offers the prospect of avoiding the need for separate negotiations with each country. This advantage is of particular importance to small countries that do not have an abundance of resources.

Reduced Treaty Shopping

A multinational convention would provide for uniform treatment of all residents of participating states. Treaty shopping to get the best deal among applicable treaties would be eliminated. Of course, the problem of persons from non-treaty states improperly obtaining benefits would not be solved merely by having a multinational agreement.

POSSIBLE DISADVANTAGES OF A MULTINATIONAL CONVENTION

Special Provisions

In some cases, a country may not be willing to enter into a multinational convention unless it retains the right to make special arrangements with some of its important trading partners. The simplification gains that might be obtained from a uniform multinational convention might be lost if many countries entered into side arrangements. Indeed, it is possible that a multinational convention, after its adornment with many side arrangements, could be more complex to interpret than the current set of bilateral agreements.

Ossification

A multinational convention, in practice, may become difficult to amend. Bilateral treaties are already difficult to amend, and they involve only two parties. If a multinational convention ossifies, it is likely to do more harm than good.

Reduced Flexibility

By its nature, a multinational convention is less flexible in dealing with the particular circumstances of countries than a bilateral convention. For example, it seems unlikely that a multinational convention could be used to define the taxes of particular countries that qualified as creditable income taxes for treaty purposes.

Capture by Powerful Countries or Special Interests

There is an increased risk that a multinational convention would be written to protect the interests of the powerful—powerful countries or powerful interest groups—at the expense of others. Such capture of an international tax convention by the powerful may not be inevitable, but serious steps would need to be taken to prevent it from happening.

The Interaction of Tax and Non-Tax Treaties

Robert A. Green

This background note consists of two parts. Part one provides an overview of the extent to which tax matters are currently covered in non-tax treaties. This discussion focuses on the general agreement on tariffs and trade (GATT)/World Trade Organization (WTO) agreement and the North American free trade agreement (NAFTA) (which cover direct tax measures only to a limited extent) and the European Community (EC) treaty (which covers direct tax measures more broadly). Part two outlines the issues raised when tax matters are covered in non-tax treaties.

The Coverage of Tax Matters in Current Non-Tax Treaties

TRADE AND INVESTMENT AGREEMENTS

International trade and investment agreements typically include tax “carveouts” that limit the extent to which these agreements cover direct tax matters. The GATT/WTO agreement is illustrative. Article I of the GATT requires most-favoured-nation (MFN) treatment with respect to customs duties and other charges imposed on the importation or exportation of products. Article III requires national treatment (that is, non-discrimination between imported and domestic products) with respect to the application of internal taxes to products. These provisions, however, are generally understood to apply only to *indirect* taxes—that is, *not* to taxes on income or capital.

The general agreement on trade in services (GATS), an annex to the WTO agreement, requires MFN and national treatment with respect to services and service suppliers. These articles, unlike articles I and III of the GATT, do apply to direct tax measures. Article XIV, however, provides a substantial tax carveout: the national treatment obligation does not apply to measures “aimed at ensuring the equitable or effective imposition or collection of direct taxes” (provided that such measures are not “a means of arbitrary or unjustifiable discrimination” or “a disguised restriction on trade in services”), and the MFN obligation does not apply to benefits conferred by tax treaties. Moreover, article XXII of the GATS prohibits members from using WTO dispute settlement procedures to challenge tax measures as inconsistent with the GATS whenever the measure in question falls within the scope of an income tax treaty. Either party to such a dispute may submit the threshold question whenever a measure falls within the scope of an income tax treaty to the Council for Trade in Services for resolution by arbitration. Even this threshold jurisdiction is very limited, however. In the case of pre-Uruguay round income tax treaties, a footnote provides that both parties must consent to having this threshold question brought before the Council for Trade in Services. In the case of post-Uruguay round income tax treaties, the parties to the tax treaty can protect themselves from any unwanted WTO interference by including pre-emptive language in the treaty that similarly requires the consent of both parties to having the threshold question brought before the Council for Trade in Services. The OECD commentary on article 25 of the OECD model convention suggests specific tax treaty language to accomplish this pre-emption of the GATS.

On the other hand, the GATT/WTO agreement does significantly constrain the use of direct tax measures to provide subsidies to domestically produced goods. These rules are contained in the agreement on subsidies and countervailing measures (“the SCM agreement”) as well as in article XVI of the GATT and in certain other agreements, such as the agreement on agriculture. The SCM agreement prohibits subsidies, including tax subsidies, that are contingent upon export performance or upon the use of domestic over imported goods. Other subsidies are “actionable” if they are firm- or industry-specific and cause specified effects adverse to the interests of other members. The reach of the prohibition of export subsidies into international tax matters is illustrated by the domestic international sales corporation

(DISC) cases of 1972-1981 and the recent foreign sales corporations (FSC) case,²⁷ which held that various US income tax measures designed to promote exports (DISC, FSC, and Extraterritorial Income Exclusion Act) violated the rules on subsidies.

The GATT/WTO agreement does not comprehensively cover international investment (although it does include a relatively narrow agreement on trade-related investment measures). The NAFTA is more illustrative of treaties that cover investment matters. The NAFTA requires MFN and national treatment with respect to inward foreign investment. Article 2103, however, states that “[e]xcept as set out in this article, nothing in this Agreement shall apply to taxation measures.” More specifically, article 2103 provides that the NAFTA’s investment rules apply to taxation measures *other than* those on income or capital. Article 2103 also states that no provision of the NAFTA shall apply to any tax measure aimed at ensuring the equitable and effective imposition or collection of taxes. In addition, no provision of the NAFTA shall impose any MFN obligation with respect to advantages accorded pursuant to tax treaties. Finally, article 2103 provides that nothing in the NAFTA shall affect the rights and obligations of any party under any tax treaty, and that in the event of any inconsistency between the NAFTA and a tax treaty, the tax treaty shall prevail. Article 2103 does, however, provide that the NAFTA article on expropriation shall apply to taxation measures. Similarly, bilateral investment treaties typically carve out tax measures except for provisions on expropriation, and the final multilateral agreement on investment negotiating text of April 24, 1998 carved out tax measures except for provisions on expropriation and transparency.

THE EC TREATY

The treaty establishing the EC covers direct tax matters much more broadly than the trade and investment agreements discussed above. The EC treaty prohibits discrimination on the ground of nationality and specifically establishes the freedom of movement of workers, the freedom of establishment, the freedom to provide services, and the freedom of movement of capital and payments. International income tax systems are at risk of violating these provisions because they typically treat non-residents differently from residents. Although the freedoms in the EC treaty are expressed in terms of nationality, it is well settled in EU jurisprudence that discrimination on the basis of residence can be a covert form of discrimination on the basis of nationality.

In addition to these provisions relating to non-discrimination, the EC treaty generally prohibits member states from granting any state aid “which distorts or threatens to distort competition by favoring certain undertakings or production of certain goods,” insofar as it affects trade between member states. This provision is applicable to tax subsidies.

There is a growing body of case law by the European Court of Justice (ECJ) applying these provisions of the EC treaty to tax measures. The EC treaty also authorizes the institutions of the EU to promulgate secondary legislation relating to taxation, such as regulations and directives, subject to a requirement of unanimity.

Issues

ARE TAXES DIFFERENT?

Tax treaties and trade and investment agreements share the underlying goal of facilitating international trade in goods and services and the free movement of capital and persons. Tax policy can have as great an effect on the flow of goods and investment across countries, and on the gains from trade and investment, as that of traditional trade policy. Unless tax matters are in some way fundamentally different from other trade- and investment-related matters, the logic for excluding tax matters from trade and investment agreements seems questionable.

One difference that is often advanced is that tax policy serves purposes other than those underlying trade agreements. In particular, taxes raise revenue. While the reduction of tariffs, quotas, and other border restrictions on trade to zero can be the ultimate objective of trade agreements, the reduction of taxes to zero is not a desirable goal. More generally, governments use tax policy to achieve a wide range of public purposes. These purposes often reflect values other than economic efficiency. In part because of this independence of tax and trade policy, some commentators argue that the rules that form part of the normative or benchmark system of taxation should not be covered by trade agreements at all.

It is not clear, however, that this consideration really distinguishes taxation from other measures that are already fully subject to international trade and investment agreements. The focus of trade agreements today has largely shifted from the reduction of tariffs and other border restrictions—an objective that the successive GATT negotiating rounds have largely accomplished—to dealing with trade barriers that exist “within the border,” such as regulatory measures pertaining to health, safety, consumer protection, the environment, and labour. With respect to these regulatory regimes, the GATT/WTO agreement attempts (1) to distinguish between measures that, although incidentally resulting in some distortion to trade, are designed to achieve bona fide domestic objectives, as opposed to measures that are merely disguised restrictions on trade; and (2) to require the former measures to achieve their domestic objectives in the least-trade-restrictive manner. Arguably, tax measures that distort trade and investment can and should be brought under the same discipline. On the other hand, the coverage of these new issues in the GATT/WTO agreement has proven to be controversial. Some view it as a threat to national sovereignty, and it has resulted in heightened conflicts between developed and developing countries. One might ask whether adding controversial tax issues to the GATT/WTO regime could turn out to be more destabilizing than beneficial.

Another possible difference between tax and trade policy relates to the congruence between national and global welfare. Under certain conditions (such as competitive markets and “small” countries), a *unilateral* policy of free trade maximizes national welfare. Thus, commentators have noted that politicians often welcome the constraints of trade agreements, which give them political cover to resist interest-group pressure for welfare-reducing protectionist measures. Politicians might even want to lose trade disputes; that is, having reluctantly given in to overwhelming interest-group pressure to enact trade restrictions, they might welcome

having these restrictions struck down by an international dispute settlement body to which they can deflect the blame. In contrast, unilateral tax policies that maximize national welfare do not necessarily maximize global welfare. As a result, politicians might want to maintain greater discretion over tax issues than over traditional trade issues.

On the other hand, trade policy also tends to involve a divergence between the interests of national politicians and the maximization of global welfare. In spite of the economists' prescription of unilateral free trade, politicians often find it in their interest to enact trade restrictions, even if these restrictions reduce aggregate national welfare, because the groups that lose from the restrictions (principally consumers) tend to be unorganized politically, while the groups that gain (principally import-competing producers) tend to be well organized. These politicians would be willing to reduce domestic trade barriers only in exchange for reciprocal "concessions" from other countries, because the political costs of making the domestic concessions could then be offset by the political gains from obtaining the foreign concessions (which would tend to benefit producers of exports, another politically organized interest group). Thus, the trade and tax regimes might present similar problems of achieving and maintaining international cooperative outcomes based on reciprocity. Ultimately, however, it appears to be an open question—one whose answer requires political analysis as much as economic analysis—whether the agreements and institutions that best serve to maintain a cooperative trade regime would also best serve to maintain a cooperative tax regime.

ARE THE BROAD NON-DISCRIMINATION OBLIGATIONS IN TRADE AND INVESTMENT AGREEMENTS APPROPRIATE FOR TAX MEASURES?

The non-discrimination provisions in international trade and investment agreements are typically much broader than the non-discrimination articles in tax treaties. The typical tax treaty non-discrimination article prohibits a host country from imposing discriminatory taxes on a business enterprise operating within its territory that is carried on, owned, or controlled by residents of the other treaty country. The non-discrimination article does not, however, prohibit the host country from imposing discriminatory taxes on the non-resident investors in such an enterprise. For example, under tax treaties, the gross-basis withholding tax levied on dividends paid to foreign shareholders may be higher than the net-basis tax levied on domestic shareholders, and shareholder integration credits available to domestic shareholders may be denied to foreign shareholders. As a result, investment by foreigners in a host country is often subject to higher overall host-country taxation than investment by domestic persons.

In contrast, the GATS, for example, broadly prohibits treatment as discriminatory whenever it "modifies the conditions of competition in favour of services or service suppliers of the Member compared to like services or service suppliers of any other Member." Absent the tax carveout in the GATS, this broad non-discrimination principle arguably might interfere with the ability of governments to design tax systems that ensure the equitable and effective imposition or collection

of direct taxes in respect of foreign taxpayers. More fundamentally, some commentators question whether a non-discrimination obligation based on competitive neutrality makes sense in the context of international income taxation. These commentators argue that the competitiveness norm in the international tax context is based on dubious economic assumptions. Moreover, they point out that the resulting non-discrimination principle—prohibiting discriminatory taxation of foreign producers, but not discriminatory taxation of foreign production—promotes capital import neutrality, which is often thought to be a relatively unimportant goal of international tax policy, but does not directly promote the competing, and traditionally favoured, goal of capital export neutrality.

Another limitation of the tax treaty non-discrimination article is that it does not prohibit discrimination *in favour of* inward foreign investment, such as occurs in preferential tax regimes available only to foreign producers. This form of discrimination is covered to some extent by the rules on subsidies in the GATT/WTO agreement and by the provision on state aids in the EC treaty. Arguably, it might be desirable for these latter rules to be broadened to deal more comprehensively with preferential tax regimes and harmful tax competition.

Finally, trade and investment agreements, but not tax treaties, typically require MFN treatment—that is, non-discrimination *among* foreign goods, services, service suppliers, and investors from different member states.

In any case, even if a broader non-discrimination principle were desirable for tax measures, one might ask whether such a principle should be implemented through broadened application of the GATT/WTO agreement (or other non-tax agreements) to direct taxes, rather than through modification of tax treaties themselves.

IS QUASI-JUDICIAL DISPUTE SETTLEMENT APPROPRIATE FOR INTERGOVERNMENTAL TAX DISPUTES?

Tax treaties generally employ a “diplomatic” approach to dispute settlement, in which the competent authorities for the two parties “endeavour” to reach agreement. (There has been a trend, however, toward use of more legalistic dispute settlement procedures in tax treaties. An increasing number of tax treaties provide for voluntary binding arbitration of tax disputes, although none of these provisions appears to have been used to date. The recent tax treaty between Austria and Germany provides for mandatory binding arbitration before the ECJ if the competent authorities fail to reach agreement.) In contrast, many trade and investment agreements, such as the GATT/WTO agreement and the NAFTA, employ quasi-judicial dispute settlement procedures. Nevertheless, the use of mandatory dispute settlement procedures is very much *not* the norm in international agreements generally. Although these procedures presumably increase the likelihood of compliance *ex ante*, they often impose joint costs on the parties *ex post* in the event that a violation does occur.

If trade and investment agreements were to cover direct tax measures more broadly, in all likelihood these agreements would continue to exist side-by-side with tax treaties, rather than superseding tax treaties. This raises the possibility of

forum shopping. One solution might be for trade and investment agreements to require the member states to exhaust their tax-treaty remedies before pursuing dispute settlement under the trade or investment agreement. This issue has arisen under the GATT/WTO agreement: in the recent FSC case, the United States argued that the EU was required to seek resolution of certain issues relating to transfer pricing through tax forums before resorting to the WTO. (The WTO panel rejected the United States' position; the appellate body, however, declined to rule on the issue, since it concluded that it was unnecessary to decide the transfer pricing issues in the case.)

ARE MORE SALIENT LINKAGES BETWEEN TAX AND TRADE MEASURES DESIRABLE?

If tax measures were brought under the scope of trade and investment agreements to a greater extent, the explicit linkages between tax issues and non-tax issues would be increased. This could have the beneficial effect of expanding the possibilities for agreement, since countries could trade non-tax concessions for tax concessions (and vice versa). It could also expand the possibilities for retaliation or compensatory concessions in the event of treaty breaches. On the other hand, the increased number of issues on the table could make it more difficult for negotiating countries to reach a stable bargain. Finally, the increased salience of linkages could cause non-tax-related trade and investment disputes to spill over into the tax regime. The FSC case illustrates this possibility. It is believed by many in the United States, including within Congress, that the EU brought the FSC case in the WTO in retaliation for successful US claims that European import regimes for bananas and hormone-treated beef violated WTO rules.

MULTILATERALISM VERSUS BILATERALISM

Many of the major international trade and investment agreements are multilateral, whereas tax treaties are typically bilateral (although commonly based on a single model treaty). The pros and cons of using a multilateral framework for tax matters is considered in the preceding session of this seminar.

Alternatives to the Existing Allocation of Tax Revenues Among Countries

Eric Zolt

This background note examines the question of how to allocate tax revenue among competing tax jurisdictions. Part one begins by setting forth a series of questions concerning the current international tax regime for different types of income. It also examines whether a more uniform approach to taxing different types of income may be preferable to the current "cubbyhole" approach.

The second part examines alternative tax characterization of corporations, particularly controlled foreign corporations. Here, the primary issue is whether related

corporations should be treated as separate taxable entities rather than mere legal fictions or tax nothings. This part then examines the consequences of separate versus flowthrough treatment for taxation of income of foreign subsidiaries, transfer pricing, and the thin capitalization rules.

The third part of the note briefly examines whether concepts of economic efficiency provide support for the current regime for allocating active business income primarily to the source country and allocating passive investment income primarily to the residence country.

The final part examines the role of redistribution in international tax arrangements.

Separate Tax Treatment of Different Types of Income

In international tax regimes, form governs in determining the tax consequences with respect to different types of income. Taxpayers often have flexibility in electing the tax regime applicable to a particular transaction (sometimes, in both jurisdictions). Sophisticated taxpayers can structure economically similar transactions to have different tax consequences (sales or leases, sales or licences, sales or financings, equity or debt, dividends or capital gains, etc.). As rules applicable to various types of income differ (source rules, exemptions and exclusions, withholding rates, treaty consequences), the characterization of transactions or financial instruments may result in different allocations of tax revenues among competing jurisdictions.

As a framework for examining the current regime, the following questions are posed:

- Does the current regime for separate treatment of different types of income make sense?
- Can we view all claims on business income as just claims with respect to cash flows and control? (Some claims are fixed in time and amount, and others may depend on contingent events as to time of receipt or existence or size of payments.)
- Do non-tax distinctions (with respect to certain corporate law or commercial rights) justify different tax rules?
- Do the administrative advantages of the cubbyhole approach outweigh the arbitrage opportunities inherent in the current regime?
- What are the costs and benefits of moving toward more uniform treatment of different types of income (in either an incremental or a wholesale manner)?

Treatment of Corporations as “Separate Entities” or “Legal Fictions”

INTRODUCTION

As an intellectual exercise, imagine a world where all taxpayers are required to adopt flowthrough treatment for international operations and where all participants in a joint venture are subject to the same tax treatment regardless of the non-tax labels associated with their participation. What would the international tax rules look like in such a world?

Legal and economic scholars offer several models of the relationship between the firm and its shareholders and other participants. The traditional shareholder-primacy model treats the shareholders as owners who elect directors, who then appoint managers to do their bidding. The “nexus of contracts” model places the firm in the centre of relationships among the various participants in the venture, including providers of equity and debt capital, labour, suppliers of raw material, etc. An alternative model or metaphor of “connected contracts” rejects reifying the firm and takes the firm as a legal fiction or construct to its logical extreme. Here, there are only formal and informal contracts among the various participants in the venture for allocating claims on cash flow and control (as well as other matters).

We can extend the “connected contracts” approach to examine the implications of ignoring for tax purposes the separate existence of corporations in the international tax context. The “strong” form of this approach would ignore all corporate entities and trace the consequences back to the individual participants. The “weak” form of this approach would accept the separate existence of the parent corporation, but reject the separate legal existence for tax purposes of some or all subsidiary corporations or entities. Thus, if one focuses on corporate taxpayers and their foreign activities, the strong form would disregard any separate entity existence, while the weak form would accept the corporate parent and disregard the separate existence of some or all of the related entities.

We can also examine the consequences of treating all participants in a joint venture the same for tax purposes. This approach rejects for tax purposes distinctions among different claimants of the joint enterprise and instead seeks to impose uniform tax treatment to the extent possible. Thus, participants who contribute various types of property to a joint venture have claims on cash flow and on control of the joint activity. Some claims on cash flow may be fixed in time and amount. Other claims may depend on a “bet” or contingent events as to the time of receipt or the existence or size of payments. This approach challenges the cubbyhole approach of the international tax regime whereby the label of the type of income determines the tax treatment for a variety of purposes.

The combination of recognizing the separate existence of corporations (including hordes of wholly owned subsidiaries) and applying separate tax treatment for different types of income strongly influences the design of tax rules applicable to cross-border transactions and the allocation of tax revenues among countries with competing claims of tax jurisdiction. The purpose of this part of the note is to examine from a different perspective several of the key components of the international tax regime that influence the allocation of tax revenues among competing tax jurisdictions to see what new or old insights may emerge. The discussion below examines three areas of international taxation to see how tax rules might change if one rejected the separate tax existence of corporations.

TAXATION OF INCOME OF FOREIGN SUBSIDIARIES

Countries have adopted different approaches to the taxation of active foreign source income, in general, and the income of controlled foreign corporations, in

particular. Subject to many exceptions, US corporations can defer the recognition of income with respect to earnings of foreign subsidiaries until such time as the earnings are repatriated. Commentators have debated the merits and demerits of this regime. For our purposes, the inquiry is different. To the extent that the rationale for this treatment rests on the existence of a second corporation, this result makes little sense. Thus, if we reject the separate existence of the controlled foreign corporation, the question becomes whether or not a deferral regime should apply to all foreign activities of domestic persons, not just those of foreign subsidiaries.

Thus, one can imagine rules where no deferral is allowed for certain types of income for both foreign branches and subsidiaries. Alternatively, foreign branches and subsidiaries could enjoy either exemption or deferral on income from foreign activities. No longer, however, would the taxpayer have the opportunity to elect the applicable tax regime.

Ignoring corporate form also changes the concept of repatriation. Transfers from one artificial entity to another would not be respected. Also note that rejecting separate corporate form changes the current regime for classifying income—even apart from discarding labels. Thus, distinctions between active and portfolio income become blurred and the same income is no longer transformed from active to passive as it moves between related entities. Similarly, the classification of a host of intercorporate transactions among related entities is no longer meaningful.

The application of various types of “residence tests” becomes much more problematic if we ignore corporate form and discard tax labels. First, depending on whether a strong or weak form is adopted, we need to look through layers of corporations to the corporate parent or to the individual participants. Note also that, if we discard labels, it is not obvious that the residence of the activity is determined by the “traditional” equity holders, as opposed to other claimants on the activity.

TRANSFER PRICING

As everyone here is painfully aware, governments and taxpayers have struggled over the last several decades in trying to devise rules to allocate income between and among related entities. A major part of the difficulty is trying to construct a hypothetical arm’s-length price under the fiction that the related entities are independent parties. This determination may even be difficult in instances where the product or service transferred is a relatively standard commodity, such as oil or shipping services. It becomes increasingly harder where the transfer involves unique property, especially types of intellectual property. Ignoring corporate form trivializes this particular inquiry.

Ignoring the separate existence of related corporations does not change the need to allocate income. It does change the way we look at the problem, or alternatively, suggest approaches that are more or less compatible with a less formalistic approach. As a start, if we ignore corporate form, we need an approach that divides income on a basis other than the artificial division between related corporate entities.

While a discussion of alternative approaches to transfer pricing is beyond the scope of this seminar, some approaches are clearly more compatible with ignoring

the separate existence of related corporations. If we take the activities as a whole, it may be desirable to allocate income based on function performed. This approach attempts to identify the various functions performed by each of the related parties and assign an appropriate return to each function, based on the average profit earned by a group of corporations carrying out similar functions. A related approach could be a “formulary” apportionment method like that used by many states in allocating income among different states for purposes of state income taxation. Under the formulary method, the entire profit of an affiliated group of corporations is allocated among different tax jurisdictions. No attempt is made to allocate profit as if the constituent parts were independent taxpayers dealing with each other at arm’s length.

Finally, transfer-pricing techniques likely take on increased importance in a world where corporate form is ignored and labels are discarded. If distinctions between source and residence, active and passive become blurred, allocating income on some formulary approach may become more attractive.

THIN CAPITALIZATION RULES

All countries have struggled with the thin capitalization problem, particularly in the context of foreign corporations. One approach is to recognize the separate tax existence of related corporations and to test the characterization of an investment by a related party by reference to a variety of factors. Thus, many jurisdictions have thin capitalization rules that allow interest deductions for related-party debt within prescribed limits, often tied to specific debt-equity ratios. This results in income being shifted from the tax jurisdiction of the debtor to the tax jurisdiction of the creditor.

Alternatively, the separate corporate existence of related corporations could be ignored. Under this approach, intercompany transfers, such as loans between related entities, are not accorded independent economic significance. This approach results in the allocation of a greater share of income to the country of the purported debtor.

Alternatives to Current Compromise of Allocating Active Business Income Primarily to Source Country and Allocating Passive Investment Income Primarily to Residence Country

One issue for discussion is whether there exists an economic efficiency rationale for the current regime for allocating tax revenues among countries. Here one could examine economic efficiency from either the global or the national perspective. The following are two important issues for discussion:

1. How successful are the current concepts of capital export neutrality, capital import neutrality, and national neutrality in designing tax rules for cross-border transactions?
2. What are the necessary conditions that must be satisfied for notions of worldwide efficiency to be achieved?

It also may be helpful to review how globalization, the movement to the “new” economy, the growth of services and intangibles as important components of value-added, and financial innovation create potential for greater discrepancies between the economic income associated with a tax jurisdiction and the taxable income actually reported to that jurisdiction.

Finally, it may be useful to review briefly the alternative approaches for allocating income among competing jurisdictions. Among the usual suspects are proposals that call for supranational authorities, regional approaches, harmonization of rules, and incremental changes and voluntary harmonization.

Role of Redistribution in International Tax Arrangements

In examining alternatives to the existing allocation of tax revenue among competing jurisdictions, one important question is what role, if any, does “redistribution” have in international tax arrangements.

A starting point could be to consider whether there is a “neutral” allocation of tax revenues. Phrased slightly differently, how neutral is the current regime in allocating income from cross-border transactions among source and residence countries? It may be useful to consider alternative baselines by which to compare the current divisions of income and tax revenues among countries.

The next issue is whether there is a role for a “worldwide” perspective for redistribution of income. It is uncertain whether concepts of fairness as generally applied in the domestic context apply with the same or similar force in the international context.

Of course, fairness can have a variety of different meanings. First, fairness can mean the “fair” share attributable to a particular tax jurisdiction. Here, perhaps, benefit theories of taxation or entitlement theories may provide some guidance. Second, one could distinguish rules that appear fair on their face but may have unfair consequences. For example, a treaty could provide for reciprocal withholding rates with respect to certain types of income (5 percent for dividends paid to residents of the treaty partner). Although the rates are the same, differences in the relative economic flows may result in an “unfair” division of tax revenues. One issue for discussion is whether treaties should explicitly consider the relative economic flows in devising tax rules. An alternative position is that any disparities in economic flows are simply part of the negotiations between parties. Third, fairness may also focus on redistribution of income and tax revenues from rich to poor countries. Here, it is important to discuss whether there exists any normative framework to evaluate alternative distributions.

A final issue that may merit discussion is whether rich countries have an obligation to allocate tax revenues to poor countries. Even if one concludes that redistribution is desirable, it is unclear whether tax is the best vehicle to achieve the redistribution.

Schedular Structure of Tax Treaties

Klaus Vogel

Problems and Alternatives

Since states started to conclude treaties for the avoidance of double taxation, these treaties always have been—and still are—organized basically in a similar way: they distinguish types of income (plus, if included, of wealth) and determine connecting factors to distribute the primary taxation among the contracting states. The state to which primary taxation is not assigned is either excluded from taxing the income in question or has to give a credit for taxes paid.

The types of income and the connecting factors in existing treaties and treaty models follow no logical order or systematic conception. They are determined in part by custom, in part by compromises of conflicting interests. During the work of the League of Nations in the 1920s, they were influenced, though not exclusively, by the schedular system of income taxation prevailing at that time in several European states. This lack of system is not just a question of aesthetics. A systematic, logical order of types of income would be helpful in interpreting treaty terms and it would diminish the opportunities for arbitrage.

The terms used by tax treaties to design types of income and connecting factors may be interpreted differently under the laws and languages of the contracting states. This can give rise to double taxation or double exemption. The OECD recently suggested eliminating those conflicts by obliging the state of residence of the taxpayer to follow the interpretation by the other contracting state (the “source state”), provided that this interpretation is correct under that state’s law and language. This suggestion, however, is still controversial.

According to the premises of this seminar, “in the foreseeable future . . . some form of residence and source taxation will continue to co-exist.”²⁸ If this premise refers to treaties, pure residence taxation is no alternative here. If it refers to domestic law only, we shall have to consider whether the reasons that led the League of Nations experts to reject pure residence taxation (as suggested in 1923 by the four “wise men”)—namely, the grave disadvantages that this method would cause for capital-importing countries—still apply.

Distinguishing Between Active Business Income and Passive Investment Income

The distinction seems to have come up in connection with the controlled foreign corporation problem. It does not cover all types of income dealt with by tax treaties—for example, it does not apply to income from employment or social security.

The function of the distinction is to prevent tax avoidance. Income generated not by industrial or commercial activities, but rather by exploiting capital assets, is not connected to certain locations. The taxpayer therefore can easily avoid taxation of that income in his/her state of residence (or citizenship) by transferring the assets to controlled corporations in low-tax jurisdictions.

Note that this possibility raises a problem only if the state of residence and/or citizenship taxes income on a worldwide basis. The distinction of active and passive income therefore reflects a certain policy presumption.

What is “active” or “passive” may be determined intuitively from the everyday meaning of those words or may be inferred from the underlying rationale of the distinction. In both cases, it remains questionable whether the distinction is more precise than the traditional characterization of types of income in tax treaties.

Distinguishing Between Different Types of Investment Income

Under the OECD model, three types of investment income are subject to particular rules (unless the capital invested belongs to a PE in the state of source): dividends, interest, and royalties, governed by articles 10 to 12. However, those rules do not apply to investment income exclusively, nor do they include all possible types of investment income.

According to everyday language, investment income includes rent from real estate, governed by article 6. It further includes income from new financial instruments if acquired for portfolio purposes. Pensions may not be called “investment” income, but are “passive” as well. On the other hand, interest on bank loans or business debts and royalties on products of activities (books, recordings, patents of a professional inventor, etc.) are not investment income, and are therefore “active.”

Moreover, the model itself in article 10(2) assumes that dividends may be “active” or “passive” income, depending on the size of the holding.

As a consequence, a new and more adequate system for distinguishing types of investment income should be conceived. It might be advisable to start by defining the sources and their respective thresholds; the distinction of types of income would have to be adjusted to those definitions.

Distinguishing Between Different Types of (Non-Investment) Business Income

The OECD model applies the wide and comprehensive concepts of “profits of an enterprise” and, synonymously, of “business.” Income falling under this category is governed in general by article 7(1) in connection with article 5. Certain types of business income defined relatively narrowly are, however, excepted from these general rules and subjected to special regimes: income from building sites or construction or installation projects (by a particular PE definition in article 5(3)); income from shipping or aircraft in international traffic and from boats engaged in inland waterway transport (article 8); directors’ fees and compensation to artistes and sportspeople, which would otherwise be business income, if they are received in an independent capacity (articles 16 and 17).

Those special regimes deviate from article 7 mainly by determining the connecting factor, and thereby the “source” of income, and the threshold beyond which primary taxation is assigned to the country of source in a different way.

It should be considered whether the general concept of business income should not be split up to make different source rules and thresholds applicable. (The thresholds as such will be discussed in a later session of this seminar.)

Such subcategories of business income might be

1. income from
 - a. production,
 - b. sale, and
 - c. leasing of material goods;
2. income from independent services (only recently and maybe wrongly included by the OECD under business income);
3. income from financial transactions (possibly with sub-subcategories); and
4. income from
 - a. production,
 - b. sale, and
 - c. leasing of “recipes” (or “programs”), meaning descriptions of a sequence of actions to be performed by human beings or mechanically to achieve a certain result, protected or not as immaterial property (such as patents, musical compositions, recordings, software, etc.).

Additional subcategories may be considered. To the extent that similar source rules and similar thresholds appear to be adequate to more than one of the above-mentioned subcategories, they may be combined under a comprehensive distributive rule.

Can a Global Approach for the Definition of Income Work in the Context of Tax Treaties?

This is one of the five questions laid before me by the organizers of the seminar. It is unclear what was meant by such “global approach.” If the question means whether a global definition can describe the taxes to which a treaty applies, the answer is yes and may be referred to article 2 of the OECD model.

If, however, the question means whether the types of income in articles 6 to 21 may be replaced by a global definition, see the last paragraph under “Problems and Alternatives” above.

Schedular Structure of Tax Treaties

David Rosenbloom

Underlying Beliefs/Assumptions

1. Tax treaties are intended to divide jurisdiction to tax between the contracting states; they are not intended to establish rules of taxation, which are a matter of domestic law.

2. Tax treaties are usually universal; that is, they cover the entirety of the tax base (although in some cases, when it proves impossible to reach agreement, one or more items may be covered by a “renvoi” to domestic law).
3. Tax treaties are optional for the taxpayer, who is entitled to reject them in favour of the rules of domestic law. The question of consistency in this regard (so-called picking and choosing between treaty and domestic law) is conceptually important, and jurisprudence is non-existent.
4. International tax arbitrage is, in the first instance, a product of domestic law; specifically, it flows from the different treatment that different countries give to the basic inputs of a tax system.
5. Tax treaties do not give rise to arbitrage; rather, they give rise to differences between contracting states in the assignment of tax jurisdiction.

Ruminations/Views

1. The debate on how to divide up taxing jurisdiction for purposes of a tax treaty is potentially endless. Although a good theoretical argument could be made for inevitably favouring the country of residence, such an approach is obviously unacceptable to many countries, and some form of compromise, on a case-by-case basis, is required.
2. Compromises are messy. Looking for conceptual purity in result is bound to be fruitless.
3. Moreover, it is not clear why the outlines of the compromise—the identified elements of the tax base which are divided up—need to make sense. Apart from aesthetic considerations, it appears that the only serious objection to any particular compromise would be if the contracting states failed to agree in substance (as opposed to form) on what they had done.
4. Agreement in substance on the detailed meaning of each element of the tax base seems just as elusive as avoiding arbitrage in domestic law. How, for example, can two contracting states hope to agree, with respect to interest, on a definition more specific than compensation for money lent?
5. Such a level of agreement will not prevent one country from viewing, for example, a repurchase agreement as a secured financing while the other sees it as a sale and buyback.
6. Better than attempting to identify and talk through the countless potential differences in interpretation is to develop a system for resolving such differences across the board.
7. Candidates for such a system are “residence country rules,” “source country rules,” “exclude it from the treaty,” and “leave it to the competent authorities.” There are, of course, variations on these themes (arbitration), and there may be alternatives that make sense.
8. In the case of arbitrage with respect to “entity characterization,” the choice has been made that “residence country rules.” In the case of “residence” arbitrage, there has been a “leave it to the competent authorities” approach

with respect to individuals and, quite often, an “exclude it from the treaty” approach to entities.

9. Arbitrage with respect to items in the tax base—where does a particular transaction belong?—is currently left to the source country, for purposes of applying its tax. It may be difficult to reverse this rule, and perhaps it should be made more general.

Concluding Questions/Thoughts

1. Is there a persuasive case for radical change in the way tax treaties are constructed?
2. Would it not be highly disruptive to discard 60-odd years of interpretive practice?
3. Do we too quickly reach the conclusion that the world has changed fundamentally by reason of
 - a. technology,
 - b. rising levels of sophistication in tax matters, and/or
 - c. the inability or unwillingness of tax administrations to challenge questionable positions taken by politically powerful interests?

Issues Related to the Identification and Characteristics of the Taxpayer

Hugh J. Ault

The issues to be considered under this topic raise two different types of questions. In some cases, commercial and technological developments may have made existing concepts and approaches no longer appropriate. In other situations, there may be a need to refine and develop existing concepts to deal with changed circumstances.

Residence as a Nexus for Treaty Benefits

The basic function of tax treaties is to relieve double taxation based on overlapping source and personal claims to taxing jurisdiction. Since most domestic systems base personal tax claims on residence, it is natural that treaties take this approach and grant treaty benefits only where a person is “liable to tax” because of the personal jurisdictional connection. How this jurisdictional test is to be applied, however, raises a number of issues.

- “Actually taxable,” “subject to tax,” “subject to the taxing jurisdiction”—how exactly should residence in terms of “liable to tax” be interpreted? It would seem administratively impossible to require that tax actually be due and paid in a period for a taxpayer to be able to claim treaty benefits, but beyond that, how is the test to be applied? Should special rules apply to any preferential regimes within the general tax system?

- How should tax-exempt organizations such as charities and pension funds be treated? While they are “subject to the taxing jurisdiction” of the residence country, they are not in fact “liable to tax.” Should the approach depend on the relative size of the tax-exempt sector in the countries involved?
- In the case of individuals, increased labour mobility makes it much more likely that there will be increased cases of “dual” residence. Are the existing rules for determining a single residence for treaty purposes still appropriate?
- In the case of corporations, is it still possible to apply the “place of management” test? The increased use of decentralized management structures and decision making and the use of telecommunications techniques make it difficult to determine the physical location of management activities. On the other hand, relying strictly on an incorporation test invites manipulation. An alternative is to focus on the residence of shareholders, but this too is problematic, especially in the case of publicly traded companies. Does this all lead to the conclusion that in the 21st century, corporate taxation will increasingly be limited to source-based taxation?
- How should the issue of “treaty shopping” and limitation of benefits be approached? In a sense, treaty-shopping clauses put an additional set of requirements on the residence definition. Should these limits be developed more directly in the residence definition? What substantive principles should they contain?
- Trusts and trust-like legal arrangements raise a number of issues in determining the appropriate taxpayer. In some cases, the trust is transparent and the underlying beneficiaries are subject to tax; in some cases, the trust is taxable; and in other cases, there is a combination of trust and beneficiary taxation. Can a principled approach be designed to deal with these issues?

Rules for Identifying the Appropriate Taxpayer

Treaties deal with the treatment of specific items or classes of income but do not contain any general rules linking those items of income to specific taxpayers. In such situations, issues both of double taxation and of double non-taxation arise where the two countries take a different approach.

- Should the substantive treaty articles dealing with the various classes of income also provide rules for attributing the income to taxpayers? Should there be a general rule in which the source country follows the attribution of the country of residence?
- Issues can also arise where the ownership of the underlying assets has been transferred between the time income has accrued and the time it has been paid. Is there any generalized approach that can deal with these situations?

Should the Same Treaty Rules Apply to Individuals and to Small and Large Businesses?

Traditionally, treaty rules have made no distinction between the classes of taxpayers to which they apply, though of course the subject matter of the rule may by definition limit it to a particular type of taxpayer (such as student or business apprentice). This approach can be justified since treaty rules, as opposed to domestic legislation, tend to be expressed in terms of principles and not detailed technical rules. Nonetheless, there is a question whether gains in administrative simplicity could be achieved by focusing treaty rules on specific classes of taxpayers.

- Would it be desirable to make more use of de minimis or “rough justice” rules to deal with the problems of smaller taxpayers?
- Are there other classes of taxpayers for whom specific treaty rules might be desirable?

Hybrid Entities

The problem of the inconsistent classification of entities as taxable entities in one treaty country and transparent entities in the other is not a new one. However, in recent years, there has been a dramatic increase of the use of such entities in tax planning, especially in the light of the elective “check-the-box” regulations in the United States. These “hybrid” entities are most typically used to create a deduction in one jurisdiction without a corresponding pickup in income in the other, and this result flows, not from treaty treatment, but from the substantive provision of domestic law. However, there are also important treaty issues concerning the appropriateness of the reduction of source-based taxation where hybrid entities are involved.

- The OECD 1999 partnerships report,²⁹ which by its terms applies only to “partnerships,” requires, in general terms, that the source state look to the classification of the partnership by the residence state for purposes of applying treaty rules relating to the reduction of source-based taxation. If, because of the inconsistent treatment of the hybrid entity, the residence country is not in fact asserting taxing jurisdiction over the income, the source country is not required to reduce its tax. Should these same principles be applied to other hybrid entities, such as limited liability companies?
- What has been the experience in negotiating treaties in the light of the partnership report and the subsequent changes in the model and commentary? Have any technical issues arisen that were not foreseen in the report?

Taxing Business Profits

Brian J. Arnold

Introduction

Under the current version of the OECD model convention, different rules are provided for the following different types of business activities:

- real or immovable property,
- shipping and air transportation,
- entertainment,
- directors' fees,
- employment,
- business activities generating income not attributable to a PE, and
- other business activities, including independent personal services.

Thus, it is necessary to distinguish not only between business income and investment income, but also between different types of business income. This approach to the taxation of business profits, although it may be justifiable, causes serious problems, and it is worthwhile considering alternative approaches.

At a fundamental level, tax treaty provisions dealing with business profits, in the broadest possible sense, involve four questions:

1. What is the distinction between business profits and investment income? This issue will be dealt with in the session dealing with the schedular nature of tax treaties.
2. When is it appropriate for a country to tax the business profits of residents of the other country (that is, what is the threshold requirement for taxing non-residents)?
3. Once the minimum threshold is met, what income or activities does the country have the right to tax (that is, what source rules apply)?
4. What rules should apply to the computation of the income subject to tax and to the imposition of tax?

The answers to these questions, together with the obligation of the residence country to relieve double taxation, will determine how the tax revenues on business profits from cross-border activities are shared between two countries. Further, each of the last three questions applies to all of the different types of businesses.

Threshold Requirements

Some threshold requirement is necessary, for purposes of both domestic law and tax treaties, to determine whether one country can tax the business profits of a resident of another country. The issues of threshold and source are closely related and could be synonymous; that is, a country could claim the right to tax any

income derived from sources in the country. They are treated separately here on the assumption that it is desirable, from both a unilateral domestic perspective and a treaty perspective, to limit a country's right to tax business profits to situations where the non-resident's activities meet a minimum threshold.

Under the current provisions of the OECD model, threshold requirements vary from a PE in a country to services rendered in a country (entertainment and employment) to property located in a country (immovable property). In the case of international shipping and air transportation, the source country is not entitled to tax at all. It is questionable whether it is appropriate to have different thresholds for different businesses.

The PE concept is under attack. It was never considered appropriate for certain types of businesses, and it is difficult to apply to e-commerce and service industries.

To generalize, what connections must a non-resident have with a country to justify that country's taxation of the non-resident's business profits? There are several factors that might justify source-country taxation:

- a fixed place of business in the country,
- a certain level of physical presence in the country,
- a certain level of income derived from the country, and
- a certain level of business activity taking place in the country.

There is no obvious reason why any one of these factors by itself or any combination of them should not be sufficient as a basis for taxation. Any test should provide certainty for taxpayers and tax administrators and provide a reasonably fair allocation of tax revenues.

Income or Activities Subject to Tax

Once the threshold requirement is met, the next step is to determine what income the country should be entitled to tax. The possibilities include

- any income generated by the relevant business activities,
- any related income, or
- any income derived from the country, whether related to the relevant business activities or not.

A full force-of-attraction rule seems difficult to justify. The UN model employs a limited force-of-attraction rule for income from activities similar to those conducted through the PE. The taxation of related income raises issues concerning the proper characterization of receipts such as interest and royalties that may be closely related to a taxpayer's business activities.

Whatever approach is adopted, it is necessary to have rules with respect to the source of income and expenses. These source rules can be derived from domestic law, or treaty source rules could be provided. Under the latter approach, the same source rules would generally apply to all treaty countries.

Rules for Computing Income and Imposing Tax

Under both articles 7 and 9 of the OECD model, the fundamental principles for the computation of income are the separate entity and arm's-length principles. These principles apply to income earned by both branches and subsidiaries, but do not apply to certain types of business income such as income from real property. It is appropriate to consider whether some alternative method for determining income from cross-border activities between two countries would be preferable to the existing rules. One alternative would be some type of formulary apportionment, although the details of transfer-pricing methodologies are beyond the scope of this seminar. Another possibility would be to provide for exclusive taxation of all or some business profits by the country of residence accompanied by some type of tax revenue sharing between the two countries.

More generally, the rules in article 7 of the OECD model for the computation of the profits attributable to a PE are vague and uncertain. Basic issues are unresolved. Does "profits" mean the total profits of the enterprise? Can a PE have a profit although the enterprise has an overall loss? Are profits computed in accordance with accounting rules or domestic law? If the amount of profit is different in the source and residence countries, it would appear to be difficult to eliminate double taxation. Is it possible to adopt clearer treaty rules for the computation of business profits?

There seems to be little justification for determining profits of different types of businesses in accordance with different computational rules. Therefore, business profits from real property or entertainment activities in a country should be computed in accordance with the same rules applicable to other businesses under article 7.

Moreover, any other treaty provisions should presumptively apply to all non-residents engaged in business activities of any nature in a country. For example, article 24(3) of the OECD model applies only to business activities carried on through a PE. Arguably, it does not apply to business activities involving real property, entertainers, or, before 2000, independent personal services carried on through a fixed base.

Relief of Double Taxation

Robert Couzin

Policy Basis for Double Taxation Relief³⁰

The operation of residence taxation in general and the relief of double taxation in particular are traditionally debated in terms of capital export neutrality (CEN) and capital import neutrality (CIN), to which the credit and exemption methods of relief are taken to correspond. Are CEN and CIN useful concepts for framing the nature of residence taxation and the methods of relief of double taxation? If not, what should be the framework of debate?

Apart from the credit versus exemption debate, there is a more fundamental lack of consensus on what relief of double taxation means. It is common to distinguish between juristic and economic double taxation. Tax treaties seek to achieve

fairly comprehensive treatment of the former but only limited treatment of the latter. The models do not even go so far as to deal with the underlying credit or participation exemption. Most treaties in practice address this issue, but they generally avoid the problem of reconciling the problem of double taxation in corporation/shareholder taxation; since this is an unresolved issue at the domestic level in many countries, international consensus is impossible to reach. Is it sensible to go to great lengths to achieve juristic double non-taxation when the basic issue of corporation/shareholder taxation remains unresolved (given that a substantial proportion of cross-border income is derived through corporations)? Is it possible to make progress on the latter issue, and should it be given greater priority?

Approaches to Double Taxation Relief

There seem to be two major approaches to double taxation relief in bilateral conventions. One prescribes that a contracting state shall provide such relief by exemption or credit without subordinating that relief to domestic law. This is the OECD approach in article 23 of the model. Under the other approach, the contracting state commits itself to applying its domestic double taxation relief to income from sources in the other state. This is the domestic law approach.

Under either approach, the treaty articles do *not* generally deal with economic double taxation (although the mutual agreement procedure may do so), “concurrent full liability to tax” (residence conflicts), or triangular situations. The treaty provisions on relief of double taxation are unnecessary where the distributive provisions of the convention allocate taxing jurisdiction on an exclusive basis. Thus, these articles serve a residual function of avoiding double taxation where the source and residence states are permitted to (and do) tax the same items of income. Limiting the jurisdiction of the source state will not eliminate double taxation unless the residence state allows an exemption or a foreign tax credit.

The OECD Approach

Unusually, article 23 allows for two alternative methods.

1. Version A is a modified exemption system. The state of residence agrees to provide
 - a. “exemption with progression” in respect of income or capital that, in accordance with the provisions of the convention, may be taxed in the other state and
 - b. a foreign tax credit for tax imposed by the source state on dividends and interest.

(Proposed paragraph 31.1 of the commentary on articles 23 A and 23 B suggests that the credit rule might also be applied to items of income that benefit from preferential tax treatment in the other state by reason of a measure introduced after the date of signature of the convention.)

2. Version B is a simple credit model. The State of residence allows a credit in respect of tax paid to the other state on income or capital that, in accordance with the provisions of the convention, may be taxed in the other state, but not exceeding the residence state tax attributable to such income or capital.

The Domestic Law Approach

Under this approach, the treaty article may provide that the state of residence will extend its domestic exemption or credit treatment with respect to income earned or tax paid in the other contracting state. Alternatively, the article grants an exemption or credit, but that relief is subject to the domestic law, perhaps with the qualification that such law “shall not affect the general principle” of the article.

While this approach thus incorporates by reference the rules of domestic law for relief against double taxation upon which taxpayers could rely without the benefit of the convention, these articles may have some substantive effects, such as the following:

- The article may limit the effect of subsequent amendments.
- The commitment prevents the state from discriminating against the other contracting state by proscribing taxes paid to or income arising in the other state as benefiting from the domestic credit or exemption system.
- In the case of credit jurisdictions, the convention clarifies, implicitly or explicitly, that the taxes imposed by the other state qualify as creditable taxes.
- Domestic law may apply in a different manner if there is an applicable convention.
- The article may specify that in applying the domestic system, income will be considered to have its source in the other state if it may be taxed there under the convention.

It should be noted that in some conventions, one state adopts the domestic law approach and the other the OECD approach.

Comparison of the Approaches

Article 23 of the OECD model is “honoured more in the breach than in the observance.” It is altered, supplemented, or even replaced wholesale in most bilateral conventions. This suggests that countries that otherwise find the OECD model a useful precedent are, rightly or wrongly, predisposed toward different solutions to this particular problem.

Both approaches provide considerable scope for domestic law. The domestic law approach is a broad concession to the primacy of national law, although subject to some restrictions, such as those related to amendment. The OECD approach permits countries to choose the exemption or the credit system and, even within these methods, leaves scope for the operation of domestic tax systems. The commentary expressly and repeatedly observes that bilateral alterations may be appropriate.

Why is this particular article so beholden to national laws? Admittedly, this area is very complex, and it can be difficult to blend the simple treaty mantra of eliminating double taxation with national systems. Is it necessary or appropriate to accommodate domestic laws to this extent? For example, some countries do not tax profits of a foreign PE. Yet, article 7 of their treaties does not simply incorporate the domestic law. What is special about article 23? Is the argument against a freestanding commitment to eliminate double taxation essentially practical or theoretical?

Change of Domestic Law

Under the pure OECD approach, exemption or credit is determined by the text of article 23. If aspects of domestic law are repeated in the article, they take on a freestanding power of application. Without an express treaty override, contracting states are restricted in their ability to change the exemption or credit allowed by the convention. This is, of course, no different from the situation in respect of other articles.

Under a domestic law approach without restriction on amendment, domestic law governs and the convention provides no specific protection against such amendments. However, in some cases, the article refers to amendments that do not affect the “general principle” of the article. This concept raises a number of difficult questions:

- Presumably, wholesale reform of the domestic double taxation relief could be ineffective in respect of income or tax subject to the article. Is this desirable where, for example, one form of elimination of double taxation is replaced by another? If it happened, how would subsequent exemptions or credits be determined?
- Would anti-avoidance legislation (such as “purchased” credit prohibitions) respect the “general principle” test?
- Is the “general principle” to be inferred from the domestic law as it stood on the date the convention took effect (or was negotiated), so that different “general principles” might apply to the same domestic law in different conventions?

Relationship Between Exemption and Credit

Even the brief exemption system prescribed by article 23 A contains a credit with respect to dividends and interest. This illustrates that national tax systems (and commonly held views regarding tax policy) are often “hybrids” as regards the appropriateness of credits and exemptions.

To what extent can or should article 23 attempt to accommodate “mixed” systems? If a country provides exemption only if a low-tax threshold test is met, is there any way to incorporate this into the convention short of the domestic law approach?

Indirect Credit or Participation Exemption

The commentary on article 23 acknowledges that many states (1) provide recognition for tax paid by (or exempt dividends from) foreign subsidiaries, (2) include provisions to this effect in their conventions, and (3) have favoured the insertion of such a provision in the OECD model. The OECD declined to accede to this request owing to the complexity arising from the lack of uniformity among national tax systems. Three simple sample clauses are contained in the commentary (for exemption [with progression], indirect credit, and assimilation to domestic dividends).

How relevant is article 23 if it does not address the indirect credit or participation issue? Does the failure of the OECD article to do so encourage countries to adopt the domestic law approach? If it is possible to be prescriptive, without reference to domestic law, in connection with exemption or credit generally, why is it not possible to prescribe an indirect credit or participation system? If a convention can prescribe an ownership threshold for source-country taxation of dividends, why not a threshold for indirect foreign tax credit or exemption?

CFC Legislation

A CFC regime causes foreign-source income earned by a foreign entity to be imputed to and taxed in the hands of a resident. It is doubtful whether either approach to article 23 provides for the elimination of double taxation in respect of such income, although the domestic rules invariably provide recognition for foreign tax in some way. The commentary on article 10 of the OECD model raises some of the relevant questions.

With the proliferation of CFC regimes, should article 23 not include such taxes in the indirect credit? As well, the interaction of competing CFC regimes can lead to double (or multiple) taxation. Should article 23 expressly address such interaction in the case of CFC legislation of the two contracting states?

Source

An important issue in any system for double taxation relief is the determination of source. Under the OECD approach, source is addressed implicitly by requiring the residence state to provide an exemption or credit in respect of income, or tax on that income, which may be taxed in the other state "in accordance with the provisions of this Convention." This provision would override domestic source rules. For example, income that may be taxed in the other state but, under domestic concepts, would not be foreign source, will qualify for exemption or credit.

Under the domestic law approach, source may be dealt with expressly, by including a stipulation that income or gains of a resident of a contracting state that may be taxed in the other contracting state in accordance with the convention shall be deemed to arise from sources in that other state. Absent such a provision, the domestic law approach may provide little effective relief.

In either case, where source conflicts are resolved by appeal to taxation "in accordance with the provisions of this Convention," how is that decided? Whose

law governs whether the taxation is in accordance with the convention—that of the state of source or that of the state of residence? Should this issue be resolved in article 23, or be left to the mutual agreement procedure?

Characterization Issues

Relief of double taxation, like many other treaty benefits, is complicated by conflicts in the characterization of income, instruments, or entities as between the contracting states. The subject should be considered in other sessions at this meeting.

With respect to article 23, consider, for example, the appropriateness of a credit for withholding tax where the state of source characterizes an item of income as interest but the state of residence views it as royalty. Whose law determines whether taxation is “in accordance with the Convention”? If the article includes an indirect credit or participation exemption, additional permutations arise where the conflict of characterization is between dividend and something else. Similar and increasingly complex questions are posed where the two states do not characterize an arrangement or entity in the same way, one viewing it as a taxpayer and the other as fiscally transparent.

The Relationship Between Domestic Tax Systems and Tax Treaties

John F. Avery Jones

Domestic Law and Common Interpretation

There is a tension between using the domestic law meaning of a treaty term in accordance with article 3(2) (which has the result that a treaty relieving provision has the same scope as a country’s taxing provision, so that if a treaty prevents the source state from taxing pensions, it cannot tax whatever it considers to be a pension under its law), and using a common meaning (which has the result that the treaty relief has the same scope in both countries).

A difficulty about article 3(2) has been that some states do not give relief for tax charged by the source state based on its internal law meaning of a term, when the residence state, by applying its law, does not categorize the income as a category that the source state may tax. This view is taken by some exemption states that, as residence states, categorize income to determine whether exemption or credit is to be given; it is not a problem for tax credit states that give credit for all types of income. On this interpretation, article 3(2) causes the failure to give relief. The commentary now states that this is not the correct approach.³¹ The source state applies its internal law to determine whether the treaty permits it to tax; the residence state gives relief if on this basis the source state is permitted to tax without asking whether it agrees with the source state’s interpretation.³² The argument in favour of the commentary’s interpretation is that article 23 does not contain any undefined terms in respect of which article 3(2) might require reference to internal law. All that it says is that credit or exemption is to be allowed where a resident

“derives income . . . which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State.”³³

The approach of the residence state giving relief for what the source state can tax on the basis of its internal law is limited to determining the type of income. If states disagree with whether, for example, the taxpayer carries on business through a fixed place of business in the other state, the residence state is not obliged to give relief on the basis of the source state’s view of the facts.³⁴

A related problem arises in connection with whether income of a transparent partnership is treated as paid to a partner. If there is a difference between the two states in the categorization of the partnership as transparent or opaque, the OECD partnerships report suggests that the source state should “take into account, as part of the factual context in which the Convention is to be applied, the way in which an item of income arising in its jurisdiction is treated in the jurisdiction of the taxpayer claiming the benefits of the treaty as a resident.”³⁵ This is the opposite approach from differences in categorization of income where the residence state follows the source state’s categorization.

Thus, where the source state treats the partnership in the residence state as opaque and the residence state treats it as transparent, the source state should follow the residence state’s view and say that the income is paid to the partners rather than the partnership, thus giving effect to the object and purpose of the treaty.³⁶

The same should apply in the reverse situation where the source state regards the residence state partnership as transparent and the residence state regards it as opaque: the source state should say that the income is paid to the partnership, rather than to the partners.³⁷ However, this solution cannot apply if the partnership is also in the source state because the source state says that the partners are entitled to the income arising in that state, while the residence state says that the source state partnership is entitled to the income. The result is that the treaty is inapplicable.³⁸

An autonomous meaning of a treaty term is required, first, where article 3(2) cannot apply because the source state does not use the term in its internal law, and, second, where internal law could apply by virtue of article 3(2) but the context requires that it does not apply. An example of the first type is whether there is a permanent establishment because of a fixed place of business, or whether the business is carried on through it. In many states, permanent establishment is an internal law concept with a similar definition, but an aspect such as whether something is fixed is not a term in internal law to which article 3(2) can sensibly apply. An example of the second type is the interpretation of the expression “artistes and sportsmen” in article 17. This is inconsistent with full application of internal law, even where internal law uses these expressions, because the commentary discusses their meaning—for example, that the former includes stage performers but excludes conference speakers and film support staff such as film directors.³⁹ It is obviously desirable that both states agree that there is a permanent establishment or that the income falls within article 17, and that accordingly the source state can tax. This is not achieved by the residence state’s following the source state’s lead; it

requires an autonomous interpretation, and it is possible for states to interpret the words differently if they work independently.

ISSUES

1. If the above approach is the desired result, could the intention be made clearer—for example, by including something in the model as required by the Netherlands observation?⁴⁰
2. Is there a better approach?

SUGGESTIONS FOR DISCUSSION

1. Subject to the discussion above on the definition of what are business profits, make more use of internal law definitions, possibly to the exclusion of any defined categories of income to avoid the present combination of some categories being defined, some being left to internal law, and others being subject to limitation in the commentary.
2. Avoid the qualification conflicts debate by clarifying that the double taxation relief article does not require the residence state to apply its own categories of income to determine whether the source state should have taxed and accordingly whether it should give relief.
3. Leave the treaty to apply between the state that taxes the income, the person who is taxed, and the source state; this solution may result in avoiding references to income paid to, derived by, etc., and beneficial owner. Provide that the source state must apply the treaty between it and the person taxable in the residence state.⁴¹

Changes in Domestic Law and Override

There are two separate issues:

1. Since article 3(2) requires recourse to internal law as it is from time to time, there is a limit to changes to internal law, beyond which the change has no effect on interpretation.
2. A change in the law that does have effect in interpreting the treaty may breach the treaty; the remedy for a material breach is termination of all or part of the treaty (which may do more harm than good).

On the limit of changes within article 3(2), the commentary draws the line between preventing a state from changing its internal law to make the treaty partially inoperative and preventing the need to refer to earlier law, but is not very clear about how one determines the limit.

Override is not possible in all countries because treaties may have a higher status than internal law. Some changes in the law that override the treaty are in order—for example, restoring the position to what both parties thought it was before a court decision to the contrary. The OECD report on treaty override disapproves of

override⁴² even when designed to prevent improper use of the treaty. It encourages consultation to solve treaty problems and states that override will be publicly and forcefully condemned.

ISSUES

1. Could the point about the limit of changes be made clearer—for example, by saying that changes should not apply if they affect only non-residents or if they significantly upset the balance of the treaty (because some changes may affect residents as well but have little effect on them)?
2. Presumably there is no issue on override.

Tax Avoidance and Tax Treaties

A problem is that a treaty will be adjudicated upon by one or other state and never by an international court. There is a natural assumption that each party cannot say that the treaty is affected by its own anti-abuse rules; that would mean that the treaty meant two different things. Or is it that internal law as modified by the treaty means two different things, which one expects?

Domestic anti-abuse provisions clearly apply at the stage of taxing in accordance with internal law.⁴³ If they have the effect of recharacterizing income or determining who is the recipient of it, that will apply for the treaty so long as internal law is to be applied under article 3(2) of the model. Anti-abuse doctrines are the same as any other provision of internal law. A minority of states dissent from this view.⁴⁴ On either view, if article 3(2) does not apply, the domestic anti-abuse doctrines cannot apply to categorizing income either.

CFC legislation might conflict with treaties depending on how it is drafted, although most countries consider that it is not affected by treaties.⁴⁵ A problem is that if it is prevented by treaties, it cannot be introduced without changing all treaties.

One of the problems is that the abuse may derive solely from using the particular treaty. It is then more difficult to see how domestic anti-abuse doctrines can apply to it.

The best argument is that an anti-abuse principle is included in the treaty interpretation principle of good faith in article 31 of the Vienna Convention on the Law of Treaties.⁴⁶ Good faith may be the limit of what is implied by treaty interpretation, and a state may therefore wish to put the matter beyond doubt and insert anti-abuse provisions in the treaty itself. A limitation-of-benefits article is an example of such an anti-abuse provision, and so is a main purpose clause limiting the application of reduced withholding tax usually found in UK treaties if

. . . it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the shares in respect of which the dividend is paid [and similarly with other forms of income] to take advantage of this article by means of that creation or assignment.

A more clearly targeted example is found in article 3(1)(n) of the new US-UK treaty⁴⁷ in the definition of conduit arrangement (which is excluded from the benefits of the dividends, interest, royalty, and other income articles):

[T]he term “conduit arrangement” means a transaction or series of transactions:

- (i) which is structured in such a way that a resident of a Contracting State entitled to the benefits of this Convention receives an item of income arising in the other Contracting State but that resident pays, directly or indirectly, all or substantially all of that income (at any time or in any form) to another person who is not a resident of either Contracting State and who, if it received that item of income direct from the other Contracting State, would not be entitled under a convention for the avoidance of double taxation between the state in which that other person is resident and the Contracting State in which the income arises, or otherwise, to benefits with respect to that item of income which are equivalent to, or more favourable than, those available under this Convention to a resident of a Contracting State; and
- (ii) which has as its main purpose, or one of its main purposes, obtaining such increased benefits as are available under this Convention.

ISSUE

In what way can the relationship between internal law anti-avoidance provisions and treaties be clarified?

Improving the Flexibility of Tax Treaties: General Issues

Jacques Sasseville⁴⁸

How Can Treaties Better Address Tax Developments?

On average, tax treaties of OECD countries remain unchanged for 15 years after they are signed or after a protocol is concluded. Compared to domestic law, which is modified almost every year, tax treaties therefore appear immutable. While this guarantees a certain degree of tax stability for taxpayers, it reduces the capacity of a country to adapt its tax treaty network to changing circumstances, including important domestic tax policy changes.

ISSUES FOR DISCUSSION

- Should tax treaties become more flexible so as to adapt to changing circumstances?
- If yes, how should this be done?

How Can We Speed Up the Negotiation/Renegotiation of Tax Treaties?

Tax treaties often take years to conclude or to amend. Frequently, a request to fix a minor issue through a protocol leads to a full reconsideration of the whole treaty, which sometimes discourages states from even trying to amend the treaty (the

Pandora's box syndrome). This has sometimes led to accusations that tax authorities were attempting to amend their treaties through changes to the commentary because they could not quickly negotiate protocols to their existing treaties. It has also led some countries to enact legislative changes that modify the legal effect of tax treaties under their law.

ISSUES FOR DISCUSSION

- Are there ways to reduce the period of time needed for the conclusion of a treaty?
- Are there ways through which uncontroversial amendments to treaties could be adopted quickly (for example, a regular or multilateral amendment process)?
- Should the competent authorities be given some leeway to adapt tax treaties to changing circumstances?
- What are the pros and cons of the process through which some countries "adapt" tax treaties through domestic law changes?

Reducing Conflicts of Interpretation and Application Between States

Contracting states often disagree as to how a tax treaty should be interpreted or applied. Such conflicts may result from differences in the domestic law of the two states, differences in the interpretation of the provisions of the tax treaty, differences in the interpretation of the domestic law of one state, or differences of views as regards the relevant facts.

ISSUE FOR DISCUSSION

- Apart from arbitration (which is discussed below), are there ways through which these various conflicts between states as regards the interpretation and application of tax treaties could be solved or reduced?

Enhancing the Status of the Commentary

In most OECD countries, the commentary is regularly used by courts for the purposes of interpreting tax conventions.

ISSUES FOR DISCUSSION

- Should that use of the commentary be encouraged, and if yes, how?
- Are there ways through which the value of the commentary as a tool for treaty interpretation by courts could be enhanced?

Bilateral Advance Rulings for Tax Treaty Issues

Bilateral advance pricing agreements (APAs) may be seen as a form of bilateral advance rulings dealing with one treaty issue—that is, transfer pricing. One could envisage extending the APA process to cover all treaty issues. Such extension would constitute a process of pre-dispute settlement of treaty issues.

ISSUES FOR DISCUSSION

- What would be the pros and cons of such a process?
- Would there be enough cases to justify implementing such a process?
- Are there legal or technical obstacles to implementing such a process?

Dispute Resolution

The main problem with the mutual agreement procedure is that it is not a binding process. For years, academics have suggested arbitration as a means to resolve disputes arising under tax treaties.

Tax authorities, however, frequently reply that the lack of a binding process for solving tax treaty disputes does not matter in practice, as evidenced by the fact that almost all mutual agreement cases between OECD countries are resolved by the competent authorities. They have also argued that the widespread use of arbitration would hamper the mutual agreement procedure since it would lead the competent authorities to refuse to compromise in order to solve disputes at the level of the mutual agreement procedure.

Tax treaty disputes are also frequently solved through recourse to domestic courts. This is a rather unusual process in the universe of treaties, which are instruments between states. This difference between tax treaties and other treaties can be explained by the fact that tax treaties involve a third party that is absent during the negotiating process—namely, the taxpayer—and the conflicting interests of the taxpayer and the states allow the adversarial process to work relatively well, even when the issue must be decided by a court of one of the contracting states.

ISSUES FOR DISCUSSION

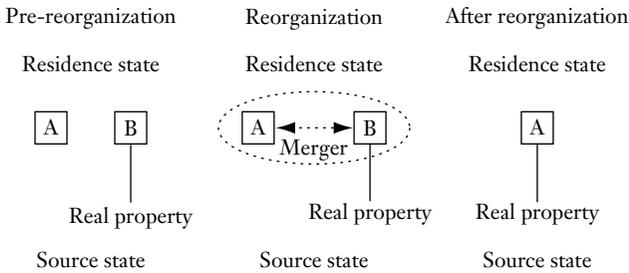
- How can the mutual agreement procedure be improved?
- Should arbitration become a feature of tax treaties?
- If yes, what should be the characteristics of a tax treaty arbitration process?
- Is it likely that arbitration will become a feature of tax treaties in the near future?
- What is the position of developing countries as regards binding arbitration of tax treaty disputes?
- What are the benefits and disadvantages of the recourse to domestic tax courts to settle treaty disputes?
- Are there other issues related to the resolution of tax treaty disputes?

Improving the Flexibility of Tax Treaties: The Specific Case of Cross-Border Tax Issues Arising from Corporate Reorganizations

Guglielmo Maisto

A particular development that is not addressed in tax treaties is the growth of cross-border issues arising from corporate reorganizations. The practical importance of the topic warrants a separate discussion of some of the issues involved.

FIGURE 1



The remaining part of this note examines the tax effects in one state (“the source state”) of reorganizations consummated in another state (“the residence state”). This is the case, for instance, of a merger effected between two companies residing in the residence state, in the event the absorbed company owns an asset in the source state (illustrated in figure 1).

The issues that may arise include

- conflict of timing (foreign tax credit),
- conflict of characterization of income, and
- non-discrimination.

Conflict of Timing

THE ISSUE

Notwithstanding the tax neutrality granted to the reorganization in the residence state, the source state may consider the change of title of the asset situated in its territory as a taxable event. If so, the following consequences arise:

1. The residence state shall not tax the reorganization.
2. The source state shall tax the gain accrued on the asset situated in its territory until the date of the reorganization.
3. The tax paid in the source state shall not be credited in the residence state at the time of the reorganization since the reorganization does not give rise to income in the residence state.
4. At the time the asset situated in the source state is sold, the tax levied in the source state on the gain arising from the sale may be credited in the residence state; however, the tax previously levied in the source state at the date of the reorganization (see point 2 above) shall not be credited in the residence state.

POSSIBLE SOLUTIONS

The timing mismatch outlined above may be eliminated by applying one of the following techniques:

- The source state grants neutrality to the merger and preserves the tax claim on the assets situated in its territory. (This is the solution laid down in article XIII(8) of the Canada-US treaty. In such a treaty, the deferral is not self-executing and needs the consent of the competent authority of the source state.)
- The source state does not grant the neutrality to the merger (that is, it taxes the gain accrued on the assets situated in its territory) but defers the payment of the tax until actual disposal of the assets. (A similar technique is applied in some treaties with regard to the change of residence of individuals.)
- The residence state grants the absorbing company the right to treat the merger as a taxable transaction so that the tax levied in the source state may be credited and the tax basis in the residence state can be stepped up. (This is the solution laid down in article XIII(7) of the Canada-US treaty, which is, however, available solely for individuals.)
- The residence state grants the absorbing company the right to defer the creditability of the tax paid in the source state until the date of actual disposition of the assets.

Conflict of Characterization

THE ISSUE

The reorganization may give rise to conflicts of characterization between the residence state and the source state. For instance, the asset situated in the source state and transferred from the absorbed company to the absorbing company, both residing in the residence state, may be characterized in the source state as capital gain, falling under article 13 of the OECD model, and as dividend in the residence state, falling under article 10 of the same model.

POSSIBLE SOLUTIONS

They include the following:

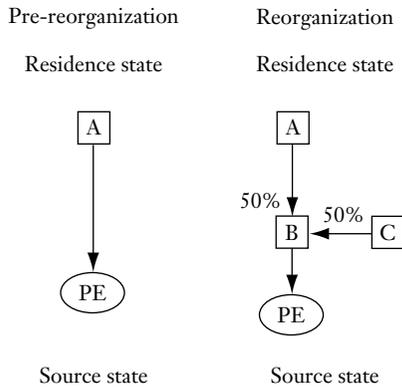
- Paragraph 32.2 of the commentary on article 23 of the OECD model covers the issue insofar as the characterization in the source state governs.
- A special treaty rule providing for a mandatory characterization of income arising from the reorganization may be included (see, for instance, article 15(8) of the Belgium-France treaty).⁴⁹

Non-Discrimination

THE ISSUE

In several states, relief otherwise available in respect of reorganizations effected solely by resident companies is denied if the parties to the reorganization are non-residents. The denial may apply whether or not the non-resident maintains a permanent establishment in the state in which the reorganization is effected. For instance, a resident company contributing a branch of activity to the capital of

FIGURE 2



another resident company may be entitled to rollover relief, but the same relief may be denied to a non-resident company contributing a permanent establishment situated in the territory of the state (see figure 2).

The extent to which article 24(3) applies to these situations needs to be explored. Indeed, it could be argued that article 24(3) deals with issues of discriminatory treatment of the income attributable to a permanent establishment itself, while in the case at issue the denial of the rollover relief does not affect the income attributable to the permanent establishment (the permanent establishment is the object of the contribution). The issue is not expressly addressed by the commentary on article 24 of the OECD model.

POSSIBLE SOLUTIONS

Either the commentary or article 24 may be changed.

NOTES

- 1 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD) (looseleaf) (herein referred to as “the model convention” or “the OECD model”).
- 2 United Nations, *Model Double Taxation Convention Between Developed and Developing Countries, 2001* (herein referred to as “the UN model convention” or “the UN model”).
- 3 See appendix 2.
- 4 Ibid.
- 5 Ibid.
- 6 Ibid.
- 7 Ibid.
- 8 Ibid.
- 9 Organisation for Economic Co-operation and Development, *The Application of the OECD Model Tax Convention to Partnerships*, Issues in International Taxation no. 6 (Paris: OECD, 1999).
- 10 See appendix 2.

- 11 Ibid.
- 12 See, for example, article 24(2) of the Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, signed at London on July 24, 2001.
- 13 Supra note 9.
- 14 See appendix 2.
- 15 Supra note 9.
- 16 See appendix 2.
- 17 UN Doc. A/Conf. 39/27, fourth annex, UNTS 1155/331, signed at Vienna on May 23, 1969.
- 18 See appendix 2.
- 19 The Convention Between Canada and the United States of America with Respect to Taxes on Income and Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997.
- 20 Austria and Germany signed a new income and capital tax treaty and protocol on August 24, 2000 (not yet in force).
- 21 This note was produced for the sole purpose of triggering a discussion on broad issues related to tax treaties and should not be considered to reflect the views of either the author or the OECD. The author wants to thank Richard Vann for his contribution to the first part of this note.
- 22 Throughout this note, “tax treaties” refers to bilateral treaties based on the OECD/UN models, unless stated otherwise.
- 23 This ground is often expressed in the perhaps misleading form of prevention of international avoidance/evasion. A frame of reference expressed in terms of avoidance/evasion recognizes the possibility that in some situations countries may agree that double non-taxation is permissible (for example, in the case of tax holidays in developing countries). Normally it is agreed that double taxation is contrary to desirable policy, though on closer examination even this proposition may need qualification (see the background notes on relief of double taxation).
- 24 Avoidance of double taxation and prevention of tax evasion are the two purposes of tax treaties that are acknowledged in their title. The “prevention of tax evasion” did not appear in the OECD 1963 draft convention (Organisation for Economic Co-operation and Development, *Draft Double Taxation Convention on Income and Capital* (Paris: OECD, 1963)) but was added in 1977 (Organisation for Economic Co-operation and Development, *Model Double Taxation Convention on Income and on Capital* (Paris: OECD, 1977)).
- 25 While a description of the purposes of tax treaties may seem theoretical, it has a significant legal consequence in light of the reference to the “object and purpose” in paragraph 31(1) of the Vienna Convention on the Law of Treaties, supra note 17. Thus, should the prevention of tax avoidance and tax discrimination be officially recognized as purposes of tax treaties (that is, through inclusion in the title)?
- 26 Wayne State University School of Law, Detroit, USA (Michael McIntyre did not attend the seminar).
- 27 World Trade Organization Appellate Body Report, *United States: Tax Treatment for “Foreign Sales Corporations,”* WT/DS108/AB/R, adopted by the Dispute Settlement Body, March 20, 2000.
- 28 See appendix 1, “Scope of the Discussions.”
- 29 Supra note 9.
- 30 The first two paragraphs of the note were drafted by Richard Vann.
- 31 Paragraphs 32.1 and following of the commentary on article 23. The Netherlands has made an observation disagreeing with this approach unless supported by the treaty or mutual agreement (paragraph 80 of the commentary on article 23).

- 32 As an exception, in article 19 the residence state takes on the role usually played by the source state by the residence state's exempting governmental income.
- 33 Article 23 A(1) (exemption) and article 23 B(1) (credit).
- 34 Paragraph 32.5 of the commentary on article 23.
- 35 Supra note 9, at paragraph 53.
- 36 Ibid., at paragraph 62, example 4. The new US-UK treaty, supra note 12, has a provision to this effect: "An item of income, profit or gain derived through a person that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a Contracting State to the extent that the item is treated for the purposes of the taxation law of such Contracting State as the income, profit or gain of a resident" (article 1(8)). See also paragraphs 2 and 4(b) of protocol I to the Convention Between the Kingdom of Belgium and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed on June 5, 2001.
- 37 Supra note 9, at paragraph 63, example 5.
- 38 Ibid., at example 6. Three state problems are determined on the same basis. Example 7 is the same but with the source state (as well as the residence state) saying that the partnership in the partnership state is opaque, while the partnership state says it is transparent.
- 39 Paragraphs 3 to 7 of the commentary on article 17. See also Organisation for Economic Co-operation and Development, "The Taxation of Income Derived from Entertainment, Artistic and Sporting Activities," in *Thin Capitalisation/Taxation of Entertainers, Artistes and Sportsmen*, Issues in International Taxation no. 2 (Paris: OECD, 1987), 37-64.
- 40 See supra note 31.
- 41 See supra note 36.
- 42 Organisation for Economic Co-operation and Development, *Tax Treaty Override* (Paris: OECD, October 1989).
- 43 This may be true only in states where treaties are incorporated into internal law. If the treaty has automatic effect and a higher status than internal law, the analysis may be different.
- 44 Paragraph 23 of the commentary on article 1.
- 45 Ibid.
- 46 Supra note 16. See International Fiscal Association, *How Domestic Anti-Avoidance Rules Affect Double Taxation Conventions*, proceedings of a seminar held in Toronto, Canada, in 1994 during the 48th Congress of the International Fiscal Association (The Hague: Kluwer Law International, 1995).
- 47 Supra note 12.
- 48 This note was produced for the sole purpose of triggering a discussion on broad issues related to tax treaties and should not be considered to reflect the views of either the author or the OECD.
- 49 The Convention Between Belgium and France for the Avoidance of Double Taxation and the Establishment of Reciprocal Rules of Administrative and Judicial Assistance in Respect of Taxes on Income, signed at Brussels on March 10, 1964, as amended by the protocols signed on February 15, 1971 and February 8, 1999.