Remedying the Power Imbalance in Negotiations for Bilateral Tax Treaties

By:

Loan Tran

June 26, 2019

Introduction

As globalization intensifies, the international community has been inundated with issues related to the taxing of cross-border trade and investment. To remedy challenges such as double taxation and tax evasion, international tax cooperation is key. This cooperation, however, is currently hindered by a power imbalance that exists between developed and developing countries. These countries enter into bilateral tax treaties based on model treaties that were created for, and used almost exclusively by, developed countries.

Developing countries are often underprepared during negotiations, which ultimately allows foreign investors to manipulate certain provisions based on the model treaties to dodge tax payments to economically challenged regions. Africa, for example, is losing an estimated $50 billion annually through illicit financial outflows of which include the avoidance of paying taxes. Today, the growth of multilateral tax instruments provides a prime opportunity for developing countries to renegotiate their bilateral tax treaties.

Bilateral Tax Treaties

Developing countries enter into bilateral tax treaties for a number of reasons: elimination of double taxation, increased foreign investment, decreased tax avoidance, and increased participation in the international community. Tax treaties attract foreign investment by creating a clear tax environment where investors are able to measure their tax liability with certainty. To advance the above goals, tax treaties will allocate taxing rights over certain income to either the country where the taxpayer lives (residence) or the country where the taxpayer's income is earned (source). Developing countries are pre-dominantly source countries, meaning that income is earned within their borders from companies that reside outside their borders. Accordingly, they rely heavily on source-based taxation. However, tax treaties typically allocate more taxing rights to resident countries. For example, a common treaty provision states that a source country can tax the active business income of a foreign-owned company in exchange for no taxation on passive income such as dividends, royalties, and interest on loans.

Now, a resident country could tax this passive income, but a foreign company can easily evade this taxation by channeling its investments through tax havens. Thus, source countries give up their right to tax passive income for no real advantage to either country. The result of this manipulation is an alarming gap as to where foreign companies and investors pay their taxes and where they conduct their business. Given the benefits and costs of tax treaties, it is important for developing countries to fully understand and negotiate the terms that they subject themselves to.

Model Tax Treaties: the OECD and UN Models

The negotiation process for a bilateral tax treaty is a critical step in which developing countries can address their needs and ensure fair treatment in the future. Unfortunately, the major model treaties used as the foundation for negotiations lean heavily towards taxing at residency rather than taxing at the source. The OECD Model Treaty for bilateral tax treaties has been the most widely adopted model since its first publication in 1963. It operates under the assumption that there is a roughly equal flow of trade and capital between countries. However, the OECD as an organizational body is a platform for powerful countries who still set the agenda for discussion today. Certain provisions in the model are harmful to developing countries. For example, its provisions on transfer pricing (the pricing of international dealings between associated enterprises) do not cover intellectual property rights, which are increasingly used for shifting profits to tax havens. The United Nations created its own UN Model Treaty in 1980.

Some developing countries quickly embraced the UN Model because it granted more taxation rights to the source state than the OECD Model. For example, the UN Model leaves the reductions of withholding rates to bilateral negotiations, typically leading to higher withholding rates and more taxable income for the source country. Some, however, found the UN Model unsatisfactory because it essentially used the OECD Model as a starting point. In fact, 80 percent of the words of the two models are identical. Moreover, certain African countries and other developing countries have been underrepresented in UN negotiations on tax matters. What complicates the negotiation process for developing countries is that the starting point for negotiations is overwhelmingly one of these models. Developing countries have little voice in the models' creations, thus the policies that they strive to implement are not embedded in the provisions.

Informed Negotiations

The UN Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries was published in 2016 to address this unequal bargaining power. The UN Manual provides that even before entering into negotiations, countries should (1) develop a tax treaty policy framework and (2) utilize a model treaty. This preparation is especially important for developing countries who often lack adequate skills and experience to effectively negotiate and administer tax treaties. First, in developing a policy framework, a developing country should determine the main policy outcomes that it wishes to achieve. Specifically, it should consider its main sources of economic revenues, areas for potential foreign investment, policies of regional economic communities, and domestic law. It should write its specific goals into the treaty itself. Second, if a developed country urges for a model tax treaty, the UN Model is more favorable than the OECD Model because it provides for more taxing rights to the source country.

At minimum, the bilateral tax treaty should cover double taxation on income, a non-discrimination provision, and a mutual agreement on the exchange of tax information. Regarding specific provisions, a commissioned report by the UN Economic Commission on Africa found “troublesome” a provision in double taxation agreements that seek to remove or lower withholding taxes on management fees and to remove limitations on intracompany loans. Accordingly, developing countries should strive for the opposite of such a provision.

Recent Developments

The recent developments in case law and the growth of multilateral tax treaties allow developing countries to re-examine inherent biases in the international tax regime. In March of 2019, Kenya’s High Court struck down a tax treaty between Kenya and Mauritius, an offshore tax haven. The two countries entered into the treaty in 2012 in which companies established in the latter island nation enjoyed reduced tax rates. The treaty, however, lacked adequate anti-abuse provisions and prevented Kenya from imposing withholding and capital gains tax. Subsequently, the International Consortium of Investigative Journalists released a series of emails from an investigation that showed third-party companies "eagerly eyeing the Mauritius-Kenya treaty to pay less tax."A Nairobi-based nonprofit, Tax Justice Network Africa (TJNA), brought the case to the Kenyan courts arguing that foreign investors could use the treaty to “dodge Kenyan tax by round-tripping their investments illicitly through a Mauritius shell company.”

The effect of such a treaty would have been a significant leakage of millions in tax and billions in revenue moved out of African countries. The Court ultimately held that the treaty was unconstitutional because it was not approved by Parliament as required by law for proper ratification.Although the Court struck down the treaty on due process grounds, the ramifications of the ruling are far-reaching. First, it is a landmark case because tax treaties are rarely struck down or even scrutinized. Second, the case signals a chance for renegotiations. The Tax Justice Network requested that Kenya renegotiate its other treaties, including with China, the Netherlands, the UAE, and South Korea. Although one small case, the decision could have a potentially significant impact in the international tax regime. It is worth noting that on April 10, 2019, only a month after the Court decision, the governments of Kenya and Mauritius signed a new tax treaty. The treaty has not been made public and its specific provisions remain unknown. In response, the Executive Director of TJNA issued a statement saying: “It is unacceptable that the Kenyan government is shifting the burden of taxation to the ordinary citizen, while deliberately opening doors for the wealthy elite and unscrupulous [multinational corporations] to evade and avoid taxes through [tax agreements] with secretive tax havens.”

One recent development has been declared a “milestone in the evolution of the international tax regime”: the OECD’s multilateral tax instrument. A multilateral tax instrument or treaty is an agreement signed by more than two countries. In 2017, the OECD published its multilateral tax instrument (“MLI”) to counter treaty abuse. The MLI contains a provision that gives authorities broad discretion to deny tax treaty benefits, i.e. non-taxation of dividends, if any principal purpose of a corporate restructuring is to obtain these benefits. This instrument may appeal to developing countries because it increases source-based taxation and limits treaty shopping. Furthermore, by operation of the MLI, certain bilateral tax treaties of MLI signatories will have to be renegotiated bilaterally. The long-term effect of the OECD’s MLI will be closely monitored by the international tax community. For the near future, however, developing countries should follow in their developed countries’ footsteps and quickly begin the process of renegotiation.

Conclusion

Developing countries are currently disadvantaged in the international tax regime. The control of the developed countries in the tax regime is evidenced in their influence in the creation of the major model tax treaties that are used as the starting point for nearly all bilateral tax treaties today. With the rise of multilateral tax instruments and an awareness of the dubious flow of tax revenue out of already disadvantaged countries, developing countries should consider renegotiating their bilateral tax treaties to ensure a more balanced international tax system that is designed for their benefit.

View online: Remedying the Power Imbalance in Negotiations for Bilateral Tax Treaties