Implications of the Interaction of Trade and Tax Rules (Part Two)

Hafiz Choudhury, Peter Hann and Daniel A. Witt

Hafiz Choudhury
Principal
The M Group, Inc

Peter Hann
Senior Consultant
The M Group, Inc

Daniel A. Witt
President
ITIC

(Continued from the last issue)

4. The Role of Double Taxation Treaties

4.1 Advantages of Tax Treaties for Developing Countries

Tax treaties are important because they can help to eliminate double taxation, facilitate cooperation and exchange of information between tax administrations, and set out a tax dispute resolution mechanism. Double taxation is an obstacle to inward investment and by concluding tax treaties with the main trading partners developing countries can reduce the risk of double taxation and boost investment.

Stability and certainty of tax treatment are important to investors, and double tax treaties can offer stability to investors in a number of ways. Investors can rely on the provisions of the treaty, which vary less frequently than domestic tax law provisions. A treaty may also reassure investors that the developing country will adhere to international standards on issues such as transfer pricing and permanent establishments.[5] Treaties generally also contain a non-discrimination article

5 Sebastien Leduc & Geerten Michielse. *Are Tax Treaties Worth It for Developing Economies?*

which can provide reassurance for potential investors.

4.2 Problems with Tax Treaties for Developing Countries

A problem faced by developing countries is that they often enter negotiations on an uneven playing field, with potential treaty partners that have more economic strength and more experience at tax treaty negotiation. This disadvantage can be partly offset by commitment of more resources if available, capacity building within the tax administration and assistance from regional and international organisations. Increased capacity development work by the United Nations, through the Financing for Development Office, Department of Economic and Social Affairs in particular,[6] and more generally by assistance programmes is helping to address this issue.

Double taxation treaties can create a better climate for investors by reducing source jurisdiction taxation, clarifying the allocation of taxing rights and reducing withholding tax rates on various categories of income such as dividends, interest, royalties or technical services. Withholding taxes are a relatively convenient method of collecting tax from foreign companies without incurring high administrative costs. They are thus a suitable mechanism for jurisdictions with scarce resources, and this source of tax revenue should not be easily negotiated away.

There is a concern that developing countries tend to give away too much in tax treaties, which is seen as part of a wider problem that developing countries have given too many broad tax exemptions to foreign investors through their domestic tax laws. This has often been seen as resulting in a race to the bottom in tax rates and special regimes but without enough monitoring by those countries of the effect on foreign investment.[7] The availability of low tax rates and special regimes is thought to allow companies the opportunity to engage in profit shifting and other tax avoidance arrangements. These arrangements can include the possibility of treaty shopping by multinationals that place an intermediary company in a low tax jurisdiction or regional investment hub to take advantage of treaty provisions.

Incentives can have a favourable effect on investment if they are carefully designed and targeted. They need to be designed in a way that can benefit those investors that might otherwise decide to go elsewhere. The effectiveness of incentives in increasing investment may be difficult to measure, but some degree of measuring and monitoring of incentives is possible. Monitoring and review of the effects of incentives can highlight areas where incentives need to be adapted to changing conditions and can indicate areas where they are not effective and should be removed.

The costs and benefits of tax concessions in treaties therefore need to be weighed carefully and constantly monitored to ensure that they are reaching the required objectives and are still providing value for money. The costs of a tax treaty include the costs and time spent negotiating the treaty, the costs associated with administration of claims made by taxpayers for the various benefits under the treaty, and the costs of monitoring the benefit of the provisions as economic conditions change.

Developing countries should note that similar benefits may be achieved by incorporating some basic principles into domestic tax law, such as a harmonised definition of permanent establishments that is consistent with treaty principles. These domestic law provisions must set adequate thresholds and scope that leave room to offer further concessions to treaty partners in negotiations, e.g., in return for better withholding tax rates or thresholds.

In removing any wasteful tax incentives, countries should consider the potential effect of investment treaty provisions. If the dispute res-

6 UN. *Tax Treaties,* https://www.un.org/development/desa/financing/capacity-development/topics/tax-treaties.

7 Park Junhyung, Bedi Sukhmani, Abbas S. M. Ali, et al. (2021). A Partial Race to the Bottom: Corporate Tax Developments in Emerging and Developing Economies. IMF Working Paper No. 2012/028.

olution provisions in an investment treaty are wide enough, an investor could invoke them to compensate for any change in the amount of tax levied, such as the removal of a tax incentive.[8]

4.3 Future of Tax Treaties

Double tax treaties should continue to play a part in the investment strategy of developing countries. It is argued, however, that countries should establish appropriate mechanisms to weigh the costs and benefits of each prospective treaty before it is negotiated. Although the provisions of a treaty apply to both contracting states, it does not mean that the taxing rights given up by each state are equivalent. If a capital importing country agrees to lower withholding tax rates in a bilateral treaty, it is potentially giving up much more taxable income than its treaty partner, so the costs and benefits of such concession must be considered. A developing country may conclude that a consistent, relatively low withholding tax rate in its domestic law is a more effective incentive for foreign investment than greater concessions in tax treaties.

After a treaty has entered into force, the main provisions of the treaty should be regularly monitored, including those on permanent establishment, business profits, withholding tax and capital gains. A double tax treaty is worthwhile only if its benefits outweigh its costs, and this can only be determined by adequate measurement of those benefits and costs.

On 8 October 2021, 136 member jurisdictions of the OECD/G20 Inclusive Framework signed the two-pillar agreement on taxation of the digital economy, which could lead to change to bilateral tax treaties. This provides for a new nexus under Pillar 1 of the proposals that will result in some profits of large multinationals being allocated to market jurisdictions even where there is no permanent establishment. This could affect tax treaty articles on permanent establishment and business profits. Pillar 1 will also include binding dispute mechanism provisions that could affect the arrangements for the mutual agreement procedure.

The multilateral instrument[9] for including tax treaty related BEPS provisions into tax treaties has shown that treaties can be updated quickly without the time and expense of entering into fresh negotiations with each trading partner. A similar multilateral mechanism could be established to implement aspects of the global minimum tax agreed under Pillar 2.[10] This could enable jurisdctions to update their treaties where this may be necessary as a result of the implementation of the OECD agreement. Articles that could be reviewed include those relating to permanent establishment, business profits, elimination of double taxation and the mutual agreement procedure. Developing countries in particular may need to review their provisions on dividends, interest and royalties to make sure that taxing rights are optimal under global minimum tax rules. They may also consider tax sparing provisions to protect the incentive value of tax exemptions offered to investors, in cases where the home jurisdiction can top up the tax to the level of the global minimum tax.

Another measure affecting treaties would be the subject to tax rule (STTR). As part of the arrangements for imposing a global minimum tax on large multinationals, the STTR is being designed as a treaty-based rule. This specifically targets risks to source jurisdictions from profit shifting structures where cross-border intragroup payments take advantage of low nominal tax rates in the residence jurisdiction of the payee.

8 Note E/C/2019/CRP.14 on the Interaction of Tax, Trade and Investment Agreements, UNDESA, 2019

9 OECD. *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*, https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm.

10 OECD (2021). *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*, https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.htm.

Where the source jurisdiction has ceded taxing rights over certain categories of income in a tax treaty, it would be able to impose a top-up tax to the agreed minimum rate if the relevant income is not taxed, or is taxed at below the minimum rate, in the other jurisdiction. The STTR targets cross-border arrangements for related party payments exploiting provisions of a tax treaty to shift profits from source jurisdictions to jurisdictions with no or low rates of nominal taxation. Source jurisdictions would therefore be able to protect their tax base.

The STTR would apply to categories of payment with more risk of base erosion, including interest, royalties and other payments that could be used for profit shifting as they relate to mobile capital, assets or risk. Other payments could include franchise fees, insurance and reinsurance premiums, guarantee or brokerage fees, rent and marketing or agency fees. There are also concerns that gains are shifted into the residence jurisdiction as a way of avoiding taxation in the source jurisdiction.

The STTR is to be implemented through a separate standalone treaty provision. It would apply to relevant payments between connected persons that are above a specified materiality threshold. The rule would be activated when the payments are subject to an adjusted nominal rate in the residence jurisdiction of the payee that is below the agreed minimum rate of 9%, after taking relevant deductions into account. The source jurisdiction would be permitted to tax the gross amount of the payment up to the minimum amount, by imposing a withholding tax on the payment equivalent to the difference between the adjusted nominal tax rate and the agreed minimum rate.

Some jurisdictions are considering the introduction of a domestic minimum tax to ensure that a proportion of any "top-up" amount under the global minimum tax will accrue to the domestic jurisdiction rather than be allocated to the jurisdiction of the ultimate parent company or another jurisdiction. The Belt and Road jurisdictions could consider this possibility, to ensure that they take a fair amount of tax from large multinationals carrying out BRI projects on their territory. The tax should be designed in a way that does not deter investors.

5. Coordination of Tax Treaties and Trade Agreements

5.1 DTTs and Investment Protection Agreements

Under the provisions of a bilateral investment treaty (BIT), foreign investors are entitled to the better of national treatment or MFN treatment, with a few specified exceptions. Foreign companies are therefore entitled to be treated as favourably as their local competitors and other foreign companies, although many BITs guarantee national and MFN treatment only after an investment has been made.

A BIT can increase certainty for investors by placing limits on the expropriation of investments and allowing foreign investors to claim compensation. Expropriation can only be carried out in line with the standards of international law, which require it to be for a public purpose, carried out in a non-discriminatory manner under due process of law and accompanied by payment of adequate compensation. The expropriation for this purpose is defined to include any measures that deprive the investor of the economic value of its investment. Thus, in some situations, arbitrary taxation could be treated by a tribunal as indirect expropriation, and investors sometimes challenge the taxation measures under the arbitration provisions of trade and investment agreements on these grounds.[11]

Under a BIT, there can be broad guarantees that investors will be treated in line with international law. Host jurisdictions may promise fair and equitable treatment for investments; and they can pledge not to engage in arbitrary

11 Note E/C/2019/CRP.14 on the Interaction of Tax, Trade and Investment Agreements, UNDESA, 2019.

or discriminatory decision making. Under the provisions of a BIT, foreign investors may transfer funds into and out of the host jurisdiction without delay at a market rate of exchange. In addition, investors can have the right to submit an investment dispute with the host jurisdiction to international arbitration. Disputes under a BIT are governed by the terms of the relevant investment treaty and international law, not necessarily by the law specified in the investment contract. Therefore, BITs and double tax treaties may cover the same ground on certain issues, including non-discrimination and the dispute resolution procedures.

Compared with the scope of a tax treaty, an investment treaty may apply to a wider group of investors. The definitions of investments or investors could affect the tax position where, for example, indirect investors have protection under an investment treaty, but the relevant tax treaty restricts certain benefits to direct investments. The provisions of an investment treaty on fair and equitable treatment may be interpreted widely by investment panels and could therefore become relevant in any tax related dispute.[12]

5.2 Treatment of Services

The trade laws within a jurisdiction may place limits on the number of foreign suppliers that can be used in a project or may require local participation. There may also be regulations to protect the public, such as licenses, which can be a barrier to trading in certain types of services. Such licensing can apply to financial institutions or to practising certain professions, where only local qualifications may be recognised, and there could also be requirements in relation to the nationality of directors. Other requirements such as data standards may be applied to services.

International or regional trade agreements can allow some standardisation of such requirements and allow foreign service providers some certainty that if the requirements of one of the signatory jurisdictions are satisfied then the national requirements of the other parties to the agreement will also be fulfilled.

Services are not normally subject to customs duties, except in certain cases where the services are closely linked to a supply of goods. For indirect tax purposes, services may be linked to items that are regarded as a "carrier medium". Imported computer software could be regarded as either a supply of goods or a supply of services, and in the case of software that uses a "carrier medium", the supply could be classified as goods or services depending on the type of software. Generally, a supply of software items that are available to, and usable by all customers independently after they have been installed may be treated similarly to a supply of goods, while specific, tailored software is much more likely to be treated as a supply of services for VAT purposes. In the case of other services, rules on the place of supply of services can be complex. For direct taxes, service providers will need to examine the local laws in relation to taxation of services, and if there is an applicable double tax treaty, they may need to study the definition of a "services PE" in the treaty.

The UN Committee of Experts on International Cooperation in Tax Matters has approved a new Article 12B, relating to income from automated digital services, for inclusion in the UN Model Tax Convention. Article 12B gives to the source state the right to tax the income from automated digital services in the place where the income arises. The maximum tax rate applicable is to be determined by negotiation between the contracting states. Under paragraph 3 of the Article, the beneficial owner of the income would have the right to be taxed on qualified net profits from automated digital services at the domestic rate of tax in the source state. For this purpose, the definition of qualified profits is 30% of the amount resulting from applying the taxpayer's profitability ratio to the gross annual revenue from automated digital services in the source state. The definition of automated digital services for this purpose includes services provided through the internet

12 Note E/C/2019/CRP.14 on the Interaction of Tax, Trade and Investment Agreements, UNDESA, 2019.

or electronic networks with minimal human involvement of service provider.

6. Tax and Trade Dispute Resolution

6.1 Trade Disputes

It is inevitable that disputes will arise in the course of international trade. The WTO has an important role in resolving cross-border trade disputes. A matter is brought to the WTO when a member state considers that another member has acted in violation of a commitment made as part of its membership of the WTO. Under the dispute settlement system, there are clear rules that set out the timetable for completing a case. A first ruling is made by a panel and then confirmed or rejected by the full membership of the WTO. An appeal against a ruling is possible on a point of law.

Under a bilateral investment protection treaty there may be a cooling off period in a dispute to allow the parties to the dispute to reach a settlement. The parties may have a choice of where to go for dispute resolution. The treaty may give the right to go to international arbitration. There would generally be a panel consisting of three arbitrators, each of the parties to the dispute may nominate one. This tribunal works out the timetable and detailed procedure, allowing for written arguments, evidence and an oral hearing.

Once constituted, the tribunal will set the timetable and details for the process, including the submission of written arguments and evidence, as well as the oral hearing. Rules along the lines of those laid down by the International Centre for Settlement of Investment Disputes (ICSID) or the UN Commission on International Trade Law (UNCITRAL) may be set out in a treaty. The result of the tribunal hearing would be an arbitral award that could be enforced in one of the states that is party to the relevant convention, for example the ICSID convention.

The UNCITRAL Arbitration Rules also set out procedures for the conduct of arbitral proceedings, covering all aspects of the arbitration process. They provide a model arbitration clause, outline rules for the appointment of arbitrators and the conduct of proceedings, and set out rules for giving effect to the arbitration award.

6.2 Advance Pricing Agreements

An advance pricing agreement (APA) is concluded by a business and a tax authority (or more than one tax authority) to establish in advance the pricing of certain specified related party transactions. This is done primarily to achieve certainty and to avoid tax disputes. The taxpayer and tax administration agree on a transfer pricing method that will be used to compute the arm's length price for the transactions into the future.

The taxpayer can rely on the tax treatment specified in the agreement provided that the terms of the agreement are adhered to, and the critical assumptions remain valid. The term and scope are set out in the agreement, together with issues such as the possibility of roll-back to previous years with open tax returns. Taxpayers would normally be required to complete an annual compliance report confirming the continued application of the critical assumptions underlying the agreement and the taxpayer's continued compliance with the provisions of the APA.

APAs can be an important tool in transfer pricing risk management and some companies are using them as a tool in dispute resolution, where there is an ongoing transfer pricing dispute and the conclusion of an APA could offer the chance of rolling back the APA to prior years that are still open. Even if a dispute in a previous year has been resolved, the conclusion of an APA can help to avoid similar disputes on the same issue in future periods.

7. Exchange of Information

7.1 Bilateral Treaties

Double tax treaties generally contain a provision on the exchange of information, based on either Article 26 of the OECD Model or Article 26 of the UN Model. The UN Mod-

el provides for information to be exchanged that would be helpful in preventing avoidance or evasion of tax and the contracting states are required to develop appropriate methods and techniques to fulfil information requests.

Developing countries have difficulty in putting in place adequate bilateral tax treaty arrangements, firstly because they often do not have sufficient bargaining power to insist on the arrangements they need, and secondly because they often do not have sufficient resources within the tax administration to establish effective mechanisms to enable them to make use of the article on exchange of information.

Bilateral Tax Information Exchange Agreements (TIEAs) contain more details on exchange of information. Model agreements have been issued by the OECD and by CIAT,[13] however, developing countries may still be disadvantaged by their lack of bargaining power when concluding bilateral agreements. Jurisdictions aiming to exchange information may have internal restrictions in the form of regulations or requirements that slow down or obstruct the process of information exchange, such as notification requirements, and the tax administration needs to have enough resources to use the agreement to its advantage.

In view of the difficulties involved in bilateral agreements for the exchange of information, developing countries might prefer to sign and implement multilateral agreements among regional groupings. This could save administrative time and resources, but investors may prefer the multilateral agreement to contain options for customising the provisions taking into account a jurisdiction's particular circumstances. Investors may look for higher levels of protection when there are particular types of risk, such as political risk.

7.2 Multilateral Provisions

The most wide-ranging multilateral convention on the exchange of tax information is the Convention on Mutual Assistance in Tax Matters.[14] The agreement provides for exchange of information on request, automatic exchange of information and spontaneous exchange of information, in addition to assistance in recovery of taxes and the possibility of simultaneous tax audits.

Although a number of developing countries are already signatories to the Convention, others have not yet joined it. Joining the Convention would represent an important step for those countries in increasing the access to tax information.

In December 2020, the Global Forum on Transparency and Exchange of Information for Tax Purposes together with the African Tax Administration Forum (ATAF) produced a toolkit[15] on establishing an effective exchange of information function within the tax administration or finance ministry. The toolkit looks at the required resources for the unit, and the different levels of information gathering, and examines the interactions required between the exchange of information function and the rest of the tax administration and other government departments.

8. Recommendations for Tax Administrations in Developing Countries

8.1 Advantages of More Coordination

Owing to mismatches between tax and in-

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13 CIAT. *Model Agreement on the Exchange of Tax Information,* https://www.ciat.org/Biblioteca/DocumentosTecnicos/Ingles/1999_model_agreement_tax_information_ciat.pdf.

14 OECD. *Convention on Mutual Administrative Assistance in Tax Matters*, https://www.oecd.org/tax/exchange-of-tax-information/convention-on-mutual-administrative-assistance-in-tax-matters.htm.

15 OECD. *Global Forum Secretariat and African Tax Administration Forum Deliver New Toolkit to Help Countries Set up and Run Effective Exchange of Information Units*, https://www.oecd.org/ctp/exchange-of-tax-information/global-forum-secretariat-and-african-tax-administration-forum-deliver-new-toolkit-to-help-countries-set-up-and-run-effective-exchange-of-information-units.htm.

vestment agreements, investors may gain certain advantages. For example, where the relevant tax and investment agreements both have separate dispute resolution provisions, it may be possible for investors to choose the most favourable provisions from their points of view, where tax issues are concerned. This may improve the investment climate from the point of view of the investor but is a consequence of the lack of coordination between investment and tax treaties, which may create problems for the tax administration.

Both investors and tax administrations would benefit from more certainty in the treatment of the investment and tax position. It is therefore in the interests of all stakeholders to align the provisions of tax and investment agreements more clearly. In addition, better coordination between government departments or within the tax and customs administrations could help to identify taxpayers who are engaging in profit shifting or other forms of tax avoidance.

8.2 Measures for Tax Administrations to Implement in the Short Term

8.2.1 Greater exchange of information between BRI tax administrations

Exchange of information between tax administrations is important in the context of the BRI, where projects may be taking place across borders and the tax administration in a particular jurisdiction needs to know more about the cross-border transactions of a multinational. The most effective way for developing countries to improve exchange of information is to sign up to multilateral agreements, and in particular the Convention on Mutual Administration Assistance in Tax Matters. Jurisdictions can ensure that the resources are available to efficiently operate the exchange of information function. The toolkit on establishing an effective exchange of information function can be used as a reference for setting up the function and developing its operations.

8.2.2 Greater coordination between customs, indirect tax and direct tax authorities within jurisdictions

A taxpayer importing goods from a related party may be interested in establishing a low price for the transaction, to reduce the customs duty payable, and this could also lead to lower VAT or excise tax. For direct tax purposes, the importer may prefer to establish a higher price for the transaction to increase the deductible costs in the importing country and lower the taxable profit. This potential conflict between the price or valuation for customs purposes and the transfer price for direct tax purposes means that there may be discrepancies in the price used for customs purposes compared with the price established for direct tax purposes.

If a jurisdiction does not use customs information in checking prices or valuations for direct and indirect tax purposes, taxpayers may be able to take advantage of the situation to manipulate cross-border prices and valuations in order to reduce their tax and customs duties. The customs and transfer pricing functions within a jurisdiction should collaborate and exchange information to ensure that the pricing of import transactions is consistent across the different taxes. Both functions could carry out risk-based compliance audits that would involve comparison of transfer pricing and customs documentation.

In some jurisdictions, the tax and customs authorities are completely independent bodies,

while in others, they are integrated into one organisation. In both cases, however, there is a need for more communication and exchange of information between the two functions, for purposes such as cross-border valuation for customs and indirect purposes or for comparison of prices and valuations for customs and transfer pricing.

8.2.3 Comparison of transfer pricing documentation with customs documentation

In the context of coordination between customs and direct tax functions, the comparison of customs and transfer pricing documentation can be established on a routine basis. Although there will be differences in the documentation owing to the different purposes of the two sets of documentation and different treatment of intangibles and services, comparison of the documents may indicate the possibility of transfer mispricing or attempts to artificially reduce the customs valuation.

8.2.4 Improved targeting of tax incentives

Developing countries have often too easily given away tax relief in the form of tax holidays and other incentives to foreign investors, leading to losses of tax revenue without necessarily affecting investment behaviour. Developing countries should abandon these wide-ranging tax exemptions and instead focus on targeted tax or non-tax relief that can have a real effect on investment behaviour. Any tax relief should be monitored regularly to ensure that it is still having the intended effect and that it is worthwhile to continue the relief. The different incentives should be coordinated and overseen by one part of government so that inefficient tax and non-tax incentives don't accumulate, which deplete government resources without increasing investment.

8.3 Measures for Tax Administrations to Implement in the Longer Term

8.3.1 Regional double tax agreements

Countries/regions with common interests could consider the possibility of regional tax agreements that take into account the specific requirements of projects in developing countries. An example of such a Convention is the Nordic Multilateral Tax Treaty concluded by Denmark, the Faroe Islands, Finland, Iceland, Norway and Sweden.

8.3.2 More harmonisation of customs and tax regulations

Countries/regions could introduce regulations to ensure that an upward adjustment to transfer prices is also reflected in valuations for customs duties and indirect taxes collected at the border. Correspondingly, a downward adjustment to transfer prices could result in a reimbursement of some customs duties. Year-end adjustments for transfer pricing purposes could be reflected in revised customs valuations.

Closer coordination of transfer pricing and customs would also help taxpayers to reduce the compliance costs in relation to cross-border transactions. In view of the compliance costs of putting together transfer pricing documentation, it would help taxpayers if much of the same documentation could also be used for customs purposes. The customs authorities could also find the detailed transfer pricing information useful if it is adapted to provide additional information to assist customs valuation.

8.3.3 Coordination of the structure of tax incentives to avoid harmful competition

Developing countries, including those involved in the Belt and Road Initiative, offer tax incentives as a way to compete with other jurisdictions in the region for investment. This can set off a race to the bottom as greater incentives are made available for foreign investors. As a result, jurisdictions feel pressure to offer greater incentives, and in doing so, they deprive themselves of much-needed tax revenue.

The jurisdictions in a region could increase their tax cooperation on this issue and reach an agreement on limiting this harmful tax competition, thus continuing to receive adequate tax revenue from foreign enterprises. This cooperation could also cover non-tax incentives such as subsidies that may also be used to attract investment.

(The end)