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by Peter Hann and Hafiz Choudhury

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Implications of the Interaction of Trade and Tax Rules

by Peter Hann and Hafiz Choudhury

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In this article, Hann and Choudhury consider how tax treaties, trade agreements, and other cross-border arrangements may be used to improve investment, trade, tax policy, administration, and dispute resolution.

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Greater cooperation and exchange of information between developing countries in trade, tax policy, and tax administration could produce multiple benefits. Importantly, such a collaboration could reduce compliance costs and facilitate efficient tax collection. Similarly, greater coordination between tax and customs authorities within a country can help detect tax avoidance and thereby increase tax revenue. Administrative improvements in general can reduce the number of tax disputes and strengthen dispute resolution procedures.

Improved administrative efficiency and dispute resolution procedures can also benefit investors. Better coordination on trade and tax agreements, for example, can ensure that the tax and other benefits available to investors are clear and unambiguous. More targeted incentives can also ensure that benefits are directed toward desired investments, and that they are not provided in inappropriate situations.

I. Trade Rules and Their Interaction

A. Overview of Trade Rules

The WTO trade agreement and General Agreement on Tariffs and Trade are broad in scope, affecting a range of issues related to trade. These agreements may affect not just general trading rules, but they can also have consequences for direct and indirect taxation. An example is the rule under GATT Article III regarding national treatment of internal taxation and regulation (GATT-AI-2012-Art03). The WTO and GATT agreements have an important effect on customs duty rates and quotas, for example through their role in facilitating customs dispute resolution.

The WTO Agreement on Subsidies and Countervailing Measures (SCM agreement) concerns the provision of subsidies, and the use of countervailing measures when harm has been caused by subsidized imports. The agreement defines a subsidy as a financial contribution made by a government or any public body within its territory that confers a benefit. It also lists the types of measures that could represent a financial contribution and therefore constitute a subsidy. These include grants, loans, equity infusions, loan guarantees, fiscal incentives, the provision of goods or services, or the purchase of goods. The SCM agreement applies to national governments, subnational governments, and public bodies such as state-owned companies. In its broad definition of a subsidy, the agreement would encompass tax incentives, but would prohibit them only if they are contingent on export performance. A prohibited export subsidy would be one that is tied to actual or anticipated exportation.

The WTO and GATT agreements also govern most favored nation (MFN) treatment, which is intended to ensure parity of treatment among WTO members. This central principle of the multilateral trading system aims to eliminate power-based, unequal trading relations by implementing a rules-based framework in which trading rights are not based on the economic or political power of a country, but instead are based on a requirement that the best conditions that

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have been conceded to one country for access to trade must automatically be extended to all other countries participating in the system. In this way, all the participants benefit from concessions between large countries that have more negotiating power.

The General Agreement on Trade in Services (GATS) established a framework of rules, including a mechanism for countries to commit to liberalizing trade in services; it also establishes a dispute resolution mechanism. Article IV of GATS requires members to negotiate commitments concerning: the strengthening of developing countries' domestic services capacity; improving access by developing countries to distribution channels and information networks; and liberalizing market access in areas that affect the exports of developing countries.

Under GATS the liberalization of services is to be carried out with consideration for national policy objectives and members' development levels. Developing countries have the flexibility to open fewer service sectors and to extend market access consistent with their level of development. Developing countries also have the right to access technical assistance from the WTO secretariat.

B. Trade Rules and Investment Agreements

In addition to the WTO and GATT agreements, which cover a broad range of trade issues, there are also regional trade agreements, such as those concluded by the Southern Common Market (known as Mercosur, for its Spanish initials), the Association of Southeast Asian Nations (ASEAN), and the European Union. These agreements add a layer of trade rules that may lead to conflict in some cases. Agreements between regional groupings, such as the EU and Mercosur, could further complicate the position.

There are also agreements between individual countries and regional trading blocs — for example, the agreements between ASEAN and China and ASEAN and Australia. The European Union has also entered some agreements with single countries. Although these agreements are generally less broad in scope than the arrangements between regional blocs, they nevertheless add a layer of complexity to the trading system.

There are also free trade agreements that include provisions to reduce customs duties between the signatories. Governments may also conclude agreements in the form of memoranda of understanding, memoranda of arrangement, or framework agreements. Cooperation between countries could also be set forth in joint communiqués or guiding principles. These various agreements give rise to interlocking obligations that may not be compatible, and therefore may give rise to challenges and disputes.

There is thus a need to consider these differences and address how they interact with other cross-border arrangements for investment protection and taxation. These issues are considered in detail in this article.[1]

II. Tax Rules and Trade Agreements

A. Trade Rules and Indirect Tax

The interaction between trade rules and indirect tax can be seen in the development of regional agreements between countries that are trying to introduce a measure of economic integration at various levels. Many regional groupings aim to create and develop a customs union, such as Mercosur, ASEAN, and some African regional groupings.

Some regional trade groups have also implemented strategies for a common framework on indirect taxes. Examples include the European Union and the Gulf Cooperation Council — as they have set out general VAT rules for their member states, subject to implementation in national laws.

The harmonization of rules on indirect tax is a logical next step following a customs union — as indirect taxes are often charged at the point of entry of goods into a country. Harmonizing indirect tax rules with customs duties may therefore bring further advantages, including, for example, the simplification and rationalization of procedures.

[1] For a broader analysis of the issue, and approaches to achieve some degree of coordination in these networks of interlocking and sometime overlapping arrangements, see Jeffrey Owens and Hafiz Choudhury, "Trade Agreements and Taxation: Removing the Final Barrier to Trade," ITIC Issues Paper (July 2014).

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B. Transfer Pricing and Customs Valuations

Transfer pricing rules for direct tax purposes and customs valuation for duty purposes both concern the valuation of cross-border transactions. These are, however, two different sets of rules, overseen by different international bodies.

The transfer pricing guidelines established by the OECD are the widely accepted standard for pricing cross-border transactions for tax purposes. The WTO's Customs Valuation Agreement sets forth the rules concerning customs valuation. In many countries the direct tax and customs issues are handled by two different government departments (although there has been a move to combine these or to introduce greater coordination).

Businesses have often questioned the need for two sets of rules and point out the administrative advantages of having a single set of rules supported by one set of documentation. Various ideas to streamline the rules have been put forward, including the possibility of using agreements to determine transfer prices and customs valuations in advance for some transactions.

There are, however, problems with combining the two sets of rules. First, they exist for different reasons. Thus, while customs duties are concerned with a transaction in goods at one point in time, the transfer pricing rules are part of the direct tax system. Accordingly, the latter looks at taxable profit over time (such as for an accounting or tax period) using profit methods, if necessary, as an alternative to the traditional transactional methods used for pricing transactions.

Another difference is that customs officials seek to collect duties based on the customs valuation; they therefore will be looking for any indication that the valuation is understated. A transfer pricing auditor, by contrast, is more likely to be looking for signs that the cross-border transaction price has been overstated by the company (with the objective of increasing the cost of goods sold and therefore reducing the profit for direct tax purposes).[2]

[2] Liu Ping and Caroline Silberztein, "Transfer Pricing, Customs Duties and VAT Rules: Can We Bridge the Gap?" 1(1) *World Commerce Rev.* 36 (2007).

There is thus an inherent tension between the administration of the customs rules and the transfer pricing regimes. Both sets of rules aim to ensure that the price or valuation is not unduly influenced by the relationship between the parties; the rules are therefore applied to establish an arm's-length price. However, the objectives, methods used, and documentation requirements are different — thus making these rules difficult to harmonize.

In terms of documentation, the transfer pricing rules are more detailed and require broader analysis, including:

- a discussion of the group's economic circumstances and the industry in which it operates;
- details of the operations of the group;
- the taxpayer's related-party transactions;
- a comparability analysis; and
- the choice of transfer pricing method.

There are also differences in the treatment of intangibles and services. Transactions involving intangibles and services would generally affect customs valuations only when they are closely related to a transaction in goods.

Even if close harmonization of customs valuation and transfer pricing is not currently possible, steps can be taken to ensure that the available information is used in a way that can save compliance costs. Improving the flow of information between customs and revenue authorities can help to highlight any inconsistencies in valuation and assist in risk assessment. Joint audits by customs and direct tax authorities can also help to achieve cost savings.

Advance pricing and customs agreements are another method that can be used to achieve cost savings. Taxpayers in Australia and the United States, for example, have obtained advanced rulings regarding their transfer pricing and customs valuations. By agreeing to transfer pricing and customs valuations in advance, taxpayers can limit costs by reducing the likelihood of disputes in the future.

Documentation is another area where progress could be made. Detailed documentation is prepared for transfer pricing purposes; customs authorities could access this information to assist in their valuation. If the documentation included adequate information for customs purposes, this

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could help the taxpayer by saving compliance time and costs. However, problems still arise from the difference in time required to prepare transfer pricing and customs documentation. There are also differences in the application of the rules.

Dispute resolution is another area where a combined approach could save costs. Joint dispute resolution mechanisms could be a logical continuation of the idea of joint audits and would benefit from the increased amount of information available from the two sets of documentation.

Developing countries may have problems implementing these approaches because of capacity restraints. Further capacity building, therefore, is necessary before some of these projects can be implemented. Input from the relevant international organizations such as the OECD, United Nations, WTO, and World Customs Organization is therefore necessary to facilitate greater coordination in the application of the transfer pricing and customs rules.

C. Direct Tax on Services and Intangibles

The GATS agreement does not affect tax issues in the way that other WTO and GATT agreements can affect taxation related to cross-border trade in goods. Generally, direct and indirect taxation of cross-border services is subject to the provisions of domestic tax legislation and the provisions of double tax treaties regarding the existence of a permanent establishment and the application of business taxation.[3]

D. Carbon Taxes and WTO Rules

Some countries and trading blocs are considering the introduction of emissions trading systems or carbon taxes. Such systems could require an adjustment at the border to align the prices of imports with domestic products, taking into consideration that the domestic products would need to comply with applicable regulations.

For example, the EU has proposed a border adjustment on imports of carbon-intensive goods. The plan would come into force in 2026, after the details are finalized. The carbon border adjustment mechanism (CBAM) would, according to the EU, be in line with WTO rules and the EU's other international commitments. The CBAM would aim to equalize the price of carbon between domestic products and imports to ensure that EU climate targets are not undermined by the relocation of production to countries outside the EU with different policies.

The EU importers would need to purchase carbon certificates corresponding to the carbon price that would have been paid if the relevant goods had been produced in line with the EU carbon pricing rules. If a non-EU producer could demonstrate that the appropriate price had already been paid for the carbon used in the production of the imported goods in a third country, the corresponding cost would become fully deductible for the EU importer.

Under WTO rules, a CBAM cannot favor domestically produced goods over imports — as this could imply an element of hidden trade protectionism. It must not discriminate against any individual trading partner and should not prevent exporters from calculating their own carbon intensities. Moreover, the measure should not impose unduly harsh compliance costs on exporters. For instance, the EU would not be able to impose unduly harsh requirements on exporters related to the calculation of the carbon intensity of production by, for example, requiring onerous methods for the calculation, or by imposing a burden of proof of the level of emissions that would require expensive inspections of the production facilities.

III. The Role of Double Tax Treaties

A. Advantages of Tax Treaties

Tax treaties are necessary because they help to eliminate double taxation, facilitate cooperation and the exchange of information between tax administrations, and establish a tax dispute resolution mechanism. Double taxation is an obstacle to cross-border investment. Tax treaties with the main investing countries can boost investment by reducing this risk.

Stability and certainty of tax treatment are important to investors. A tax treaty can offer both — as treaty provisions are modified less frequently than domestic law. A treaty can also

[3] The range of trade agreements and their impact on services and intangibles is detailed in Owens and Choudhury, *supra* note 1.

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reassure investors that the developing country will adhere to international standards on issues such as transfer pricing and PEs.[4] Treaties generally also contain a nondiscrimination article that can provide reassurance for potential investors.

B. Problems With Treaties

One problem developing countries face is that they often enter treaty negotiations on an uneven playing field — with potential partner countries that have more economic strength and more experience at tax treaty negotiation. This disadvantage can be partly offset by committing more resources (if available), building capacity within the tax administration, and with assistance from regional and international organizations. Increased capacity development work by the United Nations, through the Financing for Sustainable Development Office, Department of Economic and Social Affairs in particular,[5] and more generally by assistance programs, is helping to address this issue.

Double taxation treaties can create a better climate for investors by reducing source-country 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 countries with scarce resources. 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. This is viewed as part of a wider problem that developing countries have provided too many broad tax exemptions to foreign investors through their domestic tax laws. The perception is that this has resulted in a race to the bottom in tax rates (referring to the practice of countries competing to reduce tax rates to attract investment) and special regimes — without sufficient monitoring by those countries of the effect of these incentives on foreign investment.[6]

Low tax rates and special regimes are viewed as factors that allow companies to engage in profit shifting and tax avoidance arrangements. These arrangements can facilitate treaty shopping by multinationals, which occurs, for example, when a company places an intermediary company in a low-tax jurisdiction or regional investment hub to take advantage of treaty provisions.

On the other hand, when incentives are carefully designed and targeted, they can have a favorable effect on investment. To be effective, they need to be designed in a way that benefits investors who might otherwise decide to go elsewhere. Measuring the effectiveness of incentives in increasing investment can be difficult, but some degree of measuring and monitoring is possible. Monitoring and review, for example, can highlight areas where incentives need to be adapted; this approach can also show when measures are having no effect and therefore should be scrapped.

The costs and benefits of tax concessions need to be carefully weighed and consistently monitored to ensure that they are achieving the required objective and still providing value.

The costs of a tax treaty include:

- the costs and time spent negotiating the treaty;
- the costs associated with the 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.

Some of the benefits of a tax treaty may be achieved by incorporating some basic treaty principles into domestic tax law, such as a harmonized definition of PEs that is consistent with treaty principles. Domestic tax law provisions must establish thresholds and provide scope in a manner that enables the country to offer concessions to treaty partners in negotiations,

[4] Sébastien Leduc and Geerten Michielse, "Chapter 8: Are Tax Treaties Worth It for Developing Economies?" in *Corporate Income Taxes Under Pressure: Why Reform Is Needed and How It Could Be Designed* (2021).

[5] *See* U.N. Department of Economic and Social Affairs (UNDESA), "Capacity Development: Tax Treaties."

[6] Junhyung Park et al., "A Partial Race to the Bottom: Corporate Tax Developments in Emerging and Developing Economies," IMF Working Paper 12/28 (Jan. 1, 2012).

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such as for example, in exchange for better withholding tax rates or thresholds.

In removing wasteful tax incentives, countries should consider the potential effect of investment treaty provisions. If the dispute resolution provisions in an investment treaty are broad enough, these provisions could be invoked to compensate an investor for any change in the amount of tax levied, such as the removal of a tax incentive.[7]

C. Future of Tax Treaties

Tax treaties should continue to play a part in the investment strategy of developing countries. It is argued, however, that countries should put into place appropriate mechanisms to consider the costs and benefits of each prospective treaty before it is negotiated.

While the provisions of a treaty apply to both contracting states, this 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; it must therefore look at the costs and benefits of the concession. 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.

When a treaty has been signed, a monitoring process must be carried out on a regular basis to examine main provisions of the treaty, including those relating to PEs, business profits, withholding tax, and capital gains. A double tax treaty is only relevant when the benefits outweigh the costs, and this can only be determined by an adequate measurement of the benefits and costs.

Modifications to bilateral tax treaties are likely to result from the two-pillar agreement on taxation of the digital economy signed by 136 member countries of the OECD/G-20 inclusive framework on October 8, 2021 (137 countries as of November 4). This provides for a new nexus under pillar 1 that will result in the profits of large multinationals being allocated to market jurisdictions even when there is no PE. This could affect the treaty articles on PEs 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 for including treaty-related base erosion and profit-shifting 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 developed to implement aspects of the global minimum tax set forth under pillar 2.[8] This could enable countries to update their treaties when necessary to implement the OECD agreement.

Articles that could be reviewed include those relating to PEs, business profits, elimination of double taxation, and the mutual agreement procedure. Developing countries may need to review their provisions on dividends, interest, and royalties to confirm that taxing rights are optimal in view of the global minimum tax rules. They may also consider tax-sparing provisions to protect the incentive value of tax exemptions offered to investors, such as in cases in which the home jurisdiction can top up the tax to the level of the global minimum tax.

Another measure that affects treaties is 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 that specifically targets risks to source jurisdictions from profit-shifting structures when cross-border, intragroup payments take advantage of low nominal tax rates in the residence jurisdiction of the payee.

When the source jurisdiction has ceded taxing rights over 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 below the minimum rate in the other jurisdiction). The STTR targets cross-border arrangements for related-party payments,

[7] UNDESA, "The Interaction of Tax Trade and Investment Agreements," Secretariat Paper E/C/2019/CRP.14 (Apr. 18, 2019).

[8] *See* OECD, "Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy" (Oct. 8, 2021).

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exploiting provisions of a tax treaty to shift profits from source countries to jurisdictions with no or low rates of nominal taxation. Source countries would therefore be able to protect their tax base.

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

The STTR is to be implemented through a separate stand-alone treaty provision. It would apply to relevant payments between connected persons that are above a specific materiality threshold.[9] The materiality threshold would ensure that the STTR focuses on the arrangement with the highest risk of profit shifting and would facilitate compliance. 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 percent, after taking into account relevant deductions. 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 that is equivalent to the difference between the adjusted nominal tax rate and the agreed minimum rate.

IV. Treaties and Investment Agreements

A. Investment Agreements

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

BITs establish limits to the expropriation of investments and allow foreign investors to claim compensation. Expropriation must be conducted in accordance with international law standards, which require it to be for a public purpose, carried out in a nondiscriminatory manner under due process of law, and accompanied by payment of adequate compensation.

Expropriation for this purpose can include any measures that deprive the investor of the economic value of the investment. In some situations, arbitrary taxation could be treated by a tribunal as indirect expropriation, and investors have sometimes challenged taxation measures under the arbitration provisions of trade and investment agreements on these grounds.[10]

BITs give broad guarantees of treatment for investors in line with international law. Host countries promise fair and equitable treatment for investments, and they undertake not to engage in arbitrary or discriminatory decision-making. Under the provisions of a BIT, foreign investors may transfer funds into and out of the host country without delay, at a market rate of exchange. Moreover, investors have the right to submit an investment dispute with the host country 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. BITs and double tax treaties may therefore cover the same ground on issues such as nondiscrimination and the dispute resolution process.

An investment treaty may apply to a wider group of investors than a tax treaty. The definitions of investments or investors could affect the tax position — for example, in cases in which indirect investors have protection under an investment treaty, but the relevant tax treaty restricts benefits to direct investments. The provisions of an investment treaty on fair and equitable treatment may be interpreted broadly by investment panels and could therefore become relevant in any tax-related dispute.[11]

[9] The materiality threshold would be computed on the basis of the size of the multinational group, the value of related party payments, and the ratio of related party payments to total expenditure.

[10] UNDESA, *supra* note 7.

[11] *Id.*

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B. Services

The trade laws within a country may place limits on the number of foreign suppliers of services or impose requirements regarding local participation. In addition, there may be regulations to protect the public, such as licensing requirements, which can serve as a barrier to trading in some types of services. Licensing requirements can apply, for example, to financial institutions or to the practice of some professions (such as when licensing requirements mandate that only local qualifications are recognized). There could also be requirements regarding the nationality of directors. Other requirements, such as data standards, may also be applied to services.

International or regional trade agreements permit the standardization of such requirements and offer foreign service providers some certainty that, if the requirements of one of the signatory countries are satisfied, then the requirements of the other countries in the agreement will also be fulfilled.

Services would not be subject to customs duties except in cases in which they are closely linked to a supply of goods. For indirect tax purposes, services may be linked items that are regarded as a "carrier medium."[12] Imported computer software could be regarded as either a supply of goods or a supply of services. 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 provided. Generally, software that is made available to, and usable by, all customers independently after the software has been installed is treated like a supply of goods, while software that has been designed, altered, or configured for use by a specific customer is more likely to be treated for VAT purposes as a supply of services. For other services, the rules used to determine the place of the supply of services can be complex. For direct taxes, therefore, service providers will need to examine the local laws regarding the taxation of services, and if there is an applicable double tax treaty, they will need to study the definition of a services PE.

[12] A carrier medium is a physical object designed mainly for use in storing a digital product, from which a digital product can be reproduced or communicated, directly or indirectly.

The U.N. Committee of Experts on International Cooperation in Tax Matters has approved new article 12B, relating to income from automated digital services, for inclusion in the U.N. model tax convention. The definition of automated digital services for this purpose includes services provided through the internet or electronic networks in which there is minimal human involvement by the provider of the service.

The article gives the source state the right to tax the income from automated digital services based on the place in which the income arises. The maximum 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.

C. Intellectual Property

The WTO's Agreement on Trade-Related Aspects of Intellectual Property Rights regulates standards of IP protection, procedures for enforcement of IP rights, and dispute settlement procedures.

Regarding customs duties on cross-border trade, some countries may consider amounts related to IP or services to be subject to duty if they are closely linked to imported goods that would be regarded as carrier medium. As the value of such IP may be significantly larger than the value of the related goods, this could greatly increase the duties payable and act as a barrier to international trade.

For indirect tax purposes, the tax treatment of royalties on the use of IP would often depend on the place of supply. For direct tax purposes, the royalty would generally be business income subject to the transfer pricing rules.

V. Tax and Trade Dispute Resolution

A. Trade Disputes

The WTO has an important role in resolving cross-border trade disputes. A matter is brought to the WTO when a member state alleges that another member has violated a commitment made as part of its membership of the WTO. There are clear rules governing the matter, with

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the dispute resolution system establishing a procedure and timeline for completing a case. The first ruling is issued by a panel; it is then either 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 to allow the parties time to reach a settlement. There may be a choice of tribunal for dispute resolution, and the treaty may include the right to proceed to international arbitration. There would generally be a panel consisting of three arbitrators; the parties to the dispute each nominate one. Once constituted, the panel will establish the timeline and detailed procedures, which includes the submission of written arguments, the review of evidence, and an oral hearing.

Rules similar to those established by the International Centre for Settlement of Investment Disputes (ICSID) or the U.N. Commission on International Trade Law may be set out in a treaty. The hearing results in an arbitral award that could be enforced in one of the states that is a party to the relevant convention (for example, the ICSID convention).

The U.N. Commission on International Trade Law arbitration rules also establish procedures that cover all aspects of the arbitration process. In particular, they include 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.

B. Advance Pricing Agreements

An advance pricing agreement is an agreement between a business and a tax authority (or more than one tax authority) to price transactions in advance, primarily to achieve certainty, but also 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 future transactions.

The taxpayer can rely on the tax treatment specified in the agreement, provided that the terms of the agreement are adhered to, and that the critical assumptions remain valid. The terms and scope are set forth in the agreement, together with such issues as the possibility of rollback to previous years with open tax returns. Taxpayers would normally be required to complete an annual compliance report, confirming that the critical assumptions upon which the agreement was based continue to apply, and that the taxpayer continues to maintain the terms of the APA.

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

An advance pricing agreement could raise issues under a trade agreement — for example, it could potentially be seen as a prohibited export subsidy under the WTO's SCM agreement.[13]

C. Advance Pricing and Customs Agreements

As the OECD transfer pricing guidelines point out, a taxpayer importing goods may be interested in establishing a low price for the transaction — to lower the customs duty payable. This could also lead to lower VAT or excise tax. For direct tax purposes, by contrast, the importer may prefer to establish a higher price for the transaction to increase the deductible costs in the importing country, and thereby 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 the customs and transfer pricing functions within the tax administration 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 a comparison of transfer pricing and customs documentation.

[13] *See* Vincent Beyer, "Battling Tax Evasion Through the Trade Regime — Advance Pricing Agreements as Prohibited Export Subsidies Under the SCM Agreement," Blog of the Groningen Journal of International Law, Apr. 13, 2017.

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

A further suggestion is that the taxpayer could complete advance agreements and customs agreements — a possibility that has been explored in the past but for which practical experience is limited. The joint agreement would be an extension of the APA already used extensively for transfer pricing purposes. Negotiations for an advanced customs and transfer pricing agreement would require consultation with the direct tax and customs authorities of each country involved, and would therefore be more complex, especially in view of the differences in transfer pricing and customs rules.

VI. Exchange of Information

A. Bilateral Treaties

Double tax treaties generally contain provisions on the exchange of information, based on either article 26 of the OECD model or article 26 of the U.N. model. The latter provides for information to be exchanged that would be helpful in preventing tax avoidance or evasion. In addition, the contracting states are required to develop appropriate methods and techniques to fulfill information requests.

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

Bilateral tax information exchange agreements contain more detail on the exchange of information. Model agreements have been issued by the OECD and by the Inter-American Center of Tax Administrations; however, when concluding bilateral agreements, developing countries still would be disadvantaged by their lack of bargaining power. For example, countries seeking to exchange information may have internal restrictions in the form of regulations or requirements that slow or obstruct the process of information exchange (such as notification requirements). Moreover, the tax administration must have sufficient resources available to use the agreement to its advantage.

In view of the difficulties involved in using bilateral agreements to govern the exchange of information, developing countries might prefer to sign and implement multilateral agreements among regional groupings. While this could save administrative time and resources, investors may prefer the multilateral agreement to contain options for customizing the provisions, taking into consideration the circumstances within a country. Investors may look for higher levels of protection, for example, when specific types of risk exist, such as political risk.

B. Multilateral Provisions

The most wide-ranging multilateral convention for the exchange of tax information is the OECD's Convention on Mutual Administrative Assistance in Tax Matters. The agreement provides for the exchange of information upon request, automatic and spontaneous exchanges of information, and in addition to assistance in the recovery of taxes, the possibility of simultaneous tax audits. Several developing countries are already signatories to the convention. Joining the convention would represent an important step in increasing 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, produced a toolkit 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 function and the rest of the tax administration and other government departments.

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VII. Recommendations for Tax Administrations

A. Advantages of More Coordination

Mismatches between tax and investment agreements may provide an advantage for investors. For example, when the relevant tax and investment agreements each have their own dispute resolution provisions, it may be possible for investors to choose the most favorable provisions from their point of view. While this may improve the investment climate from the investor's perspective, the opportunity exists due to a lack of coordination between investment and tax treaties, which may create a problem for the tax administration.

Investors and tax administrations would benefit from greater certainty in the treatment of the investment and tax positions. It is in the interests of all stakeholders to align more clearly the provisions of tax and investment agreements. Moreover, greater coordination between government departments, or within the tax and customs administrations, could help to identify taxpayers that are engaging in profit shifting or other forms of tax avoidance.

B. Short-Term Measures

There could be greater exchange of information between tax administrations. The most effective way for developing countries to improve the exchange of information is to execute multilateral agreements, and in particular the OECD's Convention on Mutual Administrative Assistance in Tax Matters. Countries can ensure that the resources are available to operate efficiently the exchange of information function. The toolkit on establishing an effective exchange of information function can be used as a reference for establishing the function and developing its operations.

There is a need for greater coordination between customs and indirect and direct tax authorities within countries. In some countries, the tax and customs authorities are separate bodies; other countries have integrated these functions into one organization. In both cases, 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 tax purposes, or comparison of prices and valuations for customs and transfer pricing.

Tax audits would benefit from regular comparison of transfer pricing documentation with customs documentation. Within the context of coordination between customs and direct tax functions, the routine comparison of customs and transfer pricing documentation can be established. Although there will be differences in the documentation because of the different purposes of the two sets of documentation and the different treatment of intangibles and services, a comparison of the documents could indicate the possibility of transfer mispricing or attempts to artificially reduce the customs valuation.

C. Long-Term Measures

Countries should consider negotiating regional double tax agreements. Countries with interests in common could develop regional tax agreements that consider the specific requirements of developing country projects.

There should be more harmonization of customs and tax regulations. Countries 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.

Tax administrations could explore the possibility of combined advance pricing and customs agreements. In addition, developing countries could explore harmonizing customs and transfer pricing documentation, and in the longer term, they could develop advance pricing and customs agreements based generally on the same principles as APAs for transfer pricing purposes.

To avoid harmful competition, countries should ensure greater coordination of the structure of tax incentives. In the past, developing countries have too easily given away tax relief in the form of tax holidays and other incentives, leading to losses of tax revenue without necessarily affecting investment behavior. Developing countries should move away from

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these broad tax exemptions and instead look at targeted tax or nontax relief that can have a demonstrable effect on investment behavior. Any tax relief should be monitored regularly to ensure that it is still having the desired effect and that continued relief is worthwhile. The different incentives should be coordinated and administered by one part of government to prevent the accumulation of inefficient tax and nontax incentives, which deplete government resources without increasing investment. ■

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