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ELIMINATION OF DOUBLE TAXATION

Abstract

Taxation represents an important aspect of many established tax rules. Currently, there are more than 3,000 double income tax treaties in force and the number is growing. The development of these treaties is largely based on the Model Convention on Double Taxation Between Countries of the United Nations Development and Development (United Nations Model Convention) and the Model Tax Convention on Income and Capital of the Organization for Economic Development and Cooperation. The model tax treaty has a long history at the beginning of the 19th century. This agreement often provides that any income tax will be settled under a tax treaty.

Keywords: *international tax law, double taxation, tax treaties, economic cooperation, model conventions*

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İkiqat vergitutma probleminin həlli

Xülasə

Vergi müqavilələri bir çox ölkələrin beynəlxalq vergi qaydalarının mühüm aspektini təmsil edir. Hazırda 3000-dən çox ikitərəfli gəlir vergisi müqaviləsi qüvvədədir və onların sayı artır. Bu müqavilələrin böyük əksəriyyəti böyük ölçüdə Birləşmiş Millətlər Təşkilatının İnkişaf etmiş və İnkişaf etməkdə olan Ölkələr Arasında İkiqat Vergitutma üzrə Model Konvensiyasına (Birləşmiş Millətlər Təşkilatının Model Konvensiyası) və İqtisadi Əməkdaşlıq və İnkişaf Təşkilatının Gəlir və Kapital üzrə Model Vergi Konvensiyasına əsaslanır. Model vergi müqavilələri XIX əsrin erkən diplomatik müqavilələrindən başlayaraq uzun tarixə malikdir. Bu müqavilələr çox vaxt hər hansı gəlir vergisi məsələsinin yalnız ölkələr arasında vergi müqaviləsi çərçivəsində həll olunacağını göstərən müddəaları ehtiva edir.

Açar sözlər: *beynəlxalq vergi hüququ, ikiqat vergitutma, vergi müqavilələri, iqtisadi əməkdaşlıq, model konvensiyalar*

Introduction

Most low-income countries stare down a yawning gap between their current capacity and the achievement of the Millennium Development Goals endorsed by the General Assembly of the United Nations in 2000. While the first of the original eight millennium development goals, halving extreme poverty between 1990 and 2015, has been met, many of the other goals have not. Global development assistance to the forty-nine least developed countries has fallen as a consequence of austerity measures associated with the global financial crisis. Inadequate literacy rates and schooling, insufficient transportation and communications infrastructure, food insecurity, flagging health outcomes and other indicators of social and economic security plague low-income countries and the people who live within them. Given the disparities in living standards between high- and low-income countries, every high-income country in the world has recognized the moral and pragmatic case for providing aid to low-income countries.

Nevertheless, most high-income countries have at the same time entered into tax treaties with low-income countries that have restricted low-income countries' abilities to collect urgently needed revenue from income earned in their jurisdictions, even though normative principles of international tax support low-income countries' right to collect that tax.

Tax treaties represent an essential aspect of the international tax rules of many countries. Over 3,000 bilateral income tax treaties are currently in effect, and the number is growing. The overwhelming majority of these treaties are based in large part on the United Nations Model Double Taxation Convention between Developed and Developing Countries1 (United Nations Model Convention) and the Organization for Economic Co-operation and Development Model Tax Convention on Income and on Capital (OECD Model) (Avi-Yonah, 2004).

Bilateral tax treaties confer rights and impose obligations on the two contracting States, but not on third parties such as taxpayers. However, tax treaties are intended to benefit taxpayers of the contracting States. Whether treaties do so or not depends on the domestic law of each State. In some States, treaties are self-executing: that is, once the treaty is concluded, it confers rights on the residents of the contracting States. In other States, some additional action is necessary (for example, the provisions of the treaty must be enacted into domestic law) before benefits under a treaty can be given to residents of the contracting States (Arnold, 2013).

Under Article 26 of the Vienna Convention, treaties are binding on the contracting States and must be performed by them in good faith. This is the pacta sunt servanda principle. If a country does not respect its tax treaties, other countries may have no interest in entering into tax treaties with it (Kysar, 2015).

The following deals with income tax treaties. However, several other types of treaties deal with tax issues. For example, countries that impose estate or inheritance taxes may have treaties to eliminate double taxation concerning them. In addition, many countries have signed the Multilateral Convention on Mutual Assistance in Tax Matters. This Convention deals with administrative tax issues, such as the exchange of information, assistance in the collection of taxes, and dispute resolution. In addition, many types of treaties deal primarily with non-tax matters but include tax provisions. These non-tax treaties include air transportation agreements and trade and investment treaties, such as the agreement governing the World Trade Organization. These agreements often contain carve-out provisions indicating that any income tax issues will be dealt with exclusively under the income tax treaty between the countries (Məmmədov, Musayev, Sadıqov, Kəlbiyev, Rzayev, 2010).

The process of negotiating a tax treaty typically begins with initial contacts between the countries. In deciding whether to enter into tax treaty negotiations with other countries, a country will consider many factors, the most important of which is the level of trade and investment between the countries. Once the countries have decided to negotiate, they will exchange their model treaties (or their most recent tax treaties, if they do not have a model treaty) and schedule face-to-face negotiations. Typically, treaties are negotiated in two rounds, one in each country. During the first round of negotiations, the negotiating teams will agree on a particular text — usually one of the countries' model treaties — to use as the basis for the negotiations. After presentations by both sides about their domestic tax systems, the negotiations proceed on an article-by-article basis. Aspects of the text that cannot be agreed on are usually placed in square brackets, to be dealt with later. Once the wording of the treaty is agreed on, the parties initial it. After such agreement has been reached, arrangements will be made for the treaty to be signed by an authorized official (often an ambassador or government official). After signature, each State must ratify the treaty in accordance with its own ratification procedures. The treaty is generally concluded when the countries exchange instruments of ratification. The treaty enters into force in accordance with the specific rules in the treaty (Article 29 (Entry into force) of the United Nations Model Convention) (Holmes, 2007).

Model tax treaties have a long history, beginning with early diplomatic treaties of the nineteenth century. The limited objective of these treaties was to ensure that diplomats of one

country working in another country would not be discriminated against. These diplomatic treaties were extended to cover income taxation once it became significant in the early part of the twentieth century. After the First World War, the League of Nations commenced work on the development of model tax conventions, including models dealing with income and capital tax issues. This work culminated in Model Conventions in 1943 and 1946. These Model Conventions were not unanimously accepted, and the work of creating an acceptable model treaty was taken over by the OECD and, a few years later, the United Nations. 18. Currently, the OECD has 34 members, consisting of many of the major industrialized countries. The OECD Model Convention was first published, in draft form, in 1963. It was revised in 1977 and again in 1992, at which time it was converted to a loose-leaf format in order to facilitate more frequent revisions. Since then, revisions have been made every few years, on nine occasions, most recently in 2014. The Committee on Fiscal Affairs (CFA), which consists of senior tax officials from the member countries, has responsibility for the Model Convention as well as other aspects of international tax cooperation. CFA operates through several working parties and the Centre for Tax Policy and Administration, which contains the permanent secretariat for CFA. The working parties consist of delegates from the member countries. Working Party No. 1 on Tax Conventions and Related Questions is responsible for the Model Convention, and it examines issues related to it on an ongoing basis (Aguzarova, 2020).

The OECD Model Convention favours capital-exporting countries over capital-importing countries. Often it eliminates or mitigates double taxation by requiring the source country to give up some or all of its tax on certain categories of income earned by residents of the other treaty country. This feature of the OECD Model Convention is appropriate if the flow of trade and investment between the two countries is reasonably equal and the residence country taxes any income exempted by the source country. However, the OECD Model Convention may not be appropriate for treaties entered into by net capital-importing countries. As a result, developing countries devised their own model treaty under the auspices of the United Nations (Brooks, Krever, 2015).

The work of the United Nations on a model treaty commenced in 1968 with the establishment by the United Nations Economic and Social Council (ECOSOC) of the United Nations Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries pursuant to its resolution 1273 (XLIII). The Group of Experts produced a Manual for the Negotiation of Bilateral Tax treaties between Developed and Developing Countries which led to the publication of the United Nations Model Taxation Convention between Developed and Developing Countries in 1980 (Kysar, 2015). The Model Convention was revised in 2001 and again in 2011. In 2004, the Group of Experts became the Committee of Experts on International Cooperation in Tax Matters. The Committee maintains detailed Commentaries on the United Nations Model Convention; it is also responsible for the publication of several useful manuals on tax issues important for developing countries, such as transfer pricing and the administration of tax treaties. The members of the Committee are tax officials nominated by their governments and appointed by the Secretary-General of the United Nations, who serve in their individual capacity. A small majority of the members of the Committee are from developing countries and countries with economies in transition. The United Nations Model Convention follows the pattern set by the OECD Model Convention and many of its provisions are identical, or nearly so, to those in that Model Convention. In general, therefore, it makes sense not to view the United Nations Model Convention as an entirely separate one but rather as making important, but limited, modifications to the OECD Model Convention (Crow, 1999). The main difference between the two model Conventions is that the United Nations Model Convention imposes fewer restrictions on the taxing rights of the source country; source countries, therefore, have greater taxing rights under it compared to the OECD Model Convention. For example, unlike Article 12 (Royalties) of the OECD Model Convention, Article 12 of the United Nations Model Convention does not prevent the source country from imposing tax on royalties paid by a resident of the source country to a resident of the other country (Lang, 2021). The United Nations Model Convention also gives the source country increased taxing

rights over the business income of non-residents compared to the OECD Model Convention. For example, the time threshold for a construction site permanent establishment under the United Nations Model Convention is only 6 months, compared to 12 months under the OECD Model Convention. In addition, furnishing services in a country for 183 days or more constitutes a permanent establishment under the United Nations Model Convention, whereas under the OECD Model Convention furnishing services is a permanent establishment only if the services are provided through a fixed place of business which, according to the OECD Commentary thereon, must generally exist for more than 6 months (Radu, 2012).

Notwithstanding the obstacles that double taxation can present to the development of international economic relations, there is very limited international law constraining countries from imposing taxes on income derived outside of their borders. As a result, if double taxation is to be overcome, it must be dealt with domestically or unilaterally. Many countries have provisions in their domestic laws that are designed to unilaterally counter juridical double taxation. The tax credit method is the means adopted by most countries as a unilateral legislative tax relief mechanism. These measures, however, do not always fully combat double taxation (Ring, 2006).

Article 23 of the OECD model DTA (“Methods for elimination of double taxation”) offers a choice of the exemption method (article 23A) or the credit method (article 23B) of relief from double taxation.

Where the exemption method is chosen, under article 23A(1) a taxpayer’s country of residence prima facie must exempt income or capital from tax if that income or capital may be taxed by the source state “in accordance with the provisions of [the] Convention”, whether or not the source state actually exercises its right to tax the item of income or capital. Note that article 8(3) (Shipping, inland waterways transport and air transport), 42 Article 13(3) (Capital gains), 43 articles 19(1)(a) and 19(2)(a) (Government service)44 and article 22(3) (Capital)45 state that income or capital arising under those articles “shall be taxable only” in the source state. Therefore, such income or capital is automatically exempt from tax in the country of residence of the taxpayer. Country R is not required to apply the exemption if Country S considers that the provisions of the DTA preclude it from taxing an item of income or capital which it would otherwise have taxed. In that case, the OECD commentary provides that Country R should, for the purposes of applying article 23A(1), consider that the item of income or capital may not be taxed in Country S, even though Country R might have applied the DTA differently so as to tax that income if it were Country S. In these circumstances, Country R is not required by article 23A(1) to exempt the item of income or capital. This result is consistent with the elimination of double non-taxation (11). Article 23B(1) provides for relief from double taxation by way of the ordinary credit method. (The ordinary credit method also applies for the purposes of article 23A(2)) (10) Application of article 23B by Country R is again dependent upon the ability of Country S to be able to tax the income or capital in question “in accordance with the provisions of [the] Convention” between Country R and Country S. Article 23B(1) allows a credit for income tax paid in Country S only against income tax payable in Country R and, quite separately, a credit for capital tax paid in Country S only against capital tax payable in Country R. Practical difficulties arise with the foreign tax credit method when tax payable in Country S is not calculated in respect of the income year in which it is levied, but on the basis of a preceding year’s income or on the basis of the average income earned over a number of preceding years, and with foreign exchange rate movements between the date of payment of the tax in Country S and the date on which that tax and the income to which it relates is converted for the purposes of inclusion in the taxpayer’s assessable income in Country R. Furthermore, income on which tax may be paid in Country S may reduce a taxpayer’s net loss position in Country R without any relief for the tax paid in Country S (12).

Most tax systems impose tax on resident companies, including local subsidiaries of non-resident companies, and tax on dividends paid to shareholders. Dividends to non-residents are commonly collected by means of withholding taxes, often set at a rate below the ordinary company

tax rate to reflect the fact that it is imposed on a gross basis, without recognition of costs incurred to derive the dividends.

In tax treaty negotiations, source countries are typically urged to reduce their tax on dividend income to very low rates or withdraw it altogether. The only plausible argument for reducing withholding tax is that it would result in additional foreign direct investment in the country. If that were true and a country realized additional foreign direct investment as a result of withholding tax reductions, spin-off benefits could include increased employment, opening of new markets, the transfer of expertise and generally a higher level and faster rate of economic growth. If this growth in investment eventuated, the corporate income tax take would increase, potentially offsetting or even exceeding the loss in the revenue from the reduction or withdrawal of the withholding tax.

These arguments given in support of source countries surrendering their right to tax business income earned in their jurisdiction are not persuasive. The hypothetical benefits are unlikely to eventuate in practice. To begin with, the withholding tax is not a tax on current profits. It can be deferred indefinitely by firms willing to reinvest in the jurisdiction to build greater current profits; if anything, higher withholding tax rates might encourage more investment, not less, by companies that make the initial foray into the country.

Separately, it has long been accepted that of the matrix of factors that affect investment decisions, and in particular direct foreign investment, tax rates, and especially withholding tax rates, will play a marginal role at best in tipping a decision to or not to invest in a particular jurisdiction. Labour costs, infrastructure facilities, labour force skills, political stability, proximity to market, transportation costs, environmental costs, and a host of other factors commonly are cited as more important than tax considerations in terms of driving foreign direct investment locations. Tax is a particularly subsidiary consideration in driving the investments of firms seeking location-specific rents such as profits from mineral exploitation possible only in the jurisdiction.

It has been argued that tax may play a greater role in investments based on firm-specific rents or profits attributable to attributes of the firm, not the location where business activities take place. Thus, the iron ore miner seeking location specific rents will locate where the ore bodies are found with tax being a secondary concern. In contrast, the international running shoe manufacturer deriving profits from the production of shoes embodying its design and intellectual property features can make the shoes in any number of countries. In the unlikely case that all other costs were equal in two jurisdictions, tax may well play a role in determining in which jurisdiction the firm locates its production.

To the extent tax levels could impact on investment location decisions by multinational firms seeking firm-specific rents, their importance is receding as economies develop and shift from primary reliance on manufacturing and related heavy industry to service and consumer societies based on business that must be located in the region to service a local market. Ironically, the growth of modern internet commerce has actually increased the need for local service providers and support as well as local outlets, accelerating the shift from firm-specific rents to location specific rents. The trend further weakens any case that might be made for reducing dividend withholding taxes to attract foreign direct investment.

Conclusion

To achieve the objective of elimination of juridical double taxation, we have examined the various forms of relief from such double taxation, the rationale behind them, and their unilateral adoption in countries' domestic tax laws and in DTAs, the latter exemplified by Art 23 of the OECD model DTA. This article also explained the concept of, and the resistance towards, tax-sparing credits. Tax treaties are skeletal in nature and the reality of the international taxing system requires them to be so. Accordingly, they mandate a fluid interpretive methodology that encompasses many actors and sources, in a sense, their flesh and blood. The risk of double taxation that such an approach entail is overstated and can be minimized through harmonization devices. In contrast, a plain-meaning approach to tax treaty interpretation carries consequences: unintentional encroachment upon the sovereign's domestic tax system, policy ossification in a rapidly changing

global economy, and abusive transactions that reduce the effective tax rate to zero. These are all predictable and serious dangers. The use of a pragmatic approach to tax treaty interpretation diminishes these risks.

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