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The Role of Tax Treaties

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Tax Treaties

Basic purpose of treaties is to minimize:

- double taxation,
- excessive taxation,
- uncertain taxation,
- tax avoidance.

All of these are important tax policy goals for developing countries.

Double Taxation

- Taxation by both host country (source) and home (residence) under internationally accepted general principles.
- Potential double tax burden is impediment to cross border investment and discourages capital inflows from the point of view of the host country.
- Treaty provides a mechanism by which residence country obligates itself to relieve double taxation (credit or exemption method). While domestic law provisions often exist, treaty permits the method to be tailored to the specifics of the two countries.

Excessive taxation

- Small open economies shouldn't have too high taxes (except for rents) or will not get enough investment.
- Basic level of rates is question for domestic law.
- But it is possible to reduce in treaties on a selective basis to make sure the benefits are going where host country wants them to go.
- This is particularly important with respect to withholding taxes imposed on gross basis which can exceed net profit.

Uncertain taxation

- Investors want stability and predictability in tax system.
- That is more important in some ways than the level of the rates since it allows planning for the future.
 - Large investments are multi-year projects,
 - Unexpected changes in tax system can affect expected ROI which justified the investment in the first place.
- Treaties give an assurance that some rates cannot be changed without renegotiating the treaty.
- More assurance than domestic law of a stable environment.

Uncertain taxation

- Existence of treaty signals that tax system is stable and broadly consistent with international norms:
 - Art. 9 has principle of arms length pricing,
 - Art. 7 of attribution of profits to PE and not force of attraction,
 - Art. 24 gives assurance against discriminatory taxation,
 - In general, provides standardized rules for source of income, threshold of taxation etc and helps to avoid disputes.

Uncertain taxation

- Administrative provisions gives assurance that the system will be in applied accordance with the treaty rules.
 - Mutual Agreement procedure allows the taxpayer to present his case that he is not being taxed properly under the treaty without relying on domestic courts. Countries can discuss together how to resolve problems of treaty application.
 - Extension to arbitration in the new OECD Model ensures that there will be a single and consistent resolution of treaty disputes which is very important for taxpayer security.

Combating tax avoidance

- Exchange of Information provisions in treaty allow countries to work to gather to insure that appropriate tax is collected:
 - Assures source country that when it reduces withholding taxes in treaty that the residence country will in fact tax the income.
 - Allows country to better tax the foreign income of its own residents and companies investing abroad.

Evaluating tax treaty system

- Adequate training of tax treaty experts to negotiate tax treaties; OECD support programs.
- Domestic legal process for approving treaties.
- Look at existing treaty network: are there old treaties which you should reconsider/renegotiate because of changes in the other country?
- Look at content of existing treaties: are there rules, e.g.. limitation of benefits which you should add?
- Look at trading partners: are there countries which you should approach with respect to opening negotiations?