1. DOUBLE TAX TREATIES: THE BASICS

Double tax treaties are the fundamental building blocks of the international tax framework – so what are they, why do we have them, and are they always a good thing?

What are double tax treaties?

- international agreements governed by international law
- normally between two countries
- that assign fiscal gains/taxing rights between two countries on income from cross-border transactions.

A key point to be aware of is that they bind future governments into specific tax policy decisions, including certain tax rates, so the benefits of this need to be balanced against possible downsides.

Are they always beneficial for developing countries?

Pros

- reduces uncertainty
- signals commitment to a favourable foreign investment environment
- encourages cross-border investments
- other tax base revenue possible with creation of employment, knowledge and technology transfer

Cons

- may lead to loss of potential tax revenue if the benefit derived from foreign investment inflows is not equal or higher
- limitation of domestic rates that might otherwise be charged
- restrictions on the future right to tax
- can be used for aggressive tax planning schemes to take advantage of a new treaty, e.g. no or reduced withholding tax on distributions

Why have a double tax treaty?

- **prevent double taxation** of income arising from cross-border transactions.

  Double taxation arises where the same income or capital is subject to tax in two (or more) countries. This could be a single taxpayer being taxed on the same income in two countries ("juridical double taxation") or tax on the same income in the hands of two separate taxpayers ("economic double taxation"). Taxing income twice can make a transaction uneconomic so may deter investment.

- **prevent tax avoidance and evasion** on cross-border transactions.

  The domestic tax base can be badly affected if intra-group cross-border transactions are not done at true market value. Treaties can adjust for this by taxing such a transaction at the true value, as if it had been done on an "arm's length" basis with an unconnected third party. Secondly, countries can agree to exchange information, thereby reducing the risk of tax evasion e.g. double non-taxation when the income is not taxed anywhere.

- **eliminate any discrimination against foreign nationals and non-residents**.

Sometimes the tax rates imposed on foreign enterprises are much higher or more onerous than those imposed on a comparable local enterprise carrying on the same activity. For example, a resident may receive tax breaks for interest paid on its loans from other residents, whereas a loan from a non-resident may not benefit from these. Double tax treaties can remove these types of discrimination.

- **encourage cross-border economic activity**.

Removing or reducing double taxation facilitates and encourages investment. This not only enhances the tax base but can also result in a transfer of skills and technology, particularly valuable for developing countries.

- **strengthen political ties** .

A treaty creates a platform for dialogue and information exchange between the two countries. It also provides a degree of stability and international legal protection in relation to the taxation of investments made from one country to the other. It relieves double taxation and sets maximum rates for taxes levied at source (i.e. withholding taxes).

What concessions might we have to offer?

Many developing countries that sign a double tax treaty often cede some tax revenues (e.g. by agreeing to reduce their tax rates) in anticipation of attracting more foreign investments. Such treaty benefits granted to foreign investors in a treaty will usually benefit the richer of the two countries most (because more of its residents are likely to be international investors). Tax revenue lost by the other country under to the treaty may not be offset by the benefit derived from the foreign investment inflows.

Treaties can also create opportunities for investors to manipulate the tax system: for example, the investor based in a third country may engage in "treaty shopping". Such an investor might set up a "pass through" company which has no substantive business operations other than directing flows to another country in order to benefit from a low withholding tax rate or other benefit provided for by a double tax treaty.

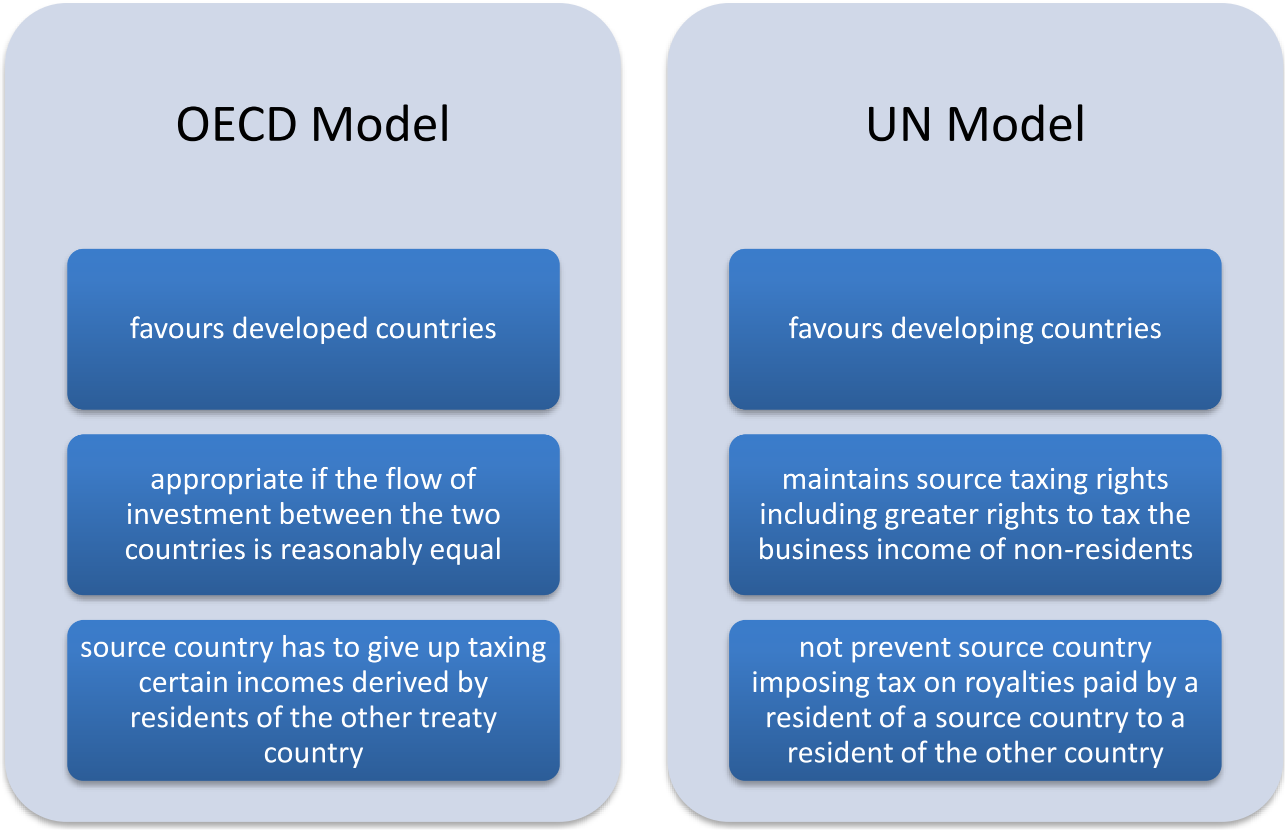
Countries entering into a tax treaty must carefully analyse and consider the impact a treaty may have on their economy.

- Avoid undue restrictions on taxing income relating to the exploitation of natural resources
- Be aware that treaties generally have priority over domestic law – will you lose valuable protections or sources of income?
- Be specific: make sure that important income/services (in particular technical services) are properly covered by the treaties
- examine the other country's tax system and the volume and nature of investment flows between the treaty partners

Introduction to model treaties

There are two main international models of treaties which can be used as a base in the negotiations and drafting of double tax treaties:

- Organization for Economic Cooperation and Development ("OECD") model, mostly used by developed countries which promotes residence taxation and is arguably more beneficial for developed country investors.
- United Nations ("UN") model, mostly used as a base for tax treaties signed between a developed country and a developing country which provides more room for "source based" taxation – beneficial for developing countries as they are capital importers.



Certain countries have developed their own tax treaty model, like the Netherlands, the United States, East African Community ("EAC") or Common Market of Eastern and Southern Africa. The EAC model includes a favoured nation clause in its withholding tax articles, but would permit less taxation by inward investment than based on UN model.

What kind of provisions are included in these models and most double taxation treaties to prevent double taxation?

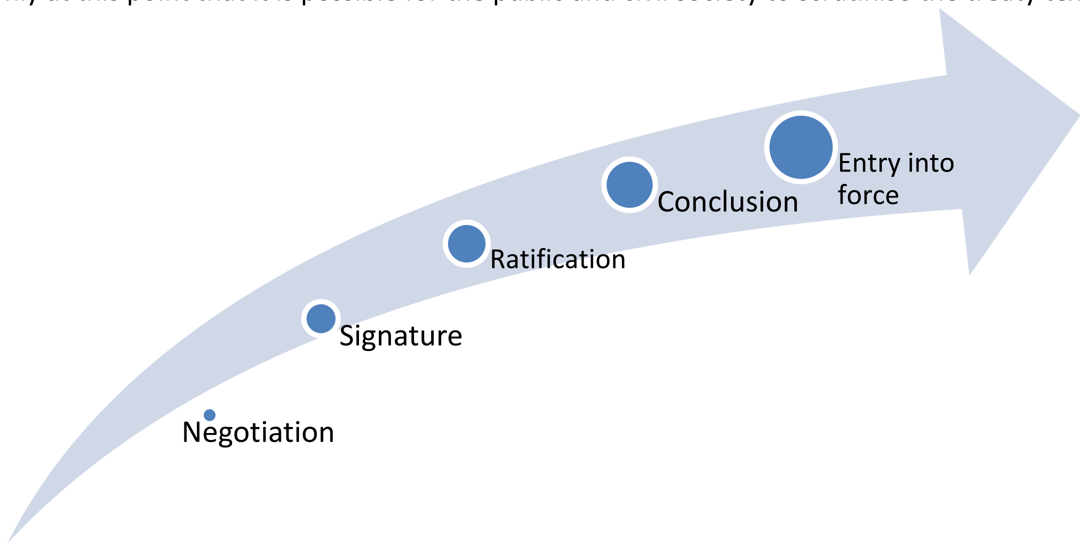
- **agree that only one country taxes certain income**. For example, agreeing that income from real estate could be imposed only in the country where the real estate is located.
- **agree to share the income**. For example, tax on dividend payments. These are often taxed both in the country where the distribution company is tax resident ("taxed at source") and in the country where the recipient of such dividends is located for tax purposes (taxed in the "residency country"). You don't want to have to change all the domestic laws to achieve a sharing of revenue so one way to achieve this is to provide in the treaty that there will be tax exemptions or some kind of credit mechanism or reduction to offset local tax. NB care should be taken to have agreed terms so it is clear what is being covered (e.g. "resident taxpayer", "immovable property" etc.).

How they are made

There are a few steps to enter into a tax treaty:

- **Negotiation** - Having considered the factors set out above, the countries commence negotiations by exchanging their model treaties and scheduling face-to-face negotiations. As tax treaties are, in almost all cases, confidential agreements until their signature, the presence of the private sector during the negotiation is a very sensitive issue and would require approval and discussion in advance with the other country.

- **Signature** – after the agreement is reached on the text, the treaty is signed by the authorised officials. It is typically only after signature that the text of a treaty is published. This is important because it may be only at this point that it is possible for the public and civil society to scrutinise the treaty text.



- **Ratification** – after signature, each country will obtain approval under a state's own internal procedures ("ratification") then notify the other parties that they consent to be bound by the treaty. After a declaration of consent by both countries, formal adoption is often achieved by means of a deposit of ratified instruments at a location agreed upon in the treaty (e.g. Vienna Convention article 9(1)). The treaty is now officially binding on the state.
- **Conclusion** – after the exchange of the ratification instruments the treaty is concluded; and
- **Entry into force** – the treaty enters into force in accordance with the specific rules set up in the treaty.

Want to find out more?

- "An introduction to tax treaties" Brian J. Arnold
- OECD Model Tax Convention on Income and on Capital
- "The OECD Model Tax Convention – a comprehensive technical analysis", Olivier R. Hoor, 2010
- United Nations Model Double Taxation Convention between Developed and Developing Countries
- United Nations Handbook "Administration of Double Tax Treaties for Developing Countries", Alexander Trepelkov, Hary Tonino and Dominika Halka, 2013
- United Nations "Negotiation of Tax Treaties for Developing Countries" 2014
- Vienna Convention of the Law of Treaties, 23 May 1969
- Berkeley Journal of International Law "Double Tax Treaties and Their Interpretation" Klaus Vogel, Volume 4, Issue 1 *Spring, 1986*
- ICTD (Working paper 50) "A review of Uganda's treaties and Recommendations for Action" Martin Hearson and Jalia Kangave, March 2016
- Glopolis "Mapping of Double Taxation Treaties of selected Central and Eastern European countries with primary focus on treaties with developing countries" JUDr. Tomas Balco, LL.M., FCCA, 2017
World Tax Journal October 2014 "An economic perspective on double tax treaties with(in) developing countries" by Julia Braun and Martin Zagler

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