Are Tax Treaties Worth It for Developing Economies?

Sébastien Leduc and Geerten Michielse*

INTRODUCTION

The complex interaction—and possible overlap—between different tax jurisdictions justifies coordination efforts to avoid double taxation, which can harm international trade and investment. Originally, countries established tax jurisdiction over their own residents and over nonresidents to the extent that they receive income from domestic sources. Tax treaties allocate—and often limit—taxing rights and impose obligations on both contracting states. The core provisions of a tax treaty deal with this allocation function, while other provisions target the elimination of double taxation (for example, through credit or exemption in the residence country) and protection of treaty provisions against tax avoidance schemes. Tax treaties intend to benefit taxpayers residing in either or both contracting states; the extent to which they do ultimately depends, inter alia, on how treaty provisions compare with the domestic law of each country.

Brief History of Tax Treaties

The first tax treaty that dealt with the avoidance of double taxation dates back to 1899 and was concluded between the Austro-Hungarian Empire and Prussia. The treaty was based on the 1870 Prussian Imperial Double Taxation Law, which focused on the elimination of double taxation within the North German Confederation and provided the legal basis for Prussian taxation of foreign nationals. Although not in concept, but certainly in wording, it was the first time that taxation of land and business, and income from them, became exclusively taxable in the state of source.1 The 1899 treaty between Austria-Hungary and Prussia laid

* The authors would like to express their thanks to Alice Park for the assistance she provided in preparing some of the charts for this chapter.

1 Article 2 of the Tax Treaty between the Austro-Hungarian Empire and Prussia: “The ownership of land and buildings, and the operation of a fixed trade, as well as the income arising from these sources are only to be assessed for direct State tax in the State in which the land and buildings are situated or where a permanent establishment for the exercise of trade is maintained. Branches, factories, depots, counting houses, places of buying and selling, and other business facilities maintained for the exercise of a fixed trade by a proprietor himself, business partners, attorneys, or other permanent
the foundation and had a profound impact on the establishment of a network of ensuing similarly worded bilateral tax treaties during the first half of the 1900s.\(^2\)

In the 1920s the League of Nations entrusted four economists to prepare a study on the economic aspects of international double taxation.\(^3\) Their report concluded that in most cases, double taxation penalizes the existing nonresident investor and prevents nonresidents from making new investments. To address these concerns, the researchers favored, for practical reasons, allocating sole taxing rights to the country of source (method of deduction for income from abroad), as opposed to the full allocation of taxing rights to the country of residence\(^4\) (method of deduction for income going abroad) or to the sharing of taxing rights between both states.

In 1928 the League of Nations adopted and published the *Report on Double Taxation and Tax Evasion*. A group of tax officials from various countries then drafted several bilateral conventions for the prevention of double taxation.\(^5\) The convention on direct taxes covered both impersonal and personal taxation\(^6\) and offered a mix of sole and shared taxing rights. It distributed the taxing rights of various incomes covered by impersonal taxes to (1) the state in which the immovable property was situated, (2) the state in which the debtor of interest income or pension was resident, (3) the state in which the real center of management of the undertaking was situated, (4) the state in which the recipients carried on their employment, and (5) the state in which the permanent establishment was situated. With respect to income subject to personal taxes, the taxing right was allocated to the state in which the recipient had its fiscal domicile (that is, normal residence). That state was also obliged to provide relief for double taxation in the form of a tax credit for taxes paid in the other contracting state.

Subsequently, the Fiscal Committee of the League of Nations worked on broadening the scope of the 1928 Convention. A regional conference held in representatives are to be regarded as permanent establishments.” Translation by Johann Hattingh, On the Origins of Model Tax Conventions: 19th Century German Tax Treaties and Laws concerned with the Avoidance of Double Tax, page 31.

\(^2\) For instance, Austria-Hungary concluded treaties with Liechtenstein (1901), Saxony (1903), Württemberg (1905), Baden (1908), and Hessen (1912). Luxembourg concluded treaties with Prussia (1909) and Hessen (1913).

\(^3\) The *Report on Double Taxation* (1923) was authored by Professors Bruins (Commercial University of Rotterdam), Einaudi (Turin University), Seligman (Columbia University, New York), and Sir Josiah Stamp, KBE (London University).

\(^4\) This was the researchers’ preferred option from a conceptual perspective.


\(^6\) Commentary on Bilateral Conventions for the Prevention of Double Taxation in the Special Matter of Direct Taxes (League of Nations, 1928): “... that impersonal taxes are in most cases levied on all kinds of income at the source, irrespective of the personal circumstances of the taxpayer (nationality, domicile, civil status, family responsibilities, etc.) thus differing from personal taxes which rather concern individuals and their aggregate income.”
1943 in Mexico City with representatives of countries in North and South America adopted a new draft tax treaty model. The significant feature about that draft was its underlying premise: the primary taxing jurisdiction was to be the state of source of the income, a position advantageous to developing countries. This, however, proved to be short lived. During the London meeting of the Fiscal Committee in 1946, the primary taxing jurisdiction shifted back in favor of the state of residence of a taxpayer.

The Mexico and London Models laid the foundation for treaty negotiations up until the late 1950s. During that period, over 70 new bilateral tax treaties were signed. However, these treaties had several gaps and consequently were not fully accepted or unanimously followed. In 1945 the United Nations (UN) succeeded the League of Nations, but it took until 1956 for the Fiscal Committee of the Organisation for European Economic Cooperation (OEEC), later transformed into the Organisation for Economic Co-operation and Development (OECD), to take over the review and further development of the League’s London Model. The committee produced four reports on the elimination of double taxation, which were published in 1963 and embodied into the Draft Double Taxation Convention on Income and on Capital.

The 1963 Draft Double Taxation Convention was built to account for the interests of the OECD membership and thus allocated considerable taxing rights to residence countries. As international fiscal relations increased, tax systems became more complicated, and new business sectors and organizations were emerging, it became apparent in the early 1970s that the 1963 draft model required updating. A final version of the first OECD Model Double Taxation Convention on Income and on Capital (OECD Model) was published in 1977 and became the standard for bilateral treaty negotiations for years to come (mainly between developed countries). Since the 1990s the OECD Committee on Fiscal Affairs regularly reviews and updates the model.

In parallel, the UN developed its own Treaty Model, which it first published in 1980. Given the premise upon which the OECD Model is written, and the interests of the members of the OECD whom the model serves, it is not unexpected that developing countries (being capital-importing countries) did not feel that it represented a reasonable sharing of taxing rights. The response of the developing countries was recourse to the UN to develop a model tax treaty that better reflected their interests. The Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries7 finalized the 1980 UN Model Double Taxation Convention between Developed and Developing Countries (UN Model), whose aim was to promote the conclusion of treaties between developed and developing countries, acceptable to both parties. In that sense, the UN Model provides a benchmark for a compromise treaty that better balances residence and source taxation. To a large

---

7 This ad hoc group was renamed the Ad Hoc Group of Experts on International Cooperation in Tax Matters in 1980; in 2005 it was renamed the Committee on International Cooperation in Tax Matters.
extent, the UN Model followed the 1977 OECD Model. However, it did grant greater taxing rights to source states, that is, the capital importing and developing countries. The UN Model has been, and continues to be, widely embraced by most developing countries (see Wijnen and Magenta 1997).

Influence of the OECD and UN Models

The success of the OECD Model and (although to a lesser extent) the UN Model has been astounding. Since World War II, the number of tax treaties concluded has rapidly increased to over 3,000 treaties (Figure 8.1), and the overwhelming majority of these treaties follow provisions that are in either or both the OECD and UN Models. Their wide acceptance and the resulting standardization of many international tax rules has been an important factor in reducing international double taxation in recent years. Although the economy has fundamentally changed since the 1920s from a brick-and-mortar economy into a globalized, integrated, and increasingly digitalized economy, both models are still to a large extent based on the underlying premise that the primary taxing jurisdiction is the state of residence of the taxpayer, whereas the state of source should limit or forgo its taxing jurisdiction.

The structure and key provisions in bilateral tax treaties based on either the OECD or UN Model tend to be very similar. Chapter 1 identifies the persons whose tax obligations are affected by the treaty, generally residents of either or both contracting states, and describes the taxes covered by the treaty, generally taxes on income and capital (that is, wealth) imposed by the contracting states and their political subdivisions. Chapter II provides definitions of important terms used in the treaty. Chapter III contains what are often referred to as the distributive or allocative rules of the treaty: a set of provisions dealing with various types of income derived by a resident of one or both of the contracting states. In general, these provisions determine whether there are shared or exclusive taxing rights. In the case of shared taxing rights, a priority is given to source taxing rights by Article 23, which deals with the elimination of double taxation. Chapter IV deals with the taxation of capital (not income from capital). Chapter V provides two alternative methods for eliminating double taxation: the exemption method and the credit method. Chapter VI contains special provisions providing protection against various forms of discriminatory taxation by the source and residence countries, administrative cooperation between the contracting states in relation to assistance in collection and exchange of information, and a mutual agreement procedure to resolve disputes concerning the application of the treaty. Finally, Chapter VII provides rules to govern the entry into force and termination of the treaty.

The OECD Model favors capital-exporting countries over capital-importing countries. Often, its proposed solution to eliminate or mitigate double taxation is to have the source country forfeit some or all its taxing rights on certain categories
of income. Good examples of this are Article 12 on royalty payments and Article 13 on capital gains related to dispositions of shares, for which the OECD Model Tax Treaty proposes exclusive taxing rights to the residence country. The UN Model imposes much fewer restrictions on source-country taxing rights (Box 8.1).

**Legal Considerations**

In general, tax treaties do not impose tax. Instead, that is the role of domestic legislation, while tax treaties are primarily relieving in nature in the sense that they can constrain the reach of domestic legislation. In other words, tax treaties limit the taxes otherwise imposed by a country but cannot extend a country’s right to tax income where such taxing rights are not provided for under domestic law. Considering this fundamental principle, it is usually appropriate before applying the treaty provisions to determine whether the income in question is subject to domestic tax. It is also worth keeping in mind that domestic legislation can be changed freely and frequently (subject to the legislature’s approval), whereas the provisions negotiated in tax treaties tend to remain in place for many years, even decades. Extreme prudence should thus be exercised in negotiating a tax treaty.

---

*Figure 8.1. Development of Worldwide Tax Treaty Network*

*Number of Tax Treaties*

Source: IMF staff based on IBFD data.

---

9 Article VI of the US Constitution states: “… laws of the United States which shall be made in pursuance thereof: and all treaties made, or which shall be made, under the authority of the United States, shall be the supreme law of the land …” The US Supreme Court has held as its interpretation that as treaties and domestic law are equal (that is, the Constitution does not imply a hierarchy between them), the principle of *lex posterior* should prevail (most recent law is that which is applicable). As such, the general US rule is that any statute that is later in time than a treaty, and that conflicts with it in some way, is a treaty override. For additional background, see Avi-Yonah and Wells (2018). This is contrary to the domestic law of most other countries.
The interpretation of tax treaties is a task that must be undertaken by taxpayers, tax authorities, and domestic courts alike. In filing their tax returns, taxpayers must claim treaty protection. Decisions made by tax authorities against a taxpayer’s views are (ultimately) subject to judicial recourse. From a simplistic perspective,

<table>
<thead>
<tr>
<th>Box 8.1. Main Differences between OECD and UN Models</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Business Income (Articles 5 and 7)</strong></td>
</tr>
<tr>
<td>The UN Model uses a permanent establishment definition allowing source countries to more easily establish a sufficient economic linkage to trigger a permanent establishment designation; this is achieved by more restrictive duration tests for building and construction permanent establishments, by defining a permanent establishment for service activities not set forth in the OECD Model, and by creating a permanent establishment for collecting premiums or insuring risks. The UN Model is also more source-country friendly when it comes to allocating profits to the permanent establishment; it includes a limited force-of-attraction rule that extends a source country’s right to tax business income to activities undertaken therein by a nonresident if these activities are identical or similar to those carried out by the permanent establishment.</td>
</tr>
<tr>
<td><strong>Investment Income (Articles 10, 11, and 12)</strong></td>
</tr>
<tr>
<td>The most important difference between the two models regarding treatment of investment income is that the UN Model maintains source-country taxing rights over royalties, whereas the OECD Model provides exclusive taxing rights to the residence country. Further, the UN Model retains source-country withholding tax rights over equipment rental fees and radio or television broadcasting royalties, whereas the OECD Model considers them business income (Article 7). Finally, the OECD Model explicitly suggests withholding tax rates (5 percent for direct dividends, 15 percent for portfolio dividends, and 10 percent for interest), whereas the UN Model leaves them up to negotiation.</td>
</tr>
<tr>
<td><strong>Service and Management Fees (Article 12A)</strong></td>
</tr>
<tr>
<td>Since 2017, the UN Model has proposed that source countries retain the right to impose a withholding tax on gross payments to nonresidents in relation to services of a managerial, technical, or consultancy nature, even if the service provider has no physical presence in the source country.</td>
</tr>
<tr>
<td><strong>Capital Gains (Article 13)</strong></td>
</tr>
<tr>
<td>The UN Model provides for source-country taxation of shares if a holding is over an agreed threshold (substantial shareholdings).</td>
</tr>
<tr>
<td><strong>Mutual Agreement Procedure (Article 25)</strong></td>
</tr>
<tr>
<td>The OECD Model proposes that countries include a clause that provides for mandatory binding arbitration for cases that remain unresolved after two years. In contrast, the UN Model provides two alternatives. The first option is for contracting states to agree to have mandatory binding arbitration if cases remain unresolved after three years (Article 25B). In this case, and unlike for the OECD, arbitration is triggered by either of the contracting states (and not the taxpayer). The second option is to forgo arbitration and simply have contracting states endeavor to revolve any issues related to the application of the tax treaty (Article 25A).</td>
</tr>
</tbody>
</table>

The interpretation of tax treaties is a task that must be undertaken by taxpayers, tax authorities, and domestic courts alike. In filing their tax returns, taxpayers must claim treaty protection. Decisions made by tax authorities against a taxpayer’s views are (ultimately) subject to judicial recourse. From a simplistic perspective,
tax treaties can be interpreted broadly to give effect to their perceived purposes or narrowly to adhere strictly to their literal wording. In that sense, the interpretation of tax treaties bears certain similarities to that of domestic tax legislation. There are, however, several important differences between the legal interpretation of treaties and that of domestic tax legislation:

- Because two contracting states are involved in every treaty, questions of interpretation should be resolved by reference to the mutual intentions and expectations of both contracting states.
- Treaties are addressed to a broader audience than domestic legislation, namely, to both the governments and taxpayers of each country.
- Treaties are often not drafted using the same terms as domestic legislation.
- Treaties are, as previously discussed, primarily relieving in nature.
- The OECD and UN Models (and their commentaries, which serve as interpretive guidance) have no counterparts in the context of domestic tax legislation.

As tax treaties are international agreements, the Vienna Convention also governs their interpretation. The basic rule of interpretation in Article 31(1) of the Vienna Convention provides that “[a] treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose.” The context includes the text of the treaty and any agreements between the parties made in connection with the conclusion of the treaty and any instrument made by one of the parties and accepted by the other party. Under Article 32 of the Vienna Convention, other elements, referred to as supplementary means of interpretation, which include the preparatory work of the treaty and the circumstances of its conclusion, are only to be considered to confirm the meaning established pursuant to Article 31, or to establish the meaning if Article 31 produces an ambiguous, obscure, absurd, or unreasonable result. In treaty cases from virtually all countries, the courts usually give the OECD and UN Models and their commentaries substantial weight. To this end, developing countries that agree to include verbatim provisions found in either model should be very familiar with the related commentary and, if they disagree with the suggested interpretation, either amend the language of the article or formally reject the interpretation by way of a technical note.

In addition to the provisions of the Vienna Convention, tax treaties based on the OECD or UN Model contain an internal rule of interpretation. Article 3(2) (general definitions) provides that any undefined terms used in a treaty should be given the meaning that they have under the domestic law of the country applying the treaty unless the context requires otherwise. However, the determination of the meaning of a term under domestic law also may be difficult.\(^\text{10}\) Another

\(^{10}\) For instance, some definitions in tax treaties are inclusive, meaning that the term has its ordinary meaning in addition to items that are specifically mentioned. Furthermore, definitions in the treaty often contain terms that are undefined in domestic legislation or have more than one meaning in the domestic legislation, depending on the context in which they are used.
important and controversial issue of interpretation in connection with Article 3(2) of the OECD and UN Models is whether a term has its meaning under domestic law at the time that the treaty was entered into (static approach) or its meaning under the domestic law as amended from time to time (ambulatory approach). As a matter of principle, international tax law experts are generally averse to the idea of an ambulatory approach (see, for example, Avery Jones 2002; Land and Brugger 2008; and Ward 2006). This reluctance seems tied to their understanding of the theoretical framework of the applicable international law, which is exclusively governed by the Vienna Convention.

**RECENT DEVELOPMENTS: BEPS AND 2017 MODEL TREATIES**

As part of its agenda to counter base erosion and profit shifting (BEPS), the OECD and G20 also looked into treaty-related tax avoidance strategies (see OECD 2013a; 2013b). The most preeminent treaty issue discussed and agreed to as part of the BEPS Project relates to the need for countries to better protect the integrity of their treaty network from potential abuses such as treaty shopping (see “Treaty Shopping,” later in this chapter, for a fuller discussion). A consensus emerged out of this work for countries to include in treaties a “principal purpose test” provision, or a limitation of benefits clause restricting access to treaty benefits, or a combination of the two (Action 6), as evidenced by the retention of this measure as a “BEPS minimum standard.” Another BEPS minimum standard that links with tax treaties is provided under Action 14 and aims at making dispute resolution mechanisms more effective by requiring countries to commit to resolving treaty-related disputes in a timely, effective, and efficient manner. The BEPS Project also resulted in several other non-minimum standard recommendations that would assist countries in strengthening the integrity of their tax treaties, including changes to the permanent establishment definition and provisions intended to address hybrid mismatch arrangements, among others.

The BEPS Project also brought forward an innovative instrument for countries to promptly amend their tax treaties. On June 7, 2017, the so-called multilateral instrument—often known as MLI—was signed by 67 countries and jurisdictions, including G20 members except Brazil, Saudi Arabia, and the United States. The multilateral instrument implements the BEPS outcomes—both minimum standards and others—in as far as it requires amendment of existing tax treaties (see Table 8.1). Signatories are required to identify those treaties that they wish to cover by the multilateral instrument: so-called covered

---

11 As of December 21, 2020, 95 jurisdictions had signed the multilateral instrument and four countries had indicated their intention of becoming signatories in the short term.

12 Further, the multilateral instrument also provides an option for countries to include in their tax treaties Article 13(4), which provides for source-country taxation on capital gains realized on indirect transfers of immovable property, which is not a BEPS-related measure.
### TABLE 8.1.
The Content of the Multilateral Instrument

<table>
<thead>
<tr>
<th>Multilateral Instrument Article(s)</th>
<th>Content</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Scope</td>
<td>Modifies all covered tax agreements</td>
</tr>
<tr>
<td>2 Interpretation of Terms</td>
<td>Identifies—among other things—which tax treaties are covered</td>
</tr>
</tbody>
</table>
| 3–5 Hybrid Mismatches              | • Incorporates a new provision in which transparent entities will be taxed according to the treatment applicable in the country of residence of its participants  
• Amends the tie-breaker rule that determines in what country an entity has its treaty residence by using the mutual agreement procedure, and provides that treaty benefits will be denied if such agreement is not reached  
• Eliminates double taxation as a result of the application of primary and defensive domestic rules |
| 6 Purpose of a Covered Tax Agreement | Changes the preamble language to add after the intention to eliminate double taxation “without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance” |
| 7 Prevention of Treaty Abuse       | Includes a general anti-abuse rule based on the principal purpose of transactions or arrangements; may be supplemented by a simplified limitation-on-benefit provision |
| 8–11 Other Anti-abuse Rules        | • Introduces a minimum holding period to obtain preferred source taxation on dividends (8)  
• Allows source-country taxation in cases of indirect sales of immovable property (9)  
• Denies tax treaty benefits to any item of income on which the tax rate in the third jurisdiction in which an exempt permanent establishment is located is taxed below 60 percent of the tax that would be imposed in the residence country of the enterprise (10)  
• Provides a so-called “saving clause” that preserves the right of a contracting state to tax its own residents (11) |
| 12–15 Avoidance of Permanent Establishment Status | • Redefines the definition of an “independent agent” to mitigate commissionaire arrangements (12)  
• Addresses situations in which the specific activity exemptions give rise to BEPS concerns (13)  
• Nullifies the splitting up of contracts for the avoidance of permanent establishment status (for example, construction sites) (14) |
| 16 Mutual Agreement Procedures      | • Modifies the wording of Article 25 of the OECD Model to allow a taxpayer to present a case to the competent authority of either contracting state within a limited period not less than three years  
• Requires that signatories implement any mutual agreement reached, notwithstanding the statute of limitation under domestic law |
| 17 Corresponding Adjustments        | Extends the mutual agreement procedure to transfer pricing disputes, unless a tax treaty contains Article 9(2) of the OECD Model |

(continued)
tax agreements. Subsequently, they must choose from the options for the minimum standards related to addressing treaty shopping (see following discussion) and can make reservations to provisions other than those relating to the minimum standards. From a legal perspective, the multilateral instrument will not change the text of existing tax treaties, but it will be applied alongside such treaties, modifying their application to implement the BEPS measures.

Out of some 3,000 tax treaties that are currently in force, over 1,500 treaties will be covered by the multilateral instrument. Thus, the multilateral instrument marks unprecedented progress in international tax cooperation. Reservations and options have nonetheless resulted in a complex matrix in which it is not immediately clear how individual tax treaties have been or will be amended. The multilateral instrument will only revise those articles of the covered tax agreements that both signatories do not reserve (other than those regarding the minimum standards) or that both signatories do not consider contain a provision described in the multilateral instrument. Thus, even if a signatory intends to apply all provisions of the multilateral instrument, the provisions that will be revised by the multilateral instrument will be limited to those agreed to by other contracting states. To this end, due to the widespread use by signatories of reservations on nonminimum standard provisions, the actual extent to which the multilateral instrument will revise individual treaty provisions may be quite limited in practice.

The treaty-related outcomes from the BEPS project are now reflected in 2017 updates to the OECD and UN Models. The main changes include amendments to the title and preamble of both models, the introduction of a new article about entitlement to benefits to protect against treaty shopping, modifications of the definition of permanent establishment, and amendments to the mutual agreement procedure. In addition to these BEPS-related changes, the OECD update also includes changes to the commentary on residency by clarifying the meaning of “permanent home available” and “habitual abode,” and explicitly noting that registration for the purpose of VAT is, by itself, irrelevant for the purpose of the application and interpretation of the permanent establishment definition.
The update of the UN Model includes a more substantive change that extends beyond BEPS-related outcomes and is specifically intended to address developing countries’ concerns over base-eroding payments in relation to services rendered by nonresidents. The 2017 UN Model includes a new Article 12A, which allows source countries to apply a final withholding tax on gross payments for technical services. All cross-border payments for technical services, irrespective of whether those services were performed inside or outside the tax jurisdiction of the source country, can be taxed in that state. As discussed later in this chapter (see “Key Allocative Provisions”), this is a major extension of the taxation right of low- and middle-income countries and establishes a better protection against erosion of their tax base.

**TAX TREATIES AND DEVELOPING COUNTRIES**

**Tax Treaties and Developing Countries: Recent Trends and Stylized Facts**

There are currently about 3,000 comprehensive bilateral income tax treaties in effect. As depicted in Figure 8.2, high-income countries have concluded substantially more tax treaties than any other income group category, while low-income countries tend to have the narrowest treaty networks. This has important

**Figure 8.2. Total Number of Tax Treaties in Force by Country Income Group**

Source: IMF staff based on IBFD data.

Note: Cumulative number of tax treaties concluded where at least one of the contracting states is part of a given country income group. There is, therefore, duplication of treaties where contracting states are part of different income groups.
implications for tax treaty negotiations between countries in these two income groups, as the former will typically have greater experience and better institutional and technical knowledge than the latter in terms of treaty negotiations.

The pace at which countries have concluded tax treaties has significantly increased starting in the mid-1990s (Figure 8.2). In the 1950s tax treaties played a marginal role in defining the international tax policy of countries in all income groups. Starting in the early 1960s high-income countries began concluding an increasing number of treaties mostly among themselves, while developing countries continued to refrain from enacting tax treaties. This all changed in the early 1970s, when the pace of concluding tax treaties increased across all country income groups (although to a lesser extent for low-income countries). Another defining point occurred in the mid-1990s, when high-income, upper-middle-income, and lower-middle-income countries all experienced a further increase in the number of tax treaties being concluded and enacted. While less apparent in Figure 8.2 due to scaling, low-income countries experienced a similar increase: the number of tax treaties concluded by countries in this category increased from an average of about one per year in the 1960s, 1970s, and 1980s to three per year in the 1990s and six per year in the 2000s and 2010s. This is shown in Figure 8.3.

13 Developing countries are taken as those that are low-income, lower-middle-income and upper-middle-income countries as per World Bank classification.
Most tax treaties that are concluded by developing countries are with a high-income country (Figure 8.4). The share of low-income countries’ tax treaties that are concluded with high-income countries sits at about 60 percent. Of the remaining share, 23 percent are concluded with upper-middle-income countries and 16 percent with lower-middle-income countries, and only 1 percent is concluded between two low-income countries. Similarly, lower-middle-income and upper-middle-income countries also tend to have close to two-thirds of their treaties concluded with high-income countries. This has notable implications for developing countries in terms of analytical capacity and experience in negotiating tax treaties, and especially in terms of the economic implications of tax treaties. For low-income countries these are dictated by mostly unilateral flows of trade and investment from more economically developed countries.

Assessing the Reciprocity Argument

It is often argued or assumed that tax treaties are reciprocal in light of the fact that the exact same provisions will generally apply to residents of both contracting states. However, assessing de jure reciprocity provides an incomplete picture of what is truly at stake for different contracting states. Taking withholding tax as an example, de jure reciprocity means that if the negotiated withholding tax on interest is 8 percent, as in the Mozambique–Mauritius treaty, this same rate applies to payments received and beneficially owned by residents of both states. Is that a sufficient condition to assess the treaty provision as being effectively de
facto reciprocal? One may argue, for instance, that reciprocity ought also to be assessed in terms of magnitude of the benefits that this provision confers to residents of both contracting states, and hence in terms of the cost the provisions, imposes to contracting states in terms of revenue forgone. As will be further discussed, this will depend, inter alia, on the degree to which the provisions in the tax treaty depart from applicable domestic legislation. To illustrate this point, consider that the applicable domestic legislations in Mozambique and Mauritius currently provide for, respectively, 20 percent and 0 percent withholding tax interest paid to nonresidents.14 Hence, as the cost of the negotiated 8 percent withholding tax rate under the Mozambique–Mauritius treaty is effectively only binding for Mozambique, it is hardly conceivable to assert that this provision is truly reciprocal.15 It is thus of critical importance to bear in mind the domestic legislations of both contracting states when engaging in treaty negotiations and assessing the desirability and reciprocity of the treaty and its provisions.

Further, and perhaps more fundamentally important for developing countries, is the fact that reciprocity also needs to be assessed in the context of the existing and prospective economic relationships. The investment flows between the two contracting states will to a large extent dictate who will bear the cost of different treaty provisions. As most tax treaty provisions will impose various constraints on source-country taxation, while providing few limitations on residence countries beyond those already contemplated under prevailing domestic legislation,16 the costs of entering into a tax treaty will generally be greater for net capital importers. This is particularly relevant for developing countries, given that investment flows make developing countries typically net capital importers.

Figures 8.5 to 8.8 illustrate the trend in inward and outward foreign direct investment stocks relative to GDP across four different country income groups, as well as the trend in the inward-to-outward foreign direct investment ratio.17 A clear picture emerges from this analysis: low-income countries and lower-middle-income countries remain large net capital importers.18 The unidirectional flow of foreign direct investment into low-income countries is in fact more pronounced today than it was in 1997, as evidenced by the fact that the inward-to-outward

---

14 Mauritius’s 0 percent withholding tax rate on interest payments to nonresidents is subject to holding a category 1 or category 2 global business license or a banking license.

15 From the perspective of reciprocity in terms of benefits to taxpayers and costs to contracting states, reciprocity would be better achieved by having the treaty stipulate an agreed reduction over the applicable statutory withholding tax rate. This, of course, runs into difficulties where one country, like Mauritius, adopts a 0 percent withholding tax rate domestically (unless a subsidy scheme is then contemplated).

16 Indeed, most capital-exporting countries have nowadays legislated foreign tax credit provisions or foreign income exemptions in their domestic legislation such that the requirement under the tax treaty to eliminate double taxation (Article 23) does not typically go beyond domestic law.

17 This ratio shows the balance between inward and outward investment flows. A ratio about 1 shows a balance in importing and exporting capital from and to international markets, while a high ratio is indicative of a net capital importer.

18 IMF Coordinated Portfolio Investment Survey data reveal a similar pattern for portfolio holdings.
Chapter 8  Are Tax Treaties Worth It for Developing Economies?

Figure 8.5. Low-Income Countries

Source: IMF staff using UNCTAD data\(^1\) and World Bank country classifications.
Note: FDI = foreign direct investment.

Figure 8.7. Upper-Middle-Income Countries

Source: IMF staff using UNCTAD data¹ and World Bank country classifications.  
Note: FDI = foreign direct investment.

Figure 8.8. High-Income Countries

Source: IMF staff using UNCTAD data¹ and World Bank country classifications.  
Note: FDI = foreign direct investment.

ratio now approaches 14. The total value of inward foreign direct investment represents 40 percent of low-income countries’ GDP, whereas outward foreign direct investment accounts for approximately 2.9 percent. Lower-middle-income countries’ ratio has declined in recent years, although inward foreign direct investment (approximately 25 percent of GDP) is still significantly higher than outward foreign direct investment (5.4 percent).

Upper-middle-income countries have in recent years increasingly exported capital, such that the outward foreign direct investment reached 14 percent of the group’s aggregate GDP. With inward foreign direct investment having seemed to stabilize at about 20 percent of GDP, the inward-to-outward foreign direct investment ratio has thus declined to about 1.6. As for high-income countries, they remain capital exporters at the margin, although the ratio has been relatively stable since 1997 at just under 1. As illustrated by these figures, the challenges posed by the limitation on source-country taxation in tax treaties may thus be particularly pronounced for the poorest countries, although such limitations remain important for high-income countries in the context of their economic relationships with other high-income countries (as illustrated, for example, by the ongoing discussions regarding appropriate nexus and profit allocation rules for companies operating in the digital economy).

BENEFITS AND COSTS OF TAX TREATIES

Proclaimed Benefits of Tax Treaties

The traditional motivation for concluding a tax treaty is to promote and reduce barriers to international trade and investment. Tax treaties may help achieve this objective through a number of different channels. First and foremost is the elimination of double taxation, which, if it exists, can indeed be harmful to investment, trade, and economic growth. Double taxation can take several forms. One of them is economic double taxation, which refers to the taxation of the same income in the hands of different taxpayers. Treaties mitigate against risks of economic double taxation through the adoption of a common understanding on the adoption of the arm’s length principle to determine appropriate pricing of transactions between associated enterprises, as stipulated under Article 9 of both the OECD and UN Models. Dispute resolution under the mutual agreement pro-

---

19 This section focuses on tax treaties in developing countries. Developed countries may have other objectives when entering into treaty negotiations, such as the facilitation of outbound investment by residents (see United Nations 2016).

20 In particular, paragraph 9(2) provides that contracting states shall make appropriate corresponding transfer pricing adjustments (a “correlative adjustment”). Paragraph 6 of the commentaries to Article 9 note, however, that this correlative adjustment is contingent on the other contracting state agreeing that the adjustment appropriately reflects an arm’s length position. Since 1999, the UN Model has included a new paragraph 3 in Article 9, which provides that there is no obligation to provide a correlative adjustment where the juridical, administrative, or other legal proceedings have resulted in a final ruling that, by actions giving rise to an adjustment of profits under 9(1), one of the enterprises is liable to penalty with respect to fraud, gross negligence, or willful default.
procedure (Article 25) is also aimed at providing a framework for resolving cases of double taxation,21 including for instances regarding correlative adjustment under paragraph 9(2) in response to a primary transfer pricing adjustment by one of the contracting states.

Another, and arguably the most prevalent, type of double taxation that tax treaties aim at addressing is juridical double taxation, which arises when the same income is taxable in the hands of the same person in more than one country. Three separate cases of juridical double taxation exist: residence-residence, source-source, and source-residence. Residence-residence double taxation arises when both contracting states’ domestic laws provide that a given taxpayer has tax residence in their jurisdiction.22 In principle, such residence-residence double taxation is addressed through the tie-breaker rules in Article 4. Source-source double taxation arises when two countries, through their domestic legislation, adopt different sourcing rules, the result of which is that a single payment is then simultaneously sourced in two countries.23 Tax treaties may eliminate some of these situations by providing sourcing rules (for example, for interest under Article 11 and royalties under Article 12), although not all source-source double taxation is necessarily resolved by treaties.24 Source-residence double taxation arises when one state exercises jurisdiction to tax on the basis of residency while another jurisdiction exercises its jurisdiction to tax income based on its domestic source. Source-residence double taxation is addressed through the allocative provisions in tax treaties (Articles 6–22), which allow for either exclusive or shared taxation rights, and the provisions for the elimination of double taxation under Article 23.

A second channel through which tax treaties could potentially promote trade and investments is by reducing source-country taxation (through limitations on withholding taxes, for example). Assuming that the residence country adopts a territorial system for active business income earned by foreign subsidiaries of domestic multinational enterprises (as is nowadays the international norm), then reducing source-country taxation could be expected to increase investment, as it will lower the pretax rate of return required by investors to make a project viable on a posttax basis. As will be discussed, the empirical validity of this effect of tax treaties (and source-country tax incentives more generally, especially in developing countries) on investment is, at best, mixed.

21 And, more generally, inappropriate application of the treaty by one of the contracting states.

22 For example, a country may use place of incorporation to establish corporate tax residency, whereas another country may use a place of effective management test, giving rise to the possibility of dual residence for companies that are incorporated in the former country with an effective place of management in the latter.

23 For example, a country may source services where they are actually performed, while another country may source services based on the tax residency of the payor.

24 For example, where services are being provided in a contracting state (which sources services based on the location of the provision) by a resident in a third country for the benefit of a resident in the other contracting state (which sources services based on where they are being utilized or consumed), the tax treaty will not be helpful, as the issue does not arise with respect to a resident of a contracting state, and therefore who is not a covered person pursuant to Article 1.
Tax treaties may also promote trade and investment by increasing predictability and stability in source-country tax systems. For example, tax treaties are, by their very nature, less prone to change than domestic law. Further, tax treaties may signal to the international community a source country’s willingness to adhere to international standards developed by the OECD (whose membership comprises of large capital exporters to developing countries), most notably in terms of key issues such as permanent establishments (Article 5), transfer pricing (Article 9), and nondiscrimination (Article 24).

Beyond its possible effect on trade and investment, tax treaties offer administrative benefits that can assist countries in monitoring and enforcing tax compliance. Of particular relevance are Article 26 (exchange of information) and Article 27 (assistance in collection). Article 26 offers a legal basis for contracting states to undertake automatic, spontaneous, or on-request exchange of information, while Article 27 provides a commitment—which can be supported by a separate memorandum of understanding—for contracting states to help each other in the collection of revenue claims. This has led some to suggest that the prevention of tax evasion and avoidance and of double nontaxation is an important operational objective of tax treaties (see, for example, Arnold 2015). As argued in the following subsection, “Assessment of the Proclaimed Benefits,” we dismiss this argument, as tax treaties have in practice been more likely to create—rather than eliminate—opportunities for tax avoidance and as other, arguably more effective, instruments exist to achieve these objectives that do not entail forfeiting taxing rights.

Last, but not least, tax treaties have at times been used support or further diplomatic relationships between states. It is, for instance, not uncommon for negotiations to be either recommended or even initiated by foreign affairs ministries rather than by ministries of finance, where as tax policy ought to be designed in support of other fiscal policy matters.

**Assessment of the Proclaimed Benefits**

The preceding discussion indicated that the benefits of tax treaties can be broken down into three main categories: tax treaties can stimulate cross-border trade and investment, support tax administration functions, and further international relations. Various channels have been argued to establish first—the linkage between tax treaties and trade and investments—including, most notably, the mitigation of double taxation and the reduction in source-country taxation.

To what extent is double taxation preventing cross-border trade and investment? A long tradition of legal scholars argue that capital-exporting countries already relieve the bulk of any possible double taxation unilaterally, such that treaties’ benefit on investment through relief from double taxation is essentially a myth (Hearson and Kangave 2016).

When tax treaties were first being negotiated, most countries adopted a worldwide corporate income tax system. The possibility for double taxation was consequently much more pronounced, and tax treaties might, in these circumstances,
have been quite useful in ensuring proper relief from double taxation, thereby encouraging trade and investment. Nowadays, however, most capital-exporting countries have shifted toward territorial tax systems where foreign-source active business income of controlled foreign corporations of domestic multinationals is fully exempt, meaning that tax treaties’ role in relieving source-residence double taxation is at best questionable. Further, where capital-exporting countries do tax foreign-source profits (for example, for some countries in the case of a foreign branch or passive income), they typically will provide unilateral relief from double taxation (either through an exemption or a foreign tax credit) through provisions in their domestic tax law.

This is not to say that double taxation no longer exists. There may, for instance, still be cases where dual residence arises or where double taxation remains given that the residence country offers an income tax deduction, as opposed to an income tax credit. That said, those cases are relatively rare. The key message is thus that policy shifts in recent decades have certainly reduced the prevalence of double taxation, to a point where it is worth questioning whether it remains a sufficiently important issue to justify the presence of tax treaties. If multinationals have been so agile in exploiting the current framework to find opportunities for double nontaxation (for example, stateless income, hybrid mismatches), then one would expect that they would also be able to avoid double taxation.25

If double taxation no longer appears to be a significant barrier to trade and investment, can source countries still benefit from tax treaties by reducing source-country taxation? Three major reasons point to a negative answer to this question:

• Empirical evidence on the impact of tax treaties on foreign direct investment is inconclusive. One of the key challenges is addressing possible endogeneity: should an increase in investment be attributed to the presence of a tax treaty, or did investors’ desire to undertake investment result in the conclusion of a tax treaty with a given country? Studies have used bilateral country-level data or microdata to assess the impact of treaties (as a binary variable) and withholding tax rates on investment, with some showing positive impacts (for example, Barthel, Busse, and Neumayer 2010; Di Giovanni 2005; Millimet and Kumas 2007; Neumayer 2007), while others find no or even negative impacts (for example, Blonigen and Davis 2004, 2005; Egger and others 2006; Louie and Rousslang 2008).26

25 Ultimately, the possibility of double taxation needs to be assessed on a case-by-case basis at a bilateral level. For example, the case for residence-residence double taxation of individuals may be more pronounced for neighboring countries. Should this prove problematic, consultations among country officials to find national solutions could prove desirable over concluding a tax treaty based on such a premise.

26 For a more extensive overview of current literature, see IMF (2014, appendix 5).
• More generally, while tax incentives—including, for instance, reduced withholding taxes under a tax treaty—may have a positive effect on investment in developing countries, the effect tends to be smaller than in developed countries (Abbas and Klemm 2013; De Mooij and Ederveen 2008; Van Parys and James 2009). In many cases, however, tax incentives have been found to be highly redundant, as was the case, for example, in Rwanda (98 percent), Uganda (93 percent), Guinea (92 percent), Tanzania (91 percent), and elsewhere (James 2014). Further, tax incentives have generally scored low in investor surveys in terms of decisional factors: a 2010 United Nations Industrial Development Organization (UNIDO) survey covering 7,000 companies in 19 sub-Saharan Africa suggests that tax incentive packages ranked 11th out of 12 factors.

• Finally, the optimal policy response would not in any case be to sign a bilateral tax treaty. Indeed, if one believes—contrary to much evidence—that source-country tax incentives bring about an important inflow of foreign direct investment and increase other social benefits such as employment and knowledge and technology spillovers, then the optimal policy would seemingly be to adopt this reduction unilaterally under domestic statutes (by legislating moderate-to-low statutory withholding tax rates, for example). Tax treaties should not be entered into for the sole or primary purpose of pursuing either administrative or political motives. Historically, developing countries have very seldom availed themselves of exchange-of-information or assistance-in-collection clauses to better monitor and enforce compliance. And, in any case, these provisions are more widely accessible under Articles 4–7 and 11 of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, which now has 125 participating jurisdictions. As for the international relations argument, there are surely better ways of making friends or soliciting development aid than by sending them a blank check.

**Costs of Tax Treaties**

There are two main costs associated with tax treaties (Hearson and Kangave 2016): first, the deliberate—although sometimes unexpectedly excessive—cost resulting from the restrictions that the treaty imposes on the developing country’s taxing rights; second, the unintended cost resulting from the abuse of certain tax

---

27 In this context, “redundant” refers to the offering of a tax incentive to an investor who, by his own admitting, would have invested even in the absence of the incentive.


29 Canada, for instance, eliminated withholding tax on interest paid or credited to arm’s length nonresidents, effective January 1, 2008, in an effort to provide increased access to foreign capital for Canadian businesses.

30 As of July 2018.
treaty provisions through tax-planning schemes, mostly in the form of treaty shopping.

As large capital importers, developing countries will bear direct costs when tax treaty provisions restrict source-country taxation. The most important provisions in this regard are generally those related to the taxation of business profits (Articles 5 and 7), services (Articles 5 and 12A of the 2017 UN Model), withholding taxes on dividends, interest and royalties (Articles 10, 11 and 12, respectively), and capital gains (Article 13). The revenue forgone as a result of these provisions can be large, albeit challenging to quantify due to data-availability constraints.

It is possible to obtain rough estimates of source countries’ revenue losses that originate from lower withholding taxes on dividend and interest payments. This can be done using a simple revenue forgone approach, along with some assumptions that are inevitable due to the lack of available data. Table 8.2 illustrates results from a select set of tax treaties for 2016. The methodology is a simple one that relies on IMF Coordinated Direct Investment Survey (CDIS) bilateral foreign direct investment positions, treaty and statutory withholding tax rates, and assumed returns on equity and debt investments. It is thus estimated in Table 8.2 that Mongolia may lose as much as 0.2 percent of its GDP in tax revenues annually due to low withholding taxes in its treaty with Canada.

Other studies have also used similar approaches to quantify revenue forgone due to dividend and interest withholding tax provisions in tax treaties, including in Janský and Šedivý (2018) and McGauran (2013). The latter study focuses on

---

31 These provisions are only referenced here, as they are discussed in greater detail in the following section.
32 The revenue forgone approach is an ex-post estimation that measures the reduction in tax revenue that is caused by the introduction of a tax preference, assuming no changes in taxpayers’ behaviors. This is the most popular method for calculating tax expenditures. However, if any increase in investment occurred the revenue forgone would be reduced.
33 Our methodology assumes a 6 percent yield on equity and 4 percent yield on debt, which we view as being relatively conservative. Ratios generated from interacting IMF balance of payment (flows of dividend and interest payments) and IMF CDIS (stock of equity and debt foreign direct investment) data in relation to investments in developing countries suggest an average expected yield on foreign direct investment equity of 10 percent and an expected yield on foreign direct investment debt of 4.4 percent.
34 It should be kept in mind that the revenue forgone as a result of low withholding tax rates in a tax treaty is a function of the domestic withholding tax rates, which set up a benchmark against which treaty rates are to be assessed. Given that the underlying objective here is to give an appreciation of the possible costs of tax treaties, the authors have purposely not included countries where treaty rates are near or above domestic statutory rates. An unknown portion of the revenue forgone estimated here is likely attributable to indirect costs such as treaty shopping.
35 Janský and Šedivý (2018) estimate dividend and interest payments on a bilateral level by multiplying balance of payment flows by the share of a given country’s foreign direct investment to total foreign direct investment (not distinguishing equity from debt foreign direct investment). They find the greatest potential aggregate revenue loss (that is, across all estimated treaties) to be about 0.2 percent of GDP for Mongolia and the Philippines. Of the country pairs presented in Table 8.1,
Chapter 8  Are Tax Treaties Worth It for Developing Economies?

145

tax treaties concluded by the Netherlands and finds revenue losses as high as 0.1 percent of GDP for treaties between the Netherlands and both Kazakhstan and Venezuela. While different methodologies will inevitably yield different outcomes, these estimates appear quite significant considering that McGuaran’s study reflects only two provisions in tax treaties and already accounts for millions in dollars of revenue forgone.

Indirect costs of tax treaties are even more opaque than their direct costs. Indirect costs essentially refer to treaty shopping, which are arrangements by which investors residing in third states attempt to avail themselves of favorable tax provisions negotiated between two other contracting states by setting in one of those states an intermediary (or conduit) structure through which investment in the other contracting state will be channeled (see following discussion).

Anecdotal evidence tends to support the claim that treaty shopping has historically been a major problem worldwide. To address the risks associated with a wide treaty network with heterogenous tax provisions, the United States has for many decades insisted on including limitations on benefits provisions in its tax treaties. More recently, broad international consensus over the high prevalence of treaty

only the Mongolia–Canada treaty can be estimated using Janský and Šedivý’s methodology, given data requirements and availability. We are unable to reconstruct Janský and Šedivý’s estimate for the Mongolia–Canada treaty, as the value of Canadian foreign direct investment stock for 2015, which we obtain from the IMF CDIS ($7,733 million), differs significantly from that used by Janský and Šedivý ($403 million). Consequently, this leads to our estimate being much larger.

TABLE 8.2.
Dividend and Interest Withholding Tax: Estimated Revenue Forgone of Select Tax Treaties

<table>
<thead>
<tr>
<th></th>
<th>Dividends</th>
<th>Interest</th>
<th>Dividends</th>
<th>Interest</th>
<th>Debt</th>
<th>Equity</th>
<th>Revenue Forgone (est.) (% of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Uganda / Netherlands</td>
<td>15%</td>
<td>15%</td>
<td>0%</td>
<td>10%</td>
<td>3,722</td>
<td>177</td>
<td>0.1%</td>
</tr>
<tr>
<td>Mozambique / Mauritius</td>
<td>20%</td>
<td>20%</td>
<td>8%</td>
<td>8%</td>
<td>1,402</td>
<td>1,001</td>
<td>0.1%</td>
</tr>
<tr>
<td>Mongolia / Canada</td>
<td>20%</td>
<td>20%</td>
<td>5%</td>
<td>10%</td>
<td>733</td>
<td>3,115</td>
<td>0.2%</td>
</tr>
<tr>
<td>Republic of Congo / France</td>
<td>15%</td>
<td>20%</td>
<td>15%</td>
<td>0%</td>
<td>2,902</td>
<td>1,694</td>
<td>0.2%</td>
</tr>
</tbody>
</table>

Sources: IMF CDIS, World Economic Outlook, and International Bureau of Fiscal Documentation. ¹
Note: Foreign direct investment in US$ in millions. Dividend rate is for qualified dividends. Assumed yield of 6 percent on equity and 4 percent on debt.

¹ IMF Coordinated Direct Investment Survey (CDIS), http://data.imf.org/?sk=40313609-F037-48C1-84B1-E1F1CE54D6D5 &slid=1482331048410.
shopping and the important risks this poses to government revenue has led the G20 and OECD to agree on a so-called minimum standard to address treaty abuse as part of the BEPS Project. Some anecdotal evidence may also be inferred from bilateral foreign direct investment data patterns, which can be suggestive of strong linkages between favorable tax treaties and inward foreign direct investment into developing countries. A few examples will serve to illustrate this point:

- At the end of 2016, about 20 percent (or $73.6 billion) of all inward foreign direct investment stocks into India came from—or transited through—Mauritius. The India–Mauritius treaty, which was signed in 1982, provides an exemption from source-country capital gains.
- The United Arab Emirates holds the largest stock of foreign direct investment into Mozambique at just over $9 billion, which accounts for about a quarter of the country’s total inward foreign direct investment. The UAE–Mozambique treaty has several favorable provisions, including 0 percent withholding tax on interest and dividends and a 5 percent withholding tax on royalties.
- About 45 percent of all inward investment into Uganda originates from—or transits through—the Netherlands, with a dollar value estimated at just under $4 billion. As previously noted, the Uganda–Netherlands treaty (which is currently under renegotiation) conveniently offers investors a 0 percent withholding tax on qualified dividends.

There are many other such examples, although the presence of a tax treaty does not always appear to be a necessary condition for investors to channel investments in developing countries through conduit countries.

Empirical evidence also tends to support the importance of treaty shopping (see the sixth section) and its effect on foreign direct investment flows. For example, Beer and Loeprick (2018) find that treaty shopping drives nominal investment flows into sub-Saharan Africa and that revenue losses for countries having concluded a treaty with at least one investment hub are on average 15 percent of corporate income tax revenues. Other studies, including those of Petkova, Stasio, and Zagler (2018); Weichenrieder and Mintz (2008); and Weyzig (2013), also find evidence suggesting that treaty conclusion with conduit countries leads to a rerouting of investment (that is, treaty shopping).

36 Treaty shopping and the minimum standards agreed to under the BEPS project to address this issue are discussed in the sixth section, “Treaty Shopping.”
37 Similar patterns are also observed across developed countries. For instance, Luxembourg, the Netherlands, and Switzerland collectively account for over 43 percent of total non-US foreign direct investment into Canada in 2017.
38 Foreign direct investment statistics referenced here are drawn from the IMF CDIS.
39 A recent protocol to the India–Mauritius Treaty was announced on May 10, 2016. The protocol provides for the phasing out of the capital gains tax exemption from 2017 to 2019, with grandfathering for shares acquired before April 1, 2017.
40 For example, there is over $3.3 billion in investment into the Democratic Republic of Congo (DRC) originating from Mauritius, and there is no tax treaty between the DRC and Mauritius.
Other costs should not be neglected. This includes the time spent on preparing for and negotiating tax treaties, which inevitably entails an opportunity cost that is particularly pronounced in the context of tax administrations with limited capacities or resources (as is most often the case in developing countries). Once in force, treaties then entail administrative costs, including for the processing of withholding tax refund claims and for the monitoring of the adequacy of treaty provisions in light of changes to domestic legislation. Yet another cost is the loss of flexibility within the tax policy framework—tax treaties tend to be in effect for a long period of time and may be difficult to renegotiate.

**KEY ALLOCATIVE PROVISIONS**

Four provisions play a key role in determining the extent to which source countries may forfeit taxing rights under a tax treaty. These provisions relate to permanent establishments, withholding taxes, service fees, and capital gains.

**Taxation of Business Income and Permanent Establishments**

In the current international tax architecture, income from business activities is typically taxable in the jurisdiction in which these activities take place. However, where these business activities are undertaken by a nonresident entity, source-based taxation is usually limited to situations in which the business activities exceed a qualitative threshold referred to as a permanent establishment. The implementation of this concept in domestic legislation is often based on administrative ease: it is hard for tax administrations to identify and determine taxable profit for each separate business transaction of a nonresident. For instance, it would be quite impractical for a country to assert tax jurisdiction over a portion of the business profits of nonresidents’ entities that merely export into its territory. Having a de minimis threshold allows the tax administration to forgo incidental transactions and concentrate on the more important taxpayers.

The notion of permanent establishment is one of the most important issues in treaty-based international fiscal law. The permanent establishment concept determines both the tax jurisdiction (or “right to tax”) and the tax base for business profits of a nonresident enterprise (Reimer 2015). It was historically founded on the basis that the nonresident needed sufficient physical presence and engagement in core activities in the source state to justify the allocation of taxation rights to the source state (Skaar 1991). It essentially contemplated that a nonresident entity needed labor or physical capital to undertake production, distribution, or retail operations in the source country to trigger source-country rights to tax business profits, and that mere exports would in turn not give rise to source-country taxing rights.

Article 5(1) of the 2017 OECD and UN Models provides for a qualitative definition of a permanent establishment. The general principle of a permanent establishment is “a fixed place of business through which the business of an enterprise is..."
wholly or partly carried on.” “Fixed” refers to a link between the place of business and a specific geographical point, as well as a degree of permanence with respect to time. In other words, to be fixed, the activities need to be at a given place for a sufficient amount of time. A “place of business” refers to some facilities used by an enterprise for carrying out its business, and the premises must be at the disposal of the enterprise (either owned or rented). Finally, the “business of the enterprise” must be carried on wholly or partly at the fixed place. Paragraph 2 of Article 5 of the OECD and UN Models contains an illustrative list of what should be considered beyond doubt as constituting a permanent establishment, while paragraph 4 lists a number of cases that should not be considered permanent establishments even if they are indeed carried out through a fixed place of business.41

In addition, most tax treaties contain special rules with respect to construction sites. Under those treaties, a building site or construction or installation project constitutes a permanent establishment only if a given project lasts more than a specified length of time, which is typically from 3 months to 12 months (Table 8.3). The 2017 OECD Model suggests a period of more than 12 months, whereas the 2017 UN Model chooses a period of 6 months. The latter also includes all the related supervisory activities in determining whether the minimum period has been met.

Beginning with its 2011 revision, the UN Model has also contained a special rule regarding the provision of services. If an enterprise, through its employees or other personnel engaged by it, continues to furnish services within a contracting state for more than 183 days in any 12-month period, that enterprise is deemed to have a permanent establishment in that state. The issue is taken up in the following subsection (“Technical Services”) as part of a broader discussion on the taxation of cross-border services.

In addition, both models provide that the activities of a dependent agent may give rise to a permanent establishment for the principal. Specifically, where a person acts on behalf of an enterprise and habitually concludes contracts, or plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprises, that enterprise will be deemed to have a permanent establishment in the country in which this person operates if the contracts are (1) in the name of the enterprise; (2) for the transfer of the ownership of, or right to use, property; or (3) for the provision of services.42 Brokers, general

---

41 This list includes business activities that are deemed not to constitute a permanent establishment given that they share the common feature of being merely preparatory or auxiliary activities in nature. A key difference between the OECD and UN Models is that the UN does not consider delivery services as being preparatory or auxiliary in nature, whereas the OECD Model does characterize such activities as such (meaning that they are deemed to give rise to a permanent establishment even in the presence of a fixed place of business under paragraph 5(1)).

42 It should be noted that the UN Model’s agency permanent establishment test is somewhat broader in scope than the OECD’s. Indeed, Article 5 of the UN Model includes a subparagraph (b) providing that a foreign enterprise will be deemed to have a permanent establishment if a person habitually maintains a stock of goods or merchandise from which it regularly delivers goods or merchandise on
commission agents, and other independent agents are explicitly excluded from becoming a permanent establishment if such persons are acting in the ordinary course of their business.\textsuperscript{43} The agency–permanent establishment concept was justifiably tightened as part of the BEPS Project; the previous agency–permanent establishment definition required that the agent have “authority to conclude contracts in the name of the enterprise,” which resulted in the common use of commissaire arrangements\textsuperscript{44} and other tax-planning techniques to avoid meeting this test. Although these structures have been subject to significant litigation by various tax authorities, the tax administrations’ arguments have been rejected in most cases. Another outcome from the BEPS Project was the tightening of the definition of an independent agent, which no longer includes independent agents that exclusively or almost exclusively act on behalf of one or more enterprises to which they are closely related. However, these modifications may be insufficient: as long as the foreign enterprise can perform functions beyond the mere rubber-stamping of contracts concluded by an agent (that is, to ensure that contracts are not “routinely adopted without material modification”), the enterprise may still be in a position to avoid having a permanent establishment.

\begin{table}[h]
\centering
\caption{Construction Permanent Establishment Thresholds in Tax Treaties}
\begin{tabular}{lccc}
\hline
 & Two Non-OECD & OECD and Non-OECD & Two OECD \\
\hline
No threshold & 1 & 1 & 0 \\
3 months & 26 & 13 & 0 \\
4 months & 2 & 1 & 0 \\
5 months & 1 & 1 & 0 \\
6 months & 391 & 337 & 57 \\
7 months & 1 & 0 & 0 \\
8 months & 7 & 2 & 0 \\
9 months & 131 & 130 & 14 \\
10 months & 0 & 1 & 1 \\
12 months & 190 & 328 & 150 \\
15 months & 0 & 1 & 0 \\
18 months & 9 & 5 & 0 \\
24 months & 1 & 0 & 2 \\
\hline
\end{tabular}
\label{tab:permanent}
\end{table}

Source: IMF staff based on Wijnen and De Goede (2014).

Note: Covers 1,811 tax treaties concluded between April 1997 and January 2013.

\textsuperscript{43} Article 5(6) of the 2017 OECD Model and Article 5(7) of the 2017 UN Model.

\textsuperscript{44} A commissaire arrangement may be loosely defined as an arrangement through which a person sells products in a country in his own name but on behalf of a foreign enterprise that is the owner of these products. Through such an arrangement, a foreign enterprise sells its products in that country without technically having a permanent establishment to which such sales may be attributed and without, therefore, being taxable in that country on the profits derived from such sales. Since the person that concludes the sales does not own the products that it sells, that person cannot be taxed on the profits derived from such sales and may only be taxed on the remuneration that it receives for its services (usually a commission). See OECD (2015).
Once a country recognizes a permanent establishment of a foreign enterprise within its jurisdiction, profits of that enterprise must be allocated to the permanent establishment. This raises practical difficulties, as both the foreign enterprise and permanent establishment are the same legal entity. The basic profit allocation rule provided for under Article 7 is that profits attributable to the permanent establishment are those that it would be expected to make “if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the [permanent establishment] and through the other parts of the enterprise.”45 This brings in the full transfer pricing issues that are discussed in Chapter 5. In addition, the 2017 UN Model explicitly notes that certain payments made by the permanent establishment to its headquarters “by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except for a banking enterprise, by way of interest on moneys lent to the permanent establishment” shall not be allowed as deductible expenses.46 In other words, internal charging to the permanent establishment by the headquarters in this form is not taken at face value and is rather subjected to the general arm’s length test described earlier. The omission of rental fees from this list is enigmatic, as it may open the door to tax planning. Executive and general administrative expenses—whether made in the permanent establishment country or elsewhere—are for their part explicitly allowed as tax deductions. A final note on allocation is that, unlike the OECD Model, the UN Model provides that income from sales and other business undertaken by the nonresident enterprise in the source country that are similar or identical to the activities of the permanent establishment can be attributed to the permanent establishment. This so-called limited force-of-attraction rule is contained in subparagraphs 7(1)(b) and (c), which developing countries should seek to include in their tax treaties. While the limited force-of-attraction rule may be successful in preventing some form of abusive tax-planning schemes, it is by no means bulletproof. For instance, it does not capture the activities of all related nonresident entities that are part of the group, which could be added to a force-of-attraction rule to increase its effectiveness.

The overall relevance and applicability of the permanent establishment threshold as currently formulated has clearly reached its limits. While there appears to be growing consensus toward this conclusion, including as part of the ongoing debate regarding the taxation of the digital economy, efforts to date have for the most part focused on incremental changes to the permanent establishment concept, as illustrated, for example, by the outcomes under Action 7 of the BEPS Project (see OECD 2015). Fundamental reforms, such as the abandonment of the permanent establishment concept in favor of formulary apportionment, could address the issue but raise challenges on their own, including questions regarding

45 Article 7(2) of the 2017 OECD Model.
46 Article 7(3) of the 2017 UN Model.
international coordination, political feasibility, and transition to this new architecture of the international tax system.

There may, however, be a more pragmatic and shorter-term solution to addressing permanent establishment–related issues: the use of a quantitative threshold as a backstop deeming rule. If the underlying motivation for the permanent establishment threshold is to require that there be sufficient economic nexus between the activities of a multinational enterprise and a given source country to allow this country to tax part of the multinational enterprise’s profits, there appears to be little better proxy to measuring that economic integration than a simple—and objective—turnover-based test in which nonresidents’ enterprises whose sales exceed a given threshold would be deemed to have a permanent establishment, notwithstanding the fact that it may not operate through a fixed place of business.

**Withholding Taxes**

Withholding taxes are final taxes levied at source on gross payments to nonresidents. Withholding taxes may also be used domestically, for example, as final or nonfinal withholding on employees’ wages. They hence matter greatly to capital-importing countries. It is helpful to divide the discussion on withholding taxes between withholding on deductible expenses and withholding on dividends, as they raise very different conceptual challenges.

Tax treaties typically provide limits on source-country withholding on two types of deductible expenses: interest payments (Article 11) and royalties (Article 12). Some treaties also provide for withholding on technical services. This is not taken up here, as it is subject to a separate discussion in the following subsection.

There are essentially two conflicting policy objectives that can influence policymakers’ determination of what constitutes a reasonable or desirable withholding tax rate on these payments:

- On the one hand, developing countries, and capital-importing countries more generally, may want to promote economic development by facilitating access to credit and foreign technologies and know-how, as discussed at length above. This weighs in the favor of adopting low withholding taxes so as to reduce the cost of capital to stimulate investment and encourage the transfer of technologies to support productivity growth.

- On the other hand, the deductible nature of these expenses poses a risk to the integrity of corporate income tax revenues. More than ever, cross-border trade and investment is dominated by multinationals. These commonly use deductible intragroup payments, such as interest charges and royalties, to engage in tax planning with a view to maximizing the after-tax return on their investments. In the context of porous interest limitation rules and weak administrative capacity to safeguard the domestic corporate income tax base

---

47 Withholding taxes may also be used domestically, for example, as final or nonfinal withholding on employees’ wages.

48 Some treaties also provide for withholding on technical services. This is not taken up here, as it is subject to a separate discussion in the following subsection.

49 The UNCTAD estimates that 80 percent of trade takes place in value chains linked to multinational enterprises.
against abusive transfer pricing, withholding taxes can serve as an important backstop that reduces—but does not eliminate—intragroup base erosion incentives and hence protects the integrity of corporate income tax revenues.

Policymakers need to carefully consider and balance these two considerations to determine an appropriate nonresident withholding tax policy for interest and royalties. While there is no one-size-fits-all solution, experience from the IMF’s technical assistance in tax policy overwhelmingly points to the need for developing countries to better safeguard corporate income tax revenues from international tax avoidance. As such, the retention of meaningful withholding tax rates on interest and royalties would in most cases be expected to outweigh any possible benefits stemming from the adoption of low withholding tax rates (Table 8.4 offers summary statistics on withholding taxes in sub-Saharan Africa). This sharply contrasts with the OECD Model’s suggestion to rely on a 0 percent withholding tax rate for royalties.51

While the preceding discussion has focused on the withholding tax rate, another important consideration relates to the definition of the payments to be covered by these provisions. Developing countries should generally aim to have as broad a scope as possible in order to maximize source-country taxing rights, simplify administration, and limit avoidance opportunities.52

Source-country withholding tax limitations on dividends, as provided for under Article 10, raise a different set of considerations. In theory, dividends are distributions of a company’s after-tax profits to its shareholders. As the distributing company has in theory already paid corporate income tax on the underlying profits, any additional taxation in the form of a withholding tax on dividends paid to its nonresident parent typically leads to economic double taxation. Further, the total tax burden faced by the multinational group will then depend on its organizational structure (that is, how many tiers it has), such that the tax system loses some of its desired neutrality. From this perspective, it would appear sensible for policymakers to consider adopting low (or no) withholding taxes on intracompany cross-border dividend distributions. Recognizing that the risk of double (or multiple) taxation is more significant in the context of closely held

50 As the corporate income tax rate will typically exceed the withholding tax rate by multiple percentage points, base-erosion incentives will not be completely eliminated even if a relatively high withholding tax is retained. This outcome is nonetheless justifiable on the basis that the withholding tax acts as a tax on the nonresident’s gross income, without regard to any related expenses.

51 The OECD Model suggest a more reasonable rate for interest (10 percent). However, this rate needs to be assessed in the context of OECD countries’ interest-stripping limitations, which are typically much more robust than those observed in developing countries, and of OECD countries’ statutory corporate income tax rates, which are generally lower than those used by low-income countries.

52 For instance, the UN Model Tax Treaty’s definition of royalties is broader than that in the OECD Model Tax Treaty, and includes payments related to broadcasting and equipment rental.

53 Nonresidents earning income not covered under Articles 11 and 12 will be assessed against the standard permanent establishment threshold in Article 5 to determine their taxable status in the source country.
entities operating as part of a multinational group, both the UN and OECD Models contemplate the use of a lower withholding tax for direct dividends than for portfolio dividends. 54

In practice, however, it is far from given that the distributing company will have fully paid corporate income tax in the developing country in which it is operating. For one, profit manipulation—which can be attributed to either or both standard tax planning and aggressive tax avoidance—may drive a wedge between “true” and “reported” taxable income, 55 with the former being unknown and hardly detectable by the tax authorities. This would consequently argue in favor of a higher withholding rate, including for direct dividends, given that the risks for profit shifting are higher in the case of subsidiaries of multinationals. 56

Developing countries will once again need to consider and balance these considerations. While country-specific circumstances will to a large extent dictate what is deemed to be a reasonable dividend withholding tax policy, a zero rate should in most cases be avoided. It will also be important to assess whether the conceptual appeal of distinguishing between direct and portfolio dividends

TABLE 8.4.

Summary Statistics on Withholding Taxes in Sub-Saharan Africa

<table>
<thead>
<tr>
<th></th>
<th>Interest</th>
<th>Royalties</th>
<th>Dividends</th>
<th>Portfolio Dividends</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Statutory</td>
<td>15</td>
<td>16</td>
<td>11</td>
<td>13</td>
</tr>
<tr>
<td>Average Treaty Withholding Tax</td>
<td>9</td>
<td>9</td>
<td>8</td>
<td>11</td>
</tr>
<tr>
<td>Maximum Treaty Withholding Tax</td>
<td>25</td>
<td>20</td>
<td>25</td>
<td>25</td>
</tr>
<tr>
<td>Minimum Treaty Withholding Tax</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Share of Countries with at least one Treaty with 0% Withholding Tax</td>
<td>36%</td>
<td>36%</td>
<td>39%</td>
<td>31%</td>
</tr>
<tr>
<td>Share of countries with at least one treaty with 5% WHT or less</td>
<td>47</td>
<td>58</td>
<td>61</td>
<td>47</td>
</tr>
</tbody>
</table>

Source: IMF staff using IBFD data.
Note: Includes 38 sub-Saharan Africa countries.

54 The 2017 OECD Model Tax Treaty proposes 5 percent for direct dividends and 15 percent for portfolio dividends, with a 25 percent ownership test defining the nature of these dividends. The UN Model also contemplates the use of a dual rate at a 25 percent threshold but does not propose specific rates.

55 Although such conflicts should be primarily solved by domestic legislation, treaties might be used as an additional line of defense.

56 Another possible justification for using a higher withholding tax rate would be to make domestic reinvestment of retained earnings domestically more attractive compared to repatriating the income overseas. However, such high withholding taxes would likely be factored in by multinational enterprises in making their investment decisions. For instance, it could either entice taxpayers into using tax-planning arrangements (for example, transfer pricing, service fees, interest payments, and so forth) to circumvent the withholding or discourage investment altogether.
warrants the additional administrative cost this dual approach would create. If a dual-rate approach is indeed retained, the minimum 365-day holding period introduced in the updated 2017 UN and OECD Models should in all cases be included to avoid tax avoidance opportunities.

**Technical Services**

Intragroup cross-border services pose important profit-shifting risks for developing countries. The high concentration of economic activity arising from subsidiaries of multinationals, coupled with often outdated anti-abuse provisions and difficulties in assessing arm’s length prices, make developing countries particularly vulnerable to the erosion of the domestic corporate income tax base through deductible charges for intragroup services. This is an issue that has not been addressed holistically as part of the G20/OECD BEPS Project, but was rather touched upon indirectly under various action items including Action 1 (Digital Economy), Action 5 (Permanent Establishment), and Action 10 (Transfer Pricing—Other High-Risk Transactions).

However, the predominant approach to dealing with services under tax treaties is to simply ignore the specific challenges that these activities pose vis-à-vis the standard permanent establishment concept. This means that contracting states provide identical treatment for business income earned either through the furnishing of services or through the sale of goods. This approach is promoted by the OECD Model, whose commentary argues that services should generally be treated the same way as other business activities with the same permanent establishment threshold test determining source-country taxing rights.

Such a view seems to derive either from an archaic view of international commerce or from an understanding that capital exporters’ best interests lie in minimizing source-country taxation. Many have recognized that the permanent establishment concept is ill suited to address the challenges raised by the service industry, particularly in the case of developing countries. Nowadays, in large part thanks to advances in information and communication technologies, it is much easier for nonresident service providers to fully participate in the economic life of a source country without having a physical presence akin to production, distribution, or retail facilities, as would be the case for the trading of goods.

Following the UN Model, some countries are attempting to bridge this gap by including a permanent establishment test that is specific to services. The so-called

---

57 The motive for multinationals to set up of service centers may in some cases predominantly arise out of efficiency gains derived from economies of scale. Nonetheless, a secondary motivation, or at least an ancillary benefit, of service centers is that they offer a convenient mechanism for conducting tax optimization strategies. Typically, these services will fall into the broad categories of human resources, finance, information technology, legal, and marketing support.

58 Other than international transportation and government services, which are dealt with in Articles 8 and 17, respectively. See paragraph 132 of the commentary to Article 5 in the 2017 OECD Model Tax Treaty.
“service permanent establishment” provision is found under Article 5(3)(b) and provides that nonresident service providers may be deemed to have a permanent establishment even in the absence of a fixed place of business under Article 5(1). More specifically, the service permanent establishment provision triggers a deemed permanent establishment where the nonresident service provider is physically present in the source country to provide services for a sufficient amount of time. Article 5(3)(b) of the 2017 UN Model defines a permanent establishment as including “[t]he furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned.”

The OECD Model does not suggest the use of a service permanent establishment clause; however, its commentary has provided elective wording for such a provision since 2008. The OECD’s elective service permanent establishment provision contemplates two alternative tests: the first is similar to the UN provision but would require that the 183-day threshold be met in respect of the “same or for connected projects,” while the second requires that more than 50 percent of the nonresident’s active business income be derived from services performed in the source country and that services be performed in the source country through an individual who is present for more than 183 days. As one can appreciate, the OECD’s elective service permanent establishment provisions place a higher threshold for the triggering of a deemed service permanent establishment as compared to the UN’s provision.

Of the 1,811 tax treaties concluded between 1997 and 2013 that were analyzed by Arnold (2014), 42 percent contained a service permanent establishment provision. Unsurprisingly, this provision was most prevalent in treaties between two non-OECD countries (58 percent), and least prevalent in countries between two OECD countries (17 percent).

While service permanent establishment provisions attempt to address specific problems related to the application of the standard permanent establishment test to service providers, several factors limit their practical usefulness:

• Most treaties rely on the UN’s previous service permanent establishment language, which applies the threshold on a project-by-project basis. This creates important administrative implications for developing countries that may be challenged in detecting and addressing avoidance schemes aimed at circumventing the test.

---

59 See paragraph 144 of Article 5 of the 2017 OECD Model Tax Treaty.
60 This language was also used in previous UN Model Tax Treaties (up to 2011 inclusively).
61 Including, most notably, multinationals’ fragmentation of intragroup activities.
• As made clear by the OECD Model and, although less explicitly, by the UN Model, the threshold applies only in respect of “working days,” which considerably narrows the application of the provision. As illustrated in Figure 8.9, the six-month test is the most common threshold.

• While this may appear prima facie as setting a half-year test, a nonresident’s presence extends from January 1 well into September if no services are being performed during weekends (as they are not working days). The working day concept is unique to the service permanent establishment provision and is not used for other duration-based tests such as the construction permanent establishment, independent personal services, or dependent personal services.

An interesting approach targeted at higher-risk transactions that conveniently circumvent the limitations posed by the application of a working-day-based test is that used by India in its treaties with Switzerland and Australia, in which the time threshold is made much shorter in the case of related-party services.

---

**Figure 8.9. Frequency of Time Thresholds for Service Permanent Establishment Provisions**

(In months)

![Figure 8.9](image_url)

Source: Arnold (2014).

---

62 See paragraph 163 of the commentary to Article 5 of the 2017 OECD Model Tax Treaty.

63 See paragraph 12 of the commentary to Article 5 of the 2017 UN Model Tax Treaty.

64 The construction permanent establishment provision relies on the length of the project from start to finish, while the independent personal services provision under Article 14 of the UN model uses a presence test. The dependent personal services or income from employment provisions under Article 15 also contemplate a presence test.

An interesting approach targeted at higher-risk transactions that conveniently circumvent the limitations posed by the application of a working-day-based test is that used by India in its treaties with Switzerland and Australia, in which the time threshold is made much shorter in the case of related-party services.
A related issue concerns the difficulties in administering a working-day-based threshold, as it is more challenging to monitor working days than it is to monitor presence days since the latter conveniently leaves behind immigration documentation.

Finally—and perhaps more fundamentally—it is not at all clear that a working day test (or a duration test more generally) is a good proxy for assessing the degree of economic integration between a nonresident service provider and the economic life of the source country. Services may lead to both high profits for the nonresident enterprise and significant base-eroding corporate income tax deductions in the source country without necessitating significant or extended physical presence. Although not seen in practice, other thresholds based on the economic activity generated by the nonresident (as could be measured by turnover, for example), would appear to offer a much better proxy of the extent of the enterprise's economic integration with the source country.

The insufficiencies of service permanent establishment provisions in meaningfully addressing the challenges posed by cross-border services has motivated a push toward finding alternatives, primarily in the form of withholding. Such a provision is found under the domestic legislation of several countries but has yet to translate broadly into tax treaties. According to Wijnen, de Goede, and Alessi (2012), only 134 of some 1,600 bilateral tax treaties concluded in the period 1997–2011 contained an autonomous withholding tax provision dealing with managerial, technical, and consulting services. The low prevalence of “service fee” withholding in tax treaties can in part be attributed to the historical absence of such provisions from both the OECD and UN Models. That is, until recently.

The UN Committee of Experts has been working since 2008 on provisions dealing with the taxation of services, although work picked up in 2011 when the committee decided to make the taxation of services fees a priority. In 2013 the committee formally endorsed the addition of a new article to the UN Model to deal with fees for technical services, and a majority supported proposing a broad provision applicable to services performed inside and outside the source country, without a threshold for source-country taxation and taxation on a gross basis. This new provision is now included as Article 12A of the 2017 UN Model. The UN’s decision to promote the use of final withholding at source on gross payments in relation to managerial, technical, and consultancy services arguably constitutes the most

---

65 Other policy responses include the institution of caps on the deductibility of service payments (for example, to a specified percentage of turnover).

66 The two other options contemplated were as follows: (1) to adopt a provision applicable only to services rendered in the source country with no threshold and taxation on a gross basis at a limited rate; or (2) to adopt a narrow provision restricted to services performed in the source country with a time threshold for source-country tax and taxation on a net basis.

67 These terms are not defined under Article 12A and will hence take the meaning attributed under the domestic law of contracting states.
substantive divergence between the OECD and UN Models to date and is hence
telling of the extent to which it poses specific problems for developing countries.

As previously discussed, even in the presence of a service permanent
establishment clause, Article 5 does not offer a sufficiently robust solution to
source-country taxation of services. The digitalization of the economy means that
physical presence is not always needed and that more and more services can be
“exported” without any sort (or at least very limited) physical presence (this also
offers scope for profit-sifting within a multinational group). Further, and perhaps
more fundamentally, developing countries are considerably challenged to assess
the presence and proper registration of permanent establishments, the ensuing
challenge of determining a proper allocation of profits based on the assets used,
risks assumed, and functions performed where such permanent establishments are
found to exist, and the application of robust arm’s length principle–based transfer
pricing legislation to assess the market value of intragroup services if such perma-
nent establishments are not found to exist. The service fee provision is precisely
aimed at addressing developing countries’ challenges in adequately protecting
their domestic tax bases from profit shifting by multinationals through intragroup
service charges and can thus be viewed as an anti-avoidance provision.

Service fee provisions may be desirable for developing countries. The key
advantage of such provisions is that they conveniently transform the traditional
determination of whether a nonresident service provider will or will not be liable
for source-country taxation based on whether a permanent establishment is found
to exist into a determination of whether the nonresident will pay tax on a net or
gross basis. Importantly, the resident will consequently inevitably be paying
taxes in the source country. Opportunities for arbitrage between gross and net
taxation may still exist, however, and will depend on the calibration of the with-
holding tax rate to the corporate income tax rate, bearing in mind companies’
profit margin and ability to minimize this margin by manipulating the allocation
of income and expenses to the permanent establishment (Box 8.2). Hence, service
fee provisions can be useful to mitigate risks related to source-country taxation of
nonresident service providers but are not a panacea.

Although the desirability of service fee provisions for low-capacity developing
countries is strong, there is considerable opposition. OECD countries—which
overwhelmingly take the role of residence countries in their economic relations
with developing countries—are reluctant to accept service fee withholding as an
acceptable solution to the problem. Some refuse to acknowledge that services
constitute a specific challenge that justifies the use of a final withholding at
source, which they argue as being an excessively blunt instrument. Turnover taxes
provide an imperfect assessment of one’s ability to pay, as they disregard the costs

68 It is thus conceptually similar to domestic tax provisions under which companies pay tax on a
net basis under the corporate income tax, but small traders are, for administrative and compliance
purposes, often rather charged tax on a presumptive basis as a percentage of their turnover.
69 That said, the question of the incidence of the withholding tax on technical services remains an
open debate that extends beyond the scope of this chapter.
involved in earning the income. Even if the withholding tax rate is carefully calibrated and provides for a sensible outcome on the aggregate, it will inevitably provide for a very heterogenous treatment of different taxpayers whose profit margins are likely to vary considerably across sectors and through time. From this perspective, there is a risk that service fee provisions could in some instances prove punitive, especially if levied at excessive rates.

Service fee provisions also conflict with the view of some countries that services should be taxed where they are provided. By disregarding the location of service provision and instead relying on a sourcing rule that relies on the fact that there is a tax-resident payor or permanent establishment (or fixed base) that bears the fees, the UN’s service fee provision is thus perceived by some as constituting

---

70 The sourcing rule is provided by Article 12A(6) of the 2017 UN Model Tax Treaty.

---

Box 8.2. Stylized Illustration of Service Permanent Establishment and Service Fee Provisions

The table below depicts the possible application of, and interaction between, the service permanent establishment and service fee provisions. The table illustrates how the overall tax burden varies for different non-resident service providers located in Country X and performing services in Country Z. As can be seen, the effective tax rate remains constant at 30% (the assumed corporate income tax rate) under profit-based taxation in the case of a permanent establishment, but will vary greatly for service fee withholdings depending on the service provider’s profit margin, since the tax is levied on turnover and not profits.

<table>
<thead>
<tr>
<th>Medium Profit Margin</th>
<th>Low Profit Margin</th>
<th>High Profit Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Residency</strong></td>
<td><strong>PE</strong></td>
<td><strong>Residency</strong></td>
</tr>
<tr>
<td>Service Fee</td>
<td>Country X</td>
<td>Country X</td>
</tr>
<tr>
<td>PE</td>
<td>Intermittent</td>
<td>Intermittent</td>
</tr>
<tr>
<td>In Country Z</td>
<td>Sustained</td>
<td>Sustained</td>
</tr>
<tr>
<td><strong>PE tax rate</strong></td>
<td>30%</td>
<td>30%</td>
</tr>
<tr>
<td>Withholding rate</td>
<td>15%</td>
<td>15%</td>
</tr>
<tr>
<td>Income from services in Country Z</td>
<td>$100</td>
<td>$100</td>
</tr>
<tr>
<td>Deductible expenses</td>
<td>($50)</td>
<td>($70)</td>
</tr>
<tr>
<td>Pre-tax profits</td>
<td>$50</td>
<td>$30</td>
</tr>
<tr>
<td>Tax payable</td>
<td>$15</td>
<td>$15</td>
</tr>
<tr>
<td>Effective tax rate</td>
<td>30%</td>
<td>50%</td>
</tr>
</tbody>
</table>
an overreach of the source country’s taxing rights. Another source of discomfort with service fee provisions lies in the fact that it departs from the long-standing principle that nonresidents should exceed a given threshold before being taxed by the source country on income earned therein.\(^{71}\) As far as tax treaties are concerned, service fee provisions may simply be too significant a departure from previous norms.\(^{72}\) That said, source-country withholding on service fees is simply an extension of the widely accepted practice of applying final withholding at source on dividends, interest, and royalties, which primarily constitute passive investment income but may also constitute income from an active business (for example in the case of banks or investment funds).

The inclusion of a service fee provision in the 2017 UN Model certainly adds legitimacy to the request of developing countries for such provisions in their treaty negotiations. However, at the other end of the spectrum, the OECD Model dismisses altogether the need to provide tailored solutions to address the specific challenges raised by the service industry. Unsurprisingly, developing countries are thus facing an uphill battle when attempting to include service permanent establishment and, more meaningfully, service fee provisions in their tax treaty network. In the meantime, however, developing countries should review their domestic legislation and consider what additional safeguards—including service fee provisions—are needed to deal with the risks posed by cross-border intragroup services. In most cases, the introduction of withholding on service fees at a moderate rate would seem desirable for developing countries.

**Capital Gains**

In general, capital gains are taxable in the country in which the seller (the recipient of the proceeds) is resident. There are some exceptions to this general rule. The taxing rights of business assets belonging to a permanent establishment are given to the country in which the enterprise holds a permanent establishment. In the case of immovable property, the country in which this immovable property is situated is given unconstrained taxing rights over the capital gain under Article 13(1) of both the OECD and UN Models. Further, the taxing right on capital gains from the alienation of ships or aircrafts used in international transportation typically remains in the country in which the place of effective management of the enterprise is located. Finally, a special allocation rule also applies to shares.

Capital gains on shares are generally taxable only in the country in which the shareholder is a resident unless targeted tests are included in the tax treaty. As provided for in Article 13(5) of the 2017 UN Model, one of those tests relates to capital gains on substantial shareholdings, which may be taxed in the country in

\(^{71}\) This principle is embodied in Articles 5 and 7, which contemplate that that nonresident enterprises should have sufficient economic nexus in the source country for this country to exercise any taxing rights over the business profits earned by this enterprise.

\(^{72}\) A risk that should not be underestimated is that of precedence—once a country agrees to include service fee provisions, it becomes increasingly challenging to defend against its propagation in the country’s treaty network.
which the company that issued the shares is a resident. This reflects the fact that some countries are of the view that they should be able to tax a gain on the alienation of shares of a company resident in that country whether the alienation occurs within or outside that country, but concede that for administrative reasons that right to tax should be limited to alienations of substantial shareholdings. A substantial shareholding is typically measured by a minimum participation (most often 25 percent of the share value or voting rights) at any time during the 365-day period preceding the alienation of the shares. There seems to be very little take-up of this provision in tax treaties: of the 1,811 treaties concluded between 1997 and 2013 analyzed by Wijnen and De Goede (2014), only 17 percent included this provision. This outcome is somewhat surprising if we consider the potential arbitrage opportunities that may arise from different tax treatment of dividends and capital gains. However, the low take-up may to a great extent be influenced by the omission of this provision from the OECD Model, as well as the provision’s somewhat narrow scope (it only applies if the alienator of the share is resident in one of the contracting states).

Article 13(4) of both the 2017 OECD and UN Models contains a provision that is intended to deal with transactions often referred to as offshore indirect transfers. The models state that capital gains on shares “derived by a resident of a Contracting State . . . may be taxed in the other Contracting State if . . . these shares . . . derived more than 50 percent of their value directly or indirectly from immovable property . . . situated in that other State.” This provision is especially important for developing countries with substantial natural resources. Taking a mining project as an example, there are in principle two main ways that an interest in this project can be realized. First, a domestic licensee company can sell its interest in tangible and intangible assets (including its interest in the mining license) relating to the mining operations. If the tangible and intangible assets are transferred, the tax consequences apply at the level of the domestic company holding the license, thereby ensuring taxation by the country in which the resources are located. Second, as depicted in Figure 8.10, the direct (Company B) or indirect (parent company) owner of the shares in the domestic licensee company (Company A) can sell the shares it owns, thereby giving the buyer indirect possession of the underlying license. There may be several tiers of companies (sometimes located in low-tax jurisdictions or countries with beneficial tax treaties) between the parent company and the licensee. If the parent company sells its shares in the licensee company (or an intermediary company), the tax consequences apply at the level of the parent company (or the intermediary company), as it may realize a gain (or loss) on its disposal of the shares. This is where Article 13, paragraph 4 of the 2017 OECD and UN Models comes into play; if the shares of this mining company are sold or transferred and more than 50 percent of the underlying value is attributable to the mining license, the source country

---

73 For example, undistributed income may be held in retained earnings, which increases the fair market value of the shares and may be accessed by the shareholder upon alienation.
Corporate Income Taxes under Pressure

It is of concern, however, that only around 35 percent of all tax treaties worldwide contain this provision, and that it is less likely to be found when one party is a low-income, resource-rich country (Platform for Collaboration on Tax 2017).74

While Article 13(4) is effective in ensuring that the source country does not forfeit its right to tax such sales, its ability to effectively tax these gains will also depend on its domestic legislation and specifically the formulation of its source rule. The domestic rule to enable taxation of offshore indirect transfers can be designed in two different ways: (1) by deeming a direct sale by a resident or (2) by taxing the nonresident seller. The first approach seeks to tax the domestic company that directly owns the asset by treating that company as disposing of, and reacquiring, its assets for their market value where a change of control occurs (for example, because of the offshore indirect transfer).75 The second approach seeks to tax the nonresident seller of the relevant shares via a source of income rule providing that the gain is sourced in the country when the value of the interest disposed of is derived, directly or indirectly,

74 Article 9 of the MLI provides signatories with the option to insert this provision in their covered tax treaties. However, with this not being a minimum standard from the BEPS project, a majority of countries have opted out of it through a reservation.

75 This approach has, for example, been adopted by Ghana, Nepal, and Tanzania.
principally from immovable property located in that country.\footnote{This approach is most commonly used (the tax liability remains with the person that receives the proceeds of the transfer).} The source of income rule may also provide that taxation of offshore indirect transfers will only apply to disposals of substantial interests (for example, where a 10 percent shareholding is met) to exclude from the scope of the rule the disposal of portfolio investments. The rule can also prescribe whether the entire gain will be subject to tax when the value of the indirect interest is less than wholly derived from local immovable property or, alternatively, whether the gain will be subject to tax on a pro rata basis. Both approaches, however, require backup measures to ensure enforcement.

**TREATY SHOPPING**

By concluding its first tax treaty, a country immediately opens up the option for taxpayers to plan their international activities in such a manner as to take advantage of the treaty benefits. In other words, as the tax treaty applies to residents of either or both contracting states, residents located in third states can avail themselves of treaty benefits by establishing residence in either contracting states (that is, treaty shopping). However, restructuring in itself does not automatically constitute an abuse, as taxpayers are typically allowed to structure their businesses in the most cost-effective manner. It can be abusive, however, if the restructuring lacks economic substance.

**Treaty Shopping as Treaty Abuse**

It is accepted that treaty shopping is an instrument of international tax planning, either as part of bona fide commercial arrangements or as part of wholly artificial arrangements that are considered to be abusive in nature. However, it is never easy to distinguish between abusive tax avoidance and legitimate tax planning, as it will always be a matter of facts and circumstances. The term “treaty shopping” generally refers to abusive arrangements and encompasses, for example, structures in which an intermediary company acts as a pure conduit with no economic substance whatsoever, completely owned and controlled by a parent company located in a third country and based in a low-tax jurisdiction. Treaty shopping by using conduit arrangements is overwhelmingly viewed as constituting an abuse of tax treaties.\footnote{See the OECD Model Tax Convention on Income and on Capital (Full Version) 2017, OECD, Paris, Commentary on Article 1.} In contrast, where the intermediary has some degree of substance in one of the contracting states (for example, it conducts its own trading activities), the structure is generally not perceived as being abusive.

Treaty shopping raises several concerns:

- Treaty shopping breaches the principle of reciprocity of a treaty and alters the balance of concessions attained therein between the two contracting states.\footnote{OECD (1987), paragraph 7, letter (a).} It results in the granting of treaty benefits to a resident whose country does not participate in the treaty and will not reciprocate with corresponding benefits.
• It has been argued that the conduit country gains revenue power, absent any (substantial) claim to economic allegiance in the case of treaty shopping (Rosenbloom and Langbein 1981). An international tax premise is that the tax base is attributable to the jurisdiction in which it is thought to owe its economic existence. In typical conduit arrangements, such economic substance is lacking for the interposed conduit company. It is a matter of interpretation as to what kind of nexus is required for the duty of economic allegiance to be generated in favor of a jurisdiction. Various countries apply different and highly variable interpretations of what is considered sufficient economic substance.79

• Treaty shopping often results in a (undesired and unforeseen) revenue loss for developing countries. Tax treaties are based on a perceived balance of actual and potential income and capital flows between the contracting states. When the benefits of a given treaty are abused, this balance is distorted. As is now commonly recognized, a generous tax treaty with one trading partner runs the risk of becoming a treaty with the world, with the consequence being a potentially large revenue loss for source countries.

Conduit Structures

A conduit company is typically regarded as a wholly owned entity located in a state for the sole or primary purpose of claiming the benefits of the tax treaty in its own name. Such benefits can generally only be denied if the entity used as a conduit is not recognized as a legal person or is not liable to tax in the state of conduit based on its place of effective management or the assets that give rise to dividends, interest, and royalties and does not enjoy freedom over the use of such assets. In practice, however, it is often not easy to verify that such specific circumstances are present.

The essence of conduit arrangements is the reduction of source-based taxation in the source country (State S) by interposing between the payer of the income and the ultimate recipient of such income a company that is entitled to more favorable treatment given the presence of a tax treaty with the source country. These arrangements are only effective if the interposed company is not subject to significant taxation in the country whose treaty network is used (State R). This entails both the residence-based corporate income taxation and the withholding tax on the income paid to the treaty “shopper” (investor). The two main forms of treaty shopping using conduit companies are via direct conduits or stepping-stone conduits (OECD 1987), described in Box 8.3.

79 The Netherlands, for instance, applies very lax substance requirements. The main requirements (regarding the place of residence of at least half of its directors; the place where board decisions are made, the principal bank account is held, and bookkeeping takes place; annual salary cost of at least €100,000; and maintenance of a business address in the Netherlands for at least 24 months) can be achieved by a trust office. The requirement that the company runs an economic risk is covered by Section 8c of the Corporate Income Tax Act 1969, which assumes, for instance, minimum equity for interest conduit companies of the lesser of 1 percent of the outstanding loans or EUR 2 million.
Chapter 8  Are Tax Treaties Worth It for Developing Economies?  165

Box 8.3. Direct and Stepping-Stone Conduits

**Direct Conduits**

A company resident of State R, owned by an investor (resident of State P), receives dividends, interest, or royalties from State S. Under the tax treaty between States R and S, the company claims it is fully or partially exempted from the withholding tax of State S. The investor, resident in State P, is not entitled to the benefit of the treaty between States R and S. The structure has been created with a view to taking advantage of the treaty’s benefits, and for this purpose the assets and rights giving rise to the dividends, interest, or royalties are transferred to the company in State R. The income is tax exempt in State R, for example in the case of dividends, by virtue of a parent–subsidiary regime provided for under the domestic laws of State R, or in the treaty between States R and S.

**Stepping-Stone Conduits**

The basic structure is identical to that of direct conduits, except that a second, related conduit company is necessary to erode the tax base in State R. The company resident of State R is fully subject to tax in that country (for example, on its interest and royalty receivables). It pays high interest, commissions, service fees, and similar expenses to a second, related conduit company set up in State B. These payments are deductible in State R and tax exempt in State B, where the company enjoys a special tax regime.


**Beneficial Ownership**

Both the OECD and UN Models have traditionally, but unsuccessfully, attempted to deal with conduit structures by denying access to lower withholding taxes on dividends, interest, and royalties if the recipient is not the so-called beneficial owner. The OECD commentary on Articles 10, 11, and 12 states that an agent or nominee would normally not qualify as a beneficial owner. A reference is also made to the Conduit Companies report (OECD 1987), which concludes that conduit companies are also less likely to be beneficial owners. Neither the OECD nor the UN Model includes a definition of beneficial owner. Undefined terms are typically interpreted according to the domestic law of the state applying the bilateral tax treaty, unless the context requires otherwise (OECD 1987). Two issues may, however, support a more international meaning: (1) most countries have not identified the term in their domestic legislation; and (2) if they have defined it, these definitions can differ widely from one country to another.

Several cases that deal with the concept of beneficial ownership have been decided under domestic jurisdictions. Although the concept remains vague and largely based on facts and circumstances, in general, two different types of tests are used to determine whether beneficial ownership is present: a technical test and a substance-over-form test:

- **Technical test:** The technical test examines whether restrictions apply to the ownership of the income. In other words, it examines who enjoys the fruits of the ownership or can dispose of it for his own benefit. As case law shows, the
difficulty is that it is hard to prove whether a person or entity has limited capability to use the income as he pleases. For instance, in the Prévost case, the UK partner in a Canadian joint venture held through a Dutch holding company requested dividend payment to alleviate its financial distress. It applied the reduced withholding tax on dividends paid by the Canadian company under the Canadian–Dutch treaty, which was denied by the Canadian tax authorities. The Tax Court of Canada ruled differently, even though one of the partners was requesting the dividend distribution; the relationship between the partners in the joint venture was structured to grant the Dutch intermediary company at least some discretion as to the use or application of funds put through it. Under other circumstances (for example, the existence of a legal binding obligation to “push through” dividends), the judge might have decided differently. One can conclude that the technical test is highly dependent on the facts and circumstances of the situation involved.

- **Substance-over-form test:** The substance-over-form test requires one to look through the legal form to the economic reality. Substance over form draws the line between legitimate tax planning and abusive tax avoidance. When this line is crossed, recharacterization of transactions is necessary to properly tax these transactions. This test was applied in the Bank of Scotland case, where the Bank of Scotland acquired usufruct rights on preference shares from a US company that entitled the Bank of Scotland to receive dividends from a French subsidiary of the US company. The Bank of Scotland requested the benefits under the UK–French tax treaty. The French Supreme Court denied the treaty benefits, as it argued that in fact the usufruct right was a concealed loan to be repaid by the French subsidiary and that this transaction was primarily based on fiscal motives (that is, receiving the avoir fiscal credit).

The result of the legal interpretation of beneficial ownership is not encouraging as to its effectiveness. The technical test relies heavily on the facts and circumstances of the case, while the substance-over-form test is heavily based on the intention of the taxpayer when entering into the arrangement, the residual taxable income remaining in the conduit, or the economic reality of the arrangement.

**Limitation-on-Benefits Provision**

The US anti-treaty-shopping efforts that have been undertaken since Aiken Industries, Inc. in 1971 are very confusing, incongruent, and heterogeneous. No

---

80 Tax Court of Canada on April 22, 2008 (Prévost Car Inc. v. The Queen, 2008 TCC 231).
81 French Supreme Court (Conseil d’État, December 20, 2006, no. 283314).
82 In this case a reduction of the French withholding tax to 15 percent and a refund of the avoir fiscal (a credit for the French corporate income tax). The latter was not available under the US–French tax treaty.
83 Aiken Industries, 56 TC 925 (1971).
general rule or principle could be clearly drawn from the US cases, and the judicial doctrines such as substance-over-form and step-transaction were sometimes denied, and sometimes accepted, by the courts. In this context, the United States started to develop limitation-on-benefits provisions in its tax treaties.

The United States first introduced a limitation-on-benefits article in its US 1996 Model Treaty and refined this limitation-on-benefits article in its 2006 Model Treaty. The technical explanation to the US 2006 Model Treaty provides a detailed interpretation for applying the limitation-on-benefits articles. Currently, limitation-on-benefits articles can be found in several tax treaties and are no longer only a US international tax policy. In 2003 the OECD added an example of a limitation-on-benefits article—like the US version—to its commentary on Article 1 of the OECD Model. In addition, the OECD BEPS Action 6 report provides for a more advanced version than that in the commentary, but still to a large extent based on the US version.

The limitation-on-benefits article is premised on the view that a resident of a contracting state must have some further connection to that country in order to benefit from that contracting state’s tax treaties. Thus, the limitation-on-benefits article limits the ability of third-country residents to engage in treaty shopping by establishing legal entities in either contracting state. Each limitation-on-benefits article sets forth several objective tests, and a resident of a contracting state that satisfies any of those tests generally is entitled to the treaty benefits, even if such resident was arguably formed or availed of for purposes of tax avoidance based on a subjective assessment of the facts and circumstances. The common objective tests include the following:

- **Public company test:** In this test, a corporation that satisfies certain public trading requirements—typically a minimum shareholding—qualifies for treaty benefits. The test reflects that treaty negotiators are relatively unconcerned about the risk that a public company might be used for treaty shopping purposes.

- **Ownership and base-erosion test:** This test generally requires that more than 50 percent of the voting power and value of the company’s shares be owned, directly or indirectly, by residents of the same country as the company (ownership). The second requirement is that less than 50 percent of the company’s gross income is accrued or paid, directly or indirectly, to persons who are not residents of the same country as the company (base erosion).

- **Active trade or business test:** This test requires that the company be engaged in an active trade or business in its country of residence, that its activities in that country be substantial in relation to its activities in the other contracting state, and that the income be derived in connection with or incidental to that trade or business.

84 See, for example, Northern Indiana Public Service Co. v. Commissioner, 105 TC 341, aff’d, 115 F.3d 506 (7th Cir. 1997); SDI Netherlands B.V. v. Commissioner, 107 TC 161 (1996); and Del Commercial Properties, Inc. v. Commissioner, 251 F.3d 210, 213 (DC Cir. 2001).

Principal Purpose Test Provision

Since 2017, and consistent with the outcomes from the BEPS Project, the OECD and UN Models have included a more general anti-abuse rule based on the principal purposes of transactions or arrangements: the principal purposes test. Under that rule, treaty benefits should not be available where one of the principal purposes of certain transactions or arrangements is to secure those benefits. Obtaining such benefits in these circumstances would be contrary to the object and purpose of the relevant provisions of the tax treaty. An additional treaty provision allows countries to address cases of improper use of tax treaties even if their domestic law does not allow them to do so (that is, due to the absence of a domestic general anti-abuse rule); it also confirms the application of these principles for countries whose domestic law already allows them to address such cases.

Whether one of the principal purposes of any person concerned with an arrangement or transaction is to obtain treaty benefits depends on an assessment of all the facts and circumstances. It is sufficient that at least one of the principal purposes was to obtain that benefit. A purpose will not be a principal purpose when it is reasonable to conclude that obtaining the benefit was not a principal consideration and the arrangement or transaction giving rise to the benefit would have been entered without the treaty considerations (for example, where an arrangement is inextricably linked to a core commercial activity and its form has not been driven by considerations of obtaining a benefit).

The commentary on the principal purposes provision suggests that—as in the case of domestic general anti-avoidance rules—tax authorities may establish some form of (administrative) approval process. In some cases, the process provides for an internal acceleration of disputes to senior officials in the administration. In other cases, the process allows for advisory panels to provide their views to the administration on the application of the rule. This reflects the serious nature of disputes in this area and promotes overall consistency in the application of the rule.

Although the principal purposes test is presented as something close to a more general anti-avoidance rule on the treaty level, it faces similar problems as the beneficial ownership concept. It requires a legal judgment of the arrangement based on facts and circumstances on a case-by-case basis, so that the source country can reasonably conclude that the intention of the taxpayer was to obtain the benefits of the tax treaty. In developing countries with less or no experience in applying general anti-abuse concepts, a principal purposes test would most likely not be very helpful to combat treaty shopping.

BEPS Solution

BEPS Action 6 requires, as a default option for addressing treaty abuse, the introduction of a principal purposes test provision in existing tax treaties, with the option either to add a simplified limitation-on-benefits provision or to replace the principal purposes test provision with a full limitation-on-benefits provision. In
capturing the broad spectrum of treaty shopping arrangements, such a full limitation-on-benefits provision is necessarily highly complex in terms of the language used, which reduces its predictability and practicability. This often results in costly litigation and uncertainty for taxpayers. On the other hand, a simplified limitation-on-benefits provision may not cover all potential treaty abuse situations, but its objective tests will be easier to apply. Developing countries may have difficulties applying a principal purposes test provision as they face issues in assessing facts and circumstances that often even occur outside their jurisdiction (for example, the intention to set up a conduit company typically occurs in the country of the ultimate investor rather than in the country of source). However, a good option would appear to apply a simplified limitation-on-benefits provision and protect its integrity with a complementary general anti-avoidance approach, such as the principal purposes test, as a backstop. Although given as an option in BEPS, this option is not the default and requires that both contracting states opt for it. Based on the current multilateral instrument matrix, this is the exception, if it at all has materialized.

**CONCLUSION**

Developing countries face specific challenges with regard to treaty policy. One of those challenges is the lack of technical experience and expertise, which generally applies to international tax issues more broadly. Two possible causes are the lack of an adequate institutional framework for undertaking tax policy analysis and the lack of experience in negotiating tax treaties. On the institutional front, many developing countries still do not have a dedicated tax policy unit, such that all policy-related matters are undertaken by the tax administration or agency. Further, the relatively low number of tax treaties in developing countries may render difficult the allocation of scarce resources to this specialized topic and accelerate the erosion of any prior institutional knowledge. Developing countries are consequently forced to play catch-up when approached to enter into treaty negotiations, which makes them particularly vulnerable to concluding bad treaties.

All countries—but developing countries in particular—should critically assess the extent to which a given tax treaty is truly reciprocal. Such an analysis should extend well beyond a de jure look at a tax treaty’s provisions and consider the domestic legislations of, and economic relationship between, contracting states. If the investment flows are largely unidirectional, as is the case for most low-income and lower-middle-income countries, the costs of forfeiting source-country taxing rights may be borne unilaterally by these countries.

---

86 Consequently, responsibility for tax policy design thus falls over and above other tasks, such that it inevitably does not receive the attention it deserves. In additional, policy recommendations by tax administrations may inadvertently give disproportionate weight to administrative considerations.
A careful analysis of the benefits and costs of tax treaties is needed to assess whether it is justified to enter into a particular negotiation. Developing countries will inevitably incur possibly large costs when agreeing to tax treaties, the size of which is mostly unknown, which is worrisome. However, tax treaties may also bring about potential benefits, although that should not be taken as a given. Historically, few developing countries have systematically conducted benefit-cost analyses to guide their choice of prospective treaty partners or to assess the merits of different tax treaties. Initiating such studies appears as a logical step in the way of guiding developing countries into adopting sound international tax policies. Ultimately, however, developing economies should be skeptical as to whether benefits of tax treaties outweigh their costs, and should view any one treaty as a treaty with the world, given the challenges in detecting and addressing treaty shopping.

Four provisions play a key role in distinguishing good from bad tax treaties. While historically broadly accepted, the permanent establishment concept seems outdated and ill suited to determine the true degree of economic integration between a nonresident enterprise and a given source country. A quantitative threshold based on the total volume of sales would appear justified as a complementary test to objectively establish permanent establishment status. On withholding taxes, different considerations arise for tax-deductible payments, such as interest and royalties, and for dividends, which are paid out of after-tax income. In any case, trade-offs exist between encouraging investment by reducing the cost of capital and ensuring proper source-country taxation, which generally points to the need to maintain withholding taxes, albeit at moderate levels. Taxation of cross-border services has proven problematic, in part due to the inappropriateness of the traditional permanent establishment test, and also due to the insufficiencies of the service permanent establishment provision proposed under the UN Model. Low-income countries would be well advised to retain the right to levy a final withholding tax on cross-border service fees as contemplated in the 2017 UN Model. Last, a specific challenge for resource-rich countries relates to indirect transfers of immovable property through the sale of shares in foreign entities, which may not be taxed in the country where the underlying property is located. This is inconsistent with the principles laid out under Article 6 of both models, to the effect that the strong linkage between immovable property and its location should give source countries unlimited taxing rights over the associated income or capital gain. Inclusion of paragraph 13(4) of the OECD and UN Models is thus important to safeguard source-country taxing rights, and so, too, is the inclusion of adequate sourcing and collection provisions under domestic law.

87 In the vast majority of cases involving a developed-developing country relationship, treaty negotiations are initiated by developed countries.
REFERENCES


