UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

TAXATION

UNCTAD Series
on issues in international investment agreements

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NOTE

UNCTAD serves as the focal point within the United Nations Secretariat for all matters related to foreign direct investment and transnational corporations. In the past, the Programme on Transnational Corporations was carried out by the United Nations Centre on Transnational Corporations (1975-1992) and the Transnational Corporations and Management Division of the United Nations Department of Economic and Social Development (1992-1993). In 1993, the Programme was transferred to the United Nations Conference on Trade and Development. UNCTAD seeks to further the understanding of the nature of transnational corporations and their contribution to development and to create an enabling environment for international investment and enterprise development. UNCTAD's work is carried out through intergovernmental deliberations, research and analysis, technical assistance activities, seminars, workshops and conferences.

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Two dots (..) indicate that data are not available or are not separately reported. Rows in tables have been omitted in those cases where no data are available for any of the elements in the row;

A dash (-) indicates that the item is equal to zero or its value is negligible;

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A slash (/) between dates representing years, e.g. 1994/95, indicates a financial year;

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IIA Issues Paper Series

The main purpose of the UNCTAD Series on issues in international investment agreements is to address key concepts and issues relevant to international investment agreements and to present them in a manner that is easily accessible to end-users. The series covers the following topics:

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Preface

The United Nations Conference on Trade and Development (UNCTAD) is implementing a work programme on a possible multilateral framework on investment, with a view towards assisting developing countries to participate as effectively as possible in international investment rule-making at the bilateral, regional, plurilateral and multilateral levels. The programme embraces capacity-building seminars, regional symposia, training courses, dialogues between negotiators and groups of civil society and the preparation of a series of issues papers.

This paper is part of that series. It is addressed to Government officials, corporate executives, representatives of non-governmental organizations, officials of international agencies and researchers. The series seeks to provide balanced analyses of issues that may arise in discussions about international investment agreements. Each study may be read by itself, independently of the others. Since, however, the issues treated closely interact with one another, the studies pay particular attention to such interactions.

The series is produced by a team led by Karl P. Sauvant and Pedro Roffe. The principal officer responsible for its production is John Gara who oversees the development of the papers at various stages. The members of the team include Mattheo Bushehri, Obiajulu Ihonor, dnna Joubin-Bret, Patricia Mira Ponton, Cynthia D. Wallace and Jörg Weber. The series' principal advisors are Arghyrios A. Fatouros, Sanjaya Lall and Peter T. Muchlinski. The present paper is based on a manuscript prepared by Dali Bouzoraa. Substantive supervision and inputs were provided by Cynthia D. Wallace. The final version reflects comments received from Susan Borkowski, Joachim Karl, Helmut Krabbe, Jeffrey Owens and Suresh Shende. The paper was desktop-published by Teresita Sabico.

Rubens Ricupero
Secretary-General of UNCTAD

Geneva, January 2000

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UNCTAD has carried out a number of activities related to the work programme in cooperation with other intergovernmental organizations, including the Secretariat of the Andean Community, L'agence intergouvernementale de la Francophonie, the Inter-Arab Investment Guarantee Corporation, the League of Arab States, the Organization of American States, and the World Trade Organization. UNCTAD has also cooperated with non-governmental organizations, including the Centro de Estudios Interdisciplinarios de Derecho Industrial y Económico - Universidad de Buenos Aires, the Consumer Unity and Trust Society - India, the Economic Research Forum - Cairo, the European Roundtable of Industrialists, the Friedrich Ebert Foundation, the International Confederation of Free Trade Unions, Oxfam, SOMO - Centre for Research on Multinational Corporations, the Third World Network, Universidad del Pacifico, University of the West Indies, and World Wildlife Fund International.

Funds for the work programme have so far been received from Australia, Brazil, Canada, France, the Netherlands, Norway, Switzerland, the United Kingdom and the European Commission. Countries such as China, Egypt, Guatemala, India, Jamaica, Morocco, Peru, Sri Lanka and Venezuela have also contributed to the work programme by hosting regional symposia. All of these contributions are gratefully acknowledged.

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Executive Summary

The paramount issue underlying all international tax considerations is how the revenue from taxes imposed on income earned by the entities of a transnational corporate system is allocated among countries. The resolution of this issue is the main purpose of international taxation agreements, which seek, among other things, to set out detailed allocation rules for different categories of income. While international tax agreements deal foremost with the elimination of double taxation, they also serve other purposes such as the provision of non-discrimination rules, the prevention of tax evasion, arbitration and conflict resolution.

The process of globalization, including growing transnational investment and trade, has increased the potential for conflict between tax jurisdictions. At the heart of jurisdictional conflict lies the issue of the jurisdiction to tax. There are no restrictions under international law to a legislative jurisdiction to impose and collect taxes. In most countries, the jurisdiction to tax is based on the domestic legislative process, which is an expression of national sovereignty. States apply their jurisdiction to tax, based on varying combinations of income source and residence principles. This, together with mismatches in definition, accounting and income recognition rules, may result in double taxation or, in some cases, in a jurisdictional vacuum.

A jurisdictional conflict arises when a taxable event falls under the jurisdiction of two or more sovereign powers. These are generally the source country and the country of residence. Jurisdictional conflicts can be, and often are, relieved unilaterally under both international investment agreements (IIAs) and double tax treaties (DTTs). The bulk of such arrangements is represented by bilateral agreements dealing exclusively with tax matters. However, taxation is also dealt with by a host of multilateral comprehensive or specific tax agreements, or bilateral agreements not dealing specifically with taxation.

Tax provisions do not typically form a principal part of IIAs, partly owing to the existence of the tax-specific DTTs. One reason for the limited role of taxation provisions in IIAs is that the inclusion of taxation matters can sometimes unduly complicate and draw out IIA negotiations and decrease the chances of successful conclusion. There nonetheless exists a wide range of models of tax provisions in IIAs, ranging from an exclusion of such issues from a treaty to the inclusion of very specific tax issues, notably the use of taxation as a means of administrative expropriation; as an incentive for investors from other countries that are members of a regional economic integration organization formed among developing countries; as a general statement of the responsibility of transnational corporations (TNCs) in the area of taxation; and as the basis for a taxation regime for regional multinational enterprises or supranational business associations. The final model involves a commitment in an IIA to avoid the double taxation of investors and/or investments. Such an agreement would be based on existing models, of which the OECD and United Nations model tax conventions are of special significance. The OECD Model Convention generally favours residence taxation, while the United Nations Model Convention generally favours source taxation. For developing countries, the OECD Model Convention may operate well under conditions of balanced economic relations such as exist between capital-exporting nations. However, it may not be as suited for the uni-directional capital flows that exist between most developed and developing countries.

DTTs themselves typically have clauses excluding national and most-favoured-nation (MFN) treatment from tax matters; and bilateral investment treaties, which provide for national and MFN treatment, typically exclude taxation from those provisions. This exemplifies the sensitive nature of the sovereign right of a State to tax.

IIAs and international tax arrangements have evolved a number of approaches in relation to the jurisdiction to tax:

- the exclusion of tax issues model;
- the qualified exclusion model;
- the tax incentives model;

- the TNC tax responsibility model;
- the regional multinational enterprise taxation model.

Even in cases where there is no double taxation to relieve (e.g. if there is no tax in one State or if the country of residence unilaterally avoids double taxation), a tax treaty can be useful as it generally offers greater and more comprehensive protection than that available under domestic rules, which can be modified at will. Indeed, the single most important advantage of a tax treaty is the relative legal certainty if offers to investors with respect to their tax position in both the source and residence countries. In addition, a country can create, through tax treaties, new business opportunities. Various efforts at multilateral agreements have been made, but with little success to date. Those that have experienced some success have been supplemented by bilateral arrangements among the various parties.

In taking into account all of the above considerations, the important issues to note are that countries that opt for the conclusion of international tax arrangements need to be aware of the tax system of the treaty partner and to draft an arrangement in such a way as to exploit all synergies with that tax system and preserve their tax base, or (and most importantly for developing countries) at least leave the opportunities open for implementing any source-based options.

INTRODUCTION

The paramount issue underlying all international tax considerations is how the revenue from taxes imposed on income earned by associated entities of a TNC is allocated among countries, i.e. how appropriately to allocate business income between associated entities of a TNC and how equitably to divide or share the revenues from foreign affiliates between host and home countries. The resolution of this issue is the main purpose of international taxation agreements, which seek, inter alia, to set out detailed allocation rules for different categories of income, for example, income (e.g. from real property) taxable without restriction in the source country, and income (e.g. interest income) subject to limited taxation in the source country (UNCTAD, 1998b).

Most countries assess taxes by reference to a connection between the taxpayer and/or the taxable transaction with their territory. International taxation issues have their origin in the framework of pure export/import activities between unrelated parties. Here the tax implications are more often than not restricted to indirect taxes such as customs duties and value-added tax. The mode of operation of such taxes is generally not conflict-prone, in that it does not involve a double imposition of taxes, since such taxes arise at the point of entry into, or at the point of resale within, the taxing jurisdiction. Even indirect taxes, however, impact upon foreign direct investment (FDI) in that they have implications for direct taxes, since two or more States may at the same time consider that a connection exists between a taxpayer or a taxable event and their territories. Therefore, the same taxpayer or taxable event may fall under the fiscal sovereignty of two or more jurisdictions (double taxation), or may fully or substantially escape taxation in all jurisdictions involved. At the same time, the global integration of the world economy and the expansion of investment and trade conducted by TNCs has added a new dimension to taxation issues.

Many countries unilaterally avoid the concurrent exercise of taxing rights, whether in pursuit of economic policies (e.g. capital-export neutrality) or simply because they recognize limits to the

enforcement of national tax laws beyond their territories. At the same time, an increasing number of countries, faced with the challenges of tax-base erosion, have extended their tax jurisdictions to persons and/or taxable events outside their territories. This often requires the negotiation of international tax arrangements. Because tax arrangements have a direct and indirect impact on the revenues of the contracting parties, the manner in which they are drafted and applied is of crucial importance to policy makers.

This paper concentrates on how various international tax issues related to FDI have been addressed in international investment agreements (IIAs) and in international tax arrangements, as well as policy options for developing countries in this regard.

Section I

EXPLANATION OF THE ISSUE

Globalization and increased transnational investment and trade imply a potential conflict of tax jurisdictions or, in certain circumstances, a jurisdictional vacuum. Central to the question of jurisdictional conflict is the issue of the jurisdiction to tax: the sovereign right of two or more jurisdictions to levy tax on one and the same event or one and the same taxpayer. Where there are mismatches between national tax laws, the jurisdictional conflict can be exacerbated by improper conduct on the part of taxpayers. Jurisdictional conflicts can be, and often are, relieved unilaterally under national tax laws, or bilaterally - and sometimes even multilaterally - under tax treaties, although the question as to which jurisdiction should bear the burden of relief is important and not uncontroversial, due to legitimate concerns about the erosion of the tax base. This is generally achieved through the elimination of definitional mismatches or the relief of double taxation.

A. The jurisdiction to tax

In most countries, the jurisdiction to tax is based on the domestic legislative process, which is an expression of national sovereignty, thus heightening the sensitivity of the surrounding issues. There are no restrictions under international law to the legislative jurisdiction to impose and collect taxes. In principle, international tax agreements do not restrict the contracting parties' legislative jurisdiction (although they may restrict the application of tax rules enacted pursuant to that jurisdiction). It is only in rare situations that such tax arrangements may impact directly on the legislative jurisdiction.[1]

Nevertheless, the impact of a country's legislative jurisdiction is restricted by the obvious limitations on its enforcement powers beyond its own national boundaries (Sandler, 1998). In other words, the unrestricted exercise of the right to impose and collect taxes is rather limited if the resulting rules cannot be enforced outside

the regulating state's own territory. Thus, most countries exercise their jurisdiction to tax by reference to factors that assume a sufficient connection between the relevant country and the taxable person and/or the taxable income.

Taxation systems based on a sufficient connection between the relevant country and the taxable person apply the principle of "residence-based taxation". Countries applying such a principle tax their residents (and sometimes their nationals) on their worldwide income, wherever derived. One method of assessing the allocation of income, which has been the subject of some controversy on jurisdictional grounds, is the "unitary taxation" method (box 1).

Taxation systems based on a sufficient connection between the relevant country and the taxable income apply the principle of "source-based taxation". Countries applying such a principle tax income derived from sources in their territory, regardless of the residence of the person deriving the income.

Most countries apply a combination of residence-based and source-based taxation. Hence, residents (and sometimes nationals, whether or not resident)[2] are taxable on their worldwide income under what is generally referred to as an "unlimited tax liability". In contrast, non-residents are taxable only on income derived or deemed to be derived from sources within the territory, under what is generally referred to as a "limited tax liability".

Box 1. Unitary tax

The unitary tax method rests on the assumption that it is too difficult to determine precisely what taxable income is being generated by any particular taxable person and, hence, what should be allocated to that person. Instead, a proportion of the worldwide income is allocated to the taxing jurisdiction, based on the relationship of assets, payroll and sales (or formulae taking into account several combinations of the same) of the taxable person (in the case of TNCs, the foreign affiliate) located within that tax jurisdiction to the TNC's worldwide assets, payroll and sales. In effect, this method pierces the corporate veil of foreign affiliates and treats all related affiliates as one corporation.

/...

Box 1 (concluded)

Critics of this method have argued, among other things, that the unitary tax method could have, as a side effect, deterrence potential as regards investment in States that choose to apply it. The method has been applied notably by certain States of the United States, in an attempt to avert possible distortive effects of transfer pricing. But a study conducted in 1982 by a large United States accounting firm showed that corporate taxation schemes do not play a definitive role in a corporation's locational decisions (Allen, 1984). The study notwithstanding, largely for the very fear of discouraging incoming investment or of encouraging disinvestment by foreign companies already established, most of the United States' States which originally adopted the unitary tax method have in fact abandoned it, and it has ceased to be a serious issue (Wallace, 2000).

It is nonetheless worth noting another criticism of the method, namely that unitary taxation assumes that profit is uniformly related to all stages in an integrated production system and that production costs are the same in different countries; in practice, however, this is not so in the majority of cases. Also, if the operations of a firm in a unitary taxation jurisdiction are more profitable (more efficient) than the rest of its worldwide operations, the affiliate company would be likely to pay lower taxes under that method than under a regular arm's-length method; conversely, if the local operations are less profitable (less efficient), the local company is likely to pay higher taxes under this method than under the arm's-length method. In effect, unprofitable firms would be more likely to pay more taxes in relation to their real income than profitable ones. To avoid those distortions, a complex analysis would be needed of the different functions of the various associated firms and the different risks and profit opportunities at various stages of production. Such calculations require complete information about all the activities of the TNC as a whole. In addition, a number of Governments and TNCs have argued that this approach runs counter to the internationally accepted arm's-length principle and exposes TNCs to double taxation (UNCTAD, 1993).

Source: UNCTAD.

1. Jurisdictional conflicts

A jurisdictional conflict arises when a taxable event falls under the jurisdiction of two or more sovereign powers.[3] These are generally the source countries and the countries of residence. The source country is where the activity is exercised, where the payer is resident, or where the property producing the income is situated. The country of residence is where the persons deriving the income or the owners of the property producing the income have their residence or domicile.

The same occurrence may be regarded as a taxable event by the source country because it involves income sourced therefrom or property situated therein, but also by the country of residence because the income accrues to, or the property is owned by, one of its residents. For example, a company resident in country A conducting business through an affiliate in country B, could be taxed in country A on its worldwide income (including that derived through the branch) if country A has a residence-based taxation system. At the same time, the affiliate could be taxed by country B on the income derived through the affiliate if country B has a source-based taxation system. The concurrent exercise of their taxing rights by the country of residence (A) and the source country (B) leads to double taxation. Thus, double taxation can be defined, in a non-exhaustive way, as the imposition of comparable taxes by two or more sovereign countries on the same item of income of the same taxable person for the same taxable period (Rivier, 1983; Arnold and McIntyre, 1995; OECD, 1997).

Double taxation most often occurs when both the source country and the country of residence concurrently exercise their taxing right without providing full relief for the other country's tax. However, double taxation can also occur in various other situations, in particular as a result of definition and/or income classification differences between different taxing authorities. Hence, a person considered as a resident by two or more States by virtue of different definitions can be taxed in each of the States involved. This can be the case for individuals maintaining habitual abode or conducting professional activities in two or more countries. It can also be the case for companies operating in countries with

different corporate laws. For example, a company may be incorporated under the laws of country A which determines residence by reference to the place of incorporation (i.e. it considers as a resident any company incorporated under its laws). At the same time, the company may be effectively managed and controlled from country B which determines residence by reference to the place of effective management. Such a company would meet the residence test in both countries and can therefore be taxed as a resident by both countries A and B.

Likewise, two or more States which each deem, by their own definition, an item of income to arise from sources within their territory can concurrently tax the same item of income. Finally, double taxation can also result from mismatches in accounting standards or in the timing of income recognition.

Occurrences of double taxation are sometimes classified as "juridical" and sometimes as "economic". Juridical double taxation occurs when one and the same person is taxed on the same income by two or more States. Double taxation is classified as economic when two *separate persons* are each taxed on the same income by two or more States (box 2).

Box 2. Juridical and economic double taxation

Juridical double taxation

Example 1:

Xco is resident in country A and operates an affiliate in country B. Xco is taxed in country A on its worldwide income (including that derived through the foreign affiliate). It is also taxed in country B on the income derived through its affiliate therein. There is juridical double taxation because one and the same taxpayer (Xco) is taxed on the same income (that of the affiliate) by two States (countries A and B).

Example 2:

Xco is resident in country A and is a shareholder in a company resident in country B. If the latter company pays dividends to Xco,

/...

Box 2 (concluded)

such dividends can be taxed by country A pursuant to the residence principle and also by country B pursuant to the source principle.

Economic double taxation

Example 1:

Affiliate company Xco realizes $100 of income and is taxed on that income in its country of residence A at 40 per cent. Xco distributes the after-tax income ($60) to its parent company Yco which parent company is taxed in its country of residence A on the income received from Xco at 35 per cent. Ultimately, the income realized by Xco was taxed twice, a first time by country A at the level of Xco and a second time by country B at the level of Yco. The total tax would have amounted to 61 per cent.

Example 2:

Xco sells goods to its parent company Yco for $100 which amount is taxable to Xco in its residence country A and deductible to Yco in country B. The tax authorities of country A determine that the price is too low and adjust it to $150, while the tax authorities of B refuse to grant Yco a corresponding adjustment (i.e. an additional deduction of $50). Therefore, the amount of $50 is taxed twice, first as an additional income for Xco and then as a non-deductible expense for Yco.

2. Jurisdictional vacuums

Overlapping tax jurisdictions can, as shown above, result in over-taxation, but can also give rise to under taxation or even effective non-taxation, stemming from mismatches between the national tax laws. Hence, if source country A grants an exemption to a specific item of income (e.g. in the framework of a tax incentive scheme), and residence country B relieves the double taxation of foreign income of its residents by applying the exemption method (see part B. 2. b, below), the item of income derived by a resident of country B from source country A will effectively escape taxation in both countries. Such situations may be exploited by both legitimate

and illegitimate tax planning techniques. Many countries have designed rules to prevent the occurrence of such phenomena, in particular when it is expected that it may be aggravated by tax payers planning techniques that are not in conformity with policy intentions.

Within this context arises perhaps the major legal preoccupation in the area of taxation as it pertains to TNCs (for both Governments and TNCs themselves): curtailing tax evasion brought about by transfer pricing abuses. Transfer pricing practices are now considered one of the leading international tax issues (UNCTAD, 1999a).

The term "transfer pricing" denotes that practice whereby a TNC, in its intra-enterprise transactions, can sometimes effectively modify the tax base on which its entities are assessed, or possibly avoid exchange controls where such exist. This is accomplished by "doing business" within the TNC corporate structure itself so as to reallocate costs and revenues in such a way that its profits are realized where the tax and exchange environment is the most favourable (Wallace, 2000). Even though, as with tax havens, the national legislation primarily addresses outbound transfers from the legislating State's own parent companies to their foreign affiliates, this issue is of common international concern and is highly relevant to foreign investors conducting cross-border transactions within their corporate systems. Moreover, the control of transfer pricing abuses is rendered largely impracticable without cooperation between nation-States. It is particularly worthy of note that transfer pricing regulations are among the few aimed primarily at TNC operations, in that it is not a real issue within a strictly national context (ibid.). One additional issue which should be mentioned in conjunction with transfer pricing is the prevention of tax evasion and the role of international tax treaties, mutual assistance and information exchange in this connection.

B. Avoidance of double taxation

In order to avoid the situation of tax being levied twice on the same income, in the forms described above, and to address the question of jurisdictional overlaps in income allocation, various solutions have been sought to deal with the problem. They can

be unilateral or international. Unilateral measures are not addressed in detail in this paper. Generally, unilateral measures are dictated by economic policy choices. For example, many capital-exporting countries exempt the foreign-source income of their TNCs in order not to put them at a competitive disadvantage in third country markets vis-à-vis TNCs of other countries. On the other hand, for many capital-importing countries, the most obvious unilateral restraint is represented by tax incentives aimed at attracting FDI. Also, in order to attract capital, many countries exempt interest-remunerating bank deposits of non-residents. Sometimes unilateral restraint measures are simply dictated by restrictions on a country's possible enforcement jurisdiction of its own laws outside its own territory.

International measures for the mitigation of double taxation problems can take various forms. Most important and most common among them are comprehensive double tax treaties (DTT). There are several reasons why tax treaties are useful and important. From the perspective of a capital-exporting country, a tax treaty is important in that it affords its own enterprises, to the extent possible, a level playing field in a given foreign market, in comparison with enterprises of other capital-exporting countries. At the same time, bilateral tax treaties also create possibilities for the exchange of information between capital-exporting and capital-importing countries and can support the prevention of fraud and abuse. The overwhelming majority of comprehensive double tax treaties is represented by *bilateral* agreements dealing exclusively with taxation matters in regard to income and, sometimes, capital. A limited number of multilateral instruments dealing exclusively with taxation matters have also been concluded. Additionally, various other types of bilateral agreements deal with some tax matters, whether exclusively or only in a very partial way. These include inheritance and gift tax treaties,[4] air and/or sea transport agreements, investment promotion and protection agreements, consular and diplomatic conventions, and cultural, technical and scientific cooperation agreements.

The avoidance of double taxation does not mean granting the taxpayer the advantage of the lowest tax. Indeed, its only purpose

is to avoid the accumulation of concurrent taxes. This is generally achieved through two simultaneous means:

- the elimination of definition mismatches; and
- the provision of relief for the tax borne in one of the contracting States.

1. Elimination of definition mismatches

One of the underlying causes of double taxation occurrences is definition mismatches. Indeed, as mentioned above, two or more countries can each consider the same taxpayer to be a resident pursuant to the definition of residence under their domestic laws, in which case the taxpayer could be taxed as a resident by each of the countries involved. Also, two or more countries can, in the application of their domestic laws, consider a given item of income to be connected to sources within their territories, in which case each of the countries involved would tax the relevant item of income.

Tax treaties eliminate such definition mismatches, to a certain extent, by providing for commonly agreed definitions. Hence, with respect to the determination of residence, treaties provide for the application of a number of criteria, such as:

- the availability of a home or permanent abode;
- the location of the taxpayer's centre of economic interest; or,
- for legal entities, the location of the statutory seat or of the place of effective management.

In case the application of these criteria does not resolve the residence determination issue, a so-called tie-breaker clause is applied to reach a solution. A tie-breaker clause could, for example, determine that a person is resident in the country of which it is a national, or in the country where effective management is located. In other circumstances, the clause could provide for the application of a mutual agreement procedure.

A treaty can also eliminate definition mismatches by providing agreed definitions of the concept of various types of income. For example, it can provide that income from profit-sharing bonds should be treated as a distribution of dividends rather than as interest payment, or that the concept of dividends does not cover constructive dividends. In most cases, however, the income definition clause also refers to the definition under the domestic law of the source country. For example, article 10 (3) of the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital (OECD Model Convention) provides:

> "The term "dividends" as used in this Article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident" (OECD, 1997, p. M-21).

Because such a clause is referenced to domestic laws, the elimination of definition mismatches may be incomplete, since the other contracting party need not necessarily follow the definition determined under the domestic laws of the source country. However, in some cases (mostly related to older treaties), the definition does not refer back to domestic law so that the parties are bound by the definition contained in the treaty. For example, article VIII, paragraph 7, of the 1962 Austria-Egypt tax treaty provides that:

> "In this Article, the term "dividends" includes in the case of the United Arab Republic profits distributed by a company to its founder share-holders as well as profits distributed to ... and in the case of Austria profits distributed by [a company with limited liability]" (IBFD, 1986 --).

2. Relief from double taxation

Relief from double taxation generally follows one of three methods:

- the deduction method;
- the credit method; or
- the exemption method.

The least applied of the three is the deduction method. Under the deduction method, which is normally applied by the country of residence, the foreign tax is treated as a deductible expense so that the income is taxed net of foreign tax. This method is generally the least favourable to the taxpayer. It is usually used as a unilateral tool in the absence of a tax treaty. International tax arrangements, whether bilateral or multilateral, normally prevent double taxation through the credit method or the exemption method.

a. The credit method

Under the credit method, the country of residence taxes the foreign income of its residents but allows the foreign tax as a credit against its own tax. Generally, it does not refund excess foreign tax over its own tax. The ultimate tax liability of the taxpayer is, therefore, the *higher* of the domestic or foreign tax (box 3).

Box 3. Double taxation relief under the credit method

Xco is resident in country X (corporate tax rate 40 per cent) and operates an affiliate in country Y (corporate tax rate 30 per cent). The affiliate derives $100 of income and pays $30 tax in Y. The remainder ($70) is remitted to X where it could be grossed up to $100 and taxed at 40 per cent resulting in a corporate tax liability of $40. However, since Xco is entitled to a credit for the tax paid in Y, it only pays $10 of tax in X (i.e. 40 less 30). Its ultimate tax liability therefore amounts to $40 (i.e. $30 in Y tax and $10 in X tax). If the corporate tax rates were reversed (i.e. 30 per cent in X and 40 per cent in Y), Xco will end up not paying any tax in X (since the tax credit is higher than X corporate tax and X does not refund excess foreign tax), but it would have paid in total $40 in Y tax. Therefore, in both situations, the ultimate tax liability of Xco is the higher of the domestic or foreign tax.

A variation of the credit method is the "tax sparing" or "matching credit" method, under which the country of residence in effect grants a credit for a tax that is higher than the tax actually levied

in the source country. The matching credit issue has been considered important by many developing countries and is addressed in greater detail under section II.

The credit method attempts to achieve full "horizontal equity" more effectively than the deduction or exemption method. Under the horizontal equity theory, resident taxpayers pay the same amount of tax regardless of whether they derive domestic-source or foreign-source income. However, the credit method is complex from both a compliance and an enforcement perspective, as the foreign income needs to be recomputed according to domestic rules. It may also discourage investments abroad or encourage the deferral (i.e. non-repatriation) of types of foreign income, such as dividends, which are normally not assessed for tax in the country of residence until actually received. Since the taxpayer's ultimate tax liability is the higher of the country of residence and source country tax, the source country can manipulate the credit method to its advantage by increasing its own tax up to the amount of the country of residence tax without, on balance, aggravating the ultimate tax position of the investor.

b. The exemption method

Under the exemption method, the country of residence disregards the foreign-source income of its residents. The foreign tax is, therefore, the only tax burden borne by that income. This method is most favourable to the taxpayer if the source country tax is lower than the country of residence tax. It is also easily enforceable, fosters capital-import neutrality and, in principle, does not encourage deferral of income. However, it is more prone to abuse and can cause discrimination between residents, depending on whether they realize domestic or foreign income.

Normally, the exemption method is applied by the country of residence. For certain types of income, however, tax arrangements may require the source country to exempt the income. This is generally the case for passive income, including royalties and capital gains.

A variation of the exemption method is the "exemption with progression" method under which the foreign-source income, while exempt from tax, is taken into account in determining the rate of tax applicable to the taxpayer's remaining income. This, of course, is relevant only when tax is levied at progressive rates.

Notes

1 This is, for example, the case under the 1963 France-Monaco tax agreement which requires Monaco to introduce and levy a tax on profits pursuant to a taxable base and a tax rate determined by the agreement. Also, within the European Union, directives and regulations may have a direct effect in the member States and may impact on their legislative jurisdiction (IBFD, 1986 --).

2 A limited number of countries, such as the Philippines and the United States, determine their jurisdiction to tax on the basis of nationality.

3 The use of the term "jurisdiction" refers to sovereign States. Conflicts arising from the application of concurring taxing rights by political or territorial sub-divisions of the same State are not addressed in this paper.

4 Inheritance and/or gift tax treaties are fewer in number than comprehensive income tax treaties, but their number is increasing (for example, 6 such treaties for Italy, 7 for Austria and the Netherlands, and 35 for France). The texts of all such treaties are reproduced in the IBFD's tax treaties CD ROM (IBFD, 1986--).

Section II

STOCKTAKING AND ANALYSIS

Taxation provisions have, to date, not played a major role in IIAs. This is explicable partly by the highly specialized nature of such issues and partly by the fact that, as a result, taxation experts and investment experts have not developed an extensive dialogue. Indeed, taxation may be seen as something of an expert "niche". This has been partially resolved by the creation of double taxation agreements with an investment component.

Despite the marginal treatment of taxation issues in IIAs, the proliferation of DTTs is one important indication that taxation has far-reaching implications for the conduct of FDI operations by TNCs. Thus, in this section of the paper, not only are tax provisions in IIAs considered but also the investment-related provisions of tax agreements. A brief historical perspective helps to provide the proper context for the ensuing discussion.

A. An historical perspective

Various types of international agreements deal with taxation matters, either exclusively or partially. The most important of these are comprehensive DTTs which deal with taxes on income and, sometimes, capital. There are also a number of international tax agreements dealing with specific tax matters, such as mutual assistance and exchange of information. Treaties dealing exclusively with the elimination of double taxation with respect to inheritance and/or gift tax are numerous but are not addressed in this paper.

International arrangements dealing exclusively with taxation matters with respect to income and capital can be divided into bilateral and multilateral arrangements. With over 1,800 arrangements concluded by the end of 1998 (UNCTAD, 1999d), bilateral DTTs represent the immense majority of all international tax arrangements.

Most international tax arrangements are drafted along a combination of the provisions of the OECD Model Convention (OECD, 1997) and those of the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model Convention) (IBFD, 1986--).[1]

1. Bilateral arrangements

a. The evolution of double tax treaties

Many tax historians regard the France-Belgium agreement of 12 August 1843 on mutual administrative assistance (Convention pour régler les relations des administrations de l'enregistrement de France et de Belgique) (Parry, 1843) as the first international agreement dealing with tax matters (Gouthière, 1991). Nevertheless, the development of international taxation and of the study of the issues raised by double taxation started only soon after the beginning of the twentieth century.

In 1921, the Finance Committee of the League of Nations was entrusted with a study of the economic aspects of international double taxation. That work was concluded by the drafting of the first model at the Geneva conference of 1928 (LoN, 1928) in which 27 countries took part. In 1928, the League of Nations established a permanent fiscal committee which was entrusted with the formulation of rules governing the taxation of enterprises active in various countries. A draft convention was elaborated in 1935 and revised in Mexico in 1943 (LoN, 1945). However, the Mexico model was regarded by developed countries as too biased towards the source-country principle, and was amended at the London conference of 1946 (LoN, 1946). In its turn, the London model was deemed too favourable to developed countries. Negotiations between developing and developed countries stalled in 1954, and work on double taxation matters continued in two separate frameworks, namely the OECD and the United Nations.

In 1967, the Economic and Social Council of the United Nations (ECOSOC) stressed the need to conclude tax treaties between developed and developing countries (UN-ECOSOC, 1967). An ad hoc group of experts on international cooperation in tax matters was formed. The group, which consists of experts proposed by Governments but acting in their personal capacity, elaborated the United Nations Model Convention of 1980 (UN-ECOSOC, 1980) and the "Manual for the Negotiations of Bilateral Tax Treaties between Developed and Developing Countries" (UN-ECOSOC, 1979). The group continued to meet regularly, including, for example, as a focus group in March 1999, in order to discuss international tax developments and the possible need to update the model.

Developed countries have continued to coordinate their work on international tax issues in the framework of the Fiscal Committee of the OECD.[2] One result was the elaboration of the 1963 draft model (OECD, 1963), later revised as the 1977 model Convention (OECD, 1977).[3] The 1977 model was revised in September 1992 and later published in loose-leaf form so as to facilitate updating the text and commentaries (OECD, 1992).[4]

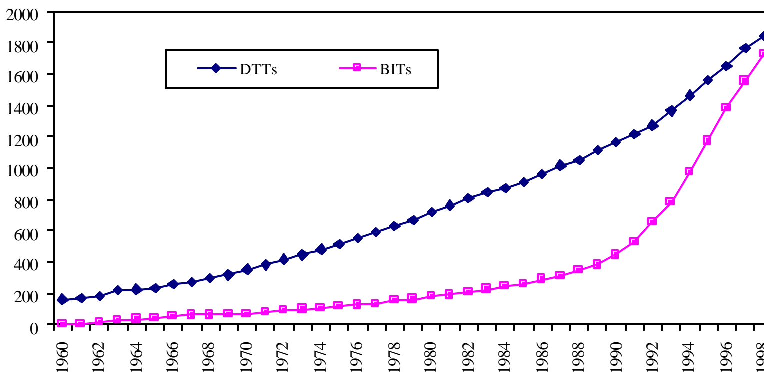
The great majority of the over 1,800 DTTs are now based on either the United Nations or OECD models (with variations that reflect the specifics of the bilateral relationship between the contracting parties).

Nevertheless, being bilateral agreements, DTTs rarely adopt the form of one model but rather tend to reflect a compromise between the positions of both parties.

b. The universe of double tax treaties[5]

The number of DTTs has increased rapidly during the past four decades (figure 1). By the end of 1998, 1,844 treaties, covering 182 countries and territories, were in existence. This compares with 1,726 bilateral investment treaties (BITs) involving 174 countries at the end of 1998. Between 1960 and 1998, the rate of increase for DTTs held steady, while the rate of increase for BITs rose sharply in the late 1980s.

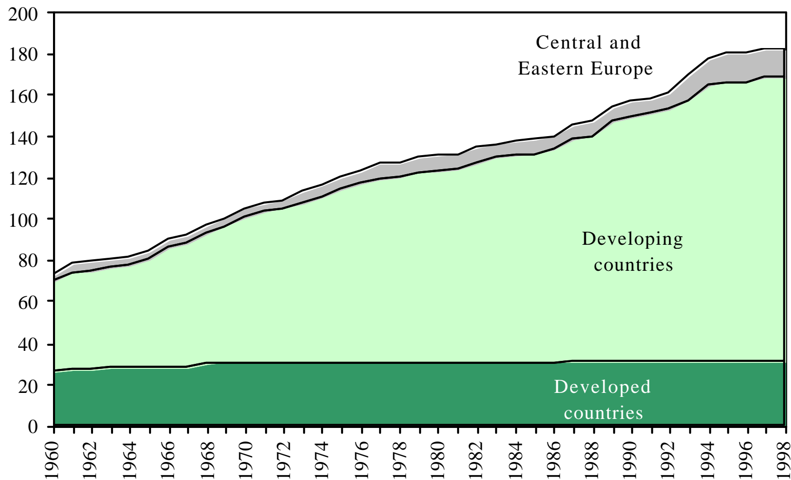
Figure 1. Cumulative number of DTTs and BITs, 1960-1998



Source: UNCTAD, database on BITs and database on DTTs.

As developed countries were traditionally the principal home and host countries for TNCs, DTT issues arose primarily between these countries, explaining why most of the earlier DTTs were between developed countries. (BITs, on the other hand, were initially concluded primarily between developed and developing countries, as developing countries were seen to involve certain risks for investors.) Over the years, however, as first the developing countries and then the countries in Central and Eastern Europe became important host countries for FDI and also emerged as home countries, the universe of tax treaties expanded to include them (figure 2). As developing countries became outward investors, and a growing part of their investment was in other developing countries (especially in Asia), they also began to conclude both types of treaties. The increased participation of developing countries and -- later -- countries in Central and Eastern Europe has not been limited to concluding agreements with developed countries. Indeed, since the 1980s, DTTs are increasingly being concluded between developing countries *inter se*, and between countries in Central and Eastern Europe *inter se*, as well as between developing countries on the one hand and countries in Central and Eastern Europe on the other (figure 3).

Figure 2. Number of countries and territories with DTTs, 1960-1998



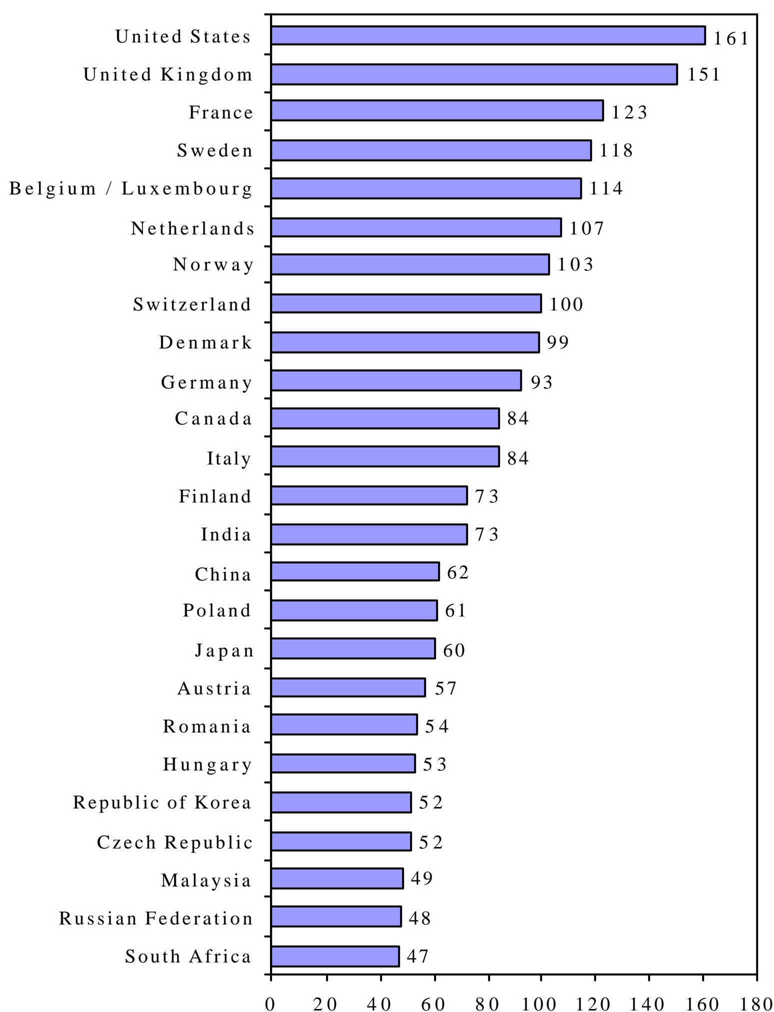
Source: UNCTAD, database on DTTs.

Other salient features of the universe of DTTs (figures 1-4) are as follows:

- Whereas the top 10 countries with the highest number of BITs include two developing countries (India, China and Egypt) and two countries in Central and Eastern Europe (Romania and Poland), *all* of the top ten countries with the highest number of DTTs concluded are developed countries.

- The most prolific countries concluding DTTs in the 1990s have been the countries of Central and Eastern Europe. The leaders are Poland and Romania, with 61 and 54 treaties respectively. The region also has the second highest number of DTTs per country and the third highest number of intraregional DTTs.

Figure 3. Number of DTTs concluded: top 20, as of end December 1998



Source: UNCTAD, database on DTTs.

- Thirty-nine African countries (excluding South Africa) have signed a total of 272 DTTs. Of these, only 18 are between themselves. The average number of DTTs per country grew rapidly for North Africa in the 1970s and 1980s, most of the growth being attributable to Egypt, Morocco and Tunisia.

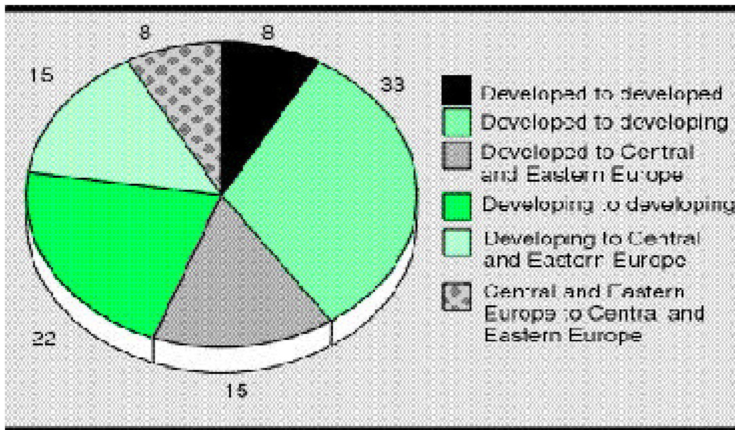
- Countries in Asia and the Pacific intensified their DTT activity in the 1980s. During the 1960s they had signed only 29 tax treaties and hence had a very low average number of treaties per country in the region. Since then, 53 countries have signed a total of 790 treaties. Part of the growth in this number includes a substantial increase in the number of DTTs concluded within the region. Of the countries in Central Asia, Kazakhstan led with 20 treaties. Not surprisingly, the most active in the region were the East Asian countries.

- Latin American and Caribbean countries have signed a total of 241 treaties, but only 11 of these are intraregional. Brazil and Mexico lead the region with 28 and 25 treaties, respectively. This region has one of the lowest number of DTTs per country.

- The United States has signed 161 DTTs, the highest number of any developed country, followed by the United Kingdom with 151 treaties.

If the universe of DTTs is compared with the universe of BITs it needs to be kept in mind that both types of treaties have specific but distinct purposes. The principal purpose of DTTs is to deal with issues arising out of the allocation of revenues between countries; the principal purpose of BITs is to protect the investments that generate these revenues (and tax issues are excluded from their provisions). The two types of treaties are therefore complementary. At the same time, the universes of BITs and DTTs, although having started from different points and for different — but complementary — purposes, are evolving in the same direction. The propensity to sign both types of treaties has increased, which is a reflection of the growing role of FDI in the world economy and the desire of countries to facilitate it.

Figure 4. DTTs concluded in 1998, by country group[a]
(percentage)



Source: UNCTAD, FDI/TNC database.

[a] A total number of 79 DTTs were concluded in 1998.

2. Multilateral arrangements

While there was some initial discussion by the the League of Nations on the possibility of developing a multilateral tax treaty only, a small group of academics (Lang et al., 1998) have recently discussed this option. Countries have, in general, preferred the bilateral form. In order better to appreciate this preference, it is useful to understand why a tax treaty has traditionally been essentially a bilateral exercise. Three main arguments supporting the bilateral form are:

- A bilateral treaty is necessarily based on the specific tax systems of the negotiating parties. Hence, one party may insist on levying a withholding tax on a given item of income because the other party exempts that item of income under

its domestic laws (otherwise the relevant income would escape taxation altogether). The same reasoning is not necessarily valid in relation to a third country.

- A bilateral treaty is necessarily based on the economic relationship between the parties involved. The parties agree to reciprocal concessions on the premise that the tradeoff is globally balanced. Hence, one party may agree to a concession with respect to a given item of income on the premise that it gains with respect to another item of income. The same reasoning may not necessarily apply in relation to a third country, as the economic relationship and financial flows with that third country can be different.

- It is unclear how, in practice, a multilateral treaty would be negotiated with a large group of countries.

The main arguments in favour of a multilateral agreement are:

- A multilateral treaty helps to avoid competitive distortions by eliminating one additional -- even if minor -- obstacle that might exert a negative influence or even play a key role in the decision-making process as to where to invest. Where the principal FDI determinants (UNCTAD, 1998, ch. IV) are essentially equal, TNCs may direct their capital towards those countries where the most favourable treaty provisions afford them the greatest protection.[6] This could actually lead to harmful tax competition to attract FDI (OECD, 1998b). A multilateral double taxation convention can neutralize the otherwise potentially distortive effects of differing bilateral arrangements and thereby avoid possible competitive advantages or disadvantages among host countries.

- A multilateral treaty helps to improve legal certainty by offering a more uniform interpretation of the various laws on taxation. Even though the commentary on the OECD Model Convention (OECD, 1997) recommends that bilateral treaties resort to its interpretations whenever provisions of the OECD Model Convention are incoporated into bilateral treaties, only a multilateral convention can assure that the interpretation

given to a given provision is applied equally among all treaty partners.

- In a multilateral treaty, the effect of treaty revisions is immediate. While the OECD Model Convention undergoes constant review and periodic revision, which then is ideally to be translated into corresponding adjustments to provisions in individual countries' bilateral tax treaties, revisions to a multilateral treaty are simultaneously applicable in all signatory States (Loukota, 1998).

Over the years, various attempts at reaching multilateral tax agreements have met varying degrees of success. The 1922 South-East European multilateral double taxation tax agreement (Convention pour éviter la double imposition) (L'Institut de Droit Public, 1934), signed between Austria, Hungary, Italy, Romania and the Kingdom of the Serbs, Croats and Slovenes, is one of the first multilateral DTTs ever concluded. This was followed by a number of unsuccessful attempts. In 1931, a sub-committee of the Fiscal Committee of the League of Nations prepared a "Draft Multilateral Convention for the Prevention of the Double Taxation of Certain Categories of Income" (LoN, 1931). In 1968, the European Commission prepared a preliminary draft for a multilateral DTT, which was ultimately abandoned. A year later, a working group of the European Free Trade Association (EFTA) made another effort to formulate a draft multilateral DTT, but this also failed to be realized. However, the work undertaken by EFTA formed the basis of the Convention between the Nordic countries for the avoidance of double taxation with respect to taxes on income and on capital (Nordic Convention) (1983) (IBFD, 1986 --), a multilateral tax treaty among the Nordic countries finally replaced by the treaty of 23 September 1996 (ibid.).

Of the limited number of multilateral comprehensive DTTs that were eventually concluded, it appears that the 1983 Nordic Convention is the only one that functions adequately (Mattsson, 1985), even if at the cost of additional complications. Other conventions have lost their substance (e.g. the 1973 Arab Tax Treaty concluded between members of the Arab Economic Unity Council (IBFD, 1986 --)[7] and the Council of Mutual Economic Assistance

Convention (COMECON) between members of the former socialist countries (ibid.)),[8] often, as with the latter example, as a result of the decomposition of the ideological and/or regional settings that justified them in the first place. Therefore, whether or not they remain in force, they are largely irrelevant -- other than, for example, in the case of COMECON where in certain cases two countries have specifically agreed between themselves to regard the agreement on a bilateral basis.

It should be noted, however, that non-comprehensive multilateral tax agreements dealing with specific issues have had a greater degree of success. Most of these deal with administrative assistance and include the Council of Europe / OECD Convention on Mutual Administrative Assistance in Tax Matters of 25 January 1988 (ibid.) and the Convention between the Nordic countries on mutual administrative assistance in tax matters of 7 December 1989 (ibid.). Exceptions include the EC Convention on the Elimination of Double Taxation with Connection to the Adjustment of Profits of Associated Enterprises of 23 July 1990 (Arbitration Convention) (ibid.) which deals with transfer pricing adjustments (UNCTAD, 1999a) and the Nordic Convention for the avoidance of double taxation with respect to taxes on inheritances and gifts of 12 September 1989 (IBFD, 1986--). Agreements on the privileges and immunities of various international organizations also contain fiscal provisions.

The difficulties of concluding *any* multilateral treaty increase exponentially with the number of parties. Owing to the particular sensitivity of Governments with respect to compromises in the sovereign right to tax, this difficulty appears to be exacerbated when it comes to the elaboration of multilateral DTTs. For this reason, although the OECD Fiscal Affairs Committee does not discourage the conclusion of multilateral conventions between specific sub-groups of member countries, it has traditionally considered that the conclusion of a multilateral DTT between its member countries is not yet practicable (OECD, 1997).

There are, nonetheless, certain multilateral effects of bilateral tax treaties (box 4). Moreover, ever-changing economic conditions, in conjunction with the points mentioned above in favour of a multilateral approach, can provide new motivation for multilateral

agreements in this field, as bilateral and multilateral agreements each have their respective advantages and are not, as exemplified by the Nordic Convention, mutually exclusive.

Box 4. Multilateral and MFN effects of bilateral tax treaties

One sub-issue that should be mentioned is whether bilateral tax treaties may produce a multilateral effect. In principle, a bilateral tax treaty is an international agreement which produces its effects between the contracting parties only. It does not bind a third non-contracting party. For example, the non-discrimination clause under the OECD Model Convention (article 24) is generally understood as a national treatment clause and not as a most-favoured-nation (MFN) clause. Thus, if State A concludes an agreement using the OECD Model Convention non-discrimination clause with State B, it undertakes to extend to nationals of B, who are in the same or substantially similar circumstances as its own nationals, a treatment which is not "other or more burdensome" than that of its own nationals. However, State A remains free to grant nationals of a third State a treatment which is other or less burdensome than that granted to its own nationals, and thus more favourable than that granted to the nationals of B. The only MFN inclination is contained in article 24(5) of the OECD Model Convention, the purpose of which is to ensure that a contracting party does not treat its own companies differently depending on whether their capital is held by nationals of the other contracting parties or by others (including nationals of other parties).

The commentary on the OECD Model Convention, in principle, disallows any MFN effect of bilateral tax treaties (OECD, 1997). This position is explicable, since an MFN approach to bilateral tax treaties would not recognize three essential points:

- Differentiated withholding taxes under different treaties are not necessarily less or more favourable to the persons involved, because the ultimate tax position of the investor is shaped by an inevitable interlinkage between source *and* residence taxation. For example, assuming source country S has treaties with both residence countries R1 (credit country) and R2 (exemption country), if the S-R1 treaty provides for a 5 per cent withholding tax on dividends and the S-R2 treaty provides

/...

Box 4 (concluded)

for a 15 per cent rate, it would appear that R2 residents are treated less favourably than R1 residents. Ultimately, however, when source *and* residence tax are taken into account, R2 residents are better off than R1 residents, so that extending to them the lower withholding tax under the S-R1 treaty would only increase their advantage.

- An MFN approach to double taxation could create difficulties for the symmetry of tax treaties (Hughes, 1997). The following example regarding royalties illustrates the point: country A has treaties with countries B (10 per cent rate) and C (0 per cent rate). All of country B's other treaties provide for a 10 per cent rate. Under the MFN approach, A would be forced to extend the 0 per cent rate to residents of B, while B can continue to apply the 10 per cent rate to residents of A. It is clear that, bearing in mind such asymmetric result, countries would be reluctant to agree to reciprocal concessions.

- The MFN approach looks only at the tax treatment in the source country with no reference to the tax treatment in the country of residence. Because MFN treatment does not extend to the tax treatment of residents, the country of residence may continue to tax its own residents differently depending on the source of their income.

Source: UNCTAD.

B. The jurisdiction to tax

In the light of the foregoing discussion, IIAs and international tax arrangements have evolved the following approaches in relation to the jurisdiction to tax.

1. The exclusion of tax issues model

As mentioned earlier, the vast majority of IIAs have excluded taxation issues from their content. The majority of BITs[9] make taxation matters exceptions to the MFN and national treatment

principles. Such an exception permits a contracting party to provide favourable tax treatment to investment by investors of another country without according the same treatment to investment by investors of third countries with which it has BITs (box 6).

For example, the 1991 BIT between the Republic of Korea and Mongolia states in its article 7 (b) that the MFN and national treatment provisions:

> "shall not be construed so as to oblige one Contracting Party to extend to the investors of the other Contracting Party the benefit of any treatment, preference or privileges which may be extended by the former Contracting Party by virtue of .... any international agreement or domestic legislation relating wholly or mainly to taxation" (UNCTAD, 1998a, p. 63).

Box 5. Excerpts from model BITs

The following texts are excerpted from prototype BITs of several developed and developing countries (UNCTAD, 1996a, vol. III). They are representative of the present tendency to exclude, specifically or by implication, the application of the MFN and national treatment provisions to the tax regulations.

- Article 4(3) of the Chilean model BIT states:

  "If a Contracting Party accords special advantages to investors of any third country by virtue of an agreement establishing a free trade area, a customs union, a common market, an economic union or any other form of regional economic organization to which the Party belongs or through the provisions of an agreement relating wholly or mainly to taxation, it shall not be obliged to accord such advantages to investors of the other Contracting Party" (UNCTAD, 1996a, vol. III, p. 145).

- Article 3(3) of the Chinese model BIT states:

  "The treatment and protection as mentioned in Paragraphs 1 and 2 of this Article shall not include any preferential treatment accorded

/...

Box 5 (continued)

by the other Contracting Party to investments of investors of a third State based on customs union, free trade zone, economic union, agreement relating to avoidance of double taxation or for facilitating frontier trade" (ibid., p. 153).

- Article 4 of the French model BIT states:

  "Ce traitement [MFN/national treatment] ne s'étend toutefois pas aux privilèges qu'une Partie contractante accorde aux nationaux ou sociétés d'un Etat tiers, en vertu de sa participation ou de son association à une zone de libre échange, une union douanière, un marché commun ou toute autre forme d'organisation économique régionale.

  Les dispositions de cet Article ne s'appliquent pas aux questions fiscales" (ibid., p. 161).

- Article 3(4) the German model BIT states:

  "The treatment [MFN/national treatment] granted under this Article shall not relate to advantages which either Contracting Party accords to nationals or companies of third States by virtue of a double taxation agreement or other agreements regarding matters of taxation" (ibid., p.169).

- Article 4(4) of the Swiss model BIT states:

  "If a Contracting Party accords special advantages to investors of any third State by virtue of an agreement establishing a free trade area, a customs union or a common market or by virtue of an agreement on the avoidance of double taxation, it shall not be obliged to accord such advantages to investors of the other Contracting Party" (ibid., p. 179).

- Article 7 of the United Kingdom model BIT states:

  "The provisions of this Agreement relative to the grant of treatment not less favourable than that accorded to the nationals or companies of either Contracting Party or of any third State shall not be construed

/...

Box 5 (concluded)

> so as to oblige one Contracting Party to extend to the nationals or companies of the other the benefit of any treatment, preference or privilege resulting from
>
> . . .
>
> (b) any international agreement or arrangement relating wholly or mainly to taxation or any domestic legislation relating wholly or mainly to taxation" (ibid., p. 189).

Source: UNCTAD, 1996a, vol. III.

The reasons for this exception in BITs are that:

- many countries prefer to address international taxation issues in separate treaties dealing specifically with such matters in order to maintain maximum fiscal sovereignty;
- the exception allows a country to conclude a tax treaty granting special tax treatment to investment from another country in return for concessions, without having to worry that other countries will have the right to the same treatment by virtue of the MFN provision in their BITs;
- the complexity of tax matters may render such matters unsuitable for inclusion in the kind of standardized provisions that are typical of BITs (UNCTAD, 1998a).

A similar approach to the exclusion of taxation issues is taken in the 1994 Protocolo de Colonia Para la Promoción y Protección Reciproca de Inversiones en el MERCOSUR (Intrazona), (Colonia Protocol) article 3(3) (UNCTAD, 1996a, vol. II) and in the 1994 Protocolo Sobre Promoción y Protección de Inversiones Provenientes de Estados No Partes del MERCOSUR (Protocol on Promotion and Protection of Investments coming from Non-Party States) article 2(3)(6) (ibid.).

Not all exclusions are based on an MFN / national treatment provision. For example the Revised Basic Agreement on ASEAN Industrial Joint Ventures (1987) (Association of South East-Asian Nations) contains a general exception in article V which states:

> "The provisions of this Agreement shall not apply to matters of taxation in the territory of the Contracting Parties. Such matters shall be governed by Avoidance of Double Taxation Treaties between Contracting Parties and the domestic laws of each Contracting Party" (ibid., p. 296).

2. The qualified exclusion model

Certain IIAs that do contain a general exclusion of taxation issues then qualify it with references to specific taxation matters that materially affect the enjoyment, by an investor, of certain protective rights under the agreement. Thus, the Energy Charter Treaty (ECT) states in article 21(1) that: "Except as otherwise provided in this Article, nothing in this Treaty shall create rights or impose obligations with respect to Taxation Measures of the Contracting Parties..." (ibid., p. 563).

The ECT provision then deals with certain specific tax issues in subsequent sub-paragraphs (box 6). Of significance to the model under discussion, in addition to the general exclusion of taxation matters in article 21(1), sub-paragraph (3)(a) of article 21, is that it introduces the MFN exception with respect to tax advantages accorded by a contracting party pursuant to a taxation convention. Sub-paragraph (3)(b) excludes taxation measures aimed at ensuring the effective collection of taxes, though investors are protected against arbitrary discrimination in the application of such measures (ibid.). Article 21(2) extends a similar regime to article 7(3) of the ECT which accords national treatment to investors in relation to provisions concerning the treatment of energy materials and products in transit (ibid.). In addition, article 21(6) states that, for the avoidance of doubt, the guarantee for free transfer of funds in article 14 of the ECT "shall not limit the right of a Contracting Party to impose or collect a tax by withholding or other means" (ibid., p. 565).

Box 6. Energy Charter Treaty

TAXATION
Article 21

"(1) Except as otherwise provided in this Article, nothing in this Treaty shall create rights or impose obligations with respect to Taxation Measures of the Contracting Parties. In the event of any inconsistency between this Article and any other provision of the Treaty, this Article shall prevail to the extent of the inconsistency.

(2) Article 7(3) shall apply to Taxation Measures other than those on income or on capital, except that such provision shall not apply to:

(a) an advantage accorded by a Contracting Party pursuant to the tax provisions of any convention, agreement or arrangement described in subparagraph (7)(a)(ii); or

(b) any Taxation Measure aimed at ensuring the effective collection of taxes, except where the measure of a Contracting Party arbitrarily discriminates against Energy Materials and Products originating in, or destined for the Area of another Contracting Party or arbitrarily restricts benefits accorded under Article 7(3).

(3) Article 10(2) and (7) shall apply to Taxation Measures of the Contracting Parties other than those on income or on capital, except that such provisions shall not apply to:

(a) impose most favoured nation obligations with respect to advantages accorded by a Contracting Party pursuant to the tax provisions of any convention, agreement or arrangement described in subparagraph (7)(a)(ii) or resulting from membership of any Regional Economic Integration Organization; or

(b) any Taxation Measure aimed at ensuring the effective collection of taxes, except where the measure arbitrarily discriminates against an Investor of another Contracting Party or arbitrarily

/...

Box 6 (continued)

restricts benefits accorded under the Investment provisions of this treaty.

(4) Article 29(2) to (6) shall apply to Taxation Measures other than those on income or on capital.

(5) (a) Article 13 shall apply to taxes.

(b) Whenever an issue arises under Article 13, to the extent it pertains to whether a tax constitutes an expropriation or whether a tax alleged to constitute an expropriation is discriminatory, the following provisions shall apply:

(i) The Investor or the Contracting Party alleging expropriation shall refer the issue of whether the tax is an expropriation or whether the tax is discriminatory to the relevant Competent Tax Authority. Failing such referral by the Investor or the Contracting Party, bodies called upon to settle disputes pursuant to Article 26(2)(c) or 27(2) shall make a referral to the relevant Competent Tax Authorities;

(ii) The Competent Tax Authorities shall, within a period of six months of such referral, strive to resolve the issues so referred. Where non-discrimination issues are concerned, the Competent Tax Authorities shall apply the non-discrimination provisions of the relevant tax convention or, if there is no non-discrimination provision in the relevant tax convention applicable to the tax or no such tax convention is in force between the Contracting Parties concerned, they shall apply the non-discrimination principles under the Model Tax Convention on Income and Capital of the Organisation for Economic Co-operation and Development;

(iii) Bodies called upon to settle disputes pursuant to Article 26(2)(c) or 27(2) may take into account any conclusions arrived at by the Competent Tax Authorities regarding whether the tax is an expropriation. Such bodies shall take into account any

/...

Box 6 (continued)

conclusions arrived at within the six-month period prescribed in subparagraph (b)(ii) by the Competent Tax Authorities regarding whether the tax is discriminatory. Such bodies may also take into account any conclusions arrived at by the Competent Tax Authorities after the expiry of the six-month period;

(iv) Under no circumstances shall involvement of the Competent Tax Authorities, beyond the end of the six-month period referred to in subparagraph (b)(ii), lead to a delay of proceedings under Articles 26 and 27.

(6) For the avoidance of doubt, Article 14 shall not limit the right of a Contracting Party to impose or collect a tax by withholding or other means.

(7) For the purposes of this Article:

(a) The term "Taxation Measure" includes:

(i) any provision relating to taxes of the domestic law of the Contracting Party or of a political subdivision thereof or a local authority therein; and

(ii) any provision relating to taxes of any convention for the avoidance of double taxation or of any other international agreement or arrangement by which the Contracting Party is bound.

(b) There shall be regarded as taxes on income or on capital all taxes imposed on total income, on total capital or on elements of income or of capital, including taxes on gains from the alienation of property, taxes on estates, inheritances and gifts, or substantially similar taxes, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.

/...

Box 6 (continued)

(c) A "Competent Tax Authority" means the competent authority pursuant to a double taxation agreement in force between the Contracting Parties or, when no such agreement is in force, the minister or ministry responsible for taxes or their authorized representatives.

(d) For the avoidance of doubt, the terms "tax provisions" and "taxes" do not include customs duties."

Source: UNCTAD, 1996a, vol. II, pp. 563-565.

A similar approach is taken in NAFTA, article 2103(1), which states: "Except as set out in this Article nothing in this agreement shall apply to taxation measures". Article 2103(2) states:

> "Nothing in this Agreement shall affect the rights and obligations of any Party under any tax convention. In the event of any inconsistency between this Agreement and any such convention, that convention shall prevail to the extent of the inconsistency" (ILM, 1993, p. 700)

However, paragraph 2 notwithstanding, NAFTA does extend national treatment and MFN to "all taxation measures, other than those on income, capital gains or on the taxable capital of corporations, taxes on estates, inheritances, gifts and generation-skipping transfers and those taxes listed in paragraph 1 of Annex 2103. 4" (NAFTA, article 2103(4)(b)) (ibid.). Given the breadth of this list, few tax measures would appear to be caught by this provision. The provision continues by asserting that the non-discrimination provisions of NAFTA shall not apply:

> "(c) [to] any most-favored-nation obligation with respect to an advantage accorded by a Party pursuant to a tax convention,
>
> (d) to a non-conforming provision of any existing taxation measure,

(e) to the continuation or prompt renewal of a non-conforming provision of any existing taxation measure,

(f) to an amendment to a non-conforming provision of any existing taxation measure to the extent that the amendment does not decrease its conformity, at the time of the amendment, with any of those Articles,

(g) to any new taxation measure aimed at ensuring the equitable and effective imposition or collection of taxes and that does not arbitrarily discriminate between persons, goods or services of the Parties or arbitrarily nullify or impair benefits accorded under those Articles, in the sense of Annex 2004, or

(h) to the measures listed in paragraph 2 of Annex 2103.4"(ibid.).

Thus NAFTA follows a rather complex structure in relation to taxation issues: first, all taxation matters are excluded, except as provided for in article 2103. Secondly, tax conventions are given priority over NAFTA in relation to the rights and obligations of any Party under such a convention. Thirdly, national treatment and MFN apply to all taxation measures other than those listed in paragraph 4(b) and the matters listed in paragraphs 4(c) to (h).

Some IIAs expressly link expropriation protection to tax measures so as to prevent direct or indirect expropriation of the assets of a foreign investor through the use of tax measures. One example is article 21(5) of the ECT (box 6). Another example occurs in the United States model BIT, article XIII (box 7), which excludes all taxation except where taxation results in an act of expropriation. NAFTA also includes taxation measures under its expropriation provision (see NAFTA, article 2103(6)) (ILM, 1993).

Box 7. United States model BIT

Article XIII

1. No provision of this Treaty shall impose obligations with respect to tax matters, except that:

(a) Articles III, IX, and X will apply with respect to expropriation; and

(b) Article IX will apply with respect to an investment agreement or an investment authorization.

2. A national or company, that asserts in an investment dispute that a tax matter involves an expropriation, may submit that dispute to arbitration pursuant to Article IX(3) only if:

(a) the national or company concerned has first referred to the competent tax authorities of both Parties the issue of whether the tax matter involves an expropriation; and

(b) the competent tax authorities have not both determined, within nine months from the time the national or company referred the issue, that the matter does not involve an expropriation.

Source: UNCTAD, 1996a, vol. III, p. 204.

3. The tax incentives model

A common taxation provision in a significant number of regional investment agreements among developing countries aims at setting down a regime of tax incentives for investors from other member countries of the region. Commonly such provisions may reduce the overall level of taxation to be levied on investors who qualify for the preferential treatment, or protect the level of taxation charged on foreign investors by reference to the national treatment standard, or guarantee the free transfer of assets without special taxation or seek to harmonize tax rates across the region.

The following examples illustrate this approach and its variations:

- The Common Convention on Investments in the States of the Customs and Economic Union of Central Africa (1965) (UNCTAD, 1996a, vol. II), in Part III, offers:
    - reduced taxation for companies that are entitled to such treatment under the agreement;
    - a variety of schemes of tax reduction.
- The Agreement on the Harmonisation of Fiscal Incentives to Industry (Caribbean Common Market (CARICOM) (1973) (ibid.), offers a scheme of fiscal benefits to approved enterprises.
- The Unified Agreement for the Investment of Arab Capital in the Arab States (1980) (ibid.), in article 7, guarantees the freedom to transfer capital, without the transfer process incurring any taxes or duties. Articles 16-17 of the agreement, which deal with investor privileges, contain no mention of tax, but this may be implicit in the freedom granted to the contracting parties to offer privileges in excess of the minimum stipulated within the agreement.
- The Agreement on Promotion, Protection and Guarantee of Investments among Member States of the Organisation of the Islamic Conference (1981) (ibid.), in article 4, mentions tax incentives.
- The Community Investment Code of the Economic Community of the Great Lakes Countries (CEPGL) (1982) (ibid.), in title II, offers extensive tax advantages to qualifying enterprises, especially in section III, articles 28-9 (tax advantages) and in chapter II, section I, articles 31-36 (tax advantages).
- The Fourth ACP-EEC Convention of Lomé (Lomé Convention) (1989), in part III, title III, chapter 5, section 6, mentions tax and customs arrangements (ILM, 1990).

- The CARICOM Agreement (UNCTAD, 1996a, vol. III), in article 40, introduces a programme for the harmonization of fiscal incentives.

- The Treaty Establishing the Latin American Integration Association (LAIA) (1980) (ibid.), in article 46, introduces the national treatment principle as regards, inter alia, taxes charged on products originating from the territory of another member country.

Many host countries offer tax incentives in various forms in order to attract FDI. The desirability and effectiveness of tax incentives is a much debated issue (UNCTAD, 1996b) but is outside the scope of this paper. Assuming an investor would not have invested in the absence of an incentive, such schemes represent a budgetary sacrifice on the part of the host country. The latter consents to the sacrifice on the premise that the revenue losses could be recouped directly or indirectly (e.g. employment, technological upgrading).

The tax incentives approach is not universally advocated. Thus article III(9) of the Guidelines on the Treatment of Foreign Direct Investment (The World Bank Group, 1992) states that the use of tax exemptions as a means of providing incentives is not recommended. The use of reasonable tax rates is preferred (UNCTAD, 1996a, vol. I).

4. The TNC tax responsibility model

Several codes and declarations concerning the conduct of TNCs have included provisions on taxation. These provisions generally call for tax responsibility on the part of TNCs in that such firms are exhorted to cooperate with the tax authorities of the countries in which they generate taxable income by offering full disclosure of their profits and losses in accordance with national laws and practices, by not engaging in tax avoidance manipulations, particularly transfer pricing (UNCTAD, 1999a) practices, and by paying all due taxes.

For example, the taxation guidelines, contained in annex 1 ("The Guidelines for Multinational Enterprises") of the 1976 OECD Declaration on International Investment and Multinational Enterprises assert that enterprises should:

> "1. Upon request of the taxation authorities of the countries in which they operate provide, in accordance with the safeguards and relevant procedures of the national laws of these countries, the information necessary to determine correctly the taxes to be assessed in connection with their operations, including relevant information concerning their operations in other countries;
>
> 2. Refrain from making use of the particular facilities available to them, such as transfer pricing which does not conform to an arm's length standard, for modifying in ways contrary to national laws the tax base on which members of the group are assessed" (UNCTAD, 1996a, vol. II, p. 190).

Similarly, the draft United Nations Code of Conduct on Transnational Corporations, paragraph 34, states:

> "Transnational corporations should / shall not, contrary to the laws and regulations of the countries in which they operate, use their corporate structure and modes of operation, such as the use of intra-corporate pricing which is not based on the arm's length principle, or other means, to modify the tax base on which their entities are assessed" (UNCTAD, 1996a, vol. I, p. 168).

As regards the payment of due taxes, illustrative provisions occur in Decision 24 of the Commission of the Cartagena Agreement (Andean Group, 1970) (UNCTAD, 1996a, vol. II), articles 9 and 10, whereby the assets resulting from the winding up of a foreign investment are deemed a capital gain and can only be remitted abroad after the payment of the taxes due. Similarly, any sum

obtained by a foreign investor as a result of the sale of its shares, capital interest or rights can be remitted after the payment of taxes due.

5. The regional multinational enterprise taxation model

A specialized taxation provision can usually be found in agreements setting up a regional multinational enterprise or other supranational form of business association. Where such an enterprise or business association is established, the constitutive agreement must determine in what manner and in which place the entity in question will be taxed. Thus, for example, the enterprise may be obliged to pay tax in the place where its principal seat or place of incorporation is located. Alternatively it may be absolved from paying tax altogether where it is seen to be a vehicle of economic development for the region and where a degree of preferential treatment for the entity is deemed desirable.

For example, article 13 of the Agreement for the Establishment of a Regime for CARICOM Enterprises (1987) (ibid.) states that the corporate profits of a CARICOM enterprise shall be subject to tax. However, an exception is made where the equity capital is wholly owned by the Governments of the member States and they agree to exempt that enterprise from tax. Equally, dividends and other distributions paid to a CARICOM enterprise in respect of equity capital owned by Governments of any of the member States shall not be subject to tax. Furthermore, CARICOM enterprises that engage solely in the business of intra- or extra-regional transport and communications may have their taxes on profits waived by the mutual agreement of the Governments of participating States. Finally, CARICOM enterprises are eligible to benefit from fiscal incentives under the Scheme for Harmonisation of Fiscal Incentives to Industry.

On the other hand, this provision is silent as to the place where CARICOM enterprises should pay tax. However, other provisions of the agreement imply that the headquarters State, the State in which the CARICOM enterprise is established, and

other member States in which the enterprise is registered, may have the right to tax. By article 5 of the agreement: "The incorporation, registration, operation, management, winding-up and dissolution of a CARICOM ENTERPRISE shall be governed by the provisions of this Agreement as well as the company law and other relevant laws of the Headquarters State and those other Member States in which the CARICOM ENTERPRISE is registered" (ibid., p. 271). Though taxation is not expressly mentioned, it must be implicit in the reference to "other laws". This in turn raises difficult questions as to the allocation of revenues among the member States. In the absence of clear rules about these matters in the agreement, it must be assumed that the applicable national rules concerning the allocation of foreign earned income would govern the matter.

By contrast, the Council Regulation on the European Economic Interest Grouping (EEIG) (Council of the European Communities, 1985), a supranational form of business association formed by members from more than one European Union member State, states that the profits of the EEIG shall be deemed to be those of its members and shall be shared among them in the proportions laid down in the contract establishing the EEIG. The members' profits shall be taxed in accordance with national tax laws.

Other provisions dealing with the taxation of regional multinational enterprises include the Charter on a Regime of Multilateral Industrial Enterprises (MIEs) in the Preferential Trade Area for Eastern and Southern African States (1990). Article 15(7) exempts the MIE and its branches and subsidiaries from the payment of taxes in any of the member States parties to this regime for five years after the first date on which the MIE first derives income from its operations (UNCTAD, 1996a, vol. II).

Finally, the Uniform Code on Andean Multinational Enterprises (AME) (Andean Group, 1991) (ibid.) states, in article 18, that the AME is entitled to the same tax treatment as national companies in respect of national taxes.

6. The avoidance of double taxation model

This issue is dealt with by both IIAs and double taxation agreements. The former may incorporate a provision encouraging the contracting parties to deal with the problem of double taxation as a part of their mutual obligations under an IIA. The modality of dealing with this issue may be specified through an obligation to conclude a double taxation agreement between the parties (see for example article 47 of Decision No. 24 of the Commission of the Cartagena Agreement) (ibid.). Such a commitment is present in article 161 of the Treaty Establishing the Common Market for Eastern and Southern Africa (1993) (COMESA):

> "The Member States undertake to conclude between themselves agreements on the avoidance of double taxation" (UNCTAD, 1996a, vol. III, p. 109).

Alternatively, there may simply be a general commitment to avoid double taxation. Thus the APEC Non-Binding Investment Principles state that "Member economies will endeavour to avoid double taxation related to foreign investment" (UNCTAD, 1996a, vol. II, p. 537). Similarly, the Agreement on Arab Economic Unity (1957), article 2(7)(b), includes as an aim for attaining the unity mentioned in article 1: "Avoiding double taxation and duties levied on the nationals of the contracting parties" (UNCTAD, 1996a, vol. III, p. 26). The EU treaty (EU, 1995) also contains a clause of this kind encouraging member states to start negotiations on the avoidance of double taxation, if necessary. But it is unclear what such a clause achieves and what the sanctions are.

As to international tax arrangements, these contain numerous clauses that are of direct relevance to the treatment of investors and investment and to the avoidance of double taxation in particular. Each will be considered in turn.

a. Tax arrangements and allocation of income

A primary objective of tax treaties, along with determining the appropriate allocation of revenues between countries, is the

mitigation of double taxation through the elimination of definition mismatches and the allocation of exclusive or shared taxing rights to the contracting parties. Also, by providing rules for cooperation in the prevention of tax avoidance and, sometimes, for the collection of tax claims, a tax treaty can indirectly contribute to the treasury of the contracting parties.

As mentioned earlier, most bilateral tax treaties concluded to date are based on the OECD Model Convention, the United Nations Model Convention, or a combination of the two. The United Nations Model Convention is actually substantially based on the OECD Model Convention, and many clauses of the two models are virtually interchangeable. The main difference between the two models is that the OECD Model Convention generally favours residence taxation while the United Nations Model Convention generally favours source taxation. For this reason, capital exporting countries have traditionally preferred the OECD model and capital importing countries the United Nations model.

However, this classification is becoming increasingly blurred as

- net capital importers have become members of the OECD which model would, therefore, need to consider their interests;
- various developing countries have become to some extent countries of residence rather than just source countries;
- not all developing countries are equally satisfied by the United Nations Model Convention, in particular because of the absence of tax-sparing provisions therein.

Most countries impose tax based on a combination of the source and residence concepts. In seeking the avoidance of double taxation, a tax treaty attributes exclusive or shared taxing rights to the source and/or residence countries.

(i) Source versus residence taxation

Most countries impose tax based on a combination of the source and residence concepts. In seeking the avoidance of double taxation, a tax treaty attributes exclusive or shared taxing rights to the source and/or residence countries.

Generally the OECD Model Convention favours exclusive taxation by the country of residence of the recipient of the income. This is most evident in article 12(1) of the OECD Model Convention which provides:

> " Royalties arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State if such resident is the beneficial owner or the royalties" (UNCTAD, 1996a, vol. II, p. 79).

Similarly, there is a marked preference, in article 11 of the OECD Model Convention, for exclusive taxation of interest in the country of residence of the beneficiary. In both cases the model excludes the country of residence principle where the royalties or interest are earned through a permanent establishment (e.g. a branch or foreign affiliate) in the country where the activity is exercised. However, the model does not easily assume the existence of such a permanent establishment.

By contrast, the United Nations Model Convention favours non-exclusive source taxation. Thus, the corresponding articles on interest (article 11) and royalties (article 12), while not prohibiting taxation by the country of residence, stipulate that these taxable flows of income "may also be taxed in the Contracting State in which it arises and according to the laws of that State...", followed by a percentage limitation on the amount of tax so chargeable if the recipient is the beneficial owner of the interest or royalties (UNCTAD, 1996a, vol. I, p. 119). Furthermore, the United Nations Model Convention assumes more easily than the OECD Model Convention the existence of a permanent establishment, so that an activity undertaken in the source country can more easily be taxed therein.

Both the residence and source principles may create problems for developing countries. To favour residence taxation may result in depriving a developing country, which typically is a source country, from much needed revenue. Equally, a major argument against the source principle is that it may be counterproductive for developing countries as it may effectively result in increased costs. The argument is that, if source tax is based on the gross amount of the income, it cannot be fully credited in the country of residence which taxes the income on a net basis, and therefore it becomes an effective cost which needs to be reflected in the price (e.g. the royalty or interest rate) charged to the developing country. For example, if a company Xco resident in country X borrows money and lends it with a margin to a company Yco in country Y, the latter would impose withholding tax on the gross payment from Yco to Xco. However, because Xco is taxed in X only on the net margin, the foreign tax would exceed the tax due in X and therefore become an effective cost to Xco. As a result, Xco will increase the interest rate charged to Yco so as to reflect the effective cost of source country tax.

The argument is sound, albeit not in all circumstances. Source country tax need not lead to an effective tax cost in the country of residence if:

- the expenses deductible therein are too low (e.g. in case of royalties, if R&D expenses have already been substantially written off); or
- the recipient receives income from various sources and the country of residence does not apply "basket" or "per country" foreign tax credit limitations. In that case, indeed, high taxes of certain source countries can be averaged with low taxes of other source countries, so that, on balance, there is no excess foreign tax credit.

To avoid the risk of such a cost increase, a limited number of tax treaties put the burden on the (developed) country of residence. Hence, article 23(1)(b) of the 1993 France-Zimbabwe tax treaty reads:

> "...where the amount of tax paid in Zimbabwe in accordance with the provisions of the Convention exceeds the amount of French tax attributable to such income, the resident of France receiving such income may represent his case to the French competent authority; if it appears to it that such a situation results in taxation which is not comparable to taxation on net income, that competent authority may, under the conditions it determines, allow the non credited amount of tax paid in Zimbabwe as a deduction from the French tax levied on other income from foreign sources derived by that resident" (IBFD, 1986 --).

Such a solution, while limited because dependent on the discretionary judgement by the competent authorities of the country of residence, do nevertheless show that countries of residence may take a part in solving the issue.

(ii) Passive investment income

Depending on the form they take, investments can generate interest or dividends. In the case of interest income, both the United Nations Model Convention and the OECD Model Convention provide for shared taxation: the source country may levy a withholding tax at a rate not exceeding 10 per cent (OECD Model Convention) or the rate agreed to by the parties (United Nations Model Convention), and the country of residence taxes the income with a credit for the tax levied in the source country.

In the case of dividends, again, both the United Nations and the OECD model provide for shared taxation: the source country may levy a withholding tax at a rate not exceeding that set forth under the treaty and the country of residence may tax the income received but must grant a credit against its own tax for the withholding tax levied in the source country. In practice, however, many capital-exporting countries provide for a regime, generally known as the participation exemption, under which dividends received by a resident parent company are exempt from tax. In that case, the

foreign withholding tax is generally not creditable since there is no tax against which it can be offset in the country of residence.

In order to prevent improper use of the participation exemption, a number of countries provide for a switch to the credit method where the income from which the dividends are paid was not (sufficiently) taxed in the source country. In that case, the dividends are taxed in the country of residence with a credit for the tax paid in the source country, if any. Depending on the way in which they are drafted, tax treaties can restrict to a certain extent the ability of the country of residence to switch from the exemption to the credit method (see below).

(iii) Capital gains

Portfolio investors in emerging markets are often more intent on realizing a capital gain on their investment than on receiving dividends. Indeed, for investments in growing firms, the potential for realizing a gain is greater than the potential for receiving a dividend.

The OECD Model Convention provides for exclusive taxation of capital gains on shares in the country of residence of the investor. The United Nations Model Convention follows suit, with the difference that it provides for shared taxation of gains on substantial participation:

Article 13(5) United Nations Model Convention provides:

> " Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of ... per cent (the percentage is to be established through bilateral negotiations) in a company which is a resident of a Contracting State may be taxed in that State" (UNCTAD, 1996a, vol. I, p. 122).

Generally, gains on shares are taxable in the country of residence, but many capital-exporting countries do extend the participation exemption to capital gains (e.g. Denmark, Luxembourg,

Netherlands). Capital-importing countries may have valid reasons to exempt capital gains derived by non-residents. Nevertheless, the retention of the right to tax capital gains under a tax treaty can be helpful:

- the source country is not required to exercise effectively the right to tax attributed to it under the treaty. Indeed, it may choose to exempt such gains under its domestic law even though the treaty gives it the right to tax; and

- the source country may choose to tax certain types of gains. For example, it may wish to reserve the exemption to gains on shares held for a minimum period of time, so as to discourage speculative trading and extreme stock market fluctuations. The attribution of the right to tax exclusively to the country of residence prevents the source country from implementing such policy choices.

(iv) Other income

Tax treaties eliminate the potential for double taxation by, inter alia, providing for commonly agreed definitions. Income that cannot be classified under one of the income categories listed under the treaty is generally referred to as "other income" or "income not expressly mentioned". Both the OECD and the United Nations models contain an "other income" clause (article 21 in both models) which provides that items of income not separately dealt with in the foregoing articles of the convention are exclusively taxable in the country of residence of the beneficiary.

In contrast to the OECD model, however, the United Nations model contains an additional provision (article 21(3)) which prescribes that "other income" may also be taxed in the country from which it arises (i.e. in the source country) (IBFD, 1986 --). Such a clause preserves the right of the source country to tax items of income derived from its territory and not covered by the treaty.

(v) Credit and exemption

The double-taxation elimination clause in international tax treaties is usually expected to reflect the domestic laws of the contracting parties and, for that reason, is one of the least difficult clauses to negotiate. As mentioned above, in order to prevent a jurisdictional vacuum, various countries provide, under their domestic laws, for a switch from the exemption to the credit method if the foreign-source income is not adequately taxed abroad. Such positions are also sometimes confirmed by tax treaties. For example, article 19(B) of the 1989 France-United Arab Emirates tax treaty provides:

> "Where a person who is a resident of the United Arab Emirates or who is established there is fiscally domiciled in France for the purposes of French domestic law or is a subsidiary directly or indirectly controlled for more than 50% by a company with its place of effective management in France, the income of that person shall be taxable in France notwithstanding any other provision of this Convention. In such event, for all income taxable in the United Arab Emirates by virtue of this Convention, France shall allow as a deduction from the tax attributable to that income the amount of tax levied by the United Arab Emirates" (IBFD, 1986 --).

Nevertheless, a strictly drafted clause can reduce the ability of the country of residence to apply its domestic legislation by, for example, switching from the exemption to the credit method. Point 6(a) of the protocol to the 1996 Germany-India tax treaty provides:

> "The exemption provided for in sub-paragraph (a) of paragraph 1 of Article 23 is granted irrespective of whether the income or capital concerned is effectively taxed in the Republic of India or not" (IBFD, 1986 --).

This type of clause can be useful only when the relevant exemption is available pursuant to the treaty. If, instead, the exemption

is available pursuant to the domestic laws of the country of residence without the treaty confirming such exemption, the clause will have no impact.

(vi) Tax sparing

The budgetary sacrifice represented by tax incentives offered by host countries, discussed above, may be made in vain if not matched by the country of residence of the investor. This is particularly the case where the country of residence applies the credit method to relieve double taxation of its residents with respect to the relevant item of income. In such a case, the investor being taxed at the higher of the source country and country of residence rate, the tax incentive does not benefit the investor but is rather appropriated by the treasury of the country of residence. The problem can be further exacerbated if the country of residence applies foreign tax credit limitations, the effect of which is to prevent averaging the tax borne in high-tax jurisdictions with that paid in low-tax jurisdictions.

For this reason, many capital-importing countries insist on including a tax-sparing or matching-credit clause in their treaties. Under such a clause, the country of residence of the investor grants a credit for the tax which would have been levied by the source country in the absence of the tax incentive. In that way, the tax incentive is channeled to the investor and not to the treasury of its home country.

Traditionally, many capital-exporting nations have accepted the granting of tax-sparing credits (table 1). The United States, however, has always been an exception to this rule. In fact, the United States position is that tax benefits to United States persons may only be granted by United States law and not by tax treaties. Thus, the most the United States has been prepared to offer so far in its tax treaties is a commitment to grant the same benefit to the treaty partner if it is ever granted to a third country. For example, the letter of submittal to the 1985 Tunisia-United States tax treaty stated as follows:

> "[...] The United States delegation, while understanding the Tunisian position, [requesting a tax-sparing credit], is not prepared to agree to such a provision. I wish to assure you, however, that should the United States position change and we agree to include such a position in an income tax treaty with another country, we agree to reopen discussions with the Tunisian Republic with a view to extending the same benefit to investments in Tunisia" (IBFD, 1986 --).

Table 1. Examples of DTTs with tax-sparing provisions (non-exhaustive)

Australia - China (1988) Article 23
Australia - Vietnam (1996) Exchange of Notes
Canada - Argentina (1993) Article 23
Canada - China (1986) Article 21
Canada - Thailand (1984) Article 22
Denmark - Poland (1994) Protocol
Germany - Indonesia (1977) Article 22(1)
Germany - Turkey (1985) Article 23(1)
Japan - Bangladesh (1991) Article 23
Japan - Brazil (1976) Protocol
Japan - Bulgaria (1991) Article 23
Japan - Vietnam (1995) Article 22
The Netherlands - Bangladesh (1993) Article 23
New Zealand - Singapore (1993) Protocol
Spain - India (1993) Article 25
Sweden - Malta (1995) Article 22(2)
United Kingdom - Indonesia (1993) Article 21
United Kingdom - Mongolia (1996) Article 24
United Kingdom - Papua New Guinea (1991) Article 23

Source: OECD, 1998a.

(a) Structuring of tax sparing credits

Tax-sparing credits are usually given for withholding taxes on interest, dividends and royalties. A number of treaties, however, grant the sparing credit for business income,[10] or for both passive income and business income.[11] Also, in certain cases, tax treaties

between capital-importing countries do provide for the reciprocal granting of sparing credits.[12] Interestingly, neither the OECD Model Convention nor the United Nations Model Convention contain tax-sparing provisions.

A number of treaties grant a sparing credit up to the amount of tax that the source country is allowed to levy under the treaty (i.e. if the treaty provides for a maximum 15 per cent rate for interest and the source country levies only 5 per cent or not at all, tax is deemed to have been paid at 15 per cent). For example, article 23(3) of the 1991 Netherlands-Nigeria tax treaty provides:

> "Where by reason of the relief given under the provisions of Nigerian laws for the purposes of encouraging investment in Nigeria the Nigerian tax actually levied on interest arising in Nigeria or on royalties arising in Nigeria is lower than the tax Nigeria may levy according to [the Convention], then the amount of the tax paid in Nigeria on such interest and royalties shall be deemed to have been paid at the rates of tax mentioned in [the Convention]" (IBFD, 1986 --).

Other treaties may grant a sparing credit for an amount higher than the rate of tax that the source country may charge under the relevant treaty. This is, for example, the case for French treaties with African countries of the former French Communauté, which base the credit on a formula whereby the sparing credit becomes higher as the source country tax becomes lower. (IBFD, 1986 --).[13]

Tax-sparing clauses under older treaties rarely contain limitations as to the time period for which they apply or the tax incentives pursuant to which the country of source does not levy (or levies a reduced) tax.

(b) Recent trends

Many developing countries consider tax sparing as an integral part of the elimination of the double taxation process. Until recently, many developed countries accepted the granting of tax-sparing

credits. There are, however, indications of a restrictive trend on the part of capital-exporting countries (OECD, 1998a).

From the perspective of developed countries, the arguments against tax sparing range from potential abuse to the determination that it actually represents foreign aid which should be granted through other more appropriate channels. Another major issue appears to be that the party granting a tax-sparing credit accepts that its foreign tax credit policy becomes to some extent dictated by the policies of the capital-importing treaty partner.

Recent treaties tend therefore to contain restrictions as to the scope of application of tax sparing, from the perspective of both the duration and type of incentive. For example, the 1998 Albania-Norway treaty (IBFD, 1986 --) restricts the tax-sparing credit to a period of five years from the date on which the treaty becomes effective. Also, article 23(4) of the 1996 Canada-India tax treaty (ibid.) provides for a tax-sparing credit for certain types of income benefiting from tax incentives under the India's 1961 Income Tax Act, "*but not the part dealing with ships or aircraft*" (ibid.). The exclusion of incentives dealing with ships and aircraft was not included in the old 1985 Canada-India treaty (ibid.).

In any case, while of utmost important in many cases, there are instances in which tax-sparing credits lose all or part of their significance:

- There is little significance if the country of the investor applies the exemption method to the relevant type of income.

- Tax sparing is useful only when the income is distributed to the investor. If the income is retained or reinvested in the source country, there is no tax in the country of residence (except under controlled-foreign-company (CFC) or other anti-deferral rules) and tax sparing is, therefore, irrelevant. Since source countries should encourage the reinvestment of the income (rather than its repatriation to the country of residence), it can be argued that tax sparing, by encouraging the repatriation of income, is in fact counterproductive.

- The usefulness of tax sparing is modified when the country of residence of the investor applies no foreign tax credit limitations. In that case, indeed, difficulties arising from the imposition of domestic tax over foreign low-tax income can be mitigated by tax credits attached to foreign high-tax income.

b. *Tax arrangements and non-discrimination rules*

As noted earlier, non-discrimination clauses in many international arrangements, such as commerce treaties and investment promotion agreements, usually carve out taxation, although older arrangements are sometimes drafted in general terms so that they can apply to tax matters as well.[14] Most tax treaties therefore contain a non-discrimination clause based on article 24 of the OECD Model Convention. A limited number of countries, notably Australia and New Zealand, generally do not include non-discrimination clauses in their tax treaties.[15]

As mentioned earlier (box 4), the non-discrimination clause under article 24 of the OECD Model Convention is generally understood as a national treatment clause and not as an MFN clause. Its first objective is to prohibit a treaty partner from granting to nationals of the contracting party a treatment which is other or more burdensome than that granted to its own nationals, provided the former are in the same or a substantially similar situation as the latter. Its second objective (article 24(5)) is to ensure that a contracting party does not treat its own companies differently depending on whether their capital is held by nationals of the other contracting party or by other persons.

Article 24 does not imply an obligation for the extension of MFN treatment. Nevertheless, various tax treaties do contain MFN clauses whereby a contracting party commits itself to extend to the other contracting party any more favourable treatment granted (later) to another country. This issue is further discussed in section III below.

In principle, the non-discrimination clause applies to all nationals of the contracting parties, whether or not actually covered by the treaty, and to all taxes applied by the contracting parties, whether or not covered by the treaty.

Various tax treaties contain restrictions as to the extension of certain tax reliefs to non-residents. This is generally the case for deductions and reliefs with respect to family allowances and social security premiums.

c. Tax arrangements and prevention of tax evasion

Tax treaties are concluded not only for the elimination of double taxation but also for the prevention of tax evasion. This aim is generally achieved through two mechanisms:

- Exclusion from treaty benefits; and
- Mutual assistance and exchange of information.

A number of tax arrangements also provide for assistance in the collection of taxes.

(i) Exclusion from treaty benefits

Tax treaties apply to residents, meaning persons covered by the treaty and who are liable to tax in the contracting country where they have their domicile, residence, place of management or any other criterion of a similar nature.

In international tax planning, certain structures are sometimes sought to obtain treaty benefits which are not otherwise available (so-called treaty shopping). Hence, a person not covered by a treaty may interpose another person covered by the relevant treaty in order to indirectly obtain treaty benefits. Also, a person covered by a treaty may prefer to obtain the benefits of a more favourable treaty, in which case various tax planning techniques are used to derive indirectly the benefits of the more favourable treaty.

In principle, the beneficial ownership clause in a tax treaty, under which treaty relief is granted only if the recipient is the

beneficial owner of the income, should be sufficient to exclude nominees and other interposed persons from treaty benefits. However, some treaties take other specific approaches to exclude potential beneficiaries.

First, many treaties include specific clauses that provide for detailed eligibility tests or exclude specific persons from treaty benefits. Detailed eligibility tests are especially found in United States tax treaties, under which they are generally known as limitations on benefits clauses. Under some of the United States treaties, the limitations-on-benefits clause is of extraordinary length and detail.[16]

Secondly, other treaties simply exclude specific persons from treaty benefits. For example, article VI, protocol of 18 July 1995 to the Malta-Netherlands tax treaty states:

> "This Agreement is not applicable to companies or other persons which are wholly or partly exempted from tax by a special regime under the laws of either one of the States" (IBFD, 1986 --).

A third approach found in a number of treaties is the inclusion of clauses which authorize the contracting parties to apply "thin capitalization rules", notwithstanding any treaty provision. Thin capitalization rules are domestic law provisions whereby the deduction of interest paid to shareholders (e.g. to a parent company) is disallowed if the debt/equity ratio of the debtor exceeds certain limits. The rationale behind the rules is to discourage financing companies through debt (the interest remuneration of which is normally deductible for the debtor), rather than through equity (the dividend remuneration of which is not deductible for the payer). However, since the rules generally do not apply to interest paid to domestic shareholders, their application to non-resident shareholders only can be in conflict with the non-discrimination clause under tax treaties. For this reason, preventive clauses are sometimes included in tax treaties.

A fourth exception (found in particular in Canadian and French treaties) is the authorization of the contracting parties to

apply CFC legislation. CFC rules are domestic law provisions pursuant to which a country taxes its own residents who control a foreign entity (the "controlled foreign company" or CFC) benefiting from a privileged tax regime (typically a “tax haven”) on any income and gains realized by that foreign entity. Ordinarily, pursuant to a long-established principle of international tax law, the resident shareholders would not be taxed in the country of residence until the income or gains realized by the CFC are distributed to them. However, in order to discourage the deferral (i.e. non-repatriation) of income in tax havens, various residence countries (eighteen in 1999, including two non-OECD countries) tax their residents currently on the CFC income without waiting for an actual distribution. Because the compatibility of CFC rules with tax treaties is still an open issue,[17] a number of treaties contain preventive clauses that authorize the contracting parties -- or one of them -- to use their (its) CFC legislation notwithstanding any other treaty provisions.

For example, article 27(2) of the 1991 Canada-Mexico tax treaty states:

> “Nothing in the Convention shall be construed as preventing a Contracting State from imposing a tax on amounts included in the income of a resident of that State with respect to a partnership, trust or controlled foreign affiliate, in which the resident has an interest” (IBFD, 1986 --).

Such measures can impact negatively on developing countries, for example (though not the only impact), if they target tax incentives. Given the unclear outcome of the ongoing debate on the compatibility of CFC rules with tax treaties, various countries insist on the inclusion of specific clauses that would allow them to use their CFC legislation notwithstanding other treaty clauses.

(ii) Mutual assistance and exchange of information

Tax treaties generally authorize the tax authorities to exchange information and lend each other assistance in carrying out the provisions of the treaty.[18] Pursuant to article 26 of the OECD model,

the exchange of information can operate simultaneously or on demand but is generally not construed to entail an obligation to:

- carry out administrative measures at variance with the laws and administrative practice of the relevant contracting party;
- supply information that is not obtainable under the laws or in the normal course of the administration of the relevant contracting party; or
- supply information that would disclose any trade, business, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

Besides bilateral tax treaties, the Council of Europe and the OECD have the 1988 Convention on Mutual Administrative Assistance in Tax Matters. The Convention is in force between the limited number of member countries that ratified it.

d. Arbitration and conflict resolution

The settlement of disputes in the framework of international taxation is more akin to the settlement of differences of interpretation and application. This mechanism is essentially based on the mutual agreement procedure under tax treaties. (See, for example, article 25 of the OECD model; OECD, 1997). But the use of other means is steadily increasing.

Under the mutual agreement clause, taxpayers who consider that the actions of one or both contracting States result for them in taxation which is not in accordance with the convention, may present their cases to the residence country authorities. The latter are required to strive, if the cases appear justified and a unilateral solution is not possible, to resolve the cases by mutual agreement with the authorities of the other State. Furthermore, the clause requires the competent authorities of both States to endeavour to resolve by mutual agreement any difficulties or doubts that arise as to the interpretation or application of the convention.

In both cases, however, the tax authorities are merely required to *endeavour* to find a solution. They are by no means required to reach a solution. Furthermore, if a solution is reached, the taxpayer is, in general, not required to be bound by it.

Outside a mutual agreement clause, the essential means of reaching a solution is arbitration. The textbook example is the Arbitration Convention mentioned earlier. Also, more recent tax treaties do sometimes contain an arbitration clause. Most such clauses are restricted to transfer-pricing arrangements (e.g. France-Germany tax treaty), but they are sometimes of a general application (e.g. arbitration board under article 26(5) of the Mexico-United States tax treaty). There are no indications to date on whether arbitration clauses under tax treaties have indeed been effectively applied.

Another dispute settlement procedure is the conclusion of joint advance pricing agreements ("APAs") with regard to the transfer pricing practice of specific taxpayers. This procedure, however, is aimed more at the *prevention* rather than at the settlement of disputes.

* * *

This section has examined a wide range of models of tax provisions in IIAs, ranging from an exclusion of such issues from a treaty to the inclusion of very specific tax issues, notably the use of taxation as a means of administrative expropriation; as an incentive for investors from other countries that are members of a regional economic integration organization formed among developing countries; as a general statement of TNC responsibility in the area of taxation; and as the basis for a taxation regime for regional multinational enterprises or supranational business associations. The final model involves a commitment in an IIA to avoid the double taxation of investors and/or investments. This may extend to an obligation among the contracting parties to conclude a double taxation agreement among themselves. Such an agreement would be based on existing models, of which the OECD and United

Nations models are of special significance. It would cover the principal issues that have been discussed above.

Notes

1 Unless otherwise noted, all instruments cited herein may be found in UNCTAD, 1996a.

2 Specific sub-groups also coordinate their (international) tax policies in the framework of other fora. This is in particular the case for coordination within the European Union. Representatives of France, Germany, the United Kingdom and the United States ("Group of four") meet regularly to exchange views and coordinate policies with respect to tax matters. Regular similar meetings are also held between representatives of Belgium, France, Germany, Luxembourg, the Netherlands and the United Kingdom ("Group of six").

3 The OECD also elaborated a Model Double Taxation Convention on Estates and Inheritances and on Gifts (3 June 1982) (OECD, 1983) and, in collaboration with the Council of Europe, the 1988 Convention between the member states of the Council of Europe and the member countries of the OECD on mutual administrative assistance in tax matters (Convention on Mutual Administrative Assistance in Tax Matters) (IBFD, 1986 --).

4 The latest update was made on 1 November 1997.

5 This section updates UNCTAD, 1998b, ch.III.

6 Indeed, substantial amounts of FDI flow to tax heavens -- without, however, actually being invested there in productive capacities.

7 Egypt, Iraq, Jordan, Kuwait, Sudan, Syria and Yemen.

8 There were two COMECON conventions, one of 22 May 1977 (COMECON (CMEA) multilateral convention with respect to the avoidance of double taxation on income and net wealth of individuals) and one of 19 May 1978 (COMECON (CMEA) multilateral convention for the avoidance of double taxation with respect to income and capital of legal entities) (IBFD, 1986 --).

9 Unless otherwise noted, the texts of the BITs mentioned in this study may be found in the United Nations treaty series and in the collection of BITs maintained by the International Centre for Settlement of Investment Disputes (ICSID, 1972 --).

10 See, for example, article 24(3) of the Albania-Norway tax treaty of 14 October 1998 (IBFD, 1986 --).

11 See, for example, article 23(2) of the Pakistan-Sweden tax treaty of 22 December 1985 (IBFD, 1986 --).

12 See, for example article 23(2) of the Spain-Tunisia tax treaty of 2 July 1982, and article 23(3) of the India-Russia tax treaty of 25 March 1997 (Tax Analysts, 1995-1999).

13 The formulae used is [100 - (t + 25) ÷ 2], whereby t is the foreign tax. Therefore, the lower the foreign tax is, the higher the sparing credit becomes.

14 For example, the French Supreme Court ruled that the non-discrimination clause of the France-Panama establishment treaty of 10 July 1957 does not explicitly exclude, and therefore does apply to, tax matters. (Decision of 15 November 1994, (Lexis, 1987 - 1995)). This required France to conclude an agreement with Panama to specifically exclude the application of the non-discrimination clause to tax matters (France-Panama agreement of 17 July 1995, (Tax Analysts, 1995 - 1999)). The agreement states that the non-discrimination provisions of the France-Panama establishment treaty of 10 July 1953 and investment promotion agreement of 5 November 1982 do not apply to fiscal matters.

15 An exception for both countries is found in their respective tax treaties with the United States which contain a non-discrimination clause.

16 See, for example, the clause under the Netherlands-United States tax treaty of 18 December 1992 (IBFD, 1986 --).

17 There are, to date, only three lower court decisions in France and one appeals court decision in the United Kingdom on the compatibility of CFC rules with tax treaties. The French decisions reached diametrically opposed conclusions although they dealt with the same France-Switzerland treaty. The United Kingdom decision held that the rules are compatible with the Netherlands-United Kingdom treaty.

18 A notable exception is found in Swiss treaties which generally do not contain an exchange-of-information or mutual-assistance clause.

Section III

INTERACTION WITH OTHER ISSUES AND CONCEPTS

The taxation issue has important interactive effects with many of the issues and concepts covered in the series (table 2).

Table 2. Interaction across issues and concepts

Concepts in other papers	Taxation
Scope and definition	+
Admission and establishment	+
Incentives	+ +
Investment-related trade measures	+
Most-favoured-nation treatment	+ +
National treatment	+ +
Fair and equitable treatment	+
Transfer pricing	+ +
Competition	+
Technology transfer	+ +
Employment	+
Social responsibility	+
Environment	+
Home country measures	+
Host country operational measures	+
Illicit payments	+ +
Taking of property	+ +
State contracts	0
Funds transfer	+
Transparency	+
Dispute settlement (investor-State)	+
Dispute settlement (State-State)	+
Modalities and implementation	0

Source: UNCTAD.

Key: 0 = negligible or no interaction.
\+ = moderate interaction.
++ = extensive interaction.

- **Incentives.** The question of incentives is of central importance to tax issues, as many countries have introduced special tax regimes to attract FDI. This has heated up the competition between nations and sometimes even between various parts of the same (federal) country. The effectiveness of tax incentives is not addressed in this paper. A measure that often accompanies tax incentives is "tax sparing" which is discussed in section II.

- **National and MFN treatment.** The interaction between national and MFN treatment on the one hand and taxation on the other is exemplified by the existence of clauses that explicitly exclude taxation from the application of such treatment.[1] National treatment and MFN provisions are generally explicit in this regard.The imposition of taxes being a sovereign right, countries are free, within the constraints of their own legal systems and international obligations, to design any revenue-raising measures they deem necessary. The non-discrimination clause in tax treaties requires a treaty partner to extend to the nationals of the contracting party a treatment that is not *other* or *more burdensome* than that granted to its own nationals, provided the former are in substantially the same circumstances as the latter; or, as in the equivalent NAFTA language: "in like situations" (box 4).

- **Transfer pricing.** Of all the issues covered in the series, transfer pricing is the most closely related to taxation, as the transfer prices of intra-group transactions (which represent one-third of world trade) impact directly on the taxable base. In fact, over the past years, transfer pricing has become one of the most important issues in international tax matters (UNCTAD, 1999a).

- **Technology transfer.** While not the most important factor, taxation can be used to encourage or discourage the transfer of technology. From a tax perspective, the approaches of developed and developing countries are dissimilar on two points. Firstly, most developed countries apply exclusive residence taxation and rarely apply the exemption method with respect to royalties. This position is opposed by developing

countries on grounds of the unbalanced one-way character of payments for the use of technology. One of the arguments used against source taxation is that the source tax would be reflected in, and thus increase the price charged by, the licensor. (This, however, need not necessarily be the case, as discussed in section II.) Secondly, there is a slight difference with regard to technical assistance fees. Under both the OECD and the United Nations models, technical fees can be taxed in the source state but only if attributable to a permanent establishment in that State. A number of developing countries, however, prefer the inclusion of technical fees under the royalty definition, since such would allow them to impose a withholding tax on the *gross* amount of the fee. Other developing countries, while accepting the exclusion of technical fees from the royalty definition, reject their taxation on a *net* basis, as should be the case with any permanent establishment income.

- **Illicit payments.** The problem presented by illicit payments can be aggravated by their taxation treatment in the home country of the payer. (They are by definition undisclosed in the country of the recipient.) Such payments have not been illegal in many home countries, and have even been accorded tax deduction, causing (among other things) a competitive disadvantage to those countries where such payments were illegal and (by definition) non-deductible. Although non-deductability only increases the effective cost of illicit payments, this is one of the few tax measures that can deal with this phenomenon with any measure of effectiveness. Traditionally, however, the general view was that illicit payments are a moral and political problem, and that tax law should not be based on moral or ethical considerations. Under general tax principles, tax is imposed on net income, i.e. after deduction of related expenses. Whether or not such expenses are ethically acceptable was not considered to be a matter for tax law.

- **Taking of property.** Generally, of course, taxation does not amount to a taking; but a tax, when unreasonable or discriminatory, can constitute an expropriation ("creeping

expropriation"). The question remains, however, to what extent and under what conditions the imposition of certain taxes could constitute expropriation. Thus, there is a need to define expropriation with respect to tax measures (UNCTAD, forthcoming a).

Note

1 See UNCTAD, 1999b, section II(b)(2)(a).

CONCLUSION: ECONOMIC AND DEVELOPMENT IMPLICATIONS AND POLICY OPTIONS

This paper has shown the variety of tax issues raised by the activities of TNCs, and the types of provisions that have emerged in IIAs and double tax treaties to deal with them. It has been shown that taxation provisions have played only a minor role in IIAs and that there are several reasons for this. First, double tax treaties are the major legal instruments used between States to deal with tax matters. Secondly, the inclusion of taxation matters can sometimes unduly complicate and draw out IIA negotiations and decrease the chances of successful conclusion. This may be particularly important in cases in which the negotiating parties are at different levels of development. Hence the limited role for taxation provisions in IIAs and for the conclusion of separate tax treaties.

The necessity of tax treaties has been a much debated issue (IFA, 1990). It would appear that a treaty is not necessary where there is no double taxation to relieve (e.g. if there is no tax in one State or if the country of residence unilaterally avoids double taxation). However, even in that case, a tax treaty can be useful, as it generally offers greater and more comprehensive protection than that available under domestic rules which can be modified at will. Thus it can be argued that, while there is no conclusive evidence as to their absolute necessity, evidence of the usefulness of tax treaties is beyond doubt, and, like domestic tax laws, they can play a complementary role in attracting FDI if other factors are satisfactory. Of course the usefulness of a treaty is not always evident where direct business relations between the two contracting parties are minimal. In addition, a country can create, through tax treaties, business opportunities which it would not have otherwise attracted.[1]

Indeed, the single most important advantage of a tax treaty is the relative legal certainty it offers to investors with respect to their tax position in both the source and residence countries.

Outside the few cases of treaty override, the discretionary power of the contracting parties to impose taxes is restricted by the framework agreed to under a treaty. This legal certainty is often greater in the source country than in the country of residence. A source country may decide under its domestic legislative process to increase the rate of dividend withholding tax or to impose tax on capital gains derived by non-residents. However, non-residents covered by a tax treaty can be protected from such domestic law changes, as the source country may not tax them beyond the level agreed under the treaty.[2] In contrast, changes in the domestic law of the country of residence may affect the investor, regardless of the existence of the treaty. For example, if a treaty provides for the elimination of double taxation through the credit method, an increase in the general tax rates of the country of residence affects the investor, notwithstanding the treaty.

When considering the importance of bilateral tax treaties, it is important to recall that the development of regional integration groupings, especially among capital-importing countries, has an important impact on the negotiating position of capital-importing third countries. In principle, bilateral double tax arrangements do not have an MFN impact nor can they apply to non-signatories. Nevertheless, the integration process leads member States of a regional grouping to consider, in their negotiations with third countries, the position of residents of other member States. Thus, the negotiating member State could insist on obtaining a treatment that is not less favourable than that granted to another regional grouping member State, while at the same time being reluctant to grant to the third country a treatment which is more favourable than that which it grants to a fellow member State.

The challenges posed by tax competition (UNCTAD, 1998b; OECD, 1998b) have also forced many capital exporting countries to adopt rules that would allow them to extend their taxing jurisdiction to income and persons not connected to their territory. One of such measures, as discussed in section II, is CFC legislation, which allows a country to tax its own residents on income and gains realized through controlled foreign entities and retained abroad.

For most developing countries, more often host than home countries to FDI, a critical issue is whether an IIA uses a source or residence tax concept.

For developing countries, the OECD Model Convention, which generally favours residence taxation, may well operate under conditions of balanced economic relations such as exist between capital-exporting nations. However, it may not be suited for the overwhelmingly uni-directional capital flows that exist between developed and developing countries.

Again for developing countries, the retention of source taxation is important even if the developing country effectively foregoes the exercise of its taxation right. This is particularly important if the attribution of the taxation right to the source country is exclusive and matched by a treaty-confirmed exemption in the country of residence. In such cases, the source country may choose effectively to forego its right to tax (for example by providing tax incentives that will not be undercut by residence taxation), or may, without being encumbered by a treaty, adopt policy options that allow it to tax on a selective basis (for example by reserving the exemption for capital gains only to shares held for a minimum period of time). In this respect, it is important to take into account that source country taxation is sometimes counter-productive, as the tax cost it may entail can be charged to the same country in the form of a higher price, fee, royalty or interest rate. A well drafted tax treaty can again limit this by involving the country of residence in resolving the issue.

In taking account of all these considerations, the important issues to note are that countries which opt for the conclusion of international tax arrangements need:

- to be aware of the tax system of the treaty partner; and
- to draft the arrangement in such a way as to exploit all synergies with that tax system and preserve their tax base, or (and most importantly for developing countries) at least leave the opportunities open for implementing any source-based options.

In the light of the foregoing discussion, the following options arise in relation to the treatment of taxation issues in IIAs:

Option 1: exclusion of taxation matters from an agreement

There are at least three variants that can be used:

Option 1 (a): a general exclusion

The contracting parties exclude taxation issues completely from an IIA. They can do so through a general, all embracing, exclusionary clause. This approach could be taken where the contracting parties already have a well developed system of double taxation agreements in place. However, this approach may leave open the possibility that the benefits of existing tax arrangements could be claimed by contracting parties to the IIA who are not themselves parties to such arrangements, on the basis of the MFN principle, unless there is an explicit partial or total exclusion from MFN and/or national treatment obligations.

Equally this approach can be taken by countries that simply wish to avoid linking tax and investment issues.

Option 1 (b): partial exclusion for national treatment / MFN

The contacting parties partially exclude taxation issues from an IIA. For example, a treaty could state that nothing in the national treatment / MFN provision shall prevent the adoption or enforcement by the contracting parties of any measure which differentiates treatment between taxpayers that are not in the same circumstances, or is aimed at preventing the avoidance or evasion of taxes. Or it could qualify the application of national treatment to disallow the effect of extending fiscal advantages granted by the contracting parties on the basis of any international agreement or arrangement by which it is or may be bound.

Option 1 (c): specific exclusion through a national treatment /MFN provision

The most common technique of excluding taxation issues from an IIA is through the use of a specific exclusion of taxation matters in the national treatment / MFN clause. This avoids the risk of the "free rider" problem described in option 1 (a). On the other hand, it may not permit certain specific tax questions, which have a direct bearing on the rights of investors under the agreement, from being fully dealt with.

Option 2: qualified exclusion of taxation matters

This approach offers the benefit of excluding taxation issues in general from an IIA while at the same time ensuring that investors' rights are not unduly interfered with by the use of taxation measures. Thus the use of tax measures as a means of expropriation is expressly prohibited in certain agreements, notably the ECT and NAFTA.

From a development perspective, such an approach can help to reinforce the protection of investors under the IIA, though it does restrict the discretion of the host country in the use of tax measures as an instrument of economic policy. Much here depends on how an expropriation is defined in the IIA and on whether a distinction is made between legitimate taxation measures and those whose effect is the economic neutralisation of the investment with the aim of expropriating it (further, UNCTAD, forthcoming a).

Option 3: provisions concerning the tax responsibility of TNCs

Provisions on this matter may be included in an IIA where the contracting parties wish to include investor responsibilities alongside investor rights in order to ensure "good corporate citizenship" from investors. This approach can serve to reinforce existing national legal obligations on taxpayers, by requiring TNCs to observe those obligations. On the other hand, such provisions may add little to those national rules unless they are themselves legally binding, other than acting as hortatory statements of desired practice.

Option 4: reference to avoidance of double taxation

An IIA may include a clause that encourages, or in the alternative obliges, the contracting parties to deal with the problem of double taxation as part of their obligations under an agreement. This may include an obligation to conclude double taxation agreements containing the kind of provisions described and analyzed in section II.

Option 5: taxation regime for regional multinational enterprises

This is a specialized option of relevance to any IIA whose purpose is to establish a regional multinational enterprise or other business association. The clarification of certain basic taxation issues, as discussed in section II, is an essential aspect of such a regime and must be addressed in the agreement.

This approach would not be required where the contracting parties already have a comprehensive network of double taxation agreements in place. On the other hand, it would be a useful course of action for contracting parties to an IIA where some, or all, of them do not already have such a network in place. In this regard an IIA can be used as a spur to effecting a new legal framework for dealing with double taxation issues. This would be a suitable policy choice for countries that are in the process of attracting increased levels of FDI but have, as yet, had no occasion to conclude double taxation arrangements.

This approach could include specific provisions relating to the conditions upon which tax incentives are offered to investors. It is an approach restricted to regional economic integration agreements among developing countries. The main advantage of specifying tax incentives is that it can ensure preferential tax treatment for investors from within the regional parties. However, such incentives can be criticized as distorting the operation of the market through state intervention. Much depends on the specific conditions for capital formation in the region concerned and whether special incentives are thought to be necessary to ensure regional economic integration.

Option 6: IIA dealing with the avoidance of double taxation

Although no example of this approach exists in practice, it is in theory possible to conclude a comprehensive code on the avoidance of double taxation for inclusion in an IIA. The obstacles to this approach, however, would be considerable: the agenda for negotiation could become overloaded; the "free rider" problem might not be able to be successfully addressed, since an MFN exception could not exist alongside commitments to avoid double taxation (although, if all parties agree to such a course of action, presumably the "free rider" problem would cease to be an issue); and the discretion to offer special concessions typical of bilateral tax agreements would be lost if the number of contracting parties to the IIA was considerable. Finally, it should be noted that multilateral regimes on taxation, as noted in section I, are very difficult to agree upon. This option is generally seen by tax experts as not feasible.

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It would be possible to create a mix of approaches based on options 1 to 6. In particular options 3, 4 and 6 could appear alongside other options where specific circumstances warrant.

Where IIAs do include a taxation provision, the development dimension can be enhanced by the inclusion of specialized clauses operationalizing transfer pricing adjustments (UNCTAD, 1999a), transparency guidelines and mechanisms for information sharing. Technical assistance and tax sparing clauses are similarly inclusions aimed at supporting the development objective.

The development dimension can also be served by a provision similar to that in the TRIPS agreement, that assures technical and financial cooperation in favour of developing and least-developed countries. Such cooperation could extend to assistance in the preparation of laws and regulations on taxation matters as well as on the prevention of their abuse, and could include support regarding the establishment of reinforcement of domestic offices and agencies relevant to these matters, including the training of personnel.

Of relevance to all IIAs involving developed and developing countries, is the fact that a commitment to such double taxation arrangements requires a sufficient level of resources to be able to administer a national revenue gathering system effectively and to carry out the cooperative activities required under double taxation arrangements. Thus, where developing countries are involved, additional provisions concerning cooperation and technical assistance from developed countries on taxation matters may be required. Furthermore, the mutual assistance and information exchange provisions in any resulting double taxation arrangement could include special elements to ensure that the developing country party benefits from the institutional arrangements without undue prejudice to its own resources. In addition, skills transfer and training obligations in the field of tax administration may be needed on the part of developed country parties. Such modifications could be introduced via the IIA itself, thereby creating a specific development orientation to the practical operation of the double taxation arrangement (further, UNCTAD, 1999a). At the same time, if it is felt that rules for the avoidance of double taxation are needed, a better solution might be to conclude a separate regional double taxation convention.

Notes

1 While this possibility is increasingly threatened by modern anti-abuse and limitation-on-benefits clauses, the examples of the Mauritius treaty with India, Cyprus treaties with Eastern European countries, and the Netherlands tax arrangement with the Netherlands Antilles are edifying. Indeed, because of their favourable tax treaties with the countries mentioned, Mauritius, Cyprus and the Netherlands Antilles have been used by investors to channel investments in a tax-efficient way.

2 On the other hand, if a source country instead reduces its taxes or introduces certain exemptions, such reductions or exemptions apply to the non-resident investor regardless of the existence of the treaty -- again a positive result for the foreign investor.

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