**Tax Treaty Issues Not Covered in Domestic Law**

A number of provisions found in tax treaties are not usually reflected in domestic

law. This section briefly describes these provisions, together with their effect on domestic

law, specifically nondiscrimination, exchange of information and assistance in collection,

and the mutual agreement procedure.

**A. Nondiscrimination**

The nondiscrimination article of tax treaties is designed to ensure that foreign

investors in a country are not discriminated against by the tax system compared with

domestic investors. The OECD Model nondiscrimination provision is narrower, however,

than similar provisions found in other areas of international law, such as trade. This

difference is necessary because the international tax system operates on the residence and

source principles and so necessarily distinguishes the tax position of residents and

nonresidents. Hence, it is not usually regarded as discriminatory to collect flat-rate gross

withholding taxes from a resident of the other state without a permanent establishment

when a resident is taxed on the same income on a net assessment basis.

148*See* OECD, Taxation and Foreign Direct Investment: The Experiences of the Economies in Transition

(1995), especially the discussion of Latvia in pt II.

The first paragraph of the nondiscrimination article in the OECD Model provides

against discrimination on the basis of nationality, but makes it clear that distinctions on

the basis of residence will not be regarded as giving rise to nationality discrimination (in

other areas, such as EU law, residence distinctions can amount to nationality

discrimination).149 Hence, to breach this provision it is necessary for a country to treat a

resident who is a national of the other state less favorably in the levy of tax or procedural

requirements than a resident national, or a nonresident national of the other state less

favorably than a nonresident national. Such forms of discrimination are rare in domestic

tax laws. The second para. of the OECD nondiscrimination article applies a similar rule

to stateless persons; this provision rarely appears in actual tax treaties.150

The third para. of the nondiscrimination article in the OECD Model requires that

a permanent establishment of a resident of the other state shall not be less favorably taxed

than enterprises of residents carrying on the same activities. This is the most important

provision of the article in practice and, combined with the other articles of the Model,

especially the business profits article, means that the profits attributable to a permanent

establishment have to be taxed on a net basis151 and that the permanent establishment

must otherwise be taxed under the same rules as domestic enterprises. The article deals

with the amount of tax liability and not connected requirements so that it is possible, for

example, to apply withholding taxes on income derived by a permanent establishment of

a nonresident even though such taxes are not applied to a domestic enterprise, so long as

the ultimate tax is on a net basis (i.e., any withholding taxes are not final, are credited

against the ultimate tax liability, and are refunded if there is an excess). If withholding

taxes are applied to income derived by domestic enterprises, there is no question of

breach of the nondiscrimination article in applying them to nonresidents, but even if the

taxes are final for a resident enterprise, they cannot be for a permanent establishment of a

nonresident because of the requirement of the business profits article that taxation be on a

net basis.

The exact extent of the nondiscrimination obligation under this para. is not clear

in all cases, especially as regards application of progressive rate scales to companies, tax

relief for intercorporate dividends, and the granting of foreign tax credits to permanent

establishments for any foreign tax levied on income attributable to the permanent

establishment. The Commentary to the OECD Model contains a lengthy discussion of

these issues.152 The second sentence of the third para. does make clear that it is not

necessary to grant personal allowances to a nonresident individual carrying on business

through a permanent establishment (this sentence often appears as a separate para. In actual treaties). Thin capitalization rules that are applied to a permanent establishment

borrowing from related parties but are not applied to resident enterprises may be contrary

to the paragraph, depending on how the rules are framed. The example of thin

capitalization rules given above will not be contrary to nondiscrimination rules because

they apply to all enterprises. Branch profits taxes may be contrary to the terms of this

paragraph, so that its terms need modification if a country wishes to levy a branch profits

tax.

149*See* Terra & Wattel, European Tax Law ¶¶ 3.2.1, 3.2.3.1, 3.2.3.2 (1993).

150In the 1977 OECD Model and in the UN Model, the second para. is a definition of national; this now

appears in the definition article of the 1992 OECD Model.

151This requirement may have implications for certain forms of presumptive taxation that imposes a tax lien

in the absence of net income. *See* vol. 1, ch. 12.

152Commentary on art. 24 ¶¶ 19–54.

The fourth and fifth paragraphs of the OECD nondiscrimination article ensure that

resident enterprises whose capital is wholly or partly owned or controlled by a resident of

the other state are not subject to discrimination. The fourth paragraph refers specifically

to deductions for interest, royalties, and other disbursements and makes clear that

deductions can be denied through the application of the arm’s-length principle by way of

exception to the requirement for the same treatment. If a developing or transition country

adopts a rule denying deductions for payments to tax havens, the rule will generally be

overridden by the fourth paragraph if a tax treaty is in effect with the tax haven. Hence,

the caution above about negotiating tax treaties with tax havens. The fourth paragraph is

more general, preventing heavier or different taxation or connected requirements than for

other similar enterprises. While it can cover the same ground in part as the fourth

paragraph, the fifth is more specific and therefore prevails in the event of overlap. Thin

capitalization can be an issue under the fourth paragraph, but not if the rules are applied

generally to all enterprises. The fifth paragraph would prevent, for example, a local

subsidiary of a parent in the other state from being subjected to a higher tax rate than

other companies.

The final paragraph in the OECD Model provides that, unlike the other provisions

of a tax treaty, the nondiscrimination article applies to all taxes levied by a state. This

provision is often omitted from actual tax treaties or altered to make clear that it applies

only to taxes covered by the treaty (which it is not strictly necessary to state).

Because tax treaties are enacted in one way or another as part of domestic law and

prevail over other taxing provisions, the nondiscrimination provision is self-executing

and overrides domestic rules that conflict with it. Because of the general terms of the

nondiscrimination article, it is necessary to be aware of its operation when drafting

domestic rules. There is generally little point in devising domestic rules that are contrary

to the nondiscrimination rules, except in the case of tax haven provisions.

The nationality paragraph aside, at first sight the nondiscrimination article seems

to have a residence state bias because its provisions operate effectively only on the source

state (where the permanent establishment or subsidiary operates). This view is not

accurate if the structure of tax treaties is looked at broadly. It was noted above that the

foreign tax credit system in particular may create an incentive for the source country to

increase its taxation on nonresidents (or subsidiaries of foreign parent companies) up to

the level of tax in the residence country. While tax treaties impose rate limits on source

taxation or exclude source taxation altogether in some cases, for income of a permanent

establishment or a subsidiary there are no such limits. Hence, the nondiscrimination

article ensures that source countries do not target higher taxes to these cases and prey on

the relief system of the residence country.153 The equivalent undertaking of the residence

country is in its treaty obligation to relieve double taxation for source taxes levied in

accordance with the treaty. The residence country could not satisfy its obligations under

this paragraph by levying tax rates on foreign investment that are higher than those on

domestic investment and then purporting to relieve double taxation through a tax

credit.154 The nondiscrimination article does not prevent a country from discriminating in favor of nonresidents (as with tax holidays or other incentives that apply only to foreign investors). Nor does the article prohibit provisions in the domestic law that favor the location of investment in the country; for example, a country can have special tax

incentives for research and development conducted in the country or for plant and

equipment used in the country, as long as these locational incentives are not confined to

residents or locally owned companies.

**B. Exchange of Information and Assistance in Collection**

Most countries have a domestic law rule that they will not directly or indirectly

assist another country in the collection of its taxes.155 This rule means that exchange of

tax information and other forms of assistance in collection of taxes are not possible

without a tax treaty that overrides this rule in domestic law. The tax secrecy rules of

many countries also prevent the exchange of information. Exchange-of-information

provisions are found in virtually all tax treaties, but other forms of assistance are less

commonly provided for.

The standard OECD and UN Model exchange-of-information article requires a

country to obtain information for its treaty partner where the information is necessary for

carrying out the provisions of the treaty or of the country’s domestic tax law. Exchanged

information is required to be kept secret in accordance with the secrecy rules of domestic

law of the recipient country and in accordance with the express treaty rules on this topic.

In addition, the standard treaty article provides that information need not be exchanged

when it involves commercial or trade secrets. Tax secrecy is often not as strong an

institution in developing or transition countries as it is in industrial countries and so can

be a very sensitive topic in tax relations between treaty partners. It is implicit in the exchange-of-information article, however, that a country cannot refuse to give

information to its treaty partner because of its own tax secrecy laws.

153Even in the absence of a treaty, this tactic may not be effective if the resident country denies a credit for

so-called soak-up taxes, as does the United States, for example. *See* Treas. Reg. § 1.901–2 (c).

154This is implicitly recognized in the paragraph in the OECD Model allowing the residence country to

apply exemption with progression to income, which it relieves from double taxation by exemption, arts.

23A(3), 23B(2). Exemption with progression takes the foreign income that has been exempted into account

in determining the tax payable on domestic income. Usually an average rate of tax is worked out on the

assumption that all the foreign and domestic income of the resident is subject to tax and this rate is then

applied to the domestic income of the resident.

155This rule is not found in the tax laws of the country but in the rules of private international law (conflict

of laws). Thus, in common law countries, it is simply part of the common law (*see* Government of India v.

Taylor [1955] AC 491).

The exchange-of-information article also serves as a test of the lowest common

denominator for procedures of collecting information. Information need not be collected

if it could not be obtained under the procedures of either country. For example, the

information being sought may be kept at the home of a taxpayer. If the tax procedure law

of either treaty country forbids entry of domestic (as opposed to commercial) premises to

obtain information, then there is no obligation to obtain the information. If, however, the

impediment arises under the law of the country making the request and if the country that

has received the request for such information is able to obtain the information under its

laws, that country may (but is not obliged to) forward the information to the other country

under the exchange-of-information article.

Unlike other articles of tax treaties, the exchange of information article is not

limited in application to residents of the treaty partners. For example, one country could

request the other to obtain information from a permanent establishment in that state of a

resident of a third state. Although the Models do not so provide, information is being

increasingly extended to taxes other than income taxes for the practical reason that many

countries use the same tax officials to enforce a number of different taxes (e.g., income

tax and value-added tax), and it is difficult for an official who has received foreign

information to use it only in relation to one tax when it is relevant to several taxes.

The OECD provides considerable practical guidance on exchange of

information.156 The use of computers in tax administration is spilling over into this area,

and the sophistication of the exchange process has increased rapidly. The OECD has

developed a standard computer format for exchange of information.157 In recent years, the exchange article has given rise to some novel extensions of its use, such as for

simultaneous audits of the same or related taxpayers by each party to a treaty (and even

by more than two countries through the use of exchange provisions in a number of

treaties). The OECD has developed a model agreement for tax administrations to

formalize the process.158 Whether developing or transition countries will be able to

participate in these recent developments will depend on their level of computerization

and audit capacity.

In addition, provisions for assistance in collection are increasingly being included

in tax treaties. Under these provisions, each country undertakes to collect the taxes of the

other. As no OECD or UN Model provision currently exists for this purpose, the

following text is provided as a sample.

Article 27. Assistance in Collection

1. The competent authorities of the Contracting States undertake to lend

assistance to each other in the collection of taxes, together with interest, costs, and

civil penalties relating to such taxes, referred to in this article as a “revenue

claim.”

2. Requests for assistance by the competent authority of a Contracting State in the

collection of a revenue claim shall include a certification by such authority that,

under the laws of that State, the revenue claim has been finally determined. For

the purposes of this article, a revenue claim is finally determined when a

Contracting State has the right under its internal law to collect the revenue claim

and the taxpayer has no further rights to restrain collection.

3. A revenue claim of a Contracting State that has been accepted for collection by

the competent authority of the other Contracting State shall be collected by the

other State as though such claim were the other State’s own revenue claim as

finally determined in accordance with the provisions of its laws relating to the

collection of its taxes.

4. Amounts collected by the competent authority of a Contracting State pursuant

to this article shall be forwarded to the competent authority of the other

Contracting State. However, except where the competent authorities of the

Contracting States otherwise agree, the ordinary costs incurred in providing

collection assistance shall be borne by the first-mentioned State, and any

extraordinary costs so incurred shall be borne by the other State.

5. No assistance shall be provided under this article for a revenue claim of a

Contracting State in respect of a taxpayer to the extent that the revenue claim

relates to a period during which the taxpayer was a resident of the other

Contracting State.

6. Nothing in this article shall be construed as imposing on either Contracting

State the obligation to carry out administrative measures of a different nature from

those used in the collection of its own taxes or that would be contrary to its public

policy (*ordre public*).

7. Notwithstanding the provisions of article 2 (Taxes Covered), the provisions of

this article shall apply to all taxes collected by or on behalf of the Government of

a Contracting State.

Whether the last paragraph is included will depend in part on a similar extension

being made to the exchange article. On the grounds of administrative capacity,

developing and transition countries may not consider such an article appropriate to their

circumstances (and, equally, industrial countries may not be willing to agree with them

on this article). More elaborate stand-alone treaties dealing with tax administration have

been developed, and the Multilateral Treaty on Mutual Administrative Assistance, which

covers exchange of information, service of documents, and assistance in collection is

open for signature to those countries that join the Council of Europe or the OECD.159 It

entered into force on April 1, 1995.

**C. Mutual Agreement Procedure**

The final provision of tax treaties that requires comment is the article on the

mutual agreement procedure. Under the Model versions, this article performs three

functions: it provides a dispute resolution mechanism in relation to the application of the

provisions of tax treaties to specific cases; it allows the countries to settle common

interpretations and applications of their tax treaty; and it allows them to resolve cases of

double taxation not otherwise dealt with by their treaty. Some countries find that the third

function and often the second are difficult to reconcile with their domestic laws and

procedures and therefore omit them from their treaties. In practice, it is dispute resolution

for the specific case that predominates, whatever the precise form of the article.

The ground on which the taxpayer can invoke this procedure is that the actions of

one of the states result or will result in taxation not in accordance with the treaty. The

taxpayer has three years to invoke the procedure from the first notification of the act

complained of. The states are obliged under the article to consult on the problem raised

by the taxpayer if the state with which the problem is raised is unable or unwilling to

resolve it unilaterally, but they are not obliged to resolve the case. If a resolution is

agreed to by the states, then under the Models it is to be implemented notwithstanding

domestic time limits on amending tax assessments. Some countries are unwilling to agree

to such overriding of domestic time limits in their tax treaties.

No specific procedure is provided, but it is made clear that the tax administrations

can make contact directly and do not need to go through diplomatic channels. The major

issue that arises in practice is the relationship between domestic appeal procedures

provided for in tax laws and the treaty dispute resolution mechanism. To avoid

competition or conflict between domestic appeals and the mutual agreement procedure,

some countries provide in their tax laws or procedures that the taxpayer must waive or

suspend appeal rights under domestic law, while other countries will not actively pursue

the competent authority procedure until domestic appeal periods have expired and the

taxpayer has not utilized them.

The mutual agreement procedure has also been the subject of novel uses in recent

times. The main development concerns advance pricing arrangements under which the

mutual agreement procedure is used to agree to a transfer price in advance, so that

taxpayers and tax administration are spared disputes after the event. This is a

sophisticated procedure that for the moment is probably only relevant to industrial countries.160 Taxpayer dissatisfaction with the mutual agreement procedure has led some countries to adopt arbitration procedures in their tax treaties for cases where it is not possible for the competent authorities to resolve disputes. The main purpose of such

provisions is to put pressure on the tax administration to resolve international disputes

rather than to actually engage in arbitrations.161

**IX. International Tax Priorities for Developing and Transition**

**Countries**

It will be evident from this chapter that the construction of the international

elements of the income tax system in domestic law and tax treaties is a complex topic.

Among developing and transition countries (as among industrial countries), there will be

wide differences in the capability of the tax administration to deal with international tax

issues. While priorities will vary from one country to another, this concluding part of the

chapter indicates a line of development that should suit many developing and transition

countries.

The priority of any tax system will always be to tax the domestic income of

resident taxpayers.162 With the increasing internationalization of economic relations,

however, even this goal means that attention must be given to international income tax

issues. For better or worse, the globalization of the world economy impinges on

developing and transition countries, and it is not possible for a country to isolate itself or

its tax system. The interdependence of market economies is a new phenomenon, and

transition countries in particular retain a residual belief in the ability of regulation to deal

with problems. In some developing countries also, the capacity of economic regulation in

the current economic environment is overrated. Developing and transition countries face

similar problems of international taxation as industrial countries, which means that,

whatever may have been the case in the past, it is not possible to adopt the attitude that

international issues can wait.

The incentives for capital flight are strong in developing and transition countries

even apart from the tax system. If a country operates the source principle only, then it is

necessary to have robust rules for the source of income to ensure that the source-based

tax is not avoided. Even with such rules, there will be a strong incentive for residents to

move income offshore in order to avoid taxation, which will be a relatively simple matter for passive portfolio income (by investment choice). The residence principle should be

adopted to prevent this form of tax avoidance. Once the residence principle is adopted,

then measures for the relief of double taxation by way of exemption or a simple foreign

tax credit are also necessary. At this point of development, the country has satisfied the

basic norms for international tax rules on which tax treaties depend.

160OECD, Transfer Pricing Guidelines ¶¶ 4.124–4.166. In the medium term, Advanced Pricing

Agreementss (APAs) developed by advanced countries may help to solve the difficulties for developing

and transition countries in enforcing transfer pricing rules.

161For a discussion of these issues, see OECD, Transfer Pricing Guidelines paras. 4.167–4.171; the EU has

implemented an arbitration procedure in transfer pricing cases, Convention of July 23, 1990, on the

Elimination of Double Taxation in connection with the Adjustment of Profits of Associated Enterprises,

90/436/EEC, O.J. No. C304 of December 21, 1976, 4.

162With the possible exception of a few countries with small populations and large resource bases exploited

by foreign investors.

The ability of residents, again by simple investment choice, to derive foreignsource

passive income through nonresident taxpayers (such as offshore mutual funds)

indicates that further measures are necessary even for the simple goal of protecting the

domestic tax base in the case of residents not engaged in active businesses. A simple

provision indicating an intention to levy tax in these cases, together with enforcement

efforts directed at tax evasion using foreign bank accounts, is the best that can be

achieved to deal with the various kinds of capital flight. Residents involved in purely

domestic business activities can also use the international tax system to avoid taxes. In

this case, investments will be looped offshore and back into the country, creating the

potential for such techniques as transfer pricing, thin capitalization, and profit stripping to

move profits out of the country, usually to tax havens. The simplest approach for dealing

with such problems is a brief provision levying tax on the resident owners of the offshore

entities. Such provisions are necessary today simply to ensure collection of tax on the

domestic income of residents.

With provisions in place to secure the domestic tax base, probably the next

priority should be tax treaties. These marginally increase the capacity to enforce taxation

of the domestic income of residents through exchange of information (although the use of

tax havens for much of the offshore activity limits the effectiveness of tax treaties). Most

important, they signal to foreign investors the country’s intention to play by the generally

accepted rules of international taxation and not to discriminate against foreign investors

while leaving room (if negotiated in an appropriate form) to extend domestic taxes to

foreign investors. Except in the increasingly unusual case of a country deciding not to

pursue the negotiation of tax treaties, the contents of tax treaties overshadow the way in

which a country should frame its tax laws for the taxation of foreign investors. It has been

suggested throughout this chapter that the rules of tax treaties should generally be

followed in domestic law for greater transparency and simplicity in the application of the

tax law where a tax treaty is operative.

Taxation of foreign investors in developing and transition countries is a politically

divisive issue. On the one hand, there is a natural resentment against the economic

resources of a country being owned and exploited by foreigners. In the past, this attitude

contributed in many developing countries to restrictions on foreign-owned operations. On

the other hand, the need for foreign capital, technology, and management skills is

increasingly felt as more and more countries compete for what is available, especially

since the transition countries have entered the picture. The result is policy and

administrative ambivalence to taxation of foreign investment.

Many countries offer tax incentives for foreign direct investors. While the efficacy of these incentives in attracting increased foreign investment may be doubted,

any attempt to tax foreign direct investors effectively involves formidable problems of

drafting the law and administering it. The basic provisions for taxing nonresidents consist

generally of withholding taxes on passive and employment income and collection by

assessment on business income. The investment choices for portfolio foreign investors

and the tax avoidance techniques available to the foreign direct investor mean that such

provisions are not adequate and that rules in domestic law on transfer pricing, thin

capitalization, and tax havens are required. These will by no means cover the tax

avoidance strategies available. A general antiavoidance provision or doctrine will assist

the tax administration to cope with international tax avoidance, but requires considerable

effort to implement. In short, any serious attempt to collect tax from foreign direct

investors is fraught with drafting and administrative difficulties, while taxation of

portfolio investors may simply induce them to move their investment out of the country.

For these reasons, the taxation of foreign investors is probably the last international

taxation issue that a developing or transition country should seriously tackle.

The number and significance of the international tax problems that confront the

income tax is one reason why developing and transition countries do well to rely on

alternative tax bases in addition to the income tax as a major source of tax revenue. The

value-added tax, excises, social security, and property taxes generally present fewer

international difficulties of drafting and enforcement than the income tax.