United Nations Model Double Taxation Convention between Developed and Developing Countries: 2011 Update

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The role of double-tax treaties in promoting international investment

International law places very few limits on the tax sovereignty of countries. As a result, income from cross-border investments and activities may generally be taxable both in the source country, which is the country where investment or other activity takes place, and in the residence country, which is the country of the investor or trader, according to their respective domestic tax laws. Double-tax treaties are bilateral agreements between two countries, which allocate taxing rights over such income between these countries and thus prevent double taxation of this income. The prevention or elimination of international double taxation is a significant aspect of countries' investment climate, which is essential for investment flows between countries, the exchange of goods and services, the movement of capital and persons, as well as the transfer of technology.

Over the past decade, the relationship between the mobilization of financial resources for development and international tax cooperation featured prominently in the outcome documents of major United Nations conferences and summits on economic and social matters, including the 2002 Monterrey Consensus, the 2008 Doha Declaration on Financing for Development, as well as the outcomes of the 2009 Financial Crisis Conference and the 2010 MDG Summit.

Double-tax treaty models

Double tax treaty models, as developed by international organizations, are generally used by countries as a basis for negotiations of their bilateral tax treaties. The two models most widely used as part of the continuing international efforts aimed at eliminating double taxation are: 1) the United Nations Model Double Taxation Convention between Developed and Developing Countries (the UN Model); and 2) the OECD Model Tax Convention on Income and on Capital (the OECD Model). These models formed the basis for most of the several thousands tax treaties currently in force, thus providing a profound influence on international tax treaty practice.

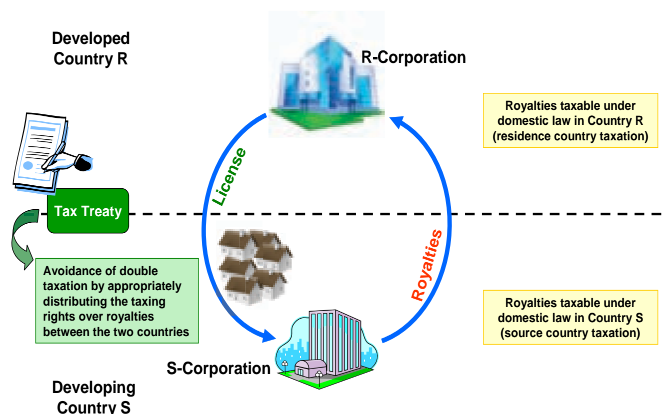
The similarities between these two leading models reflect the importance of achieving consistency where possible. On the other hand, the divergences between them reflect the different membership and priorities of the two Organizations. The key differences relate, in particular, to the issue of to what extent a country should forego, under bilateral tax treaties, taxing rights, which would be otherwise available to it under domestic law, with a view to avoiding double taxation and encouraging investments.

In general terms, the UN Model tends to preserve a greater share of taxing rights for the source country, which is the country where investment or other activity takes place. The OECD Model, on the other hand, favours retention of a greater share of taxing rights by the residence country, which is the country of the investor or trader. Thus, the UN Model would normally allow developing countries more taxing rights on income generated by foreign investments in these countries. This has long been regarded as an issue of particular importance for developing countries in view of their development goals. Nevertheless, it is also a position that some developed countries seek in their bilateral tax treaties.

How do double-tax treaties work?

In a hypothetical scenario (see Figure 1), R-Corporation, a steel company which is a resident of developed country R, wishes to license S-Corporation, a manufacturing company which is a resident of developing country S, to produce and market a new line of cheap but sturdy prefabricated housing. S-Corporation will pay royalties in return for the rights to manufacture and

Figure 1



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distribute the housing in developing country S. Such royalties are taxable as the income of R-Corporation under the laws of both developed country R (the country of its residence) and developing country S (the country where the profits are generated).

In this case, there is a risk that R-Corporation might be discouraged from licensing the patent rights to S-Corporation due to its income being taxed twice. Alternatively, R-Corporation may require the payment of considerably higher royalties to safeguard its return on the relevant research and development costs. This will force S-Corporation to raise their prices, putting the housing out of reach for many citizens of developing country S and limiting the ability of S-Corporation to compete and be profitable in the local market. As a result, in both cases the development goals of developing country S, namely, to provide more affordable housing for all citizens and to promote profitability of local enterprises, might be jeopardised. Also, the transfer of technology and of business skills to developing country S might be prevented from taking place.

Domestic tax laws can deal with some aspects of this double taxation discouraging investment, but not as effectively as a bilateral tax treaty operating at the international law level. Such a treaty avoids double taxation of the royalties by appropriately distributing the taxing rights over that income between the two countries.

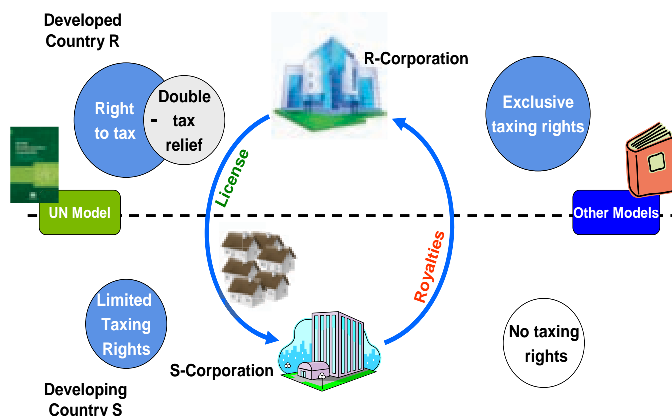
Advantages of the UN Model

The UN Model aims at both encouraging investments and increasing public revenues for sustainable development. To this end, it seeks a compromise between the so called "source taxation" (i.e. taxation in the host country of the investment) and the so called "residence taxation" (i.e. taxation in the home country of the investor). However, compared to other leading international double tax treaty models, the UN Model gives more weight to source taxation, thus protecting the specific interest of developing countries to retain a greater share of taxing rights over the income sourced in those countries, so that the proceeds can be used to meet development needs. On the other hand, however, the provisions of the UN Model take into consideration that taxation in the source country should not be too high in order not to discourage investment and recognize the appropriateness of the sharing of revenue with the country providing the capital.

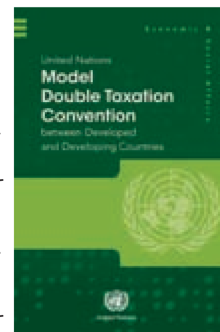
In the above scenario, for instance, unlike other leading international tax treaty models, which allocate taxing rights over royalties only to the country of residence of the recipient (i.e. developed country R), the UN Model provides that royalties may also be taxed in the country, where they originate (i.e. developing country S) to a maximum percentage negotiated in the bilateral tax treaty. Developed country R is also allowed to tax the royalties, but needs to deduct the amount already paid in developing country S. There is an obligation in the UN Model that the country of residence of the recipient grant double taxation relief for taxes paid in the country where the royalties originate (see Figure 2).

Tax treaties based on the UN Model, therefore, play a key role in preventing double taxation over cross-border income, thus promoting international investments, trade and transfer of technology. By the same token, they also retain appropriate shares of taxing rights over income sourced in developing countries in support of achieving their development goals.

Figure 2



2011 update of the UN Model



The United Nations has recently reached a milestone in its ongoing effort to enhance international tax cooperation, with a view to encouraging international investments for development. An updated version of the United Nations Model Double Taxation Convention between Developed and Developing Countries has been adopted. It culminates the work carried out by the UN Committee of Experts on International Cooperation in Tax Matters over more than a decade, since the last revision of the UN Model in 1999, which was published in 2001.

The main objective of this revision of the UN Model has been to take into account recent developments in the area of international tax policies of both developing and developed countries. Moreover, the updated UN Model further clarifies and improves the operation of its provisions aimed to prevent double taxation over income from cross-border investments and activities, and offers improved explanations to help countries make their own decisions on these important issues of tax policy and practice. ■

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