Economic & Social Affairs

Papers on Selected Topics in

Negotiation of Tax Treaties

for Developing Countries

United Nations

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Preface

Tax treaties play a key role in the context of international cooperation in tax matters. On the one hand, they serve to encourage international investment and, consequently, global economic growth, by reducing or eliminating double taxation over cross-border income. On the other hand, they seek to enhance cooperation among tax administrations, especially in tackling international tax evasion. Developing countries, in particular the least developed ones, often lack the adequate skills and experience to efficiently interpret and negotiate tax treaties. This may result in difficult, time-consuming and, in worst-case scenarios, unsuccessful negotiation of tax treaties, which may not adequately address policy priorities of developing countries. Moreover, their capacity to be effective treaty partners may be jeopardized, especially as it relates to cooperation in combating international tax evasion.

The importance of raising tax revenues for development, including through international tax cooperation, features prominently in the ongoing intergovernmental discussions on a new financing strategy, in support of the post-2015 development agenda, with poverty eradication and sustainable development at its core. The United Nations General Assembly, in its resolution 68/204 of 20 December 2013 on Financing for Development, recalled the ongoing commitment of Member States to enhance and strengthen domestic resource mobilization and fiscal space, including, where appropriate, through modernized tax systems, more efficient tax collection, the broadening of the tax base and the effective combating of tax evasion and capital flight. While each country is responsible for its tax system, it is important to support national efforts in these areas by strengthening technical assistance and enhancing international cooperation and participation in addressing international tax matters.

There is a clear need for capacity-building initiatives, which would strengthen the skills of the relevant officials in developing countries in the tax treaty area, as a contribution to further enhancing their

role in support of the global efforts aimed at improving the investment climate and effectively curbing international tax evasion. We hope that this collection of papers will contribute to fulfilling that need. The papers were written by experienced treaty negotiators, in consultation with numerous experts from the national tax authorities and ministries of finance of developing countries. An effort was made to keep the material basic and practical. We hope that it will serve a useful purpose in providing practical guidance to tax treaty negotiators from developing countries to advance their countries' double tax treaty practices.

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Alex Trepelkov, Harry Tonino and Dominika Halka
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Introduction

At its eighth session (Geneva, 15–19 October 2012), the Committee of Experts on International Cooperation in Tax Matters (the Committee) requested the secretariat "to seek additional resources to advance the work to strengthen the capacity of developing countries to negotiate tax treaties."

Accordingly, the Financing for Development Office (FfDO) organized an expert group meeting on "Tax Treaty Negotiation and Capacity Development" (New York, 13-14 December 2012) with the participation of several members of the Committee, as well as current and former tax treaty negotiators representing both developed and developing countries. The purpose of the meeting was to discuss and identify the most suitable strategies and modalities for the development and implementation of tools aimed at strengthening the skills of national tax authorities in developing countries in the area of double tax treaty negotiation.

The experts shared their experiences in this area, with a focus on the needs of developing countries at different levels of development and with diverse macroeconomic conditions and goals. They also analysed the existing knowledge on the subject, as well as available materials and capacity development tools, including those developed by the Committee. They then determined how and to what extent these resources could be effectively used and/or needed to be improved or complemented for the purposes of delivering capacity-development initiatives in the above area. They also put forward proposals on content and implementation of such activities.

One of the proposals was to develop a number of practical papers on selected issues in the negotiation of tax treaties and offer them to developing countries free of charge. The experts identified tentative topics of these papers as well as potential authors who would be in the best position to draft them. In follow up, FfDO requested the proposed authors to prepare outlines for the papers that were envisaged.

These outlines were then discussed during a technical meeting on “Capacity Building on Tax Treaty Negotiation” (Rome, 28-29 January 2013), which was held with the participation of 25 representatives of the national tax authorities and ministries of finance from developing countries, representing all the regions of the world. This meeting was held as part of a joint project undertaken by FfDO and the International Tax Compact (ITC). The financial contribution for the project has been provided by the German Federal Ministry for Economic Development and Cooperation (BMZ).

The authors presented the outlines of their papers, followed by interactive discussions facilitated by selected members of the Committee and representatives of several international and regional organizations. National participants were frank in sharing their countries’ experiences and concerns. The discussion contributed to: (i) identifying the needs of developing countries in the area of tax treaty negotiation and taking stock of the available capacity development tools at their disposal; and (ii) determining the actual skills gaps and challenges faced by developing countries in negotiating their tax treaties. The report of the Rome meeting summarizing the main findings is available at http://www.un.org/esa/ffd/tax/2013CBTTNA/Summary.pdf.

Following the Rome meeting, the outlines were revised taking into account feedback received from representatives of developing countries. Subsequently, the authors drafted their papers.

They were then presented by the authors and discussed during the technical meeting on “Tax Treaty Administration and Negotiation” (New York, 30-31 May, 2013), with the participation of 32 representatives of developing countries, several members of the Committee, as well as representatives of international and regional organizations.

Each paper was presented by the author and had a designated lead discussant, representing the relevant authority in a developing country, who commented on its relevance in view of the experience of his/her country and proposed specific revisions to it. The comments by the lead discussant were followed by an interactive discussion among the participants that was chaired by a member of the Committee or a representative of an international organization. Additional revisions

to the papers were then proposed with a view to ensuring that they would adequately address the actual skills gaps and challenges faced by developing countries. The report of the New York meeting summarizing the main findings is available at: http://www.un.org/esa/ffd/tax/2013TMTTAN/Newsletter5_2013.pdf

Following the New York meeting, the authors revised and finalized their papers taking into account the feedback received during the meeting.

The papers were then presented to the Committee during its ninth session (Geneva, 21-25 October 2013) as possible input to the United Nations Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries.

At that session, the Committee formed a Subcommittee on Negotiation of Tax Treaties — Practical Manual, to be coordinated by Mr. Wolfgang Lasars and mandated it to develop a new practical manual for the negotiation of bilateral tax treaties between developed and developing countries. The objectives were to report to the Committee at its tenth session and to present a complete draft manual for adoption at the eleventh session, in 2015. As a first step, the Subcommittee prepared an outline of the manual, which included a summary of the above-mentioned papers.

In parallel, given a lot of positive feedback received from developing countries on the papers and the urgent need for more assistance in the area of negotiation of tax treaties, FfDO decided to publish them in their entirety for the benefit of tax treaty negotiators from developing countries, who are just starting their work.

The papers which comprise this collection should be considered self-standing rather than constituting a cohesive publication. As such, there may naturally be a certain amount of overlap. The views and opinions expressed therein are those of the respective authors and do not necessarily reflect those of the generality of treaty negotiators, nor of the United Nations, its Secretariat or the Committee.

Contents

Preface iii
Acknowledgements v
Introduction ix

Why negotiate tax treaties? **1**
1. Introduction 1
2. Facilitating cross-border investment and transfer of skills and technology 5
   2.1 Relief of double taxation 5
   2.2 Reducing excessive source taxation 10
   2.3 Preventing tax discrimination 11
   2.4 Providing certainty and simplicity 12
   2.5 Maintaining or accessing benefits of domestic tax concessions 14
3. Preventing fiscal evasion 17
4. Political reasons 19
5. Summary of costs and benefits to developing countries of having tax treaties 21
   5.1 Benefits 21
   5.2 Costs 23
6. Conclusions 27

Tax treaty policy framework and country model **29**
1. Introduction 29
2. Policy framework for developing countries 29
   2.1 General 29
   2.2 International norms 32
   2.3 Designing a policy framework 37
   2.4 Distributive rules 38
3. Designing a model tax treaty 45
   3.1 Persons covered 47
   3.2 Taxes covered 47

3.3 Distributive rules 49
3.4 Relief of double taxation 62
3.5 Non-discrimination 63
3.6 Mutual agreement procedure and arbitration 64
3.7 Anti-abuse provisions 65
3.8 Administrative assistance 65
3.9 Protocol 67
4. Conclusions 67

Preparation for tax treaty negotiations 69
1. Introduction 69
2. Preparation of a country model treaty 69
3. Authority to negotiate 71
4. Logistics 73
5. Definition of the roles of each member of the team 77
6. Consultations with business and relevant ministries and agencies 79
7. Preparation of the draft country model used for a particular negotiation 80
8. Preparation of alternative provisions 81
9. Non-negotiable provisions 81
10. Interaction between domestic legislation and treaty provisions 82
11. Preparation of a short explanation of the domestic tax system and provision of it and draft country model to the treaty partner 83
12. Preparation of a comparison of the respective draft country models — identification of issues 83
13. Identification of provisions proposed in the two draft country models that deviate from provisions agreed in treaties with third countries 84
14. Study of the culture and habits of the other country 86
15. Conclusions 87

Annex I:
Example of a comparison of draft country model treaties: Article 15 88

Annex II:
Example of a comparison of draft country model treaties 89

How to conduct tax treaty negotiations. 93
1. Introduction 93
2. Negotiation style 94
3. Trust. 95
4. Building a relationship 96
5. Discussion. 97
6. Arguments 107
7. Use of protocols, exchange of notes and memoranda of understanding 113
8. Records of discussions 114
9. Conclusions 117

Annex I:
Example of agreed minutes of first-round negotiations 118

Annex II:
Example of agreed minutes of second-round negotiations 119

Post-negotiation activities 121
1. Introduction 121
2. Entry into force and termination 121
3. Preparation for signature 127
   - 3.1 Introduction 127
   - 3.2 Translation. 129
   - 3.3 Signing of the treaty 131
   - 3.4 Post-signing activities 133
   - 3.5 Post-entering into force 134
   - 3.6 New legislation 135
   - 3.7 Changes to the provisions of a treaty. 136
4. Conclusions 137

Why negotiate tax treaties?

Ariane Pickering*

1. Introduction

Countries entering into tax treaty negotiations need a good understanding of why they are doing so, and of the benefits and costs that arise from having tax treaties.

Developing countries will often negotiate tax treaties in order to attract foreign investment, sometimes in conjunction with investment protection and promotion agreements. In many cases, there may be pressing diplomatic reasons (for instance, as a response to pressure from another country). Sometimes they are negotiated because an adviser has suggested that it would be a good thing to do. On the other hand, some developing countries may refuse to have tax treaties, either generally or with particular countries, because of a fear of reduced revenue as a result of the limitations on source taxation that such treaties impose.

The decision to enter into treaty negotiations with another country is not one to be undertaken lightly, especially for developing countries. There are both benefits and potential costs to them from concluding a tax treaty, so it is desirable to have a comprehensive tax treaty strategy, agreed (if possible) across the whole of government (especially with the Ministry of Foreign Affairs), before embarking on tax treaty negotiations.

Having an understanding of the potential costs and benefits of tax treaties, and the ways in which treaties operate to achieve intended outcomes, will assist in ensuring that the right negotiations are given priority and that particular negotiations result in the most beneficial outcomes. By understanding the reasons for entering into a treaty, tax

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treaty negotiators, tax administrations and taxpayers will better comprehend the policy framework underpinning their own and the other country's tax treaties.

Tax treaties can benefit both developed and developing countries. For treaties between two developed countries, where the capital flows are approximately equal in both directions, the removal of tax obstacles to cross-border investment and the prevention of fiscal evasion provide clear benefits to both countries. Any reductions in source taxation are generally offset by increased residence-based taxation.

The benefits to developing countries of tax treaties with developed countries, where the capital flows are almost exclusively one way, are less obvious. Nevertheless, in 1967, the United Nations Economic and Social Council (ECOSOC) noted that it was "[c]onfident that tax treaties between developed and developing countries can serve to promote the flow of investment useful to the economic development of the latter, especially if the treaties provide favourable tax treatment to such investments on the part of the countries of origin, both by outright tax relief and by measures which would ensure to them the full benefit of any tax incentives allowed by the country of investment".[1]

The economic benefits of treaties between two developing countries, though relatively small, may encourage development more generally within a region and may be a valuable tool in preventing cross-border tax avoidance and evasion. Tax treaties may also have other benefits, such as political benefits.

Countries enter into tax treaties for a variety of reasons. For each country, and indeed for each treaty entered into by that country, the reasons are likely to be different, depending on the economic and political situation of the country and its relations with the potential treaty partner country. The priority that would be given to each reason will differ, depending on the circumstances prevailing in each country, and having regard to the relationship between the two countries. In some countries, the desire to attract foreign investment will be paramount, whereas in others revenue or political considerations may be more important.

[1]Economic and Social Council resolution 1273 (XLIII) on Tax Treaties between Developed and Developing Countries of 4 August 1967.

This paper seeks to examine the most common reasons why a country would enter into a tax treaty with another country. These may include some or all of the following:

(a) To facilitate outbound investment by residents by:

- Removing or reducing double taxation on investment in the other country;
- Reducing excessive source country taxation;
- In the case of low-tax countries, creating a competitive advantage for its residents by reducing or removing source taxation;
- Removing or reducing tax discrimination on investment in the other country;
- Providing certainty and/or simplicity with respect to taxation on investment in the other country on outbound investment by residents.

(b) To facilitate and encourage inbound investment and inbound transfers of skills and technology by residents of the other country by:

- Removing or reducing double taxation on the inbound investment or transfers;
- Reducing excessive source taxation;
- Providing increased certainty and/or simplicity with respect to taxation of the inbound investment or transfers (for instance, through non-discrimination rules, provision of international standards, inclusion of a mutual agreement procedure (MAP));
- Developing a closer relationship between tax authorities and business (for instance, through the mutual agreement procedure);
- Maintaining benefits of tax concessions and tax holidays provided with respect to inbound investment or transfers.

(c) To reduce cross-border tax avoidance and evasion through:

- Exchange of tax information;
- Mutual assistance in collection of taxes.

(d) For political reasons, such as:

- Sending a message of willingness to adopt international tax norms;
- Fostering diplomatic or other relations with the other country;
- Strengthening regional diplomatic, trade and economic ties;
- Complying with international obligations (for instance, under regional economic agreements);
- Responding to pressure from the other country.

The importance of each of these reasons will be different in each situation. Motivations may vary depending on whether a country is a net exporter of capital (typically a developed country) or a net importer of capital (typically a developing country). It is important to understand all perspectives when considering a negotiation request from another country or designing a broader tax treaty strategy.

In developing countries, there may be little outbound investment by its residents. For these countries, the main reasons for entering into treaty negotiations are commonly:

(a) To attract foreign direct investment;

(b) To attract inbound transfers of technology or skills;

(c) To respond to political or other pressure from other countries.

Other benefits of increased tax cooperation should also be taken into account by developing countries.

It should be noted that, even if one country has concluded that it would serve its interests to enter into a tax treaty with another country, that country may not be willing or able to commence negotiations. Before treaty negotiations can commence, both countries must consider that a tax treaty would benefit them, and must be in a position to start them.

The reasons for entering into tax treaties are explored further below.

2. Facilitating cross-border investment and transfer of skills and technology

Relief from double taxation and prevention of tax discrimination have as their main aim the removal or reduction of tax obstacles to cross-border trade and investment. Prevention of fiscal evasion serves to support and protect the revenues of the treaty partner countries, especially where cross-border investment or dealings are involved.

2.1 Relief of double taxation

The primary purpose of tax treaties is commonly stated or understood to be "for the avoidance of double taxation" of income arising from cross-border transactions. Until 2001, the United Nations Model Taxation Convention between Developed and Developing Countries[2] specifically referred to avoidance of double taxation in its title.[3] A similar reference was found in the title of the Organisation for Economic Co-operation and Development Model Double Taxation Convention on Income and on Capital[4] prior to 1992. The Introduction to the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital,[5] while acknowledging that elimination of juridical double taxation is the main purpose of tax treaties, notes that this reference was deleted from the title because tax treaties also address other issues such as the prevention of tax evasion and non-discrimination. Presumably, the reference was deleted from the title in the United Nations Model Convention for similar reasons. Nevertheless, many countries continue to include a reference to avoidance of double taxation in the title of their conventions.

Double taxation arises where the same income or capital is taxed in both treaty partner countries. Juridical double taxation, that

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[2] *United Nations Model Taxation Convention between Developed and Developing Countries* (New York: 1980).

[3] The title read: *"Convention between (State A) and (State B) for avoidance of double taxation with respect to taxes on income (and on capital)"*.

[4] Organisation for Economic Co-operation and Development, *Model Double Taxation Convention on Income and on Capital* (Paris: OECD, 1977).

[5] Ibid., *Model Tax Convention on Income and on Capital* (Paris: OECD, 2010) (loose-leaf), Introduction, para. 16.

is to say, taxation of the same income in the hands of the same person in more than one country, occurs where:

(a) The same income is taxed in the hands of a person in both the country where it arises and in the country of which the person deriving the income is a resident (source/residence double taxation); or

(b) The same person is treated by both countries as being its own resident and is taxed on worldwide income or capital in both countries (residence/residence double taxation); or

(c) A person is taxed in both countries because the income is treated by both countries as having a source in its jurisdiction (source/source double taxation).

Juridical double taxation of this kind is clearly undesirable. As noted in the Introduction to the United Nations Model Convention "… the effects of which [international double taxation in respect of the same income] are harmful to the exchange of goods and services and movements of capital and persons …".[6] This is true irrespective of whether the countries are developed or developing. Elimination of such double taxation will enhance the investment climate which, in turn, will assist in the growth of investment flows between countries.

Another type of double taxation occurs where the same income or capital is taxed by the two countries in the hands of different persons (so called "economic double taxation"). Typically this occurs in transfer pricing cases where enterprises in different countries are treated as having accrued the same profits.

Developing countries will frequently come under pressure from their own residents or from foreign investors to reduce double taxation on their cross-border transactions. Tax treaties seek to eliminate (or at least reduce) double taxation in a number of ways.

[6] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011), Introduction, para. 5.

2.1.1 Source/residence double taxation

Source/residence double taxation is addressed under tax treaties by the allocation of exclusive taxing rights over income or capital to one of the treaty partner countries, or, where taxation is permitted in both countries under the treaty, by requiring the country of residence to provide relief for tax imposed by the source country.

Relief from source/residence double taxation was once seen as the most important function of a tax treaty. Although most countries these days will provide double tax relief, in the form of foreign tax credits or exemption of foreign income or capital located abroad under their domestic laws, a few countries will only provide such relief under treaties. Even where double tax relief is provided unilaterally, the confirmation of such relief under tax treaties provides an additional level of certainty to taxpayers with cross-border dealings. It may also clarify whether certain "presumptive" income taxes - typically based on turnover and applying to small businesses - are to be credited by the other country. Tax treaties may also provide additional double tax relief benefits to taxpayers that are not available under domestic law (or are only available under domestic law where a treaty is in effect), for instance, by providing for exemption of certain foreign income where domestic law would otherwise provide only for foreign tax credits.

Allocation of exclusive taxing rights to one or other country has the dual benefit for the recipient of the income, or the owner of the capital, of ensuring no double taxation and simplifying that person's tax affairs. However, such provisions will also have revenue effects for the treaty partner country. Where, as is generally the case, sole taxing rights are given to the country of residence, the provisions will result in a loss of revenue for the source country.

For countries where the economic flows are approximately equal, any loss of source taxation revenue on inbound investment is likely to be offset by revenue gains resulting from not having to provide foreign tax credits or exemption of foreign income or capital in respect of outbound investment. There may even be an overall revenue gain for countries that are net exporters of capital, technology, etc. However, developing countries will generally have little outbound investment to offset the loss of revenue from source taxation of inbound investment.

Accordingly, such countries are likely to find that the provision of relief from double taxation through the allocation of exclusive taxing rights to the country of residence will result in an overall reduction of revenue, at least in the short term.

Any immediate loss of revenue may be ameliorated if entry into the tax treaty results in additional foreign investment that contributes to the growth of the recipient country's economy and/or leads to increased employment in that country. Measurement of such flow-on effects is, however, notoriously difficult and speculative.

2.1.2 Residence/residence double taxation

Residence/residence double taxation can occur where a person is taxed on worldwide income or capital in more than one country on the basis that the person is regarded as a resident for tax purposes in each of those countries. For example, an individual may be regarded by one country as its resident because that person ordinarily resides in that country, and is also regarded by another country as its resident because he or she has spent more than 183 days there. Such double taxation is dealt with under tax treaties by the inclusion of tie-breaker rules that deem the person to be, for purposes of the treaty, a resident of only one of the countries. This ensures that, at least between the two treaty partner countries, the person is taxed only on a source basis in one country with relief from double taxation being provided by the other country.

The revenue implications of the tie-breaker rules are generally not significant. While the effect of the tie-breaker rules is to limit one country's ability to tax the worldwide income of a person who would otherwise be regarded as a resident for tax purposes, cases of dual residence are relatively rare. However, the revenue of the "losing" country may be adversely affected if the treaty includes tie-breaker rules that are easy to manipulate (such as those based on formalities such as place of incorporation).

2.1.3 Source/source double taxation

Double taxation may arise where more than one country regards the same income as having a source in their territory under domestic law.

For example, one country may regard income from certain services as being sourced in their territory if the activities are performed in that country, while another country may treat the same income as sourced in their territory if the services are paid for by a resident of that country.

For certain categories of income, such as dividends and interest, a tax treaty will provide explicit rules for determining the source of income for treaty purposes. In treaties that follow the United Nations Model Convention, source rules are also provided for in Article 12 (Royalties). These source rules not only clarify the circumstances in which the country where the income is deemed to arise may tax that income under the treaty; they also ensure that where that country does impose tax on it in accordance with the treaty, the other country (that is to say, the country of which the recipient is a resident) must provide double tax relief in accordance with Article 23 A (Exemption method) or Article 23 B (Credit method).[7]

For other categories of income, such as business profits, there are no explicit source rules included in the treaty. However, by limiting the circumstances in which source taxation may be imposed (for instance, where the income is attributable to a permanent establishment situated in a country) and providing extensive guidance on when those conditions should be regarded as having been met, the United Nations and OECD Model Conventions will often provide solutions to problems of double taxation based on source.

2.1.4 Economic double taxation

Tax treaties seek to address problems of economic double taxation (where the same income or capital is taxed in more than one country in the hands of different taxpayers) only in certain limited circumstances.

The most common form of economic double taxation arises where associated enterprises are treated in different countries as having accrued the same profits. By putting in place, in Article 9 (Associated enterprises), an "arm's length" standard for transactions between the

[7]Paragraph 14 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraph 7 of the Commentary on Article 23 of the OECD Model Convention.

associated enterprises, tax treaties help to ensure that profits are subject to neither double taxation nor less than single taxation.[8]

Economic double taxation may also be dealt with under a treaty to the extent that Article 25 (Mutual agreement procedure) allows the competent authorities of the treaty partner countries to "consult together for the elimination of double taxation in cases not provided for in the Convention".[9]

2.2 Reducing excessive source taxation

Tax treaties can facilitate cross-border trade and investment by limiting source taxation that might otherwise act as a deterrent to that trade or investment. This may occur, for example, where the source country imposes a final withholding tax under its domestic law on a payment to a non-resident, irrespective of any expenses that may have been incurred in connection with the derivation of that income. In these circumstances, the effective tax rate on the income may be extremely high. Measures by the taxpayer's country of residence to relieve double taxation may not be effective in eliminating excessive levels of taxation, for instance, where no relief is available for source taxation that exceeds the tax liability on that income in the country of residence.

For example, in many developing countries, income from certain services provided by non-residents is taxed on a gross basis. By limiting source taxation to "profits" from business activities, or by imposing a limit on the rate of source tax that may be imposed on gross amounts of income, tax treaties can help to ensure that excessive taxation in the source country does not provide an obstacle to cross-border investment and activities.

On the other hand the International Monetary Fund (IMF) has noted in the context of transfer pricing by multinational enterprises,[10]

[8]See Commentary on Article 9 of the United Nations Model Convention.

[9]See also paragraph 9 of the Commentary on Article 25 of the United Nations Model Convention, quoting paragraphs 10-12 of the Commentary on Article 25 of the OECD Model Convention.

[10]Revenue Mobilization in Developing Countries, p. 36, Fiscal Affairs Department, IMF. Washington, D.C.: International Monetary Fund. 8 March 2011.

that "[s]ome argue, moreover, that present [tax treaty] norms are tilted against developing countries; the low withholding taxes common in double tax treaties (DTTs), for instance, can weaken a last line of protection for weak administrations".

2.3 Preventing tax discrimination

Discriminatory tax rules can be a significant deterrent to foreign investment. For example, it would be difficult for a foreign enterprise carrying on a business in a country to compete with a local enterprise if the rate of tax or tax-related requirements imposed on the foreign enterprise are much higher or more onerous than those imposed on a comparable local enterprise carrying on the same activities. Similarly, tax rules may prove an obstacle to cross-border loans or transfers of technology if deductibility of interest or royalties paid by a resident to a non-resident is denied or limited in circumstances where there would be no such limitation where a similar payment is made to a resident.

Tax treaties aim to remove these obstacles to cross-border activities by addressing some common forms of tax discrimination. The Commentary on Article 24 (Non-discrimination) of the OECD Model Convention notes that while "All tax systems incorporate legitimate distinctions based, for example, on differences in liability to tax or ability to pay",[11] the non-discrimination provisions provided in tax treaties "seek to balance the need to prevent unjustified discrimination with the need to take account of these legitimate distinctions".[12] However, not all forms of tax discrimination are dealt with in tax treaties, as discussed in paragraphs 1-4 of the Commentary on Article 24 of the OECD Model Convention.

In broad terms, treaty rules prohibit tax discrimination in certain limited situations, such as:

(a) Nationality: Countries cannot subject a national of a treaty partner country to more burdensome taxation than its own

[11] Paragraph 1 of the Commentary on Article 24 of the United Nations Model Convention, quoting paragraph 1 of the Commentary on Article 24 of the OECD Model Convention.

[12] Ibid.

nationals who are in the same circumstances and have the same residential status for tax purposes;

(b) Stateless persons: Similar rules apply to stateless persons, who must be provided equality of treatment to nationals of a country;

(c) Permanent establishments: Permanent establishments of a treaty partner enterprise cannot be subjected to more burdensome taxation than a local enterprise carrying on the same activities;

(d) Disbursements: A payment of interest, royalties or other disbursements by a resident enterprise to a resident of a treaty partner country must be deductible under the same conditions as if it had been paid to a local resident; and

(e) Foreign-ownership: A resident enterprise that is foreign-owned cannot be subjected to more burdensome taxation than locally-owned enterprises.

Non-discrimination provisions apply to all taxes, not just income taxes and capital taxes covered by the treaty.[13]

Tax discrimination of the kinds addressed under tax treaties could be removed unilaterally by countries wishing to attract foreign investment, and many countries seek to ensure that their domestic tax laws are non-discriminatory. However, by including non-discrimination provisions in tax treaties, countries are able to provide a measure of certainty to potential investors that they will not be subject to tax discrimination in the event of future changes to domestic law.

2.4 Providing certainty and simplicity

One of the main ways in which a developing country can attract foreign investment is by ensuring that the tax environment for investors is clear, transparent and certain. Tax treaties can assist in achieving this by setting well-recognized and widely-adopted rules for the allocation of taxing rights over different types of income and for the determination of profits attributable to a permanent establishment or in dealings

[13] Article 24 (6) (Non-discrimination) of the United Nations and OECD Model Conventions.

between related enterprises. Such rules can help to reduce complexity for taxpayers with cross-border activities, particularly where the treaty provides for taxation only in one country.

Since tax treaties usually continue for an extended period (often 15 years or more), they also provide a level of comfort to taxpayers that the tax treatment afforded to the income from their activities or investments in the other country will be reasonably stable. In the absence of a treaty, tax treatment under domestic law can, and often does, change frequently. Tax treaties do not preclude such changes, but they do impose limits on source taxation of certain types of income, and provide certain protections such as relief from double taxation, the application of the arm's length principle and non-discrimination rules. As discussed below, while this is an advantage for investors, it does restrict the policy flexibility of the treaty countries.

Importantly, tax treaties also provide a mechanism for tax administrations to agree on how to interpret or apply treaty provisions, and to resolve disputes. Article 25 (Mutual agreement procedure) of the OECD Model Convention and the two alternatives of it put forward in the United Nations Model Convention[14] set out a procedure pursuant to which the competent authorities of the treaty partner countries can reach mutual agreement.

Under this procedure, a taxpayer who considers that the treaty has not been, or will not be, correctly applied may, in addition to any domestic law remedies, initiate the mutual agreement procedure. The competent authority in his/her country of residence would then review the case and, if the taxpayer's complaint appears to be justified and cannot be resolved in that country, the competent authority is obliged to endeavour "… to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with this Convention".[15] In some tax treaties, access to the mutual agreement procedure may be denied where the transactions in question are abusive.

Although the provision does not oblige the competent authorities to reach agreement (it only requires them to endeavour to do so),

[14] Article 25 (alternative A) and (alternative B).

[15] Article 25 (2) (alternative A).

the procedure has proved successful in resolving treaty issues in many cases. Many countries also use the mutual agreement procedure for advance pricing agreements, pursuant to which the competent authority enters into an agreement, either with the taxpayer alone or with both the taxpayer and the competent authority of the other country, on how transfer prices between parts of a multinational enterprise operating in the two countries will be determined. For taxpayers with cross-border dealings, access to the mutual agreement procedure is often a key benefit of tax treaties, particularly with respect to resolution of transfer pricing and profit attribution issues, or determination of factual matters such as residential status or the existence of a permanent establishment.

In an environment where cross-border transactions are rapidly increasing in both number and complexity, resolution of issues under the mutual agreement procedure can be drawn-out and sometimes unsuccessful. To ensure a timely outcome, provision has been included in paragraph 5 of Article 25 of the OECD Model Convention and alternative B of Article 25 of the United Nations Model Convention that provides for mandatory arbitration in certain cases where resolution is not reached within a given time period. While arbitration provisions in tax treaties are highly valued by taxpayers, it is recognized that in some countries, national law, policy or administrative considerations may not allow or justify the inclusion of the provision.[16]

Paragraph 3 of Article 25 also authorizes and requires the competent authorities to try to resolve any difficulties or doubts arising as to the interpretation or application of the treaty. It also allows them to consult together for the elimination of double taxation in cases not provided for in the treaty.

2.5 Maintaining or accessing benefits of domestic tax concessions

One of the most important benefits that may be available to developing countries under a tax treaty is what is known as "tax sparing". Tax

[16]See footnote to paragraph 5 of Article 25 of the OECD Model Convention, and paragraph 13 of the Commentary on Article 25 of the United Nations Model Convention.

sparing occurs when another country gives foreign tax credits for tax that has been reduced or forgone in accordance with tax incentives provided in the source country.

Many developing countries seek to attract foreign investment by offering tax incentives, such as tax holidays or concessions (for instance, on income derived from investment in certain industries or in certain regions where the country wishes to encourage development). However, the benefits to the taxpayer of these incentives may be lost if the income is taxed in the taxpayer's home country. Where, for example, the income is taxed in full and a credit is allowed in the country of residence for the foreign tax paid, reductions in source taxation will merely result in increased revenue for the residence country, without any overall tax benefit to the investor. Accordingly, the tax incentives effectively result in a transfer of revenue from the source country to the country of residence of the investor.

In treaties with countries that use the credit method, or that make exemption of foreign income conditional on a certain level of taxation in the source country, the inclusion of tax-sparing provisions under a tax treaty can ensure that the benefit of tax incentives of the source country is maintained. Under these provisions, the treaty partner country would be obliged to recognize some or all of the tax forgone as if it had been paid, that is to say, as if there had been no tax incentive in the source country.

The Commentary on Article 23 of the United Nations Model Convention recognized that for some developing countries the inclusion of tax-sparing provisions (or relief of double taxation by the exemption method) "is a basic and fundamental aim in the negotiation of tax treaties".[17] A discussion of tax sparing can be found in paragraphs 3-12 of that Commentary.

On the other hand, many countries resist the inclusion of tax-sparing provisions in their tax treaties. In 1998, the OECD published a report[18] which identified a number of concerns with tax sparing.

[17] See paragraph 4 of the Commentary on Article 23 of the United Nations Model Convention.

[18] Report of the OECD Committee on Fiscal Affairs: *Tax Sparing: A Reconsideration* (Paris: OECD, 1998).

In particular, it considered that tax sparing is vulnerable to taxpayer abuse, and was not necessarily an effective tool for promoting economic development. The report did not say that tax sparing should never be granted, but suggested that it should only be considered in regard to States whose economic levels are considerably below that of OECD Member States. It also recommended the use of "best practices" to minimize potential for abuse.[19]

In negotiations with some of the least developed countries, developed countries may be prepared to agree to tax-sparing provisions, particularly if they are drafted in a way that limits the potential for abuse. Examples of such limitations that are found in some tax treaties include:

(a) A precise description of the incentives for which tax sparing is sought (for instance, a reference to legislation which sets out which income or projects are eligible for the incentive);

(b) Limitation of eligible incentives to certain types of investment or activities (for instance, genuine investments aimed at enhancing the domestic infrastructure of the developing country);

(c) Application only to active business income (not passive income such as interest, royalties or leasing payments);

(d) Inclusion of an anti-abuse provision (for instance, where the two competent authorities agree it would be inappropriate to grant tax sparing);

(e) Inclusion of a "sunset" clause (for instance, a provision that states that tax sparing will only apply for a limited period, or until a certain level of economic development is reached, unless further extended by agreement between the two countries).

Of course, if the home country of the enterprise exempts the income (either unilaterally or under domestic double tax relief provisions or under tax treaties that provide for relief by the exemption method), tax-sparing provisions are not required in order to preserve the benefit of the source country's tax incentives as the country of residence will not tax the income.

[19]See paragraphs 72-78.1 of the Commentary on Article 23 of the OECD Model Convention.

In some countries, certain favourable tax treatment (such as participation exemptions on dividends derived from abroad, exemption from the application of controlled foreign corporation (CFC) rules, or reduced rates of withholding at source) is provided under domestic law, but such treatment is available only where a tax treaty is in force or where full exchange of information is available under a tax treaty or a Tax Information Exchange Agreement (TIEA).

3. Preventing fiscal evasion

One of the main reasons that a country may wish to enter into a tax treaty with another country is to improve coordination and cooperation between tax administrations in order to address tax avoidance or evasion. Through the exchange of information and, in some cases, assistance in collection of taxes, tax administrations are able to assist each other in ensuring the proper application of tax treaties, as well as enforcement of domestic laws.

While it is often developed countries that have the most to gain in terms of revenue from assistance provided under tax treaties, it is in the interests of both developed and developing countries to minimize cross-border tax evasion and avoidance because both of them are vulnerable to capital flight and erosion of their tax revenue bases.

Improved cooperation between tax administrations has been a key focus of international tax work in recent years. As noted in the OECD manual on the exchange of information,[20] "the efficient functioning of tax co-operation helps to ensure that taxpayers who have access to cross-border transactions do not also have access to greater tax evasion and avoidance possibilities than taxpayers operating only in their domestic market. Co-operation in tax matters also reflects the basic principle that participation in the global economy carries both benefits and responsibilities. The continued viability of an open world economy depends on international co-operation, including co-operation in tax matters".

Tax treaties authorize and require the competent authorities of both States to exchange tax information that is "foreseeably relevant"

[20] *OECD Manual on the Implementation of Exchange of Information Provisions for Tax Purposes*, para. 6 (Paris: OECD, 2006).

to the application of either the treaty or domestic tax laws. Such information may relate to a specific taxpayer, or may be more general (for instance, information about particular industries or abusive tax avoidance schemes). Article 26 (1) (Exchange of information) of the United Nations Model Convention states that "In particular, information shall be exchanged that would be helpful to a Contracting State in preventing avoidance or evasion …". However, exchange is not limited to such information and often may be merely to assist in determining a factual situation (for instance, the existence of a permanent establishment or the residential status of a person).

The obligation under Article 26 is broad, and is not limited to residents of the treaty partner countries or to income or activities in one or other country. Information must be exchanged even if it is not required for purposes of applying the domestic tax law of the requested State. Information held by banks or other financial institutions or fiduciaries must generally also be exchanged, notwithstanding any domestic confidentiality rules.

Some developing countries, particularly those whose capacity to obtain and exchange information is limited, may be concerned that the administrative burden of complying with Article 26 will be excessively onerous. For this reason, these countries sometimes prefer to limit the scope of the Article to taxes covered by the treaty and perhaps some key domestic taxes.[21] They may also (or alternatively) provide that extraordinary costs associated with a request for information be borne by the country that requests the information.[22] It should be noted, however, that the Article provides benefits to both countries, and that it "does not allow a developed country to refuse to provide information to a developing country on the ground that the developing country does not have an administrative capacity comparable to the developed country".[23] Some countries may find it useful to develop, in consultation with their treaty partners, a Memorandum

[21] See paragraph 8.1 of the Commentary on Article 26 of the United Nations Model Convention.

[22] See paragraphs 29.3 and 29.4 of the Commentary on Article 26 of the United Nations Model Convention.

[23] Paragraph 1.3 of the Commentary on Article 26 of the United Nations Model Convention.

of Understanding on how exchange of information will be handled in their country.

Administrative assistance may also be provided under tax treaties in the form of assistance in collection of taxes. Article 27 of the United Nations Model Convention obliges each country to assist the other to collect taxes owed to the latter, as if it were a revenue claim of the first country. While this would clearly benefit the revenue of both treaty partners, and further support the prevention of fiscal evasion, it is recognized that in some countries, national law or policy, or administrative considerations, may preclude or limit the provision of such assistance.[24] For developing countries, the capacity of their tax administrations often limits their ability to undertake these obligations.

4. Political reasons

Sometimes political considerations may influence a country's decision to enter into tax treaties. For example, a country may want to signal to the global economy and potential investors that it is a responsible member of the international tax community that is willing and able to conform to widely-accepted tax rules and norms, such as the international standard for exchange of information or the arm's length principle for profit attribution within a multinational enterprise.

International or regional obligations or expectations may also influence decisions to enter into negotiations. These may be as a result of membership of international organizations, economic or trade arrangements or bilateral agreements.

OECD member countries, for example, are expected to enter into tax treaties with each other.[25] While there is no equivalent

[24]See paragraphs 1 and 2 of the Commentary on Article 27 of the United Nations Model Convention.

[25]See Recommendation of the OECD Council on the Model Tax Convention on Income and on Capital, adopted on 23 October 1997, that Governments of member countries pursue their efforts to conclude bilateral tax conventions with other member countries.

recommendation for United Nations countries,[26] member countries are certainly encouraged to do so.[27]

Regional economic or trade communities involving developing countries often require or encourage member countries to enter into tax treaties with each other. For example, in 2007 the Association of Southeast Asian Nations (ASEAN) Finance Ministers agreed to "accelerate the completion of bilateral agreements on avoidance of double taxation and cooperation in other tax matters".[28] The Southern African Development Community (SADC) has similarly agreed that "Member States will take such steps as are necessary to establish amongst themselves a comprehensive [tax] treaty network".[29]

Countries may also agree to enter into tax treaty negotiations as part of arrangements to enhance bilateral relations or in the context of close trade or economic relations between the two countries. These may be linked to bilateral trade or investment promotion and protection agreements, but may equally be driven by diplomatic or other considerations.

Frequently, developing countries commence negotiations for a tax treaty primarily because they feel pressured to do so by another country. The pressure may come in the form of diplomatic or political representations, from the tax administration or revenue officials from the other country or directly from taxpayers resident in that country. The fact that another country requests a treaty is not, of itself, a good reason to commence negotiations. It is important to consider whether entering into a tax treaty with that country is in the best interests of the country receiving the request.

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[26]See paragraph 12 of the Introduction to the United Nations Model Convention.

[27]See Economic and Social Council resolution 1273 (XLIII) of 4 August 1967.

[28]Joint Ministerial Statement of the 11th ASEAN Finance Ministers' Meeting, Chang Mai, Thailand, 5 April 2007.

[29]Southern African Development Community, Memorandum of Understanding on Co-operation in Taxation and Related Matters, 2002, Article 5: Tax Treaties.

5. Summary of costs and benefits to developing countries of having tax treaties

5.1 Benefits

5.1.1 Increased foreign investment

By providing a clear, transparent, non-discriminatory and predictable tax environment, developing countries may facilitate and encourage foreign investment. While it seems self-evident that taxpayers looking to invest in another country will be encouraged to do so when they have confidence in the tax system of that country, there is little empirical evidence to show the extent to which the entry into a tax treaty will result in increased foreign investment. Nevertheless, it would appear that, for developing countries, a link can be made between the conclusion of a tax treaty and increased foreign direct investment.[30]

Provision for tax sparing under the treaty may be of particular benefit to developing countries to the extent that it prevents revenue forgone by the country under its tax incentives being soaked up by the country of residence of the foreign investor.

However, tax treaties alone will not ensure increased foreign investment if the underlying legal and economic infrastructure does not effectively support such investment. For example, a lack of suitable investment protection (for instance, where there is a significant risk of expropriation of the investment), an unstable economy or a lack of a robust regulatory framework may discourage inbound investment, irrespective of the existence of a tax treaty. Countries with a good infrastructure for investment, that is to say, political and economic stability, robust regulatory framework, suitable workforce, and reliable and effective administration, are much more likely to attract foreign investment.

[30]Eric Neumayer, "Do Double Taxation Treaties Increase Foreign Direct Investment to Developing Countries?", in *The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties and Investment Flows,* Karl P. Sauvant and Lisa E. Sachs, eds. (New York: Oxford University Press, 2009).

5.1.2 Flow-on benefits to the local economy from increased foreign investment

Increased foreign investment can have many benefits for a developing country in addition to increased revenue, such as higher economic growth, transfer of knowledge and skills, infrastructure building, increased employment and higher living standards.

5.1.3 Increased certainty

Foreign investors, and the tax administrations in their country of residence, welcome the certainty and stability that tax treaties provide. Even where there is little cross-border investment (for instance, between developing countries, especially between neighbouring countries or members of a regional economic community) tax treaties can provide the benefits of increased certainty with respect to taxation, and may resolve particular issues that have arisen between two countries. While there may be little likelihood of attracting significant additional foreign investment through such treaties, the existence of a treaty would be expected to facilitate and encourage cross-border investment flows and economic activity between both countries.

5.1.4 Improved consistency of tax treatment

By negotiating tax treaties that conform to international tax norms, a developing country may reduce the likelihood of inconsistent or inappropriate tax treatment of income or capital that can occur where tax issues are dealt with in non-tax treaties, such as bilateral investment or trade agreements, or in agreements with private enterprises.

5.1.5 Protection for investment abroad

Although there may be little or no investment abroad by a developing country at the time at which a treaty is negotiated, such outbound investment may grow as the country's economy develops. Because tax treaties are usually of long duration (often 15 years or more), treaties will provide certainty, protection from tax discrimination and relief from double taxation for future investment by residents of a developing country in treaty partner countries.

5.1.6 Avoidance of fiscal evasion

Tax treaties help tax administrations to ensure that taxpayers do not escape taxation by moving capital abroad, by not declaring income earned abroad or by participating in abusive tax avoidance schemes. Exchange of information and, where provided, assistance in the collection of tax debts, help to protect the revenue and to ensure the integrity of the tax system in both countries.

5.2 Costs

5.2.1 Tax treaties have an immediate revenue cost

Tax treaties limit source taxation of certain income derived by non-residents. This will have an immediate impact on revenue in the source country, especially with respect to withholding tax collections, if the treaty rate of withholding is significantly lower than the domestic law rate. Other limitations on source taxation will also reduce revenue. However, to the extent that those limitations affect income in respect of which the tax liability is problematic to collect (for instance, tax on profits from mobile activities in the absence of a permanent establishment, fixed base or long-term presence), the actual revenue forgone may not be significant.

The revenue cost of source tax limitations imposed by tax treaties will largely depend on the capital flows between the countries. However, it is important to consider not just the existing flows, but also the potential for future growth, both in inbound investment and in the domestic economy. The short-term loss of revenue from reductions in withholding tax rates (or other limitations on source taxation) may be wholly or partly offset by increased revenue resulting from increased foreign investment, growth in the economy and/or reduced fiscal evasion. However, there is no effective methodology for accurately predicting the future revenue benefits that could result from tax treaties.

5.2.2 Tax treaties may affect or limit the operation of certain domestic tax laws

Tax treaties include certain rules that take precedence over domestic law, such as:

- Rules for determining profits of related enterprises. These require the profits of a subsidiary or a permanent establishment of a foreign enterprise to be determined on an arm's length basis, irrespective of whether this is consistent with domestic law calculation of profit;
- Non-discrimination rules. These may prevent the operation of domestic law rules that have been designed to protect revenue by taxing foreign enterprises in a particular way;
- Treaties may also limit future tax policy options.

While tax treaties do not prevent changes to domestic law, such changes will not be effective where an inconsistent treaty provision exists. As a country's treaty network grows, this will increasingly limit the effectiveness of future tax changes where those changes do not accord with the tax treaties. Where a developing country has not had significant experience in the application of its own cross-border tax laws (for example if those laws have only recently been introduced, or the country has only recently been integrated with international markets), it will be difficult to appreciate the extent to which policy freedom is being incrementally limited by new tax treaties.

5.2.3 Risk of treaty-shopping and treaty abuse

Taxpayers may enter into transactions designed to abuse the benefits provided by tax treaties (for instance, by the use of artificial legal constructions such as conduit companies, or by exploiting differences in tax treatment in the treaty partner countries). Residents of third countries may also be able to access treaty benefits intended only for residents of the treaty partner country. This may have the effect of reducing tax in the source country without the provision of reciprocal benefits by the third country. It means also that the revenue impacts of previous treaties may be greater than the current level of investment from these countries may suggest. While these risks can be reduced by the inclusion of certain treaty provisions such as Limitation on Benefits (LOB) articles or anti-avoidance provisions in Articles 10 (Dividends), 11 (Interest) and 12 (Royalties), treaty abuse and treaty-shopping are difficult to eliminate entirely.

5.2.4 Risk of double non-taxation

Tax treaties can create unintended double non-taxation where a treaty provision precludes taxation in one country of income or capital that is not taxed in the other country. For example, the treaty may preclude source taxation of certain capital gains. If the other country does not impose capital gains taxes, the result will be that the capital gain is not taxed in either State. While in some cases the contracting States may deliberately provide that certain income is not subject to tax in either country (for instance, in the case of short-term visits by foreign teachers), tax treaties are generally not intended to create double non-taxation.

Tax treaties with low-tax countries may also result in double non-taxation and/or in reductions in revenue without reciprocal benefits in the other country. Tax treaties with low-tax countries may provide a competitive advantage to investors from such countries over domestic investors or investors from other treaty partner countries because the overall tax burden on investors whose income is not subject to tax (or is subject only to very low tax rates) in their country of residence will be significantly lower than the tax burden on investors who have to pay ordinary tax rates. Treaties with low-tax countries are also likely to encourage treaty-shopping through those countries. For these reasons, and in the absence of a risk of significant double taxation of cross-border investment from low-tax countries, developing countries should carefully consider whether tax treaties with such countries are in their best interests. Any tax administration concerns with these countries might be better addressed through Tax Information Exchange Agreements (TIEA).

5.2.5 Changes and/or clarifications to domestic law

Certain changes to, or clarifications of, domestic law may be required to ensure that the treaty can be properly applied and administered. It may be necessary to enact law that provides that, in the event of any inconsistency between the treaty and domestic law, the treaty obligations prevail. Changes may be necessary to ensure that treaty obligations can be met (for instance, to ensure that the competent authority has the legal and practical ability to collect and exchange bank information if requested by a treaty partner country).

To simplify the application of treaty profit allocation, transfer pricing and non-discrimination rules, it may also be desirable to review domestic law to minimize any inconsistency with the treaty provisions.

5.2.6 Tax administration capacity

Negotiation of tax treaties is a protracted, resource-intensive task. Furthermore, negotiation, interpretation and administration of tax treaties require highly skilled staff. Developing the necessary expertise, and ensuring that sufficient numbers of trained staff are available to undertake these tasks, is likely to divert scarce resources within the revenue authorities of developing countries away from other important tax priorities.

The tax administrations of these countries may also need additional resourcing and/or technical assistance to meet obligations under tax treaties, such as:

- Development of a binding rulings system to ensure consistent application and interpretation of treaties. Inevitably, this also requires access to (sometimes costly) international research services. Often there is an additional layer of difficulty for tax administrators if these international documents are not available in their own language;
- Establishment of processes to undertake mutual agreement procedures with the tax administrations of treaty partner countries;
- Capacity to collect and exchange information with the tax administrations of treaty partner countries;
- Capacity to collect tax debts owing to treaty partner governments (where assistance in collection provisions is included).

Countries will need to appoint competent authorities for purposes of their tax treaties. These will usually be senior officials from the revenue administration or the Ministry of Finance.

6. Conclusions

While tax treaties can be beneficial to developing countries, there are also significant costs to entering into such treaties. By understanding what outcomes are desired, and how treaties can assist in achieving those outcomes, countries are better able to determine whether or not to enter into treaty negotiations.

Understanding the reasons for entering into treaty negotiations will also help those countries to design treaty policies that are best suited to achieving their desired outcomes.

Tax treaty policy framework and country model

Ariane Pickering*

1. Introduction

All countries would find it beneficial to develop a tax treaty policy framework and a model treaty before entering into negotiations. You have to "know what you want".

The policy framework should set out the main policy outcomes that your country wishes to achieve under its tax treaties. It should identify:

(a) Policy outcomes that are most beneficial to your country;

(b) Outcomes that must be achieved in any negotiation; and

(c) How much flexibility negotiators have on other issues, including what is their "bottom line" (that is to say, the minimum outcome that must be achieved).

The model treaty should reflect the country's key policy and drafting preferences, having regard to international treaty norms and to domestic law.

This paper seeks to provide guidance to developing countries on how to develop a tax treaty policy framework and their own model tax treaty.

2. Policy framework for developing countries

2.1 General

(a) As far as practicable, countries should follow the international norms for tax treaties with respect to structure and policy positions.

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- For developing countries, these international norms are mainly set out in the United Nations Model Double Taxation Convention between Developed and Developing Countries[1] (United Nations Model Convention). The Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital[2] (OECD Model Convention) is also important and, for some countries, a regional model such as the Andean Community Model, the Southern African Development Community (SADAC) Model or the Association of Southeast Asian Nations (ASEAN) Model[3] may also be relevant.

(b) It is important for developing countries to strike the right balance between protecting revenue (by maintaining source taxing rights) and encouraging inbound investment (by reducing tax barriers). To achieve this, tax treaties of most developing countries generally follow the United Nations Model Convention, rather than the OECD Model Convention.

- The United Nations Model Convention is better suited to developing countries in that it seeks to preserve a higher level of source taxation than the OECD Model Convention, which has been designed by and for developed countries. While the OECD Model Convention is most beneficial to business, and therefore is most effective in attracting foreign investment, the revenue balance is generally best suited to capital-exporting countries and to situations where the balance of investment between the two treaty partner countries is approximately equal. The United Nations Model Convention modifies the OECD Model Convention to better suit the circumstances of developing countries.

[1]United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

[2]Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2010) (loose-leaf).

[3]Intra-ASEAN Model Double Tax Convention on Income, 1987.

(c) The policy framework of a country should take account of key aspects of its economy, including its main sources of revenue and areas of current or potential foreign investment.

- If, for example, a developing country has significant natural resources such as oil reserves, it may wish to ensure that its tax treaties do not unduly restrict its ability to tax the income from activities relating to the exploitation of such resources. Similarly, if there are significant road or rail transport activities between two neighbouring countries, those countries may wish to extend the operation of Article 8 (Shipping, inland waterways transport and air transport) to those forms of transport.

(d) Tax treaty policy should take account of domestic law. The interaction between domestic law and treaties is important.

- Treaties generally have priority over domestic law so that, to the extent that the treaty is inconsistent with domestic law, the treaty will prevail. It is unrealistic to expect that treaties will be wholly consistent with domestic law, but nevertheless domestic law may be a relevant consideration in designing tax treaty policies and models. In particular, countries should consider whether and how a taxing right allocated in a treaty would be exercised under domestic law. For example, a treaty right to tax fees for technical services on a net basis at source may be difficult to apply in practice if such fees are taxed on a withholding basis under domestic law. In this case, the country may prefer to include a provision that provides for source taxation on a gross basis, even if the tax rate provided under the treaty is lower than the domestic law rate.
- A right to tax under a treaty that cannot be exercised under domestic law, or that cannot be collected in the ordinary course of tax administration, is likely to be of little value to a country. For example, there would be little revenue benefit to be gained by providing for source taxation of pensions (in accordance with Article 18 (2) (alternative B) (Pensions and social security payments) of the United Nations Model Convention) if such

pensions are not taxable under domestic law. There may, however, be circumstances in which a country would wish to preserve a taxing right that cannot currently be exercised under existing domestic law (for instance, where it is anticipated that future governments may wish to change that domestic law).

- In some circumstances, non-tax laws may be relevant. For example, social security pensions may not be payable to non-residents. If this is the case, that country will not pay cross-border social security payments and negotiators should not insist on source taxation of these payments.

(e) Countries should take into account the ability of their tax administrations to comply with treaty obligations.

- For example, some treaties require tax administrations to collect taxes on behalf of a treaty partner. If the tax administration does not have the legal or practical ability to do so, that country may wish to consider not including the article, amending it or delaying its implementation.

2.2 International norms

(a) Coverage:

Tax treaties apply to individuals and entities that are residents of one or both of the treaty partner countries. Generally, residential status will be determined by the domestic law of each country. However, for treaty purposes, the United Nations Model Convention (like the OECD Model Convention) specifies that the person must be "liable to tax" in the country by reason of particular criteria.

Treaties apply to all income taxes, including capital gains taxes, taxes on profits, withholding taxes and tax on salaries. In some circumstances, other taxes such as tonnage taxes, or minimum taxes, may also be covered.

The United Nations and OECD Model Conventions also apply to taxes on capital, such as wealth taxes.

(b) Distributive rules:

One of the main effects of a tax treaty is to allocate taxing rights over different categories of income derived by a resident of one treaty partner from sources in the other treaty partner country.

The distributive rules of the United Nations Model Convention broadly allocate source country taxing rights as follows:[4]

- Income from immovable property: Income such as rents, agricultural or forestry profits, or other income derived from immovable property, is seen as having a very strong economic link with the country in which it arises. Accordingly, the source country is allocated unlimited taxing rights over this income.[5]
- Business profits: Such profits are generally only subject to source taxation where the foreign enterprise has established a strong economic connection with the source country, for instance, by establishing a fixed place of business in that country or by performing services in it for an extended period. Profits from short-term activities (generally less than six months), or preparatory or auxiliary activities, may not be taxed in the source country.[6]

  Treaties include rules that determine the profits attributable to the enterprise, or the part of an enterprise, operating in the source country. Under the United Nations Model Convention, as under the OECD Model Convention, profit allocation between a permanent establishment and the rest of the enterprise of which it is a part, and between related enterprises, must be made on an arm's length basis (that is to say, as if they were separate and independent entities). However, the

[4]The description of the operation of the provisions is only intended to be broadly indicative of the allocation of taxing rights, and is not comprehensive.

[5]Article 6 (Income from immovable property).

[6]Article 5 (Permanent establishment).

United Nations Model Convention provides limits on the extent to which dealings between parts of an enterprise will be recognized. Article 7 of the OECD Model Convention, on the other hand, was amended in 2010 to give full effect to the arm's length principle.

- International transport: Taxation of profits from international air and sea transport is generally not permitted in the source State. However, for income from certain shipping operations in the source country, one of the two alternative provisions in the United Nations Model Convention provides for limited source taxation. Source taxation is not provided for under the OECD Model Convention.
- Dividends, interest and royalties: This income is usually taxed on a withholding basis in the source country. To prevent excessive taxation and to achieve a sharing of revenue from such income between the two countries, source taxation is limited to a percentage of the gross amount of the income. In most treaties entered into by developing countries, the agreed rates are commonly between 10 and 20 per cent. The OECD Model Convention specifies withholding tax rates of 5 and 15 per cent for dividends and 10 per cent for interest, while royalties may not be taxed at source.
- Capital gains: Gains on disposal of immovable property or assets of a permanent establishment may be taxed in the source country, as may some gains on the alienation of shares in resident companies or companies whose assets consist mainly of immovable property. Source taxation of most other capital gains is generally not permitted. The OECD Model Convention does not provide for source taxation of gains from the alienation of shares in resident companies.
- Independent personal services: Income from professional services and other independent personal services is permitted in the source country only if the services are performed through a fixed base in the source country, or if they are provided in the source country for more than

183 days. Such income is dealt with as business profits under the OECD Model Convention.

- Employment income: Source taxation is generally permitted for employment activities performed in that country. However, an exemption is provided for certain short-term employment activities undertaken in a country on behalf of a foreign employer.
- Directors' fees: Remuneration paid to directors and other top-level managers of a local company may be taxed in the country of which the company is a resident. Under the OECD Model Convention, remuneration of top-level managers is treated in the same way as other employment income.
- Entertainers: Income of entertainers and sportspersons may be taxed in the country where they perform those activities.
- Pensions: For pensions paid in respect of past employment, two alternatives are found in the United Nations Model Convention: (i) taxation only in the country of which the recipient is a resident; or (ii) source taxation if the pension is paid by a resident or permanent establishment. Pensions paid under the social security system of a country may be taxed at source. Under the OECD Model Convention, pensions are taxable only in the country of residence.
- Government service: Salaries paid to government employees are generally taxable only in the paying country.
- Students: Taxation of payments from abroad for the education and maintenance of a visiting student is not permitted.
- Other income: Income that is not otherwise specifically covered by the above articles may be taxed in a country if it arises in that country. The OECD Model Convention provides for taxation only in the country of residence.
- Capital: The allocation of taxing rights over capital generally mirrors the allocation of rights to tax income.

(c) Elimination of double taxation:

Where source taxation is permitted under the tax treaty, the country of which the taxpayer is a resident is required to relieve any resulting double taxation. This may be achieved by exempting the income that is taxed at source (exemption method), or by providing a credit for the foreign tax against the tax liability of the taxpayer in the country of residence (credit method).

Though not included in the United Nations Model Convention itself, some treaties entered into by developing countries include tax-sparing provisions. Developing countries may seek to attract foreign investment by offering tax incentives with respect to certain activities. However, if the country of residence of the investor provides relief using the credit method, the benefit of the tax incentives may be effectively passed to the foreign treasury instead of to the investor. To preserve the benefit of the source country tax incentives, tax-sparing provisions provide relief from taxation in the country of residence as if tax had been paid in the source country.

(d) Non-discrimination:

International tax treaty rules prevent either country from applying discriminatory tax rules in certain circumstances. These are:

- Nationals of the other country may not be taxed more harshly than the country's own nationals;
- Tax discrimination against stateless persons is not permitted;
- A permanent establishment of an enterprise resident in the treaty partner cannot be taxed less favourably than a local enterprise;
- Payments to a resident of the other country must be deductible under the same conditions as if paid to a local resident;
- Foreign-owned resident companies cannot be taxed more harshly than locally-owned resident companies.

(e) Mutual agreement procedure (MAP):

A key benefit of tax treaties is that they allow the tax administrations to consult together on the application and interpretation of the treaty and to reach agreement on how best to achieve its aims, especially removal of double taxation. The mutual agreement procedure is most commonly invoked in the context of transfer pricing and profit allocation. The two tax authorities may agree on the allocation of profits within a multinational enterprise operating in both countries.

In the case of disputes as to the proper attribution of such profits, taxpayers themselves may seek agreement between the tax authorities of the two countries under the mutual agreement procedure.

A recent addition to the United Nations and OECD Model Conventions is a provision for binding arbitration in treaties (see, for example, Article 25 (5) (alternative B) (Mutual agreement procedure) of the United Nations Model Convention)).

(f) Exchange of information:

A tax treaty authorizes and requires tax administrations to exchange relevant tax information, including information held by financial institutions. This is a very powerful tool in preventing fiscal evasion by taxpayers.

Some countries seek to include an article in their treaties that provides for reciprocal assistance between the two tax administrations in collecting outstanding tax liabilities. This helps to ensure that revenue claims in both developed and developing countries can be enforced.

2.3 Designing a policy framework

A developing country's tax treaty policy framework should take into account international norms. At a minimum, the treaty should cover elimination of double taxation on income, non-discrimination, mutual

agreement procedure and exchange of tax information. The provisions of the United Nations and OECD Model Conventions on these aspects of a tax treaty should be accepted as representative of the international standard by any country if it wishes to enter into tax treaties, although there may be room for negotiation with respect to certain details, discussed further below.

Other aspects of a tax treaty may be open to negotiation, such as coverage of capital taxes and levels of source taxation permitted under the treaty. Departures from the international models will almost always increase the difficulty of negotiating a satisfactory treaty. Accordingly, countries, especially those with limited negotiating capacity, should deviate from the international norms only sparingly (for instance, where there is a clear national interest in doing so). On these aspects, each country should determine:

(a) Its preferred position;
(b) The priority the country places on achieving that position; and
(c) The degree of flexibility available to negotiators and any fixed "bottom line".

2.4 Distributive rules

The allocation of taxing rights between the source and residence countries is generally the most controversial part of tax treaty negotiations. The distributive rules of a treaty, which are set out in the United Nations Model Convention in Articles 6 to 22, determine how the taxing rights will be allocated with respect to different categories of income. In developing its tax treaty policy framework, it is important that each country decide its preferred position on the balance between source and residence taxation, the priority it gives to maintaining that preferred position and, where flexibility is appropriate, the bottom line for negotiators.

A developing economy with minimal outbound investment may feel that it should protect its revenue by retaining the maximum possible source taxation. However, this must be balanced against the primary objective for entering into tax treaties, that is to say, to make

the country a more attractive destination for foreign investment by removing or reducing tax barriers to inbound investment.

Tax treaties inevitably involve some reductions in source taxation. Under the international Models, the reductions generally occur where:

- Source taxation may result in excessive taxation that cannot be relieved by the country of residence (for instance, where high rates of withholding tax are likely to result in source tax that exceeds the tax on profit in the residence country);
- The economic link between the derivation of the income and the country where it arises is not strong (for instance, in the case of casual or temporary business operations or employment activities); or
- The compliance burden on taxpayers is very high or is administratively difficult or inefficient (for instance, in the case of international transport).

The distributive rules in the United Nations Model Convention are generally the starting point for developing countries, often with the addition of a provision that allows source taxation of fees for technical services. Regional models reflect rules that are acceptable between countries within that region, which may be different to those that would be acceptable in treaties with other countries. For example, the ASEAN Model is indicative of the reductions in source taxation that are likely to be found in a tax treaty between countries in the South-East Asian region. Much more significant reductions in source taxation may be required in a tax treaty between an ASEAN member and another country.

In negotiations with developing countries, even countries that follow the OECD Model Convention will usually (though not always) agree to allow source taxation to the extent provided in the United Nations Model Convention. It must be kept in mind, however, that deviations from the United Nations Model Convention or, where relevant, a regional model, to provide for increased source taxing rights over a particular category of income will almost inevitably be achieved only by making concessions on other aspects of the treaty (for instance, a lower rate or a higher threshold for source taxation with respect to

another category of income). It is therefore extremely important for a country that wishes to provide for additional source taxing rights, over and above those found in the United Nations Model Convention or its regional model, to decide how much priority should be given to achieving that outcome. For example, if it is a high priority for a country to provide for source taxing rights over fees for technical services in its treaties, then that country may be requested to forgo source taxation over other categories of income in order to achieve this result.

With respect to each category of income, developing countries may find it helpful to analyse the distributive rules of the United Nations and OECD Model Conventions in the context of their own circumstances. In particular, they may wish to consider:

(a) Category of income:

Does the treaty classification of income give rise to difficulties in applying the treaty, or to unacceptable policy outcomes?

Example 1: A payment is treated under domestic law as a royalty to which withholding tax applies. If that payment is regarded as business profits rather than a royalty as defined for tax treaty purposes, payers and recipients of the payments, as well as tax administrations, may find it difficult to apply the rules of Article 7 (Business profits) in respect of that payment.

Example 2: Fees for technical services are often treated under domestic law in developing countries as a separate category of income from other business profits and are subject to different tax treatment. Article 7, if applied to such income, may give rise to outcomes that, from a policy perspective, are unacceptable to those countries.

(b) Tax treatment:

(i) Can taxing rights allocated under a tax treaty be exercised in your country? If not, consider whether this is an outcome that your country wishes to provide for under a treaty.

Example: Article 16 (Directors' fees and remuneration of top-level managerial officials) of the United Nations Model Convention provides for taxation of directors' fees in the country in which the company is a resident. Some countries may not be able to exercise this taxing right unless the director's activities are performed in that country.

(ii) Is the proposed source taxation treatment consistent with the method of taxation of that category of income under domestic law (for instance, net taxation by assessment, withholding, etc.)?

Example: Article 7 of the United Nations Model Convention provides for net taxation of business profits. However, certain payments that are classified for treaty purposes as business profits (for instance, fees for technical services) are taxed on a withholding basis under the domestic law of some countries. Such countries may wish to consider whether to adopt a different approach under their treaties.

(c) Ease of administration:

(i) Does the proposed treatment present any particular difficulties for the tax administration of your country? Such difficulties may include issues relating to administrative burden, especially where tax liability is determined by assessment by tax authorities (rather than self-assessment or withholding), or relating to interpretation or application of treaty provisions.

Example: Difficulties can arise where an undefined term used in the United Nations Model Convention (for instance, "paid" in Article 11 (Interest)) is interpreted in the Commentary in a way that is contrary to the established meaning of the same term for purposes of domestic law.

(ii) Is relevant information that is necessary for the administration of the provision readily obtainable?

Example: Article 8 (alternative B) (Shipping, inland waterways transport and air transport) of the United Nations Model Convention allows a country to tax "an appropriate allocation of the overall net profits" of a non-resident shipping enterprise. Determination of such profits may be difficult, particularly if non-resident shipping enterprises are taxed under the domestic law of that country on a deemed profit calculated by reference to the fares or freight received by the enterprise in that country.

(d) Ease of compliance:

Does the proposed treatment place an onerous compliance burden on taxpayers? This can be a particular problem where taxpayers are required to keep detailed records that they would not ordinarily keep, or meet strict information disclosure requirements in order to obtain treaty benefits.

Example: Many countries choose to simplify compliance by taxpayers by not including the "force of attraction" provisions of the United Nations Model Convention in Article 7 (1) (Business profits). Others may consider that the provisions of Article 5 (3) (b) (Permanent establishment) of the United Nations Model Convention relating to the existence of a deemed services permanent establishment create an undue compliance burden on taxpayers.

Countries are well advised to follow the provisions of the United Nations or OECD Model Conventions as closely as possible for the reasons outlined above. However, having regard to their particular circumstances, countries may determine that these Model Conventions do not fully meet their needs, or that certain provisions of one or other of them cause unacceptable difficulties. By developing a policy framework, these countries will be able to decide in advance what rules will best serve their country's interests, and how important those rules are to that country.

In deciding to move away from a policy position endorsed in the United Nations Model Convention, or the OECD Model Convention,

countries should, in relation to each policy issue, consider the matters mentioned above. In addition, they should also consider the following:

(a) Reason:

(i) What is the reason for the departure from the policy position found in the international models? For example, is the proposed approach intended to protect a significant source of revenue in your country (for instance, income from natural resources, manufacturing profits, fees for technical services, etc.)?

(ii) Is the departure intended to attract investment in an area of your country's economy that your government is seeking to develop (for instance, building technical expertise, financial services, etc.)?

(iii) Is the usual approach found in the international models too difficult for the tax administration or taxpayers to administer in the context of your domestic law?

(iv) Is the departure necessary in the context of the bilateral relationship, especially having regard to the other country's tax system? For example, while a developing country's model may include tax-sparing provisions, such provisions would not be required to protect domestic law concessions if the tax-spared income is exempt from tax in the other country, either under the treaty or under the other country's domestic law.

(b) Priority:

(i) How much of a priority is it for your country that this outcome be achieved vis-à-vis other issues? Is this an outcome that must be achieved, or something that is highly desirable but not essential, or is achieving this outcome not of particular importance to your country?

(ii) As far as possible, departures from the international norms should only be sought for important issues. If a policy outcome is preferred, but not important, countries with limited negotiating skills and experience may be better off focussing those resources on achieving key outcomes.

(c) Achievability:

Is this treatment likely to be readily accepted by the treaty partner country? Is it consistent with regional norms? Have other countries sought or accepted this approach in their treaties?

(d) Flexibility:

Is your government prepared to allow negotiators any flexibility on this issue? Is this a deal-breaker? Is there scope for compromise (for instance, different time threshold, different rate limit, exclusion/inclusion of certain provisions)?

If no flexibility is possible at the time of negotiation, would negotiators be permitted to agree to a most-favoured-nation provision? Such a provision could create an obligation to provide similar treatment if a more favourable position is agreed in a treaty with another country.

(e) Fall-back positions:

If there is scope for compromise, what fall-back positions would be acceptable to your government? What is the bottom line?

Finally, countries should be forward-looking in designing their policy framework and model. Treaties usually last for many years — often decades. Renegotiation of a treaty is time-consuming and expensive, so it is worthwhile to consider policies that are robust and sustainable in the long term, and that have regard to likely developments within the country and in the international tax context.

If possible, the policy framework and model should be agreed on a whole-of-government basis. In particular, the support of the Ministry of Finance or Treasury is important in ensuring that the treaty policy is consistent with the government's objectives. Other ministries, such as those responsible for foreign policy or trade, may also be relevant.

Policy concerns that are commonly encountered by developing countries, and the issues that they raise for designing a model tax treaty, are discussed in more detail below.

3. Designing a model tax treaty

Countries should develop a model tax treaty (model) that reflects the key aspects of their policy framework. For ease of negotiation, and to maximize the likelihood of designing effective provisions that achieve the desired outcomes, developing countries would be well-advised to base their models as far as practicable on the United Nations Model Convention.

Certain features of the United Nations and OECD Model Conventions are found in virtually all modern tax treaties, such as:

- Provision for elimination of double taxation;
- Inclusion of non-discrimination rules;
- Provision for mutual agreement between tax administrations; and
- Provision, most importantly, for exchange of tax information between tax administrations, including information held by banks and other financial institutions.

It is highly recommended that any country's model should include these fundamental provisions. In addition, most treaties adopt the basic structure of the United Nations and OECD Model Conventions, that is to say:

I. Scope of the Convention (Articles 1 and 2)
II. Definitions (Articles 3 to 5)
III. Taxation of income (Articles 6 to 21)
IV. Taxation of capital (Article 22)
V. Methods for the elimination of double taxation (Article 23)
VI. Special provisions (Articles 24 to 28)
VII. Final provisions (Articles 29 and 30)

In designing a model, developing countries are strongly advised to use not only the structure and principles but also the text of the United Nations or OECD Model Conventions wherever possible. Although the meaning of the texts of the Model Conventions may not always be entirely clear, especially where their language is not the first language of the reader, the terms used therein are found in thousands of tax treaties and are interpreted in accordance with their Commentaries and/or in jurisprudence around the world.

Developing countries would be well-advised to avoid making minor drafting changes, notwithstanding that those changes might better align the text of their treaties to terms used in their local language or in their domestic law. Deviations from the text of the United Nations or OECD Model Conventions may well be taken to signal that the negotiators intended to achieve a different outcome to that provided under them. By adopting the text used in the relevant Model Convention, countries are able to demonstrate their intention to achieve the outcomes provided therein as interpreted in the Commentaries. As far as possible, drafting changes should only be used where a different result is sought.

In cases where, in accordance with their policy framework, countries want to achieve a different outcome to that provided in the United Nations Model Convention, different provisions will need to be used. In these circumstances, if no suitable text can be found in the OECD Model Convention or in the Commentaries to either the United Nations or OECD Model Conventions, it is advisable to search for examples of provisions used in other treaties to achieve the same or a similar outcome. These may be found in regional models or on the OECD tax treaty website for tax officials.[7] The OECD website sets out many alternative provisions from existing treaties and is an extremely valuable free resource for treaty negotiators. If no suitable precedent is available, the drafting of a new provision in a country's model should seek to follow the style and text of the United Nations and OECD Model Conventions as closely as possible.

Countries should regularly review their model to ensure that it remains up to date in the light of international developments and

[7]Tax officials from all countries may register with the OECD Centre for Tax Policy and Administration secretariat.

changes in the country's circumstances. In particular, changes to the United Nations or OECD Model Conventions should be considered and, where appropriate, incorporated into a country's model tax treaty.

Issues commonly encountered by developing countries in designing their model

3.1 Persons covered

Tax treaties apply to persons who are residents of one or both contracting States (Article 1 (Persons covered)). "Person" is defined in Article 3 (General definitions) of the United Nations and OECD Model Conventions to include "an individual, a company and any other body of persons". Issues commonly arise as to how treaties apply to different types of entities and arrangements, such as partnerships and pension funds. While some of these issues are discussed in the Commentaries on the Model Conventions (for instance, there is an extensive discussion of the application of treaties to partnerships in the Commentary on Article 1 of the OECD Model Convention), countries should consider how treaties would apply to entities and arrangements existing in their country. Where doubt exists, it may be useful to clarify in the country model whether such entities are to be regarded as a "person" or a "resident" for treaty purposes.

3.2 Taxes covered

3.2.1 Capital taxes

While both the United Nations and OECD Model Conventions cover capital taxes, some treaties do not. The decision whether to include capital taxes in a tax treaty depends on whether they are imposed in both treaty partner countries. If both countries do so, then double taxation can arise where capital belonging to a resident of one country is taxed by the other country. In these circumstances, provisions to eliminate such double taxation should be included in any treaty between the two countries.

However, not all countries impose capital taxes under their domestic law. In designing their model, countries that do not

themselves impose capital taxes will need to consider whether they wish to cover them therein.

Double taxation of capital will not arise if one of the treaty partner countries does not impose capital taxes, or if neither does. In this case, it is a policy decision whether a country that does not impose capital taxes would want to include an article dealing with them in its treaties. Such an article may encourage outbound investment by residents of that country by limiting the circumstances in which the other country could impose tax on the capital of residents of the first country. However, this may not be seen as particularly desirable by developing countries that want their residents to keep their capital at home.

Coverage of capital taxes would ensure that, if a country subsequently introduces such taxes, any double taxation arising in respect of those taxes would be relieved. However, the imposition of such taxes in the future would be limited in accordance with the treaty provisions.

Taxing rights over capital taxes are generally allocated in accordance with Article 22 (Capital) of the United Nations or OECD Model Conventions. These provisions allow taxation of capital represented by immovable property situated in a country, or movable property of a permanent establishment (or a fixed base, under the United Nations Model Convention) situated in that country. Capital represented by ships and aircraft used in international traffic may only be taxed in the country where the place of effective management is situated. Under the OECD Model Convention, all other elements of capital are taxable only in the country of residence. The United Nations Model Convention leaves the question open to negotiations.

If a developing country that does not currently impose capital taxes decides to include this Article, and is concerned about limitations on future policy options with respect to capital taxes, one option may be to provide, in respect of capital that is not otherwise specifically dealt with under the Article, for taxation in the country where the capital is situated. This would ensure that, if in the future that country introduces capital taxes, the treaty would not limit their application (other than with respect to capital represented by ships and aircraft used in international traffic).

Some treaties provide, for example, that all other capital may be taxed in both countries. If double taxation arises as a result, the

country of residence of the taxpayer would be required to provide relief. An alternative approach is to provide for taxation only in the country where the capital is located. However, this is likely to be more difficult to negotiate since few countries are prepared to give up taxing rights over their own residents.

3.3 Distributive rules

Treaties provide for different methods of source taxation and for certain minimum thresholds for taxation of income derived by non-residents. The method and threshold depends on the category of income derived.

3.3.1 Business activities

Treaties generally provide an exemption from source taxation for income derived from temporary or preliminary business activities of non-resident enterprises. The aim of these provisions is to reduce the tax compliance burden of such enterprises unless they have a substantial participation in the economy of the host country. The relevant thresholds for source taxation are as follows:

(a) Fixed place of business:

Business profits of a non-resident will be taxable in the source country only if the non-resident enterprise has a permanent establishment (PE) in that country and the profits are attributable to that PE. A PE is primarily defined as a fixed place of business through which the enterprise conducts its business. A place of business will generally be regarded as “fixed” if it is at the disposal of the non-resident enterprise for at least six months.

This threshold for source taxation is widely accepted by both developing and developed countries for most non-service business activities (for instance, manufacture, hotels, mining, retail, etc.). For service activities, the United Nations Model Convention includes an additional time threshold (see below).

Countries with significant natural resources, especially off-shore resources such as gas or petroleum reserves, may

consider that a lower threshold is appropriate. These countries often include special provisions in the definition of "permanent establishment" (such as provisions to deem substantial equipment or natural resource activities to be a PE) or include an article on offshore activities which provides a shorter time threshold in respect of such activities.

Some treaties also provide an exception to the fixed place of business threshold in respect of insurance activities. For example, countries that impose tax on the basis of gross premiums paid to non-resident insurers under domestic law may preserve the operation of this law under tax treaties, sometimes with the rate of tax being capped to a certain percentage (for instance, 5 or 10 per cent) of the gross amount of the premiums.

(b) Construction sites:

While the OECD Model Convention provides for a 12-month threshold for construction and assembly projects, a 6-month threshold is provided under the United Nations Model Convention and is widely accepted internationally. Some developing countries seek a shorter time threshold in their treaties (for instance, 90 days).

In designing a model, the time threshold should not be less than any domestic time threshold for taxation of such activities. Doing so could lead to double non-taxation of income of non-resident construction or assembly enterprises in treaties with countries that apply an exemption system (that is to say, where the income that may be taxed in the host State under the treaty is exempted from tax in the other State). This is because, while the treaty accords the host State the right to tax the income, that State would not be able to exercise that right if the construction site lasts less than the domestic law time threshold.

(c) Services:

Income from services is commonly dealt with under a number of different articles of a tax treaty. Under the

United Nations Model Convention, services are deemed to constitute a PE (and therefore be taxable under Article 7 (Business profits) unless dealt with under another specific article) where:

- Supervisory activities in connection with a building site or assembly project, etc., are carried on in the State for more than six months; or
- Services are performed in a State for the same or connected project for more than six months.

These additional threshold provisions, though not part of the OECD Model Convention, are widely accepted in treaties with developing countries.

Another threshold that is not found in either the United Nations or OECD Model Conventions, but is found in a few treaties, deems a PE to exist where substantial equipment is used in a State. This additional threshold is particularly relevant to countries with off-shore natural resources because large mobile equipment such as oil rigs may not meet the criteria for being a fixed place of business. As noted above, a lower time threshold is provided where the equipment is used for natural resource activities. The substantial equipment provision may also be relevant to domestic transport operations.

Specific types of services are dealt with under the following provisions. Where these provisions apply, they will have priority over the general rules provided in respect of services income in Article 7.

(d) Profit attribution:

Treaties seek to avoid the double taxation that can arise as a result of differing attribution by the two countries of profits to a permanent establishment under Article 7 (Business profits) or to a related enterprise under Article 9 (Associated enterprises). While the arm's length standard is common to virtually all tax treaties, countries need to decide the extent to which dealings between different parts of an enterprise

should be taken into account. In this regard, Article 7 of the United Nations Model Convention differs from the OECD Model Convention in that it generally disallows deductions for amount "paid" by a permanent establishment to another part of the enterprise, such as the head office.[8] Countries that wish to adopt the more limited approach to profit attribution should be careful to follow the wording of Article 7 of the United Nations Model Convention.

The United Nations Model Convention also provides for the limited "force of attraction" principle, which allows the source country to tax, in addition to profits attributable to a permanent establishment, profits arising in that country from sales of the same or similar goods, or the provision of the same or similar services. Although this approach is not commonly found, even in treaties of developing countries, those countries that wish to provide for such force of attraction should include in their Model the additional wording found in the United Nations Model Convention.

(e) International traffic:

Article 8 (Shipping, inland waterways transport and air transport) of the United Nations and OECD Model Conventions deal with income from international transport separately from other business profits, primarily because the usual rules for taxation of business profits would be difficult to apply in the context of international transport operations as airlines and shipping operators would be likely to have a PE in many countries. Furthermore, the calculation of the profits attributable to each PE would be very difficult because much of the income is derived from activities carried out on or above international waters.

International treaty practice is to provide for profits from international transport by air, or by boat in inland waterways transport, to be taxed only in the country where the place of management of the enterprise is situated. Article

[8]See discussion in paragraphs 1–3 of the Commentary on Article 7 of the United Nations Model Convention.

8 (alternative A) of the United Nations Model Convention and Article 8 of the OECD Model Convention provide for similar treatment of profits from international shipping. Article 8 (alternative B) of the United Nations Model Convention provides a different approach, which allows the source country to tax a percentage of the overall net profits from the shipping operations if such operations in that State are more than casual.

Another approach found in some treaties is to allow the source country to tax income from international shipping in accordance with domestic law, but to reduce the tax payable by 50 per cent. This allows those countries that apply source taxation on a gross basis to the freight payable on goods or passengers shipped in that country to continue to do so, albeit at a reduced rate of taxation.

Developing countries will need to decide which approach they should adopt for international shipping, having regard to their policy preferences, administrative capacity and their domestic law. They may also want to consider whether profits from international road and rail transport should be dealt with under this Article, or in accordance with the usual rules of Article 7 for business profits.

(f) Income from independent personal services:

Under the United Nations Model Convention, income derived by a resident from professional services or other independent activities would be taxable in the country in which the services are performed if:

(i) The non-resident service provider has a fixed base in that country through which the services are provided; or

(ii) The service provider is present in that country for more than 183 days.

The OECD Model Convention no longer includes a specific article dealing with independent personal services. Such income is dealt with under Article 7 (Business profits), which requires that the income be attributable to a PE of the non-resident service provider.

Although the majority of countries take the view that Article 14 applies only to personal services provided by individuals, the use of the term "resident" leaves the scope of the Article open to interpretation. For this reason, some countries like to clarify that this Article applies only to individuals, while others extend its scope to activities performed by entities such as companies.

As Article 14 refers to "income", countries that tax independent personal services incomes on a gross basis under their domestic law are not precluded from doing so under this Article. However, as the majority of countries apply Article 14 to net income, countries that wish to apply gross basis taxation should clarify this during negotiations.[9]

Some treaties include a third threshold which allows a country to tax income from independent personal services where income exceeding a monetary threshold is paid by a resident of that country or a PE situated in that country. Such a threshold was previously found in the United Nations Model Convention but was deleted in 1999. Countries considering whether to include such a provision should note that monetary thresholds are difficult to administer and the amount becomes meaningless over time.

Independent personal services income may also be dealt with under provisions dealing with fees for technical services (see below). Where a treaty includes technical services provisions, the relationship between the two articles should be clarified, for instance, by excluding such fees from the scope of Article 14.

(g) Fees for technical services:

Under their domestic law, many developing countries collect withholding taxes on fees for technical services paid by one of their residents or borne by a PE situated in their

[9]See paragraphs 10 and 11 of the Commentary on Article 14 of the United Nations Model Convention.

country. The application of the usual tax rules provided under Article 7 (Business profits) may present an administrative problem for fees that are taxed on a withholding basis under domestic law as there may be no mechanism for reporting this income or allowing deductions against it. Accordingly, these countries often wish to include a provision in their treaties that allows them to continue to apply their withholding taxes.

Provisions to allow withholding on fees for technical services generally extend similar treatment to such fees as is provided in respect of royalties. This is achieved either by including fees for technical services in the definition of "royalties" in Article 12 (Royalties), or by including a separate article dealing specifically with such fees and drafted along similar lines to the article of the United Nations Model Convention dealing with royalties. A limit (generally around 10-15 per cent of the gross amount of the fees) is imposed on source taxation.

Although such a provision is not currently included in either the United Nations or OECD Model Conventions, it can be found in a significant number of treaties of developing countries. The United Nations Committee of Experts on International Cooperation in Tax Matters is currently considering whether to add a provision to the United Nations Model Convention to deal with fees for technical services.

As this provision is not consistent with current international treaty norms (which would require a PE or fixed base threshold, or at least a minimum time threshold), it may be resisted, particularly by countries that follow the OECD Model Convention. If it is a high priority for a developing country to include this provision in its treaties, it must be recognized that some treaty partner countries are likely to insist on concessions on other articles of the treaty (for instance, reductions on withholding taxes or other reductions in source taxation).

For this reason, it would be prudent for any country that includes a provision for technical services fees to have

fall-back positions. For example, inclusion of the article may be strongly resisted by some treaty partners because it does not include a requirement that the income be from services performed in that State. Including such a requirement would also be consistent with taxation of services income under Article 5 (Permanent establishment), Article 7 (Business profits) and Article 14 (Independent personal services). Consideration could also be given to including a minimum time or monetary threshold, at least as a fall-back position.

Income from technical services that is effectively connected with a PE would be excluded from the scope of such an Article, and would fall under Article 7, pursuant to which only the profits from such services may be taxed in the source country. This may encourage non-resident service providers to establish a PE in order to obtain the benefit of net taxation (which may result in less tax imposed at source).

The relationship between the fees for technical services provision and Article 14 dealing with income from independent personal services should be clarified. It may be expected that the technical services provision, being more specific, would have priority over Article 14. Nevertheless, it would be useful to put this beyond doubt by, for example, excluding fees for technical services from the scope of Article 14.

Countries that include a provision dealing with fees for technical services should ensure that the meaning of "technical services" (or other term used) is clear. Some countries define these services as services of a "technical, managerial or consultancy nature", while others consider that all services involving a technical element are covered, while yet others will only apply the provision to services connected to a transfer of technology.

(h) Entertainment:

In international tax treaty practice, under Article 17 (Artistes and sportspersons) unlimited source taxation of income

derived by artistes and sportspersons from their entertainment activities is permitted. Taxation on a gross basis is not precluded under this Article, but countries should consider whether they wish to include in their Model, or would be prepared to agree in negotiations to, provision for:

- Net taxation only;
- A minimum monetary threshold; and/or
- An exemption from source taxation for remuneration of entertainers who participate in a cultural exchange funded by government.

(i) Professors and teachers:

Although neither the United Nations nor OECD Model Conventions includes a separate provision dealing with income derived by visiting teachers or professors, a limited exemption is often found in treaties of developing countries that wish to attract the services of foreign educators.

The Commentary on Article 20 (Students) of the United Nations Model Convention includes a discussion on issues that should be considered in preparing a provision dealing with remuneration of teachers and professors, including:

- The possibility of creating double exemption (for instance, if the teacher ceases to be a resident for tax purposes in the other country);
- The inclusion of a time limit (normally two years) and the application of that limit;
- The possibility of limiting the exemption to teaching services performed at "recognized" institutions or research performed in the public (vs. private) interest;
- Whether an individual should be entitled to benefits under the Article in respect of more than one visit.

As these provisions are often difficult to administer and the same benefit could be achieved with more precision through domestic law, consideration should be given to whether any benefit or exemption for such remuneration should be provided under it.

3.3.2 Withholding taxes on dividends, interest and royalties

(a) Dividends and branch profits tax:

Most countries impose a withholding tax on some or all dividends paid by a resident company to its foreign shareholders. Treaties generally provide that the country of residence of the paying company may tax dividends paid to a resident of the other country, but if that person is the beneficial owner of the dividends, the rate of tax is limited to a certain percentage of the gross amount of dividends.

Treaty withholding tax rate limits on dividends often differentiate between non-portfolio inter-corporate dividends (that is to say, where the shareholder is a company that owns a significant holding in the paying company) and other dividends. The United Nations Model Convention Article 10 (Dividends) does not specify percentage rates, but Article 10 of the OECD Model Convention provides a rate limit of 5 per cent for non-portfolio inter-corporate dividends, and 15 per cent for all other dividends. There are, however, many different approaches and rate limits found in existing treaties, ranging from a single rate for all dividends, or split rates ranging from 0 per cent to much higher rates.

In designing their model, developing countries should take into account the total tax that will be imposed on corporate profit, including tax at the company level and tax imposed on successive levels of shareholders. A high level of dividend withholding tax, while it may operate to defer repatriation of profits by local companies to foreign owners, is also likely to discourage foreign investors from establishing or investing in local companies in the first place.

Most treaties provide lower rates of withholding on non-portfolio inter-corporate dividends to reduce the incidence of recurrent taxation. However, some countries may find it difficult to administer the dual rates under their domestic law and may prefer to provide in their model a single rate applicable to all dividends.

Under their domestic law, some countries impose an additional tax on the profits of a local branch of foreign enterprises. This tax is intended to provide broad equivalence between methods of conducting business so that, regardless of whether a foreign enterprise conducts business in the source country through a branch or a subsidiary, similar levels of source tax are payable. The additional tax may take many forms, including the imposition of a higher rate of tax on branch profits of foreign enterprises, a tax on the after-tax profits of the branch at a similar rate to dividend withholding taxes or a tax on remittances of branches to their head office.

Neither the United Nations nor OECD Model Conventions provide for any additional branch profits tax. However, provision for branch profits taxation in tax treaties is not uncommon, particularly in treaties of developing countries. If such a provision is included, the additional tax should be limited to the same rate as that applicable to non-portfolio inter-corporate dividends, and should apply to the after-tax amount of the branch profits, to ensure maximum consistency between taxation of profits of subsidiaries and branches.

(b) Interest:

The United Nations Model Convention does not provide specific figures for limits on interest withholding tax rates. However, treaties with developing countries generally limit withholding tax on interest beneficially owned by a resident of a treaty partner country to 10 or 15 per cent. Some regional models, such as the ASEAN Model, specify 15 per cent.

Developing countries should decide what rate they would consider appropriate for their model, bearing in mind that high rates of withholding may deter investment or may result in the tax cost being passed on to resident payers through increased interest rates.

Consideration should also be given to whether, either as part of their model or as a concession as part of the treaty negotiation process, a lower rate could be accepted in certain circumstances. Such a lower rate, or exemption, could apply to all interest, or to certain categories of interest, such as those discussed in paragraphs 12-17 of the United Nations Commentary on Article 11 (Interest).

In particular, consideration should be given to the withholding tax rate on interest derived by financial institutions. Given the cost of funds to financial institutions, and the narrow margins of profit obtained on funds lent by those institutions, even a low rate of withholding on the gross amount of the interest will frequently absorb (or even exceed) the whole amount of the profit on the lending activities.

(c) Royalties:

The United Nations Model Convention differs from the OECD Model Convention in that the former allows source taxation of royalties, while the latter provides for exclusive residence taxation. Unsurprisingly, treaties of developing countries almost invariably provide for source taxation. Article 12 of the United Nations Model Convention does not specify a withholding rate limit on royalties that are beneficially owned by residents of the other country, but in practice limits in developing country treaties range between 10 and 25 per cent. When setting the rate limit in their model, countries are advised to take into account the considerations set out in paragraphs 4-11 of the Commentary on Article 12 of the United Nations Model Convention.

One issue that commonly arises is the treatment of income from equipment leasing. Payments for the use of equipment are excluded from the definition of royalties in the OECD Model Convention, but remain in the United Nations Model Convention definition. Countries may wish to consider providing a lower rate for income from equipment leasing, either in their country model or as a fallback. Leasing income will have costs associated with it, and even a fairly

low withholding tax rate imposed on the gross amount of the income may well result in excessive taxation which would discourage cross-border equipment leasing or may be passed on to resident lessees. A limit of about half of the general rate for royalties may be appropriate.

3.3.3 Capital gains

Treaties generally ensure that tax imposed on capital gains on alienation of immovable property located in a country, and movable property which is part of business property of a permanent establishment or a fixed base in that country, may be taxed in that country. Capital gains arising from the disposal of ships or aircraft used in international traffic, and boats used in inland waterways transport, are generally taxable only in the country in which the place of effective management of the enterprise is situated.

For other gains, treaty practice varies. Some countries provide for exclusive residence-country taxation. However others, including most developing countries, prefer to retain source-country taxing rights over a broader range of capital gains, especially gains from the disposal of shares in a resident company or interests in an entity of which the assets consist mainly of immovable property.

In designing their model provisions on capital gains, countries should consider, in particular, which gains are taxable under their domestic law, and the extent to which their tax administration is able to enforce tax liabilities of non-residents on such gains.

3.3.4 Pensions

While Article 18 of the OECD Model Convention and Article 18 (alternative A) of the United Nations Model Convention provide that pensions paid in consideration of past employment are generally taxable only in the country in which the recipient resides, Article 18 (alternative B) of the United Nations Model Convention allows source taxation of such pensions if they are paid by a resident of the source country or a permanent establishment situated in that country. The United Nations Model Convention also provides that pensions paid in respect of government service and social security payments are taxable only

in the paying country. In practice, many countries seek source taxing rights over pensions in their treaties. Examples of different provisions are found in the OECD Commentary on Article 18.[10]

Countries should make a policy decision as to which alternative they prefer (or indeed, whether they would prefer another alternative such as a single tax treatment for all pensions). This decision should take into account, inter alia, the ability of the tax administration to collect source taxation on pensions paid to non-residents. Countries that tax pensions by withholding under domestic law, for instance, are more likely to be able to collect source tax in accordance with Article 18 (alternative B) of the United Nations Model Convention.

3.4 Relief of double taxation

(a) Elimination of double taxation:

The United Nations and OECD Model Conventions require the country of residence to relieve double taxation that arises in cases where source taxation is permitted under the treaty. The residence country has the option of relieving such double taxation either by the exemption method or the credit method.

A policy decision should be made as to which of these methods is preferred in relation to the different categories of income. Most countries prefer to align the method of relief to their domestic law relief provisions. However, some countries that relieve double taxation by the credit method under domestic law may provide for exemption of certain categories of income under a tax treaty in order to simplify compliance and administration.

(b) Tax sparing:

Tax sparing is an arrangement under which one country will agree to provide a credit for another country's tax, notwithstanding that the tax has not actually been imposed because of tax incentives provided by that other country.

[10] See paragraphs 12–21 of the Commentary on Article 18 of the OECD Model Convention.

The purpose of tax sparing is to ensure that the benefit of the incentive is not "soaked-up" by the country of residence of the taxpayer.

The treaties of many developing countries include a tax-sparing provision to protect the application to residents of the treaty partner country of tax incentives.

While some countries are prepared to agree to such provisions with their least developed treaty partners, others are more resistant, especially since the OECD published a report recommending caution in agreeing to tax-sparing provisions in treaties.[11] Nevertheless, this can be an important benefit to developing countries of entering into tax treaties with countries that provide relief from double taxation through the credit method.[12] Developing countries that wish to seek tax sparing would be well advised to consider how important the inclusion of such provision is to them, and the extent to which they might be prepared to consider limitations such as limitations on the activities to which the tax-sparing provisions would apply, or limitations on the duration for which the provisions would apply.

3.5 Non-discrimination

Rules to prevent tax discrimination are designed to encourage inbound foreign investment in a State and protect investment abroad. The non-discrimination rules in the United Nations and OECD Model Conventions apply to all taxes, including national and sub-national level taxes, income tax, Value Added Tax (VAT), property taxes, petroleum taxes, etc. In some countries, there may be constitutional or other barriers to applying the non-discrimination rules to all taxes. While it is desirable that the rules apply as widely as possible, these countries may need to limit the application of these rules in their treaties to taxes covered by the treaty, or to those taxes and other major taxes imposed in the two countries.

[11] See the 1998 Report by the OECD Committee on Fiscal Affairs, *Tax Sparing: A Reconsideration* (Paris: OECD, 1998).

[12] See paper on Why Negotiate Tax Treaties? by Ariane Pickering, para. 2.5.

Countries should review their domestic tax law to determine whether discrimination of the kind precluded by tax treaties exists. In conducting this review, it should be noted that different treatment of residents and non-residents exists in most countries and is not prohibited, provided that there is no discrimination of a type that would breach the tax treaty non-discrimination rules.

If a domestic law would potentially breach the non-discrimination rules, and for good policy reasons (such as the prevention of tax avoidance or evasion) the country considers that the law must be maintained, the country model should clearly specify the laws that are to be excluded from the operation of the treaty rules.

3.6 Mutual agreement procedure and arbitration

In accordance with usual tax treaty practice, a country's model should provide an avenue for taxpayers to seek solutions to tax issues arising out the treaty, such as transfer pricing issues, through the mutual agreement procedure. Under this procedure, the taxpayer can request the competent authority of his/her country to try to resolve such problems, either alone or in consultation with the competent authority of the other country. The second sentence of paragraph 4 of Article 25 (alternative B) (Mutual agreement procedure) of the United Nations Model Convention allows the competent authorities to develop "appropriate bilateral procedures, conditions, methods and techniques" for the implementation of the mutual agreement procedure. Developing countries should consider the procedural issues discussed in section C of the United Nations Commentary on Article 25, having regard, in particular, to the administrative capacity and resources of their tax administration and competent authorities.

The United Nations and OECD Model Conventions also include an optional provision[13] that provides for binding arbitration procedures to resolve issues that the competent authorities are unable to resolve under the mutual agreement procedure. While the benefits of providing taxpayers with the certainty of arbitration procedures

[13]Paragraph 5 of Article 25 (alternative B) of the United Nations Model Convention and OECD Model Convention Article 25 (5).

are beyond doubt, arbitration in the context of tax treaties is a relatively recent development and few tax treaties of developing countries currently include such an article. As noted in the United Nations Commentary on Article 25, countries with limited experience in the mutual agreement procedure could have difficulties in determining the consequences of adding arbitration.[14] Developing countries should consider whether their tax administrations have the legal and practical ability to support arbitration procedures and whether, as a matter of policy, they wish to do so.

3.7 Anti-abuse provisions

Some countries, particularly those with only a small tax treaty network, may be concerned that the reductions in source taxation offered through their treaties may expose them to abusive arrangements designed to obtain those benefits in unintended circumstances. They may also be concerned that residents of third countries with which they do not have a treaty may try to obtain the benefits of a treaty (treaty-shopping).

The Commentary on Article 1 of the United Nations Model Convention contains an extensive discussion of potentially abusive situations and suggests a number of possible solutions to combat such arrangements. In designing their model, countries should consider whether to include any specific anti-abuse rules[15] or general anti-abuse rules[16] in their treaties.

3.8 Administrative assistance

3.8.1 Exchange of information

In accordance with modern tax treaty practice, and with a view to joining the worldwide push to stamp out harmful tax practices, the

[14]Paragraph 3.

[15]See paragraphs 31–33 of the Commentary on Article 1 of the United Nations Model Convention.

[16]See paragraphs 34–37 of the Commentary on Article 1 of the United Nations Model Convention.

model that any country develops should adopt the wide exchange of information provisions in accordance with Article 26 of the current United Nations and OECD Model Conventions.

These provisions authorize and require the exchange of relevant information on all taxes, whether or not they are taxes covered by the treaty. The tax administration, if requested by the other tax administration, is required to collect and exchange all relevant information, even if that information is not required for its own purposes or is held by a financial institution. Countries should ensure that their tax administrations have the legal and administrative ability to obtain and exchange such information notwithstanding, for instance, domestic bank secrecy laws.

Article 26 (6) of the United Nations Model Convention provides that the competent authorities shall develop, through consultation, "appropriate methods and techniques" concerning exchange of information. Countries should consider what procedures are appropriate for the competent authority of their country to provide effective exchange of information, including exchanges made on request, automatically or spontaneously.

Some developing countries may have concerns about the administrative burden placed on their revenue agencies by the obligation to exchange tax information. These countries may wish to include in their model a provision requiring extraordinary costs incurred in providing information to be borne by the party requesting the information.[17]

3.8.2 Assistance in the collection of taxes

While the current United Nations and OECD Model Conventions include Article 27, which requires the tax administrations of both countries to provide assistance to each other in collecting taxes outstanding in the other country, it is recognized that not all countries will be in a position to accept such a provision.[18]

[17]See paragraphs 29.3 and 29.4 of the Commentary on Article 26 of the United Nations Model Convention.

[18]See footnote to Article 27 of the United Nations Model Convention.

Having regard, in particular, to the administrative burden this could place on the tax administration, developing countries may want to consider whether they are in a position to include such provisions in their model.

3.9 Protocol

Some countries like to append a protocol to their tax treaties, which sets out important interpretations and/or administrative provisions. Such protocols are generally negotiated at the same time as the tax treaty and have the same legal status as it.

Interpretive provisions are particularly useful where there might otherwise be doubt as to the intended operation or application of a tax treaty provision in one or both countries. This may occur, for example, where domestic law or jurisprudence in one country requires an interpretation that would not be followed in the other country. In this case, the two countries may agree during negotiations on a particular interpretation and set this out in the protocol.

4. Conclusions

By developing a tax treaty policy framework, countries will be in a much better position to "know what they want" out of treaty negotiations and to achieve outcomes that are in the best interests of the country. Such a framework will also assist countries in designing their country model, which should reflect the policy outcomes sought.

Both the policy framework and the country model should be reviewed regularly to ensure that future tax treaties continue to provide beneficial and appropriate outcomes for the country and remain up to date with international developments.

Preparation for tax treaty negotiations

Odd Hengsle*

1. Introduction

Preparations are an extremely important part of the negotiation process. Without adequate planning, the team will be at a disadvantage during the negotiations and the optimum result will most probably not be achieved for the country it represents. Some important aspects of these preparations are described below.

2. Preparation of a country model treaty

When the decision to negotiate tax treaties has been made, the first step will be to prepare a country model treaty. Before it is drafted, it will be necessary to agree on policy in order to decide on important issues that have to be considered in the treaty.[1] The United Nations Model Double Taxation Convention between Developed and Developing Countries[2] (United Nations Model Convention), the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital[3] (OECD Model Convention), regional model(s), if any, and models made by countries which were in a comparable situation should be studied. When drafting the provisions of a country model, it is advisable to follow the recognized wording used in international

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[1]See paper on Tax treaty policy framework and country model, by Ariane Pickering.

[2]United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

[3]Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2010) (loose-leaf).

models unless there are good reasons to use alternative wording. These reasons can be found, for example, in relation to industries where the employees work on a rotational basis. The activities on a continental shelf are usually based on people who stay at a platform for two weeks at a time, then spend the next four weeks in their home country. In such cases, the 183 days test in Article 15 (Dependent personal services) of the United Nations Model Convention and Article 15 (Income from employment) of the OECD Model Convention will not be satisfactory and new wording may be necessary, either by reducing the number of days or considering the number of days of employment rather than the days of presence.

If a provision in a country model deviates from the recognized wording used in international models, it may nevertheless be incorporated in it unless there is a good and valid reason to have it included in an additional protocol. A protocol is mainly used to set out important interpretative or administrative provisions. However, the reasons behind such deviations should be explained if necessary.

Yet, different wording can create issues, such as arguments over whether the commentaries to that provision will apply. It may also create uncertainty as to whether new wording is supposed to be only an improvement or is intended to introduce a new meaning. It should be noted that both the United Nations and OECD Model Conventions have drafted alternative optional provisions in their Commentaries that can be very useful if the Model Articles themselves do not provide a satisfactory solution.

When creating a country model, some countries set up a study group comprised of representatives from the relevant ministries and the private sector, while others hire consultants as advisers. Such consultants can be from the private sector with experience in international tax matters and treaty negotiations or from agencies dealing with international tax questions.

A special issue to be aware of when creating a country model is to state clearly the area to which the treaty shall apply. Neither the United Nations nor OECD Model Conventions has a definition of the two contracting States. However, in the Commentaries to Article 3 (General definitions) of the United Nations Model Convention it is stated that:

> "The parties to a convention are left free to agree bilaterally on a definition of the terms "a Contracting State" and "the other Contracting State". They may also include in the definition of a Contracting State a reference to continental shelves."[4]

It is important to be aware that the main purpose of those definitions is to state the scope of the application of the treaty, not to make a definition of the country as such. There may be several reasons for having a definition of a "Contracting State" that deviates from that of the country itself. One reason could be to exclude an area with a special tax regime, for example, areas with favourable tax incentive legislation. Another reason may be to include an area which is not regarded as part of the country itself but may be one where a country may exercise certain taxation rights, for example, regarding its continental shelf, which may encompass an area beyond the territorial sea.

Taking the purpose of the definition of a "Contracting State" into consideration, there may well be good reasons why it may vary from one treaty to another. However, it is important to explain to the Ministry of Foreign Affairs that the purpose of making a definition of a "Contracting State" in a treaty is to decide on the scope of application, not to define the country as such. The Ministry of Foreign Affairs should be informed of the proposed definition and its agreement should be sought on one that has not been agreed to before. It may also be consulted, if necessary, on the definition of "the other Contracting State".

3. Authority to negotiate

Familiarity with the constitutional and legal requirements of one's country for negotiating and giving effect to treaties is essential. The process varies from country to country. In some cases, approval from the Ministry of Foreign Affairs is required. In others, it is the prerogative of the Ministry of Finance or of the Treasury. Some countries prefer to submit a report establishing priorities thereon to the relevant

[4]See paragraph 3 of the Commentary on Article 3 of the United Nations Model Convention.

minister(s) that seeks approval for the work programme on negotiations for the following year or for the next few years. This really is determined by what is consistent with a country's legal and political framework. Approval of the work programme may then replace individual requests for approval. In other countries, authority to negotiate is given in response to individual requests, either from other countries or from industries in the home country. Even if the government has decided that, as a general policy, the country should enter into tax treaties with other countries and has approved a negotiations plan, it will usually be necessary, in each individual case, to get authority to negotiate. Such authority will usually be given when the Ministry of Finance or the Treasury has agreed on the content and policy framework of the individual treaty. Even if the relevant authority to give approval for negotiations may vary, the Ministry of Foreign Affairs should be consulted before any decision is made. It may also be advisable to consult with the ministries responsible for trade. In addition, some countries prefer to consult with the private sector to ascertain whether there are any particular problems that need to be resolved.

Authority to negotiate should be obtained before any final decision on negotiations with another country is taken. This is necessary, whether one is considering approaching another country asking for negotiations or deciding on a request from it.

There may be several reasons for not entering into negotiations at a specific time, and it may also be necessary to establish priorities among several countries. In some cases, treaties with neighbouring countries will have first priority. In others, treaties with countries with which important economic relations exist will be given precedence. It may also be that a request is received from a country with which there is no economic or political reason to enter into a treaty. Moreover, it may also happen that there are important political or economic reasons why a tax treaty should not be negotiated. For instance, there could be diplomatic tensions between the two countries. If the other country has no tax in effect, or is a tax haven, that could also be a reason not to have a tax treaty. Another could be that the balance of benefits between the two countries heavily favours only one of them.

4. Logistics

There are several issues that have to be decided when a decision to proceed with negotiations is made.

- How to communicate:

  The initial approach requesting negotiations will usually be made either through diplomatic channels or by a request made directly by the minister in charge of the negotiation of tax treaties in one country to the relevant minister in the other. To continue to communicate with one another only through diplomatic channels should be avoided. The aim should be to open a more informal dialogue between the lead negotiators through e-mail and/or telephone calls so that the logistics can be worked out more easily. Most countries have an updated directory of persons who are allowed to act as the competent authorities in relation to the negotiation of tax treaties. It is always useful to obtain a copy of it from the other country, even if it would not show who will be part of the forthcoming negotiations team. An updated directory will, however, be more useful after the treaty has become effective and there would be a reason to have direct contact with persons who are allowed to act as competent authorities. However, during the preparatory period, it is preferable to have such contact with persons in the other country who are responsible for the preparation of the treaty at hand.

- When will the negotiations take place?

  A date for the negotiations to commence has to be agreed and, as they require preparation, sufficient time should be allowed for this purpose. A minimum of six weeks is desirable as this would enable a comprehensive study of the other country's tax system and treaty practice to be undertaken. Additional time may be required if the public is invited to provide submissions on issues that should be addressed in negotiations.

- Where will the negotiations take place?

  As it is regarded as a disadvantage to travel, it should, in principle, be the country that asks for negotiations that should be

prepared to do so. However, this is by no means an established policy. If a country with limited economic resources asks for the negotiations to take place in their country, a developed country may be willing to travel to it for the first round of negotiations. If, as is usually the case, the negotiations require more than one round, it could be agreed that travel would be on a rotational basis.

The country hosting the negotiations should be prepared to offer suggestions to the visiting delegation about suitable hotels within easy reach travel of the meeting venue as well as other relevant information.

The advantages of having the negotiations "at home" include having easy access to reference materials and the possibility of consulting with other officials in the department or with the relevant policy makers. In addition, travel costs, jet lag and other inconveniences of travel will also be avoided. It is also customary for the host country to table its country model and ask for negotiations to proceed on the basis of it, a request that is usually accepted. It is always an advantage to have one's own model as a working document. On the other hand, it could be difficult to avoid other official duties, such as treaty interpretation issues or other urgent matters, which require daily attention.

- In which language will the negotiations be performed?

If the same language is spoken in both countries, there will not be any problem, of course. However, if the languages are different, it will be necessary to agree on which language should be used during the meeting. As English is the language most commonly used, it is advisable that the negotiating team members have a good knowledge of it. If the team members of the two countries are unable to carry out the negotiations in the same language, it will be necessary to have interpreters present during the meeting. This should be agreed upon in advance. In some cases, both countries may prefer to have their own interpreter in order to facilitate discussions within each team. However, in many cases, there will be difficulties in finding interpreters with an adequate knowledge of the terms used in treaties. Such a lack of knowledge may create difficulties and

unnecessary misunderstanding during the discussions. It is advisable that the interpreters have learned and understand the terms used in tax treaties prior to the meetings. This can be done by insisting that they study the terms used in other treaties the country has entered into or which are used in internationally recognized models, such as the United Nations or OECD Model Conventions. In this context, it is important to remember that both these Model Conventions have been translated into several different languages, which will hopefully make it easier to find what terms are commonly used in the language that is required.

The two teams will also have to agree upon the language in which the two draft treaties should be prepared.

- How many members should constitute the negotiating team?

In most cases, there should be at least three members: one to lead the negotiations, one to provide advice to the leader, and one to take comprehensive notes. One team member should be responsible for maintaining the agreed text. This matter is simplified if the text can be electronically displayed on a screen. If that is not possible, accurate paper drafts need to be kept. In countries where the tax administration is separate from the policy department, it is advisable to include members from both areas. The number may vary depending on where the meeting is to take place, but should not exceed six people (including any interpreter). If the negotiations are taking place in the home country, it could be beneficial to have more people attend the meetings in order for them to gain experience. However, they should be present merely as observers and would generally not participate in the negotiations.

- Who should be members of the team?

The team should be comprised, if possible, of people with experience and knowledge of tax treaties, international tax issues and domestic tax legislation. In some cases, an official from the Ministry of Foreign Affairs may also be a member of the team. The reason for this is that entering into treaties with other countries is often the responsibility of the Ministry of Foreign Affairs, which can give advice on important questions such as

the definition of the country, the entry into force and the termination provisions of the treaty, as well as on constitutional issues. If the entity acting as the competent authority for the treaty negotiations is different from the one that is responsible for the administration or interpretation of treaties, it is advisable that its members are included. When deciding on the members of the team, it is also important to remember that there may be more than one round of negotiations and also that there will be much work to be done when the negotiations are finished.[5] It would also be prudent, if possible, not to include members who are about to move elsewhere.

Some countries prefer to have persons from the private sector present during the negotiations. This is a very sensitive issue because the negotiations are between States and the agreement in most cases will be confidential until signed. The same rationale applies to hired consultants. Whether such persons should be present during negotiations is a matter that should be discussed and agreed upon in advance with the other country.

- Other preparations:

The country where the negotiations are taking place should provide suitable meeting rooms. If at all possible, the room should be set up with a projector to display the draft treaty text as it is being negotiated on a screen that is visible to both teams. Arrangements should be made for suitable refreshments, such as water, tea and coffee, and light snacks to be provided for morning and afternoon breaks. Printing facilities are also very helpful. As many delegations like to bring their own laptop computers to the negotiations, it would be advantageous if a sufficient number of power outlets could be provided, as also Internet connectivity, if available.

If the meeting room is in a secure building, the necessary security passes or escorts to the meeting room should be arranged in advance for members of both teams. For this reason, and as a matter of courtesy, each team should advise the other of

[5]See paper on Post-negotiation activities, by Odd Hengsle.

the number of people in its team, their names, role and contact details, and also identify their leader. Furthermore, it is advisable to make the gender of each team member clear (for example, by using a gender-specific title such as Mr. or Ms.) as this may not be readily apparent to the other team from the name alone.

The host country should also propose a tentative agenda for the meeting and send it to the other team for approval. In addition to showing the time set aside for discussions, it should contain information about coffee breaks, invitations for possible lunch and/or dinners and cultural programmes. The visiting team should also be informed of transportation to/from the airport, the venue of the meeting and the availability of transportation to/from it.

The team that is required to travel should apply for permission to do so and obtain any necessary visas. This should be done early to avoid unnecessary delays. It may create a bad impression, and also not be conducive to the negotiations, if a team is kept waiting until the last minute before receiving final confirmation of the arrival of a treaty partner.

Some countries like to provide gifts to the other delegation, either to each of its members or just to the delegation leader, although other countries have public sector policies against accepting them. As well, gifts should always be of little value. Furthermore, it should be remembered that gifts are subject to airport inspections, and some countries impose restrictions on the import of certain products. Bulky or heavy items should also be avoided.

5. Definition of the roles of each member of the team

As there is much work to be done in the preparatory period before the negotiations as well as during them, it is important that all members of the team know the duties for which they will be responsible as early as possible.

The leader of the team should be a senior official with the authority to make important decisions during the negotiations. These include

accepting or rejecting the other team's proposals, making his or her country's own proposals, and finding and accepting compromises, even if they are ultimately subject to approval by more senior authorities. Unless a senior official always leads the team, the other country may get the impression that the negotiations are being regarded as of little or no importance. This may cause misunderstanding and create an unpleasant atmosphere.

It is preferable that the leader has a comprehensive knowledge of domestic tax legislation and its interaction with tax treaties; if not, at least one of the other members of the team should have such knowledge. Experience in tax treaty negotiations is also highly desirable.

It is the leader who should direct the discussions and present the team's arguments. However, he/she may decide to ask one of the other members of the team to do so, to explain a position or a special feature in the domestic legislation. This should have been agreed upon beforehand, if possible. From time to time, it may also be advisable to let a junior member of the team do some presentation, as this will help him/her to gain experience and get a more direct feeling of ownership over the final result. The leader should use all opportunities to train his/her team to negotiate. In general, it is advisable that members of a negotiating team should have participated in training courses organized either by the country itself or by international organizations. It is important that the entire team carrying out tax treaty negotiations gain experience and knowledge. It could mean a serious setback for it subsequently if it is dependent upon one senior person who has left for some reason, perhaps because they moved to a different position elsewhere, went into the private sector or retired.

In some countries, the team is sometimes led by the most senior official of the negotiating authority, who may not necessarily have the specific expertise required. This can create problems during negotiations and it may be advisable for that person to indicate that most of the discussions will be led by a team member who has the relevant expertise.

As mentioned above, it is important that at least one of the members of the team is made responsible for taking notes of the discussions and of any agreements reached during the meeting. Notes are extremely important if a second round of negotiations is needed, and for when the treaty is being prepared for signature and subsequent

ratification. It is also important to have them when the competent authority may need to interpret issues arising from the treaty at a later stage. This responsibility should not be given to a junior person without experience because they may often have difficulties in understanding and differentiating between what is important and what is of less significance. It is unusual to record the discussions electronically and should never be done without advance agreement with the other team.

It is advisable to note the reaction of the members of the other team to the arguments being made during the discussions, as also to the proposals that are put on the table. Body language, as well as verbal responses, can give valuable insights into how they view a proposal. These may also give an indication of the relative importance of an issue to them, and help to find acceptable compromises.

6. Consultations with business and relevant ministries and agencies

When preparing for negotiations with another country, it is beneficial to consult with business and relevant ministries and agencies. In most cases, there will be business in one or both countries that has initiated the decision to proceed with the negotiation of a tax treaty. This may be due to problems they have met, or anticipate, when engaged in cross-border activities. Such problems will usually arise from domestic legislation in one or both of the countries, preventing or hampering the desired economic activity or creating a barrier to the desired cooperation between industries in the two countries. It may also be that one of the countries entered into a tax treaty with a third country which gave a competitive advantage to business in that country.

Consultation with business will, in most cases, provide significant information on economic areas which will be important to address during the negotiations. Such consultations could be done by approaching business associations and asking them to consult with their members to establish if there are particular points of importance to be aware of during the negotiations. Depending on their remarks, a meeting could be arranged with them.

Relevant ministries and agencies may also have information of importance to the negotiations. For example, they may have knowledge

about areas where they would like to encourage or make investments, or where they would like to attract investments. However, experience shows that it can be difficult to get feedback when the relevant ministries and agencies are asked for information. In order to receive an answer in time for preparations, it is advisable to stress how important it is. Furthermore, if a time limit for a reply is set, it enables a reminder to be sent. It may also be advisable for the host country to consult with its embassy in the other country because it may have important information on economic as well as non-economic areas that could be of value in the preparations.

7. Preparation of the draft country model used for a particular negotiation

Many countries will always use their general model treaty without making any changes. Although this indicates what they regard as their preferred treaty, it should always be open for negotiations. Other countries will take into consideration particular inputs they have received from different sources, such as previous negotiations or public submissions. Some developed countries may even have prepared a specific draft for negotiations with developing countries, allowing more taxation rights for the source State.

Whether a country uses a general model treaty or a draft specially prepared for the negotiations at hand, the team must have a clear understanding of all the articles therein and how they interact. The model may have been changed in some areas subsequent to previous negotiations and the team should be aware of when and why such changes were made, and of their effects.

The team should also have a clear understanding of why the articles have been drafted the way they are and be able to explain them. The articles may have been derived from the United Nations Model Convention, the OECD Model Convention or a regional model, or specifically drafted by the appropriate ministry. They may also have been given as alternatives in the Commentaries to the Models mentioned above. However, it is vital that the team is aware of, and can explain, any provisions that do not follow them. Such deviations may be due to domestic legislation or to important economic areas that need special attention.

8. Preparation of alternative provisions

Many countries have provisions in their country models which they know from experience the other country may find it difficult to accept in negotiations. To facilitate the negotiation process, therefore, it is advisable to draft alternative provisions which might be more likely to be accepted by that country. These may be provisions that have been accepted in negotiations with third countries, or that the other country has previously accepted in treaties with other countries. They could also be unique provisions intended to specifically address the concerns that have been expressed. When realizing that a preferred provision is not acceptable, such drafted alternative provisions can be presented and explained. It will be easier to have alternative provisions accepted when they are presented in writing rather than orally.

9. Non-negotiable provisions

Some countries have non-negotiable provisions in their country model. This position can be due to certain business activities or industries, such as mining or extraction of natural resources. It may also be related to economic incentive legislation or other areas of great importance to that country. It could also relate to policy issues, such as exchange of information. Most countries have difficulty in accepting that exchange of information may be prevented by bank secrecy legislation.

Non-negotiable positions may be found in the Commentaries to the OECD Model Convention. OECD member countries that disagree with the text of the Model lodge Reservations to it, expressing their view, while disagreements with the interpretations found in the Commentaries are reflected as Observations. A number of non-OECD member countries have also set out their positions on the Model Convention and the Commentaries. Although these Reservations, Observations and Positions do not always indicate a non-negotiable position, they are a very valuable indicator of strongly-held positions.

It is important to distinguish between provisions that are really non-negotiable and those for which the other country has a strong preference but which, under certain circumstances, can be flexible. Provisions that are only a strong preference should not be presented as completely non-negotiable.

Some countries prefer to list their non-negotiable provisions and present them to the other country during the preparations, either in writing or in a pre-meeting. Presenting such provisions in a pre-meeting would give the team the possibility of explaining the reasons for its standpoint. By presenting the non-negotiable provisions during the preparations, however, one may avoid unnecessary discussions or entering into negotiations that are doomed to fail.

Other countries are of the opinion that such pre-presentation of non-negotiable provisions may deter the other country from entering into what might otherwise be a successful negotiation. By looking at what is achieved on balance in relation to all the other provisions of the treaty during the negotiations, and by explaining why some provisions are of such importance that a superior authority or the legislative body would not accept any deviation, these countries hope, based on experience, that their standpoint could be accepted. However, if it has also been the case that some non-negotiable provisions have been a hindrance to achieving an agreement, it would be advisable to consult with a senior policy maker, the relevant minister or even the legislative body, to see whether compromises might be acceptable.

10. Interaction between domestic legislation and treaty provisions

It is important to have a clear understanding of the interaction between domestic legislation and treaty provisions. During negotiations, a team may be asked how their domestic legislation interacts with the provisions proposed in the draft country model. One reason to have such knowledge is to understand to what extent the proposal deviates from the domestic legislation and also what kind of benefits are offered. One simple example is the withholding taxes on dividends, interest and royalties. If what is being proposed is strictly in line with the domestic legislation, there are no treaty benefits and the treaty partner will be less interested in dealing with that.

For the same reason, it is advisable for a team to study the interaction with the provisions of the domestic legislation of the other country to also have a clear understanding of the benefits offered in its proposed draft treaty.

11. Preparation of a short explanation of the domestic tax system and the provision of it and the draft country model to the treaty partner

Many countries prepare a brief summary of their domestic tax system, with a special focus on areas relating to the treaty, including an explanation on any area which may require special attention. A short explanation of the main points in the legislation will make it easier to understand why some articles need special drafting and will also identify issues that need to be considered.

To facilitate the negotiations, this summary of the domestic legislation and a draft country model should be sent to the treaty partner well in advance of the meeting. At the same time, the treaty partner may be asked for a similar summary and draft country model. If such explanations and draft country models are received well ahead of the meetings, the two teams will be sufficiently prepared and time will be saved during the negotiations.

If no summary is received from the other country, it is advisable to look for such information elsewhere. It may be that it could be obtained from the relevant websites relating to it, in outlines prepared by major international tax companies or by searching on the Internet. It could also be a good idea to subscribe to tax treaty services. Some companies provide these services, which include the published texts of all treaties entered into between different countries. They also provide information on the dates of entry into force and termination of treaties, additional protocols, new legislation, court decisions and mutual agreements entered into by competent authorities (if made public), all of which can prove to be very valuable.

12. Preparation of a comparison of the respective draft country models — identification of issues

After having received the draft country model from a treaty partner, it is important to prepare a comparison between the two drafts. This may be done in several ways, as can be seen from the examples shown in annexes I and II. It should be noted that the use of two colours in annex II simplifies identifying the differences between them.

All differences between the two drafts should be identified because, in addition to the major issues being considered, small and less important textual differences have also to be agreed upon during negotiations. If some of these are overlooked, difficulties could arise at the time of signature or, even worse, after the treaty has entered into force. If the latter happened, a protocol to the treaty would have to be prepared and the laborious work of bringing it into force would have to be undertaken.

When comparing and identifying the differences, it is advisable to decide on the greater or lesser degree of importance of each of them. It will facilitate future negotiations to focus more on the important issues as they will present the most difficulties. Having identified them, they should be discussed internally to formulate the arguments to be used, and to determine what tactics should be followed when trying to convince the treaty partner to accept one's proposal. By identifying the important issues early in the comparative process, there will also be enough time to draft compromises and to consult with a superior authority regarding the acceptability of different solutions that could be anticipated. If a compromise solution would be possible, a prepared draft may be easier for the other team to consider and accept rather than one proposed orally at the meeting. A briefing note, where the origins of the draft are set out should accompany it (for instance, indicating whether they are in internationally recognized models, in examples found in one's own or in the other country's tax treaties, or were drafted specifically for the present negotiations). This exercise will also ensure that all members of the team are aware of, and can explain, its origins.

13. Identification of provisions proposed in the two draft country models that deviate from provisions agreed in treaties with third countries

When preparing for negotiations, a team should be aware of the treaties its country has entered into with third countries as it has to be prepared for the fact that the other country has also studied them. If the other team finds provisions in those treaties that are either identical to its own proposals, or are regarded as more favourable than the one put forward in the draft they have received, it will most likely

ask for the same treatment. To avoid unexpected outcomes during the negotiations, it is advisable to be prepared either to accept the same solution or to explain why it was acceptable when negotiating with the third country but is no longer the case. There may be many reasons for different solutions with different countries, including a change of policy or a compromise accepted to achieve favourable treatment in other areas of greater importance.

For the same reason as knowledge of one's own existing treaties is important, it is equally the case that a team should study the treaties the other country has already entered into with countries which are comparable (economically or regionally) to one's own. If the treaties used as a comparison are not too old, they will give an indication of its current policy and what the other team may be willing to accept. They may also indicate how strongly the other team is likely to argue for its own position. For example, if the other country has never agreed to a provision allowing withholding tax on fees for technical services, or has never agreed to tax-sparing provisions, it is unlikely that it will agree to include such provisions in negotiations with one's country. Conversely, if a provision is always included in the other country's treaties (for instance, certain anti-avoidance provisions), one can expect that it will be insisted that a similar provision should be included in any other treaty.

If the negotiations at hand are with a developed country, a comparison with treaties that it has entered into with other developing countries will be of great value as the provisions found therein may indicate what may be acceptable.

However, treaties between two developed countries may also be of great interest as their provisions may indicate that there are special issues to be aware of. One such example could be an article on limitation of double-taxation relief. If, according to its domestic legislation, a country uses a remittance basis of taxation whereby foreign-source income is taxed only when it is actually received in the country of residence, it could be advisable to have a provision that states that any such relief to be allowed in the residence country should be restricted to as much of the income as is taxed in the other country. An example of such a provision can be found in the tax treaty of 12 October 2000 between the Kingdom of Norway and the United Kingdom of Great Britain and Northern Ireland:

"Article 33

Limitation of relief

1. Where under any provision of this Convention income is relieved from Norwegian tax and, under the law in force in the United Kingdom, an individual, in respect of the said income is subject to tax by reference to the amount thereof which is remitted to or received in the United Kingdom and not by reference to the full amount thereof, then the relief to be allowed under this Convention in Norway shall apply only to so much of the income as is taxed in the United Kingdom.
2. Where under Article 13 of this Convention gains are relieved from tax in Norway and, under the law in force in the United Kingdom, an individual is subject to tax in respect of those gains by reference to the amount thereof which is remitted to or received in the United Kingdom and not by reference to the full amount thereof, then the relief to be allowed under this Convention in Norway shall apply only to so much of the gains as are taxed in the United Kingdom."[6]

Treaties entered into many years in the past are also of less value than new treaties. Recent treaties entered into by the other country may also help the team to develop drafting that is likely to be acceptable to it.

During this preparatory process, it is important to always remember to keep the focus on the overall balance of the treaty and not on specific issues.

14. Study of the culture and habits of the other country

When preparing the draft country model or when studying the draft received, it is advisable to have some background knowledge of the

[6]Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Kingdom of Norway for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital, 12 October 2000.

country with which one is going to negotiate. This may be in relation to its economic situation, gross national product (GNP), important industries or its relations with other countries.

If the negotiations are with a country with which one is not familiar, it is advisable to check if there are issues to be aware of and considered. These could relate to food, alcohol, religious beliefs or what is regarded as bad conduct. The timing of the negotiations is one example as they should not be proposed to take place during important religious holidays. Awareness of the dress code when visiting a country is another example. This may relate to the attire of both men and women. Informal dress should be avoided unless it would be appropriate for the occasion.

It may harm an otherwise good atmosphere between the two teams if someone feels offended because of their perception of bad conduct as a result of a lack of knowledge of local customs. A consultation with one's embassy in the other country may prevent such incidents. In general, it is advisable to have enough information so that one does not seem to be unaware or uninterested in those customs.

15. Conclusions

As has been demonstrated in this paper, preparations are an essential element of the whole negotiation process and, indeed, may be the most important part of it. If one does not come to the discussions fully prepared, the treaty may not be as beneficial to one's country as it might otherwise be. Without sufficient planning, it is easy to miss possibilities. It is, therefore, advisable not to rush into negotiations, but to take the necessary time to be prepared for them.

Annex I:

Example of a comparison of draft country model treaties: Article 15 (Dependent personal services)

Country A: Article 15 (Dependent personal services); **Country B: Article 14** (Income from employment)

No.	Country A	Country B	Country B's treaties with countries C and D	Comments
1.	Reference to Article 16 (Directors' fees) and Article 19 (Government service)	Country B has a reference to the same Articles but they are numbered Articles 15 and 18. In addition, there is a reference to Article 17 (Pensions and annuities)	Country B has a reference to the Article on pensions in treaties with countries C and D	
2.	(a) "period of twelve months" (b) "… an employer who is a resident of the State of which the recipient is a resident, …" (c) hiring out of labour (d) reference to "fixed base"	"twelve-month period" (b) "… an employer who is not a resident of the other State …" ------------	Country B's proposals are contained in treaties with countries C and D No such provision	
3.	International traffic — "… employment exercised aboard a ship or aircraft may be taxed in that State."	International traffic — "… may be taxed in the Contracting State in which the place of effective management is situated."	Taxation in the State where the shipping company is a resident in both the treaties with countries C and D	

Annex II:

Example of a comparison of draft country model treaties

Article 13 (Capital gains) and Article 14 (Income from employment)

Proposal from State A; Proposal from State B

Article 13 (Capital gains)

1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.
2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.
3. Gains derived by an enterprise of a Contracting State from the alienation of ships or aircraft operated in international traffic, or movable property pertaining to the operation of such ships or aircraft shall be taxable only in that the Contracting State in which the place of effective management of the enterprise is situated.
4. Gains derived by an enterprise of a Contracting State from the alienation of containers (including trailers and related equipment for the transport of containers) used for the transport of goods or merchandise shall be taxable only in that State, except insofar as those containers or trailers and related equipment are used for transport solely between places within the other Contracting State.

5. Gains from the alienation of any property, other than that referred to in the preceding paragraphs, shall be taxable only in the Contracting State of which the alienator is a resident.

Article 14 (Income from employment)

1. Subject to the provisions of Articles 15, 17 and 18, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.
2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:
   (a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned; and
   (b) the remuneration is paid by, or on behalf of, an employer who is a resident of the first-mentioned State not a resident of the other State; and
   (c) the remuneration is not borne by a permanent establishment which the employer has in that other State.
3. Paragraph 2 of this Article shall not apply to remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State and paid by, or on behalf of, an employer who is a resident of the first-mentioned State if:
   (a) the recipient renders services in the course of that employment to a person other than the employer who is a resident of that other State or has a permanent establishment in that other State, and who directly or indirectly, supervises, directs or controls the manner in which those services are performed; and

(b) the employer is not responsible for carrying out the purposes for which the services are performed.

4. Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic by an enterprise of a Contracting State may be taxed in that the Contracting State in which the place of effective management of the enterprise is situated.

5. Where a resident of a Contracting State derives remuneration in respect of an employment exercised aboard an aircraft operated in international traffic, such remuneration …

How to conduct tax treaty negotiations

Odd Hengsle*

1. Introduction

The objective of bilateral tax treaty negotiations is to achieve a treaty that is advantageous to both countries and meets their interests as far as possible. A treaty that favours only one country will not be beneficial in the long run. If one of these countries feels that it has been taken advantage of, it may resist applying the treaty or may not apply it in the way intended. It may also create a strained relationship between the competent authorities. The treaty may even be terminated or that country may ask for renegotiations.

It is important that negotiations are conducted in a cooperative atmosphere, with a willingness by each team to achieve the best result for their country. Consequently, it is critical that they negotiate in good faith.

The treaty needs to work smoothly in practice and should be effective and undue difficulties should not be created regarding compliance issues. In most cases, a tax treaty will last for many years; it is important, therefore, that it is drafted to stand the test of time.

Reaching a good agreement is dependent on many factors, including research, planning and preparations, as well as on the conduct and management of the negotiations. Suitable preparations are, therefore, very important.[1]

When two teams meet for the first time, the first issue to be decided is which draft country model should be used as the working document. It is always an advantage to have one's own draft accepted

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[1]See paper on Preparation for tax treaty negotiations, by Odd Hengsle.

as such because any proposed change to it would then have to be argued and explained by the other team, with the result that in many instances minor differences may be agreed to without difficulty.

The host team will usually ask for its draft to be the working document and this is often agreed to by the visiting team. However, both drafts will be on the table and should be taken into consideration during the discussions. It is advisable to use a projector to display the working draft on a screen. If possible, a merged document showing the text of both drafts should also be screened to facilitate a full discussion. This could then be updated to make it easier to see what has actually been agreed upon.

When the two teams have resolved all outstanding issues, two final Articles then have to be drafted, that is to say the Article on Entry into force and the Article on Termination. These Articles are important because there should be no doubt as to which tax year the treaty should be applied for the first time or, if terminated, which tax year would be the last year in which it would be applied. These Articles are discussed in the paper on Post–negotiation activities.[2]

2. Negotiation style

Negotiation style is very important and can vary from being soft to aggressive.

The objective of a soft negotiator may be to reach agreement on all articles as soon as possible. He/she may search for solutions that are acceptable to the other side while trying to avoid conflict. However, unnecessary concessions can easily be made when a too conciliatory approach is taken.

The objective of an aggressive negotiator will be to defeat the other side on all issues, insisting on his/her proposals and demanding concessions. However, such an approach will easily create an unfriendly atmosphere and should be avoided. In a worst-case scenario, the other team will feel offended and may react by ending the discussions without further negotiation, or by insisting on a change of leadership and approach by the counterpart.

[2]See paper on Post-negotiation activities, by Odd Hengsle.

A negotiation style that is balanced between the above is obviously desirable. Negotiators should be consistent in their approach but always polite. They should be prepared for the negotiations, knowing what is important for their country and able to propose and explain the preferred solutions without being aggressive.

Whatever approach is adopted, negotiators must remember that their style should take into account the goal of the negotiations, which is to achieve a mutually beneficial treaty. It is important to remember to keep the focus on the overall balance of the treaty and not on specific issues.

3. Trust

It is necessary to gain the trust of the other team to achieve a productive atmosphere during the negotiation process. A loss of credibility may lead to negotiating difficulties if the other team does not trust the validity of arguments put forward and becomes sceptical of what is said.

It is important that the explanations provided by a team are accurate. If it is asked to explain its domestic legislation or its position on a certain issue, the answer should be truthful. If the leader is not familiar with the issue, there may be others on the team who can clarify it. If the team cannot respond immediately, or is in doubt, it is advisable to say so and give assurances that an answer will be forthcoming. On the other hand, it is not always necessary to give more information than is requested.

One should always be transparent and never misleading. The other team may already know the reasons for a particular position but could be checking to see if the answers it receives are correct. It may also confirm the validity of the explanation it has received after returning home. For example, it is easily ascertainable if a team is giving incorrect information in relation to what has been accepted with third countries.

Incomplete disclosure can be very harmful. It should be recognized that negotiators are a small group and form a closed circle. If one's reputation with one party is damaged, it will soon be known to others thus, perhaps, creating a disadvantage in future negotiations

with other countries. One should always be aware that it is easier to lose credibility than to gain it.

4. Building a relationship

If the negotiations are with a country with which one is not familiar, it is advisable to find out if there are issues to be aware of which should be taken into consideration. These could relate to food, alcohol, religious beliefs or what is considered to be bad conduct. The timing of the negotiations is one example as they should not be proposed to take place during important religious holidays of the other country. Another example is awareness of the dress code when visiting the other country. This may relate to the attire of both men and women. Informal dress should be avoided unless it would be appropriate for the occasion.

At the negotiation table, formality is appropriate even if one already knows the members of the other team. However, it should be recognized that informal discussions or contacts which occur, either during a break, at lunches or dinners, also contribute to building good relationships and perhaps will make negotiations more fruitful. The conduct of any member of a team during meetings, or even after hours, may also have an influence on the relationship one is trying to build.

As meetings should begin on time, if a (member of a) team has been inadvertently delayed, it would be courteous to provide a brief explanation and apologize.

The leaders of both teams should direct the negotiations. To prevent confusion or give offense, no other member of the team should take the floor without being invited to do so by their leader, who should decide what can be said and by whom. If any member of the team feels they have a valuable contribution to make, they should address their leader. In order for a junior member of a team to gain experience in negotiations, it could be advisable to let him/her present an issue. However, this should be agreed upon in advance as part of the preparatory process. One should always address and look at the other party's leader when speaking, unless it is obvious that it is correct to address someone else.

When the leader of the other team (or another person on that team) is presenting their arguments, one should listen and show respect for the case that is being made even if one is not in agreement with it. It is ill-mannered to interrupt, shake one's head or tell the other team that it is wrong. It is important to be polite while explaining to the other team why one has a different opinion or would prefer a different solution. It is the strength of one's argument that should convince the other team and not by a show of any disrespect.

5. Discussion

When the time and place for negotiations have been agreed upon, a list with the names and titles of the participants of the two teams should be exchanged. The respective leaders should also be identified. In addition, when the two teams meet for the first time, both leaders should introduce themselves and their team so that everyone knows who is present and what the role of each team member is. For example, the leader might introduce a team member as "Peter Smith, from the revenue agency" or "Linda Jones, who is a member of the treaties team in the Ministry of Finance". This would also be the time to exchange business cards, thus making it easier to identify each team member. Most countries provide business cards for their negotiators and it is courteous to exchange them when the teams first meet.

The leader of the host country team should also confirm that the agenda it had tentatively proposed earlier is acceptable.

Usually, it will be the leader from the host country who leads the discussions but this may vary and there are no set rules. Sometimes it could be the leader of the more experienced team who would do so. It may also vary from one article to another depending on whose proposal is being discussed.

From time to time, the question of naming the treaty a "Convention" or an "Agreement" arises. Most countries will use the word "Convention" throughout the treaty. However, to some countries there is a difference between an "Agreement" and a "Convention". These countries use "Agreement" in relation to a bilateral treaty and "Convention" in the context of a multilateral treaty. It is best to check

with the Ministry of Foreign Affairs to ascertain if they have any preference. However, this is a minor issue and should be resolved easily. If one country prefers to use the term "Agreement", the other team should concur where possible and move on.

It is beneficial to agree on the process of the discussions. If it is the first round of negotiations between the two teams, an agreement could be reached to work through all the articles one by one without an in-depth discussion on each article. In this way, issues of less importance to both parties can be settled. However, some countries prefer to deal with linked provisions at the same time (for instance, the taxation of shipping in Article 3 (General definitions), Article 8 (Shipping, inland waterways transport and air transport (alternatives A and B)), Article 13 (Capital gains) and Article 22 (Capital)).

By examining each article individually, it will be easy to ascertain where the difficult issues are and also to identify which are of most importance to one or both countries. It is also important to understand the value of the particular issue under discussion because what is of significance to one country may not be so to the other. Understanding the respective values of the issues to teams is essential when trying to reach a compromise or doing a trade-off.

When all the articles have been considered, it is time to concentrate on resolving any remaining difficult issues. This may be done during the first round of the negotiations but, depending on time constraints, may be postponed to a second round.

Another way to begin negotiations is to first identify which issues are of most importance to each team and then discuss them. However, this method is probably best used after the first round of discussions on the draft has taken place because the decision to begin with them may prove a disadvantage to both teams. Moreover, it is not always prudent to identify very early in the negotiations what the most important issues are to either team. Even if the other team has no serious objections to a proposal (for instance, because the issue is not important to it), it may defer acceptance of the proposal in the hope of achieving something in return at a later stage in the negotiations.

If a provision mostly relates to one of the countries, or is a clarification of the wording of an article, it may be better to include it in a

protocol rather than trying to draft wording to that effect in the treaty itself.[3] This might simplify the reading of the treaty text. However, if a protocol is used, it is important to draw attention to it in an explanatory note to the treaty otherwise it could be easily overlooked.

Negotiators should remember that even if the issues which are not agreed upon are important it is not necessarily difficult to find solutions. It may be that the two teams would identify the same ones as significant and thus, perhaps, make it easier to find common solutions and reach agreement on which one would be preferable or at least acceptable. However, if both teams regard an issue as important but disagree on the solution, a compromise may be difficult (but not impossible) to find. It may also be that an issue which is regarded as important to only one of the teams is not contrary to what can be accepted by the other team provided the arguments advanced are satisfactory.

For an effective discussion to take place, one should introduce the issue and present one's position clearly. It is not necessary to present all arguments at once. In fact, it may be better to hold some of them back, to be used if the other team does not agree and has explained its reasons why.

After the arguments for a position have been presented, it is important to note carefully the reactions of the other team, although they may be difficult to understand. In such a case, one should seek clarification, and continue to do so if the response is not clearly understood. One should never move to a new provision in a treaty without having obtained this clarification. To accept or reject a proposal without a clear understanding of what has been put forward by the other team may lead to unforeseen consequences.

By listening carefully to the arguments put forward by the other team, it will be clear from time to time that its proposal is actually advantageous and better than one's own. If this is the case, it should be accepted and the necessary amendments to improve one's own country model should be made.

[3] See paper on Tax treaty policy framework and country model, by Ariane Pickering.

A team may resist a proposal and the arguments used in its favour. When it is seeking a different solution, it should be prepared to counter them. It is for this reason that is not prudent to present all arguments at the first presentation but to keep some of them for use as the discussion continues. If it seems difficult to get acceptance for the proposal that is being discussed, the point has been reached when it is time to look for alternatives. These may have been prepared before the negotiations, or developed during them. Alternatives may also be found in the Commentaries to the United Nations Model Double Taxation Convention between Developed and Developing Countries[4] (United Nations Model Convention) and the Organisation for Economic Co-operation and Development Model Tax Convention on Income and Capital[5] (OECD Model Convention), or on the OECD official website where commonly used alternative provisions may be found. These may be easier to accept as they indicate internationally accepted solutions. Alternatives may also be found in one of the country's treaties with other countries. Careful preparation before the meeting may enable teams to settle their differences more quickly and effectively.

One way to try to solve a difficult issue is to propose a "most-favoured-nation" (MFN) clause. The purpose of such a clause is to ensure that if a team accepts a less satisfactory proposal put forward by the team from the other country and that country at a later stage agrees to a more favourable provision with a third country, the latter provision should also be applied in relation to them. MFN-clauses can be found, for instance, in relation to withholding taxes on interest and royalties. In relation to royalties, such a provision may be drafted, for example, as follows:

> "However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the royalties is a resident of the other Contracting State, the tax so charged shall not exceed ___ per cent of the gross

[4]United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries (New York: United Nations, 2011).*

[5]Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital (Paris: OECD, 2010) (loose-leaf).*

> amount of the royalties. For the purpose of this paragraph, if a lower rate of State A tax is agreed upon with any other State than State B after the entry into force of this Convention such rate shall automatically be applied."

A MFN-clause may also be included in a protocol to the treaty and may be further restricted to treaties entered into with a group of countries, such as OECD member countries or countries within a region. Such a provision might read as follows:

> "Protocol:
>
> If after the date of signature of the Convention State A concludes a double taxation Convention with a State that is a member country of the Organisation for Economic Co-operation and Development which limits the taxation in State A of dividends as referred to in Article 10, interest as referred to in Article 11 or royalties as referred to in Article 12, the lower rate shall automatically apply for the purposes of this Convention from the date of entry into force of the first-mentioned Convention."

If a negotiation is preferred to an automatic entry into force, a third alternative might be to introduce the following provision into a protocol:

> "For the purpose of Articles 11 and 12, if a lower rate of State A tax is agreed upon with any other State than State B after the entry into force of this Convention, State A shall without undue delay inform the Government of State B in writing through diplomatic channels and shall enter into negotiations with the Government of State B with a view to including a similar provision in the present Convention."

A different way of dealing with difficult issues is to propose a "sunset clause". Such a provision can, for instance, be found in relation to tax-sparing provisions in the article on the elimination of double taxation. A sunset clause could then be inserted as a last sentence in the tax-sparing provision and may be drafted as follows:

> "... This provision shall apply for the first ten years for which the Convention is effective, but the competent authorities may consult each other to determine whether this period shall be extended."

A third proposal to deal with difficult issues may be a "grandfathering clause". Such a clause can be a solution when a treaty is renegotiated. If the existing treaty gives more favourable treatment to a person than the one proposed in the new draft treaty, a solution might be to let the old provision apply to persons already benefiting from the existing one. Such a clause can be applied without limitation, or limited to a certain period of time. Grandfathering clauses can be inserted in a protocol to the treaty or in the Article on Termination. Draft wording for insertion in a paragraph in that Article could read as follows:

> "Notwithstanding the termination of this Convention in accordance with paragraph 1 of this Article, this Convention shall in any event continue to apply to persons receiving income as mentioned in Article ___. However, this provision shall only apply to persons receiving such income at the time this Convention becomes effective."

A fourth proposal to deal with difficult issues may be to agree that a provision or an article shall become effective not at the same time as the rest of the treaty but at a later date, to be agreed between the competent authorities.

One country may be prepared to accept a proposal about an article from the other country but at the time of negotiations does not have the legislative instruments in place to give effect to its provisions. An example could be where the government is considering introducing an article into its treaties on assistance in the collection of taxes, the same as Article 27 of the United Nations and OECD Model Conventions. However, because the necessary legislation had not been passed by the legislative body at the time of negotiations, it could not become effective until it had been approved. If the legislation is expected to be in place within a reasonable period of time, a solution might be to accept the article but defer its entry into force. This would avoid the time-consuming work of introducing it into the treaty

through an amending protocol at later stage. To achieve a deferral, one solution is to add a paragraph or sub-paragraph in the Article on the entry into force reading as follows:

> "Article 29
>
> Entry into force
>
> 1. The Contracting States shall notify each other in writing, through diplomatic channels, that the legal requirements for the entry into force have been complied with.
>
> 2. This Convention shall enter into force upon the later of these notifications and shall thereupon have effect:
>
>   (a) In State A in respect of taxes on income for any tax year beginning on or after [day and month] of the year following that in which this Convention enters into force;
>
>   (b) In State B in respect of taxes on income relating to any calendar year following that in which the Convention enters into force;
>
>   (c) For the purposes of Article 27 (Assistance in the collection of taxes), from a date to be agreed in an exchange of notes through the diplomatic channels."

Even if a team does not accept a proposal immediately, it does not mean that it will not do so at a later stage in the negotiations. The team may have understood that the solution being argued is of great importance to the other team and is holding back to see what it may receive in return. If, during the discussions, a team indicates in its response that it may be willing to accept a proposal if certain conditions are met, one should try to establish what they are; if they are not quite clear, they should be clarified.

During the discussions, compromises will often be suggested. Unless they represent well-known positions and careful drafting, it is advisable to be cautious about accepting them. Compromises which

have been drafted quickly across the table are not always of the best quality and may lead to unexpected results. In worst-case scenarios, these could be harmful to one or both countries. Unless one is very experienced, it can be difficult to foresee all the implications of wording which may be unfamiliar. Even if the proposed wording seems to solve a problem, the best way to handle such compromises is to put them in brackets for further consideration. If the issue is not too important, and the wording is not too problematic, it may be enough to have studied it during a break or after that day's session has ended. However, depending on the issue's significance, it may also be prudent to take sufficient time to consult qualified persons regarding its acceptability.

A team may realize during the discussions that the other team has misunderstood the effect of a proposal that has been made. It may, therefore, have accepted a proposal it might not otherwise have agreed to.

For example, a country may be of the opinion that its domestic legislation regarding the taxation of money transmitted from a branch of a foreign company to its headquarters in the other country (branch profit tax) is not in conflict with its obligations under the Non-discrimination Article. The other country may be of a different opinion. In such cases, it would be better to deal with the problem either in the relevant Article or in a protocol. One way would be to clarify the common understanding in the Non-discrimination Article itself as follows:

> "The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. However, branch profits tax levied on income repatriated by a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be regarded as being contrary to the provisions of this paragraph. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances,

reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents."

A team could also realize that the other team differs with its own interpretation of an article. An example of this may be the interpretation of Article 14 (Independent personal services) of the United Nations Model Convention. This Article was deleted from the OECD Model Convention on 29 April 2000 on the basis of an OECD report entitled "Issues related to Article 14 of the OECD Model Convention". The reason was that the report stated as a fact that there were no intended differences between the concept of "permanent establishment" in Article 7 (Business profits) and the concept of "fixed base" in Article 14 (Independent personal services) of the OECD Model Convention. The report also concluded that there were no differences in how profits were computed and the tax was calculated.[6] However, there are countries which disagree with the report and maintain that an interpretation allows for both individuals and companies being included and permits gross taxation as well.

It may also happen that a team becomes aware that the other team's understanding of its own proposal differs from the general international understanding, or that its proposal will not give the intended result.

If a team believes that the other has misunderstood the meaning or effect of a proposal or that a different interpretation of an article exists, the issue should be raised. If it is important to the other team, which realizes later in the negotiations that it misunderstood a proposal to which it agreed, it may feel that it was misled and want to reopen the issue. It may even lose trust in the integrity of the team in question and hence be reluctant to agree on new issues. If the misunderstanding is not realized during the negotiations but before the treaty is signed, a delicate situation may arise when the country concerned refuses to sign the treaty or insists on renegotiation.

If a team at any time during the negotiations wishes to clarify issues or discuss arguments among themselves, it should ask for the

[6]See Commentary on Article 14 (Independent personal services) of the OECD Model Convention (2010).

opportunity to do so. It is better to take a time-out than make a wrong decision. All countries, developed as well as developing, have been in situations where a pause in the proceedings was necessary. Such internal discussions within a team do not require a separate meeting room to be available. In most cases, it will be sufficient that the other team provide privacy by leaving the meeting room. However, even if the two teams speak different languages, it is not advisable to believe that someone in the other team does not understand one's language. Care should therefore be taken in internal discussions when members of the other team are present.

If agreement has been reached on an issue, it should be so accepted and the proceedings should go forward. It is not advisable to return to an issue by informing the other team, for instance, how important the solution was, or to begin repeating the arguments, as this could result in it changing its mind or asking for further reflection.

To avoid unnecessary misunderstandings, it is important that both teams send correct signals on their attitude to proposals that are put forward. The situation should be avoided where a team at the end of a discussion has understood that an agreement has been reached but the other team at a later stage claims that it had not intended such an outcome; it had, rather, just signalled a positive attitude to a future accord, provided that all other issues in the treaty had been satisfactorily settled.

Notes should always be taken of the meeting. They are extremely important if a second round of negotiations is needed as some time usually elapses between the first and the second rounds. Members of the team during the first round of negotiations may have left or moved to other positions. The team preparing for the second round will, therefore, often be dependent on what can be discerned from the notes. They are also useful when drafting compromises, discussing positions with qualified persons or producing proposals for approval.

Notes are also important when preparing the treaty for signature, for instance, to explain the solutions agreed upon to the appropriate minister or to be used at a hearing in the legislative body. They can also be of great interest when the competent authority, at a later stage, may need to interpret issues arising from the treaty.

6. Arguments

During the discussions, the teams should be prepared to present relevant arguments to explain the proposals they have put forward for the different articles of their draft. This is true for all the articles, but is essential where the wording of an article deviates from what is common wording in international models, such as the United Nations and OECD Model Conventions, or any commonly used regional models. This is why preparations are so important. Without having done the necessary background work to support a different rationale before the negotiations take place, one team may not be able to convince the other why different wording would be an improvement on recognized international models. This alternative wording may be considered necessary to take care of certain economic activities, such as mining or the extraction of natural resources. It may also be related to activities in the financial sector, such as those of banks, or was drafted to remove uncertainty in relation to the use of new financial instruments.

Wording different from the international models can often be found in their related Commentaries. In such cases, the Commentaries will usually explain the reasons and the relevant arguments for it. However, a team should be able to show where the wording can be found and explain why it is the preferred approach. With respect to the OECD Model Convention, such wording can be found, for instance, in relation to the taxation of services, pensions or dependent personal services.

In this connection, the various arguments that are commonly used relate to concerns such as policy, protection of tax base, precedent and anti-abuse.

The policy argument focuses on well-established rationales. It is often based on economic arguments and is closely linked to revenue concerns. In many cases, it will be difficult to tell which one it is.

An example is the situation where a foreign company, for bona fide reasons, establishes a branch in a country through which it performs its economic activities in that country. Any profit made will be taxed according to Article 7 (Business profits). However, any remittance of money (after tax) to its headquarters will be transferred without further taxation in the source country. If the foreign company had

established a subsidiary company in that country instead, any remittance of money after tax would have been in the form of dividends and would have been taxed in accordance with the provisions of Article 10 (Dividends). To avoid such different treatment, a country may wish to tax the transfer of money from the branch in the same way as a dividend distribution would be taxed (branch profits tax). The reason for the introduction of this tax would be based on both the economic and revenue arguments.

Another example is the taxation of royalties. As is the case for interest payments, a country that imports a lot of know-how from abroad may use similar explanations to argue for a withholding tax, or to widen the definition of royalties to include, for instance, fees for technical services.

A third example may be that a certain economic activity in a country is of such importance to it that special provisions have to be introduced in the treaty to prevent revenue losses. To achieve this, a country may want to introduce provisions enabling it to tax any activity performed there by a foreign enterprise no matter the length of its stay. Such provisions will often be linked to mining or the extraction of natural resources.

A further example is when a lot of building or renovation activities are taking place in a country and it is dependent on services performed by foreign enterprises. To avoid having loss of revenue, such services may necessitate the introduction of a provision on the rendering of services in general. Examples of such provisions can be found in the United Nations Model Convention, as well as in the Commentaries to both the United Nations and OECD Model Conventions.

The policy argument can also be based on mutual benefit reasoning, for instance, to introduce provisions to prevent treaty abuse or tax avoidance or evasion. It may also be a reason for having an Article on assistance in collection of taxes.

Another reason often used in support of a proposal is the precedent argument.

Whether alone, or in addition to other arguments, a team may show that other countries have accepted the proposed wording of an article. For a developing country negotiating with a developed country,

such an argument will be of greater value if it can demonstrate that other developed countries have accepted the wording.

Conversely, the team from one country may ask for wording that the other country has accepted in treaties with third countries. It may point to those treaties and ask why such wording would no longer be acceptable.

A further argument in this regard arises when the other country has accepted a certain provision with a country to which one would like to be compared and business in one's country would be placed at a disadvantage unless one received the same benefits. This would often be the case when discussing rates in the Articles on dividends, interest and royalties.

One's argument will always carry more force if it can be shown that one's proposed provision is contained in the United Nations or OECD Model Conventions or is suggested as an alternative in their respective Commentaries.

In several cases, a provision may be asked for to prevent abuse.

When negotiating a tax treaty, it is important to bear in mind that its purpose is to avoid double taxation and to stimulate cross-border activities; it is not to create a situation of double non-taxation. It is also important for a country to be aware of provisions in a treaty that business can misuse to avoid taxation in the country of source, or even in the country of residence.

In the Commentary on Article 1 of the United Nations Model Convention there is a discussion on the use of general anti-abuse rules found in domestic legislation.[7] A similar discussion is found in the Commentary on Article 1 of the OECD Model Convention. It is generally accepted that such anti-abuse rules found in domestic legislation are not contrary to tax treaty provisions and could be used to combat improper use of tax treaties.[8]

[7]See chapter X, Improper use of tax treaties, tax avoidance and tax evasion, by Phillip Baker, in the United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries, New York, 2013.

[8]See paragraphs 21-23 of the Commentaries on Article 1 of the United Nations Model Convention (2011).

However, despite the good arguments in the United Nations and OECD Model Conventions for using domestic legislation to combat the improper use of tax treaties, it may be advisable in certain cases to introduce specific anti-abuse provisions in these treaties. Both the United Nations and the OECD Model Conventions discuss the use of specific anti-abuse rules found in tax treaties.

When prevention of abuse is used as an argument, it is important to use examples to illustrate why certain wording is necessary.

An example could be the introduction of thin capitalization rules in domestic legislation. Depending on the wording of such legislation, the rules could be argued to be contrary to the Article on Non-discrimination in the tax treaty. To avoid such an argument with respect to the legislation aimed at discouraging the use of excessive debt capital instead of equity capital to finance the establishment of a subsidiary company in one's country, it might be useful to propose a sentence, either in the Non-discrimination Article or in a protocol to the treaty, indicating that such a provision is not in breach of the provisions of that Article.

If the domestic legislation in one's country contains other provisions that could be argued to be contrary to the Article on Non-discrimination, it could be prudent, after explaining them, to propose a provision in a protocol to the treaty reading as follows:

"Ad Article:

> Nothing in the domestic legislation in State A at the time of the entering into force of this Convention shall be regarded as being contrary to the article on non-discrimination."

Another example may be that a country might want to include a paragraph in the Article on dependent personal services to deal with international hiring out of labour. Such a provision could be introduced to prevent the situation whereby in order to avoid taxation of its employees a local company hires them through a foreign company. Such wording, together with an explanation, can be found in the Commentaries to that Article in both the United Nations and OECD Model Conventions.

A third example could be a provision, added as a new paragraph, in the Articles on dividends, interest and royalties, stating that their provisions should not apply if a dividend, interest or royalty payment was created mainly for the purpose of taking advantage of the respective Articles and not for bona fide reasons. An example of such a paragraph in Article 11 (Interest) might be as follows:

> "The provisions of this Article shall not apply if the debt claim in respect of which the interest is paid was created or assigned mainly for the purpose of taking advantage of this Article and not for bona fide commercial reasons."

Similar provisions could be inserted in the Articles on dividends and royalties.

Another possibility could be to add an Article on the limitations on benefits. An example of such drafting might be:

> "Article:
>
> Limitations on benefits
>
> Benefits of this Convention shall not be available to a resident of a Contracting State, or with respect to any transaction undertaken by such a resident, if the main purpose or one of the main purposes of the creation or existence of such a resident or of the transaction undertaken by him, was to obtain the benefits under this Convention that would not otherwise be available."

Some countries have introduced comprehensive limitations on benefits (LOB) rules in their models. The United States of America (USA) is an example of a country that has introduced such an Article in all their recent treaties. In many cases, such rules are complex and difficult to understand. It would not be advisable, therefore, to introduce such rules in one's own country model unless one was very experienced. When negotiating with countries that have such rules in their country models, they should be asked to clarify the provision and the necessary time should be taken to understand its implications.

An argument that is frequently made is that a proposal is based on firm policy. However, the question is how firm is "firm"?

A country may have found that a certain provision is not effective in relation to what it tried to achieve. However, an argument based on that kind of experience should be illustrated by examples.

Some countries have non-negotiable provisions in their country model. That can be due to certain business activities or industries, such as mining or extraction of natural resources. It may also be related to incentive legislation or other areas of great importance, or it may be for policy reasons such as exchange of information. If experience has shown that some non-negotiable provisions have been a hindrance to achieving an agreement, it would be advisable to consult with a senior policy maker, the relevant minister, or even the legislative body, to see whether compromises may be acceptable.

It is important, however, to distinguish between provisions that are really non-negotiable and those which are only strongly preferred. The provisions of the latter should not be presented as non-negotiable.

When an argument of firm policy is used, it does not mean that the provision in question is not negotiable. It should be understood to mean that a provision, or a wording, is regarded as of great importance but may be open for discussion under certain circumstances. However, it will not be given up easily and one should be prepared, in return, to accept something that is important to the other team. It may be that such a provision should be put in brackets and dealt with in the final bargaining process. However, it is never advisable to use the argument of firm policy too often as it will weaken it, or make the whole negotiation process more difficult. It may even encourage the other team to use the same argument in cases where it otherwise would not. In many instances, therefore, it may be better to tell the other team that an issue is important rather than basing it on firm policy.

When using the argument of firm policy, it is advisable to remember that by looking at other treaties that the other country has entered into, it can easily be ascertained how firm that policy really is. If these treaties show that a firm policy argument is not sustained, that country would need to give a good explanation as to why it does not seem as firm as has been claimed. One possible explanation may be that a change of domestic legislation has taken place or that experience from earlier treaties has made a change of policy necessary.

There are at least two arguments that are of little or no value unless they are substantiated. One is that a specific provision is required due to the status of one of the parties as a developing country. Another is that a provision is required merely because it is provided under one's domestic legislation. It may be true that a country is a developing country and, therefore, needs a particular provision. It may also be true that a specific provision in domestic legislation necessitates such a provision in a treaty. However, in both cases, it is important to explain clearly why it is required.

7. Use of protocols, exchange of notes and memoranda of understanding

A "protocol" to a treaty may be negotiated at the same time as the tax treaty itself to set out important interpretations or to introduce administrative provisions. It may also deal with issues mostly related to only one of the countries. A protocol may also be negotiated at a later date to make changes in an existing treaty. To have it in force, the same legal procedures as for bringing the treaty itself into force must be followed.[9] The protocol will then be a legally binding document.

An "exchange of notes" is a record of an agreement to clarify a common understanding of an issue where agreement has been reached between governments during the negotiations of a treaty. The agreement consists of the exchange of two documents, each of the parties being in possession of the one signed by the other party. Under the usual procedure, the accepting State repeats the text of the offering State to record its assent. The signatories of the notes may be government ministers, diplomats or departmental heads. The notes will usually be signed and exchanged on the same date as the treaty. Those notes constitute very formal documents whose interpretation will usually be followed even if they are not legally binding.

A Memorandum of Understanding (MoU) is a less formal kind of document. It is often used for detailed or technical matters which may not be set out easily in a treaty or a protocol. It may also clarify an understanding of a provision or an issue. A MoU is usually drafted

[9]See paper on Post-negotiation activities, by Odd Hengsle.

at the end of the negotiations and is signed by the negotiators on the same date as the agreed treaty. It may also be made at a later date but, in such cases, it would probably be more correct to follow the procedures laid down in Article 25 (3) (Mutual Agreement Procedure) of the United Nations and OECD Model Conventions. The document is not legally binding, but should be taken into consideration when interpreting the treaty.[10]

8. Records of discussions

During the discussions, it is advisable to have the working draft treaty electronically projected on a screen that is visible to both teams. One team member needs to be made responsible for maintaining the agreed text. In this way, everybody can check that the changes made are correct. When going through the working draft treaty, article by article, all wording that is not agreed should be put in brackets. Each team's preferred wording could be shown using different colours. This would make it easier to identify where agreement is not achieved and what each team's position is. What is not put in brackets should be regarded as agreed and closed. If there is no screen, it is important to read the text before moving on to the next issue. One example of brackets and colours might be by using different colours of fonts, as follows:

> "Gains derived by an enterprise of a Contracting State from the alienation of ships or aircraft operated in international traffic or movable property pertaining to the operation of such ships or aircraft shall be taxable only in that the Contracting State in which the place of effective management of the enterprise is situated."

Another example could be to highlight the relevant text using alternative colours, as follows:

> "Gains derived by an enterprise of a Contracting State from the alienation of ships or aircraft operated in international traffic or movable property pertaining to the operation of such ships or aircraft shall be taxable

[10] Ibid.

only in that the Contracting State in which the place of effective management of the enterprise is situated."

If no colours are used, the following alternatives could mark the different proposals:

> "Gains (country A: derived by an enterprise of a Contracting State) from the alienation of ships or aircraft operated in international traffic or movable property pertaining to the operation of such ships or aircraft shall be taxable only in (country A: that) (country B: the Contracting State in which the place of effective management of the enterprise is situated.)"

However, the last example clearly shows that the use of colours simplifies the understanding of the differences.

Alternatively, if colours are not used, it would be a better solution in many cases to present the two proposals as follows:

> "Country A: Gains derived by an enterprise of a Contracting State from the alienation of ships or aircraft operated in international traffic or movable property pertaining to the operation of such ships or aircraft shall be taxable only in that State."

> "Country B: Gains from the alienation of ships or aircraft operated in international traffic or movable property pertaining to the operation of such ships or aircraft shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated."

At the end of the meetings, it is important to ensure that there is agreement on which issues have been resolved and which are postponed for a second, or subsequent, round of negotiations. Both teams should have a printed version of the working draft treaty as it stands at the end of the discussions. Enough time should always have been left so that it could be read and checked for mistakes beforehand. However, when the draft treaty is based on a merged text that has been on a screen there will be fewer possibilities for serious mistakes. Misprints can always be corrected in later correspondence between the two teams.

If it is not possible to have the working draft treaty projected on a screen, accurate paper drafts need to be kept. This requires very careful organization. These drafts should be dated so that it is clear which text is the latest.

When the two teams have agreed that the working draft treaty is in accordance with what has been agreed, the two leaders should initial each page. Even if there are still brackets and a second round is necessary, initialling this text is advisable. As several drafts may have been on the table, an initialled draft proves what has been agreed to and that it is the correct one.

A copy of the draft treaty should first be initialled on the left-hand side of the page. The initials should be placed just below the last line on each page, which is not necessarily at the bottom of the page. The theory behind this is to avoid anything being added to, or removed from, the text without being noticed. When all pages have been initialled, the two draft copies should be exchanged and initialled on the right-hand side of the page. Therefore, when both leaders have initialled the two drafts there will be one such copy for each country, it being the one where their initials appear on the left-hand side of the page. However, if a different system of initialling has been used, it is of no importance as long as the two leaders have a draft treaty that shows what has been agreed. The draft that has been initialled has no binding effect on the countries. It shows what the two leaders have agreed to and what they are prepared to present to the relevant authority in their country for approval.

Before ending the meetings, it is advisable to produce agreed minutes in which all major outstanding issues should be noted (see annexes I and II for examples of the drafting of such minutes).

If the understanding of a provision has been discussed and agreed on during the meeting, or one of the teams has stated how it will interpret a provision, this understanding or interpretation should be reflected in the minutes.

If there is to be a second round of negotiations, the open issues should be placed in brackets indicating, either in colours or otherwise, the positions of the two countries. It is also prudent to agree on a (tentative) date for future negotiations and to note it in the minutes. That

date should not be too far into the future. If too much time elapses between the first and second rounds of negotiations, the members of the teams from the first round may not be available to attend the second one. The result could be that issues agreed to during the first round will be reopened by a new leader, which may harm the process of finalizing the treaty.

Even if the second round of negotiations is supposed to continue with discussions on the outstanding issues as reflected in the agreed minutes, there may be valid reasons why a team has to reopen issues which were agreed upon during the first round. One reason could be a change in domestic tax legislation following a change of policy. An example could be that a country has introduced a withholding tax on pension payments made to non-residents and, accordingly, wants to change from an agreed resident taxation to source taxation. Another example could be that the legislative body has clearly stated that a certain provision will no longer be accepted.

When a country, for any reason, reopens an agreed provision, the other country should not reject discussing the issue once more. It would then, however, be free to reopen other issues, especially if the agreed issue had been based on a compromise made during the earlier discussions. However, to reopen issues that had previously been agreed to should be avoided as far as possible and the country that asks for further discussions should be prepared to explain its reasons for doing so.

9. Conclusions

It is during the discussions that it will become apparent how important the preparations were. To summarize, one should be fully familiar with the policy of one's country and the draft country model treaty. It is essential to meet well prepared and be able to explain the proposals being presented and the reasoning behind them. One's conduct should be respectful and arguments that are put forward should be listened to carefully. Furthermore, it is important to take notes during the discussions. To achieve a treaty that is beneficial to one's country, it is essential to be patient and to be prepared to propose alternatives and compromises to break what appears to be a deadlock. If necessary, one should be prepared for a second round of negotiations.

Annex I:

Example of agreed minutes of first-round negotiations

AGREED MINUTES

A first round of negotiations of a Convention between State A and State B for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income was held in [city/country] from [date] to [date]. The delegation from State A was headed by Mr./Ms. [name], [title], [organization]. The delegation from State B was headed by Mr./Ms. [name], [title], [organization]. A list of both delegations is attached as annex I.

The negotiations were conducted in a friendly atmosphere of mutual understanding and cordiality. While most Articles of the Convention were discussed in depth and agreed, some provisions were left pending and these are indicated in brackets and are marked in colour: yellow for State A and green for State B. The pending issues include Article 5, paragraph 3, and Articles 8, 11, 12, 13, 19, 21 and 26. These pending issues are set out in the joint draft text attached as annex II, which will be used in the future negotiations to be held in [city/country] on a date to be agreed.

Done in State A on [date]

For the delegation from State A:	For the delegation from State B:
Mr./Ms. [name]	Mr./Ms. [name]
(Head of delegation)	(Head of delegation)

Annex II:

Example of agreed minutes of second-round negotiations

AGREED MINUTES

A second round of negotiations for the conclusion of a Convention between State A and State B for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income was held in [city/country] from [date] to [date]. The delegation from State A was headed by Mr./Ms. [name], [title], [organization]. The delegation from State B was headed by Mr./Ms. [name], [title], [organization]. A list of both delegations is attached as annex I.

The negotiations were conducted in a friendly atmosphere of mutual understanding and cordiality. The provisions of the Convention that were left open after the first round of discussions in [city/country], as well as a number of other provisions previously accepted, were discussed in depth. The discussions led to an agreement at official levels on all issues and an agreed text was initialled on [date]. The agreed text is attached herewith as annex II.

Done in State A on [date]

For the delegation from State A:	For the delegation from State B:
Mr./Ms. [name]	Mr./Ms. [name]
(Head of delegation)	(Head of delegation)

Post-negotiation activities

Odd Hengsle*

1. Introduction

This paper focuses on several matters that have to be dealt with after agreement is reached on all major issues concerning a proposed treaty. The first issue regards the drafting of the two Articles on Entry into force and Termination where several problems may be met. The paper then discusses how to proceed with the preparation of the treaty for signature, including its translation (if necessary), getting the authority to sign it and then the actual signing. Issues relating to the post-signing activities that are necessary to bring the treaty into force and the obligations to be met after it has entered into force are also discussed. However, questions regarding the fulfilment of obligations laid down in Articles 26 (Exchange of information) and Article 27 (Assistance in the collection of taxes) are not considered.

2. Entry into force and termination

When the two teams have resolved all outstanding issues, the Articles on Entry into force and Termination must be drafted. Both these Articles are important because there should be no doubt as to when the treaty could be applied for the first time or, if it is terminated, which tax year would be the last year to which it should be applied.

When drafting the Article on Entry into force, it is prudent to consult the Ministry of Foreign Affairs to make sure that the domestic laws for the entry into force and ratification of a treaty have been complied with.

Some States have a requirement that instruments of ratification must be exchanged before a treaty can enter into force. However, most

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States will only ask for a notification that the legal requirements are complied with. To avoid any misunderstanding or confusion, it should be stated in the treaty provision that such notification should be in writing and sent through diplomatic channels. An exchange of e-mails between the competent authorities will not provide for the necessary clarity or possible legal certainty. One example of such drafting is as follows:

> "1. The Contracting States shall notify each other in writing, through diplomatic channels, that the legal requirements for the entry into force of the Convention have been complied with.
>
> 2. The Convention shall enter into force on the date of the later of these notifications and shall thereupon have effect in both Contracting States in respect of taxes on income relating to any calendar year following that in which the Convention enters into force."

The two States may also agree that the treaty shall enter into force when a certain period of time has elapsed after the exchange of instruments of ratification, or after the later confirmation that each State has completed the procedures required for the entry into force. One way to deal with this kind of requirement is to draft the above paragraphs as follows:

> "1. The Contracting States shall notify each other in writing, through diplomatic channels, that the legal requirements for the entry into force of the Convention have been complied with.
>
> 2. The Convention shall enter into force on the thirtieth day after the day of the later of these notifications and shall thereupon have effect in both Contracting States in respect of taxes on income relating to any calendar year following that in which the Convention enters into force."

If the initialled draft also contains an Article on capital taxes, these should also be covered by the provision on Entry into force. Some

States may regard their capital gains taxes as being different from ordinary taxes on income. For those States, it is necessary to make a reference to such taxes as well. Normally, however, a capital gains tax is considered to be a tax on income.

It may also happen that the two States have different tax years. If that is the case, the Article on Entry into force has to be drafted accordingly. One example of such drafting might be:

> "1. The Contracting States shall notify each other in writing, through diplomatic channels, that the legal requirements for the entry into force of the Convention have been complied with.
>
> 2. This Convention shall enter into force upon the date of the later of these notifications and shall thereupon have effect:
>
> (a) In State A in respect of taxes on income for any tax year beginning on or after [day and month] of the year following that in which this Convention enters into force;
>
> (b) In State B in respect of taxes on income relating to any calendar year following that in which the Convention enters into force."

If the two States have an existing Convention in force, it should be terminated at the same time as the new Convention enters into force. In this connection, one example of drafting would be to add an additional paragraph in the Article on Entry into force, as follows:

> "3. The Convention between State A and State B for the [title of Convention] signed at [city/country] on [date] shall be terminated and shall cease to have effect in respect of the taxes to which this Convention applies in accordance with the provisions of paragraph 2 of this Article."; or

to provide for a solution in the case of a later Protocol to the existing treaty, as follows:

> "3. The Convention between State A and State B for the [title of Convention], signed at [city/country] on [date], with Protocol, signed [city/country] on [date], shall be terminated with effect from the date of entry into force of this Convention and shall cease to have effect for any period thereafter for which the provisions of this Convention shall apply."

When the Article on Entry into force has been finalized, the Article on Termination has to be drafted. To avoid any uncertainty, it is best to consult the Ministry of Foreign Affairs. It is important that there is no doubt as to the last period for which the Convention should be applied.

The purpose of a tax treaty is to improve the economic relations between the two countries concerned. The negotiations have been given priority, time has passed and compromises have been made to reach the agreed wording of the treaty. If it should be terminated before it has been tested, time and effort will have been wasted. To leave enough time to see if the treaty fulfils its purpose, some States are of the opinion that the Convention should remain in force for at least a certain period. If this is agreed, wording to that effect should be inserted into the Article on Termination and might read as follows:

> "This Convention shall remain in force until terminated by a Contracting State. Either of the Contracting States may, after the expiration of a period of five years from the date of its entry into force, terminate this Convention, by giving written notice of termination to the other Contracting State through diplomatic channels at least six months before the end of any calendar year. In such event, this Convention shall cease to have effect:
>
> 1. (a) (In State A): ....
>
> 2. (b) (In State B): ...."

The termination notice should be in writing and sent through diplomatic channels.

It is important to bear in mind that the two Articles on Entry into force and Termination operate with a difference between the date

the treaty enters into force or is terminated and the date from which the treaty shall be applied, or eventually will no longer be applied.

Depending on the wording, a treaty enters into force on the date of the exchange of the instruments of ratification, or the date of the later of the notifications that all legal requirements have been complied with. However, the treaty becomes effective, and shall only be applied, from 1 January in the next year following the year the treaty enters into force. As the treaty should be of great benefit to both countries, it is important that the instruments of ratification or notification of legal requirements are made as soon as possible. A delay may eventually result in an unnecessary postponement of the date from which the treaty shall be applied.

With regard to the termination of a treaty, it is important to remember that it usually shall be terminated (in writing) at least six months before the end of a calendar year. A notice of termination delivered before the end of June in a given year will mean that the treaty will cease to have effect and should not be applied on or after 1 January of the following year. However, a notice of termination delivered in July in a given year will mean that the treaty will not cease to have effect on 1 January in the following year but on 1 January of the second following year.

If a country has a different tax year than the calendar year, the date a new treaty becomes effective, or an existing treaty no longer shall be applied, will change accordingly.

Special problems related to Article 24 (Non-discrimination), Article 26 (Exchange of information) and Article 27 (Assistance in the collection of taxes) of the United Nations and OECD Model Conventions

In Article 24 (Non-discrimination) of the United Nations Model Double Taxation Convention between Developed and Developing Countries[1] (United Nations Model Convention) and the Organisation for Economic Co-operation and Development Model Tax Convention

[1] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries (New York: United Nations, 2011).*

on Income and on Capital[2] (OECD Model Convention), it is stated that the provisions of that Article shall also apply to persons that are not resident of one or both of the contracting States and, furthermore, that they shall apply to taxes of every kind and description. The same applies to Article 26 (Exchange of information) and Article 27 (Assistance in the collection of taxes). In other words, the application of these Articles is not restricted to persons and taxes referred to in Article 1 (Persons covered) and Article 2 (Taxes covered). Therefore, it is important to have a clear understanding of the entry into force and the termination of the obligations laid down in Articles 24, 26 and 27.

If in a treaty the Articles on Entry into force and Termination merely refer to income taxes covered by it, or to income taxes in general, without referring specifically to the other taxes covered under Articles 24, 26 and 27, uncertainty may arise as to the entry into force or the termination of the treaty obligations laid down in these Articles with respect to those other taxes. It is hard to find examples where this issue has been solved in existing treaties. On the other hand, there are only a few examples where this "uncertainty" has created problems.

One way to deal with this issue is to add a paragraph in the Articles on Entry into force and Termination stating that the treaty obligations regarding the other taxes covered by Articles 24, 26 and 27 shall enter into force or be terminated on the same date as those regarding the taxes referred to under Article 2 (Taxes covered). If such an addition is problematic or seems unnecessary, the entry into force or termination of the treaty obligations regarding the other taxes covered under Articles 24, 26 and 27 could be clarified in an Agreed Minute or a Memorandum of Understanding.[3] Such clarification can be made in connection with the signing of the convention or in writing at a later date if, or when, the problem is raised. Even if such statements are not binding on the courts, it is stated in Article 31 (General rule of interpretation) in the Vienna Convention on the Law of Treaties[4] that

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[2]Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital (Paris: OECD, 2010) (loose-leaf).*

[3]See paper on How to conduct tax treaty negotiations, by Odd Hengsle.

[4]Vienna Convention on the Law of Treaties, signed in Vienna on 23 May 1967, and entered into force on 27 January 1980.

such statements should be taken into consideration when interpreting the treaty even if the statements are made at a later date.

Even if the date of the entry into force of the Articles on Exchange of information and Assistance in collection is clarified, the question arises if the application of the relevant provisions may be asked in relation to tax years beginning prior to the year in which the treaty enters into force and is applicable. Some countries are of the opinion that allowing an exchange of information or assistance in collection of taxes for tax years prior to the entry into force of the treaty would give the treaty retroactive effect and should be denied. However, the general opinion is that, unless otherwise stated, such information should be exchanged and assistance given also in relation to tax years prior to the entry into force of the treaty and should not be regarded as giving the treaty a retroactive effect. It is advisable to have this issue clarified during the negotiations.

As for termination, when the treaty is terminated and is no longer in effect, a treaty partner may no longer ask for information or assistance in the collection of taxes, even if related to tax years when the treaty was still in force.

3. Preparation for signature

3.1 Introduction

When the two leaders of the teams have initialled the agreed draft,[5] the next step is to prepare the treaty for signature. When doing so, it is important to note that in relation to the Title of the treaty, the Preamble and the signature block, each country should be mentioned first in its own copy or copies (if more than one language is used). There should be no alteration in the text of the treaty, and the paragraphs or subparagraphs should remain in the order agreed upon in the draft treaty.

The time gap between initialling and signing the treaty should be as short as possible. The relevant industries in the two States will usually be aware that negotiations have taken place and will be eager

[5]See paper on How to conduct tax treaty negotiations, by Odd Hengsle.

to know the result as it may be of great importance to them when decisions on investment are to be taken. Any delay could result in a situation whereby because of the resulting uncertainty the industries in both States may decide to make investments in third States instead.

However, the draft treaty is normally confidential, at least until it has been signed. To avoid the situation that treaty provisions are made public in one country while they are still confidential in the other, it is advisable that the two negotiating teams discuss and agree on the time of publication. If one or both countries immediately after initialling wishes to issue a press release informing the public that an agreement has been reached and that the draft treaty is being prepared for signing, it may be advisable that the two teams agree on its wording. However, if some countries have legislation that obliges them to make the treaty public at a date earlier than that of signature, it may be advisable to inform the other country of such a requirement.

In some countries, the procedures before signing a treaty are comprehensive and time-consuming. There are examples of years having passed between initialling and signing it. This is unfortunate, but is sometimes unavoidable due to the need to comply with these procedures.

Most countries must submit the initialled treaty for comments or approval by a relevant authority before they can begin the preparations for signing it. Such an authority may be the Ministry of Foreign Affairs, the Ministry of Justice, the Supreme Court or one that has been established for the purpose of commenting on new tax legislation proposals as well as initialled tax treaties. This authority may have comments on the wording of the treaty, which would have to be presented and discussed with the other country. Even if the authority has no comments to make, its review could easily delay the signing process. The other country may even decide to defer completion of its own procedures until it is clear that approval from the relevant authority has been granted.

If several years elapse before signing occurs, the initialled treaty may have become obsolete in some respects. One or the other country may therefore be reluctant to sign and may ask for redrafting of some of the agreed articles. To get an idea of the time usually required to

prepare a treaty for signature, it is recommended that information be exchanged during the negotiations on the procedures that are needed to get the necessary approval.

3.2 Translation

When the initialled treaty is not negotiated in the official language of one or both States, the first step will be for each country to have it translated into its own language.

If a thorough proofreading of the treaty was not done at the time of initialling due to time constraints, it should be completed before it is translated. The articles in the initialled treaty should read exactly the way the negotiators have agreed. It may easily delay the signing process if errors are discovered later, especially if there are disagreements on the correct content or wording of a provision. On the other hand, minor misprints can easily be corrected in writing, either by correspondence or by e-mails, at any time before signature.

Who carries out the translation may vary from one State to another. In some States, the negotiators themselves do the translation; in others, an office in a Ministry or a governmental agency undertakes that task, or a private translation service is used. In all cases, it should be borne in mind that the initialled draft is confidential. When someone unfamiliar with the international standard terms used in tax treaties does the translation, it is highly advisable that it is checked to ensure that the terms used are consistent with those of the United Nations and OECD Model Conventions. It is helpful, therefore, to provide the translator with existing treaties so that he/she is aware of these specific terms. In this connection, the fact that the United Nations and OECD Model Conventions have been translated into several languages could be helpful.

When the treaty has been translated into an official language, it should be transmitted to the other country for approval. It is important that the translation is accurate and that all official versions of the treaty have consistent wording so that the same results are achieved, even in different languages. If the persons checking the translation are not familiar with the other country's language, they should consult with the translation service in the Ministry of Foreign Affairs or any

other such service established elsewhere. If those checking the translation are not satisfied with it, the two countries should negotiate to agree on which wording would be acceptable to them. When both countries agree that the translated drafts completely and accurately reflect the initialled text, the next step for the signing of the treaty can be taken.

When the two States do not have a common language, the initialled text may not necessarily be in the official language of either of the two States, or the language of the negotiated draft may be the official language of only one of the States. When more than one language is involved, it is necessary to decide in which language the treaty will be signed. Depending on the domestic regulations in a State, it may be agreed that the treaty will be signed in one, two or three languages. To clarify the domestic rules, it is important to consult with the Ministry of Foreign Affairs.

Only the languages used for the signed treaty are regarded as constituting the official text. However, in all States a translation into the official language(s) is normally necessary even if the treaty is not going to be signed in that language, but it will then only be an unofficial translation.

A treaty may be negotiated in the English language even if the two countries are not English-speaking countries. To avoid a problem with translation errors, they may agree to have the treaty signed in the English language only and have two unofficial translations. Alternatively, they may agree to have three official languages where the English language shall prevail in case of differences of interpretation. An example of a Convention signed in three official languages can be found in the treaty between the Kingdom of Norway and Georgia, signed on 10 November 2011:

> "In witness whereof the undersigned, duly authorized thereto by their respective Governments, have signed this Agreement.
>
> Done in duplicate at Tbilisi this 10th day of November 2011, in the Norwegian, Georgian and English languages, all three texts being equally authentic. In the case of

> divergence of interpretation, the English text shall prevail."[6]

It is important to bear in mind that a country will always have its official language mentioned first in its copy of the treaty, the language of the other treaty partner will be second, with the prevailing language last.

If a treaty is signed in several languages, it should be remembered that one copy of the text in each language must be signed. Each country should have a signed version of the treaty in all the official languages.

Even if only one language has been used, two copies of the treaty must always be signed, one of which should be retained by each State.

If a treaty is signed in two languages, both languages will be equally authentic. If there are differences discovered after the signing, but before the entry into force of the treaty, the two countries may consult in order to agree on the necessary corrections. Such consultations will usually be made through diplomatic channels. It will be the relevant Ministries of Foreign Affairs that will determine the procedures to be followed and decide if a new signing process is necessary.

Differences discovered after the treaty has entered into force may create a more difficult situation, especially if they lead to a different understanding. Unless the differences are minor, a protocol to the treaty will be necessary to correct them. Such a protocol would have to follow the same legal procedure as the original treaty.

3.3 Signing of the treaty

When any necessary translation of the treaty has been made and agreed to by the two countries, the next step will be to seek approval from the respective governments to sign it. To get approval, the (translated) treaty and a technical explanation will normally have to be submitted to the Minister of Finance or an approved authority.

[6] Agreement between the Kingdom of Norway and Georgia for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income.

The procedure for approval may vary from one country to the other.

In some countries, the Minister is required to present the treaty to the Cabinet for approval. When approval to sign the treaty is given, the text should normally be transmitted to the Ministry of Foreign Affairs, which is the government agency usually responsible for arranging the signing ceremony and for deciding who will sign the treaty on behalf of the State.

In most cases, according to Article 7 (Full powers) in the Vienna Convention on the Law of Treaties,[7] only Heads of State, Heads of Government and Ministers for Foreign Affairs have full powers to bind a country by signing a treaty without having to produce them. If the Minister of Finance, or any other minister or person, is the one signing the treaty, he/she will need a power of attorney signed by the Minister for Foreign Affairs stating that they have been given the appropriate full powers to sign. Many countries also consider that the Vienna Convention accepts that heads of diplomatic missions have the power of attorney to sign a convention, though other countries do not agree.

Some States that have not ratified the Vienna Convention recognize it as a statement of customary international law and binding upon them as such. If there is doubt about the authority of the person who is going to sign the treaty, the Ministry of Foreign Affairs should be consulted. There have been several examples of embarrassment at the signing ceremony when a document of full powers has not been presented. If that document is missing at the signing ceremony, the signing itself may be delayed until it is produced. Another possibility is that the treaty will be signed but the signature will not be recognized until this occurs. To avoid this situation and possible discomfiture and delays, it is best to be aware of this potential problem.

To ensure that there are no delays in the entry into force of a treaty, it is important that it is signed as soon as possible. It is generally not desirable to delay entry into force of a treaty unnecessarily, for example, by waiting for an official visit by a minister. The treaty is expected to be of economic advantage to the countries concerned and any delay can have a negative effect on the economic relations between

[7] Convention on the Law of Treaties, Vienna, 23 May 1969.

the two States. One way to avoid such delays is to remind the relevant ministers of the importance of early signing.

Some States are of the opinion that a treaty initialled in one country should be signed in the other country or, if a new treaty replaces an old one, its signing should not occur in the same country where the existing treaty was signed but rather in the other country.

3.4 Post-signing activities

In almost all countries, the signed treaty has to be presented to the parliament or other competent legislative body for final approval and ratification.

When the treaty has been signed, the Ministry of Foreign Affairs should report back to the Ministry of Finance or the relevant authorized agency. A technical explanation should then be prepared and sent to the parliament or other competent legislative body together with the treaty. In most cases, the treaty will be submitted to a committee which will study and comment on it. If necessary, the minister or the person or persons designated thereto will be called by the committee to explain the provisions.

After the legislative committee has received all the explanations they have asked for, in most States the treaty will be presented to the parliament or other competent legislative body with a recommendation to approve it. In the rare case where a treaty is not approved, the other country has to be informed and told of the problems raised either by the committee, the parliament or other competent legislative body. The negotiators will then meet to see if there is an easy way to resolve them. Since the treaty is usually a result of several compromises, a solution may not be found easily. The question of renegotiating one article might lead to the reopening of all articles in the initialled treaty and previous compromises or concessions may be lost.

The way of dealing with the treaty in the parliament or other competent legislative body may differ from one country to the other. A consultation with the relevant government office, or the administrative office of the parliament or other competent legislative body, is advisable. In many countries, the approval of a tax treaty will follow the same procedures as the approval of a change in tax legislation.

The last step in the process of the entry into force of a tax treaty is to inform the Ministry of Foreign Affairs that all legal procedures pertaining thereto have been followed and to ask it to so inform the other State, in accordance with the Article on Entry into force. If the treaty provisions require an exchange of instruments of ratification, a meeting between representatives of the two countries should take place and the relevant instruments prepared for exchange. However, in most cases, the last procedure before the treaty enters into force will be a notification in writing, sent through diplomatic channels, informing the other State that all legal requirements for the entry into force of the treaty have been complied with. The treaty will then enter into force, either on the receipt of the later of these notifications or at a date specified in the Article.

Occasionally, a long time may elapse between the approval by the parliament or other competent legislative body and the exchange of instruments of ratification or of notes. The undesired result may be that the application of the treaty will be delayed by a year because it would normally only come into effect from the tax year following the year in which it enters into force. There have been occasions where the Ministries of Foreign Affairs have not been aware of this consequence and have exchanged instruments of ratification, or sent notes, at the beginning of January of a year rather than some time in the previous year. In this respect, it is important to know whether the two countries have agreed that the treaty shall come into effect only after a certain period (say 30 days) after the exchange of instruments of ratification, or after the confirmation that each State has completed the procedures required for the entry into force of the treaty. The Ministry of Finance (or other relevant authority) and the Ministry of Foreign Affairs should therefore be reminded of the importance of an early exchange of instruments of ratification, or exchange of notes, and should cooperate in order to avoid this kind of unintended delay.

3.5 Post-entering into force

It may be advisable to ensure that the tax administration is aware of the new treaty, which can be achieved through an explanatory note. Whether this should be presented in a separate paper or merely be a reproduction of earlier explanatory notes will differ from one country to another. It is also important that the industries and other taxpayers

are made aware of the new tax treaty. Such information can be furnished in several ways. Usually, countries publish a press release with information on where details can be found. Most countries publish their treaties on their relevant websites; in many countries, the law requires that the treaty also be published in a government gazette.

3.6 New legislation

In the first sentence of Article 2 (4) (Taxes covered) in both the United Nations and OECD Model Conventions it is stated that:

> "The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention, or in addition to, or in place of, the existing taxes".

However, it is not to be expected that new taxes will automatically be accepted and applied by treaty partners. When new taxes are introduced, all treaty partners must be informed as soon as possible and asked if they can agree that they are of an identical or substantially similar nature, either replacing or supplementing the taxes referred to in the treaty in force. If the answer is affirmative, there is no problem and the tax administrations in both countries should be informed. However, if the answer is negative, the problem could be resolved through the mutual agreement procedure. If no agreement is achieved, a change in law or a protocol to the treaty may be the only solution.

When a State makes changes in its domestic tax legislation after the entry into force of a treaty, it will usually be obliged to inform its treaty partners of them, at least if they could affect treaties in force. This obligation follows from the last sentence of paragraph 4 of the above-mentioned Article, where it is stated that:

> "The competent authorities of the Contracting States shall notify each other of significant changes made to their tax law."

The State making the changes should inform its treaty partner of the new legislation and of any potential effect on how the treaty is applied. If the changes are significant enough, negotiations with a view to proposing changes to the treaty may be necessary.

In some cases, it may be prudent to get an explanation from the other team on the interaction between its domestic legislation and its treaties in order to avoid unexpected outcomes. In cases where a treaty deviates from domestic legislation, it is important to establish whether the domestic legislation or the treaty provisions will prevail. There are no current examples that domestic legislation in force at the time of negotiations has prevailed. However, there are examples that later changes in domestic legislation could potentially prevail over existing treaties in certain cases. If it is the case that a State, according to its domestic legislation, may override an existing treaty, this should be clarified. Many countries claim that such overriding would be contrary to Article 27 (Internal law and observance of treaties) of the Vienna Convention of the Law of Treaties, where it is stated:

> "A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty. This rule is without prejudice to article 46."[8]

Even if countries are not signatories to the Vienna Convention, most of them will regard it as representing customary international law and will object to any overriding of the treaty through domestic law. Other countries may disagree but, in almost all cases, will avoid an interpretation of domestic law that sets aside a provision in a tax treaty already in force. It should be remembered that an international treaty imposes obligations on the treaty partners to act in accordance with the treaty.

3.7 Changes to the provisions of a treaty

When the treaty is approved by the legislative body and has entered into force, the only legal procedure to make changes to its provisions is by a protocol, carefully following the process described above. Any changes made by an exchange of notes or any other written statements will not be legally binding and may be rejected by the courts. It is important to follow the constitutional and legal requirements for negotiating and giving effect to a treaty, which are laid down in the legislation of the two States.

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[8] Ibid.

4. Conclusions

When agreement is reached on all major issues, it is important not to lose momentum in preparing the initialled draft for signature and the entry into force. There are several obstacles to be overcome before the treaty becomes effective. While it may sometimes be necessary to give priority to other important work that has been assigned by ministers, it should be remembered that the purpose of the treaty is to improve the economic relations between two countries. Businesses in these countries may be planning and waiting for a treaty to come into force to take advantage of the possibilities it offers. If too much time passes before the treaty is signed, the whole negotiation process may result in an entirely ineffective exercise and will be a waste of opportunities.

14-29215