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The Troubling Role of Tax Treaties

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CHAPTER 6

The Troubling Role of Tax Treaties

Kim Brooks & Richard Krever

§6.01 INTRODUCTION

Most low-income countries stare down a yawning gap between their current capacity and the achievement of the Millennium Development Goals endorsed by the General Assembly of the United Nations in 2000. While the first of the original eight millennium development goals, halving extreme poverty between 1990 and 2015, has been met, many of the other goals have not.[1] Global development assistance to the forty-nine least developed countries has fallen as a consequence of austerity measures associated with the global financial crisis.[2] Inadequate literacy rates and schooling, insufficient transportation and communications infrastructure, food insecurity, flagging health outcomes and other indicators of social and economic security plague low-income countries and the people who live within them. Given the disparities in living standards between high- and low-income countries, every high-income country in the world has recognized the moral and pragmatic case for providing aid to low-income countries.[3] Nevertheless, most high-income countries have at the same time entered into tax treaties with low-income countries that have restricted low-income countries' abilities to collect urgently needed revenue from income earned in their jurisdictions, even

1. Millennium Development Goals, *Eradicating Extreme Poverty and Hunger*, Online: Millennium Development Goals and Beyond 2015 http://www.un.org/millenniumgoals/poverty.shtml.
2. MDG Gap Task Force Report 2013, *The Global Partnership for Economic Development: The Challenge We Face* (19 Sep. 2013), Online: United Nations Department of Economic and Social Affairs http://www.un.org/en/development/desa/publications/mdg-gap-task-force-report-2013.html.
3. G20, *G20 Leaders Declaration* at paras 81-89, September 2013 (Saint Petersburg Summit); See also *Report of the Special Rapporteur on extreme poverty and human rights,* UNGAOR, 26th sess., UN Doc A/HRC/26/28 (2014).

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though normative principles of international tax support low-income countries' right to collect that tax.

The staggering proliferation of tax treaties (there are now over 3,000 bilateral income tax treaties between countries around the world) has sometimes been celebrated as indicative of their success.[4] The tragedy for low-income countries is that the success of the high-income states in negotiating ever more treaties has come at the expense of the tax revenue bases of low-income countries. These treaties may be a true 'poisoned chalice' for developing countries,[5] perversely transferring tax revenue from low-income countries to high-income countries (and from low-income countries to multinationals) while yielding limited or no offsetting benefits such as increased foreign direct investment. Surprisingly, however, sceptical questioning by scholars of the need for tax treaties as a way of dividing taxing rights between nations is a relatively recent phenomenon.[6]

In 2009, Sebastien Drevet and Victor Thuronyi took stock of the tax treaties entered into by OECD and non-OECD members.[7] At the time, the 30 members of the OECD had an average of 72 treaties each, while the 162 non-OECD members had an average of 17 treaties. The countries with the fewest tax treaties were those with extremely low-income levels. In the five years since that study, the number of treaties entered into by lower-income, non-OECD countries has continued to grow. In 2014, there were 34 OECD member countries, with an average of 75 tax treaties each and 158 non-OECD members with an average of 20 tax treaties. The increase in treaties is troubling given the growing scepticism about their advisability for low-income countries.

There are, however, modest signs that lower-income countries may be recognizing that tax treaties have distinct disadvantages. In late 2012, Mongolia cancelled its tax treaties with the Netherlands, Luxembourg, Kuwait, and the United Arab Emirates on the grounds that those treaties were facilitating the tax free expatriation of profits from Mongolia's extractive industries.[8] In 2013, Argentina, which had also agreed to tax

4. See John Avery Jones, *Are Tax Treaties Necessary?*, 53(1) Tax L. Rev. 1, 2 (1999) ('The success of tax treaties can be measured by their number.')
5. The description of tax treaties as a 'poisoned chalice' for developing countries has been borrowed from Martin Hearson of the London School of Economics in his presentation of 11 Sep. 2013 to the Strathmore Business School, Nairobi – see http://www.slideshare.net/martinhearson/double-tax-treaties-a-poisoned-chalice.
6. See, e.g., Allison Christians, *Tax Treaties for Investment and Aid to Sub-Saharan Africa: A Case Study*, 71(2) Brook. L. Rev. 639 (2005); John Avery Jones, *supra* n. 4; Richard Vann, 'International Aspects of Income Taxation' in Victor Thuronyi (ed.), *Tax law design and drafting*, 725 (Washington, DC: International Monetary Fund, 1996); Alex Easson, *Do we still need Tax Treaties?*, 54 Bull. Int'l Tax'n 619 (2000); Tsilly Dagan, *The Tax Treaties Myth*, 32(4) N.Y.U. J. Int'l L. & Pol. 939 (2000); Lee Sheppard, *How Can Vulnerable Countries Cope With Tax Avoidance?*, 69 Tax Notes Int'l 410 (2013).
7. Sebastien Drevet & Victor Thuronyi, *The Tax Treaty Network of the U.N. Member States*, 54 Tax Notes Int'l 783 (2009).
8. The IMF had advised Mongolia to renegotiate its treaty with the Netherlands, given the use of that bilateral agreement to strip profits without withholding tax from Mongolia. See Geerten M.M. Michielse, *Safeguarding Domestic Revenue – a Mongolian DTA Model*, (Washington, DC: IMF Publication Services, 2012) Online: IMF http://www.imf.org/external/pubs/ft/scr/2012/cr12306.pdf.

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treaties with other countries that demanded low source-based taxation, cancelled treaties with Austria, Chile, Spain, and Switzerland. On 5 June 2013, Malawi cancelled its tax treaty with the Netherlands.[9] Also in 2013, Rwanda renegotiated its unfavourable tax treaty with Mauritius. In 2014, Uganda suspended new treaty negotiations and announced its intention to renegotiate its existing tax treaties to better protect its interests.[10]

In his work at the IMF, Victor Thuronyi strove to design tax systems for low-income countries that would be effective in raising revenue, that would support the revitalization of their economies, and that would assist in achieving an acceptable distribution of income. In his scholarly work, he frequently wrote about the need to protect the integrity of the taxation systems of low-income countries from international tax policy pressures. He well recognized that there was little point in designing optimal tax systems for low-income countries if pressures from high-income countries and multinationals made their tax systems vulnerable. In the course of pursuing this theme across a number of areas of tax law, one issue that he frequently returned to was the pernicious effect and even the lack of necessity of tax treaties.[11]

In view of the considerable amount that has been written questioning the legitimacy of tax treaties, the object of this chapter is modest. Picking up on Thuronyi's misgiving about tax treaties, it simply restates in summary form the case against tax treaties. Again, reflecting a concern that permeated all of Thuronyi's work, it suggests that low-income countries should fiercely guard their jurisdiction to tax. Finally, it notes that if there are any circumstances in which low-income countries might consider ceding tax rights, there are no advantages to ceding that tax jurisdiction through tax treaties as opposed to unilaterally in domestic legislation.

To provide some context for these conclusions, Part §6.02 briefly reviews the development of the tax treaty network. Even from the earliest days of model treaty design, participants in the process understood that the standard treaty provisions would favour capital exporting over capital importing countries.[12] Indeed, many South

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9. Development in Dutch Tax Treaties, *Cancellation of tax treaty with Malawi*, Online: Deloitte https://testregfollower.wordpress.com/2014/02/17/malawi-netherlands-dta-terminated/. An Australian business report has suggested that Australia should terminate its tax treaty with low tax jurisdictions such as Ireland: see Georgia Wilkins, 'Call to tear up treaties with tax havens', *Sydney Morning Herald* (22 Jan. 2014), http://www.smh.com.au/business/call-to-tear-up-treaties-with-tax-havens-20140121-316wq.html.
10. See generally Amanda Athanasiou, *Developing Countries Rethinking Tax Treaties* 76(5) Tax Notes Int'l 395 (2014).
11. Victor Thuronyi, 'Tax Treaties and Developing Countries' in Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer, Alfred Storck & Martin Zagler (eds.), *Tax Treaties: Building Bridges between Law and Economics*, 441, 455 (Amsterdam: IBFD Publications, 2010). ('These countries probably do not need a lot of treaties and can accomplish unilaterally virtually all things that can get done via treaties. In doing so they would avoid the cost of treaty negotiations and possible negative aspects of treaties.')
12. Throughout this chapter we refer to capital importing countries as low-income countries rather than as developing or emerging economies because it focuses on the relevant factor in considerations of the distributive possibilities of taxation: income. The language masks the enormous heterogeneity between low- and middle- income countries, of course. See the plea by Michael Keen, *Taxation and Development, Again*, 4 (Washington, DC: IMF, 2012) ('[T]he

American countries have refused to enter into tax treaties because of the obvious bias in the proposed treaties.[13] Nevertheless, as the data above reveal, treaties have proliferated. Part §6.03, headed 'Are Tax Treaties Necessary' reviews the traditional purposes assigned to tax treaties and suggests none are compelling. Part §6.04 focuses on the key outcome of tax treaties, shifting taxing rights from a source jurisdiction to the country in which a foreign investor is resident and considers the alleged benefits a source country might enjoy from reducing its tax base. It suggests none of the arguments suggesting benefits flow from reductions of taxing rights are persuasive. Part §6.05 assumes that despite the strong case for maintaining the scope of source-based taxation, some countries may nevertheless decide to sacrifice some of their source-based taxing rights. It considers whether this sacrifice is best undertaken through the use of tax treaties or through unilateral measures. The study concludes that there is no real advantage to the tax treaty mechanism and there are some notable reasons why tax treaties create new challenges for tax administrations.

§6.02 THE SHIFTING OF TAXING RIGHTS AWAY FROM CAPITAL IMPORTING COUNTRIES

From the early days of modern tax systems, business interests pressured governments to coordinate their taxing legislation to avoid taxing the same income in two jurisdictions.[14] Colloquially referred to as 'double tax', the taxation of the same income in two jurisdictions might be avoided in any number of ways. To broadly characterize the approaches available for states that wish to act unilaterally, double taxation can be avoided by the residence state (the state where the taxpayer has significant economic or political ties) exempting the tax owing on all or some income earned abroad (an exemption system or a tax credit system), or by the source state (the state that supports the production of the income, regardless of the residence of the taxpayer) deciding not to tax the income at source.

Tax treaties provide the legal framework through which countries might bilaterally bargain a different allocation of taxing rights than the allocation that they could achieve through unilateral legislation. However, since the source state always has the initial potential taxing jurisdiction, these arrangements can only ever result in the sacrifice of taxing rights by the source state. Put another way, tax treaties are not used as a way of increasing the taxing rights or revenue of a source state. In contrast, tax

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recurrent title [Tax and Development] does reflect a search for generalization that, after decades of work in the area one might have hoped to move beyond. By comparison, public finance specialists rarely set out to provide similarly generic treatments of taxation in advanced economies.')

13. See Lee Sheppard, *supra* n. 4 ('Smaller, capital-importing, mineral-exporting, or market countries should never sign OECD model bilateral double tax treaties. South American countries do not sign them.')
14. The International Chamber of Commerce motivated much of the early work by the League of Nations on the eradication or reduction of double taxation. Kim Brooks, 'The Potential of Multilateral Tax Treaties' in Michael Lang et al. (eds), *supra* n. 11, at 211, 219.

treaties can increase the tax revenue of a residence state, if the residence state can exact a commitment by the source state to limit its taxing jurisdiction.

Acceptance of the right of source countries to tax income derived in the jurisdiction by non-residents is as old as income taxation. In the 1920s, the League of Nations published a report authored by four economists that articulated an appropriate basis for delimiting the tax jurisdiction of nations. That report concluded, and it has been widely accepted since that time, that nations are justified in taxing income where the taxpayer owes some economic allegiance to the country.[15] Therefore, even where the taxpayer itself was not resident in a jurisdiction, it was accepted that income with an economic attachment to that jurisdiction is justifiably taxed by that state.

After reviewing different methods of allocating the tax base between a source and a residence state, the authors of the League of Nations report ultimately leaned in favour of residence state taxation for income from personal property while recognizing the logic of greater source country taxing rights over income related to land and business property in the source country. The preference for residence-based taxation in some cases was largely pragmatic. The four economists worried that it would be harder to determine in which countries income was sourced than to determine in which country the taxpayer was resident. However, even in the 1920s, they recognized that a division of taxing rights, which shifted rights from the source country to the residence country was only appropriate where countries had similar economies.[16]

Latin American countries especially resisted the preference for residence-based taxation in tax treaties in the early formulations of the model. In 1943, they took advantage of the absence of rich countries from the League of Nations meetings at which a model treaty was being crafted and produced the so-called 'Mexico' model tax treaty, which had a source country bias.[17] Unfortunately, when the rich countries returned to the meetings after the war, meeting in London in 1946, the 'Mexico' model was swiftly replaced with a 'London' model that reverted to residence state bias.[18]

Lacking organizational endorsement, the 'London' model had relatively little impact until 1956 when the Organisation for European Economic Cooperation (OEEC), the post-war organization that emerged in 1948 from the Marshall Plan, started work

15. Bruins, Einaudi, Seligman, Stamp, *Report on Double Taxation submitted to the Financial Committee, Economic and Financial Commission Report by the Experts on Double Taxation* (League of Nations report), League of Nations Doc. E.F.S. 73. F. 19, 5 Apr. 1923. One of the most important surveys of the policy arguments concerning source and residence based taxation is Richard Musgrave & Peggy Musgrave, 'Inter-nation equity' in Richard Bird & John Head (eds), *Modern Fiscal Issues: Essays in Honor of Carl Shoup*, 63 (Toronto: University of Toronto Press, 1972).
16. See the League of Nations report, *ibid.* at 48.
17. League of Nations, *Fiscal Committee Model Tax Conventions: Commentary and Text*, 64 (1946); Michael Kobetsky, *International Taxation of Permanent Establishments*, Ch. 4 ('History of tax treaties and the permanent establishment concept'), 106 (Cambridge: Cambridge University Press, 2011).
18. See League of Nations *ibid.* at 65. See also Richard Vann, 'Writing Tax Treaty History' in Michael Lang & Ekkehart Reimer (eds), *History of Tax Treaties* (Berlin: Nomos, forthcoming), Online: SSRN http://papers.ssrn.com/sol3/papers.cfm?abstract_id = 1788603. The Andean states developed an alternative to the OECD model in the early 1970s, but it did not receive the international attention of the OECD model. See Klaus Vogel, *Double Tax Treaties and Their Interpretation*, 4(1) Berkeley J. Int'l L. 1, 10 (1986).

on a model tax treaty for use by its members. In 1963, two years after the OEEC had evolved into the OECD, the successor institution released a model tax treaty that mirrored the residence country bias of the 'London' model. Updated a number of times since, the OECD model has served as a starting point for almost all of the over 3,000 bilateral income tax treaties between countries in the world.[19]

At the time it released its first model treaty shifting taxing rights from source countries to residence countries, the Council of the OECD indicated the model was for use by member countries when negotiating treaties with each other.[20] Despite the clear intention of the designers to craft a model for treaties between higher income, outward investing countries, in the absence of a widely supported alternative model, the OECD model became the starting point for treaties by OECD members with countries outside the OECD camp.

As the influence of the OECD model spread, scholars began to articulate the risks tax treaties posed to the revenue resources of low-income countries and the impact they had on the taxing rights of lower-income, capital importing countries.[21] Concerns about the consequences of divisions of taxing rights in treaties based on the OECD model triggered a response by the United Nations,[22] which led to the release in 1980 of a UN model tax treaty. Like its OECD counterpart, the UN model has been updated from time to time.[23] It is designed to be more favourable to low-income countries by

19. OECD, *OECD Draft Double Taxation Convention on Income and Capital (1963)*, (OECD, 1963).
20. OECD, *Model Tax Convention on Income and on Capital (2010)*, 8 (OECD, 2010).
21. See, e.g., Charles Irish, *International Double Taxation Agreements and Income Taxation at Source*, 23(2) Int'l & Comp. L.Q. 292, 303 (1974). ('As between the two countries, the potential residence country thus has the stronger economic position and the evidence indicates that it has used its superior position to "persuade" the source country to forgo tax revenues'), ('However significant the loss of revenues would be to developed countries as a result of greater taxation at source, the present system of tax agreement causes a much more significant loss of badly needed revenues for developing countries'); Yitzhak (Isaac) Hadari, *Tax Treaties and Their Role in the Financial Planning of the Multinational Enterprise*, 20(1) Am. J. Comp. L. 111, 125 (1972). ('Very commonly today developing countries offer tax concessions to encourage investments. Yet, as representatives from these countries have been at pains to point out, such concessions are often frustrated in their purpose of attracting foreign capital, and only serve to increase the tax revenue of the investor's home country').
22. UN Financing for Development, *Committee of Experts on International Cooperation in Tax Matters*, Online: United Nations http://www.un.org/esa/ffd/tax/overview.htm. (The UN established an Ad Hoc Group of Experts on Tax Treaties Between Developed and Developing Countries in 1967. The group had ten developed and ten developing country representatives). Harvard Professor Stanley Surrey was a key advisor. In a speech delivered in 1964, US Treasury Assistant Secretary Stanley Surrey explained that the US would not require developing countries to reduce their tax rights to the level required by a model if the countries did not believe it was in their interest to do so. See Stanley Surrey, *The United States Tax System and International Tax Relationships*, 17(2) Tax Executive 104 (1965). For an early comprehensive survey of the work of the UN experts, see Stanley Surrey, *United Nations Group of Experts and the Guidelines for Tax Treaties between Developed and Developing Countries*, 19(1) Harv. L. Rev. 1 (1978). Surrey later compared the UN and OECD approaches in Stanley Surrey, *Reflections on the Allocation of Income and Expenses among National Tax Jurisdictions*, 10 Law & Pol'y Int'l Bus. 409 (1978) and prepared a full analysis of the UN model in Stanley Surrey, *United Nations Model Convention for Tax Treaties between Developed and Developing Countries: A Description and Analysis* (IBFD, 1980).
23. Department of Economic & Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

removing fewer taxing rights from source countries, but it is essentially a variation of the OECD model.[24]

Since the early days of treaty design spearheaded by the League of Nations, times have changed dramatically. Globalization, financial innovation, and increased reliance on services and intangibles as the key generators of business profit have undermined or largely eliminated the potential for simpler administration of residence-based taxation. Trade and investment among nations, not just between high-income nations, have proliferated. Policy makers and scholars recognize that robust tax systems will require coordination and assistance in tracking income and collecting tax, especially on the profit of multinational enterprises. A growing body of scholarship has worked to redefine the normative foundation from which high-income countries could justify allocating a greater share of the taxing rights to low-income states.[25] However, this chapter does not depend on that scholarship. Instead, it requires only the acceptance of the source state's right to tax, and a recognition that relying solely or primarily on residence-based taxation will exacerbate the enforcement challenges for tax administrators in this changing economic environment.

§6.03 ARE TAX TREATIES NECESSARY?

The notional purpose of tax treaties, reflected in the original long title of the League of Nations and then the OECD model tax treaty, is to reduce double taxation and prevent international tax evasion and avoidance. Only a small part of tax treaties is directly aimed at these two objectives, however. An article that provides for an exchange of information assists in combating tax evasion while the prevention of double taxation follows from an article that requires the residence country to provide relief from double taxation by way of credit for source country tax or exemption from residence country taxation of income derived in the partner source country. Other articles facilitate international trade and investment by preventing tax discrimination against non-residents, providing a dispute resolution mechanism, and establishing a tie-breaker rule to determine residence where a taxpayer satisfies the residence definition of both jurisdictions.

24. See Sergio Rocha, *International Fiscal Imperialism and the 'Principle' of the Permanent Establishment*, 64 Bull. Int'l Tax'n 83, 84 (2014) ('As the position of the developed countries prevailed [on the development of the UN Model], the UN Model ended up very similar to the OECD Model and failed to achieve its objective of fairly distributing taxing rights between developed and developing countries.')
25. See, e.g., Allison Christians, *supra* n. 6; Gillian Brock, *Reforming Our Taxation Arrangements to Promote Global Gender Justice*, 37 Philosophical Topics 141 (2009); Ilan Benshalom, *The New Poor at our Gates: Global Justice Implications for International Trade and Tax Law*, 85(1) N.Y.U. L. Rev. 1 (2010); Karen Brown, *Missing Africa: Should U.S. International Tax Rules Accommodate Investment in Developing Countries?*, 23(1) U. Pa. J. Int'l Econ. L. 45 (2002); Tsilly Dagan, *Just Harmonization*, 42(2) U.B.C. L. Rev. 331 (2010); Yariv Brauner, *Brain Drain Taxation as Development Policy*, 55(1) St. Louis U. L.J. 221 (2010); Reuven Avi-Yonah & Yoram Margalioth, *Taxation in Developing Countries: Some Recent Support and Challenges to the Conventional View*, 27(1) Va. Tax Rev. 1 (2007).

The bulk of the measures in tax treaties achieves an outcome that does not fit clearly into any of these objectives, the reallocation of taxing rights between the source jurisdiction and residence jurisdiction. In the absence of a treaty, the source jurisdiction, by virtue of its command over the sources of income, would enjoy first taxing rights over income, leaving the residence jurisdiction to double tax the income or provide relief for source country tax. In the latter case, the residence country would enjoy only a residual taxing right over income derived from abroad. Tax treaties shift the balance significantly in favour of residence countries, however. They limit the source country's right to tax income such as dividends, interest, and royalties paid to investors from the residence country by setting caps to source country taxes on these types of income. They remove entirely the right to tax business income derived from the source country other than income derived through a permanent establishment in the source country. In treaties based on the OECD model, they also remove entirely the source country's right to tax any other type of income not specifically enumerated in the treaty. The transfer of taxing rights from source country to residence country reduces double taxation only to the extent the residence country relieves double taxation by providing a credit for source country tax and the credit rules do not provide full recognition of source country taxation.

To be sure, many outcomes of tax treaties apart from the reallocation of taxing rights require agreements of some sort. To the extent country-to-country agreements are desirable or necessary, however, there is no need for the agreements to also reallocate taxing rights. Country-to-country agreements provide a simple path to exchange of information, for example, although unilateral action such as the US Foreign Account Tax Compliance Act or centrally imposed edicts such as the European Union Savings Directive can also generate information sought by tax authorities. While there is some question whether information exchange mechanisms in bilateral treaties or any of these alternatives yield data of genuine value to tax collectors in a macro sense (no doubt information in some particular cases can be important),[26] to the extent information exchange by agreement is desirable, the means to achieve it are wholly unrelated to the division of taxing rights.

The same is true of dispute resolution mechanisms. Tax treaties nominate 'competent authorities' in the respective tax administration as negotiators in the case of disputes arising from the intersection of each country's domestic tax laws as well as application of the treaties and may also provide for arbitration, including binding arbitration to resolve cross-border tax disputes. International agreements other than comprehensive tax treaties can serve as vehicles for establishing dispute resolution

26. Michael McIntyre, *How to End the Charade of Information Exchange*, 56 Tax Notes Int'l 255, 260 (2009) ('The view is widely held that the OECD tax information exchange act is ineffective – not nothing, but not much.'), ('The OECD efforts at getting countries to sign information exchange agreements based on its model TIEA is a sideshow, even a charade.'); Lee Sheppard, *Don't Ask, Don't Tell, Part 4: Ineffectual Information Sharing*, 63 Tax Notes Int'l 1139 (2009) ('The standard OECD information exchange agreement is nearly worthless. Information exchange under the standard agreement is sporadic, difficult, and unwieldy for tax administrators even under the best of circumstances.')

mechanisms.[27] There is no need to forgo taxing rights to establish a dispute resolution system.

A third function of tax treaties, facilitating international investment, by requiring the parties to treat domestic and foreign investors similarly, is achieved through a non-discrimination clause.[28] While the aim may be admirable in terms of encouraging cross-border investment by levelling the playing field, there are limits to what bilateral agreements can achieve in terms of preventing discrimination against non-residents. For example, countries with multiple treaties that include non-discrimination clauses manage to retain an array of tax expenditures available only to residents of the jurisdiction and those with imputation systems are similarly able to restrict access to imputation benefits to residents. To the extent non-discrimination is important to growing cross-border investment, the surest way of achieving it is unilateral domestic legislation. If international agreement is seen as a desirable or necessary assurance against shifts in domestic policy, agreement can be set out in investment treaties that do not mandate overarching source country losses of taxing rights.

A related investment facilitation benefit sometimes attributed to tax treaties is the supposed signalling effect they might have, assuring foreign investors that a capital importing source country follows international norms in cross-border tax practice.[29] There is, however, little empirical evidence that entering into comprehensive tax treaties is a meaningful signal.[30] To the extent entering into treaties might be viewed as a signal of adherence to norms expected by foreign investors, it would be regarded as truly trivial compared to the more important signal that a country follows international

27. See, e.g., the European Union approach in EC, *90/436/EEC: Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises - Final Act - Joint Declarations - Unilateral Declarations*, [1990] O.J., L. 225/10; EC, *Protocol amending the Convention of 23 July 1999 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises*, [1999] O.J. C. 202/1.
28. See, e.g., Ruth Mason & Michael Knoll, *What is Tax Discrimination?*, 121(5) Yale L.J. 1014 (2012).
29. See Allison Christians, *supra* n. 6, at 706-707 ('It has been suggested that tax treaties may signal a stable investment and business climate in which treaty partners express their dedication to protecting and fostering foreign investment'), ('Thus bilateral tax treaties may serve largely to "signal that a country is willing to adopt the international norms" regarding trade and investment, and hence, that the country is a safe place to invest'); Horst Raff & Krishna Srinivasan, *Tax Incentives for Import-Substituting Foreign Investment: Does Signaling Play a Role?*, 67(2) J. Pub. Econ. 167, 168 (1998) ('To attract FDI, governments may therefore have to signal a positive investment environment to foreign firms. Tax incentives can serve this signaling role better than tariff walls').
30. The possible impact of treaties on levels of foreign direct investment has been subject to numerous studies. The conclusion of the IMF in a review of the studies is that they show 'mixed results', noting treaties contain measures that might encourage investment (e.g., lower tax rates) or discourage investment (e.g., information exchange articles). See IMF, *Spillovers in International Corporate Taxation*, 26 (Washington, DC: IMF, 2014). See also, Paul Baker, *An Analysis of Double Taxation Treaties and their Effect on Foreign Direct Investment*, University of Cambridge (2012), Online: http://www2.warwick.ac.uk/fac/soc/economics/news_events/conferences/peuk12/paul_l__baker_dtts_on_fdi_23_may_2012.pdf. ('As to the other potential benefits of a DTT - fiscal certainty, stability and the signalling of a favourable Host investment climate - these are incidental and do not appear to be enough to influence the MNE's FDI locational decisions.')

tax norms by staffing an effective (and non-corrupt) tax administration and by enforcing robust legislation in a consistent way in line with the rule of law.

The most widely heralded purpose of tax treaties is their supposed role in preventing double taxation where income derived in one country by a resident of a second country is subject to tax imposed by the first country on local source income and again by the second country imposing tax on the worldwide income of its residents. Tax treaties use two mechanisms to resolve the problem of double taxation. The draconian method, used for some business income and sometimes for 'other' income not otherwise enumerated in the treaties, is simply to strip the source country of all taxing rights over this income. The second method shifts the onus for relieving double taxation to the residence jurisdiction, requiring that country to either exempt from tax income derived from the other country or provide a tax credit for taxes paid in the source country. In a sense, these latter rules are largely redundant, effectively replicating exemption and credit measures already found in the domestic tax laws of most countries.

Somewhat ironically, notwithstanding their alleged purpose, tax treaties are remarkably ineffective at addressing the most important causes of double taxation, inconsistent characterization of income, and inconsistent source rules. If two countries attribute different characters and consequently different sources to the same income flow, neither country's rules for preventing double taxation will be triggered as neither will recognize the income as having a source in the other country. This can happen, for example, if a first country characterizes income as income from personal services sources from that country and a second country characterizes the same income as royalty income from the exploitation of property rights with a source in the second country.[31] Because they contain almost no characterization rules, treaties are unable to address a root cause of double taxation.

The principal purpose of tax treaties is to reallocate taxing rights between the source and residence countries that are parties to the treaty by removing entirely or capping the source country's taxing rights. The inherent policy objective of tax treaties to reduce the taxing rights of source countries raises two policy issues. The first is whether it is in the interest of developing countries to forgo taxing rights in favour of capital exporting nations and the second, which arises only if it is concluded that the benefit of forgoing taxing rights outweighs the cost of lost tax revenue, is whether this should be done by way of treaty or through unilateral action by a capital importing source country.

§6.04 RATIONALES FOR REDUCING SOURCE TAXATION

Different rationales have been offered in respect of different types of income to support a case for capital importing countries to reduce taxing rights by way of treaty or unilaterally. Viewed objectively, the rationales are weak, making it difficult to see how

31. The dilemma faced by Pierre Boulez, a famous conductor who was subject to double taxation for this reason, is often cited by tax professionals as an example of the Achilles' heel of tax treaties.

the supposed benefits can offset the fiscal costs of sacrificing badly needed revenue in low-income countries, creating tax avoidance opportunities, and reducing the effectiveness of tax enforcement efforts. To the extent a rationale might be plausible, the case for using treaties to achieve the intended objectives in all cases bar one is weak.

[A] Recognizing Administrative Limitations: Forgoing Tax on Business Income Not Derived through a Permanent Establishment

When a multinational sells goods or services in a country, that country has a strong claim to tax some of the multinational's profits due to the sale of those goods and services. While manufacturing and distribution are essential precursors to a final sale, it is the sale itself that yields profits from the entire business chain. The link between profits and the benefit of public goods and services provided by the government in the country of sale is clear. Thus far, however, jurisdictions have not generally sought to tax the profits of a multinational attributable to sales alone in the country,[32] with domestic laws only seeking to tax profits attributable to actual business activities, a threshold that includes sales in conjunction with a modest presence or additional activities such as solicitation.

Tax treaties remove entirely the taxing rights of a source country over business income derived in the country by a non-resident unless the profits are attributable to a permanent establishment in the jurisdiction. This threshold requires a substantial economic presence in the source country by a non-resident business and on its face could lead to a considerable revenue sacrifice for source jurisdictions.

The case for abandoning taxing rights over business income derived by non-residents where the income is sourced in the country but not attributable to a permanent establishment in the jurisdiction has been made on policy and pragmatic rationales. The policy argument suggests that revenue sacrifice would encourage more international trade and investment since multinationals would be freed of the administrative burden of filing tax returns in every country in which they did business. The trade-off would be sensible if subsidiary benefits of increased competition and business activity were greater than the cost of lost revenue.

The pragmatic reason stems from the obvious difficulty of identifying and tracking business income of a non-resident with little physical presence or activity in the jurisdiction. In some cases, a business person's high profile as, say, a sportsperson or a performer, can alert authorities to the activities that generate business income without an enduring presence in the jurisdiction but in other cases identifying and taxing that income presents a significant challenge to local authorities. It has thus been argued that the residence jurisdiction, having access to all financial data of its residents, is in the best position to track and tax this income. As the model was originally intended to apply to a small group of advanced economies enjoying mutual

32. Within economic unions that divide tax revenues using a formula apportionment approach, sales may be a key factor in dividing taxing rights. This is true in Canada and the United States, for example, and has been proposed for the EU.

cross-border trade and business activities, it was assumed the treaty rule would not have a significant impact on overall tax revenues from business income.

The challenge of taxing enterprises deriving business income without a permanent establishment in the jurisdiction has been exacerbated in recent years by the advent of electronic commerce and electronic payment systems.[33] Recent initiatives by the OECD to revisit the concept of permanent establishment in the context of a programme to address problems of 'base erosion and profit shifting' may alter taxing rights at the margin but will have no impact on the practical difficulty of taxing business profits derived by a non-resident with no enduring presence or high profile in the jurisdiction. At best, it is uncertain from a practical perspective if a source country actually loses significant tax revenue by agreeing to forgo taxing rights on business income derived by a non-resident other than through a permanent establishment or high profile activity. The risk, however, is that adoption of a conventional treaty definition of permanent establishment may eliminate taxing rights over some sorts of business activities that can be tracked and taxed in the source jurisdiction. As explained further below, this is thus a concession that if it is to be adopted is best adopted through unilateral measures that set boundaries based on the source country's actual tax administration capacity, not a standard treaty definition of a permanent establishment.[34]

[B] Reducing Costs for Domestic Businesses: Limiting Tax on Interest Income

A source country's claim for taxing interest income derived in the country is not based on activity by or presence of the lender in the source country. Rather, it is based on the fact that the borrowed funds are used by the borrower in the source country to generate the returns paid to the lender for the use of the funds. Since the expenses the investor incurred in earning the income are difficult to verify, and since it is difficult to collect the tax from the non-resident investor, interest income is normally taxed by means of a flat rate withholding tax imposed on the payor. The rate of tax is usually set lower than the country's company tax rate or its highest individual tax rate to reflect the fact that the tax is imposed on the gross interest income. A source country's right to impose withholding tax at the rates prescribed in national laws is reduced, often substantially, where a treaty is in place as treaties almost invariably prescribe maximum interest

33. See D. A. Albregtse, *The Server as a Permanent Establishment and the Revised Commentary on Article 5 of the OECD Model Tax Treaty: Are the E-Commerce Corporate Income Tax Problems Solved?*, 30(10) Intertax 356 (2002); Dale Pinto, *The Need to Reconceptualise the Permanent Establishment Threshold*, 60(7) Bull. Int'l Tax'n 266 (2006); Craig Elliffe, *Meaning of 'Permanent Establishment' in Article 5 of Double Tax Conventions*, 16 N.Z. J. Tax'n L. & Pol'y 11 (2010); Craig Elliffe, *Canadian Tax Court on the Meaning of 'Permanent Establishment' Treaties*, 22 J. Int'l Tax'n 26 (2011).
34. See, e.g., OECD, *OECD Model Tax Convention: Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment)*, (2013); OECD, *Action Plan on Base Erosion and Profit Shifting*, ACTION 7, (2013).

withholding tax rates well below those found in the national laws of capital importing nations.

The rationale most often made for reducing withholding tax rates on interest paid from a source country by way of treaties is that the reduction is necessary to reduce financing costs of domestic borrowers. It is assumed that in many if not all instances, particularly where lenders are able to route loans through low or no-tax jurisdictions, foreign lenders seek particular after-tax rates of return on loans. Interest rates are accordingly grossed-up to include the effect of any withholding tax that might be imposed on the income.[35] In effect, it is domestic borrowers who pay the tax of foreign lenders, not the lenders. If this is the case, reduction of the withholding tax on interest could lower the borrowing costs of domestic borrowers relying on offshore-sourced debt.

The overall revenue effect of reducing interest withholding tax rates will depend on whether resident companies or subsidiaries of multinational firms are conducting the borrowing. In the case of a resident company, borrowing may be a genuine cost of doing business and any reduction in interest costs due to a drop in withholding tax rates would reduce deductible expenses and thus increase domestic taxes payable on net corporate profits. To the extent interest rates are grossed-up to include withholding taxes, there may, therefore, be an increase in domestic tax revenues from a drop in interest withholding tax rates. The increase cannot be as great as the lost withholding tax revenue since domestic tax will be a percentage (the local tax rate) of the reduced deduction, which is smaller than the gross withholding tax amount that was incorporated into the lending rate. Nevertheless, there is an offset and the costs are not as great as may first seem.

If the international tax system were designed to enable jurisdictions to effectively tax cross-border investment, the potential for increased financing costs for resident borrowers would not be a significant issue. In the general case, a non-resident investor might be presumed to pay tax on worldwide income in the residence state and receive a tax credit for tax paid to the source state. Where that system operates effectively, the interest withholding tax should not change the cost of borrowing. Where, however, the non-resident investor is able to route interest payments through a country where no domestic tax is imposed on the interest, then the tax imposed by the source state would affect the total cost of borrowing.

This phenomenon may not be true with non-arm's length loans between related enterprises. An important tax minimization strategy for multinational firms is to shift profits from the source country to a lower tax jurisdiction by way of 'thin capitalization' techniques. Company groups using thin capitalization to minimize taxes in a source country will finance a subsidiary in that country largely through debt, so that much or even most of the gross profit is used to pay interest on the excessive debt. The interest payments are deductible when calculating taxable income in the source country, thus

35. See Tim Edgar, *Interest Deductibility Restrictions and Inbound Direct Investment: Research Report Prepared for the Advisory Panel on Canada's System of International Taxation* (Government of Canada Publications, 2008) Online: Government of Canada Publications http://publications.gc.ca/collections/collection_2010/fin/F34-3-3-2009-eng.pdf.

reducing tax payable by the local company, leaving the company instead to bear only interest withholding tax. The tax on distributed profits – the dividend withholding tax – is also avoided through this technique.

The primary anti-avoidance tool used to prevent tax minimization in this way is a thin capitalization rule that denies taxpayers a deduction for interest expenses above a specified ratio of capital. Commonly, the ratio is generous, anticipating a higher level of debt funding than would be used by a resident company with similar capital needs so the rule, in effect, acts as a cap on tax minimization but does not prevent it. To the extent thin capitalization is allowed, a reduction in the interest withholding tax rate gives rise to a further loss in tax revenue. Since lending in these circumstances is based on tax minimization goals rather than commercial considerations, there is no grossing up of interest rates to offset the effect of the withholding tax and thus no offsetting increase in taxes paid by the borrower on source country profits. In these cases, therefore, reductions in withholding tax rates represent real uncompensated losses of tax revenue.

[C] Reducing the Cost of Accessing Intangible Property Rights: Limiting Taxation of Royalties

Royalty payments are returns to the owner of intangible property for the use or exploitation of that property. Following the direct nexus between the payments and the use of property, it is an accepted international norm that the source of the income is the jurisdiction in which the property is used and from which payments are made. Remuneration for the use of the property is only possible because the source state provides infrastructure to support that use and, more importantly, the intellectual property protection that gives value to the property and the ability to command rents for its use.

The primary rationale argued for a source country forgoing taxing rights on interest income – because the tax may be passed on to borrowers, increasing the cost of borrowing by business – does not apply to royalties. Lenders may be able to seek an after-tax rate of return and shift lending from any jurisdiction not offering that rate. The same is not true of the owners of intangible property. Licenses to use intangible property usually include commitments by both parties to limit the distribution of property rights associated with the property, limiting the potential pool of customers.[36] It simply is not possible to shift a licence to another jurisdiction as it is with debt if the after-tax rate of return is reduced. Put simply, if the owner of intangible property wants to derive income from a particular jurisdiction, the owner has no option but to bear a tax burden in the jurisdiction if tax is imposed on royalties. The policy rationale for reducing tax on royalties as means of reducing costs for domestic users of intangible property is very weak at best.

36. See, e.g., Peter C. Dawson, *Royalty Rate Determination*, 8 J. Bus. Valuation & Econ. Loss Analysis 133 (2013).

Again, as was the case with interest, a serious concern is that any royalty tax concession aimed at reducing the cost of accessing intangible property rights for domestic business will be exploited by multinational firms to avoid source jurisdiction taxation. Through the use of thin capitalization rules and arm's length pricing rules, it is possible to control to some extent the syphoning of local profits to overseas low-tax jurisdictions by way of excessive interest charges. It is much more difficult to prevent erosion of the domestic tax base by way of payments to related parties for the use of intangible property. There are no agreed precedents for anti-avoidance rules for royalty payments comparable to the thin capitalization rules used to limit the diversion of profits as interest and because of the unique nature of each type of intellectual property, it is difficult to establish any arm's length price to control deductions. The problem of profit diversion may be severely compounded if royalty withholding tax rates are unilaterally reduced. In this case, they would then be available for payments to tax havens in addition to treaty partners, encouraging tax avoidance through royalty payments. Given the absence of any evidence that domestic businesses pay higher royalty rates if withholding tax is imposed on royalties and the significant risk of profit base erosion as taxes reduce on royalties outside of treaties, reduction of source-based taxation of royalty payments appears not to be a sensible move.

[D] Attracting More Foreign Direct Investment: Limiting Withholding Tax Imposed on Dividends

Most tax systems impose tax on resident companies, including local subsidiaries of non-resident companies, and tax on dividends paid to shareholders. Dividends to non-residents are commonly collected by means of withholding taxes, often set at a rate below the ordinary company tax rate to reflect the fact that it is imposed on a gross basis, without recognition of costs incurred to derive the dividends.

In tax treaty negotiations, source countries are typically urged to reduce their tax on dividend income to very low rates or withdraw it altogether. The only plausible argument for reducing withholding tax is that it would result in additional foreign direct investment in the country. If that were true and a country realized additional foreign direct investment as a result of withholding tax reductions, spin-off benefits could include increased employment, opening of new markets, the transfer of expertise and generally a higher level and faster rate of economic growth. If this growth in investment eventuated, the corporate income tax take would increase, potentially offsetting or even exceeding the loss in the revenue from the reduction or withdrawal of the withholding tax.

These arguments given in support of source countries surrendering their right to tax business income earned in their jurisdiction are not persuasive. The hypothetical benefits are unlikely to eventuate in practice. To begin with, the withholding tax is not a tax on current profits. It can be deferred indefinitely by firms willing to reinvest in the jurisdiction to build greater current profits; if anything, higher withholding tax rates might encourage more investment, not less, by companies that make the initial foray into the country.

Separately, it has long been accepted that of the matrix of factors that affect investment decisions, and in particular direct foreign investment, tax rates, and especially withholding tax rates, will play a marginal role at best in tipping a decision to or not to invest in a particular jurisdiction. Labour costs, infrastructure facilities, labour force skills, political stability, proximity to market, transportation costs, environmental costs, and a host of other factors commonly are cited as more important than tax considerations in terms of driving foreign direct investment locations.[37] Tax is a particularly subsidiary consideration in driving the investments of firms seeking location specific rents such as profits from mineral exploitation possible only in the jurisdiction.

It has been argued that tax may play a greater role in investments based on firm-specific rents or profits attributable to attributes of the firm, not the location where business activities take place. Thus, the iron ore miner seeking location specific rents will locate where the ore bodies are found with tax being a secondary concern. In contrast, the international running shoe manufacturer deriving profits from the production of shoes embodying its design and intellectual property features can make the shoes in any number of countries. In the unlikely case that all other costs were equal in two jurisdictions, tax may well play a role in determining in which jurisdiction the firm locates its production.

To the extent tax levels could impact on investment location decisions by multinational firms seeking firm-specific rents, their importance is receding as economies develop and shift from primary reliance on manufacturing and related heavy industry to service and consumer societies based on business that must be located in the region to service a local market. Ironically, the growth of modern internet commerce has actually increased the need for local service providers and support as well as local outlets, accelerating the shift from firm-specific rents to location specific rents. The trend further weakens any case that might be made for reducing dividend withholding taxes to attract foreign direct investment.

[E] Achieving Non-tax Strategic Benefits

The final reason a country might forgo taxing rights under a tax treaty is the perception that voluntarily shifting taxing rights to a capital exporting treaty partner can yield strategic benefits that outweigh the cost of lost tax revenue. A country might, for example, conclude that better relations with the treaty partner will enhance a security or trade relationship, or result in other economic benefits, such as the provision of aid. These types of strategic reasons for entering into tax treaties might seem particularly compelling if a source country observes its competitor countries making similar concessions. A complementary explanation for why countries cede taxing rights is that

37. For an excellent review of the empirical case against incentives to increase foreign direct investment into low-income countries see Yariv Brauner, 'The Future of Tax Incentives for Developing Countries' in Yariv Brauner & Miranda Stewart (eds), *Tax Law and Development*, 25 (Cheltenham: Edward Elgar Publishing, 2013). For a recent IMF review see Tidiane Kinda, *The Quest for Non-Resource-Based FDI: Do Taxes Matter?*, IMF working paper WP14/15 (2014).

poorer countries are caught in a prisoner's dilemma, which inspires them to provide harmful tax incentives to investors in wealthy countries. These low-income countries cede taxing rights because they believe they need to do so before other competitor countries do so.[38]

Other non-tax objectives behind a decision to reduce source country taxing rights may include strategic political benefits such creating an impression of a government playing a proactive role in internationalizing the economy[39] or simply using the tax treaty as an indirect means of signalling recognition of independence or legitimacy by a treaty partner.

An irony of using tax treaties as a means of achieving non-tax strategic benefits is that comparable high-income countries are likely to be in much stronger negotiating positions to achieve these ancillary outcomes than their low-income counterparts. There is, thus, more likelihood of quid pro quo outcomes in treaty negotiations between two higher income capital exporting jurisdictions than in negotiations between a high-income capital exporting country and a low-income capital importing jurisdiction.

§6.05 THE CASE FOR DEFINING A COUNTRY'S TAXING JURISDICTION IN DOMESTIC LEGISLATION AS OPPOSED TO TAX TREATIES

Few of the five rationales for a capital importing country to forgo taxing rights on income derived by non-residents withstand critical scrutiny. Despite the apparent weaknesses with the rationales for reducing taxation, there will be jurisdictions that nevertheless accept the arguments for forgoing taxing rights. With one exception, to the extent sacrificing taxing rights might actually yield ancillary benefits, the beneficial outcomes would be maximized if the jurisdiction acted unilaterally rather than selectively traded off taxing rights for perceived non-tax advantages by means of treaties.[40]

If, for example, the administrative and compliance cost of taxing business income other than that associated with a permanent establishment or derived by a high profile sportsperson or performing artist outweighs any possible revenue gains from comprehensive taxation of this income, it would be most logical to define the domestic tax base

38. Eduardo A. Baistrocchi, *The Use and Interpretation of Tax Treaties in the Emerging World: Theory and Implications*, Brit. Tax Rev. 352 (2008); OECD, *Harmful Tax Competition: An Emerging Global Issue*, 34 (Paris, OECD, 1998), Online: OECD www.oecd.org.

39. See, e.g., WikiLeaks, *Bulgaria: Next Step on Negotiating a Double Taxation Treaty* (4 Apr. 2005), Online: WikiLeaks www.wikileaks.org (despite the low level of trade between Bulgaria and the US, the Bulgarian government pushed strongly for a DTT in 2005 'in return for [their] support in Iraq and Afghanistan.' The Bulgarian government was 'eager to publically announce [the recent movement toward a negotiation of a DTT] ahead of the June general elections.')

40. While raised in the context of treaties by developing countries, the argument advanced by Dauer that unilateral action will yield a revenue loss without any guarantee of offsetting gains resulting from reciprocal action by a treaty partner is arguably only relevant to cross-border investment between two capital exporting nations. If a convincing reason could be found for revenue sacrifices by a developing country, offsetting sacrifices by a treaty partner are unimportant; *cf*. Veronika Dauer, *Tax Treaties and Developing Countries*, 12 (Alphen aan den Rijn: Kluwer Law International, 2014).

to exclude this income generally. This way, the base can be broadened in the future as administrative capacity improves. Similarly, if a country believes reductions in interest withholding tax reduced borrowing costs for domestic businesses generally and can be partly recovered through lower interest expense deductions, the presumed benefits could be amplified by adoption of a general reduction of interest withholding tax rates rather than limited reductions by means of selective tax treaties. The same is true in respect of the theory that reductions in withholding tax on royalties could reduce the cost for domestic enterprises to access intangible property rights. As noted, this appears to be the weakest of all the possible rationales for forgoing domestic taxing rights. Nevertheless, if it were accepted as a legitimate reason to give up taxing rights, the rationale would extend to all royalty payments, not just payments to treaty partners.

The exception to the general rule that unilateral action is preferable to reducing taxing rights through bilateral agreements is where taxing rights are sacrificed not in recognition of administrative limitations or to affect taxpayers' costs or investment returns but rather to obtain a non-tax strategic benefit from a specific treaty partner. This goal for obvious reasons cannot be achieved by way of unilateral action, though countries may want to consider carefully whether sacrificing revenue needed for government functions is an appropriate or necessary trade-off for non-tax goals.

Apart from the question of obtaining maximum benefit from concessional treatment of non-resident investors or businesses operating in the jurisdiction, if it is assumed there are benefits from concessional treatment, there are seven additional reasons why source countries would be ill advised to forgo taxing rights by means of bilateral tax treaties rather than unilateral action.

To begin with, even if a country has treaties with all of its major trading partners, it may not have treaties with investment partners – many investment flows from capital exporting nations are routed through tax havens with no or few treaties. If source country tax rates matter in these cases, they must be adjusted through unilateral domestic law.

Second, defining a country's tax jurisdiction in domestic legislation as opposed to bilateral tax treaties is more consistent with principles of good democratic governance. The tax concessions made in bilateral treaties are often negotiated by bureaucrats reporting to the executive. Although ultimately most countries require their tax treaties be approved by the legislative branch, this approval process, with a few country exceptions, is not generally as rigorous as the process for drafting and approving domestic tax legislation. Unilateral concessions, by contrast, must be debated by the legislature and may additionally face exposure through tax expenditure reporting.

Third, concessions granted in tax treaties are not as accessible or as transparent for source country citizens or legislators as domestic tax legislation. Tax treaties are individually negotiated and inevitably each one varies slightly from the others. To determine the specific rules for a particular country, an interested source country citizen or legislator needs to look at each of the tax treaties the country has entered. Additionally, treaties are amended periodically by protocol or mutual agreement. Finding those amendments can be difficult and time consuming.

Fourth, tax treaties are expensive to negotiate and difficult to change. Renegotiations take time, political will, and agreement by both parties. In contrast, taxing

rights provided in domestic legislation can be amended by the legislative body of the source country alone, without approval or negotiation with the residence state. Unilateral action avoids the risk of being locked into tax rules no longer appropriate as the economy evolves to deal with loopholes as they are uncovered.

Fifth, experience has shown that if a country cedes its taxing jurisdiction in individual bilateral tax treaties, tax avoidance will be difficult to prevent.[41] The inherent lack of coordination between states to minimize taxes in a world of bilateral treaties generates new opportunities for enterprises to reduce their tax burdens through avoidance arrangements.[42]

Sixth, lower-income countries are particularly likely to be prejudiced by the relative bargaining disparities enhanced in bilateral relations. Thuronyi suggested multilateral treaties could redress the problems posed by bilateral treaties,[43] but in the absence of such arrangements it is far from clear that bilateral negotiations are desirable.

Seventh, the basic design of tax treaties is highly stylized and in particular relies upon a detailed breakdown of income into different schedules. For example, passive income must be classified as interest, royalties, dividends, management fees, technical services income, or other income. The withholding tax rate on each of these sources of income often varies in each treaty and from treaty to treaty. Yet it is often easy to transform one source into another. Countries have much greater freedom in dealing with the tax avoidance opportunities presented by passive income in their domestic legislation.

§6.06 RETURNING TO THURONYI: RENEGOTIATING INTERNATIONAL TAX NORMS

The tax norms underlying the over 3,000 bilateral tax treaties that countries throughout the world have signed with one another, and which govern around 85% of world trade, form the basis of the international tax regime.[44] Apart from their pernicious effect in transferring taxing rights from capital importing nations to capital exporting countries, treaties reinforce a tax policy principle advocated by the OECD – the 'arm's length' principle – that allows multinational corporations to allocate the total income derived by the entire group among each member of the group, including subsidiaries located in tax havens, on the basis of transactions arranged between the related parts of the single group. Multinational corporations have found the system offers a simple path to avoid

41. Victor Thuronyi, *In Defense of International Tax Cooperation and a Multilateral Tax Treaty*, 22 Tax Notes Int'l 1291 (2001).
42. *Ibid.* at 1293.
43. Victor Thuronyi, *International Tax Cooperation and a Multilateral Tax Treaty*, 26(4) Brook. J. Int'l 1641 (2001); Victor Thuronyi, *Coordination Rules as a Solution to Tax Arbitrage*, 57 Tax Notes Int'l 1053 (2010); Victor Thuronyi, 'Tax Treaties and Developing Countries', *supra* n. 11.
44. Reuven S. Avi-Yonah, *International Tax as International Law: An Analysis of the International Tax Regime*, 3 (New York: Cambridge University Press, 2007) ('I would argue that the network of two thousand or more bilateral tax treaties that are largely similar in policy, and even language, constitutes an international tax regime, which has definable principles that underlie it and are common to the treaties.')

taxation.[45] An alternative approach – the formula apportionment system, which attributes the source of income to objective factors based on inputs (tangible capital and payroll costs) and outputs (place of sales) – is used within economic unions such as Canada and the United States but has gained little traction internationally.

Revelations of the extent of tax avoidance by multinationals based on exploitation of the arm's length system prompted a rear-guard action by the OECD described as the base erosion and profit shifting (BEPS) programme but the programme deliberately avoids any principled re-examination of norms underlying the international tax regime or any consideration of a shift from residence to source-based taxation.[46] Genuine reform of the international tax system requires multinational action as opposed to dissected bilateral agreements. Thuronyi, in the context of a discussion of multilateral tax treaties, suggested establishing a World Tax Organization.[47] That organization could be charged with developing a multilateral treaty to allocate income from cross-border business and investment in a fairer manner that reflects the actual source of income, not the source nominated by multinational companies through intra-group transactions intended to shift profits and minimize taxes. The first stage towards a more equitable global tax system is a halt by capital importing countries to new bilateral treaties and support through the international organizations to which they belong for a multilateral body along the lines advocated by Thuronyi.

45. See, e.g., Allison Christians, *How Starbucks Lost Its Social License -- and Paid £20 Million to Get It Back*, 71 Tax Notes Int'l 637 (2013); Conrad Mapp, *Apple Funnels Italian Subsidiaries' Profits to Ireland*, 74 Tax Notes Int'l 711 (2014); Stephanie Scong Johnston, *EU to Investigate Apple, Starbucks, and Fiat Tax Rulings*, 74 Tax Notes Int'l 991 (2014); Thomas Jaworski, *SEC Exam of Google Leads to More Disclosure of Foreign Earnings*, 74 Tax Notes Int'l 727 (2014).
46. For an excellent review of the BEPS proposals, see Yariv Brauner, *What the BEPS?* 16 Fla. Tax Rev. 55 (2014).
47. Victor Thuronyi, *International Tax Cooperation and a Multilateral Treaty*, *supra* n. 43. Dale Pinto and Adrian Sawyer have similarly argued for a world tax organization; see Dale Pinto & Adrian Sawyer, *Building Bridges between Revenue Authorities: Would a World Tax Organisation be a Key Facilitator?*, J. Applied L. & Pol'y 25 (2011). Nolan Sharkey has suggested a South East Asian Tax Organization would be useful; see Nolan Sharkey, *A South East Asian tax organisation*, Brit. Tax Rev. 175 (2013).