DEVELOPING AND EMERGING ECONOMIES -THEIR SIGNIFICANCE TO TAX TREATIES

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INTRODUCTION:-

Tax treaties may help to create a stable investment climate within which FDI may take place. A tax treaty may contain a number of provisions that contribute to this climate and increase the confidence of a foreign investor, creating more certainty in relation to the tax treatment. For example, in addition to the elimination of double taxation a treaty may contain provisions in respect of non-discrimination, exchange of information and a mutual agreement procedure in the event of tax disputes. In this paper I have tried to answer an important question of How do tax treaties facilitate inward investment into DEEs and what risks do they pose for these countries?

Using these four main components:-

1. Treaties as an instrument to promote inward investment.
2. Distributive function of tax treaties
3. Tax treaties as tools to counter offshore non-compliance
4. The cost of negotiating and implementing treaties

How do tax treaties facilitate inward investment into DEEs and what risks do they pose for these countries?

(i) Treaties as a tool to promote inward investment-

OECD and UN encourage both developed and developing countries to conclude tax treaties since both organisations believe that these facilitate FDI and cross border trade. This view is shared by the vast majority of countries around the world, which is why over the last three decades we have seen a tripling of the number of treaties. It is also a view supported by the business community.

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Nevertheless, some empirical research has pointed out that the signing of a tax treaty has either no effect or a negative effect on FDI, especially in those cases where the countries involved are a developed country on the one hand and a capital importing country on the other hand.

Traditionally the following arguments have been put forward in favour of treaties as facilitating inward investment:

1. The elimination of double taxation: Tax treaties send a strong signal to the business community that a country is prepared to respect the international norms and is committed to the elimination of double taxation, although this may also be achieved by means of unilateral domestic measures.

2. Certainty and predictability: tax treaties provide foreign investors with a stable and predictable tax environment since tax treaties tend on average to remain in force for 10-15 years and generally override domestic tax laws, which change much more frequently. Tax treaties increase certainty about the tax liability generated in a foreign country through the clarification of given tax rules and the limitation of withholding taxes of respective countries. Some studies have, however, suggested that this goal may be achieved through the enactment of domestic rules to eliminate double taxation without the need to make the concessions to the residence country that may be required by a treaty.

3. Non-discrimination: treaties aim to avoid the possibility that the nationals of one contracting state are subject to discriminatory treatment which places a heavier tax burden on them than that applied to the nationals of the other contracting state (or stateless persons); the possibility that taxation might be less favourably levied on a permanent establishment in a state than on enterprises of that state; or the possibility of discrimination against domestic enterprises owned or controlled by non-residents.

4. Mechanisms to minimize and resolve tax disputes: treaties provide for extensive mechanisms to avoid disputes and where they do arise, as is inevitable, to resolve them.

5. Dividing up the tax base: the division of the tax base between the source and resident countries depends upon the way that treaties are drafted. DEEs are increasing giving up some of their source taxation rights, (e.g. lower withholding taxes). This may reflect pressure from developed countries or it may reflect a belief on the part of DEEs that

lower source taxation, while implying an immediate revenue loss, will in the long term lead to more FDI and higher growth rates which in turn will increase the revenue base.

There remains a lively debate in the academic literature on whether treaties between developed and developing countries are in the broad interest of developing countries. Research has suggested that the only way developing countries may avoid signing tax treaties is if they act as a group, but the lack of such consensus brings them into a situation where they have to create their own treaty network in order to become attractive for foreign investment[1]. A large majority of bilateral tax treaties follow the OECD Model which is more beneficial for the residence state. If the treaty partners are roughly balanced in terms of their economic relations, this bias is not a problem since eventually one country will be the residence state as often as the other. In developing countries, however, capital and income flows are not balanced. The developed country stays in the role of the residence state, whereas the developing country stays in the role of the source state. Some have criticised this system since developing countries are deprived from levying taxes at source and tax revenues are shifted from the source to the residence state.

The existing system of allocating taxing rights is linked to the concept of neutrality (efficiency). Economic efficiency, also referred to as tax neutrality, can be defined as the "optimal allocation of production resources and, from the taxation point of view, the minimisation of any distortion caused to the private sector by the tax system"[2]: This definition is based on the assumption that the highest productivity can be achieved "when income producing factors are distributed by market mechanisms without public interference". Even though tax laws can never be absolutely neutral, they should at least be drafted in a way which keeps distortions as minimal as possible. Many years ago, Richard and Peggy Musgrave, convincingly argued that economic efficiency can best be reached when the international tax rules support capital export neutrality (as opposed to capital import neutrality)[3]. This, in turn, can only be reached by implementing residence

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[1] Eduardo Baistrocchi (2008), the Use and Interpretation of Tax Treaties in the Emerging World: Theory and Implications, British Tax Review, 4, 352-391. Also see Barthel, F., Neumayer E. Op Cit

[2] Paul L. Baker "An Analysis of Double Taxation Treaties and their Effect on Foreign Direct Investment

[3] Capital export neutrality means that an investor should be subject to the same amount of tax irrespective of where the investment income is sourced; following capital import neutrality, an investment should be treated on equal terms on the market of a country irrespective of where it comes from (see Musgrave, R., Criteria for Foreign Tax Credit, in Taxation and Operations Abroad, Symposium, 1960, p. 83, as cited in Vogel, Intertax 1988, 311; also Brewer Richman, P. (later Musgrave), 1963: 8; Graetz, TLR 2001, 270; Schindel/Atchabahian, 'General Report', p. 35)

taxation combined with a foreign tax credit mechanism. It should be noted that the foreign credit regime cannot fully realise the concept of CEN, as the taxpayer may defer home country tax by not remitting foreign income to the home country.

Others have argued that there are other criteria which are relevant to this decision: equity, simplicity, ease of compliance, all of which may be particularly important in the context of developing countries[4]. There have been a number of empirical studies which attempt to determine the impact of tax treaties on FDI flows into DEEs. Nevertheless, at present, there appears to be no consensus, with Baker (2012), Blonigen and Davies (2004) showing a very weak correlation between the existence of a treaty and FDI and others showing a stronger correlation with either a positive effect on FDI like Neumayer (2007) and Barthel (2010) or a negative effect like Blonigen and Davies (2002) and Egger et al. (2006). All studies acknowledge the difficulty in isolating the influence of treaties from other variables such as the economic and political environment. Surveys of business, however, do suggest that MNEs look both at the existence of a treaty and its provisions when making a decision on where to locate and that other things being equal they will favour a country that has a good treaty network. How important this is will very much depend upon the economic structure in each of the two countries, the relationship between treaty and domestic law and the attitude of the administration and the courts in the application of the treaty. Dagan (2000) and Baker (2012) have argued that tax treaties restrict developing countries from levying taxes on the income derived by foreign investors and are therefore not beneficial for developing countries. From this perspective, developing countries should refrain from signing treaties in which they give up taxing rights and thereby revenue unless they expect a long term benefit in terms of additional inward investment. However, as mentionedabove, the only way DEE's may achieve this position is by acting together, otherwise they are obliged to develop treaty networks with developed countries in order to remain as competitive as their direct competitors among developing countries and be attractive to developed country investments[5]. This situation may be affected as more countries move towards exemption (territoriality) systems. The current debate on base erosion and profit shifting may also lead to a reconsideration of the role of withholding taxes on interest, dividends and royalties. Also, some benefits of tax treaties may be available in alternative ways, for example measures on exchange of

[4]McInerney, "The Emerging Developmental Approach to Multilateral Treaty Compliance"
[5]Barthel, F., Neumayer E., "Competing for Scarce Foreign Capital: Spatial Dependence in the Diffusion of Double Taxation Treaties.Citn and Baistrocchi (2008)

information could be implemented as part of a bilateral agreement on the exchange of tax information without the need for a comprehensive double tax treaty. The Multilateral Convention on Mutual Administrative Assistance in Tax Matters is another possibility for accessing exchange of information. In practice, whether the potential benefits of a treaty are realised will depend on the specific provisions found in the treaty. Some authors outside the treaty world have begun to examine how a tax treaty could be used as a new means of development assistance[6]. The thought behind this is that the allocation rules could be drafted in a way that more taxing rights are transferred to the source state so that revenue can be shifted from the developed to the developing country. This could be an important step towards public resource mobilization which is a major goal in today's development strategies in order to end aid dependency.

(ii) The distributive function of tax treaties-

From a theoretical perspective the distributive function of tax treaties can be justified on the basis of what Benshalom (2010) calls "relational-distributive duties"[7]. According to his reasoning, globalization and international trade have put people into a joint economic system, in which persons from developed countries benefit from "disadvantages and low bargaining power of people from developing countries". Developing countries may, on the basis of this view, not benefit from international trade as much as developed countries and in addition many low income countries do not have enough power and influence to have a say in global trade policies and rule-setting. Following Benshalom, this interrelation combined with unfair market transactions give rise to moral (including redistributive) duties especially when developed countries, which are mainly benefiting from this unfairness, are in a position to remedy it[8]. The status quo of the international tax system falls short of considering any distributive justice arguments. The allocation rules of tax treaties may be a suitable instrument to distribute wealth across borders but as Pistone (2010) has suggested, many modifications are required before they meet this goal.Many developing countries are well aware of these risks and have been relatively successful in negotiating treaties which favour source taxation. One might add that developed countries often take into account the level of development of their potential

[6]Brooks, eJournal of Tax Research 2007, 171; Pistone, 'Tax Treaties with Developing Countries'

[7] The New Poor at our Gates: Global Justice Implications for International Trade and Tax Law, 85 NYU Law Rev. 2010

[8]Benshalom, NYU Law Rev. 2010, 38 and 43

treaty partners and make appropriate adjustments to treaty provisions when negotiating tax treaties.

(iii) Tax treaties as a tool to counter offshore non-compliance-

Apart from facilitating an on-going relationship between the two tax authorities, another reason put forward in favour of treaties is that they provide a legal framework for cooperation between tax authorities to counter offshore non-compliance, profit shifting and base erosion. Tax treaties provide the legal basis for administrative assistance among tax authorities and for the exchange of information. This particular function of tax treaties has been highlighted by the actions of the OECD to eliminate bank secrecy as a veil behind which tax evaders can hide and to ensure developing countries benefit from the resulting more transparent environment. (Almost 110 countries are in the global forum on tax transparency.) The OECD standards for the exchange of information are now globally accepted, even by non-OECD countries. Two arguments support the view that DEEs should benefit from this new era of global tax transparency. Firstly, the problem of capital flight is particularly severe in these countries because many of their "high net-worth individuals"[9] find it easy to get their capital out of the country into low or zero tax jurisdictions. Tax, however, is not only reason for capital flight: it may also be due to political and economic instability or terrorist threats. Entering into tax treaties with countries which facilitate non-compliance can help to track down such capital flight. Secondly, entering into agreements which allow for the exchange of information may discourage small LDC from becoming tax havens themselves, as a way of trying to attract foreign investments[10]. Another way in which tax treaties can curb tax avoidance is to provide a legal basis for implementing transfer pricing principles. Transfer pricing per se is neutral and the arm's length principle was originally developed as a commercial concept enabling MNEs to assess the profitability of different subsidiaries. Also an agreed implementation approach on transfer pricing rules is an important instrument to eliminate economic double taxation by determining which parts of the profits of associated enterprises may be taxed in which country[11]. Transfer pricing rules may however be misused by multinational enterprises to engage in aggressive tax planning and mispricing which might lead to shifting profits from least developed countries to lower tax

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[9]OECD, Engaging with high net worth individuals on tax compliance, www.oecd.org/ctp/ta/hnw

[10]Mutén, Double Taxation Conventions between Industrialised and Developing Countries, OECD and UN models

[11]"Myths and Misconceptions about Transfer Pricing", by Owen Stan

jurisdictions. An effective exchange of information under Article 26 of the OECD and UN model can help counter such practices, as can the new emphasis on improving tax transparency. Finally, DEEs may also suffer from offshore non-compliance due to levels of corruption in their own country and relaxed laws in tax havens where companies may create affiliates. However, as Hebous and Lipatov (2011) mention, signing a tax treaty with tax havens which enforces strong exchange of information rules may reduce the chances for MNEs to take advantage of the corruption existing in those countries.[12]

(iv) The cost of negotiating and implementing treaties

The biggest challenge facing DEEs and especially LDCs is how to build up the capacity of their tax administrations. Extending their network of tax treaties should not distract from this fundamental task. Treaty negotiations are expensive in terms of time, skills and money; also, a country might have other priorities than negotiating tax treaties or may simply not have the capacity for extensive negotiations[13]. Moreover, the application of a tax treaty is intensive in terms of cost and personnel used. Especially for developing countries, these restraints need to be considered carefully before entering into treaty negotiations and a clear policy rationale should be explicitly set out on why a country wants to extend its treaty network and with which countries. Ideally this should be based upon an economic analysis, although this research may be difficult due to the need for it to be conducted on a case by case basis and to assess all the costs and benefits associated with a tax treaty. In conclusion, what this section shows is that countries will need to carefully weight up the cost and benefits of treaties. They also need to accept that concluding treaties is only the first step in a process: they need to have the resources to apply the treaties.

Conclusion:-

Certainty in regulatory treatment is a key factor for foreign investors in considering an investment location. The negotiation of double tax treaties can create a more stable and certain climate in which FDI can take place. The creation of a network of bilateral tax treaties is therefore one aspect of tax policy for developing countries looking to attract FDI. A treaty ensures a clear allocation of taxing rights between the two contracting

[12]Hebous and Lipatov (2011): A journey from a corruption port to a tax haven.
[13]Thuronyi, 'Tax Treaties and Developing Countries', p. 442

states and provides for elimination of double taxation and a procedure for dispute resolution.

Treaties may help developing countries to protect their tax base by ensuring sufficient taxing rights for the source country; and for DEE with enterprises that are becoming investors in other countries treaties provide certainty as mentioned above. A treaty can also be a basis for administrative assistance and exchange of information between tax authorities, helping the developing country to combat all forms of offshore non-compliance.

A central consideration of tax policy for developing countries is to balance the need of foreign investors for certainty with the right of the source country to collect the right amount of tax. DEEs must therefore consider the costs and benefits of double tax treaties. The process of negotiating and implementing the provisions of treaties requires considerable resources and the country must be sure that the benefit in terms of tax collection and increased FDI is worth the expenditure of time and money on the negotiation of treaties. DEE need to be pro-active in determining which countries they wish to negotiate with rather than just reacting to requests from developed countries. DEEs also need to build up the skills and experience of their tax administrations and need to take decisions on allocation of scarce resources.