TAX PRACTICE

Taxation treaty models vary in approach

TAX VIEWS

By Vern Krishna

Since each country has its own tax system, which may conflict with other systems, we need a mechanism to ameliorate the frictions that can arise from their interaction — typically, in the form of double taxation.

To be sure, all sophisticated tax systems provide credits in their domestic tax regimes for tax paid by residents to a foreign country. If, for example, a Canadian earns dividend income in the United States, he or she will pay tax on the income in the U.S. and in Canada, and receive a foreign tax credit against Canadian tax payable.

However, the foreign tax credit is usually limited to a maximum of the domestic tax rate. Hence, it is possible for some tax slippage or double taxation of the same income.

Canada has a small network of tax treaties with developed and developing countries that assist in alleviating double taxation. More recently, these treaties and their cousins (tax information exchange agreements) are also concerned with tax avoidance and evasion. There is no single model for all of our tax treaties. Countries negotiate with each other based upon their economic development and capital flows, with three major model treaties used to provide some consistency of international rules and interpretation: (1) OECD treaty; (2) UN model convention; and (3) U.S. model treaty.

All of the models address two broad purposes. The first is to eliminate double taxation of income that residents of one country earn from sources within the other country. Eliminating double taxation promotes closer economic co-operation between treaty countries and reduces barriers to trade caused by overlapping taxing jurisdictions. The models achieve this by providing that the country of residence will eliminate double taxation of income by allowing a foreign tax credit for foreign income or by exempting the income from tax.

Additionally, the models provide that the source country will reduce the scope of its jurisdiction to tax income at source by reducing its withholding tax on income that a non-resident earns in the country.

The second purpose is to reduce tax avoidance and evasion in international trade and commerce.

Developed countries use a model developed by the Organization for Economic Cooperation and Development (OECD) in negotiating with each other.

The UN model, which developing countries use in negotiating treaties with developed countries, serves an additional purpose. In addition to eliminating double taxation and reducing inappropriate tax avoidance and evasion, it promotes politically acceptable investment in developing countries.

As a UN commentary from a *1998 report states:*

"The desirability of promoting greater inflows of foreign investment to developing countries on conditions which are politically acceptable as well as economically and socially beneficial has been frequently affirmed in resolutions of the General Assembly and the Economic and Social Council of the United Nations and the United Nations Conference on Trade and Development.

Broadly speaking, the general objectives of bilateral tax conventions may today be seen to include the full protection of taxpayers against double taxation (whether direct or indirect) and the prevention of discouragement that taxation may provide for the free flow of international trade and investment and the transfer of technology.

They also aim to prevent discrimination between taxpayers in the international field, and to provide a reasonable element of legal and fiscal certainty as a framework within which international operations can be carried on.

With this background, tax treaties should contribute to the furtherance of the development

aims of the developing countries. In addition, the treaties have as an objective the improvement of co-operation between taxing authorities in carrying out their duties."

Thus, the UN model is more than a simple tax instrument. It serves as a vehicle for subsidies and foreign aid under the guise of fiscal legislation.

There is some tension in treaties between developed and developing countries. Developed countries adopt the OECD approach – tax credits, exemptions and reduction in withholding taxes – as appropriate in the negotiation of bilateral tax treaties; developing countries do not.

Developing countries accept the first principle – reduction of taxes by the country of residence through a tax credit or exemption for foreign income. This approach causes the residence country to yield its jurisdiction to tax foreign source income. However, developing countries, such as India, are reluctant to reduce their yield on source taxation. Indeed, some developing countries go so far as to say that the source country should have the exclusive jurisdiction to tax income arising in the country. The UN model does not go that far.

The U.S. model (developed by the U.S. Treasury) is similar to the OECD model in most respects, but has some unique features that are of particular concern to the United States, particularly in connection with tax havens, treaty shopping and tax sparing. As a capital and intellectual property exporting country, the United States adopts the position in all its treaty negotiations that the country of source of income should defer to the country of residence in taxing royalties and rentals from intellectual property. Hence, there is some tension between developing countries and the U.S. in treaty negotiations.

Regardless of the tensions and friction between countries in negotiating treaties to serve different economic interests and political philosophies, the treaties do ameliorate double taxation and, in some cases, provide indirect tax subsidies to developing countries. Thus, treaties promote international trade in the global economy.

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