

# Tax treaties and developing countries

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## Tax Treaties and Developing Countries

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There has been a steady drumbeat by academics and others over the last 50 or more years that developing countries should refrain from entering into bilateral tax treaties with developed countries because the terms of these tax treaties favor developed countries at the expense of developing countries.<sup>1</sup> To be sure, developing countries face tough choices about whether to enter into tax treaties with developed countries. Several benefits flow from entering into tax treaties, including potentially increasing foreign direct and portfolio investments from reducing double taxation, creating greater tax certainty for investors, and providing for dispute resolution mechanisms for tax controversies. But there are real costs of entering into tax treaties. Treaty provisions invariably result in developing countries yielding taxing rights with respect to economic activity taking place in their country.

This article takes a more nuanced, and perhaps contrary, view about the desirability of tax treaties between developed and developing countries. I offer four observations:

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<sup>1</sup> In 1967, a United Nations Group of Experts on Tax Treaties between Developed and Developing Countries began their review of the provisions on the OECD Model Treaty that limited the ability of developing countries to collect tax revenue. Stanley S. Surrey, *United Nations Group of Experts and the Guidelines for Tax Treaties between Developed and Developing Countries*, 19 HARV. INT'L L.J. 1 (1978). For more recent critiques of the desirability of tax treaties between developed and developing countries, see Charles R. Irish, *International Double Taxation Agreements and Income Taxation at Source*, 23:2 INT'L & COMP. L. Q. 292 (1974); Tsilly Dagan, *The Tax Treaty Myth*, 32 NYU J. OF INT'L L. & POL. 939 (2000); Michael J. McIntyre, *Developing Countries and International Cooperation on Income Tax Matters: An Historical Review* (2005) (unpublished manuscript) ([www.michielse.com/files/mcintyre\\_intl\\_cooperation.pdf](http://www.michielse.com/files/mcintyre_intl_cooperation.pdf)); Lee Sheppard, *How Can Vulnerable Countries Cope with Tax Avoidance*, 69 TAX NOTES INT'L 410 (2013); Kim Brooks & Richard Krever, *The Troubling Role of Tax Treaties*, in *TAX DESIGN ISSUES WORLDWIDE, SERIES ON INTERNATIONAL TAXATION*, ch. 6 (Geerten M. M. Michielse & Victor Thuronyi, eds., 2015); TSILLY DAGAN, *INTERNATIONAL TAX POLICY: BETWEEN COMPETITION AND COOPERATION* (2018);

1. The conventional wisdom rests on a questionable narrative. It assumes that tax treaties result in a transfer of tax revenues from poor countries to rich countries. Existing treaty provisions arguably do allocate greater taxing rights to the country where the investor resides (generally, capital-exporting developed countries) and less taxing rights to the country where the income is earned (capital-importing developing countries). But transfers of taxing rights are not the same as transfers of tax revenues. For a variety of reasons, tax revenue yielded by developing countries likely results in relatively little revenue gains by developed countries. The second treaty myth is that in the current economic environment, tax treaties are less about distributive rules between countries and more about developed countries assisting their multinational entities (MNEs) in reducing their foreign tax liabilities;<sup>2</sup>
2. In determining the desirability of tax treaties, it may be more useful to view treaties as partly or largely tax incentives rather than agreements on how to divide tax revenue among countries with competing claims. Thus viewed, tax treaties are more tools to influence economic decisions regarding cross-border investments and less formal rules for allocating taxing rights;
3. Treating developing countries as a single group fails to appreciate the great diversity among countries that fall within the category of “developing countries.” Without a better understanding of the particular economic objectives and characteristics, political choices, and administrative capabilities of individual countries, general conclusions about the desirability of tax treaties are of limited use; and
4. Assessing the desirability of tax treaties between developing and developed countries requires the hard work of making difficult country-specific and treaty-

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<sup>2</sup> The first treaty myth is that tax treaties are essential to reduce or eliminate double taxation. Dagan, *The Tax Treaty Myth*, *supra* note 1.

specific determinations about costs and benefits associated with tax treaties (which in turn requires making assumptions about investment flows and tax revenue in a world with and without tax treaties).

Part I examines why tax treaties with developed countries may be a bad deal for developing countries and reviews the treaty provisions that are most problematic in terms of lost revenue. It then examines why the tax revenue losses by developing countries may not result in revenue gains by developed countries.

Part II examines the costs and benefits to developing countries from entering into tax treaties. It starts with a simple thought experiment: *How would the level of foreign investment and the amount of tax revenue change if treaties between developed and developing countries adopted a source-friendly, pro-developing country standard for taxing business activity (for example, a significant economic presence test such as in-country revenues greater than \$10 million)?*

This part then reviews what policymakers would need to know in order to estimate the costs and benefits associated with entering into a treaty with a developed country. It notes that the existing economic studies examining the relationship of tax treaties and levels of foreign investments are of limited usefulness in making these determinations. This exercise also highlights the folly of offering blanket conclusions about the desirability of tax treaties between developed and developing countries. The relative costs and benefits for a particular developing country will vary by treaty partner. Similarly, economic, political, and administrative differences among developing countries will likely result in different conclusions about the desirability of tax treaties.

Part III reviews how the OECD's BEPS project and the reforms that may result from these efforts may change the calculus about whether developing countries should enter into tax treaties with developed countries. It then offers some observations about factors that may influence the desirability of treaties going forward.

Part IV concludes that while tax treaties with developed countries may be a poor decision for some developing countries, other developing countries may find tax treaties with developed countries in their economic interests.

## **I. Why Bilateral Tax Treaties are a Bad Deal for Developing Countries**

### **A. The case against tax treaties**

Jurisdiction to tax can be assigned to the taxpayer's country of residence (residence-based taxation), to the country where the income is earned (source-based taxation), or both countries can be allowed to tax. Bilateral tax treaties allocate taxing rights between countries based on such factors as the type of income and the nature in which the business is conducted in the country. Generally, countries can tax the active business income of a resident of a treaty partner only if the activities meet a threshold requirement generally tied to having a permanent establishment in the country.<sup>3</sup>

Several academics and policy advisers contend that developing countries should hesitate before entering into tax treaties with developed countries.<sup>4</sup> The case against tax treaties between developed and developing countries comes in three parts: (1) doubts about the general utility of tax treaties; (2) a belief that the lost revenue from yielding taxing rights exceeds the benefits of the treaties (the "poisoned chalice" effect);<sup>5</sup> and (3) concerns that tax treaties facilitate aggressive tax-avoidance strategies by MNEs and other taxpayers.

#### *1. General Utility of Tax Treaties*

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<sup>3</sup> Brian J. Arnold, *Threshold Requirements for Taxing Business Profits under Tax Treaties*, in THE TAXATION OF BUSINESS PROFITS UNDER TAX TREATIES (Brian J. Arnold, Jacques Sasseville & Eric M. Zolt, eds., 2004); Adolfo Martín Jimenéz, *Preventing Avoidance of Permanent Establishment Status*, in UNITED NATIONS HANDBOOK ON SELECTED ISSUES IN PROTECTING THE TAX BASE OF DEVELOPING COUNTRIES, ch. 7 (2d ed. 2017).

<sup>4</sup> Irish, *supra* note 1; McIntyre, *supra* note 1; Dagan, *The Tax Treaty Myth*, *supra* note 1; IMF, *Spillovers in International Corporate Taxation*, 28–29 (IMF Policy Paper, 2014).

<sup>5</sup> Brooks & Krever, *supra* note 1 at 160.

Why bother with tax treaties? When does it make sense for countries to yield voluntary taxing rights with respect to economic activity in their country? The first step in addressing these questions is to identify the objectives for entering into tax treaties and to determine how countries can best achieve these objectives. Not surprisingly, countries can differ from one another, both in the importance that they assign to different objectives and in their notions of how to address them. Three common objectives of bilateral tax treaties are to reduce double taxation, to prevent tax evasion and avoidance, and to further economic policy.<sup>6</sup> Other non-tax objectives include the role tax treaties play in furthering diplomatic relations, including development assistance from treaty partners.<sup>7</sup>

*Double taxation.* Tax treaties have long been sold as a means to reduce double taxation.<sup>8</sup> For countries to realize the benefits from cross-border activity, they need to ensure the total taxes imposed (by them and other countries) are not so high as to make engaging in these activities economically unattractive. If two countries have the right to tax an activity or investment, and each imposes tax at a significant tax rate (say 35% tax rate), then the very high pre-tax rate of return required for an investment to be economically viable will result in relatively little cross-border activity. The primary task for the original designers of the international tax framework was to design a system to reduce the aggregate tax liability and to allocate taxing rights to different countries depending on the nature of activity and types of investment. The fundamental treaty structure adopted by the League of Nations in 1928 allocated the corporate-level tax to the country where the business was conducted and the personal-level tax on dividends to the country where the recipients resided.<sup>9</sup>

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<sup>6</sup> Treaties also play an important role in preventing certain forms of tax discrimination.

<sup>7</sup> See Julia Braun & Martin Zagler, *The True Art of the Tax Deal: Evidence on Aid Flows and Bilateral Double Tax Agreements*, (Ctr. For Economic Research, Discussion Paper No. 17-011, 2017) for a study that finds, on average, developing countries which enter into treaties with developed countries receive an additional 22% in official development assistance (roughly \$6 million) in the year the treaty is signed.

<sup>8</sup> DAGAN, *INTERNATIONAL TAX POLICY*, *supra* note 1, at 73-80.

<sup>9</sup> John Avery Jones, *Are Treaties Necessary?*, 53 *TAX L. REV.* 1 (1999); Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of US International Taxation*, 46 *DUKE L. J.* 1021 (1997).

To the extent that double taxation is undesirable, countries can reduce or eliminate many of the instances of double taxation through unilateral action rather than entering into treaties.<sup>10</sup> Countries have long yielded taxing rights by allowing foreign tax credits (the US adopted a foreign tax credit in 1918) or exemptions through their domestic tax legislation without resorting to treaty provisions.<sup>11</sup> As more countries adopt exemption systems for active business income (or allowed for substantial or permanent deferral under the vintage US-style tax regimes), the potential for double taxation is likely much less now than it was 10 or 20 years ago.

In an influential article, Professor Tsilly Dagan nicely demonstrates that countries left to their own devices will conclude that it makes economic sense for them to adopt measures to provide tax relief for foreign taxes paid by their residents (either through a foreign tax credit, deduction, or exemption) -- even without reciprocation by other countries.<sup>12</sup> Dagan uses a game-theoretic approach to show that countries acting in their own self-interest will adopt unilateral measures to avoid or reduce double taxation—thus making treaties unnecessary for these purposes. Dagan’s approach assumes that revenues lost by one country (for example, the source country) are completely picked up by the other country (the country of residence).<sup>13</sup> If this assumption holds, treaties that provide for source countries (generally developing countries) to yield taxing rights will result in greater revenues for residence countries (generally developed countries).<sup>14</sup> Under this scenario, treaties will not reduce the aggregate level of tax liability below what it would have been in a world of unilateral action, thus resulting in no increase in the level of foreign investment. Developing countries give up potential tax revenues but get no additional investment. In other words, developing countries get nothing for something.

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<sup>10</sup> Elizabeth A. Owens, *United States Income Tax Treaties: Their Role in Relieving Double Taxation*, 17 RUTGERS L. REV. 428, 430 (1963); Alex A. Easson, *Do We Still Need Tax Treaties?*, 54 BULL. FOR INT’L FISCAL DOCUMENTATION 619 (2000); and Dagan, *The Tax Treaty Myth*, *supra* note 1 at 939.

<sup>11</sup> Graetz & O’Hear, *supra* note 9.

<sup>12</sup> Dagan, *The Tax Treaty Myth*, *supra* note 1.

<sup>13</sup> Dagan, *The Tax Treaty Myth*, *supra* note 1, at 40-41,46-47, and 51-52.

<sup>14</sup> See discussion accompanying footnotes 50 to 57 for the economic consequences if the assumption of full transferability of tax revenues does not apply.

While countries can unilaterally eliminate most forms of source-residence double taxation,<sup>15</sup> the potential for double taxation still exists with respect to the source of income and residence status. Countries have different rules for determining the source of income for domestic tax purposes and for determining residence status. This is not surprising given the lack of any theoretical coherence in determining where different types of income are sourced and the remarkable electivity of residence by taxpayers.<sup>16</sup> Here, tax treaties are necessary to provide for consistent rules to prevent potential double taxation.

*Assistance in tax enforcement.* Taxpayers are global, but tax authorities are local. Treaties not only provide a mechanism for local tax authorities to obtain information from other countries about taxpayers who do business in their country, but also about domestic taxpayers who have investments and activities in other countries. Historically, the information exchange mechanism proved to be of little use to developing countries because of challenges with respect to the process for obtaining the information, as well as the existence of bank secrecy laws that shielded access to the information.<sup>17</sup> However, with the transition from exchange of information on request to automatic exchange of information through a common reporting standard, the game has changed. Assuming developing countries can satisfy privacy and data protection obligations, access to information from other countries will be an important tool in improving compliance and reducing tax evasion.

Treaties also provide for administrative cooperation in tax collection between countries (including allowing the enforcement of tax judgments in the treaty partner's courts) and for a mechanism for resolving disputes among taxpayers and the treaty countries. While countries can either adopt domestic measures or seek arrangements with other countries

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<sup>15</sup> Differences in source rules and in characterization of income make it difficult for domestic tax law to completely eliminate source-residence double taxation. Here, treaties play an important role in supplementing domestic rules on relief of double taxation.

<sup>16</sup> Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policy*, 26 BROOK. J. INT'L L. 1357, 1417–26 (2001); DANIEL N. SHAVIRO, FIXING U.S. INTERNATIONAL TAXATION 31–48 (2014).

<sup>17</sup> For a review of some of the challenges facing developing countries in obtaining information, see Michael McIntyre, *How to End of the Charade of Information Exchange*, 56 TAX NOTES INT'L 695 (2009).



for information exchanges or dispute resolution without entering into bilateral tax treaties, a tax treaty between two countries facilitates the adoption of automatic exchanges of information agreements and dispute resolution procedures. For countries that prefer the treaty route to gain administrative assistance, a “skinny” tax treaty that covers only information exchanges, dispute resolution, and transfer-pricing guidelines may achieve many of the benefits of tax treaties without yielding taxing rights.<sup>18</sup>

*Instrument to further economic objectives.* Both developed and developing countries use tax treaties to create a tax environment that encourages foreign direct and portfolio investment. Countries compete for jobs, capital investment, the location of intangible property (such as patents and other forms of intellectual property), to develop natural resources, and to serve as global or regional hubs for corporate headquarters, research and development, and the provision of financial services.<sup>19</sup> While scholars differ about whether treaties are effective in achieving these objectives, this remains the primary reason developing countries enter into tax treaties.

While many factors influence decisions about where to invest (such as quality of infrastructure, political stability, labor productivity, rule of law, and levels of corruption), taxes play an important role. Treaty supporters highlight the important role treaties play in creating an “investor-friendly” tax environment and in signaling that a country welcomes foreign investment.<sup>20</sup> One of the major benefits from treaties is providing a degree of certainty and predictability for foreign investors in estimating projected tax liability for potential investments in a country. Treaty provisions shape the basic framework for taxing potential investments, and the impact of domestic tax law, while still important, is constrained with a treaty in place. Greater predictability of tax liabilities exists for investments in treaty countries because changes in the terms of tax treaties are

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<sup>18</sup> Victor Thuronyi, *Tax Treaties and Developing Countries*, in TAX TREATIES: BUILDING BRIDGES BETWEEN LAW AND ECONOMICS 441, 445 (Michael Lang et al. eds., 2010).

<sup>19</sup> MICHAEL J. GRAETZ, FOLLOW THE MONEY: ESSAYS IN INTERNATIONAL TAXATION 262 (2016).

<sup>20</sup> Michael Lang & Jeffrey Owens, *The Role of Tax Treaties in Facilitating Development and Protecting the Tax Base* 4 (2014), <http://ssrn.com/abstract=2398438>.

less frequent than changes in domestic tax legislation.<sup>21</sup> Foreign investors also value the role of treaties in potentially minimizing disputes with tax authorities, as well as providing a mechanism for dispute resolution.

Tax treaties may have a greater impact on the level of foreign investment in countries with a history of political and economic instability, where foreign investors perceive that the tax regime deviates from global norms (or might in the future), and where challenges exist in dealing with the tax authorities with respect to compliance and resolving tax controversies (for corruption or other reasons). In choosing where to invest, foreign investors are likely to place less value on the existence of a tax treaty with Singapore than they would with some other countries in the region. Even without a treaty, investors in Singapore benefit from a stable tax environment and a good mechanism for dispute resolution. In other countries, treaties would add more value to creating an investor-friendly tax environment. But even here, countries do not need treaties to improve the tax environment for foreign investment. In many developing countries, much can be done to improve domestic tax legislation and tax administration to provide a more effective tax system for all investors, not just those from treaty countries.

In deciding whether a country should use domestic legislation or tax treaties to establish rules for cross-border taxation (including rules that define the country's tax jurisdiction), it is important to consider process issues. Several factors weigh in favor of domestic legislation. These include the greater flexibility to amend or repeal rules that prove to be disadvantageous, the greater transparency for the public and legislators of rules and concessions that are made through the domestic legislative process rather than through treaty negotiations,<sup>22</sup> and the greater coverage afforded by a regime that applies to all foreign investors, not just those from treaty countries.<sup>23</sup>

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<sup>21</sup> For some countries (such as the US), later changes in domestic tax law can override existing tax treaties. But for many other countries treaties prevail over subsequent changes in domestic law.

<sup>22</sup> This difference depends on whether the domestic rules governing ratifying treaties provide for similar levels of transparency as compared to domestic tax legislation.

<sup>23</sup> Brooks & Krever, *supra* note 1.

However, exclusive use of domestic legislation prevents countries from providing favorable provisions selectively, through tax treaties, rather than universally, through domestic tax legislation. Tax treaties allow countries the flexibility to discriminate among countries and provide favorable treatment when the benefits justify yielding tax revenue. Finally, while countries can adopt unilateral measures to achieve many treaty objectives, the lack of a treaty deprives their residents of reciprocal benefits.<sup>24</sup>

In sum, strong arguments exist that countries do not need tax treaties to avoid double taxation resulting from most source-residence conflicts (treaties are still necessary to resolve disagreements between countries related to different rules for determining the source of income or for residence status). Treaties do play an important role in assistance in collecting taxes, dispute resolution, and information exchanges (particularly if countries can take advantage of automatic information exchanges), but opportunities exist for countries to achieve these objectives without entering into bilateral tax treaties. While treaties contribute to improving the tax environment for foreign investment, the questions remain by how much and at what cost. Part II attempts to provide some answers.

## 2. *Poisoned Chalice*

For many observers, the price of admission to the tax treaty club is too steep for developing countries. Developed countries designed the original rules and generally controlled the process for changing them when it was in their interest.<sup>25</sup> Because of differences in bargaining power and the lack of experience in negotiating treaties, developing countries often faced a “take it or leave it” proposition. If developing

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<sup>24</sup> For example, Singapore is quite successful in making their country attractive to US investors through unilateral action. But because there is no US-Singapore tax treaty, Singapore investors in the US bear high withholding taxes and other penalties.

<sup>25</sup> As an African tax official stated in a UN tax subcommittee meeting, “If you are not at the table, you are on the menu,” repeating a remark that is thought to have originated in Washington around twenty years ago, and recently used by U.S. Senator Patty Murray with respect to the all-male 13-member Republican working group to reform the Affordable Care Act. Patty Murray, *If You’re Not at the Table, You’re on the Menu*, MEDIUM (May 23, 2017), <https://medium.com/@PattyMurray/if-youre-not-at-the-table-you-re-on-the-menu-932c0f76550a>. Developing countries have been unsuccessful in their efforts to establish an intergovernmental UN tax body to represent developing countries in reforming the international tax regime. Stephanie Soong Johnston, *UN Rejects Global Tax Body*, 79 TAX NOTES INT’L 195 (2015).

countries wanted to conclude treaties with developed countries (and the purported additional foreign investment that would follow), they accepted terms that required them to forego taxing economic activity in their country.

Tax treaties are nominally reciprocal. If capital flows are roughly equal between the countries, rules that skew taxing rights towards residence-based taxation, away from source-based taxation, will result in little shifting of tax revenue between the countries. There is rough justice here; what a country loses on the source side is made up on the residence side. If residence countries are better able to collect taxes on their resident taxpayers than source countries, then allocation of greater rights to residence countries will make both countries better off.

If capital flows are less even, the revenue consequences may be substantial.<sup>26</sup> The existing treaty provisions generally result in greater tax revenues for residence countries (generally, capital-exporting developed countries) and less tax revenues for source countries (capital-importing developing countries). Thus, as developing countries enter into more treaties with developed countries, the greater the negative revenue consequences.

Professors Kim Brooks and Rick Krever forcefully argue that tax treaties are a “poisoned chalice” for developing countries, as tax revenues shift from developing to developed countries with little or no offsetting benefits to developing countries (such as increased levels of foreign investment).<sup>27</sup> To achieve a more equitable global tax system, they call for developing countries to refrain from entering into new tax treaties with developed countries.<sup>28</sup>

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<sup>26</sup> See, e.g., Dagan, *The Tax Treaty Myth* *supra* note 1; Brooks & Krever, *supra* note 1; Victor Thuronyi, *supra* note 18; Reuven S. Avi-Yonah, *Double Tax Treaties: An Introduction*, in THE EFFECT OF TREATIES ON FOREIGN DIRECT INVESTMENT: BILATERAL INVESTMENT TREATIES, DOUBLE TAXATION TREATIES, AND INVESTMENT FLOWS (2009).

<sup>27</sup> Brooks & Krever, *supra* note 1 at 160. Brooks and Krever recognize that tax treaties also shift tax revenue from developing countries to foreign investors, but they do not consider the consequences of such transfer. *Id.*

<sup>28</sup> Brooks & Krever, *supra* note 1 at 178.

While it is clear that developing countries yield taxing rights to developed countries by entering into tax treaties, it is less clear where the revenue goes. One alternative, put forth by such scholars as Dagan, Brooks, and Krever,<sup>29</sup> finds the revenue is transferred to developed countries with little or no economic benefits to developing countries. It is a zero-sum game, with a full transfer of tax revenues, such that one country's gain is another country's loss. A second alternative, examined further in Section II.B, *Tax Treaties as Tax Incentives*, posits the lost revenue is partly or largely picked up by foreign investors (through lower aggregate tax liability). This can result if the foreign investors' home country has an exemption system for active business income,<sup>30</sup> if worldwide tax systems allow for substantial deferral opportunities, or from tax minimization strategies (including using affiliates in low-tax jurisdictions to receive dividends, interest, and royalties from activities in developing countries). MNEs have long been successful in shifting income earned in either developed or developing countries to low- or no-tax jurisdictions as "homeless" or "stateless" income to avoid both source- and residence-based taxation.<sup>31</sup> In some instances, residence countries have been complicit in these efforts by facilitating avoidance of source-based taxation to assist their MNEs in minimizing their foreign tax liability (which also has the favorable result of, in some countries, reducing the amount of foreign tax credits that can be credited against domestic taxes).<sup>32</sup>

Under the second alternative, the focus on the transfer of tax revenues from developing countries to developed countries is misplaced. To see why, it may be helpful to distinguish between three types of foreign investments in a developing country: (1) existing foreign investments in the country; (2) new foreign investments that would have

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<sup>29</sup> Dagan, *The Tax Treaty Myth*, *supra* note 1; DAGAN, INTERNATIONAL TAX POLICY, *supra* note 1; and Brooks & Krever, *supra* note 1.

<sup>30</sup> Foreign investors' ability to capture the full benefit will be limited if the exemption system requires the foreign active business income to be subject to a minimum tax rate.

<sup>31</sup> Bret Wells & Cym Lowell, *Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin*, 65 TAX L. REV. 535 (2011); Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699 (2011); Edward D. Kleinbard, *Stateless Income's Challenge to Tax Policy*, 68 TAX NOTES INT'L 499 (2012).

<sup>32</sup> Rosanne Altshuler and Harry Grubert, *Governments and Multinational Corporations in the Race to the Bottom*, 41 TAX NOTES INT'L, 459 (2006).

been made even without a treaty (“non-treaty related investments”); and (3) new foreign investments that result from treaty adoption (“treaty-related investments”). New tax treaties have both infra-marginal and marginal effects. The infra-marginal effects of a new treaty for existing investments and non-treaty-related investments are as follows: foreign investors receive treaty benefits and pay less taxes to the developing country, but there is no marginal increase in investment due to the treaty. Whether the economic benefits from the developing country yielding taxing rights accrues to the foreign investor or the developed country does not affect either the level of investment or the developing country’s tax revenues.

The marginal effects from tax treaties focus on treaty-related investments. Developing countries face this cost-benefit trade-off: are the economic benefits from this additional marginal investment (including any additional tax revenue attributable to the incremental investment by the investor or any spillover effects) greater than the lost revenue from treaty benefits granted to old investments and non-treaty related investments? For these purposes, no revenue losses result from the treaty-related investments to the developing country because without the treaty, there would be no investment, and therefore no revenue. Here, the relative allocation of treaty benefits between the foreign investor and the developed country matters, but only with respect to the economic effect of the tax subsidies on increasing marginal investment. The greater the share to the foreign investor, the greater incentive to invest in the developing country.<sup>33</sup>

Under this second alternative, whether developing countries should enter into tax treaties with developed countries depends on the relative costs from lost revenues and the expected economic benefits from entering into the treaty. Unlike the first alternative, this

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<sup>33</sup> An example may be helpful. Assume a developing country has \$100 million of existing investment, \$50 million of new investment that would have been made even without a treaty, and \$50 million of new investment that results from treaty adoption and that the investments generate a 10% return and the earnings are distributed as dividends to the parent company. If a developing country enters into a treaty and reduces the withholding rate on dividends from 15% to 5%, the existing investment and the non-treaty related investments get a windfall and the developing country loses \$1.5 million in tax revenue (\$15 million of dividends and a 10% tax reduction), assuming the level of dividends remain the same pre-and post-treaty. If the level of dividends increases, then the revenue loss would be reduced. Whether a treaty with a developed country makes economic sense depends on whether the economic benefits from the treaty exceeds the lost revenue attribute to lower withholding rates on dividends and other treaty benefits.

requires a country-specific and treaty-specific determination of the economic consequences to decide whether tax treaties are a good or bad deal.

### 3. *Facilitating Tax Avoidance*

The discussion of the desirability of tax treaties between developing and developed countries has focused primarily on developing countries' yielding of taxing rights to treaty partners. Concerns also exist, however, that the tax treaty networks of developing countries are subject to abuses that generate significant revenue losses to developing countries.<sup>34</sup> Although countries agree to yield taxing rights with respect to investors from their treaty partner, they may not have bargained on other investors taking advantage of the tax benefits.<sup>35</sup> These tax losses can result from foreign investors' routing investment through the treaty country or from local investors' "round tripping" investment through the treaty country to obtain tax benefits not available under domestic law.

For most developing countries, a low-tax jurisdiction (often a tax haven) serves as the entry point for investment into the country—with favorable tax treatment resulting from favorable tax treaties between the developing country and the low-tax jurisdiction. Whether these tax havens are beneficial to developing countries again depends on the tradeoff between greater foreign investment and lost tax revenue. For those who contend that tax havens allow developing countries to adopt, indirectly, favorable tax rules for foreign investors while maintaining more robust tax regimes for domestic investors, tax havens play an important role in achieving this differentiation.<sup>36</sup> Indeed, as discussed later, a similar argument can be made with respect to tax treaties writ large – the existence of a treaty network allows countries to provide different tax regimes for foreign and domestic investors without having to provide explicitly favorable provisions in their tax legislation. Perhaps a less appreciated advantage is that developing countries can use

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<sup>34</sup> Graeme S. Cooper, *Preventing Tax Treaty Abuse*, in UNITED NATIONS HANDBOOK ON SELECTED ISSUES IN PROTECTING THE TAX BASE OF DEVELOPING COUNTRIES, ch. 6 (2d ed. 2017).

<sup>35</sup> In some instances, developing countries may have intended to allow treaty-shopping opportunities as a way to provide indirect tax incentives to increase foreign investment.

<sup>36</sup> Dhammika Dharmapala, *What Problems and Opportunities are Created by Tax Havens*, 24 OXFORD REV. OF ECON. POL'Y 661 (2008).

treaties with tax havens to assist some foreign investors in minimizing their tax liability in their residence country.

According to those who contend that tax havens are evil and parasitic, strong arguments exist for reconsidering the desirability of tax treaties between developing countries and tax havens.<sup>37</sup> The combination of relatively low tax revenues collected from business activities (whether because of tax incentives, aggressive tax strategies, or tax administration challenges), treaty withholding rates of zero on dividends, interest, and royalties, and ineffective measures to prevent treaty shopping, is a recipe for minimizing tax revenues for developing countries. To prevent foreign investors from claiming benefits to shift profits out of the country, several countries have recently terminated or renegotiated tax treaties with tax havens.<sup>38</sup> As discussed later, developing countries can use higher withholding tax rates, limitation of benefits clauses, or other anti-abuse provisions to address revenue losses from investments through tax havens.

## **B. Which Treaty Provisions Are Most Problematic?**

The starting point of determining the potential costs of entering into tax treaties is the allocation of taxing rights under bilateral tax treaties. One reading of the allocation rules is that they reflect a historical compromise among the original participating countries, which held competing views on the relative merits of source- and residence-based taxation.<sup>39</sup> Whatever the initial logic for the allocation, these rules remained in place

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<sup>37</sup> Joel Slemrod & John Wilson, *Tax Competition with Parasitic Tax Havens*, 93 J. OF PUB. ECON. 1261 (2009).

<sup>38</sup> Martin Hearson, *When Do Developing Countries Negotiate Away Their Corporate Tax Base*, 30 J. OF INT'L DEV 233 (2018) (Argentina, Malawi, Mongolia, Rwanda, and Zambia have terminated or renegotiated tax treaties) (“*Corporate Tax Base*”); Martin Hearson, *TAX TREATIES IN SUB-SAHARAN AFRICA: A CRITICAL REVIEW* (Tax Justice Network) (2015), [https://martinhearsen.files.wordpress.com/2015/11/tjna\\_treaties.pdf](https://martinhearsen.files.wordpress.com/2015/11/tjna_treaties.pdf). In 2012, Mongolia cancelled its tax treaty with several countries, including the Netherlands, because the zero or low withholding rates on dividends, interest, and royalties allowed MNEs engaged in the mining sector to shift profits out of the country with little or no tax liability. IMF, *Mongolia: Technical Assistance Report – Safeguarding Domestic Revenue – A Mongolian DTA Model*, IMF Country Report No. 12/306 (2012).

<sup>39</sup> Graetz & O’Hear, *supra* note 9.



through changes in the political and economic landscape and through dramatic increases in the number of countries entering into tax treaties. A less charitable view is that developed countries controlled the decision-making process and preferred rules that benefited capital-exporting countries. Both historically and recently, efforts to change the basic allocation of taxing rights have been largely unsuccessful.

Three types of limitations on source-country taxation result in substantial revenue losses for developing countries.<sup>40</sup> First, treaties establish taxing rights for active business income by requiring a certain threshold of activity before the source country can tax profits earned in that country. The permanent establishment (PE) concept plays a central role in fixing tax jurisdiction. The existence of a PE is required before a source country can tax the business income derived by a resident of the treaty partner. High thresholds favor capital-exporting countries and low thresholds favor capital-importing countries. Second, treaties limit the rates of withholding taxes that countries can impose on certain types of income earned in the country, such as interest, dividends, and royalties, as well as income earned for management, technical and consulting services. These limited withholding rates are often lower than the withholding rates provided under domestic law. Finally, treaties allocate the exclusive right to tax certain types of income to the residence country, including pensions, social security payments, service income related to infrastructure projects, and capital gains (except for real estate).<sup>41</sup> Restrictions on taxing capital gains on shares of domestic corporations held by foreign investors are problematic from the perspective of a developing country.<sup>42</sup>

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<sup>40</sup> Treaties also bring developing countries into or closer to the OECD's orbit for transfer pricing regimes, separate accounting for related corporations, and rules regarding attribution of income to a PE. Even where developing countries have taxing rights under the treaty, these elements limit the amount of tax revenue developing countries can collect from business activity in their country. But even without treaties, the domestic laws of many developing countries generally follow the OECD provisions.

<sup>41</sup> Developing countries are the beneficiaries of treaty provisions that allocate the rights to tax artists and athletes and government pensions to source countries.

<sup>42</sup> Wei Cui, *Taxing Indirect Transfers: Improving an Instrument for Stemming Tax and Legal Base Erosion*, 33 VA. TAX REV. 653 (2014).

For over 50 years, the United Nations (UN) has, through the efforts of ad hoc working groups of tax officials and tax experts, worked to formulate guidelines for tax treaties between developed and developing countries.<sup>43</sup> The UN published the first *Manual for the Negotiation of Tax Treaties between Developed and Developing Countries* in 1979, and in 1980, it developed the *United Nations Model Double Taxation Convention between Developed and Developing Countries*. Detailed reviews of the differences between the OECD and the UN Model Tax Conventions are available from several sources.<sup>44</sup>

The key differences between the OECD and UN model conventions center on the same three limitations discussed above: the threshold for taxing business income, limitations on withholding taxes, and limitations on the rights to tax certain types of income.<sup>45</sup> The UN objective was to increase source-based taxation of business income by lowering the threshold for source-country taxation under tax treaties. Over the years, the UN has expanded the definition of “permanent establishment” under Article 5 of the UN model convention to include more activities than are found in the OECD provisions (such as services PES, construction sites, and insurance) and to limit some of the exceptions for PE status (by treating delivery and maintenance of a stock of goods as sufficient activity for an economic nexus).

The UN model convention also provides for greater source-based taxation for dividends, interest, and royalties, not only by providing countries with greater flexibility in setting withholding rates (especially a positive rate on royalty income), but also by expanding the scope of royalties to include rent for industrial, commercial, and scientific equipment.<sup>46</sup> Finally, the UN model convention provides greater opportunities for source-country taxation of certain types of income (including income from international shipping

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<sup>43</sup> Surrey, *supra* note 1. An excellent review of the history of the UN efforts to provide a forum for developing countries is set forth in McIntyre, *supra* note 1.

<sup>44</sup> See, e.g., Michael Lennard, *The UN Model Tax Convention as Compared with the OECD Model Tax Convention*, 49 ASIA-PACIFIC TAX BULL. 4 (2009); Avi-Yonah, *supra* note 24. See, also, Carrie Elliot, *The Convergence of U.N. and OECD Global Tax Policy*, 90 TAX NOTES INT’L 200 (2018).

<sup>45</sup> Other differences relate to shipping, insurance, and the treatment of payments to top-level managerial officials.

<sup>46</sup> While providing greater flexibility for choice of withholding rates has some advantages, developing countries may be better served if the UN model convention provided suggested withholding rates for these types of income that could serve as a baseline for treaty negotiation.

and payments to top-level managers), as well as for source-country taxation of capital gains of non-residents from the disposition of substantial interests in resident companies.

To determine the influence of the UN model convention on treaty negotiations, scholars from the International Bureau of Fiscal Documentation (IBFD) reviewed treaties of many developed and developing countries to determine whether treaties contained UN-specific treaty provisions.<sup>47</sup> The most recent IBFD study, completed in March 2014, reviewed about 1800 treaties that were concluded between April 1, 1997 and January 2013 to see whether they contained any of the 30 UN-specific provisions. The findings of the 2014 IBFD study paint an interesting picture of the influence of the UN model convention on actual treaty practice. The UN model convention has clearly influenced treaty practice between non-OECD countries as well as between non-OECD and OECD countries.<sup>48</sup>

But two factors limit the impact of the UN model convention. First, for many UN provisions, the adoption rates are remarkably low. The IBFD study found for 21 of the 30 UN provisions, the adoption rate was lower than 40 percent and for 12 of the UN provisions, the rate was lower than 20 percent.<sup>49</sup> Second, as long as the UN convention retains the basic architecture of the OECD model, revenue gains to developing companies will be limited. Without major changes to transfer pricing regimes, separate treatment of related corporations, and the PE standard, adopting UN treaty provisions in treaties with developing countries will increase tax revenues, but likely not dramatically.

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<sup>47</sup> W.F.G. Wijnen & Marco Magenta, *The UN Model in Practice*, 51 BULL. FOR INT'L FISCAL DOCUMENTATION 574 (1997) (the "1997 study"); W.F.G. Wijnen et al., *The Treatment of Services in Tax Treaties*, 66 BULL. FOR INT'L TAX'N 27 (2011) (the "2011 study"); W.J.G. Wijnen and J. de Goede, *The UN Model in Practice 1997–2013*, 68 BULL. FOR INT'L TAX'N 118 (2014) (the "2014 study"). The 1997 study reviewed 811 treaties entered into between January 1980 and April 1997 to see which treaties contained 26 UN-specific provisions. The 2011 study examined 1,586 treaties entered into between April 1, 1997 and June 2011 to see whether they contained 16 UN-specific provisions.

<sup>48</sup> For a thoughtful discussion of why developing countries would conclude treaties with developed countries on the basis of the OECD model, see Eduardo Baistroocchi, *The Use and Interpretations of Tax Treaties in the Emerging World: Theory and Implications*, BRITISH TAX REVIEW NO. 4 (2008).

<sup>49</sup> Wijnen & Magenta, the 2014 study, *supra* note 47.

### C. How much tax revenue is really transferred from developing countries to developed countries because of tax treaties?

Although tax treaties result in reduced source-country revenues, residence countries have not been particularly interested or successful in capturing a large share of the lost tax revenues. Countries have long adopted tax regimes that provide favorable treatment for active business income earned outside their country. Exemption systems are the most common approach, resulting in so-called territorial taxation, while vintage US-style deferral tax systems provide for nominal world-wide taxation but in practice, result in substantial tax subsidies for foreign business activity.<sup>50</sup> Countries have not adopted “pure” exemption or world-wide systems, and, in practice, countries have different types of hybrid systems.<sup>51</sup> Recent US tax legislation has made this hybrid explicit through the move towards a territorial-style exemption system with a world-wide minimum tax on excess profits (the tax on global intangible low-tax income or “GILTI” provision).<sup>52</sup>

The objective of these domestic rules governing out-bound transactions is clear: to make home country MNEs competitive in the global economy. But perhaps much less appreciated is that in the current tax environment, countries use tax treaties to assist resident MNEs in minimizing their tax liability in other countries. Countries can assist their MNEs either through the formal treaty process or, less formally, through domestic tax provisions that facilitate aggressive tax behavior by their resident MNEs in reducing their foreign tax liability (often taking advantage of treaty benefits).<sup>53</sup> Stripping away

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<sup>50</sup> Thornton Matheson, Victoria Perry & Chandara Veung, *Territorial v. Worldwide Corporate Taxation: Implications for Developing Countries* (IMF Working Paper 13/205) (Oct. 3, 2013). Matheson et al. highlight that when countries move from a world-wide tax system to a territorial tax system, foreign investors are likely to shift income from high-tax to low-tax source countries. See also Li Liu, *Country Taxation and Multilateral Investment: Evidence from the UK Changes to Territoriality* (Oxford University Centre for Business Taxation, Working Paper, 2015).

<sup>51</sup> Rosanne Altshuler, Stephen Shay & Eric Toder, *Lessons the United States Can Learn from Other Countries' Territorial Systems for Taxing Income of Multinational Corporations*, (Tax Policy Center, 2015).

<sup>52</sup> GILTI presumes that excess profits from foreign operations are attributable to intangibles and effectively act as a US minimum income for the excess of the normal return attributable to foreign depreciable tangible property. See, generally, Lee Sheppard, *GILTI as Charged*, 90 TAX NOTES 767 (2018).

<sup>53</sup> 26 C.F.R. 301.7701-3. For some historical perspective, see Kenan Mullis, *Check-the-Box and Hybrids: A Second Look at Elective U.S Tax Classification of Foreign Entities*, 64 TAX NOTES 371 (2011).

source country tax revenue does not necessarily translate into higher tax revenues for residence countries.

How much revenue is actually collected by residence countries from foreign source income? The answer is probably a relatively low percentage of the residence country's total corporate tax revenue. For countries with exemption systems, only the non-qualifying income would be subject to tax, and even that income could be shifted to low-tax jurisdictions or could often be reduced by a credit for foreign taxes paid. For countries with a nominal world-wide system (such as the vintage US-style deferral system), the answer again is probably not much. To the extent the foreign income is taxed in high-taxed countries, the foreign tax credits reduce or eliminate US tax liability and, to the extent the foreign income is taxed in low-taxed countries, MNEs avoid US tax liability by not repatriating the income. Rough approximations of tax revenue from foreign source income and the relative amount of foreign income shifted to low-tax jurisdictions are available from several sources. One approach uses US Treasury tax data to estimate the share of taxes attributable to foreign source income. Using US Treasury tax data for 2006, Harry Grubert and Rosanne Altshuler found that total tax revenues from foreign-source income amounted to \$32 billion, which represented about 9% of total corporate tax revenues and less than 4% of all foreign-source income.<sup>54</sup> Other approaches include reviewing publicly-available financial statements of large corporations to determine the effective tax rates of these firms<sup>55</sup> or using Bureau of Economic Analysis survey data on

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<sup>54</sup> Harry Grubert & Rosanne Altshuler, *Fixing the Tax System: An Analysis of Proposals for Reform of International Taxation*, 6 NAT'L TAX J. 671 (2013). Interestingly, Grubert and Altshuler find that corporate tax revenue would actually increase by about \$1 billion if the US exempted dividends from foreign taxable income. The insight here, is that US MNEs use excess credits from dividends from high-tax countries to reduce taxes on royalties and other low-tax active income.

<sup>55</sup> The non-profit Citizens for Tax Justice reviewed the tax information from the 288 Fortune 500 companies that reported profits in each of five years between 2008 and 2012. As a group, the corporations paid an effective tax rate of 19.4%, but what was interesting is the wide variation of effective tax rates among these corporations. Twenty-six of the corporations paid no federal income tax over the five-year period and about a third paid an effective tax rate of less than 10 percent. Notable among those corporations with low effective tax rates is the relatively large share of foreign operations. Robert S. McIntyre, Matthew Gardner, and Richard Phillips, *The Sorry State of Corporate Taxes: What the Fortune 500 Firms Pay (or Don't Pay) in the USA And What They Pay Abroad—2008 to 2012* (Citizens for Tax Justice, 2014).

US MNEs to estimate the amount of corporate tax base erosion due to profit shifting from high-tax countries to low-tax countries.<sup>56</sup>

Why do countries subsidize active foreign business activity with their own and other countries' money? In addition to the political economy explanation that MNEs successfully lobby their home countries for favorable tax treatment, here are a few reasons. First, for countries with foreign tax credit systems (either for all types of income or just for income not qualifying under exemption systems), facilitating lower foreign tax liability for home country MNEs means greater tax revenue. Second, to the extent foreign business activities complement domestic operations, greater profitability will contribute to additional domestic capital investment and employment.<sup>57</sup> Third, the reduced tax liabilities for MNEs will contribute to higher share prices (increasing tax revenue from capital gains on the dispositions of the stock) and higher dividends to shareholders, and perhaps higher wages to domestic workers, that will result in more tax revenue at the individual-level.

But even without the assistance of their home countries, MNEs have been quite adept in shifting profits from both developed and developing countries to low-tax jurisdictions, even though little or none of the economic activity takes place in those jurisdictions. As set forth in the next section, even if developing countries succeed in getting greater taxing rights under treaties, this would not necessarily result in greater tax revenues.

## **II. Costs and Benefits of Entering into Tax Treaties**

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<sup>56</sup> Kimberly A. Clausing, *The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond*, 69 NAT'L T. J. 905 (2016) (estimating that US MNEs profit shifting reduced US corporate tax revenue for 2012 by between \$77-111 billion and that foreign affiliates of US MNEs booked \$800 billion of income (about 75% of total foreign income) in countries with an effective tax rates of 6.6%); Gabriel Zucman, *Taxing Across Borders: Tracking Personal Wealth and Corporate Profits*, 28 J. OF ECON. PERSP. 121 (Fall 2014) (estimating for the 2013 tax year that 55% of the \$2.1 trillion in profits for US MNEs were located in tax-haven countries subject to an effective tax rate of 3%).

<sup>57</sup> If foreign business activity substitutes for domestic activity, these subsidies will negatively impact domestic investment and employment.

## A. Thought experiment

Here is a thought experiment that might be useful in thinking about the desirability of tax treaties between developed and developing countries:

Assume tax treaties between developed and developing countries adopted a source-friendly, pro-developing country standard for taxing business activity (for example, a substantial economic presence test such as revenues in country greater than \$10 million).<sup>58</sup>

Question 1: How would the level of foreign investment into the developing country differ from investment levels under the current OECD or UN PE threshold?

Question 2: How much more revenue would the developing country collect compared to revenues collected under the current PE thresholds?

Moving to an economic presence threshold may reduce the level of foreign investment, but it is difficult to determine the impact without additional information. The initial question is how much business activity is currently conducted in the country without a PE. For some sectors of the economy (parts of the digital economy and some types of services), there may be substantial activity in the country that is currently not subject to tax in the country. But for other sectors, it is probably difficult to generate that level of revenue without a PE.

The next inquiry is to estimate the amount of lost revenue from business activity where the investor has used different strategies to avoid PE status (whether through legitimate use of independent agents or more artificial arrangements). Moving to an economic presence test has the advantage of taxing business activity where foreign investors are

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<sup>58</sup> The US threshold for business activity to constitute a US trade or business relies on a substantial, regular and continuous test. This would not be a good standard for developing countries because of both the administrative challenges in enforcing the standard and the tax uncertainty that foreign investors would face in deciding whether to conduct business activities in a particular country.

using strategies to artificially avoid PE status, but again, at the margin, may discourage some activity. The choice of dollar threshold (for example, \$10 million or \$50 million in revenue) may also influence the level of investment. The minimum amount creates a safe harbor to conduct business activity without being subject to tax liability for businesses with projected revenues below the threshold, but a source-friendly standard for taxing business activity would deter some investment for businesses above the threshold.

The question related to additional revenue from moving to an economic presence test raises different types of issues. The first issue is whether as a policy matter, a developing country would want to tax the business activity. Countries face challenges in setting the tax rates with respect to domestic and foreign investment.<sup>59</sup> A strong case can be made that developing countries should refrain from taxing income from foreign capital. The intuition here is that for small, open economies, the optimal level of tax would be zero.<sup>60</sup> If the supply of foreign direct investment is highly elastic, then any tax would cause capital to migrate to other countries until the after-tax return in the taxing country increases to the international rate of return. This results in a decline in productivity for fixed local factors of production, such that these factors bear the entire tax burden (perhaps exceeding one hundred percent of the tax when general equilibrium effects are included).<sup>61</sup> However, there is a competing argument that countries should impose source-based taxes on above-normal returns of location-specific capital. This has even greater appeal where the assets generating the above-normal returns are largely owned by foreigners. In choosing between and within these prescriptions, countries can design a tax regime for foreign investment considering such factors as the proportion of above-normal returns that accrue to foreigners, the ability of foreign investors to avoid any sourced-

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<sup>59</sup> Michael Devereux, *Investment, Saving, and Taxation in an Open Economy*, 12 OXFORD REV. OF ECON. POLICY 90 (1996); Margaret K. McKeehan & George R. Zodrow, *Balancing Act: Weighing the Factors affecting the Taxation of Capital Income in a Small Open Economy*, 24 INT'L TAX AND PUBLIC FINANCE 1 (2017).

<sup>60</sup> R.H. Gordon, *Taxation of Investment and Savings in the World Economy*, 76 AM. ECON. REV. 1086 (1986).

<sup>61</sup> Arnold C. Harberger, *Corporate Tax Incidence: Reflections on What is Known, Unknown, and Unknowable*, in FUNDAMENTAL TAX REFORM: ISSUES, CHOICES AND IMPLICATIONS (J.W. Diamond & G.R. Zodrow eds., 2008).



based tax through tax minimizations strategies (with and without the assistance of local tax authorities), the domestic challenges from adopting a lower rate of tax on income from capital than labor income (domestic taxpayers disguising labor income as income from capital), and the extent the imposition of a source-based tax does not increase a MNEs' aggregate tax liability (because the MNE get a foreign tax credit for taxes paid in the source country).<sup>62</sup>

For our purposes, the key insight is that developing countries have several options in setting the effective tax rates for foreign investment, including through the general tax regime (applicable to both domestic and foreign investors), tax incentives (such as tax holidays), lax tax enforcement (ignoring transfer-pricing abuses), and tax treaties. If countries want to exempt the normal return from capital income for both domestic and foreign investors, then adopting a type of cash-flow tax in the general tax regime will be the preferred approach. In contrast, tax treaties provide countries the opportunity to have a different tax regime for more mobile investments from foreign investors than the regime applicable to less mobile domestic investors. Tax treaties and other types of tax incentives allow countries to differentiate without explicitly providing for favorable treatment in the tax legislation.

Second, different considerations arise when the focus moves from taxing business profits to withholding taxes on interest, dividends, and royalties. Withholding taxes on payments made to unrelated parties often acts as a tariff, increasing the costs to residents (and perhaps providing the foreign recipient with the benefit of a foreign tax credit). For example, increasing withholding taxes on interest under treaties may result in less tax revenue for developing countries. Zero or low withholding rates on interest are often justified by the mobility of debt financing such that any taxes are likely borne by the borrower. To the extent these taxes increase the effective interest rate for domestic borrowers (whether or not through interest "gross-up" provisions), the reduction in corporate tax revenues from interest deductions will exceed the additional withholding taxes by an amount that reflects the difference in the respective tax rates. To the extent

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<sup>62</sup> McKeehan & Zodrow, *supra* note 59.

taxpayers are using related-party financing to siphon income out of the country, using earning stripping or thin capitalization tools to disallow interest at the corporate level is likely a more effective strategy than collecting additional withholding tax. But if countries seek to impose withholding taxes, one proposal that merits further consideration is to adopt a low withholding rate on interest paid to unrelated creditors and a higher withholding rate on related-party debt. This approach mimics the US domestic tax approach that provides for no withholding on portfolio interest but 30% withholding on related-party debt.

The choice of withholding rates for dividends depends in part on how effective countries are at taxing profits when earned. If the profits are fully-taxed at the corporate level, then the case for high withholding taxes on dividends is greatly weakened. If the profits were not taxed or taxed at a low rate (whether because of favorable tax provisions or tax incentives, challenges in tax administration, or aggressive tax planning), a dividend withholding tax serves as a minimum tax by recapturing some of the tax benefit. For example, many developing countries provide favorable tax treatment for foreign investors in the extractive sector. Because these investors pay relatively little taxes when the income is earned, a withholding tax on dividends is likely the best opportunity for developing countries to collect taxes on this activity.<sup>63</sup>

The strongest case for higher withholding rates is for royalty income and income from technical services. Unlike debt capital which can be easily moved to countries that yield the highest after-tax rate of return, royalty payments are generally made for use of intangible property in a particular jurisdiction.<sup>64</sup> Again, it may make sense to differentiate between royalty payments made to independent and related parties. Unlike the thin-capitalization rules for interest payments, transfer-pricing challenges make it difficult to limit the siphoning of income to related-parties in low-tax jurisdictions through royalty payments.

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<sup>63</sup> Withholding taxes on dividends may also increase investment in a country by providing disincentives to repatriate profits. Brooks & Krever, *supra* note 1 at 173.

<sup>64</sup> Brooks & Krever, *supra* note 1 at 172-73.

Countries could also consider greater use of withholding taxes for non-passive income. The 2017 version of the UN model convention added Article 12A. UN Article 12A provides for a source country to impose a withholding tax on gross payments for technical services made by a resident (or a non-resident with a PE) to non-resident services providers.<sup>65</sup> While it is uncertain how successful developing countries will be in including Article 12A in treaties with developed and developing countries, this provision increases source-based taxation by having a zero dollar threshold on the amount of fees subject to withholding and not requiring the service provider to have a PE in the country.

The final consideration is to determine how successful the developing country would be in actually taxing the business activity. Although a strong case can be made for providing greater taxing rights for source countries in tax treaties (such as replacing the PE standard with an economic presence test), it is not clear that including provisions friendly to source countries will necessarily translate into substantially greater tax revenue. Two areas of potential leakage are the domestic tax regimes (both policy and administration) for taxing cross-border income and the use of tax incentives to attract foreign investors.

Foreign investors take advantage of tax treaties to limit their tax liability in source countries, but they also use several other tax-minimization strategies to avoid or evade source-country taxation. It is likely that many of the common base erosion and profit shifting (BEPS) strategies that prompted concerns among developed countries are comparatively easy to structure, and they are harder for tax authorities to address in developing countries. Merely changing treaty provisions may not increase tax revenues unless countries adopt robust rules limiting earnings stripping, transfer-pricing abuses, and other tax reduction strategies,

The move from the PE standard to an economic presence test will provide developing countries with greater taxing rights for active business income conducted without a PE

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<sup>65</sup> Brian J. Arnold, *Taxation of Income from Services*, in UNITED NATIONS HANDBOOK ON SELECTED ISSUES IN PROTECTING THE TAX BASE OF DEVELOPING COUNTRIES, ch. 2, 108-14 (2d ed. 2017).

and certain types of services income. Whether the greater tax rights result in greater tax revenues depends on the ability of the developing country to identify and determine the business or service income of a foreign investor with little physical presence or activity in the country.<sup>66</sup> While developing countries may be able to tax certain types of high-profile business and service income (such as the activities of Google or Amazon), other types of business income and services will escape the attention of local tax authorities.

The interaction of tax treaties and tax incentives has received limited attention, and the academic writing has mostly focused on the role of “tax sparing” provisions that seek to ensure that the tax benefits awarded by source countries flow to the investor and not to the residence country’s tax authorities. In some instances, treaty negotiators from developing countries may have placed more emphasis on limiting residence-based taxation of income earned in their country than on seeking source-based taxation. My focus on the interaction of tax incentives and tax treaties is separate from the tax-sparing discussion. First, greater use of tax incentives by developing countries could easily undermine the benefits of providing greater source taxation under treaties. Second, tax incentives can be a selective or a general substitute for tax treaties insofar as countries can achieve a more investor-friendly tax environment by unilaterally granting tax incentives rather than entering into tax treaties.

## **B. Tax Treaties as Tax Incentives**

There is little disagreement that the distributive provisions of tax treaties work against the interests of many developing countries. Developing countries acting collectively through the UN or other regional organizations, or individually in their own treaty negotiations, have strong incentives to seek more favorable treaty provisions. But while those efforts move forward, the question of whether developing countries should move forward with tax treaties with developed countries remains.

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<sup>66</sup> Brooks & Krever, *supra* note 1 at 169-70.

One approach to this question is to treat tax treaties as just another type of tax incentive. The inquiry then becomes whether tax treaties are the best instrument to achieve a country's economic objectives. This inquiry has two parts: (1) are the economic benefits resulting from tax treaties greater than the economic costs; and (2) are treaties the best tool to achieve the economic objectives or are other types of tax incentives (such as tax holidays, reduced corporate tax rates, and favorable depreciation regimes) or other government action more effective?

Viewing tax treaties as partly or largely tax incentives changes the focus from an examination of the allocation of taxing rights between countries to a determination of how tax treaties fit, if at all, in the country's strategy to achieve economic objectives. This framing also provides an opportunity to profit from developing countries' experience with tax incentives with respect to such issues as how the foreign investor's home country tax system influences the benefits provided by tax incentives and what factors and assumptions are important in estimating the costs and benefits from tax incentives.

*Potential revenue transfer from developing to developed countries.* In previous work, I addressed how a foreign investor's home country's tax system affects the attractiveness of developing countries' tax incentives.<sup>67</sup> I began with a simple model of foreign direct investment that assumes the foreign investor invests directly in a developing country, either through a branch or through a subsidiary that immediately repatriates any profits to the parent corporation.

Under an exemption system, the tax imposed by the host country for many types of income would constitute a final tax on profits earned in that country. Because foreign active business income is generally not subject to tax in the investor's country of residence, any tax advantages from tax incentives will flow directly to the foreign investor. In contrast, under a "worldwide" tax system, the foreign investor is subject to

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<sup>67</sup>Eric M. Zolt, *Tax Incentives in Developing Countries: Maximizing the Benefits and Minimizing the Costs*, in UNITED NATIONS HANDBOOK ON SELECTED ISSUES IN PROTECTING THE TAX BASE OF DEVELOPING COUNTRIES, ch. 9 (2d ed. 2017).

tax in both the country that was the source of the income and the country of residence of the foreign investor. This potential double taxation is generally reduced through the resident country providing a credit for foreign income taxes paid on foreign source income. But what happens if the foreign investor receives a tax incentive that substantially reduces or eliminates the tax in the country of investment?

The 2000 UNCTAD Survey on Tax Incentives and Foreign Direct Investment provides an answer to the question above:

In order to assess the full tax treatment of FDI [foreign direct investment], it is necessary to look into the way home countries tax the income generated in host countries. Where an investor is subject to tax under a residence-based principle, the introduction of a tax incentive such as a tax holiday reduces or eliminates tax credit in the host country. It has the effect of increasing the tax revenues in the home country dollar for dollar. For an investor, the total tax burden remains unchanged, negating the benefits of tax incentives. Tax incentives simply result in the transfer of tax revenues from the host country treasury to the home country treasury.<sup>68</sup>

Tax policy advisors used this view of tax incentives as merely transferring tax revenues from poor to rich countries to caution developing countries from adopting tax incentive regimes. This shares much in common with the arguments by those who recommend that developing countries refrain from entering into treaties with developed countries because the tax revenue yielded by the source country is picked up by the residence country without any increase in the level of foreign investment.

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<sup>68</sup> United Nations Conference on Trade and Development, SURVEY ON TAX INCENTIVES AND FOREIGN DIRECT INVESTMENT: A GLOBAL SURVEY (2000). Here is a simple example assuming that the corporate tax rate in South Africa is 30% and the US corporate tax rate is 35% and that the US corporation invests directly in a business in South Africa. If the South African business generates \$1 million in profits and repatriates the remaining profits to the US, the South African Revenue Service would collect \$300,000 in taxes and the US Internal Revenue Service would collect \$50,000 (the US would impose a 35% tax on the foreign income but then allow a foreign tax credit for the \$300,000 tax paid to the South African Government). If the South African Government provides a tax holiday for this investment in South Africa, the South African tax liability would be reduced to zero, but the US tax liability would increase from \$50,000 to \$350,000 (the 35% US tax without any reduction for foreign income taxes paid). While the aggregate tax liability of the United States investor remains the same, the South African tax incentive results in an effective transfer of \$300,000 from the South African Government to the US Government.

But how much revenue is really being transferred from developing countries to the treasuries of developed countries, and how much foreign investment is being deterred? The answer for both traditional tax incentives and for tax treaties is probably very little. This is partly because many countries that previously had worldwide tax regimes have moved to exemption regimes for active business income. Even if a country still retained a nominal worldwide regime (such as the vintage US system which provided for deferral for unrepatriated active income), several features of the tax regime make it highly unlikely that the income earned outside the country of residence would be subject to current (or, in many cases, future) taxation.

Relatively little foreign investment likely follows the simple model of direct investment through a branch or through a subsidiary that immediately repatriates profits to the parent corporation. Instead, foreign investors use more complex tax minimization strategies, including structuring their investments in developing countries through other countries (including tax havens) so as to minimize the potential tax liability associated with foreign investments. As the BEPS project highlights, investors use a variety of base-erosion strategies to move income to low-tax or no-tax jurisdictions.

In sum, the tax regimes of developed countries probably have little impact on the desirability or effectiveness of tax incentives in developing countries, or on the ability of MNEs to capture treaty benefits from developing countries. For MNEs from countries allowing foreign tax credits, the potential availability of zero or low-taxed active income from foreign sources will be attractive to those tax directors in MNEs who seek to minimize the overall worldwide tax liability of the corporation. This results because tax directors can effectively “blend” other types of foreign income that are subject to tax rates above the tax rate of the country of residence with low-taxed income from developing or other countries to reduce the tax liability in the investor’s home country.<sup>69</sup>

Interestingly, some current provisions and recent changes to the tax regimes governing cross-border transactions of some developed countries may change the conclusion that

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<sup>69</sup> For example, India and Japan benefit from the ability of US MNEs to bring down the effective tax rates in those countries with low-tax income earned elsewhere. Without cross-crediting, effective tax rates for investments in India and Japan would be higher. With the US move to quasi-territorial taxation, these countries may face greater pressure to reduce their tax rates.

developed countries' tax regimes have little impact on the effectiveness of tax incentives and the likelihood that tax treaties result in little revenue transfers from source to residence countries. To the extent countries currently have or adopt minimum taxes on active foreign business income (whether in a relatively straightforward way through including the requirement that foreign income bear a minimum tax rate on a per-country basis before qualifying for exception or a more complex approach such as the US GILTI provisions), this may result in developing countries foregoing tax incentives and imposing taxes at the minimum rate. With respect to tax treaties, taxing rights yielded by source countries will result in tax revenue transfers to the residence country at the minimum tax rate, thus reducing the value of treaties in attracting foreign investment.

Treating tax treaties as a type of tax incentive encourages countries to consider whether treaties are the right tool to attract foreign investment, or whether they might be better off using traditional tax incentives such as tax holidays, reduced tax rates, or favorable depreciation provisions. While the comparisons of the relative merits of using treaties or traditional tax incentives depend heavily of the specifics of the treaty or incentive regime, several factors weigh in favor of traditional tax incentives. For example, policymakers are better able to target traditional tax incentives to specific types of projects or investors rather than offer tax subsidies to all who qualify for treaty benefits. Traditional tax incentives can also be designed to last a limited duration, either for the entire incentive regime or for specific investors, while treaties generally have a long, often indefinite time horizon. If tax treaties are more effective in attracting new investors rather than influencing additional investments by existing investors, then the continued tax benefits offered by treaties may yield little additional investment over levels that would have occurred without the treaty. Finally, it is likely that traditional tax incentives are easier to monitor and evaluate than treaties, especially where the incentive regimes are narrowly targeted and where substantial reporting requirements are imposed on the recipients of tax subsidies.

Process concerns of the stripe raised by Brooks and Kreyer in choosing between domestic tax legislation and tax treaties to achieve treaty objectives also apply to the choice



between tax treaties and traditional tax incentives.<sup>70</sup> To the extent traditional tax incentives comply with a host of best practices,<sup>71</sup> including requiring the tax incentive be part of tax legislation voted on by Parliament and vesting the Minister of Finance with responsibility to administer the regime, then there may be greater oversight and transparency from a traditional tax incentives regime than tax treaties. But where tax incentive regimes are less efficient and transparent, and where the potential for abuse is substantial, then tax treaties would be the preferred route to provide incentives for foreign investment.

### **C. Determining Costs and Benefits of Tax Treaties**

#### *1. Introduction and Studies*

In assessing the desirability of tax treaties, it may be more useful to focus less on whether the treaty provisions are “fair” between developed and developing countries and more on whether it makes economic sense for developing countries to enter into the treaties. This determination depends on the costs and benefits to the developing country resulting from a particular treaty. Some types of costs and benefits are more easily quantified (such as estimates of greater levels of foreign investment or lost revenue from reduced withholding rates), while other types are harder to value (such as improved diplomatic relations with treaty partners).

Many studies have examined whether tax treaties are associated with higher levels of foreign investment.<sup>72</sup> The intuition is straight-forward: if treaties reduce double taxation, provide greater tax certainty to foreign investors, and provide an effective mechanism for

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<sup>70</sup> Brooks and Krever, *supra* note 1 and discussion accompanying notes 22 to 24.

<sup>71</sup> See Zolt, *Tax Incentives in Developing Countries*, *supra* note 67 at 542-56.

<sup>72</sup> See, e.g., Eric Neumayer, *Do Double Taxation Treaties Increase Foreign Investment to Developing Countries?*, 43 J. OF DEV. STUD. 1501 (2006); Fabian Barthel et al., *The Impact of Double Taxation Treaties on Foreign Direct Investment: Evidence from Large Dyadic Panel Data*, 28 CONTEMP. ECON. POL'Y 366 (2010); Ronald B. Davies, *Tax Treaties and Foreign Direct Investment: Potential Versus Performance*, 11 INT'L TAX & PUB. FIN. 775 (2004); and Paul L. Baker, *An Analysis of Double Taxation Treaties and Their Effect on Foreign Direct Investment*, 21 INT'L J. ECON. BUS. 341 (2014).

resolving disputes between the taxpayer and taxing authorities, then levels of cross-border investment should increase between two countries following adoption of a bilateral tax treaty. These studies fall into two general groups. The first type focuses on individual countries and measures changes in cross-border investment following treaty adoptions; the second type uses cross-country comparisons to examine whether countries with more extensive treaty networks have higher levels of foreign direct investment.<sup>73</sup> The general consensus is that empirical evidence is mixed as to whether treaties lead to greater investment,<sup>74</sup> with some studies finding stronger effects for middle-income countries than low-income countries,<sup>75</sup> and later studies finding positive effects through the use of more comprehensive bilateral investment data.<sup>76</sup>

The inconclusive findings are perhaps not surprising given two types of limitations. First, it is hard to isolate the tax treaty effect on investment from other endogenous factors that influence either changes in the number of treaties or the level of investment. Second, these studies consider the binary question of whether or not countries entered into tax treaties; they do not consider the actual terms of the tax treaties. This is not surprising: only recently has information become available about the heterogeneity of tax treaty provisions.<sup>77</sup>

In addition to the IBFD studies, the ActionAid Tax Treaties Dataset constructed by Martin Hearson and other researchers at the International Center for Tax and Development provides valuable information on treaty provisions of developing countries.<sup>78</sup> These scholars reviewed 519 tax treaties from developing countries in sub-Saharan Africa and Asia focusing primarily on treaty provisions covering PE status, withholding rates, and taxation of capital gains of non-residents. The dataset enabled them to determine regional differences in the level of source-based taxation provided in

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<sup>73</sup> DAGAN, *INTERNATIONAL TAX POLICY*, *supra* note 1 at 108-09.

<sup>74</sup> IMF, *Spillovers*, *supra* note 3; DAGAN, *INTERNATIONAL TAX POLICY*, *supra* note 1; Michael Lang & Jeffrey Owens, *supra* note 20.

<sup>75</sup> Neumayer, *supra* note 72.

<sup>76</sup> Hearson, *Corporate Tax Base*, *supra* note 38 at 236 and Barthel et al. *supra* note 72.

<sup>77</sup> Wijnen & de Goede, *The UN Model in Practice 1997–2013*, *supra* note 47.

<sup>78</sup> Martin Hearson, *Measuring Tax Treaty Negotiation Outcomes: The ActionAid Tax Treaty Dataset* (ICTD Working Paper 47, 2016).

treaties as well as to isolate differences in treaties between developing countries and in treaties between developed and developing countries. They found that while developing countries have, on average, given up greater taxing rights because of falling withholding rates, the PE provisions over time have become more source-based (with no clear pattern found with respect to taxing capital gains and other types of income). This variation among treaties should allow scholars to more effectively isolate the relationship between different types of favorable treaty provisions and increased foreign investment.

But even with better information about the benefits of tax treaties from increased foreign investment, challenges still exist when it comes to estimating the revenue lost through treaty provisions that deprive the source country of taxing jurisdiction. While the ActionAid Tax Treaties Dataset is helpful in identifying treaty provisions that result in revenue losses, this is only part of the story. In order to estimate revenue lost because of treaty provisions, we would still need to know the domestic tax provisions that would apply in the absence of a treaty. For example, because many countries in their domestic tax law adopt the PE standard for taxing business activity, the revenue losses from business activity conducted without a PE would be the same whether or not a treaty existed. In addition, revenue estimates would need to reflect a country's administrative capacity to combat tax-minimization strategies that result in MNEs shifting income to other jurisdictions.

While there are several country-specific studies that highlight lost revenue from treaty abuses or from high-profile foreign investors who generated great profits but paid little in taxes,<sup>79</sup> less attention has been directed at estimating the revenue costs resulting from tax treaties. A Dutch not-for-profit research group, Stichting Onderzoek Multinationale Ondernemingen (SOMO or in English, Centre for Research on Multinational Organizations), has compiled some of the best estimates of lost tax revenue from tax

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<sup>79</sup> ACTIONAID, MISTREATED: THE TAX TREATIES THAT ARE DEPRIVING THE WORLD'S POOREST COUNTRIES OF VITAL REVENUE (2016), [http://www.actionaid.org/sites/files/actionaid/actionaid\\_-\\_mistreated\\_tax\\_treaties\\_report\\_-\\_feb\\_2016.pdf](http://www.actionaid.org/sites/files/actionaid/actionaid_-_mistreated_tax_treaties_report_-_feb_2016.pdf).

treaties.<sup>80</sup> The SOMO study focuses on the withholding tax provisions for dividends and interest for treaties between the Netherlands and several developing countries. Two factors make this study extremely useful: first, the Netherlands is a key jurisdiction for conduit structures that facilitate treaty shopping; and second, the Dutch Central Statistics Bureau collects information on interest and dividends income received by Netherland corporations, including “special financial institutions” (conduit or mailbox companies). Using this data, SOMO was able to calculate lost tax revenue for 29 developing countries by comparing the differences between withholding tax rates that apply with and without treaties to interest and dividends received by special financial institutions. The biggest loser was Venezuela, but Mexico, Indonesia, Argentina, Ukraine, and the Philippines also suffer substantial revenue losses. While this study uses several assumptions in making the calculations (such as no change in investments levels from the existence of a tax treaty and the choice of method for allocating foreign investment holdings to special financial institutions) and considers only lost revenue from lower withholding rates on dividends and interest (and not revenue losses from lower withholding taxes on royalties and losses from transfer-pricing strategies), it highlights the negative impact treaties have on raising tax revenue.

Viewing tax treaties as partly or largely tax incentives also has the advantage of using the existing approaches developed for determining the costs and benefits of various types of tax incentives (such as tax holidays, reduced corporate tax rates, and favorable depreciation regimes). These exercises highlight the information and assumptions required to make assessments as well as the different types of models policymakers could use. For example, in order for policymakers to determine the increase in incremental foreign investments from traditional tax incentives or tax treaties, they must estimate the projected additions to existing capital stock decreased by the amount of investment that would have been made in the absence of a tax treaty (the “non-treaty related foreign investments” from Part I.A, also known as the “redundancy” ratio), as well as the impact on the level of local investment (any “crowding out” effect). The infra-marginal effects

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<sup>80</sup> Katrin McGauran, *Should the Netherlands Sign Tax Treaties with Developing Countries* (Centre for Research on Multinational Organizations, 2013).

would be the lost tax revenue from treaty benefits accruing to existing and non-treaty related foreign investment. The marginal effects would be the level of increased foreign investment attributable to the tax treaty. The exercises also require estimating the direct impact of the investment (for example, increase in number of jobs), indirect impacts related to economic activities triggered by the foreign investment (spillover effects to suppliers and related to productivity increases from new technologies and skills), and induced impact (the multiplier effect of the spending of the income generated by the increased economic activities).<sup>81</sup>

Countries can use different tools to estimate the costs and benefits from favorable tax provisions, whether the incentives are provided directly to taxpayers through traditional tax incentives or through the use of treaty benefits. These models include traditional cost-benefit analysis, tax expenditure assessments, corporate micro simulation models, and effective tax rate models.<sup>82</sup> The choice among these alternatives depends on the questions being raised, data availability, and the developing country's capacity to work with these models. At least for these purposes, studies that focus on individual countries and either predict or measure changes in investment flows following treaty adoptions are more useful than cross-country comparisons examining the relationship between treaty policy and level of foreign direct investment.

The major point is that deciding whether developing countries should enter into treaties with developed countries requires country-specific and treaty-specific determinations (including provision-by-provision determinations) of the costs and benefits from treaty adoption. As the relative costs and benefits will differ by country, developing countries will likely reach different conclusions about the desirability of tax treaties with developed

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<sup>81</sup> See Duanjie Chen, *The Framework for Assessing Tax Incentives: A Cost-Benefit Approach Analysis* (2015), [http://www.un.org/esa/ffd/wp-content/uploads/2015/04/2015TIBP\\_PaperChen.pdf](http://www.un.org/esa/ffd/wp-content/uploads/2015/04/2015TIBP_PaperChen.pdf),

<sup>82</sup> A joint paper by the IMF, OECD, UN, and World Bank for the G-20 Development Working Group provides an excellent overview of different models for estimating costs and benefits of tax incentives, OECD, *Options for Low Income Countries' Effective and Efficient Use of Tax Incentives: Background Document: Tools for the Assessment of Tax Incentives* (2015), <http://www.oecd.org/tax/tax-global/options-for-low-income-countries-effective-and-efficient-use-of-tax-incentives-for-investment-background-document.pdf>.

countries, and, even within a particular country, reach different conclusions about treaties with different treaty partners.

### **III. BEPS Project and Observations**

#### **A. Does the BEPS Project Change the Calculus?**

Although the primary focus of the BEPS project was on preserving the tax base in developed countries, developing countries will also benefit from many of the proposed recommendations and changes resulting from these efforts.<sup>83</sup> The recommendations of the BEPS project can be grouped into four categories: changes in domestic legislation; changes to treaties; changes to the OECD transfer-pricing guidelines; and actions with respect to transparency and exchange of information.<sup>84</sup>

For many countries, the BEPS project provides an excellent opportunity to improve the domestic legislation governing cross-border transactions. At least for the next couple of years, tax authorities have political cover and support from international organizations in adopting a more robust international tax regime, which includes more effective controlled foreign corporation (CFC) rules, interest-stripping limitations, and general anti-abuse rules. Although many of the specific BEPS recommendations fit some developing countries better than others, the opportunity to adopt rules to limit many types of aggressive tax strategies is too good to pass up.

Similarly, many of the proposed treaty changes will benefit developing countries. For example, the proposed changes in the OECD model convention and commentary that

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<sup>83</sup> For an excellent summary of the BEPS project from a developing country perspective, see Hugh J. Ault & Brian J. Arnold, *Protecting the Tax Base of Developing Countries: An Overview*, in UNITED NATIONS HANDBOOK ON SELECTED ISSUES IN PROTECTING THE TAX BASE OF DEVELOPING COUNTRIES, ch. 1 (2d ed. 2017).

<sup>84</sup> Mindy Herzfeld, *The Case Against BEPS – Lessons for Coordination* (Aug. 2, 2017) (unpublished manuscript) ([https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2985752](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2985752)).

address the artificial avoidance of PE status will increase source-based taxation, although the changes reflect the tightening of the rules rather than any fundamental changes in the scope of PE status.<sup>85</sup> Developing countries will also benefit from adopting provisions that provide a higher level of protection against treaty shopping than exists in many current treaties. Although some developing countries may find it advantageous to adopt some version of the limitation-of-benefits article, the general anti-abuse rule based on a “principal purposes” test would provide greater protection against abusive transactions than current treaty provisions do.

The minimum standard and the set of best practices, set forth in BEPS Action 14 related to the resolution of treaty-related disputes under the mutual agreement procedure provide developing countries with a potentially more effective mechanism for resolving disputes with foreign investors than current alternatives.<sup>86</sup> Even without an acceptance of mandatory arbitration, a country’s commitment to act responsibly in resolving treaty disputes is an important development. With more anti-abuse standards and new legislation to combat profit shifting and base-erosion, the BEPS project will likely result in more, rather than fewer, disputes between taxpayers and taxing authorities. If countries seek to provide greater tax certainty to foreign investors in order to increase foreign investment, then providing for the resolution of treaty-related disputes under an effective mutual agreement procedure is an attractive option.

Finally, the multilateral instrument may also prove to be a useful tool for developing countries to address some unfavorable provisions in existing tax treaties—for example, by providing a cost-effective and timely way of modifying existing tax treaties and providing some opportunity to compensate and correct for prior mistakes. The process of deciding whether to make reservations with respect to certain provisions of the multilateral instrument gives countries an opportunity to highlight changes in their treaty policies.

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<sup>85</sup> Adolfo Martín Jiménez, *supra* note 3.

<sup>86</sup> OECD, *BEPS Action 14 Final Report: Making Dispute Resolution Mechanisms More Effective* (2015).

The BEPS project's actions on transfer-pricing methods and documentation likely have both positive and negative implications for many developing countries. In a UN survey on the relative importance of different BEPS action items, many developing countries identified transfer pricing as the major cause of base erosion in their country.<sup>87</sup> On the positive side, providing tax authorities with information from standardized transfer-pricing documentation, especially country-by-country reporting, will both constrain taxpayer behavior in adopting inconsistent positions across tax jurisdictions and enable tax authorities to better identify aggressive pricing strategies. Developing countries will vary greatly in their administrative capacity to take advantage of the additional information and in their ability to secure agreements with developing countries to obtain the information.

Although the movement toward the greater use of profit-split methodologies may result in more tax revenue for developing countries,<sup>88</sup> some, but not all, developing countries might have been better served if the BEPS project had considered the feasibility of a formulary approach to transfer pricing.<sup>89</sup> While toolkits are useful to help developing countries apply transfer-pricing rules where data concerning comparable uncontrolled prices are lacking,<sup>90</sup> other approaches to transfer pricing that better reflect where value is created and that better fit the administrative capacities of many developing countries merit serious consideration.

The BEPS project will probably result in little change to the fundamental allocation of taxing rights among countries.<sup>91</sup> Although one of the objectives of the BEPS project was

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<sup>87</sup> Carmel Peters, *Developing Countries' Reactions to the G20/OECD Action Plan on Base Erosion and Profit Shifting*, 69 BULL. FOR INT'L TAX'N 375 (2015).

<sup>88</sup> This assumes that the countries can agree on a profit-splitting methodology and on when the methodology should apply. OECD, *BEPS Action 10: Revised Guidance on Profit Splits* (2017).

<sup>89</sup> Alex Cobham & Simon Lorez, *International Distribution of the Corporate Tax Base: Implications of Different Apportionment Factors under Unitary Taxation* (ICTD Working Paper 27, 2014).

<sup>90</sup> IMF, et al., *A Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses* (Platform for Collaboration on Tax, 2017), <http://www.oecd.org/tax/toolkit-on-comparability-and-mineral-pricing.pdf>.

<sup>91</sup> The BEPS project action plan specifically notes that it is "not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income." OECD, *Action Plan on Base Erosion and Profit Shifting* 11 (2013).



to increase source-based taxation by better aligning taxing rights and value creation, it is uncertain whether the gains will be substantial. The BEPS project avoided opportunities to address the challenges of taxing the digital economy, to reevaluate the PE standard, and to consider fundamental changes to the transfer-pricing rules. Although any fundamental reform will result in winners and losers among both developed and developing countries, it is likely that reforms in any of these three areas would result in greater source-based taxation, to the benefit of many developing countries.

But despite the BEPS project's failure to address these challenges, developing countries, in many but not all ways, have ended up as unintended beneficiaries of the project. The BEPS project will likely curtail the most aggressive tax-avoidance strategies by MNEs, particularly with respect to the use of intermediaries to siphon off profits to low-tax jurisdictions. The BEPS project also increased awareness of how countries use their tax systems to aid their MNEs, often at the expense of tax revenues for source countries. Finally, even where the BEPS project failed to act, the unilateral actions of countries (such as the United Kingdom, Australia, India, and the US), in devising their own rules to increase source-based taxation, provide a template for developing countries to craft their own provisions that could be tailored to country-specific tax environments. Because we are still at the early stages in implementing the BEPS project recommendations, it remains unclear how the BEPS project will influence the ability of developing countries to tax cross-border transactions and the desirability of tax treaties with developed countries.

## **B. Observations Going Forward on the Desirability of Tax Treaties**

Whether the BEPS project has changed the calculus about whether developing countries should enter into treaties with developed countries remains uncertain. It is uncertain partly because it is difficult to determine the BEPS counterfactual—that is, what the international tax regime would have looked like without the BEPS project. The BEPS project could be viewed as part of the continued movement towards greater source-based taxation and increased awareness of the tax avoidance schemes of MNEs. While many of

the BEPS action items were under serious consideration by the OECD before the BEPS initiative, the BEPS project accelerated progress on these items and increased the likelihood of their successful completion. The momentum for greater source-based taxation would likely have existed even without the BEPS project.

It is important to appreciate that this movement toward greater source-based taxation does not reflect a heightened concern on the part of developed countries about tax revenue potentially lost by developing countries because of treaty provisions. Rather, it reflects an alignment of interests between many developed countries and developing countries concerning the mismatch between profits earned in the source country and the amount of tax revenue actually collected.

This mismatch will generate support in both developed and developing countries for increased source-based taxation through such measures as an expanded view of activities that are deemed to be a PE, nexus requirements with respect to the digital economy, equalization taxes on designated activities, as well as taxes on diverted profits and surtaxes on base-erosion payments. It could also provide momentum for fundamental international tax changes that move beyond the simple dichotomy of source and residence. These could include proposals for global apportionment or a destination-based cash flow tax. Given the great diversity among developing countries, any fundamental change would generate tax winners and losers as compared to the current international tax regime.

While the traditional focus has been on *whether* developing countries should enter into tax treaties with developed countries, the better questions may be *what form* the treaties should take and *with whom* developing countries should enter into treaties. For many countries, it is likely better not to enter into treaties unless they can secure meaningful withholding rates and safeguards against treaty abuse.

Developing countries could also be more selective in choosing new treaty partners and more aggressive in deciding whether to terminate or amend existing treaties (especially

with countries that are obviously acting as conduits for foreign investors). Where administrative resources are limited, countries should identify the four or five countries that represent the bulk of in-bound investment rather than try to establish a large treaty network. By focusing on only a few high-value treaties, countries can conduct the necessary economic analysis to get some estimate of both the revenue costs of specific treaty provisions and the potential benefits of increased economic activity. Developing countries could also review their existing treaties to identify those treaties that facilitate substantial tax revenue losses.

#### **IV. Conclusions**

For some, perhaps many, developing countries, it makes little economic sense to enter into tax treaties with developed countries. The game is not worth the candle. The potential tax revenues lost under either OECD or UN-type tax treaties do not justify the gains from increased foreign investment and the other treaty benefits (such as information exchanges with other countries and assistance in collection of taxes).

But for many other developing countries, the calculus is more complex. Here are three reasons. First, the stylized world where tax revenue yielded by source countries is picked up by residence countries is more fiction than fact. The amount of tax revenue collected by developed countries for income earned in developing countries is likely relatively small. This results either from deliberate decisions made by developed countries to minimize the tax burden on foreign source income to make their MNEs more competitive in the global arena (either through domestic legislation, regulations, or through treaty terms) or from the MNEs using a host of tax-minimization strategies to move income to low-tax or no-tax jurisdictions. Likewise, the amount of revenue foregone by developing countries due to tax treaties (even those with source-friendly and pro-developing country provisions) may be decreased because of challenges in collecting taxes due to policy or administrative constraints or the use of tax incentives. If foreign investors can capture treaty benefits, then it is certainly plausible that treaties increase the amount of foreign

investment into a country by lowering the pre-tax return for the investment, either by reducing the level of aggregate tax liability or by reducing the risk premium associated with an investment due to uncertainties related to tax policy and tax administration.

Second, developing countries vary greatly by economic objectives and characteristics, political choices, and administrative capacity. Some developing countries have a large stock of existing foreign investment and country-specific advantages that make foreign investment attractive even without treaty benefits (such that the countries would incur substantial infra-marginal costs from treaty adoptions). In contrast, other countries may find that tax treaties are an attractive vehicle to attract more mobile investments. The simple model of developing countries as primarily or solely capital importers no longer rings true. Differences in the countries' tax rules governing cross-border activity and tax administrative capacity means that some countries may lose little tax revenue by yielding taxing rights, while the revenue losses in other countries may be much greater. Blanket conclusions about the desirability of tax treaties between developed and developing countries are of limited utility.

Finally, it is likely helpful to view tax treaties more as instruments of pursuing economic objectives and less as negotiations between countries over splitting tax revenue from cross-border activity. Viewing tax treaties as tax incentives changes the focus to whether this type of incentive generates economic benefits that justify the revenue costs and whether tax treaties (as opposed to other forms of tax incentives) are the right tool for the job.

Where does this take us? Countries (both developed and developing) need to do the hard work of estimating the economic consequences of entering into tax treaties. This country-specific and treaty-specific cost-benefit exercise will be challenging and frustrating, given the many different assumptions that will influence the calculations. But these challenges are similar to those for estimating the costs and benefits of tax incentives and other types of tax expenditures. The exercise will also inform a country's negotiating

positions by highlighting those provisions (such as zero or low withholding taxes) that contribute to potential revenue losses.

Developing countries can continue to search for ways to increase source-based taxation if they determine that it is in their self-interest, whether through unilateral, bilateral or multilateral avenues. The recent actions of the United Kingdom, Australia, India and the US as well as recent EU proposals on taxing the digital economy provide interesting approaches that developing countries could imitate and perhaps improve. Another potentially promising alternative is greater use of withholding taxes on business activity in the country either related to provision of technical services by providers without a PE in the country (UN Article 12A) or, even more broadly, through a withholding tax on any business activity above a certain threshold where the provider of goods and services does not have a PE. Developing countries also have strong incentives to continue to work with the UN or other regional groups to increase source-based taxation in treaties or to renegotiate terms of existing treaties, particularly where countries have signaled a willingness to provide for terms more favorable to developing countries.

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