DEVELOPING COUNTRIES, TAX TREATIES AND THE UNITED NATIONS MODEL TAX CONVENTION

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Welcome everyone. My name is Peter Byrne. I am the Deputy Director of the International Tax Program at Harvard Law School. We have a great panel this morning, and I think you will be very interested in what they have to say. I will introduce them before we start.

Here on my right is Denise Strain, who is Vice President and Associate General Tax Counsel of Citibank. On a daily basis, she works on international tax issues presented by Citibank's substantial overseas operations. To my immediate right is Marlin Risinger, who is a friend of mine from the Treasury Department, where we both worked in the late 1980's. Marlin is a native of Louisiana. Most people regard him as one of the best tax lawyers around. He is now in the International Tax Department of General Electric. He did that after becoming a partner at Caplin and Drysdale, which is a prestigious tax law firm in Washington.

To my left, we have two Peruvians. We were only expecting one, but we have two. To my immediate left is Adrian Revilla, who is the National Director of Taxation of Peru. In a way, it is unfortunate that he is going to talk today about tax treaties, because the most interesting story for me from Peru is what they have done with the Tax Administration there. In the last eight years or so, they have totally overhauled the tax authority. In 1986 or 1987 Peru's tax administration was described as a model of corruption. They have totally turned that around now. In fact, it is considered to be the most efficient public institution in Peru now, and certainly among the most efficient tax authorities in Latin America. He is a lawyer from the Catholic University in Lima and he has a Masters in Economics from Suffolk University, which certainly covers all the bases for him for being a good tax policy-maker and administrator. Before joining the Tax Administration in Lima, he was the head of the Legal Department at Peru's Central Bank. Prior to that he was General Counsel for the Institute for Liberty and Democracy, which is a think-tank in Lima.

Our unexpected visitor is Miguel de Pomar who is an advisor to the Tax Administration in Lima and is reputed to be the international tax expert for the Peruvian government. He is a graduate of the Law School

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of the University of Lima. Prior to joining the Government, he was Senior Tax Specialist at Arthur Anderson.

We will proceed as follows: I am going to give you a broad overview of what a tax treaty is, and then Marlin and Denise are going to explain why tax treaties are important for multinational corporations. They are going to describe some of the problems that they confront in the international environment and how a tax treaty can help. And then, Mr. Revilla will talk about a developing country's perspective on tax treaties. I am told that he is going to give a very upbeat assessment of Peru's prospects for tax treaties, which is encouraging, I have to say. On the other hand, it is a bit surprising to me, because Latin American countries, historically, have not had tax treaties. I hope that during the course of our discussion, we can talk a little more about the reasons why they have not had tax treaties, and the reasons for not having tax treaties. In any event, let me begin by explaining what a tax treaty is.

Since this is the International Law Association, I do not have to explain to you the legal aspects of a treaty. But I will say that most tax treaties are bilateral. There are some multilateral tax treaties - there is one for information exchange and there have been a few multilateral income tax treaties. In fact, Peru is a member of one of the few multilateral income tax treaties, but the income tax treaty is a bilateral concept by and large. The United States, for example, has about seventy income tax treaties. They are all bilateral. The United States also has a number of shipping and air transport tax agreements, and a set of Tax Information Exchange Agreements. These agreements covering transport and information exchange are much more limited than comprehensive income tax treaty, and it is this comprehensive type of tax treaty that we are going to talk about today. So, the first thing is that tax treaties ordinarily are bilateral in nature.

The principal goal of a tax treaty is to rationalize the tax systems of the two contracting countries. Naturally, each country is going to have its own tax policies and tax law. Sometimes, they conflict with each other, with negative consequences for the investor. The idea is that once the tax systems are rationalized, that will facilitate investment. There are a few fundamental characteristics that I am going to touch on, but then I am going to leave it to the other speakers to flesh them out.

The most important goal of a tax treaty is to eliminate double taxation. Historically, they were designed primarily to eliminate double taxation. More recently, elimination of excessive taxation has become almost as important. To explain to you what double taxation is, I am going to have to introduce you to a couple technical concepts. To illustrate this problem, I have drawn a map of two countries that I will call
Country R and Country S. And they are divided by a river. We are calling this Country R because that is what we call the "Residence" country. That is the country where the corporation, in non-technical terms, is located -its country of residence. In the United States, that would be the place of incorporation. In other countries, it might be the place of management. We are just going to call it the Country of Residence. You worry about problems of double taxation when a business is carrying on activity in another country. The reason that we have called the other country "Country S" is to call it the Country of Source - that is, the source of its income.

Now, you can have double taxation under a number of circumstances, but I am going to limit my comments to the principal ones. For example, you might have a conflict in the two countries as to which is the residence of the taxpayer. As I mentioned, the United States defines the country of residence as the country of incorporation. There are other countries that look at the place of management. Theoretically, you could have a company that is incorporated in Country R, but its place of management is in Country S. Under the laws of both countries, it could be considered to be a resident, and therefore a basis exists for the same income to be taxed by both countries. If that is the case, if both countries want to tax the total income of the company, then you have the potential, literally, for double taxation. If you have $100 of income from that company for all of its activities on both sides of the border, then it is subject to 35% tax in the United States, 35% tax in Mexico. If neither one recognizes the other's tax, you could have a whopping 70% tax.

You also could have a conflict of source. Say that you are a lawyer and you are a resident in Country R and you are hired by a company in Country S to do some legal work for them. It is not just conceivable, it happens, that you could have a conflict of source. Country R could say the money that you receive for carrying out these legal services will be taxable, will be "sourced" there, because you did the work while you were sitting at your desk in that country. You were within its borders when the work was done. The activity that generated the income took place here, and therefore we should get the tax. Country S could have a different source rule that says that you are doing the work for someone who is a resident of Country S, and the payment was made from Country S, the income is "sourced" in Country S, giving it the right to tax the income.

These are just general examples of where you could have double taxation. A treaty provides a means to resolve these conflicts, and will insure that you do not have a company or an individual that is deemed to
be a resident of both countries, or income that is deemed to be sourced in both countries.

I want to talk about two general types of activities which I have designated by putting two blue arrows and two red arrows. This blue arrow will be an activity that is carried on by a company in Country R, but the business activity is taking place in Country S. If the company has been sending sales people down to Country S and they are selling things in Country S, the profit that they make for these activities (the proceeds of the sales) will be the blue arrow going back to Country R.

One of the most fundamental terms that you have in a tax treaty is the concept of a “permanent establishment” in the case of a business or a company, and what we call “fixed base” in the case of an individual performing personal services. The activity is carried on in Country S and the money goes back to country R. The first question is: what level of activity will cause our business to be subject to income tax in Country S in the absence of a treaty? This often is not an easy question. Every country has a different rule. The United States has a rule (engaged in a trade or business) that I think no one understands totally. All we know is that pretty much any level of activity above and beyond a bare minimum is going to subject you to tax.

What does a tax treaty do? It establishes a clear threshold of activity, and if you are below that threshold, you will not be subject to tax in Country S. This is called either a permanent establishment rule or a fixed base rule.

Another way that a tax treaty will try to address this potential problem for double taxation (or excessive taxation) is if you have an activity that is a passive investment. A person in Country R might hold an investment, such as shares of stock, a debt instrument, or a patent, entitling such person to payments from Country S. Holding this interest is represented by the red arrow from Country R into Country S. Naturally, there is a return that you get on this instrument, which could be dividends, interest, or royalties (represented by the other red arrow). Normally a tax treaty will reduce the withholding tax that is imposed by the source country on these payments.

Just to give you an example, in the absence of a treaty, the United States imposes a 30% withholding rate on these types of income. Now, if you think about it, 30% imposed on a gross basis is a very heavy tax. Through a treaty, the goal is to reduce this gross level of taxation to a much lower level - to make it more or less reasonable when you compare that gross basis tax to the tax on net income which a domestic taxpayer would have to pay. The 30% withholding imposed in the absence of a
Treaty could cause double taxation, but certainly will result in excessive taxation. The treaty relieves the excessive tax.

So, the first significant advantage of a tax treaty is the elimination of either double taxation or excessive taxation. This is achieved by first solving source and residence problems; second, by creating an activity threshold so that a business not having a fixed base or a permanent establishment will not be subject to tax in the other country; and third, by reducing the level of withholding so that you do not have an excessive level of gross-basis taxation.

Another advantage to an investor is that the treaty will give access to what is called “mutual agreement.” Basically, if you have a problem with the way you are being taxed by the other country, this gives you the right to appeal to your tax authority (or in limited cases, to the other tax authority). Assume a tax treaty between the United States and Peru. If Peru taxed me because I had performed legal services in Peru, and I felt that Peru was not permitted to tax me under the treaty, I would go to the United States government and ask them to intervene on my behalf. If the United States tax authorities agree that I have a legitimate gripe, then the two tax authorities (the term we use is “competent authority”) will get together to try to work out the problem. In the absence of a treaty, the United States does not care if Peru is taxing me in a way that I do not like.

A treaty also guarantees “non-discrimination,” that is, the guarantee of national treatment, which is even better than most favored-nation treatment. National treatment guarantees you that you will be taxed no more harshly than a national of the country where you are doing business, as long as you are similarly situated. Let me illustrate again the operation of “mutual agreement.” Assume a United States—Peru tax treaty. If your United States business is being taxed by Peru more heavily than a similarly situated Peruvian you could go to the competent United States authority, and say: will you intervene on my behalf? They are not treating me in the manner specified in the treaty.

Next are two items that are mostly of interest to the tax authorities. The first one is information exchange. That gives the tax authorities of the two countries the ability to exchange information with each other - but only information that is related to tax. The idea is to help the tax authority of the other country control the taxes of its taxpayers who happen to have activities in the other country. Information exchange is part of virtually all comprehensive tax treaties, and sometimes is authorized by a separate Tax Information Exchange Agreement (TIEA). In fact, we have a TIEA with Peru. If a Peruvian taxpayer has a bank account in America, and Peru wants to tax the interest (a nonresident alien’s bank account in the United States is exempt from tax) then if Peru is lucky enough to stumble across
the location of the bank account, such as Citibank, then, Peru can ask for the information. If the IRS can find the requested information, it will be given to Peru.

The second major advantage for governments is Article 9, which is normally called “Associated Enterprises”. It is very much related to an issue that I am sure you have all heard of, which is transfer pricing. This gives the specific right to a government to adjust the prices charged on transfers of goods or services between related companies. If a price is adjusted and a taxpayer is in the unfortunate position of having inconsistent prices on items, which results in excessive taxation in both countries that will be an example of something that the company could take to the competent authorities through mutual agreement procedure and say: look, I am willing to pay the tax on this income to one of you, but I am not going to pay it to both.

So, to summarize, there are aspects of a tax treaty that benefit both investors and governments. In the absence of a treaty there are obstacles to investment. Those obstacles may be true legal obstacles in the sense that you could be subjected to double taxation or excessive taxation, or it might just be the uncertainty that an investor has in the absence of a treaty. That uncertainty can take two forms. The company from Country R may choose not to do business in Country S, because it simply does not know what its tax situation is going to be. When you have a treaty you have a pretty clear idea of what level of activity will subject you to tax. But the other kind of uncertainty is that when you have a treaty, you know that there are certain limits to the level of taxation that the other country can impose on you. General Electric, for example, would not be too concerned about Peru’s current levels of withholding. They are only 10%, which is very low in the international environment. However, General Electric, in the absence of a treaty, has no guarantee that next year Peru will not raise that level of withholding to 40%. With a tax treaty, they have a guarantee that, at least until the tax treaty is terminated, the level of withholding that is called for in the treaty cannot be exceeded. As a practical matter, there are very few cases in history where a tax treaty has been terminated.

So, tax treaties give you a certain amount of predictability in your taxation, and as Marlin and Denise will tell you, it is of ultimate importance to an investor to be able to predict what its situation is going to be - to have a stable environment. A tax treaty is certainly only one of the many characteristics or aspects of a country that an investor will analyze in terms of predictability and stability, but it is one of the few aspects that the country actually has control over. It might be nice to have a stable labor force, but a country has to view that as a long term problem. It cannot
negotiate a stable labor force in six months. You might want to have a good infrastructure. That is very important for any foreign investor, but you cannot just build an infrastructure of railroads and highways in six months. You can have a tax treaty in six months if you really work at it.

Just to summarize, with a tax treaty in force you have lower withholding rates, you have the guarantee that you will not be subject to discriminatory taxation compared to the nationals of the country of the treaty partner country, and you have the right to recourse under the mutual agreement procedure if you feel that you are being treated unfairly.

I am just going to finish up with a very short history of tax treaties. Tax treaties have been around since the 1920’s. They were initiated by the League of Nations. In this year, the 50th anniversary year of the United Nations, I suppose we should have a moment of silence for the League of Nations, which was the predecessor of the United Nations. But when the League of Nations went out of business, the tax treaty football was picked up by the Organization for Economic Cooperation and Development (OECD) and the OECD has had a series of model tax treaties since the 1950’s. The OECD’s approach to international taxation has basically been to facilitate international commerce by reducing the level of taxation in the source country. In the OECD model tax treaty you find what most countries consider to be a high level of activity threshold before you are subject to tax in the source country, and also relatively low rates of withholding on items such as dividends, interest, and royalties.

In 1977, the OECD came out with the new model and the United Nations decided to get back into the tax treaty game. The reason is that some countries wanted to have a treaty more sympathetic to the interests of developing countries. The OECD model was not considered to be fair to developing countries. In the real world, the residence country is generally going to be a developed country, and source country is going to be a developing country. When you have international economic activity between a developed and a developing country, the direction of the flow of investment is almost always from Country R (being the developed country) into Country S (the developing country), whether you are talking about a business activity or a passive investment such as shares of stock or a debt instrument. So, the UN Model basically lowered the threshold of activity that can trigger taxation in the source country, and left open the rates of withholding on interest dividends and royalties. The understanding is that they would be somewhat higher than the rates called for in the OECD model.

A lot has changed in the last fifteen years. The first thing, from a technical point of view, is that the OECD is a better financed organization than the UN, and has continued to work on its treaty and continued to
update it. So from a technical point of view, the current OECD model is a more advanced model than the UN model.

I think it is perhaps more important that the attitude toward foreign investment around the world has changed dramatically in the last fifteen years. I am sure most of you, if you do not remember it personally, you have heard that in the 1970’s and early 1980’s that multinational companies were viewed as the enemy - they were out to exploit developing countries and you really had to watch them closely. Maybe you were better off not having foreign investment at all. It has been a long time since I have heard anyone say this. To the extent that anyone says it, it is normally not someone from a developing country.

Developing countries are competing for capital from developed countries. So the UN model is now being revised and some of the people here have been participating in the effort. The dilemma is whether the UN model should move more toward the OECD model. The question then becomes, if we are going to have a UN model that is very similar to the OECD model, why have a UN model treaty at all? Or should we have a UN model that is updated technically, but keeps the same kind of developing country bias? The problem here is that many developing countries, in their pursuit of foreign investment, are going with the OECD model anyway. If the UN model does not become more like the OECD model, it runs the risk of becoming totally obsolete.