Understanding international tax treaties

Introduction

A tax treaty is an international agreement between two or more countries (referred to as "Contracting states"). Tax treaties affect the tax rules prevailing under the domestic tax laws of the contracting states by providing which contracting state shall have jurisdiction to given income item. Consequently, a country wishing to enter into bilateral tax treaty negotiations should analyse carefully the applicable provisions of its domestic tax laws in order to assess the impact of the proposed treaty on domestic legislations.

Exercising of the taxing power is one of the fundamental attributes of sovereignty, often requiring sensitive political and economic choices. In some cases, the contracting states may have quite different rules for taxing international income. Some states may use the credit method for relieving double taxation, whereas the other states may use the exemption method or may not provide any form of unilateral relief. Some states may have bank secrecy legislation that it wishes to maintain, whereas the other states may insist on an exchange of information provision in the proposed treaty.

How double taxation may arise

International double taxation arises because each country has its own sovereign right to tax income and frame own set of tax rules. The areas in which two countries' tax systems may differ:

1. The scope of taxation - Some countries are on the territorial system (e.g. Singapore) whereas others have adopted a worldwide taxation basis (e.g. Australia)

2. Source rule for income – This rule determines whether income is sourced in the state where income arises or in the state where the income is received. Conflict of source rule can result in an income having a source in both countries

3. Rules for determining the tax residence of an individual or a company

4. Measures provided under a country's domestic laws to provide relief from double taxation

Role of tax treaties

A tax treaty provides for the avoidance of double taxation and the prevention of fiscal evasion. Tax treaties also provide for protections against tax discrimination. In their origin, the main focus of tax treaties is the avoidance of double taxation.

Double taxation may arise from a residence/source conflict (both the residence and source countries taxing the same taxpayer on the same income). It may also arise from dual tax residence conflicts, i.e., both countries treat the taxpayer as a resident with the result that the taxpayer is liable for tax on worldwide income in both countries. Tax treaties resolve this conflict by including tiebreaker rules that treat a dual resident as a resident of only one of the contracting state for the purposes of the taxation.

There are three ways in which tax treaties resolve residence/source conflicts. First, they may oblige the residence country to give relief for source country taxation properly imposed under the treaty. However, this may simply replicate the relief available under domestic law or it may involve providing greater relief (such as an exemption instead of a credit). Secondly, they may completely exclude source country taxation thereby leaving the income to be fully taxed by the residence country (e.g., royalties under the OECD Model). Thirdly, although less commonly, they may completely exclude residence country taxation thereby leaving certain item of income to be taxed fully by the source country (e.g. government service).

Domestic tax laws may exert an important influence on the content of bilateral tax treaties

Contracting states may differ widely in their approaches while determining rules and procedures for operating double tax conventions. There is a trend among contracting states towards the adoption of general regulations applicable to all double taxation conventions. These regulations are sometimes promulgated at the administrative level. Another approach is to adopt implementing provisions through domestic legislation.

Different practices and approaches trigger a fundamental question: Is the application of a double taxation convention a matter of tax law or of the general administrative law of the contracting state? In a sense, it is both. However, in some contracting states the application of a double taxation convention is regarded as part of the general administration, whereas in other states, the procedures for application may be specific to taxes or specific to the double taxation convention alone. These different approaches may also be relevant in determining whether disputes about the application of a double taxation convention should go to a tax court or an administrative court.

Myth concerning model conventions

The UN model convention and the OECD model convention are not enforceable legislations. Views expressed in such conventions are not binding and should not be treated as formal recommendations of the issuing authority. These conventions aim at facilitating the negotiation of tax treaties by eliminating the need for elaborate analysis and protracted discussion of every issue concerning the treaty.

These model conventions are designed to constitute a framework for the negotiators. Model convention are the outcome of in-depth examination of the issues by experts of various countries who, by agreeing to become members of the group of experts in their personal capacity, express entirely objective opinions based solely on technical considerations with no emphasis on political consideration which is also a influential factor in shaping of bilateral agreements.

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